

Stock Report

Issue 73 - 7 April 2010

'Time is the friend of the wonderful company, the enemy of the mediocre.' - Warren Buffett

Woolworths Limited

By George Whitehouse - StockVal Analyst

Value investing is about:

1. Searching the stockmarket for great businesses.
2. Understanding those businesses to answer the questions: How does this business make money? Is it a sustainable business model? What are the likely returns or profits from this business?
3. This leads to estimation of how much of the profit is distributed and how much is retained to grow the business. From this a calculation of intrinsic value can be attained. This intrinsic value is determined by an appropriate multiple of equity.
4. Waiting for an opportunity to buy attractive businesses when the prices in the market are below the intrinsic value. This provides investors with a margin of safety.
5. Generally the acquisition of attractive businesses at a discount to intrinsic value will reward an investor whom can simply hold them over a long period. That said when Mr. Market offers prices that are way above today's intrinsic valuation it may be time to consider selling and awaiting the inevitable mood change.

With that framework in mind let's shine the StockVal spotlight on Woolworths Limited (ASX:WOW).

Woolworths was founded in 1924 when 'Woolworths Stupendous Bargain Basement' opened for business in Sydney's Imperial Arcade. It took three years for Woolworths to become a 'chain' when in 1927 Woolworths opened a store in Queen Street, Brisbane followed by a store in Hay Street, Perth in 1928. In 1929 Woolworths opened a store in New Zealand and by 1930 Woolworths was operating 16 stores in Australia and New Zealand. The Great

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Depression and World War II slowed progress but by 1959 Woolworths had opened its 300th store. In 1976 Big W was launched selling general merchandise in a format that proved successful and led to 13 Big W stores being in operation by 1978 in all states of Australia. In 1988 Woolworths was taken over by Industrial Equity Limited (IEL) at \$3.65 a share and on May 31st was delisted. Woolworths was to remain directly unavailable to investors until IEL under debt problems floated it again in June 1993 at \$2.45 in what was the largest float in Australian history at the time.

Today Woolworths is Australia's largest retailer with operations across food and grocery, liquor & hotels, petrol, general merchandise, consumer electronics and financial services serving more than 24 million customers weekly across Australia and New Zealand. In 2009 Woolworths sold just over \$49.5 billion worth of goods.

Woolworths also operates 23 Big W Optical stores staffed with qualified optometrists and via a joint venture with TATA in India services 40 retail stores operating under

the Croma brand. Woolworths recently acquired a 25% stake in Gage Roads Brewery where it offers the private label beer 'Dry Dock' to its distribution network (what a joy owning the other 75% would be with a partner such as Woolworths to distribute your product).

Woolworths has commenced its entry into the wholesale and retail hardware sector via a partnership with US home improvement company Lowe's.

Woolworths management has the stated strategies of:

- Sales to grow in the upper single digits assisted by bolt-on acquisitions.
- EBIT growth outperforming sales.
- EPS growth outperforming EBIT growth.
- Cost of doing business (CODB) reduction of at least 0.2% per year.
- Maintenance of credit ratings and a disciplined investment methodology and approach.

WOOLWORTHS LIMITED		Performance and Valuation						Performance Chart																									
Stock Code	WOW	Currency	AUD	<input type="radio"/> NROE for last year of review 37.8% <input type="radio"/> IRR 42.2% <input checked="" type="radio"/> Other 38.0%				<table border="1"> <thead> <tr> <th>Year</th> <th>Dist.</th> <th>Reinv.</th> <th>NROE</th> </tr> </thead> <tbody> <tr> <td>2006</td> <td>29.6%</td> <td>13.6%</td> <td>43.2%</td> </tr> <tr> <td>2007</td> <td>26.4%</td> <td>11.9%</td> <td>38.2%</td> </tr> <tr> <td>2008</td> <td>26.7%</td> <td>11.5%</td> <td>38.2%</td> </tr> <tr> <td>2009</td> <td>27.4%</td> <td>10.8%</td> <td>38.3%</td> </tr> <tr> <td>2010</td> <td>25.9%</td> <td>12.0%</td> <td>37.8%</td> </tr> </tbody> </table>		Year	Dist.	Reinv.	NROE	2006	29.6%	13.6%	43.2%	2007	26.4%	11.9%	38.2%	2008	26.7%	11.5%	38.2%	2009	27.4%	10.8%	38.3%	2010	25.9%	12.0%	37.8%
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Sector	Consumer Staples		Adopted Profitability Forecast		38.0%																												
Last Equity Date	25/06/2010		Distributed		26.6%																												
Intangibles	4,933.1		Reinvested		11.4%																												
Total Liabilities	10,027.6		Investment Value at Required Return		11.4% \$33.84																												
Cash Equivalents	762.6		Value/Price Margin at adopted Required Return		19.2%																												
Interest Bearing Debt	3,174.9		'Required Return' to justify market price		12.7%																												
Average Funds Employed	9,882.4		'Assumed Return On Equity' to justify market price		34.0%																												
Total Shareholders Equity	7,404.2																																
Less Minorities	0.0																																
Less Non Ordinary Equity	0.0																																
Net Ordinary Share Equity	7,404.2																																
				<input type="button" value="Create Adjusted"/> <input type="button" value="Save"/> <input type="button" value="Preview"/>																													
	2005	2006A	2007A	2008A	2009A	2010F	Totals	Vital Statistics																									
Amortisation of Goodwill		0.0	0.0	0.0	0.0	0.0	0.0	No. Ordinary Shares (m)	1,240.0																								
Abnormal Gains (Loss)		-314.7	250.3	-118.8	-82.1	0.0	-265.3	Market Price at 06/04/2010	\$28.39																								
Net Profit inc. Abnormals less Pref Divs		1,014.6	1,294.0	1,626.8	1,835.7	2,016.3	7,787.4	Equity per Ordinary Share	\$5.97																								
Dividends on Ordinary Shares Only		613.1	788.9	1,006.4	1,174.3	1,214.7	4,797.4	Year High - Market Price	\$30.57																								
% of Dividends Franked		100%	100%	100%	100%	100%	100%	Year Low - Market Price	\$25.10																								
Grossed up Dividends		875.9	1,127.0	1,437.7	1,677.6	1,735.2	6,853.4	NTA per share	\$1.99																								
Opening Equity		1,974.2	4,027.8	5,275.3	5,992.9	6,812.5	1,974.2	Intangibles	\$3.98																								
Retained Profits		401.5	505.1	620.4	661.4	801.7	2,990.1	Liabilities	\$8.09																								
Change in Reserves		-314.7	252.0	-118.8	-82.1	0.0	-263.6	Borrowings per share	\$2.56																								
New Ordinary Share Capital		1,966.8	490.4	216.0	240.3	190.0	3,103.5	Net Debt to Equity Ratio	32.6%																								
Ordinary Capital Buybacks		0.0	0.0	0.0	0.0	400.0	400.0	Normalised Earnings	\$2.05																								
Closing Ord. Equity Ex Minorities	1,974.2	4,027.8	5,275.3	5,992.9	6,812.5	7,404.2	7,404.2	Normalised ROFE	28.2%																								
Normalised IRR Cash Flows	-1,974.2	-1,090.9	636.6	1,221.7	1,437.3	9,614.7	9,845.2	Dividend per share	\$0.98																								
Normalised Earnings		1,277.4	1,633.8	2,058.1	2,339.0	2,536.9	9,845.2	Dividend Yield	3.5%																								
Normalised ROE		43.2%	38.2%	38.2%	38.3%	37.8%	39.1%	Grossed Up Dividend Yield	4.9%																								
								Equity Ratio	42.5%																								

StockVal Valuation - Woolworths Limited (ASX:WOW)

Source: www.stockval.com.au

Has management been successful in growing sales, EBIT and EPS over time while reducing CODB?

	Sale of goods (\$m)	Sales growth	EBIT (\$m)	EBIT growth	EPS (\$)	EPS growth	CODB	CODB Reduction
1999	18,766		463.9		0.22		23.95%	
2000	20,392	8.67%	542.4	16.92%	0.28	25.05%	23.09%	0.86%
2001	20,915	2.56%	729.2	34.44%	0.46	64.80%	22.22%	0.87%
2002	24,473	17.01%	849.4	16.48%	0.54	16.80%	21.84%	0.38%
2003	26,321	7.55%	960.5	13.08%	0.64	18.76%	21.55%	0.29%
2004	27,933	6.13%	1080.7	12.51%	0.72	12.20%	21.10%	0.45%
2005	31,353	12.24%	1323.9	22.50%	0.78	8.75%	20.73%	0.37%
2006	37,734	20.35%	1742.8	31.64%	0.87	11.34%	20.47%	0.26%
2007	42,477	12.57%	2151.2	23.43%	1.08	24.62%	20.35%	0.12%
2008	47,034	10.73%	2574.2	19.66%	1.34	24.56%	19.92%	0.43%
2009	49,594	5.44%	2883.7	12.02%	1.50	11.63%	19.98%	-0.06%
Average		10.33%		20.27%		21.85%		0.40%

Table 1 shows:

- Sales have grown at high single digits;
- EBIT growth has outperformed sales growth and EPS growth has outperformed EBIT growth;
- Management has managed to squeeze an average 0.4% out of the cost of doing business each year.

Comparing managements strategy to the business performance over a reasonable time period, shows that management has done a fine job over the last decade.

Other measures of performance

Consider the NPAT to sales ratio for example. This ratio shows how many dollars of net profit after tax result from a dollar of sales. Woolworths NPAT to sales ratio in 1999 was 1.37% and in 2009 management had increased this to a whopping 3.7%. This means for every \$100 dollars that went through the check out \$3.70 appeared as net profit in the Profit & Loss account. This may not appear to be significant but for a mass retailer tiny movements in this margin make huge effects on profits, dividends and our valuation of the business.

Another method used to judge the efficiency of a retailer is the stock turn ratio. This method uses average inventory divided into sales to estimate how many time the

business was re-stocked each year. In 1999 Woolworths completely restocked 11.36 times in the year. By 2009 the business replaced its inventory 15.74 times. The theory goes that the faster a retailer can turn over its stock the better it should perform. Further the lower is the gross margin then the higher should be the stock turn. As grocery retailers operate on low gross margins (i.e. around 20%) then stock turn is very important.

	1995	2000	2005	2009
Stock Turn Ratio	11.05	12.36	16.40	15.74

All retailers try to carry minimal inventory (without sacrificing sales) and attempt to turn it over as fast as possible, even to the point of selling the goods before they have to pay for them. An attribute Woolworths is fortunate to enjoy. The above stock turn ratio indicates management has been successful in increasing efficiency over time. This is assisted by investment in supply chain systems that automate restocking tasks without human input.

Management is a key ingredient to any successful business and Woolworths has had its share of good managers from Paul Simons to Roger Corbett and the

current CEO Michael Luscombe who started with the company in 1978. The current nine board members own 891,684 shares in the business representing around \$25 million (Sep. 2009). Although not that significant in a company with a market capitalisation of around \$35 billion it should be sufficient to keep the directors focused on shareholder returns.

Management announced an on market share buyback with the first half results of \$400 million. We view this as a good use of shareholder funds as our valuation is above today's price. It should be noted the buyback basically offsets the shares issued under the management incentive and dividend reinvestment schemes in FY2010.

The new venture into hardware (via Danks and the US domiciled Lowes) will be a challenge for management. Bunnings has an established footprint and will no doubt

provide strong competition. Management has targeted 150+ stores within 5 years and has begun securing sites. Also Metcash has acquired just over half of Mitre 10 with an option for full ownership in a couple of years time. It appears a challenging time to be an independent hardware retailer. It will be interesting to see if the hardware division will become as profitable as the rest of the business.

Competitive threats include a reargent Coles offering, an ambitious Aldi, IGA and new entrants such as Costco.

Woolworths competitive advantages consist of an efficient supply chain, a low cost culture and the network effects that come with scale. Customers vote with their wallets and the challenge is to keep them voting for Woolworths.

Valuation & shareholder returns

The significant components required for the valuation are listed in Table 2 below.

	NPAT (\$m)	Operating Cash Flow (\$m)	Dividends (\$m)	Equity (\$m)	Net Debt / Equity	NROE
1999	257.0	574.0	207.2	1,481.4	49.37%	27.88%
2000	295.5	1,066.9	243.5	1,044.7	7.87%	9.42%
2001	475.7	809.0	517.0*	1,521.9	25.47%	119.09%*
2002	563.0	1,174.5	345.9	1,818.1	13.05%	42.56%
2003	650.6	1,250.6	380.9	1,818.4	19.78%	29.15%
2004	730.7	1,262.3	428.7	2,047.3	8.01%	48.39%
2005	816.2	1,214.4	499.8	1,974.2	122.18%	10.46%
2006	1,014.6	1,705.1	613.1	4,027.8	94.11%	43.19%
2007	1,294.0	2,294.2	788.9	5,275.3	43.07%	38.7%
2008	1,626.8	2,654.0	1,006.4	5,992.9	33.70%	38.5%
2009	1,835.7	2,604.2	1,174.3	6,812.5	35.41%	38.4%
2010 E	2,016.3	NA	1,214.7	7,769.1	NA	37.8%
2011 E	2,217.0	NA	1,421.6	8,765.5	NA	43.4%
2012 E	2,415.0	NA	1,585.7	9,794.3	NA	36.8%

* Special Dividend

1999-2009 Growth Rates	Annualised	Total
NPAT	19.6%	614.3%
Dividends	17.1%	466.8%
Equity	14.9%	359.9%

Table 3 shows that NPAT has grown every year for a decade and in each year operating cash flow has exceeded NPAT. This is a sign of a strong business. We can also see that dividends have grown every year taking into account the special dividend in 2001. It is pleasing to see that NPAT & dividends have grown faster than Equity over the period. A sign that management is working the equity in the business harder and the business has become more efficient via scale and network effects.

The table also shows that net debt / equity has been acceptable (<50%) in all but a couple of years (2005 & 2006). In 2005 & 2006 Woolworths made a couple of significant acquisitions in Australian Leisure and Hospitality group and Foodland in New Zealand. A retailer with the strength of Woolworths can handle some debt as the cash flows of its business are reliable and strong.

Over the review and forecast periods the business will

generate NPAT of \$16,203 million and pay fully franked dividends of \$10,457 million giving us a payout ratio of 65%.

The average NROE over the forecast periods is 39.33%. In selecting an Adopted Performance Forecast (APF) an investor needs to review past performance and form a view of the likely sustainable future performance. Being a little conservative is a rational approach so we have adopted an APF of 37%, of which Distributions (D) make up 26% & the Reinvestment of profit (RI) the remaining 11%.

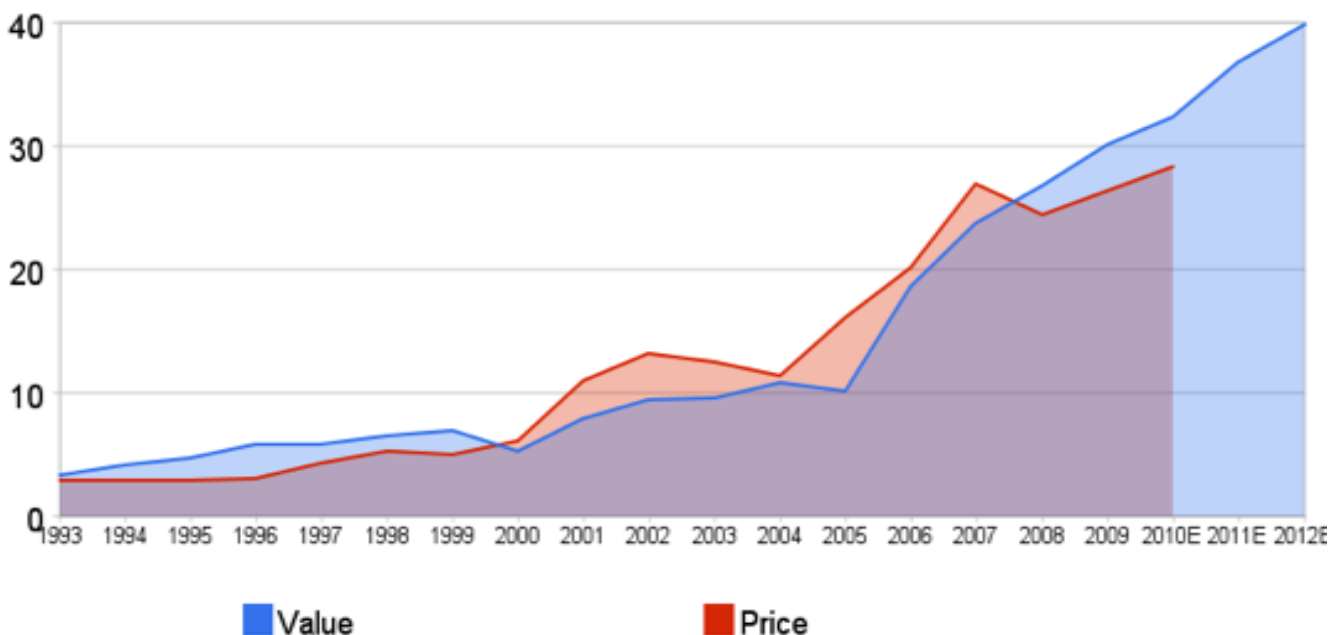
Thus, we now have the key inputs StockVal requires to value Woolworths.

RR	11.4%
APF	37%
D	26%
RI	11%

Using the above inputs and the equity per share StockVal produces the following values:

	2009A	2010E	2011E	2012E
Value	\$30.13	\$32.32	\$36.8	\$39.81

Woolworths: Value & Price



An investor who purchased \$10,000 of WOW shares in June 1994 shortly after the business was re-floated would have achieved an annual compound return of 19.52% (\$121,450) compared to the All Ordinaries Accumulation Index return of 9.6% (\$36,100) to June 2009.

With a share price around \$28 Woolworths is currently available at a discount to its intrinsic value providing investors with an opportunity to become a part owner in this wonderful business on business like terms. A reason this analyst owns shares and has recently purchased some for his 4 month old son.

Of course the future of Woolworths may well be materially different to the past and it becomes more difficult to earn outsized returns on equity as that equity grows. With a growing population and an ingrained retailing culture extending for the best part of a century the future appears bright.

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- How to choose an APC
- Why adjustments to historical financial statement figures are necessary.

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Sydney	Wednesday, 14 April	StockVal Sydney Office	10am - 12pm
Canberra	Wednesday, 21 April	Crown Plaza, Canberra	11am – 1pm
Wollongong	Wednesday, 28 April	Novotel, North Beach	11am – 1pm
Newcastle	Wednesday, 5 May	Crown Plaza Hotel	11am – 1pm
Brisbane	Tuesday, 8 June	Holiday Inn, Brisbane	10am - 12pm
Adelaide	Tuesday, 15 June	Hotel Grand Chancellor	10am - 12pm
Perth	Thursday, 17 June	Holiday Inn, City Centre	10am - 12pm
Sydney	Tuesday, 22 June	StockVal Sydney Office	10am - 12pm

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Sydney	Wednesday, 14 April	StockVal Sydney Office	2pm – 4pm
Canberra	Wednesday, 21 April	Crown Plaza, Canberra	3pm – 5pm
Wollongong	Wednesday, 28 April	Novotel, North Beach	3pm – 5pm
Newcastle	Wednesday, 5 May	Crown Plaza Hotel	3pm – 5pm
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