Tabled by
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Wesfarmers 01 Feb 11

WES

Milk run

The battle for supermarket share in Australia is well and truly on. Wesfarmers reported its second quarter sales yesterday which showed Coles is aggressively discounting key products to get more customers through its newly formatted stores and win back a lost generation of customers. Flood-affected higher vegetable and fruit prices are a side dish. The main course has Coles discounting fresh milk and bread house brands, aimed squarely at drawing in customers old and new.

"Coles is demonstrating the extent of its market power relative to its suppliers"

After breaking to the downside from a symmetrical triangle, Wesfarmers printed a low of $30.96 on January 7. Having formed a basing formation at the $31.00 support level, WES managed to surge higher, breaking above the confluence of the 50 period moving average (green line) and downtrend line at the $32.00 region. This indicates momentum and trend in the short term to favour the upside once more.

Overhead resistance lies at the September 2010 high of $34.83. A sustained break above this resistance level will result in a strong boost of upside momentum.

Make no mistake - Coles will be privately fist-pumping at its latest win over Woolworths in the quarterly sales results. Whereas Woolworths reported comparable store sales growth of 2.5% for the quarter, Coles churned out 6.7% across its network of food and liquor stores. The comparison is not strictly apples with apples but serves to indicate the level of price promotion (read as price cuts) that Coles has been prepared to invest to gain customer traffic and transaction volume in its stores.

Wesfarmers noted that trading had been very strong in the week leading up to Christmas, spurred on by a 'double discount' to its usual 4 cents per litre petrol promotion. That helped encourage 15.5 million customers to file through the checkouts at Coles (all with new cash registers), leading to 'double digit' headline sales growth in that week.

Coles has launched an intriguing lunge for market share in recent weeks. Not content with treading softly, it has ripped a large chunk off the price (about one third) of its house brand milk and is now selling it at roughly $1 per litre. As milk is a key staple item and finds its way into nearly every shopping trolley, it will have an outsized effect on shopper behaviour. The same can be said of bread.

The move has obviously angered Coles' big suppliers who are squealing loudly about the threat to their own profit margins. But is interesting to note that there may be little they can do about the situation. If National Foods/Dairy Farmers wants to take its business away from Coles as its main supplier of house brand milk, who will they sell it to instead? As house brand milk accounts for up to 60% of total fresh milk sales, it is unlikely the processors can find an alternative buyer. Indeed, Woolworths, Franklins and

Aldi have all followed suit leaving the milk processors no choice but to swallow the change.

This is an example of what we look for in a company. Coles is demonstrating the extent of its market power relative to its suppliers. We can see from its unilateral price shift on milk that it clearly has a strong position relative to its suppliers in that particular category. The same is occurring in bread and may yet extend to other key products. In that sense, Coles can control its operating margins rather than be dictated to by its suppliers, some of which are very powerful multinational food manufacturers.

Coles Managing Director Ian McLeod wasn't getting too carried away with these sales numbers, reminding investors that the repair job to the food and liquor chain was only halfway through its five year timeframe.

A large dent has been put in the project to install Coles' auto-replenishment system (Easy Ordering) which is now in 600 stores. This system still needs to improve its link with the group's distribution centres to fully capitalise on the benefits. If Coles needs a reality check, this is a good place to look as Woolworths has been refining its equivalent system for nearly a decade.

The store refurbishment program achieved 30 renewal stores in the quarter bringing the cumulative total to 91 stores. By the end of the financial year in June, around 150 stores will have been refurbished. With a national footprint of 742 supermarkets, there is some way to go yet.

The renewal stores are delivering the right amount of additional sales growth. Basket sizes are generally increasing and important categories such as fresh food are recording better sales.

The total number of liquor outlets rose to 787 stores across Australia as 14 new liquor stores were opened in the period.

During the half year, excluding the impact of higher tobacco excise, food and liquor deflation was 1.7%. Higher fresh food prices are pulsing through as flood damaged crops limit supply of some fruit and vegetables such as tomatoes, broccoli and capsicum. But it is the actions of Coles (and other supermarkets) in bringing the price of groceries down overall on most of its product lines that is causing the price deflation. This is likely to continue.

Coles pointed out the generally poor weather conditions during the period, especially on the east coast, as a limiting factor. This was the main explanation for the softness in the discretionary businesses of Target, Kmart and Bunnings.

Target's customer numbers are up, but its average selling price is down reflecting further price declines courtesy of the high Australian dollar. Higher interest rates don't help either. Total store sales declined by 4.2% for the quarter and by 3.1% for the half year.

Kmart has now completed 12 months on its new 'everyday low pricing' model as opposed to the previous 'high-low' strategy. That also marks a year of drastically reducing the number of product lines in the stores. The comparisons with previous periods are therefore now likely to be more indicative of the real turnaround at the business.

For the record, total sales of $1.4 billion grew 0.8% with same store sales declining by 0.6% in the quarter. First half sales were up 1.9% and same store sales rose 1.7%.

The strong customer and transaction growth that had marked the early months of Kmart's resurrection have continued with an additional 7 million transactions during the half.

Bunnings sales grew by 4.8% in the December quarter to $2 billion with same store sales growth of 2.4%. Price deflation is at work in the home improvement sector as well, along with more subdued consumer spending. Nonetheless, the business is in a commanding position ahead of the entry of Woolworths' home improvement format.

Bunnings was particularly busy building its own stores in the period with four warehouses, four smaller format stores and three trade centres opened. Across all three variants, there are now 280 stores. Members may recall that Woolworths is attempting to put up 150 home improvement stores over five years.

No mention was made during the analysts' conference call of whether Bunnings had been deliberately outbidding Woolworths on strategic properties and land-banking these sites. We will leave that for the media to speculate on but simply take the message that Bunnings will fiercely contest the sector.

Office supplies sales grew 4.2% on the prior quarter with better transaction growth as the business continues to lift its game.

With reference to the weekly chart, Wesfarmers bounced off both the 39 (green line) and 200 (red line) week moving averages, which is bullish. Broader term, we would expect a continuation of the upward ascent with sights on the psychological $40.00 level as the upside target.

Summary

Wesfarmers managing director, Richard Goyder, said the sales result had been strong considering the conditions were not. Weather and deflation weren't helping but Coles had been aggressively 'investing in value for customers' – Mr Goyder's way of saying price cuts.

The impact of the Queensland floods is still too early to quantify but insurance cover for trading and stock losses could limit the impact on the retail businesses to around $20 million. A better answer may be provided at the half-yearly profit release on 17 February.

The resources business will of course be a different story.

We remain encouraged by the progress being made at Coles, tempered by the economic conditions. With more work to do, there should be more upside for profits and investors.

We will continue to hold Wesfarmers in the Fat Prophets Portfolio.

Snapshot WES

Wesfarmers
Latest closing price: $33.68

Wesfarmers operates in a diverse range of industries, including retail, coal mining, fertilisers and chemicals, industrial distribution, insurance and LPG extraction. In 2007 Wesfarmers acquired Coles, significantly lifting its exposure to retail spending.

Market Capitalisation **$39,375m**

	FY1	FY2
Price to Earnings	18.0	15.6
Dividend Yield(%)	4.6	5.1
Price to Book	1.55	1.51
Return on Equity(%)	8.8	9.9