Grant Thornton

An instinct for growth™

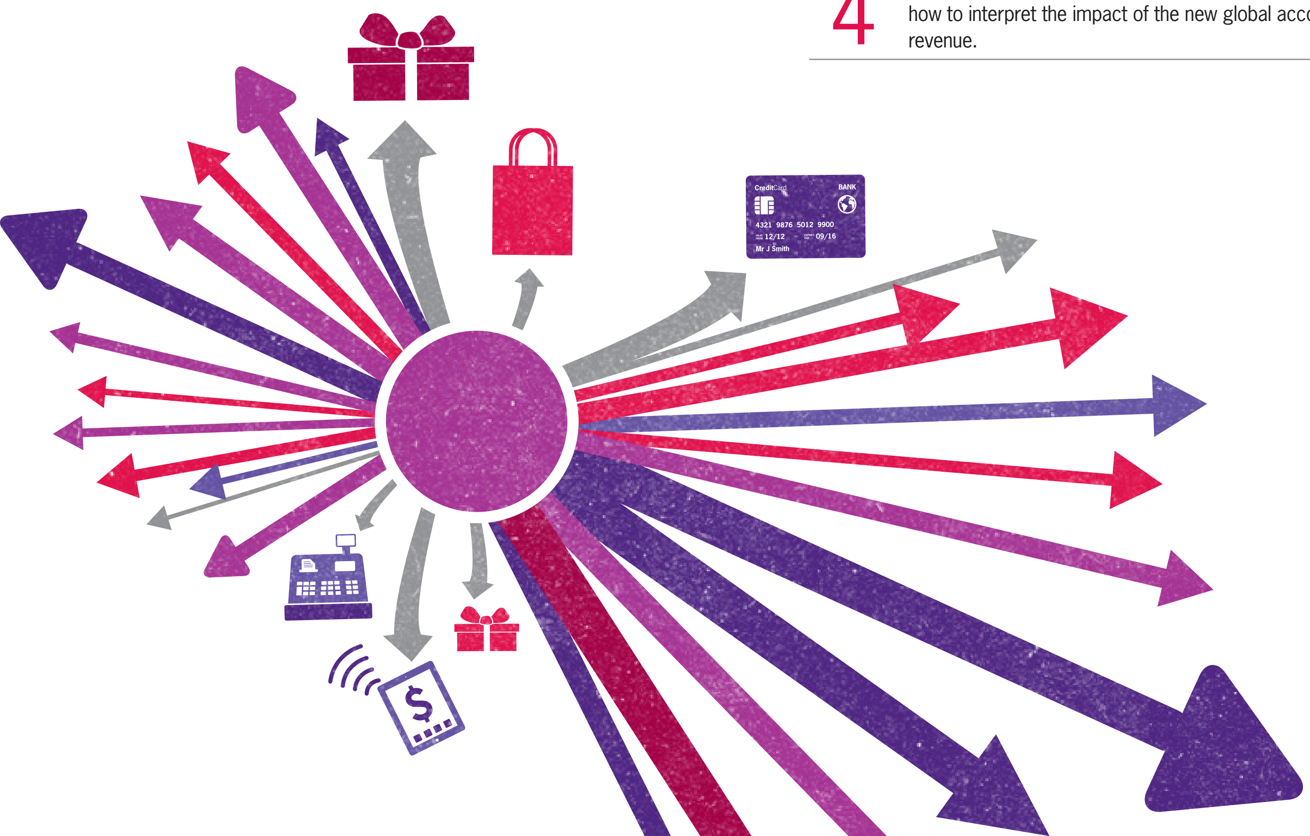
DECEMBER 2014

Industry Intelligence Unit
Retail sector

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.

This edition covers a number of topical issues for retailers, as well as our usual summary of the latest retail statistics:

1	Our reflections on 2014 and predictions for Christmas.
2	We provide a snapshot of global and Australian M&A activity for the retail sector – there are growing opportunities for retailers with a strong brand and story.
3	How does the proposed competition reforms by government, in particular to the pharmacy sector, which will remove barriers to entry and possibly allow supermarket chains to enter the space, impact retailers. We also provide some key performance metrics to assess the performance of a pharmacy based on our industry experience.
4	Article for retail finance professionals and lenders to the industry – how to interpret the impact of the new global accounting standard on revenue.



We were recently the proud sponsors of the inaugural CPA Australia Retail Accounting and Finance Forum in Melbourne in September 2014

Grant Thornton's retail industry Partners spoke on panel sessions during the course of the day to over 120 retail finance professionals. The discussion wasn't about new accounting standards or tax changes but a dedicated day on discussing the trends, challenges and practical strategies for growth in the sector. Some of the key themes and trends which kept emerging were:

1 It's about the consumers personal brand not about your brand:

- Consumers, particularly Millennials/Generation Y, have very clear views on what they want from a retailer. They want to be active co-creators, not passive consumers
- They are more changeable and show lower brand loyalty. Their personal brand is more important than yours! Retailers that offer products that are seen to enhance their personal brands will do well; and
- Customer experience is the new brand: retailers need to deliver a positive experience across every customer touch point

2 Personalisation:

- We will see personalisation and localised customisation for products increase. This applies from the end product through to personalised marketing. The supply chain may move closer to the end consumer; and
- A current example is "Pizza Mogul" established by Domino's, where the consumer designs a pizza and can generates sales through leveraging social media (and take a slice of the profits)

3 Growth of private labels:

- Retailers are competing directly with established brands with their own private label offerings. Anecdotal evidence suggests Australia lags behind other major markets such as Europe and the US who have a much higher concentration of private label products

4 How can retailers use data to get ahead?

- Harley Davison shared their story of how they have reinvented themselves using data to break into new markets; and
- A recurring theme was that much data is available, but whether it is used effectively varies greatly between retailers

5 Consumer attention is less and less:

- Mobile devices and online shopping has reshaped everything we do in retail. Consumers are equipped with all possible information before purchasing – however cost isn't always a driver as evidence shows people will pay more for service delivery; and
- Retailers need to constantly seek to hook in consumers through multiple methods to compete and build a connection with the customer

Some of the leading retailers who attended the CPA Australia Retail Accounting and Finance Forum were:

- Ebay who spoke about their new flash sale initiative of 12 x 5 minute flash sales on a Sunday night
- The Iconic who spoke about their consumer centric strategies including pop-up changing rooms at Australia Post stores

We look forward to supporting the event in 2015.

Challenges and Growth Survey

We also conducted a survey of a sample of retailers attending the CPA Australia Retail Accounting and Finance Forum. The survey was focussed on what challenges they are currently facing and where they expect to see growth occur. Full results of the survey are available on our website at: www.grantthornton.com.au

Some items that came through from the survey were:

- 32% saw implementing an omni-channel/technology strategy as their number one priority
- 48% had keeping up with the cost of systems/ technology as the biggest challenge facing their business. This was consistent with 64% ranking technology costs as the number one obstacle to driving growth in their business
- It was interesting that labour and occupancy cost featured down the list as obstacles to growth. There is a lot of "noise" about these costs in the media; and
- The majority of respondents had less than 5-10% of their total sales occurring online, however were expecting this to increase

Upcoming events

We will be presenting at the National Retailers' Association Innovation and Technology discussion group in December 2014 on some of the themes emerging from the CPA conference – Big Data and Technology trends. Please do not hesitate to contact us if you would like to know more.

The retail story 2014 – will it have a happy ending?

Sales growth was higher than expected in September 2014, with retail spending month on month growth at 1.2%, after less than expected growth of 0.1% in August.

This continues the story of marginal growth for the year in retail sales, however, shows signs of improvement leading into the Christmas trading period. Year on year sales growth is a better story at 5%.

The improvement in September retail spending appears to have been fuelled by a 9.2% increase in electrical and electronic goods coinciding with the release of the iPhone 6 (although we're not suggesting this is entirely the reason). The remaining retail sub-sectors recorded flat month on month growth as limited wages growth continues to hamper consumer confidence.

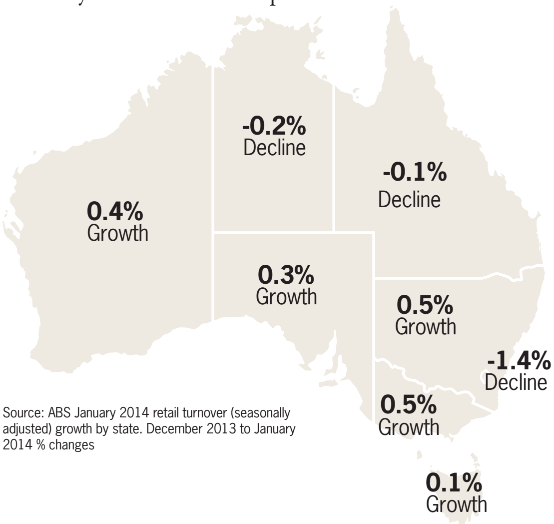
The mild winter hasn't helped many apparel retailers who would probably rather forget this year and focus on achieving a bumper Christmas. The October 2014 retail sales numbers are on track to meet the forecast. Consumer confidence is still subdued but expectations remain that this year will be a better year than last Christmas. The upcoming Christmas trading period is expected to see moderate growth on prior year performance, with sales tipped to increase 4.3% on 2014. The strongest growth is forecast to be achieved in hospitality (6.8%), food (4.9%) and household goods (4.4%).

Retailers are expecting the online trend to continue this Christmas with 83% of retailers expecting higher online sales than this time last year according to the Australian Retailers Association. The retailers that are most likely to benefit from the projected increase in consumer spending are those that have embraced online and digital programs to increase their exposure and ensure the shopping experience for consumers is fast and simple.

On the other hand, retailers expect that discounting will be a strong feature of this Christmas trading period. The challenge for retailers will be to ensure their pricing strategy is managed to share in the projected sales growth and see this growth flow through to the bottom line.

Overall, it is going to be a mixed bag across retail: there will be some happy Santas but also some turkeys!

The Australian Dollar has also continued its downward trend, losing 5% over the past two months, and is expected to continue further with the AUD seen as being over-valued against the USD. In previous years the USD was impacted by the US Federal Reserve's quantitative easing program. This is likely to cause some angst for importers and wholesalers, although as an aside, some domestic products may become more competitive to overseas online sales.



Source: ABS January 2014 retail turnover (seasonally adjusted) growth by state. December 2013 to January 2014 % changes

Detail by industry

Are you shopping for growth?

For more information, checkout out dealtracker for the retail industry "Checkout: Shopping for growth" located on the retail industry page of the Grant Thornton website. The publication reviews global M&A activity in the retail sector between 1 January 2011 and 30 June 2014, over a period of time which presented very tough trading conditions

Despite a recently sluggish period for global M&A activity, deal volumes in the retail sector have remained strong.

A recent study undertaken by Grant Thornton revealed that, in the face of low consumer confidence and high levels of competition, many traditional retailers are pursuing the acquisition route to achieve growth, instead of building from within.

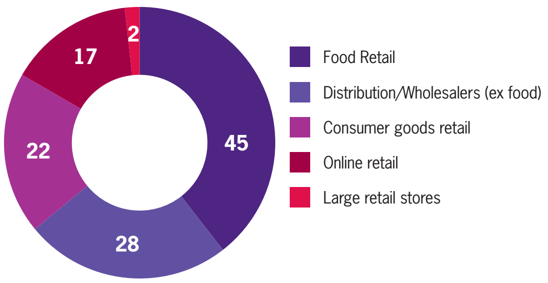
A review of global retail deal activity over the past four years placed Australia seventh in terms of deal volume - a high ranking considering the relative size of Australia's economy.

Total deal position (top 15 countries)

Position	Country	Total Deals
1	USA	1,161
2	UK	719
3	Japan	258
4	France	206
5	Germany	128
6	Russia	116
7	Australia	114
8	Sweden	112
9	Canada	108
10	China	107
11	Netherlands	97
12	Spain	82
13	Italy	69
14	Finland	65
15	Malaysia	64
	Total	**3,406**

We provide some of the key insights from Grant Thornton's study are outlined below:

Australian deal mix - number of deals



Australian transaction multiples per subsector

Subsector	Median revenue at transaction date (A$m)	Median EV/ EBITDA transaction multiple
Online Retail	152	12.0x
Large Retail Store	3,091	10.2x
Consumer Goods Retail	713	8.4x
Food Retail	362	8.0x
Distributors/Wholesalers (ex food)	109	7.0x
Median		**3,406**

1 Omni Channel

Under increasing pressure to grow their offering and customer reach; many purchasers are targeting online businesses that offer a competitive advantage through providing a complete consumer experience. As a result, high multiples have been paid from some online businesses, particularly those of a reasonable size in a specialist niche. The challenge is to integrate these businesses to achieve a true seamless experience for the customer.

Online transactions accounted for approximately 15% of Australian deals, which is considerably high considering online sales are estimated to account for only 4-7% of total Australian retail turnover[1]. This level of activity reflects the strong growth prospects for the subsector which is expected to grow at an annualised rate circa 10% over the next five years[2].

Other factors driving M&A in the online retail sector include:

- Bricks and mortar retailers are acquiring online businesses to gain immediate scale and expertise and enable them to quickly grow their online offering
- Large online businesses are consolidating the market by been acquiring smaller online competitors
- Retailers are looking for new ways to differentiate and broaden their product offerings, making online businesses an attract channel given they do not have the same shelf space restrictions as traditional retailers; and
- Private equity investors are seeking to capitalise on growth opportunities in niche sectors
- We expect M&A activity to remain strong in the online retail space over the next few years as we continue to see consolidation in the space.

1 Retail Trade 8501.0 May 2014, Australian Bureau of Statistics
2 IBISWorld Industry Report X004, Online Shopping in Australia, January 2014

2 Niche Segments

Buyers have been looking for businesses in niche segments of the market where strong growth is expected. Areas that have attracted buyer interest include:

- **Health & Nutrition** – driven by a growing trend by consumers towards healthier food products, fitness wear and lifestyle
- **Restaurant Chains** – which were particularly popular with Private Equity buyers, who are looking for profitable, multi-site businesses, with strong brands and geographical growth potential
- **Luxury Goods** – acquirers expect this sector to rebound strongly as the economy continues to recover from the Global Financial Crisis (GFC)
- **Pet Care** – driven by the increasing population of pets, big box pet stores have become the relationship point for pet owners, offering everything from puppy training to high end veterinary care to meet customer needs

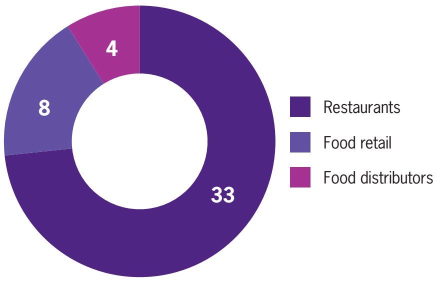
3 Strategic Buyers

In order to compete on more than just price, retailers have been keen to acquire businesses that can help them create a unique merchandise offering. Of particular interest to buyers are businesses with clearly differentiated brands, strong online capability, broad product ranged and/or strategically located store. Buyers have also been looking for opportunities to improve their profit margins through economies of scale by gaining cost savings through increased purchasing power, supply chain efficiencies, improved systems and better inventory management.

4 Demand for Food

The Australian food retail subsector has experienced the highest level of M&A activity, accounting for 39% of all Australian transactions. Investors have been particularly attracted to the food retail subsector as it is generally considered to be one of the most resilient retail sectors as the level of discretionary spending tends to be lower.

Australian food retail distribution - number of deals



- **Restaurant businesses** were particularly popular with Private Equity buyers, who are looking for profitable, multi-site businesses, with strong brands and geographical growth potential
- **Food retailers** comprised many of the larger transaction in the food retail sector, involving large grocery chains purchasing other grocery chains. This was driven by a desire to expand their geographical footprint and improve competitiveness, by accessing cost savings from improved systems procurement and inventory management
- **Food distributor** transactions reflect appetite to capitalise on growth opportunities from growing populations, increasing incomes and greater demand from Western foods in Asia

5 Globalisation

Many large retailers have been acquiring businesses as part of a strategy to expand their companies globally. The rise in cross-border transactions is expected to increase as large retailers seek to expand their businesses internationally in order to bolster stagnant organic growth. Overseas buyers are particularly interested in Australian retail businesses because of our stable regulatory environment, our strong positioning in the Asia Pacific region and the strength of our currency. We expect the level of retail competition to remain strong, as new global entrants come into our market by either buying Australian businesses, setting up their own store, or by targeting Australian consumers through their online offering.

25% of deals involved international acquirers

6 Private Equity

There has been significant investment by Private Equity firms (PE) in all retail sectors over the last few years, as well as a number of successful PE exist. In addition to this, PE firms have funded the growth plans for a number of other Australian businesses through contributing additional equity via private placements. PE firms have been acquiring and investing in businesses with strong brands and leading positions in niche, fast growing markets. Private equity is becoming the perfect partnership for mid-size retailers looking for strategic support, and access to capital to execute growth plans.

15% of deals involved private equity

Overall, as retail conditions slowly improving, we expect the level of M&A activity in the sector to increase. Retail businesses are seeing a need to change their strategies around M&A, joint ventures and strategic alliances to capitalise on global trends they believe will most transform their business.

Will the proposed changes in the competition policy review help you grow or fail?

The issuance of the draft report of the Federal Government's competition policy review in late September 2014 has caused quite a stir in the retail industry.

Key amongst the proposed reforms are recommendations that:

1 The remaining restrictions on retail trading hours be removed, or to the extent that jurisdictions retain restrictions, these should only be limited to Christmas Day, Good Friday and ANZAC day; and

2 The current restrictions on ownership and location of pharmacies are not necessary to ensure the quality of advice and care provided to patients and should be removed.

The underlying aim of the reform is to introduce more competition for the benefit of the consumer.

Most retailers are happy with the relaxing of trading hours, which is some way to get us in line with the rest of the world and can't hurt to encourage people in store rather than online.

Pharmacists, particularly sole traders, are very concerned about the proposed relaxation in relation to what has been a very tightly controlled sector. They are already facing significant downward pricing pressures due to the growth in "discount warehouse" style operations.

These proposed changes have the potential to bring us in line with global trends whereby major supermarkets like Sainsbury's in the UK and Kmart in the US have built substantial in-house pharmacy businesses.

Highlights...

Retail Trading Hours reform

- The review panel noted that although retail trading hours have been progressively deregulated by state governments across Australia, some states maintain regulations which provide an impediment to competition and consumer preferences; and
- "Bricks and mortar" retailers were felt to be at a disadvantage to online retailers as these restriction on hours of trade impede their ability to meet customer demand, especially given the shift in consumer habits to online shopping.

Pharmacy Sector Reform & Pharmacy Health Check

- The panel believed that the current restrictions on ownership and location of pharmacies is not necessary to ensure the quality of advice provided to patients and should be removed
- These current rules place limitations on ownership:
  - how many pharmacies each pharmacist can own
  - how close one pharmacy can be to another (which varies state to state); and
- The panel found that it is generally accepted that some regulation of pharmacies is justified to uphold patient and community care, however restricting the location of pharmacies or requirements that only a pharmacist can own a pharmacy impose a cost on consumers and limit choice

It seems likely that the ownership and location rules for pharmacies will be deregulated after July 2015.

How can you best prepare for the changes?

We have determined some key performance benchmarks to use as a guide to assess the performance of a pharmacy. This matrix, based on a percentage of sales, is similar to what bankers and lenders would use to assess the performance of your business for lending purposes:

Key benchmarks	% Sales benchmark		
	Industry average*	Medical centre	Discount warehouse
Turnover			
- dispensary	75%	90%	
- front of shop	25%	10%	
COGS	64%	-	71% – 72%
Rent	3% – 5%	-	-
Advertising	1% – 2%	-	-
Operating/overheads (excl. interest)	20% – 25%	-	-
Wages	10% – 12%	15%	7%
GP Retail	32% – 37%	40%	27%
Dispensary	31% – 32%	-	-
Average Pharmacy EBIDTDA	6% - 12.5%	-	-
CAP Rates	16% - 20%	-	-

A new global accounting standard on revenue - potential to significantly impact timing and dollars reported

The new global accounting standard on revenue has finally been finalised – 'Revenue from Contracts with Customers' [IFRS 15], which is expected for release in Australia during Q4 of 2014.

What has it changed?

It changes the criteria for determining whether revenue is recognised at a point in time or over time. IFRS 15 also has more guidance in many areas where current accounting regulations are lacking such as:

- multiple-element arrangements
- non-cash and variable consideration
- rights of return and other customer options
- seller repurchase options and agreements
- warranties
- principal versus agent (gross versus net)
- licensing intellectual property
- breakage
- non-refundable upfront fees
- consignment and bill-and-hold arrangements

IFRS 15 will require considerably more disclosure about revenue including information about contract balances, remaining performance obligations (backlog), and key judgements made.

What does this mean for Retailers?

The new rules have the potential to significantly impact the timing and the amount of revenue recognised. Accounting for revenue in the retail industry frequently exhibits traits of both routine simplicity and surprising complexity and judgement, from assessing the true nature of product warranties and complex shipping terms modified by well established (but non-contractual) practices, to evaluating the impact of complex distributor agreements where each party has specific rights over the product following delivery.

With the issuance of IFRS 15, the focus shifts to the question of 'control', and this will require a change in the way entities have traditionally approached these issues.

Some key areas now addressed by the new standards are:

- Do customer loyalty programmes impact revenue on current sales?
- How does breakage impact revenue on gift card sales?
- Do promised installation services represent a separate performance obligation or must they be evaluated together with the related product sale?
- How are standard and extended warranties treated?
- How do customer return and refund rights impact revenue?
- Can non-refundable upfront fees be recognised in revenue when received?

Start thinking now about whether you are ready for the change and the potential impact of the timing and amount of revenue recognised.

For more information on what the impact of the new revenue accounting standard may have on retailers, and the five-step mechanics of the standard, have a look at our publication, IFRS update: The new global revenue standard which can be found on our Retail Industry website page, www.grantthornton.com.au/Industry-specialisation/retail.asp.

Industry intelligence unit

About Grant Thornton Australia

Grant Thornton is one of the world's leading organisations of independent assurance, tax and advisory firms.

These firms help dynamic organisations unlock their potential for growth by providing meaningful, forward looking advice. Proactive teams, led by approachable partners in these firms, use insights, experience and instinct to understand complex issues for privately owned, publicly listed and public sector clients and help them to find solutions.

Grant Thornton Australia has more than 1,040 people working in offices in Adelaide, Brisbane, Cairns, Melbourne, Perth and Sydney. We combine service breadth, depth of expertise and industry insight with an approachable 'client first' mindset and a broad commercial perspective.

More than 38,500 Grant Thornton people, across over 100 countries, are focused on making a difference to clients, colleagues and the communities in which we live and work. Through this membership, we access global resources and methodologies that enable us to deliver consistently high quality outcomes for owners and key executives in our clients.

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 subindustries. 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:

Industry specialisations
Automotive
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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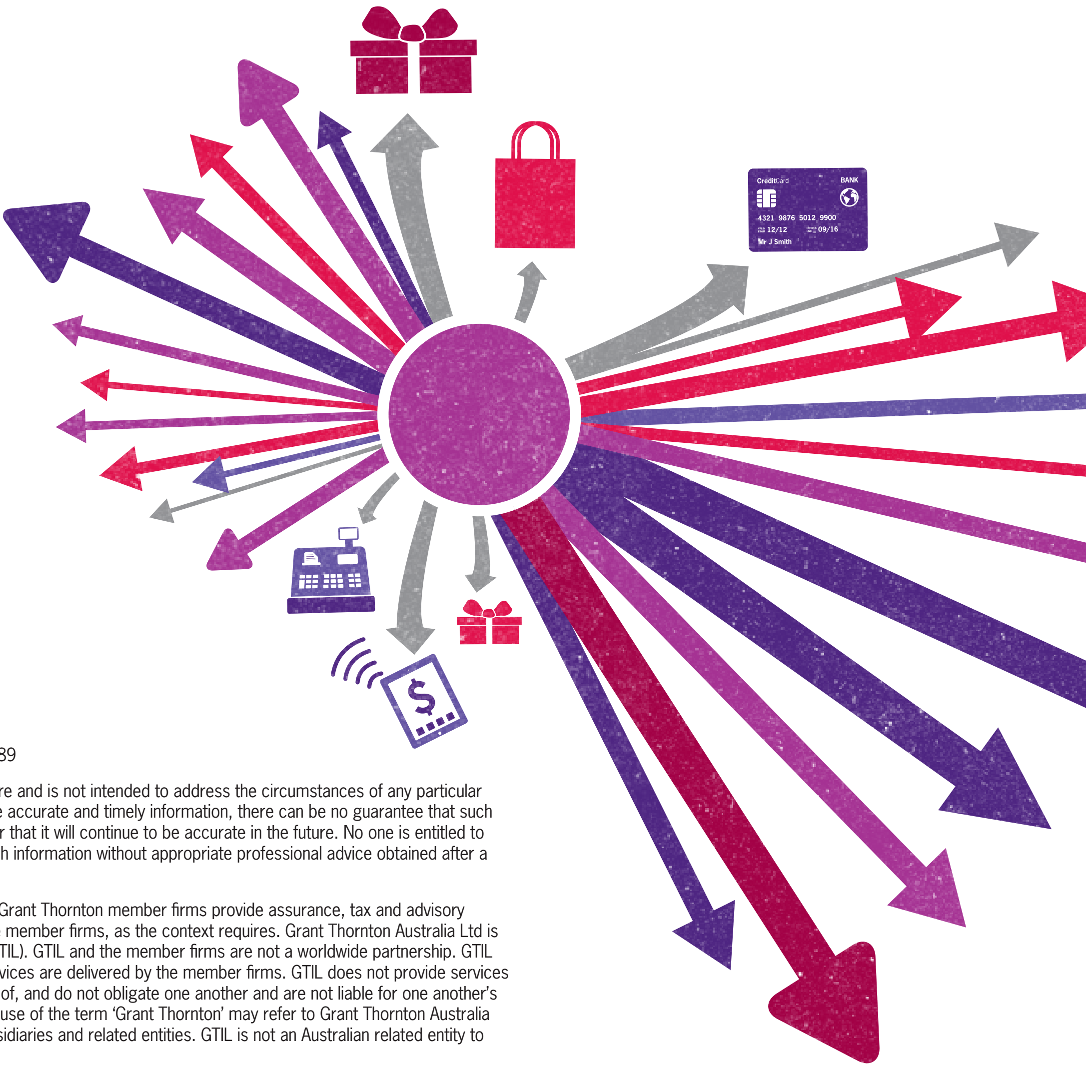

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