

# Market Commentary

# NZFUNDS

## WAREHOUSE RESULT SHOWS MARGIN RECOVERY

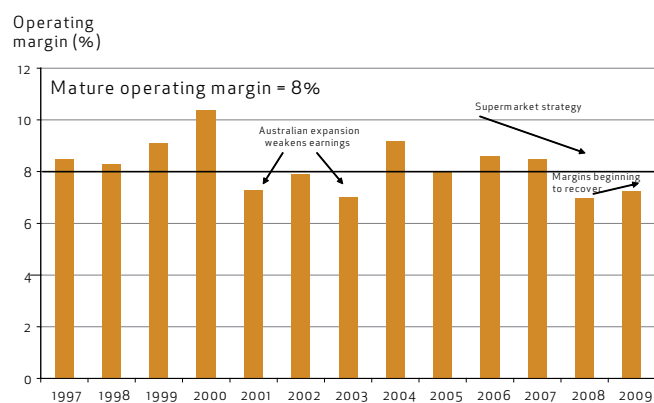
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"The Warehouse ("WHS") result this morning confirmed the company's defensive qualities and its market power" says Nick Dravitzki, Portfolio Manager of NZ Funds Management ("NZ Funds") Dividend Yield Strategy.

The company's revenue was flat in what has been a very difficult retail environment, illustrating its broad based attractiveness to consumers across the entire New Zealand market. Most pleasingly it has begun to show recovery in its operating margins.

In the past investors have looked for the Warehouse to attempt to sustain its early stage sales and earnings growth by taking dramatic steps. They would have been better off encouraging the company to stick to its knitting. The expensive mistake of moving into Australia and the failed supermarket strategy saw the company move away from its core focus and led to margin degradation. The graph below illustrates the history of margin movement in the Red Sheds.

### OPERATING MARGIN SET TO REBOUND



Source: Bloomberg.

The real attraction of the Warehouse in its current position is that it has stopped trying to be something it's not. It's not an Australian bargain business and it's not a supermarket. It is a retailer of general merchandise and a giant in the New Zealand market. It has stores in every sizeable centre in the country and has the scale to ensure it is the lowest cost provider of almost anything it stocks. "Market share and scale are the foundation of a great

business" says Dravitzki. "It is these twin pillars that enable the Warehouse to generate market leading margins and excellent earnings".

Now that the business appears to be focused on its core business it offers the very attractive prospect of being able to turn its intrinsic advantages of scale and market share into highly defensible, ongoing incremental earnings growth. By way of many micro strategies like rolling out smaller stores, steadily widening its product range, better managing its inventory and increasing the focus on high margin ranges like apparel, the Warehouse is carefully becoming a mature business.

"The nature of the Warehouse changed some years ago from being a fast growth company to being a large, stable market player" said Dravitzki. "Unfortunately management at the time didn't want to see that change. Now management seems to be clearly focused on using the company's hard won market power to provide investors with great returns".

As a mature business the Warehouse should be returning cash to shareholders and management has confirmed their willingness to do this by paying a special dividend of 10c.

### OFFERS GOOD VALUE

The Warehouse is a great business and at the moment it is also an excellent investment. In the 2009 year it generated operating earnings of \$125m yet the entire business is currently only valued at \$1.3b – an EBIT yield of approximately 10%, and an EV/EBIT multiple of 10.4x. With very low debt its adjusted Price to Earnings Ratio (PER) is less than 15x, cheap for a business with such market power. Even if sales stay the same, if margins rebound to 8% and it continues to trade on the same multiple investors stand to earn 15% - 5% via dividend yield and a 10% capital gain.

## WHS PRICE



Source: Bloomberg.

## WHS RELATIVE TO NZ SHARES



Source: Bloomberg.

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