



**Grant Thornton**

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Regular research papers and articles providing sector specific insights and issues analysis - Retail sector

**March edition 2013**

# Industry Intelligence Unit

Grant Thornton's Industry Intelligence Unit (IIU) blends the latest information and analysis of specific industries from publicly available sources (including the Australian Bureau of Statistics and the national press) with pragmatic, commercial and practical initiatives to improve stakeholder value.

## **Welcome to our latest edition of the Retail IIU**

The Christmas and New Year sales results are in. How did the retailers perform? Who were on top of their game, and what lies in wait for the industry this year?

The January 2013 retail figures (released March 2013) show a modest improvement on the December 2012 figures (adjusted retail growth of 0.9%) and a whopping 2.5% increase in turnover when compared to January 2012.

So, have we turned a corner? Early evidence suggests that following the December 2012 RBA rate cut to 3.0%, there has been a modest increase of consumer confidence. However, this did not immediately translate into stellar pre-Christmas sales, as December 2012 showed a decrease in seasonally adjusted sales of 0.4%, which followed a fall of 0.2% in November 2012.

### **This edition of our Retail IIU provides the following thought leadership**

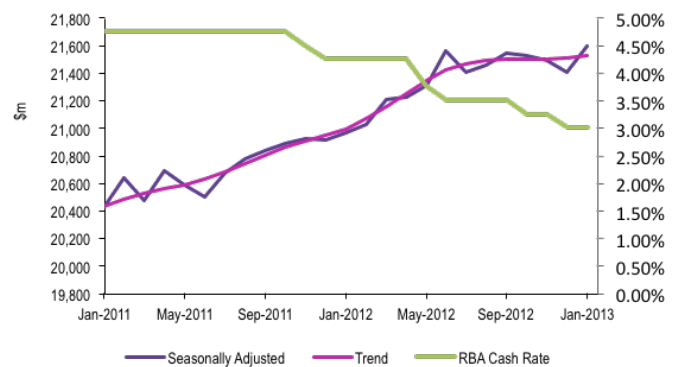
- Retail industry snapshot from the Australian Bureau of Statistics with comments from Simon Trivett (National Head of Retail), Gayle Dickerson (Partner, Financial Advisory) and David Kelly (Manager, Financial Advisory)
- We also touch base on developments in the retail industry since our October 2012 update, and look at how some of our big listed retailers have performed for their HY2013 results
- Developing your online sales channel strategy to optimise multi device searches – Jasper Vallance of the Online Retail Consultant provides his perspectives and insights on customising an online search strategy
- Entering China: Considerations on Structuring - In continuing our articles on doing business in China, Michael Catterall (Partner, Tax) provides the top five considerations for retail businesses structuring their operations in China
- In Negotiating Retail Leases, Simon Trivett notes some of the key themes coming out of our recent roundtable discussions

So the January 2013 adjusted retail growth result of 0.9% appears as something of an anomaly, although everyone is hoping this could be maintained if we finally have some consumer confidence back. Hopefully there will be something for the retail industry to cheer about soon!

Early 'lead indicators' from the retail industry for February 2013 suggest sales growth will be maintained through March 2013, although reasonably static job-growth forecasts may place a dampener on future performance. Nevertheless, no one was surprised by the RBA's decision to hold interest rates steady at their March 2013 meeting. So hopefully the early indicators of some consumer confidence returning can be maintained.

Meanwhile, some economists are predicting a further interest rate drop by the RBA later in the year. The continued uncertain global economic conditions are likely to cause households to remain cautious with their spending in 2013. Retail conditions have generally remained weak in Australia's non-mining states due partly to the weak labour market despite the reduction in interest rates.

Retail sales vs cash rate Jan 2011 - Jan 2013



Retail sales and month on month movement, last 6 months



Source: ABS January 2013 retail turnover (seasonally adjusted) growth by state

#### The detail

On a sub-industry basis, the January 2013 improvement was attributed as follows:

- Food retailing: Up 0.3%
- Household good retailing: Up 1.3%
- Other retailing: Up 2.6%
- Café, restaurant and takeaway food services: Up 1.0%
- Clothing, footwear and personal accessory retailing: Up 0.7%
- Department stores: Down -0.6%

# What has happened in retail since the October 2012 Retail IIU?

- We had our first taste of a 'Cyber Black Friday' style online sales campaign from retailers in the form of Click Frenzy, which required subscribers to access participating retailers through the Click Frenzy website. However, on the day, the website was plagued with problems, crashing under the weight of two million visitors
- Despite this, Myer, who participated in Click Frenzy achieved a daily online sales record
- The RBA lowered the cash rate by 0.25 percentage points in December 2012 to 3.00%, the lowest it has been since September 2009
- Myer posted its first annual increase in quarterly sales since November 2009
- In December 2012, the treasurers of NSW and South Australia were appointed to lead a working group to examine changes to the taxing of goods bought online, with a view to reducing the current \$1,000 GST threshold on foreign online purchases. Recommendations from the reporting group are expected by the end of 2013
- Consumer confidence was reported by Bloomberg as being at a 19 month high in November 2012
- The half year results of the major retailers were generally up, although most note this was largely due to solid performance through November and December 2012

## Half year results of selected ASX listed retailers

**Woolworths Limited** has announced a 4.8% increase in sales for the first half of FY13 after completing the sale of its Indian business to Infiniti Retail Limited and the sale of Dick Smith Electronics in Australia and New Zealand to Anchorage Capital Partners in November 2012 for initial cash proceeds of \$20million (with Woolworths potentially benefiting from any upside resulting from a future sale) and transferring of lease commitments of \$300million. The company noted an increase of online sales of 40% (continuing to highlight the importance of this new sales channel). Management continues to forecast an increase in full FY13 NPAT to remain in the range of 3-6%.

**Myer** has reported an increase in first half sales results, up 1.7%, including a strong second quarter reflecting Christmas and Stocktake sales. Myer's management believe that this is the result of the successful execution of their new strategy, which has included the exit and rationalisation of whitegoods, gaming and CDs/DVD categories whilst concentrating on the more profitable clothes wear lines. Interestingly, stores located in Western Australia and Queensland were the best performing.

**Wesfarmers** had a solid performance with operating revenue up 3.2% and a net profit after tax up 9.3% on prior half year results. Management note that the turnaround of the Coles and Myer brands has delivered strong transactional and earnings growth, and Bunnings and Officeworks lines have remained solid despite challenging housing market and deflation in technology.

**JB Hi-Fi** reported sales growth of 2.3% on HY12 results, together with an improved gross margin, although TV sales were in decline as the category moved towards a more typical 'replacement driven' sales market. JB's trial with whitegoods (known as JB Hi-Fi HOME, and includes an online presence and stores in Queensland) exceeded management's initial expectations, so far with no noted adverse effect on the traditional sales channels. Online store sales were up 40.3% for the half year, although it's important to note these only equated to 2.0% of sales. January 2013 sales (1 month) grew a whopping 11.7%, on the back of New Year promotions.

**Harvey Norman** reported a retraction on sales growth of 8.6% in Australia, although January 2013 sales (1 month) showed an increase of 4.1%. Management noted that aggressive discounting was experienced in the last few months of HY13, although historical lows in interest rates should start moving the consumer back into the buying cycle. The AV/IT areas of the business remained challenging.

**SuperRetail Group** reported very strong sales growth, however this was the first six month period including both Rebel and Amart, therefore year on year results are not directly comparable. Management continue to forecast a small sales growth, driven partly by the introduction of new stores across the auto, leisure and sports retailing areas.

## What has happened in retail internationally?

In January 2013 in the United Kingdom, Administrators have been appointed over Jessops, HMV and Blockbuster. The failures could lead to more than 10,300 job losses and almost 1,000 store closures. January is seen as the optimum time for creditors to call in administrators due to cash increases over the Christmas period and shop stock being at all year lows.

# Multi device search strategy to drive online and in store sales

Jasper Vallance, Director of Online Retail Consultant provides perspective and insights on driving effective multi-channel strategies. For this Retail IIU, Jasper provides some insights on customising an online search strategy.

Working at Google over the last six years it has been incredible to see the impact the internet has had on the retail industry. The rapid growth of the use of mobile phones to access the internet was one trend that caught us by surprise as we witnessed mobile search volumes in the retail category go from 15% of all Google searches in December 2010 to nearly 40% in the lead up to Christmas 2012! Retail is one industry that has been impacted more than most as smartphones become a consumers shopping companion to find products and ensure they get the best deal. Recent Google research found that 55% of shopping experiences start on a smartphone and 22% of Australians have abandoned an in store purchase as a result of information they found on their mobile device<sup>1</sup>.

With an estimated 65% of Australians now owning a Smartphone, and 35% owning a tablet, this type of behaviour is becoming wide spread. Google search on mobile and tablet devices, presents an opportunity to connect with people 24/7 when they are looking for your products and win sales from your competition. I will discuss some of the search strategies you can take to drive online and in store sales.

Before I talk about your search strategy there are a few things to make sure you have covered with your mobile strategy.

Firstly, make sure you have a mobile optimised site. Google forecasts people will access the web through their mobile phone more than through a PC this year. I am sure you have experienced how frustrating it is trying to navigate on your smartphone screen. 65% of

Australians use their phones to connect with a business<sup>2</sup> so make sure you have click-to-call functionality and an easy to use store locator. Effective site search and simple navigation helps people find the products you sell. It's also important not to ignore how your site renders on different tablet devices. As you're using your fingers to do the navigating it's helpful to have buttons that are easy to press, scrolling which enables easy browsing and a simple check out process as people are more likely to buy online with their tablets.

Secondly, make sure your price/value proposition is competitive because if it isn't people will find out and probably not buy from you! Shopping comparison sites like Google Shopping make it very easy to search for products and compare prices on their mobile devices when in store. You need to spend time benchmarking your offer to make sure it will win customers. Otherwise you could be helping customers buy from the competition!

The UK department store John Lewis is a good example of a retailer who has executed well in both these areas. They have delivered on their 'never knowingly undersold' promise ensuring their prices are always the best and they encourage people to 'showroom' their products and compare prices by offering free internet access in stores. Their mobile site is easy to use and adds value in making purchase decisions in store where you can scan a QR code to access product reviews online.



If you have achieved both these points you're ready to capitalise on the millions of searches on mobile and tablets devices that take place every day for the products you sell. There are three main search strategies you can take based on how consumers use their smart device in the purchase process.

### 1. Connect with consumers researching products to drive in store

One in three searches on Google are looking for local information and this is especially true for those searching on a mobile device. Google research shows that 94% of Australians with a Smartphone use it to research products and 34% use it when they are out shopping looking for where they can buy a product or to find alternatives before making a decision. With Google Adword's you can target specific product searches and take advantage of location extensions which help people navigate to your store or click to call where people can call directly from clicking on a button in your ad. Another feature which Google is trialling is to be able to increase bids on people searching within a specific radius of your stores which means you can ensure your ads show at the top of the search results page for those that are closer to your stores. This is especially important as there are only two ad spots at the top of the page on a mobile search results page so if you're not top two you're unlikely to be found.

### 2. Win customers from the competition at the point of purchase

As people use their smartphones in store to compare prices it's a great opportunity to be considered and highlight that you have a better offer than the competition. It's like stealing someone from a competitor's store who is ready to buy. You will focus on searches for product numbers and more specific product searches indicating that those people know exactly what they want and could be shopping around. In this instance Google Shopping is worth taking advantage of, because it enables you to show images on the search results page as part of your ad and showcase you're pricing. As you may appreciate images of

your products are more engaging than text and can increase the chance of your brand and products being considered.

### 3. Integrate with offline media to drive the sale

77% of Australians say they multi-task on their smart devices while watching TV which presents the opportunity to integrate campaigns between offline and online<sup>3</sup>. TV ads generate awareness and demand for products resulting in searches for more information. In fact one in 10 of all smartphone searches are prompted by TV content. Make sure you promote your TV offer in your Adword's ad creative. Even if you're not advertising on TV your competitors may be, which can create the interest for a product in your category so it's the perfect time to promote your offer when they search for more information. The same can be said for people on the bus seeing your outdoor advertising on billboards or bus shelters. Search helps connect the loop with your offline media and gets people to your website where you can drive a specific action.

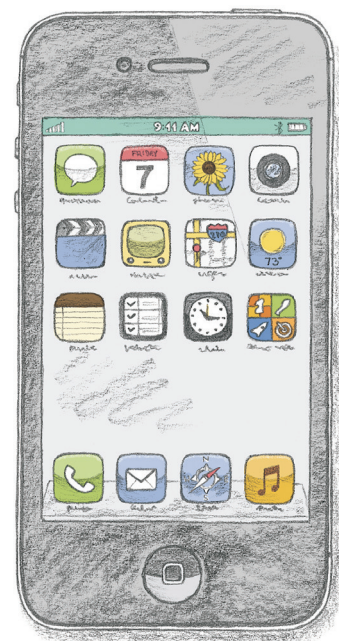
#### Jasper can help companies to:

1. Optimise their online marketing strategy to give them the competitive edge
2. Improve their online customer experience to win more sales online and in store
3. Take advantage of online media to improve their marketing ROI
4. Utilise company analytics to use data to make better marketing decisions.
5. Offer unbiased advice to help companies choose the right 3rd parties

A final point I would like to cover is how you measure the success of search campaigns across mobile and tablet devices. The online conversion rate on tablets has proven to be much higher than smartphones (as much as four times higher!) which you would expect given the screen size and the location where you tend to use a tablet (i.e. on the sofa!). When measuring the value of mobile Adwords traffic it's important to use soft engagement metrics like visits to your store locator rather than online sales to measure success as it's more than likely the sale will be completed in store or back at home on a larger screen.

Mobile search presents an opportunity to drive in-store traffic and win customers at the point of purchase who are looking for the best deal. A successful sale will depend on how easy your mobile site is to use and how compelling your offer is. Next time you're near one of your stores try searching for the products you sell on your smartphone - are you being considered?

For more information, you can read Jasper's blog at [OnlineRetailConsultant.com.au](http://OnlineRetailConsultant.com.au)



<sup>1</sup> Google/Ipsos, The Multi Screen Consumer Dec 2012

<sup>2</sup> Google/Ipsos, Our Mobile Planet Australia May 2012

<sup>3</sup> Google/Ipsos, The Multi Screen Consumer Dec 2012

# Unlocking the China opportunity: Considerations when structuring retail operations in China

Further to our October 2012 article on ‘Entering China: Opportunities for Retailers’, this follow up article underlines the top five considerations for retail businesses structuring their operations in China.

China is the world’s fastest-growing major retail market as a result of rapid urbanisation, continuous reform of the social welfare system and concerted government efforts to promote domestic consumption. Gaining entry into this market needs to be researched and planned carefully.

## **Choosing the right model**

A key question for retailers is deciding what operating model to use. This can range from starting in a small but controlled fashion, for example using a representative office aligned with an online presence, possibly provided by a third party, to looking for high turnover entry via franchising or a joint venture with a Chinese retailer or distributor. Other choices include making a longer term commitment through a 100% owned subsidiary, a wholly foreign-owned enterprise (WFOE), or using intermediate holding companies. Each route has different legal and tax issues and we touch on some of these below.

### **Representative office/e-commerce**

Using a representative office can be a relatively low-cost way of entering the Chinese market. In this model, the ultimate sale of the product typically takes place on the internet or outside China, sometimes in Hong Kong or Singapore. Careful consideration must be given to customs duties and payment mechanisms.

### **Franchise**

Many well-known Western brands have entered China through the use of franchise arrangements. This provides good visibility for the brand, and rapid expansion, but with less control over how the brand is used. Protecting intellectual property rights must be considered carefully. In order to operate a franchise arrangement, at least two

shops must be operated by the foreign investor for 12 months before the investor is allowed to grant a franchise to others. Such time restraints must be factored into the investor’s expansion plans.

### **Joint ventures**

Joint ventures operated with a Chinese party may be the only option for investors who want to engage in restricted activities which require majority Chinese ownership. Partnering can offer excellent opportunities to access the contacts and distribution channels of a local retailer. This can be an inflexible option however, and arrangements made between the local party and the Australian company can be difficult to change.

### **Wholly foreign owned enterprise (WFOE)**

A WFOE is often used by retailers who want to expand in China in a controlled fashion. It is popular because it can be owned and controlled 100% by the Australian parent group. Transfer pricing must be managed to ensure that profit allocation between Australia and China is appropriate. The other key issue is profit extraction.

## Selecting a location

### Store location in China

There are many considerations when assessing location and this will depend, in particular, on the type of product, existing brand awareness and pricing architecture. The first tier cities such as Beijing and Shanghai stand out as the largest and most appropriate markets for luxury brands. However, although the cost of operating in these cities is significant because of factors such as high rents and staff salaries, a presence there may be necessary in order to establish a brand. For less known retailers operating in a second or third tier city may be sufficient to establish a profitable business and a base to expand from, especially where it would be difficult to break-even running retail stores in first tier cities. However, there is evidence that rental and staff costs are plateauing which suggests that these costs may start falling in both Shanghai and Beijing in due course.

### Intermediate holding company

Historically companies expanding to the region focused on the use of an intermediate holding company and this is still a valid potential alternative. This can offer benefits in terms of Chinese regulatory requirements, create flexibility on exit or restructure, and potentially reduce tax on return of funds to Australia. Preferred locations include Hong Kong and Singapore because of their favourable double taxation agreements with China, as well as the commercial opportunities these cities offer. Many retailers use these high-profile international shopping locations to site a high profile store, or to locate a management hub for the wider Asian region.

### Managing indirect tax costs

Indirect taxes are an important consideration for retail businesses expanding into China. Goods entering into the country may be subject to customs duty. The importer (or his agent) will need to identify and declare the customs duty code (chosen from several hundred) which most appropriately describes the product. The goods will also have to be valued for

customs duty purposes to ensure that the correct amount of duty is paid. A Value Added Tax (VAT) is also levied on imports.

It is very important that the correct documentation is in place if the goods are not to be held up at the port or airport of importation.

Business tax also needs to be considered, and is typically levied at 5% on the provision of certain services and the transfer of intangibles. However, China is currently piloting a single VAT system that may eventually replace business tax. The pilot scheme began in Shanghai on 1 January 2012, but has since been expanded to cover additional cities/provinces during 2013.

The co-existence of business tax and the VAT pilot scheme presents businesses with a number of issues to consider.

## Funding and cash extraction

Funding requirements must be considered carefully because it can be difficult to inject cash into, or extract cash from, China.

Debt funding is often chosen because it is more flexible and there are fewer regulatory and administrative hurdles to overcome in order to pay interest as opposed to a dividend. Payment of interest can also be more tax efficient.

There are certain minimum restrictions on capital, which vary depending on whether the business is wholesale or retail, and on location and size of the proposed business operation. The minimum registered capital for wholesale companies is RMB 500,000 and for retail companies is RMB 300,000.

The minimum registered capital is also dependent on the total investment amount and is calculated as follows:

Total investment amount (USD)	Minimum registered capital (USD)
\$0 to \$3 million	70% of the total investment amount
\$3 million to \$10 million	50% of the total investment amount but not lower than \$2.1 million
\$10 million to \$30 million	40% of the total investment amount but not lower than \$5 million
Above \$30 million	1/3 of the total investment but not lower than \$12 million

Taking an investment of under USD\$3 million, for example, only 30% of the total investment can be by way of debt. Formal approval is required to inject new debt or equity into China, which can take several months to obtain. Therefore, careful cash flow management and advance planning is required.

### Awareness of sector specific restrictions on stores and products

Restrictions are imposed on the number of stores depending on the size of store:

- Where a store exceeds 3,000 square metres, the number of stores should not exceed three in each province and the total number of stores established by the foreign investor in China should not exceed 30 and
- Where a store exceeds 300 square metres, the number of stores should not exceed 30 in each province, and the total number of stores established by the foreign investor in China should not exceed 300.

There are also prescribed restrictions on products that can be traded in China by foreign investors.

Foreign investors are not allowed to have more than 49% of the shares in a company if:

- they have more than 30 stores
- the products are sourced by different suppliers and brands, and
- they trade the following products: books, newspapers, magazines, drugs, pesticides, agricultural films/membranes, fertilizers, refined oils, food, vegetable oil, sugar, cotton.

In certain circumstances, it may be possible to benefit from an exemption for 'qualified investors' from Hong Kong and Macau under the respective Closer Economic Partnership Arrangements, whereby such investors can operate independently even if dealing in some of the above products. However, this does not apply to dealing in books, newspapers and magazines which are still restricted.

### Who should I contact about structuring China operations?

Whether you are looking to grow your business by exporting, investing or doing business in China, Grant Thornton Australia has the international capability, the cultural understanding and the partner commitment to help you drive your business forward.

For further information, please contact a member of our Retail Team or:

#### Michael Catterall

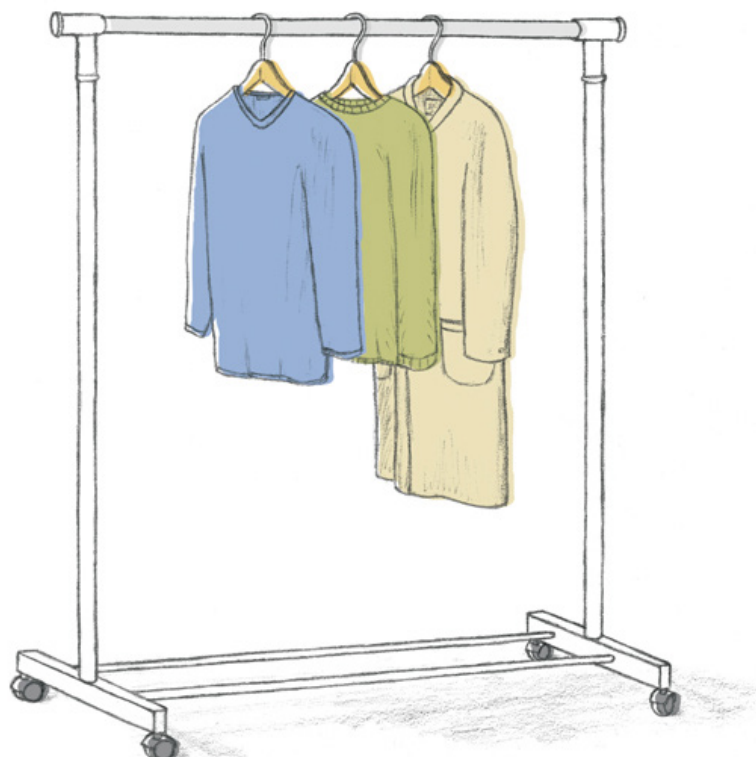
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# Negotiating retail leases

In February and March this year in Melbourne and Sydney respectively we ran a series of round table discussions for retailers on negotiating retail leases. Our presenters were from M3 Property (Shaun O'Sullivan and Andrew Duguid) and Corrs Chambers Westgarth (Nathaniel Popelianski and Jay Andrews). This discussion was aimed to be more strategic about the trips and traps of retail leases, negotiating techniques and also a general update about the current landscape for retail properties. There were a couple of key takeaways from the discussions:

- Retail occupancy costs are still a very large component of retailers' expenditures, our round the room straw poll had these costs ranging from 8% to 30% of turnover.
- When industry statistics from sources such as IBIS are reviewed, the industry percentages typically fall to below 5% of turnover for occupancy costs – these industry averages are heavily skewed down due to the inclusion of supermarkets in particular.
- Tenants in shopping centres do have less bargaining power individually, but there is little coordination or comparison occurring with tenants in the same shopping centre, before they individually negotiate their leases. This contrasts with overseas trends (particularly in the US) where tenants are rather more coordinated in their information sharing, if not negotiating strategies.
- When negotiating leases, it really is critical to get your property lawyers (like Corrs) or property consultants (like M3 Property) involved early on so that they can provide the strategic and negotiating advice to get the best outcome.
- Online retailers generally don't face the same level of occupancy costs, so how do you compete. The feeling from retailers around the room was that the customer experience and face to face customer service still plays a major role. But online retail and its assumed cost advantage can't be ignored.

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## Our retail team

Grant Thornton is a national full service accounting and business advisory practice that specialises in working with retailers of all makes and types, big and small. We work closely with many retail clients, so we understand this complex and diverse market well. If you would like to discuss any aspect of the above, please do not hesitate to contact one of our industry experts.

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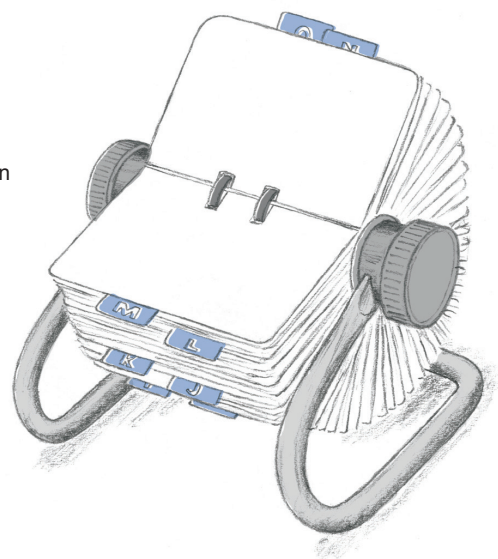
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# Industry Intelligence Unit

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Through empowered client service teams, approachable partners and shorter decision making chains, our 1,300 people across eight offices in Adelaide, Brisbane, Melbourne, Perth and Sydney provide a wider point of view and more meaningful and forward-looking advice, operating in a way that's as fast and agile as our clients.

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## What is the Industry Intelligence Unit?

The IIU is unique in its objective of providing stakeholders with information, understanding and analysis of the issues faced within specific industries and sub industries. The IIU also seeks to provide pragmatic, commercial, practical measures and initiatives to improve stakeholder value.

## Industry focus

The IIU utilises the industry experience and expertise of Grant Thornton partners and staff across Australia. The IIU is predominantly focused on the following industries and their related sub industries:

- Automotive Dealerships
- Energy & Resources
- Financial Services
- Food & Beverage
- Health & Aged Care
- Hospitality & Tourism
- Life Sciences
- Major Projects & Infrastructure
- Manufacturing
- Not For Profit
- Professional Services
- Public Sector
- Real Estate & Construction
- Retail
- Technology & Media

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