

Attention to Retail

A More Jolly Christmas...

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With Christmas only eight weeks away, the approaching seasonal spend looks to be better than previously anticipated. Retail sales momentum is supported by a buoyant housing market and low interest rates, reducing the incentive to save, while continued border closures allow for a re-allocation of travel spend towards other categories. However, the underlying economic picture remains unclear and we carry a degree of caution into 2021. Within our coverage our preferred consumer retail exposure is Kathmandu (KMD).

Positively positioned for the Christmas peak...

The retail sector is poised to positively surprise into Christmas, in our opinion. The housing market remains buoyant and is unlikely to reverse near-term with tight inventory, low borrowing costs, and returning kiwis re-entering the market. Interest rates at record lows also reduces incentive to save, supportive of continued retail activity, particularly in the homeware segment. With borders remaining shut, there has been a re-allocation of travel spend towards other discretionary categories. We view the likelihood of New Zealand's borders reopening (meaningfully) in the next six months as low. A key concern during lockdown was the possible build up of retail inventory and therefore elevated discounting pressure. The surge in spending as New Zealand moved into lower alert levels combined with inventory management has alleviated concerns and reduces the likelihood of gross margin pressure, albeit with a possible swing towards inventory shortage risk.

...outlook into 2021 remains cautious

Our view of the world has improved as government restrictions eased and consumer activity proved to be resilient, however, we remain cautious heading into 2021 as broad government support tapers off and the economic realities become clearer. Economic forecasts suggest New Zealand GDP will be below pre COVID-19 levels in 2020 and 2021, with unemployment peaking in 2Q21.

Preferred exposure KMD and MHJ

The best placed categories amid the current backdrop of nesting behaviour, border closures, and economic uncertainty are homeware and outdoors, in our view. Given fluid lockdown restrictions, companies with strong online offerings and well recognised brands are likely to outperform. Within our listed retail coverage, we view Kathmandu (KMD) and Michael Hill (MHJ) as offering investors the best risk/return.

- KMD's well established brands, track record of performance, and our view that adventure retail is well positioned to benefit from increased domestic tourism are supportive of near-term earnings. Having lagged a recovery against peers and the wider retail sector, we see KMD's valuation as attractive and is our preferred pick. In addition, its leverage to the Christmas/Summer sales period has increased following the acquisition of Rip Curl.
- Productivity and gross margin turnaround was evident at MHJ prior to COVID-19. Whilst it is exposed to a more discretionary category and therefore higher risk, at current multiples (9x two year forward PE ratio) we view valuation as more than compensating for the uncertainty.

Figure 1. Retail sector multiples

Company	Ticker	Rating	Price (NZ\$)	Target price (NZ\$)	12m fwd PE	24m fwd PE
Briscoe Group	BGP	n/a	4.15	n/a	15.4x	14.9x
Kathmandu	KMD	OUTPERFORM	1.23	1.65	16.4x	10.7x
Michael Hill	MHJ	OUTPERFORM	0.58	0.55	9.1x	8.9x
Restaurant Brands	RBD	NEUTRAL	11.90	13.50	31.1x	25.6x
The Warehouse Group	WHS	n/a	2.41	n/a	11.9x	10.2x

Source: Bloomberg, Forsyth Barr analysis

Retail outlook

The important Christmas trading period is approaching, and whilst there remains a high level of uncertainty the health of the consumer appears better than previously expected. November and December (Christmas trading) represents 20% of annual core retail sales and a significant portion of company earnings. Our view of the near-term outlook has continued to improve following the gloom of lockdowns, as consumer activity proved to be resilient and economic indicators remained supportive. We think investors are best placed investing in retail categories exposed to favourable purchasing trends (e.g. homeware and outdoor gear), and companies backed by well established brands with an attractive online offering. We have an OUTPERFORM rating on KMD and MHJ.

Poised to positively surprise in the short term...

The New Zealand retail sector is positioned to surprise into Christmas, in our opinion. We expect recent momentum in consumer activity to carry into the key Christmas period, supported by:

- **Re-allocation of travel spend** – Border closures are likely to see consumers reallocate funds destined for travel towards other discretionary categories.
- **House prices remain buoyant** – Rising house prices are supportive of a buoyant housing market and retail activity (wealth effect).
- **Low incentive to save** – Near-zero deposit rates are further incentive to spend.

...but maintain caution into 2021

Whilst Christmas could positively surprise, we maintain a level of caution into 2021 (albeit not as cautious as previously thought).

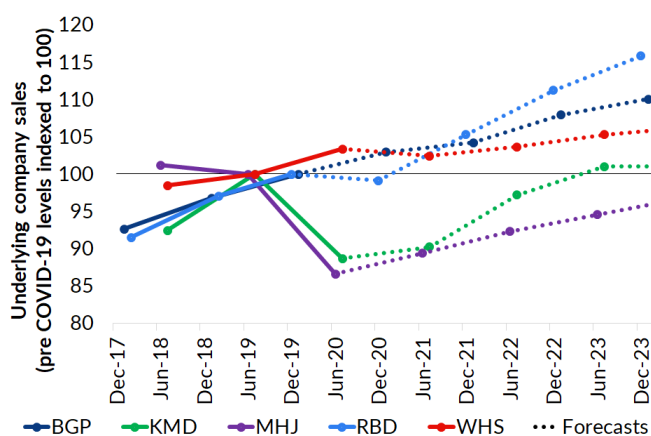
- **Government stimulus wanes** – The flood of government transfers, namely wage subsidies, has tapered off. We expect to see smaller and more targeted stimulus measures, the exact form is unclear.
- **Unemployment to spike** – As wage subsidies roll off businesses are likely to review cost levels and ultimately headcount, particularly in the face of further minimum wage increases.
- **Retail spend pull forward** – Categories that benefited from the surge in activity were largely durable goods. These goods have a longer life cycle, and sales likely represent a consolidated/pulled forward upgrade cycle as consumers invested in the home.

Category and market exposure drivers of our recovery assumptions

Our underlying sales (adjusted for acquisitions and balance date changes) forecast profile is varied, with those companies with less international exposure and sell into categories benefitting from purchase trends not expected to experience a material sales decline.

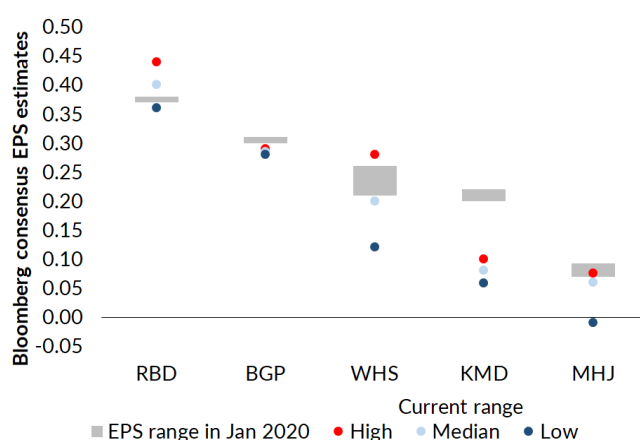
- We assume sales growth above pre COVID-19 levels at BGP and WHS, which experienced significant sales growth ahead of and following lockdowns. These are also the only two listed New Zealand retailers without international earnings exposure.
- We do not expect specialty retailers KMD and MHJ sales to recover to pre COVID-19 until FY23 (MHJ recovery on a sales per store basis), given discretionary and international exposure. Both companies' forecasts carry the most upside should the economy and/or borders surprise.
- The historically wide range of consensus earnings estimates highlights both the difficulty and uncertainty in forecasting the retail outlook. The standard deviation of consensus retail forecasts has increased to c. 6.0% from a three year average of c. 2.5%.

Figure 2. Company underlying sales forecast profile*



Source: Company reports, Forsyth Barr analysis *adjusted for acquisitions & balance date changes

Figure 3. Dispersion of consensus estimates has widened



Source: Bloomberg, Forsyth Barr analysis

Poised to positively surprise in the short term...

We expect consumer spend to remain at healthy levels over the short-term, supported by border closures driving a re-allocation of travel spend, a buoyant housing market, and a recent boost to savings accounts.

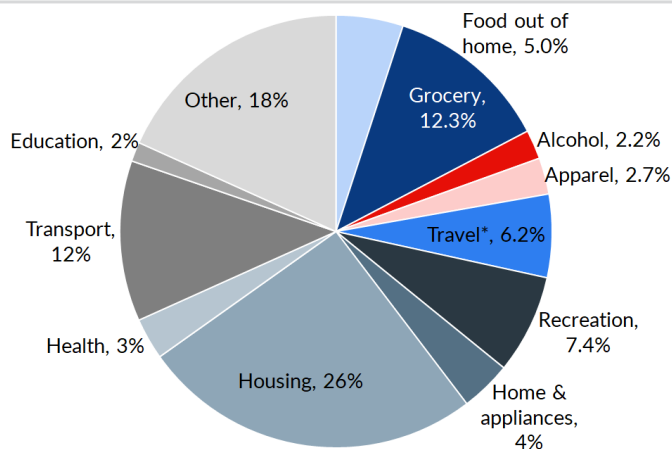
Border closures and a re-allocation of travel spend

With borders remaining shut there has been a re-allocation of travel spend towards other discretionary categories. We view the likelihood of New Zealand's borders reopening (meaningfully) in the next six months as low. Although a Trans-Tasman bubble could come earlier than this, with select states already opening the border to inbound Kiwis, we believe robust track, trace, and testing technology is required before a bubble is established (or a more fundamental shift e.g. vaccine, Australia's elimination of the virus etc.). The recent difficulty of tracing arriving Kiwis highlights that this remains a challenge.

In 2019 consumers spent 5.3% of total expenditure on international travel and accommodation (c. NZ\$3,700/household). Whilst domestic tourism is experiencing a boost as a result of border closures, the nature of that spend is typically lower than offshore travel and therefore provides a net benefit for domestic consumer spend. Whilst consumer spend itself may decline, we expect retail spend to experience a greater share of wallet, offsetting any decline in total spend.

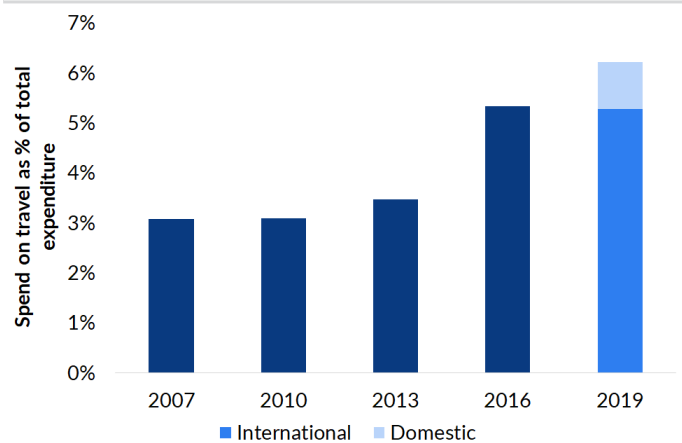
The flipside being that those retailers with exposure to tourism spend are likely to experience a challenging summer period (peak tourism). In the listed market, tourism exposure is relatively low with Michael Hill (MHJ) most exposed to inbound, while Briscoe Group (BGP) and Kathmandu (KMD) have exposure to travel accessories (e.g. luggage).

Figure 4. 2019 consumer expenditure by category



Source: StatsNZ household economic survey, Forsyth Barr analysis, *Travel = flights & accommodation only

Figure 5. Travel* as a % of total consumer expenditure



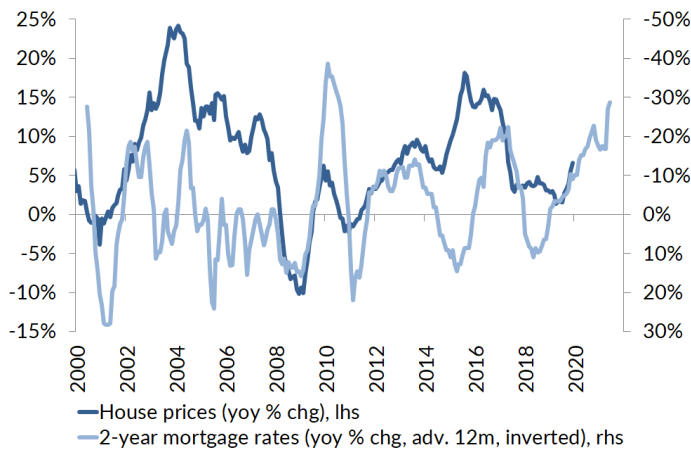
Source: StatsNZ household economic survey, Forsyth Barr analysis, *Travel = flights & accommodation only

Buoyant housing market supports continued big ticket spend

House prices continue to increase, with low inventory, returning Kiwis looking to enter the housing market, and low interest rates all supportive. The accompanying wealth effect for homeowners is likely to continue to support retail activity.

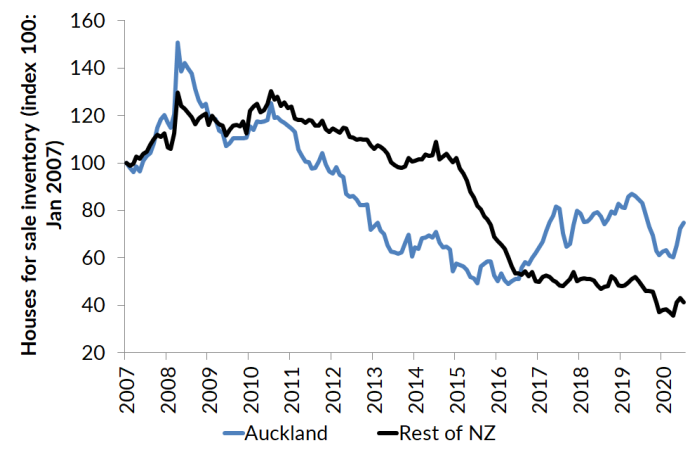
Both international travel and wealth effect dollars are typically skewed towards higher income households, which typically limits the marginal dollar spent. Retail spend is likely to be re-directed towards larger purchases such as new vehicles and home renovations, which indirectly benefits the homeware category.

Figure 6. House price growth holds up, supported by...



Source: REINZ, Forsyth Barr analysis

Figure 7. ...Low housing inventory, and ...



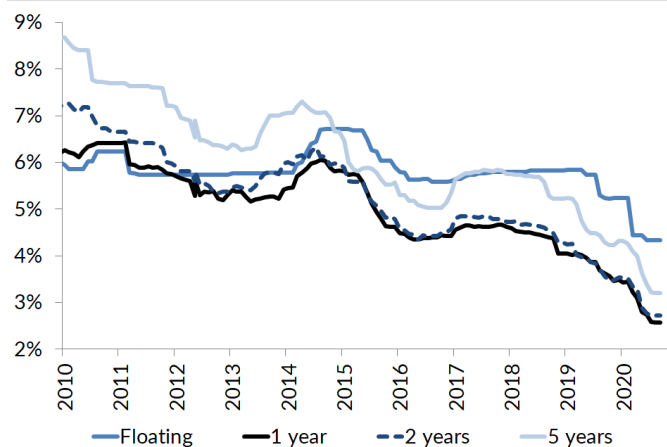
Source: Realestate.co.nz, Forsyth Barr analysis

Lockdown savings support recent spending momentum; Low interest rates reduce incentives to save

We expect recent spending momentum will be supported in the short-term by "lockdown savings". Interest rates and therefore deposit rates continue to decline and are expected to be "lower for longer". The fall in interest rates, as well as supporting house prices, makes savings less attractive which limits the incentive for consumers to save instead of spend.

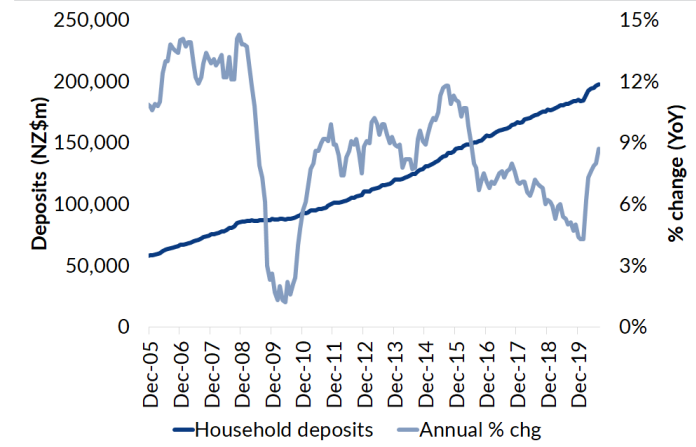
Household savings surged in March 2020 (up +6% on the prior year period) amid elevated uncertainty, and has maintained high growth rates to July. We suspect a key driver of the high savings has been lockdowns and the inability to spend, with higher deposits during that time supportive of continued consumer momentum in the short-term.

Figure 8. ... Low mortgage rates



Source: Forsyth Barr analysis, interest.co.nz

Figure 9. Savings spiked during lockdown



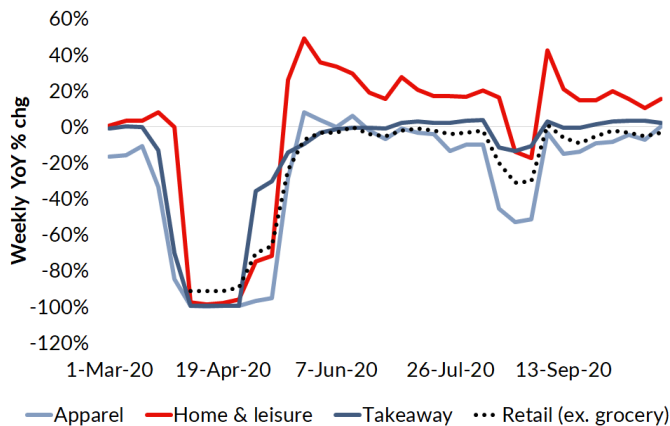
Source: RBNZ, Forsyth Barr analysis

Sales momentum in key categories

Retail sales activity both offline and online has maintained positive momentum, although growth varies by category. Categories exposed to nesting, such as homeware and technology, have experienced significant growth. As we head into summer feedback suggests the DIY and garden category is beginning to see a lift.

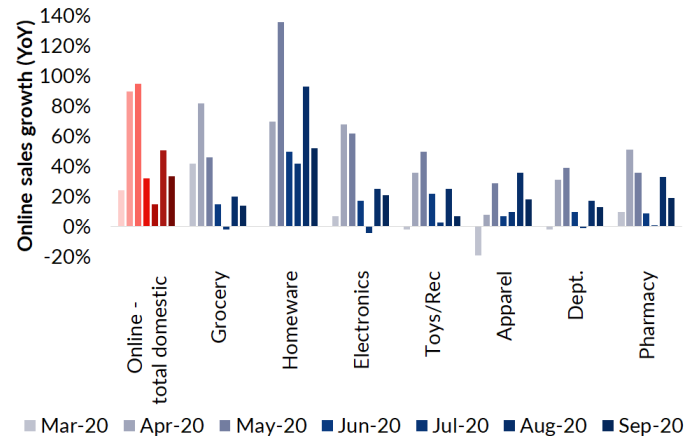
Whilst apparel growth has lagged other categories, it appears to be improving. Within the wider category, industry commentary suggests there are pockets of strong growth, such as recreational and athleisure.

Figure 10. Weekly sales growth (YoY, % change)



Source: Paymark, Forsyth Barr analysis

Figure 11. Online sales growth by category (YoY, % change)

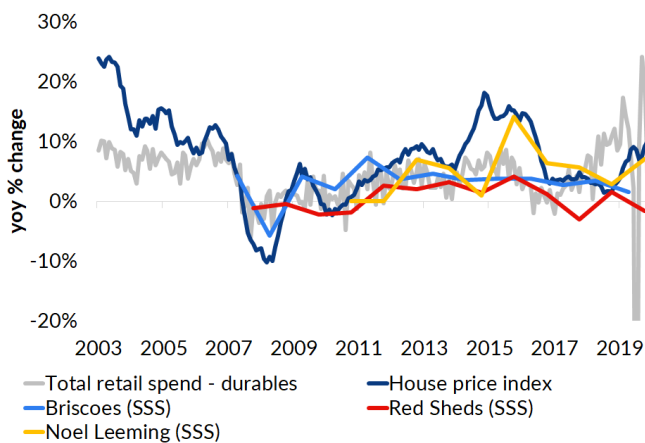


Source: Marketview, Forsyth Barr analysis

Higher house prices supportive homeware and technology

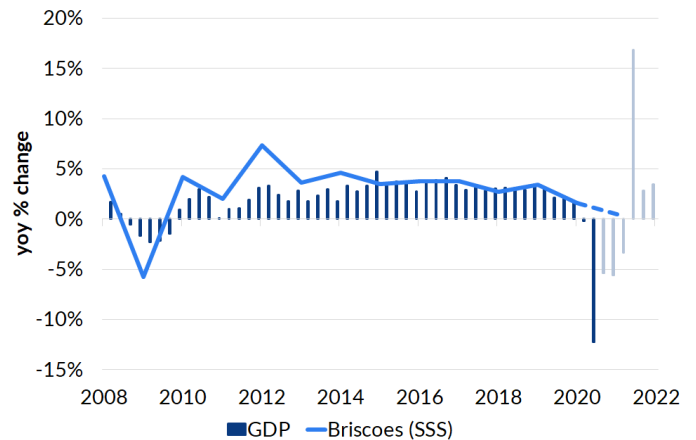
Historically, retailers with categories most positively correlated with housing activity include BGP and WHS (Noel Leeming most so).

Figure 12. House price index vs. company same store sales (SSS)



Source: Company reports, StatsNZ, Forsyth Barr analysis

Figure 13. Briscoes homeware historically linked to GDP



Source: StatsNZ, company reports, Forsyth Barr analysis

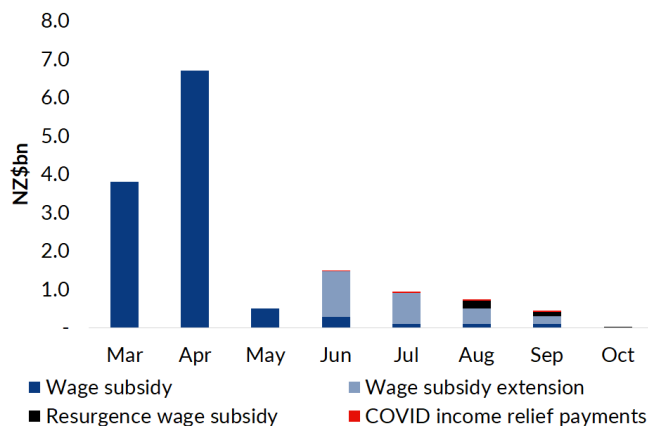
...but maintain caution into 2021

The near term outlook is balanced against a backdrop that is likely to deteriorate in 2021. We expect to see unemployment increase and consumer caution to materialise into lower retail sales activity. However, the data is noisy and the underlying state of the economy is unknown, creating significant uncertainty.

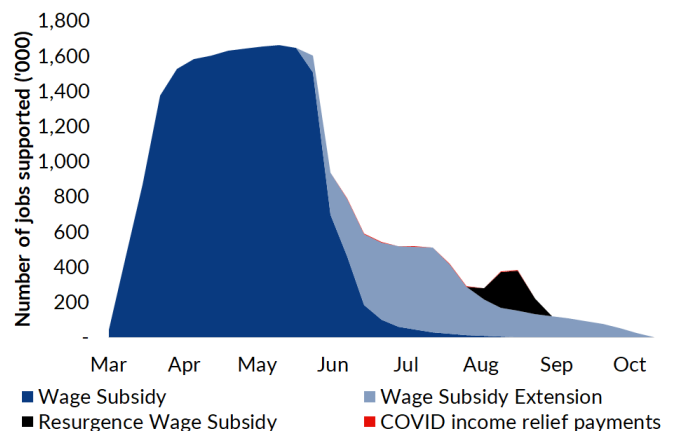
Government stimulus tapers off

The government has paid out NZ\$14.0bn in wage subsidy and COVID-19 income relief payments, supporting short term employment levels. In addition, government business loans and mortgage deferral schemes have maintained a level of stimulus in the economy

A condition to the wage subsidy schemes is that employees are retained for the period the subsidy is paid. Figure 15 shows the number of jobs supported by the wage subsidy with the scheme now effectively complete. Unemployment is likely to increase as this tapers off.

Figure 14. Wage support payments


Source: Ministry of Social Development, Forsyth Barr analysis

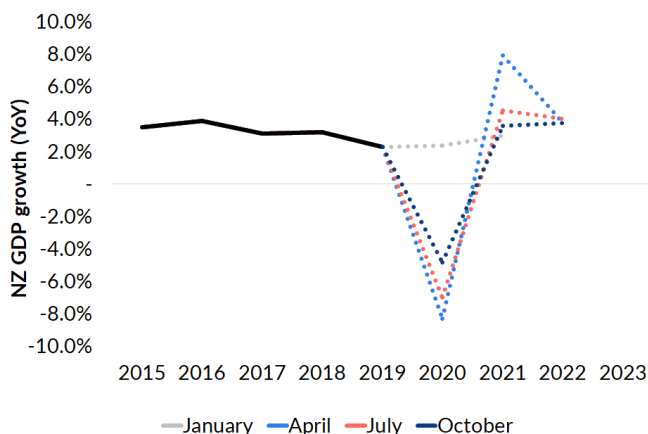
Figure 15. Jobs supported by the wage subsidy


Source: Ministry of Social Development, Forsyth Barr analysis

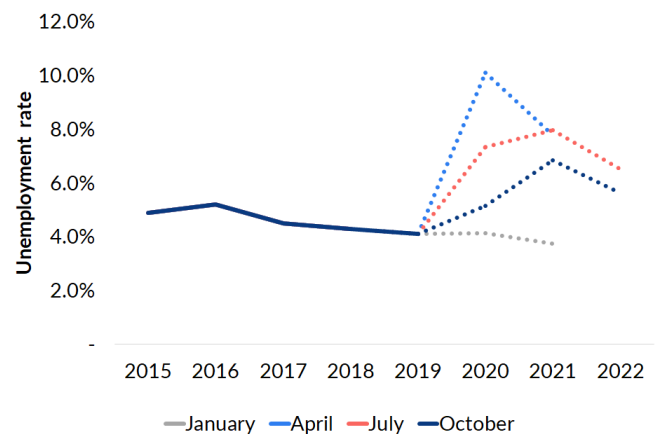
Economic indicators improving but forecasts don't paint a rosy picture

Although economists have tempered the negative forecasts during the lockdown gloom of April, the outlook remains challenging. Economic forecasts from the major banks and Treasury expect a return to 2019 real GDP levels in 2022, with recovery growth in 2023 and beyond.

Unemployment is expected to peak in 3Q20, as wage subsidies roll off and companies look to both right size for new levels of demand and address the cost base. Minimum wage hikes over the past three years have added to employee cost pressure, with COVID-19 possibly acting as an accelerant. An element of unemployment is likely to be transitional, as labour from impacted sectors re-skills/rotates into sectors likely to be boosted by fiscal support.

Figure 16. Average GDP forecast movements


Source: Bloomberg, ANZ, ASB, BNZ, Westpac, Forsyth Barr analysis

Figure 17. Average unemployment rate forecast movements


Source: Bloomberg, ANZ, ASB, BNZ, Westpac, Forsyth Barr analysis

Lockdown surge pull forward of demand cycle

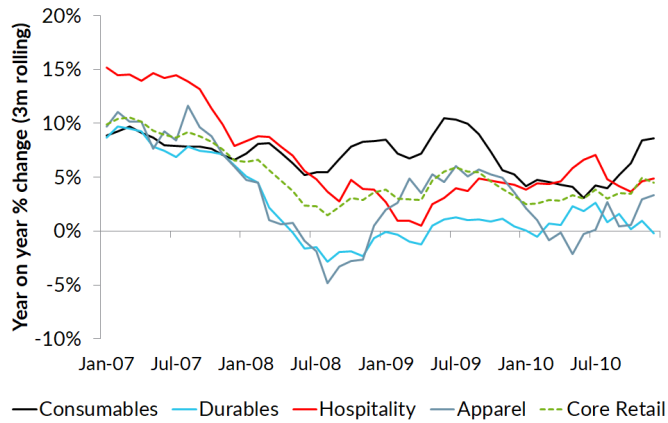
Many retailers experienced a surge in sales, both in the lead up and immediately following lockdowns. Categories that performed well are those related to WfH (work from home) and nesting behaviour (investment in the home/home environment), which tend to be durable goods. We suspect an element of the demand relates to a pull forward of the demand cycle. Whilst technology spend typically has a short (albeit lengthening) upgrade cycle, appliance purchases are more long dated.

How did sales fare in the GFC

In recessionary environments, grocery retail (consumables) typically outperforms, as consumers focus discretionary spend towards staples. Relatively inexpensive entertainment and food options, such as take-out also typically perform well during times of economic turmoil (hospitality). Underperforming categories include apparel and durables. This was illustrated during the Global Financial Crisis (Figure 19).

RBD and WHS offer exposure to categories which are typically more defensive through an economic slow down. This point is illustrated in Figure 18, with same store sales growth appearing comparatively robust for KFC and Red Sheds through the GFC.

Figure 18. NZ retail category performance through the GFC



Source: StatsNZ, Forsyth Barr analysis

Figure 19. Listed NZ retailers experience during the GFC

	FY08	FY09	FY10
Michael Hill - NZ	-2.5%	-8.2%	+6.1%
Michael Hill - Australia	+0.1%	+0.3%	+4.9%
Michael Hill - Canada	-1.8%	-9.8%	-3.2%
Briscoes	+4.3%	-5.8%	+4.2%
Rebel Sport	-1.1%	-14.5%	+6.0%
The Warehouse	-1.2%	-0.4%	-2.2%
The Warehouse Stationary	-4.5%	-7.1%	+7.8%
KFC - New Zealand	+7.7%	+4.1%	+9.2%
Pizza Hut - New Zealand	-7.0%	-6.5%	+3.9%
Starbucks - New Zealand	+4.0%	+3.6%	-2.9%

Source: Company reports, Forsyth Barr analysis

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