SNAPSHOT

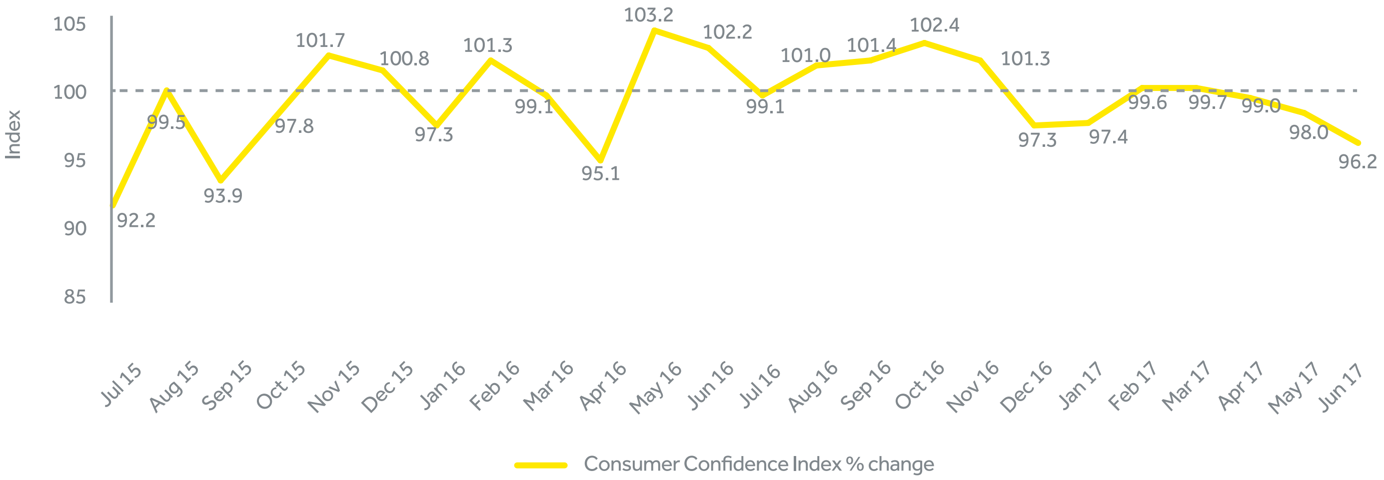
- Retail sales up 2.9% to $307 billion
- Online sales slowing, but continuing to outpace traditional retail sales
- Consumer confidence in pessimistic territory and down a further 5.9%
- As was predicted, retailers faced headwinds throughout FY17. The year was characterised by lower consumer confidence, slowing retail growth, varied category performance and a number of high profile retail failures.
- We expect more of the same in FY18. Material risks to retail and the broader economy exist, such as housing prices and affordability, international entrants (including Amazon), and increasing domestic competition, so we expect parts of the retail market to remain subdued meaning operators underperforming their respective categories are at risk of failure.

CONSUMERS MORE BEARISH ON THE ECONOMY

Despite residential housing prices holding up or increasing across many major metropolitan markets and interest rates remaining steady, consumer confidence as measured by the Westpac-Melbourne Institute deteriorated over the 12 months to June 2017.

The index slipped into and remained in pessimistic territory for all of H2 FY17. The index sat at 96.2 in June 2017 which was the lowest level recorded since April 2016 and represents a decline of 5.9% compared to the prior year.

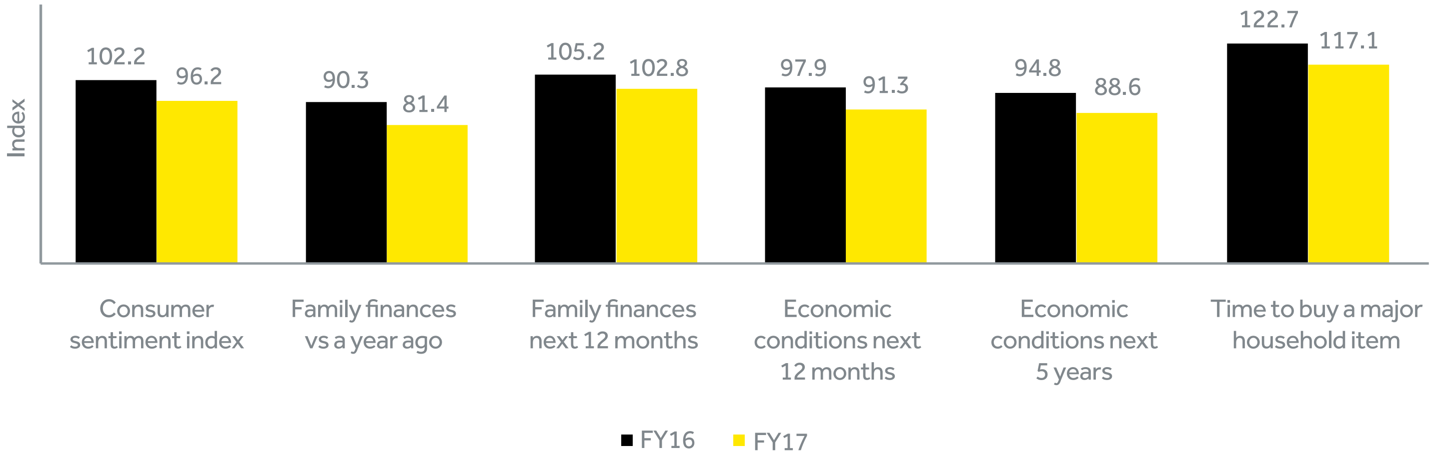
Westpac Melbourne Institute Consumer Confidence Index



Source: Westpac Melbourne Institute Consumer Confidence Index

As can be seen in the chart below, each of the five component indices declined over the 12 months to June 2017, as perceptions of the current conditions and expectations over the next twelve months deteriorated.

Consumer confidence component index performance



Source: Westpac Melbourne Institute Consumer Confidence Index

Three component indices remain firmly in pessimistic territory, with unfavourable expectations around the economic outlook. 'Family finances vs a year ago' started the year as the most pessimistic index and also suffered the largest deterioration (9.9%).

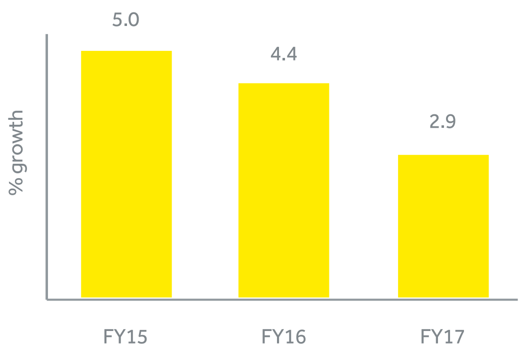
Somewhat surprisingly, despite this weaker consumer confidence, both traditional and online sales grew.

CONSUMERS SPENDING DESPITE PESSIMISM

The Australian Bureau of Statistics reported retail sales to be $307 billion in FY17, representing an increase of $8.7 billion (2.9%) compared to FY16.

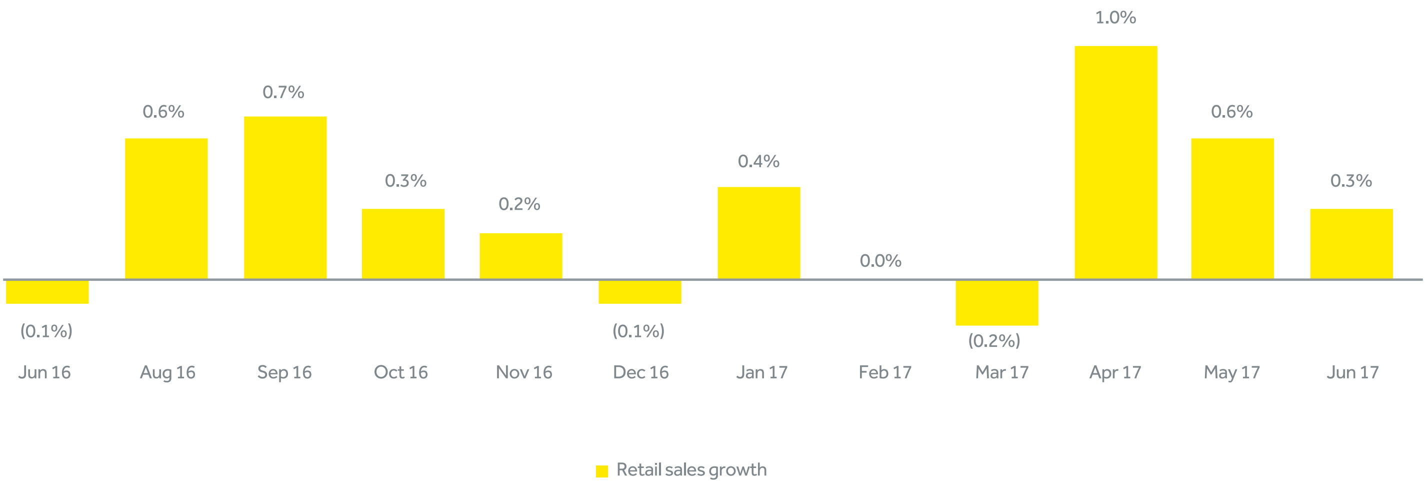
The modest annual growth was underpinned by a strong Q4, which delivered three consecutive months of growth, after six months of limited growth over the traditionally warmer months including a subdued Christmas period. The Q4 growth was, counterintuitively, achieved during a period of declining consumer confidence.

Retail sales growth



Source: ABS Retail Trade

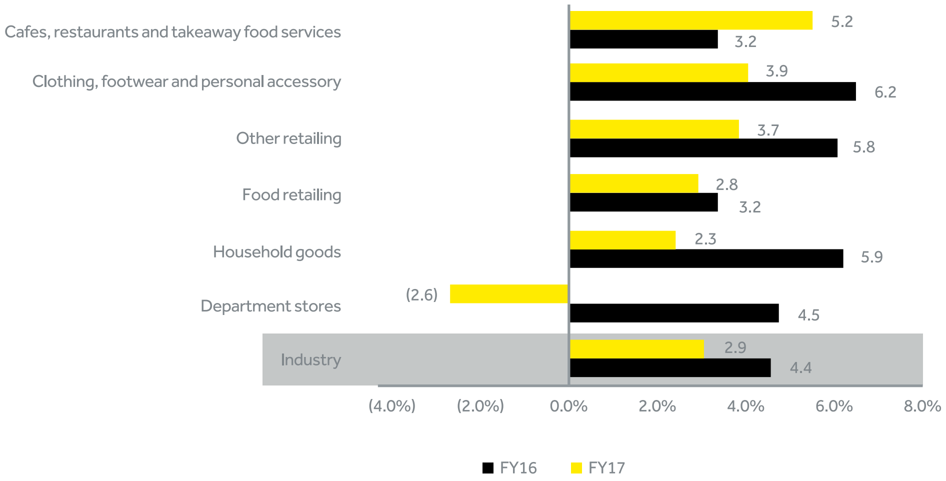
Retail sales by month FY17



Source: ABS Retail Trade

The results by category were mixed. The discretionary categories again outperformed the broader retail industry, with consumers showing a willingness to spend despite declining consumer confidence and limited wage growth (utilising savings). Results within categories were even more interesting so we have included more analysis and commentary later in this report.

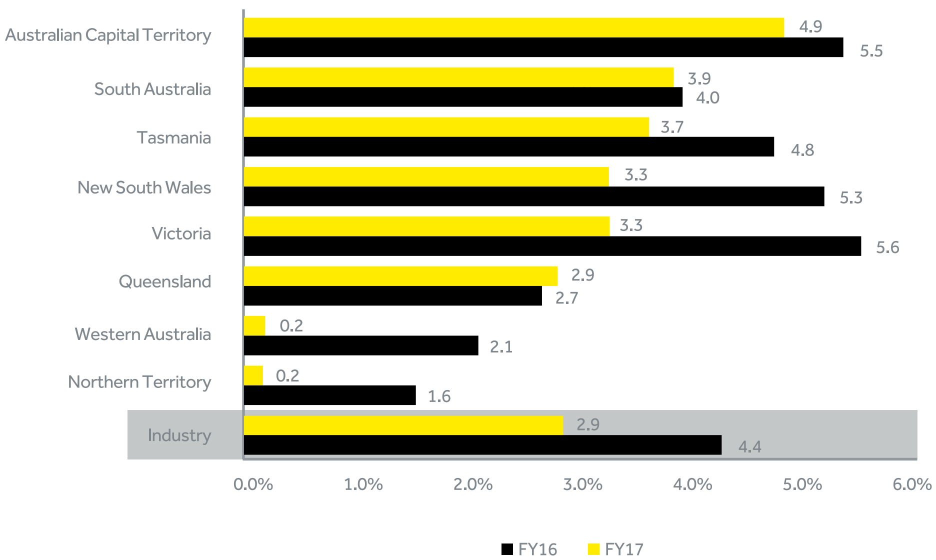
Retail sales growth by category FY16 vs FY17



Source: ABS Retail Trade

All states experienced growth however those with greater exposure to mining and the knock-on effect on residential property prices including Queensland, Northern Territory and Western Australia each again grew more slowly than the industry, continuing a period of relative underperformance over the past three years.

Retail sales by state FY16 vs FY17



Source: ABS Retail Trade

CLICKS OVER BRICKS

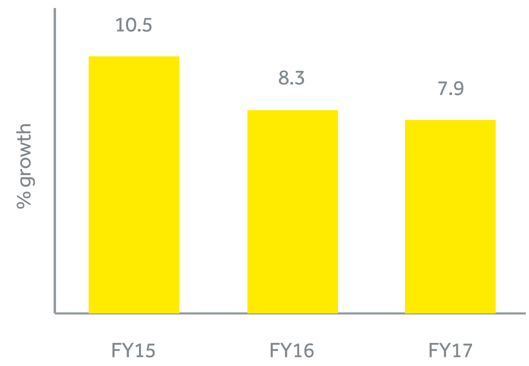
Online sales to May 2017[1] as reported by NAB grew by $2.4 billion (7.9%) to $22.5 billion demonstrating the continued penetration of online sales.

Online sales growth continues to outpace traditional sales, however the rate of growth has shown a trend of slowing compared to 8.3% in FY16 and 10.5% in FY15.

Given the rate of growth in online sales outpaced retail sales, online sales increased to the equivalent of 7.4% of retail sales as measured by the ABS (up from 6.8% in June 2016). This level remains below the double digit penetration reported by many countries in North America and Europe, indicating more growth potential, a likely factor in Amazon's entry into Australia.

[1]NAB commenced reporting on cashless retail sales rather than online retail sales in June 2017

Online retail sales growth



Source: NAB Online Retail Sales Index

PICKING WINNERS – WHICH CATEGORIES PERFORMED THE BEST?

Overall, announcements from this reporting season have shown ASX-listed retailers have been able to generate some growth and deliver cost reductions. We have seen share price volatility as conditions remain challenging. More than ever, retailers need to remain responsive to customers and retail is "difficult to pick".

A staggering two thirds of the growth in dollar terms was delivered by the two food related categories. While only delivering growth of 2.8%, 'food retailing' remained the most significant category and accounted for almost 40% of total dollar growth alone, with 'cafes, restaurants and takeaway food' (+5.2%) accounting for a further 25%.

As was the case in FY16, discretionary categories generally drove the rate of growth.

Looking at subcategory performance, there are some clear trends emerging, many of which we consider below and in our recent blog on lifestyle habits shaping retail trends.

Sales by category

Source: ABS Retail Trade

TOP PERFORMERS

Takeaway food services +8.2%

This category continues to be driven by a proliferation of new mobile apps and delivery services which has assisted the sub-category generate growth of 20.8% over the past three years.

Other retailing not elsewhere classified +5.1%

While the 'catch all category' which includes stationery, gifts and flowers, amongst others, delivered solid growth, the rate has more than halved compared to the 10%+ growth reported in this category in FY15 and FY16.

Pharmaceuticals, cosmetics and toiletries +4.2%

This category is growing as a share of wallet (+5.4% in FY16) as wellness is increasingly being seen as a status symbol.

Furniture, floor coverings, housewares and textile goods +4.1%

This sub-category continues to perform well on the back of the renovation boom, however its rate of growth has more than halved since FY15.

Liquor retailing +4.0%

Liquor retailing has outperformed supermarket and speciality food retailing for the past three years.

Clothing retailing +3.9%

After being the strongest performer in FY16, this category again outperformed the market as a category. We have however seen some disparity within the sector. There has been more distress in women's fast fashion (which continues to experience sales and margin pressure), with men's apparel appearing to hold up better, perhaps driven by a 'menaissance' where a larger number of men are willing to spend on maintaining their appearance.

CATEGORIES UNDER PRESSURE

Department stores (2.6%)

This category continues to struggle achieving no category growth in dollar terms over the past six years. High competition within the category from the likes of Harris Scarf and TK Maxx (as well as other international and online competition) means pressure on department store operators is unlikely to ease any time soon.

Newspapers and books (0.9%)

While many people still like the tactile experience of printed media, there are many more examples where circulation of magazines and newspapers has decreased as a result of increased digital media adoption.

Other recreational goods (0.3%)

There is evidence of a shift in consumer behaviour from seeking experiences in the leisure and recreational category, and away from products.

Electronics +0.3%

Existing retailers have benefited from a level of sales absorption from the exit of Dick Smith. Going into FY18, operators will likely need to deliver some in-store experience if they are to fend off online competition because products are often commoditised or substitutable.

Specialised food +1.1%

This category is unable to match the growth rate delivered by supermarkets and grocery stores who continue to maintain market share through undertaking major refurbishments and improving their ranging. This means specialised food retailers will continue to find it harder to differentiate.

THE WRESTLE FOR MARKET SHARE

Irrespective of category performance, there are company-level factors that influence the success of individual retailers. It comes down to their competitive position.

A slowing retail growth environment makes success more challenging. Retailers cannot rely on the market to deliver top line growth. In order to take market share from competitors, operators must understand the drivers of performance and look to influence specific levers having regard to their competitive position.

We saw a number of retailer failures in FY17. The lower growth environment has seen some of the category underperformers and marginal players fail.

We see a big difference between the best and the worst in each category, with many of the underperforming operators coming under intense pressure. This has particularly been evident in the 'middle market' where competition for the same dollar has increased, resulting in increased price based competition, often leading to margin compression.

It is important to look at an operator's relative performance compared to its category. If it isn't able to deliver like-for-like growth that is comparable (or better) than its competitors then it is vital to understand why.

Some characteristics we see in those who have outperformed are:

- **Having an appropriate (and flexible) organisation and financial structure** - having regard to capital structure (access to funds to support investment, provide runway to implement strategies) flexibility in cost structure particularly in workforce, and ensuring working capital efficiency
- **Increasing usage of and sophistication in analytics** – specifically in terms of increased measurement of different levers and combining internal datasets with third party data for insight and foresight (but there is still a long way to go for most retailers who only use analytics to deliver hindsight, if at all).
- **Actively measuring and monitoring how they are performing compared to their market** – identifying changes in the key levers, understanding the factors driving these changes and being responsive with their strategy.
- **Understanding and investing in point of difference**

We consider the key for operators across all categories going into FY18 will be to have a deliberate strategy to deal with threats and maintain flexibility to be able to take advantage of opportunities in the market to wrestle market share from their competitors.

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