FINANCIAL REVIEW

HD Woolworths' growth dilemma

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There has always been a degree of conservatism around the Woolworths boardroom table, but the caution has been amplified by the blowout of its push into hardware, the supermarket group's biggest strategic move in years.

With the worse than expected losses in the Masters hardware division out in the open ahead of this week's annual result, it is worth stepping back to look at the Woolworths empire in total.

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Hardware has dominated the headlines for chief executive Grant O'Brien for some time. The expected $169 **million** loss from Masters in 2014 is not material in the context of an expected $2.4 **billion** annual profit.

However, it has raised concern about the **billions** of dollars in capital being sunk into a business that is years away from breaking even and puts a lot of pressure on O'Brien and the board to get the next big strategic move right.

Like rival Wesfarmers-owned Coles, Woolworths needs to expand and diversify. Woolworths is still aggressively rolling out new stores as it narrows the gap with Coles in terms of same-store sales growth for the first time in years. But both supermarket giants, which dominate the $85 **billion** grocery market, still need to expand outside their core business.

Woolworths pulled the plug on plans to spend up to US$3 **billion** on **Hong Kong** supermarket chain PARKnSHOP last year. International expansion is part of the strategy, but the risks are high. Woolworths also still harbours ambitions to expand into the $16 **billion** pharmacy market but remains restricted by legislative hurdles.

O'Brien is also not ready to give up on hardware, despite the mounting losses. Comparisons are being made internally to the same flak the **company** got when liquor failed to make a profit for years after it acquired a handful of suburban liquor stores called Dan Murphy's in 1998.

The difference with liquor, which is one category where Woolworths outshines its competitor, is that those results were hidden behind the supermarket results for years, whereas Masters is out in the open.

The overall Woolworths business is performing well and O'Brien – who worked his way up the ranks from a shelf-stacker in a Woolworths-owned supermarket in Tasmania – to chief executive three years ago, still has the benefit of the doubt.

But it does mean he cannot afford any strategic slip ups. The board, headed by chairman Ralph Waters, is unlikely to sign off on any radical moves for some time.High margins in food and liquor

When the **company** reports full-year earnings on August 29, high margins in food and liquor are expected to offset a weak result from Big W and the Masters losses.There are early signs efforts to finally match or beat Coles on same-store growth for the first time in years are working.

Everyone in the industry knows the story. Coles dropped the ball for years until it was sold to Wesfarmers in 2007 and new management staged a spectacular recovery. After a decade of double-digit profit and sales growth, Woolworths was unprepared for its strong competitor and growth stalled in 2011. O'Brien implemented a five-year plan to retake the **lead** with cost cuts, lower prices, more global sourcing and investing in new stores.

In the March quarter this year, Woolworths matched Coles with a 3.5 per cent increase in same-store sales. More recently, it has been changing store formats, adding things like sushi bars and baristas, and reviving old marketing campaigns to get more customers through the door.

Woolworths is investing heavily in new stores, which has put it in the competition regulator's sights, while widening the gap between sales growth and space growth.

Australia's grocery market is dominated by Woolworths, with almost 40 per cent market share, and Coles. But new players like ALDI and Costco are making an impact and neither can afford to drop the ball. UBS expects growth at 3 to 5 per cent a year.

Analysts will be keeping a close eye on the **company**'s internal capital in this week's annual result. Citi analyst Craig Woolford notes that Woolworths has sunk $2.6 **billion** into home improvement, 5 per cent of the **company**'s enterprise value. The capital will rise to $3 **billion** as more stores are opened.

"This is the risk for Woolworths shareholders and should be considered in light of the defensive nature of its supermarkets business," Woolford says.

Hardware is important because supermarkets have been under pressure for some time to find new revenue streams. Woolworths has been doing this by expanding into private label, liquor, petrol retailing, insurance and telephony. Coles has had success with insurance and financial services.

Pharmacy is an obvious path for Woolworths to take, but it is hamstrung by federal government policy that pharmacies must be owned by pharmacists. Behind-the-scenes, Woolworths has been making a play for the sector without any progress. It has registered a pharmacy trademark covering the **sale** of medical products and has lobbied for change on competition grounds.

But at this stage the Community Pharmacy agreement means its chance of success are low and management has no plans for that area. The arrival of discount retailer Chemist Warehouse into the market means it may already be too late. Chemist Warehouse has already cut the margins out of the business, which is something the supermarkets would have done well.

Growing offshore has also been on the radar but, like Wesfarmers, there is a shortage of low-risk opportunities for the right price in what are far more competitive markets than Australia. Still, the rewards are potentially huge for a **company** like Woolworths if it could break into a market like Guangdong in **China** where PARKnSHOP has a presence. It has also looked at India, but a retail partnership there with Tata ended prematurely in 2011. International expansion is still on the agenda, although investors will prefer to see excess capital returned to shareholders at this stage.Priority focus on four areas

O'Brien's immediate strategic priorities focus on four areas. Securing a leadership position in food and liquor tops the list, and online is an important part of this strategy. Woolworths is Australia's biggest online retailer and will post more than $1 **billion** in online sales for the 2014 financial year. Woolworths acquired New Zealand's EziBuy last year for $306 **million**.

There will also be a lot of talk at the results about managing its portfolio for shareholders. Like Coles, Woolworths has turned to the United Kingdom to hire new management talent. British retail veteran Alistair McGeorge was brought in earlier this year to replace Julie Coates as managing director of Big W. This followed the appointment of another Brit, Matt Tyson, to head the home improvement business. Surprisingly for a man who has worked at Woolworths for 26 years, O'Brien has replaced every divisional head, and many of those came from outside the **company**. The only gap left to be filled is Coates, who quit suddenly in July , apparently unhappy in her new role overseeing a supply and logistics transformation program called Mercury 2.

Mercury 2 is another strategic priority, though it will not be able to generate the kind of returns that past programs like Project Refresh under former chief Roger Corbett did. That program generated strong returns for a decade when Coles was falling apart.

Woolworths is also close to a decision on the potential $650 **million sale** of pubs and liquor stores. Advisers UBS and Goldman Sachs have been looking at whether to sell or float the portfolio. ALE Property Group and Charter Hall are potential buyers.

Like Richard Goyder at Wesfarmers, O'Brien's investors want surplus cash returned to shareholders without sacrificing future growth opportunities.

It is a delicate juggling act, one made more difficult for Woolworths until it can show signs that progress is being made with hardware. Analysts believe Masters may not break even until 2018 – nine years after Woolworths announced its plans to compete head on against Wesfarmers' Bunnings in the big-box home improvement market.

Woolworths' engine room is sound, though there are risks. Investors believe food and liquor margins will be flat over the next five years and food inflation will accelerate in the next 12 to 24 months, according to a survey of investors by UBS this month.

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