Stock Pitch on Metcash Limited (MTS-AU)

22 August 2024

Metcash is a leading Australian wholesale distribution and marketing company, supporting independent retailers in the food, liquor, and hardware sectors. It owns many different banners including IGA, Home Hardware, Cellarbrations.

Long

2-year Target Price: $5.73

Investment Thesis:

- Metcash has maintained a ROE over 15% for four consecutive years, and is also significantly undervalued with a P/E ratio of 13.92 whereas the industry average is 28.93.
- Its diversification among defensive sectors (food and liquor) and cyclical sectors entails valuation potential during economic recession and revenue potential during economic expansion.
- The business model of outsourcing brands to retailers is cost efficient.

Company Overview:

- Business Model: Metcash operates a B2B (business-to-business) model, primarily serving as a wholesale distributor to independent retailers across Australia. It generates revenue by supplying products purchased from manufacturers, private label sales, franchise and licensing fees, and marketing and brand support service fees. Metcash is featured by a diversification across defensive consumer staples industry and cyclical construction industry.
- Competitive Advantages: Metcash has several competitive advantages. First, Metcash owns various famous brands including IGA, which is one of the strongest competitors with Woolworths and Coles in the grocery retailer business. Strong brands indicate market recognition, and customer loyalty for Metcash. Second, retailers operated under Metcash owned brands tend to occupy prime retail sites. Such geographic proximity secures retailers' sales volume and Metcash's margin. Finally, the company showcases cost efficiency. Cost advantages mainly arise because brands owned by Metcash are ran by independent retailers. The expansion of its private label products such as IGA Signature brands further contributes to the efficiency gain.

Industry Outlook:

- As an export-oriented country, Australia's economic prospects are tied to global economic conditions. With high global economic uncertainty, and high domestic inflation rate and high domestic interest rate, the slowdown in Australian GDP growth might continue in the short term. The projected slowdown might render the consumer staples sector still performing relatively well in financial year 2025.

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Market performance

Figure 1. Metcash stock price

Profitability and leverage

	2021	2022	2023	2024
ROE	20.1%	22.8%	23.0%	16.9%
Gross Margin	10.1%	10.9%	11.5%	12.1%
Dividend Payout	71%	70%	70%	71%
EPS (cents)	21.8	24.7	31.8	28.3
Equity Multiplier	4.1	4.9	4.8	3.8

Table 1. Profitability and leverage

Operational efficiency

	2021	2022	2023	2024
Receivables turnover	8.6	8.4	8.7	9.6
Inventory turnover	12.6	12.7	12.1	11.8
Payables turnover	6.9	6.8	6.8	6.5
Asset turnover	3.0	3.0	2.9	2.8

Table 2. Operational efficiency

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Financial Metrics and Valuation:

- Strong Profitability: Metcash demonstrates strong profitability in recent years (see Table 1 for profitability and leverage). Despite the challenges posed by the COVID-19 pandemic, the company has maintained a Return on Equity (ROE) exceeding 15% for four consecutive years. This impressive ROE is largely attributed to a combination of a robust net profit margin, efficient asset turnover—hovering around 3 as shown in Table 2—and significant leverage. The equity multiplier dropped in FY24, which indicates that the significant acquisitions made by the company this year (Superior Food Group, Bianco Construction Supplies, and Alpine Truss) are not heavily financed by debt, reflecting Metcash's awareness of its financial risk. It also has a remarkable dividend payout ratio of over 70%.

- Slowdown in Growth: The slowdown in growth as shown in Table 3 was mainly driven by a decline in tobacco sales due to an acceleration in illicit trade and the shift to alternative, and a decrease in hardware sales due to reduced construction market activities. Metcash's recent acquisitions in FY24 further contributed to the negative EBIT growth.

- Undervaluation: The average P/E ratio of consumer staples section shown in Table 4 is around 28.93. Implied price of Metcash in the comparative analysis, assuming that its valuation reaches 70% of the industry average P/E, is $5.73, which is over 50% higher than the current market price.

Growth	2020	2021	2022	2023	2024
Sales revenue ($m)	13,025.4	14,315.3	15,164.8	15,803.4	15,912 .4
Sales growth	NA	9.9%	5.9%	4.2%	0.7%
EBIT ($m)	334.9	401.4	472.3	500.8	496.3
EBIT growth	NA	19.9%	17.7%	6.0%	-0.9%

Table 3. Growth in revenue and EBIT

Investment Risks:

- Metcash continues to compete with larger players like Coles and Woolworths, particularly in food and liquor, which could pressure margins and market share.

Valuation	PE
Metcash	13.92x
Woolworths	28.19x
Coles	23.18x
Wesfarmers	33.84x
Reece	39.81x
Bid Corp. Ltd.	19.65x
Mean	28.93x
Indicated price of Metcash	$5.73

Table 4. Comparable analysis with P/E ratio

Catalysts:

- The slowdown in growth is highly likely to disappear during the future global economic recovery (as construction industry is cyclical) or when the synergy of the recent acquisitions kick in.