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Podcast Transcript

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Nick Burgess, Research Analyst: Welcome to the podcast, Nick Burgess with you. This is Update 4 on the current bear market and COVID-19 crisis.

We mentioned a couple of days ago in Update 3, our most preferred and least preferred sectors at the moment in the Australian equity market. We said that the Consumer Staples sector looked relatively better. We said obviously supermarkets were very busy at the moment, but that also Woolworths (WOW) and Coles (COL) in particular had proven business models over a very long period of time in Australia.

So what you're about to hear is EL&C Baillieu analyst James Casey give his up-to-date thoughts on the Consumer Staples sector. And this is taken from a recent presentation James did to EL&C Baillieu advisors.

James Casey, Research Analyst: Obviously, the Consumer Staples sector is topical at the moment, given the defensive nature of its earnings, but also the boost in sales they're currently receiving due to the COVID-19 virus spread. The Consumer Staples sector currently represents about 7% of the ASX 200. So it's what most people are benchmarking their portfolios against. So it's a significant component of the index. The main constituents, of course, are the major supermarket retailers Woolworths (WOW), Coles (COL) and Metcash (MTS), which represent about two thirds of that index. It's also made up of a number of FMCG (Fast Moving Consumer Goods) companies such as Treasury Wine Estates (TWE) and Coca-Cola Amatil (CCL).

If we look at the food retailing industry, which represents about $111bn in turnover, and liquor, which is about $12bn in turnover a year, they represent about 41% of total retail sales. Over the last 10 years, the average growth rate of grocery and liquor spend has been 3.6%. And so despite changes in economic conditions, food and liquor spend continues to grow year after year.

In terms of the current COVID-19 virus, there's obviously an unprecedented spike in demand for groceries. So some commentators are suggesting this is a temporary pull forward of demand. I think it could be a little bit different to that. I think there's going to be a short to medium term shift to household consumption as consumers choose to eat at home. It's safer. It saves money. And clearly people won't be eating out as much as they have done previously.

Just on the grocery market share trends over the last 10 years, Woolworths (WOW) is the dominant supermarket retailer in Australia with 38%; Coles (COL) currently around 31% share; combined they have a total of 69% share of Australian supermarket sales. Aldi down at 10% and IGA at 7%, which has been in decline for some time.

In terms of the stocks, we'll start off with the market leader, Woolworths (WOW). So the first half result was strong: total EBIT up 11% strong earnings growth across the board. Australian supermarkets and New Zealand supermarket EBIT up 8%. The one negative from the result was the comp store sales growth slowed slightly. So comp store sales grew at 3.6% in the second quarter. Now the company said that it slowed to 2% early in the third quarter owing to a temporary disruption from the bushfires and supplying some of their regional stores. I think that's clearly abated now. And those comp store sales would, at the moment, be in the high single digits, if not double digits. Going forward for Woolworths (WOW), not only have they got strong sales momentum, they've also got a couple of portfolio changes occurring with the potential demerger of Endeavour drinks later in 2020. And with Big W returning to profitability for the first time in five years, there's a potential change in ownership of that. The stock's highly priced at the moment. Given what I've just described. But nevertheless, it should be a core part of any portfolio.

Moving on to Coles (COL). Coles was recently upgraded to a BUY. The key points around Coles: 1) it's a refocused operation. So since the demerger from Wesfarmers (WES), it's focused on the food and liquor industry exclusively through its three business segments: Supermarkets, Liquor and Convenience Stores. 2), supermarket sales momentum is strong. So even before the current panic buying, comp store sales growth from Coles had improved from 0.1% in the first quarter to 3.6% in the second quarter. And that has clearly improved further into the third quarter. The final point on Coles is just their focus on cost saving and the cost savings initiatives. They've identified a billion dollars in cost savings to be achieved by FY23. They achieved $95mn in cost savings in the 1H20. So that is a stock clearly, which I think could be added to portfolios currently alongside the core holding in Woolworths (WOW).

In terms of Metcash (MTS), just moving on to Metcash. To go back to their most recent result, total EBIT was down 5%, food EBIT down 8% and hardware EBIT down 1%. Recall that they've lost two major customers recently in Drakes in South Australia and 7-Eleven on the East Coast. This is going to put longer term pressure on their business model. So long longer term they remain structurally challenged.

Just moving on to the major Fast Moving Consumer Goods (FMCG). So Treasury Wine Estates (TWE), they obviously pre released their 1H20 result. The EBIT increase was actually okay, was 8% for the group. Unfortunately, however, in the US, their EBIT declined 17% and what had become apparent in that market was a surplus of grapes, which was seeing significant discounting in the market. As a result, Treasury Wine Estates lowered their guidance. One month later, in February, they withdrew that guidance, given the impact of COVID-19 on demand, particularly in China. They also announced the early departure of its CEO, Michael Clarke, who had been selling stock over the past 12 months. There's been subsequent market downgrades to earnings for this stock. So despite the price decline or the share price decline, I'd still rate this as an "Avoid" given the uncertainty to earnings and the uncertainty over its management team.

Finally, the last major FMCG company, Coca-Cola Amatil (CCL). Coca-Cola Amatil's result back in February actually was a return to growth of its Australian beverages business after five years of declines in CSDs or Carbonated Soft Drinks. So they bounced back to growth. As well as that, their Indonesian business delivered strong growth of 14.3% in EBIT. So investors started to get a feel of a bit of a turnaround in Coca-Cola Amatil and the company guided to mid-single digit EPS growth in FY20 and beyond. Unfortunately, Coca-Cola withdrew its company guidance given uncertainty in current trading. So in Australia, whilst the grocery channel has been strong, that's been offset by lower volumes in what they call it's On The Go category. Essentially, it's convenience category. So this is more subject to discretionary spend and clearly been impacted by consumers staying at home and the cancellation of major sporting and entertainment events. So that's a higher margin business, that On The Go business, which is suffering from lower demand. The other major negative for Coca-Cola Amatil has been the decline in tourism in Indonesia, specifically Bali, which has seen a significant decline. And that's clearly impacting volumes currently. So earnings have been downgraded for Coca-Cola Amatil. And despite a reasonably resilient business model, there's still some downgrades filtering through in an uncertain environment.

So just moving to the conclusion in terms of our stock preferences. So Woolworths (WOW) should be a core holding in any portfolio. Its core supermarket business is strong. It's consistent, delivers sustainable growth. But also within Woolworths, this potential upside from changes to its portfolio through Endeavour Drinks later this year and potentially Big W going forward.

In terms of Coles (COL), that's worth adding to the portfolio I think. As I mentioned, they've got a more focused business, strong sales momentum and they've got a cost out strategy looking to realise a billion dollars in cost savings over the next three years.

In terms of Metcash (MTS), obviously you'd be doing well at the moment, but longer term, structurally challenged. Within the FMCG companies, TWE has its challenges particularly in the US, but also more recently in Asia.

And the Coca-Cola (CCL) withdrawal of guidance will certainly create some further uncertainty towards that business.

Nick Burgess: So that was James Casey, analyst for the Consumer Staples sector. So in closing, we'd like to reiterate to stay in touch with your EL&C Baillieu adviser as much as you can. We appreciate that may be difficult at times, given advisers are now working from home and don't have the normal office support to help with such things as overflow calls. So please be patient. Leave a message if you can or use email. We'll endeavour to keep you up to date through this medium, the podcast, as well as through our published research as well.

Thank you for listening.

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www.baillieu.com.au

Melbourne (Head Office)
Address Level 22, 35 Collins Street
Melbourne, VIC 3000 Australia
Postal PO Box 48, Collins Street West
Melbourne, VIC 8007 Australia
Phone +61 3 9602 9222
Facsimile +61 3 9602 2350
Email melbourne@baillieu.com.au

Adelaide Office
Address Ground Floor, 226 Greenhill Road,
Eastwood SA 5063
Postal PO Box 171
Fullarton SA 5063
Phone +61 8 7074 8400
Facsimile +61 8 8362 3942
Email adelaide@baillieu.com.au

Bendigo Office
Address Level 1, 103 Mitchell Street
Bendigo, VIC 3550
Postal PO Box 84
Bendigo, VIC 3552
Phone +61 3 4433 3400
Facsimile +61 3 4433 3430
Email bendigo@baillieu.com.au

Geelong Office
Address 16 Aberdeen Street
Geelong West Vic 3218
Postal PO Box 364
Geelong Vic 3220 Australia
Phone +61 3 5229 4637
Facsimile +61 3 4229 4142
Email geelong@baillieu.com.au

Gold Coast Office
Address Suite 202 Level 2, Eastside Building
6 Waterfront Place, Robina QLD 4226
Phone +61 7 5628 2670
Facsimile +61 7 5677 0258
Email goldcoast@baillieu.com.au

Newcastle Office
Address Level 1, 120 Darby Street
Cooks Hill, NSW 2300 Australia
Postal PO Box 111
The Junction, NSW 2291 Australia
Phone +61 2 4037 3500
Facsimile +61 2 4037 3511
Email newcastle@baillieu.com.au

Perth Office
Address Level 9, 216 St Georges Terrace
Perth WA 6000 Australia
Postal PO Box 7662, Cloisters Square
Perth, WA 6850 Australia
Phone +61 8 6141 9450
Facsimile +61 8 6141 9499
Email perth@baillieu.com.au

Sydney Office
Address Level 40, 259 George Street
Sydney, NSW 2000 Australia
Postal PO Box R1797
Royal Exchange, NSW 1225 Australia
Phone +61 2 9250 8900
Facsimile +61 2 9247 4092
Email sydney@baillieu.com.au