The supermarket duopoly is starting to fray

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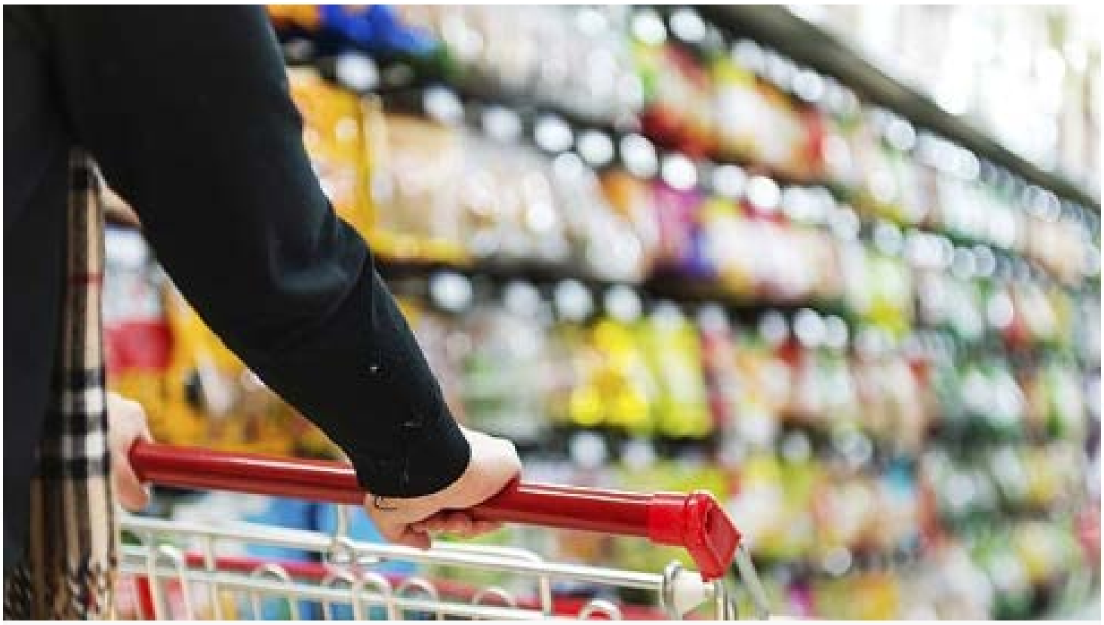

CARRIE LAFRENZ

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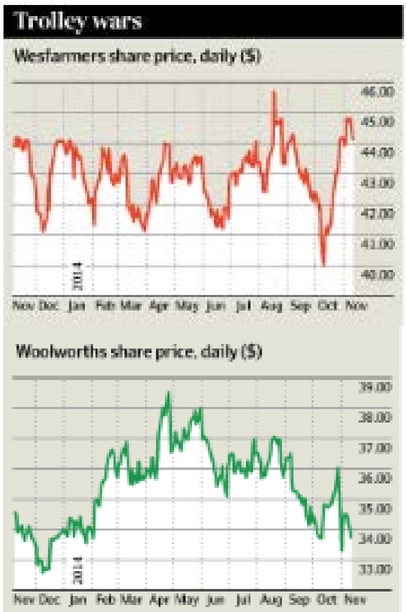


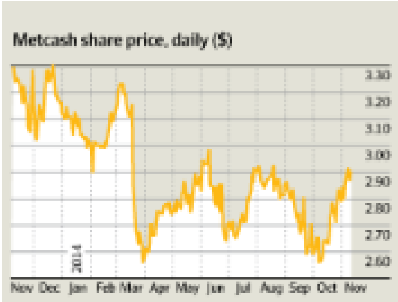
Supermarket giants Coles and Woolworths – and smaller rival Metcash – were always considered reliable, defensive stocks, from which investors could make healthy dividends and good capital gains with little worry about the retailers' growth prospects.

While the outlook for the Australian grocery market looks positive – underpinned by population growth and food inflation – the landscape is changing. International competitors are taking market share and the competition regulator is going after Coles for the treatment of suppliers.

Woolworths, the once mighty powerhouse of grocery retailing, has stumbled in the wake of a reinvigorated Coles, while its hardware venture struggles amid cost blowouts. Still the nation's largest grocer, Woolworths earlier this month posted its lowest quarterly sales growth for over a decade.

The poor sales performance jolted investors. The stock fell 3 per cent on the day, but has staged some recovery. While the tumble in share price may prompt some to buy the stock, industry experts have flagged changes in the $85 billion Australian grocery sector.

Wesfarmers-backed Coles and Woolworths still corner the market at a combined 74 per cent, Roy Morgan Research says. Germany's Aldi has overtaken IGA/Metcash at 10 per cent and 9.5 per cent respectively. Independent grocers make up the balance.



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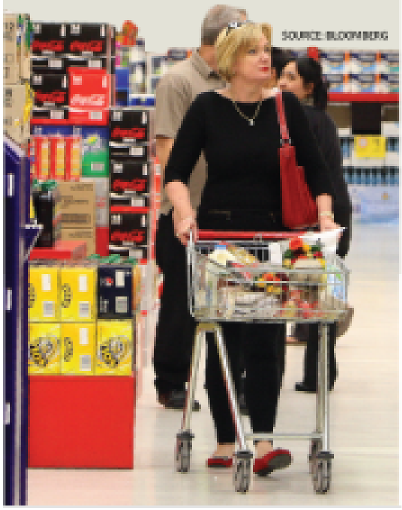

Philo Capital Advisers head of equity, Hugh Dive, says the market is noticing the growing share of discount grocers Aldi and US-based Costco. "These [supermarket] stocks are no longer stocks you can just put in the bottom drawer," Dive says. "The competitive landscape is changing. For years Coles and Woolworths have shrugged off Aldi – that's not the case any more.

DISCOUNTERS LOOK TO PRICE LOWER

"While the sector has been dominated by the big two, Aldi and Costco are creeping in. The discounters are looking to price items about 20 per cent lower. Metcash has been hit the hardest, but Coles and Woolworths are feeling it. Costco is rolling out stores as well. The big thing as a fund manger is will this turn into a Tesco situation, where in the UK market [Tesco's] share is sliding due to two German discounters, Aldi and Lidl?"

Aldi and Lidl have almost doubled their share of the UK market to more than 8 per cent in the past few years. Aldi has been even more successful in Australia, as local consumers become more frugal and seek to reduce the cost of their weekly grocery shop.

UBS analyst Ben Gilbert agrees Woolworths has come under pressure due to discounters taking share, and says Coles is also lifting its game. "Momentum has slowed in Woolworths food and liquor, with like-for-like sales growth of 2.1 per cent (half of Coles) despite stronger market growth," he says. "Coles and discounters Aldi and Costco are putting more pressure on Woolworths, along with Metcash."

Gilbert says new initiatives at Woolworths – including the re-launch of the Fresh Food People campaign in August and the launch of Cheap Cheap in September – have not resonated with the market as well as management would have liked.

"We think the Australian grocery market is becoming more price-competitive, with Aldi leading the charge. They are highly efficient, have compelling value to customers and are difficult for the major supermarket chains to compete against," Gilbert says.

MAJORS LOSING TO ALDI

UBS estimates Coles, Woolworths and Metcash will lose $250 million to $350 million of sales a year to Aldi. Gilbert suggests that for the majors to stem losses, they need to differentiate their offer via fresh food, service, in-stock positions and loyalty programs. He has a sell call on Metcash, noting the company's core grocery business is structurally challenged, with continued store roll-outs and discounting by Coles and Woolworths putting more pressure on independents. "Metcash needs to invest more in value, focus on the core 'buy as you need' shop and drive efficiencies through the business," Gilbert says.

He has a buy on Woolworths and neutral call on Wesfarmers/Coles.

Commonwealth Bank analyst Andrew McLennan says there is room for a second discount grocery chain in the Australian grocery market.

He sees scope for Danish supermarket Netto, Lidl or other discount operators to open locally – either on their own or in partnership with incumbents such as Woolworths, Coles or Metcash.

Lidl, owned by Germany's Schwarz Group, was reported to have been scouting for sites in Australia and speaking to potential suppliers this year with a view to opening its first stores in 2015.

Woolworths and Coles have consistently played down the perceived threat, saying Aldi had taken market share from Metcash and they were well-placed to compete after reducing prices and investing in customer loyalty and online retailing.

Philo Capital's Dive says Australia is an attractive market with some of the highest grocery margins in the world. But it is challenging in terms of distribution, giving the incumbents a leg up on rivals. The outlook is not all negative, Dive adds, with rising food inflation a plus for supermarket investors.

"The falling Australian dollar will help with pushing up prices of imported goods. This is positive for protecting the grocers' margins. In the near future, we may face higher inflation with century-low interest rates. Rates are only going up in years to come, which contributes to food inflation."

While food inflation may help to stabilise margins, a less favourable regulatory environment will make it tough for supermarkets to expand margins.

AVAILABLE PROFIT POOL SHRINKS

Morgan Stanley analyst Tom Kierath says profit growth for the major chains is likely to slow as the available profit pool shrinks and the federal government and the Australian Competition and Consumer Commission take a more active approach to increasing competition.

"While suppliers are profitable, we feel the profit migration from suppliers to retailers will need to slow, otherwise suppliers will [have] to exit the market," Kierath says.

The ACCC launched its second big legal action against Coles in six months, accusing the retailer of unconscionable conduct against five grocery suppliers by forcing them to plug gaps in its profits, pay for wastage in stores and pay fines for late deliveries.

Coles has rejected the allegations, describing its communications with suppliers as "normal topics for business discussions" between grocery suppliers and retailers worldwide.

The competition watchdog has also forced Coles and Woolworths to stop offering excessive fuel discounts subsidised by grocery profits, and has stepped in to unwind restrictive lease provisions that prevented rivals from opening stores.

"Less favourable regulation will make it more difficult for those majors to expand margins," Kierath says. He has a buy on Wesfarmers/Coles, a sell on Woolworths and a hold on Metcash.

While the regulator's decisions may open the door to a more competitive market, Woolworths is facing ongoing problems with its hardware venture, Masters.

Sales appeared to stabilise during the first quarter, but it has a long way to go before becoming profitable in 2016. Analysts say accumulated losses at Masters could reach $1 billion before it breaks even.

STRATEGY QUESTIONED

Masters losses rose 12 per cent to $176 million in 2014, while profits in the home hardware business fell 60 per cent to $7 million.

Aberdeen Asset Management senior investment manager Andrew Preston questions some of the strategy.

"When it was new off the ground, Woolworths had targets but were not meeting [them]," Preston says. "We were prepared to given them more time. They have continued to roll out stores, but don't seem to be getting traction in stores that are now two or three years old. There is a Masters near me in Toorak Road, which you would say intuitively is not the place for such a store.

"The most successful stores are in the outer suburbs where new housing is going up, people are looking for lower price-point kitchens and bathrooms. I don't think they have sited these stores correctly. I think the strategy has not been ideal.

"However, I think the new chief executive has changed the perception of the stores and changed the marketing approach, which should have some positive results."

ASIA OPPORTUNITIES

Elsewhere, while the Tesco accounting scandal raised eyebrows around the globe, it may present an opportunity for Australia's big two supermarkets in Asia.

The UK supermarket is considering spinning off or selling its Asian supermarket operations to raise cash and plug a hole in its accounts after a £260 million ($474 million) accounting scandal, according to British media reports. Tesco is one of the largest grocery retailers in Asia, with more than 2000 stores in Malaysia, Thailand, China and South Korea and combined revenue of more than £10 billion.

Woolworths and Wesfarmers (Coles) have been looking for acquisitions in Asia for years and now have teams on the ground assessing opportunities. They are keen to leverage their retail, sourcing and supply-chain expertise and tap new markets as growth becomes constrained in Australia.

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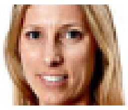
BY CARRIE LAFRENZ

Carrie covers companies news from our Sydney newsroom.



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