BARCLAYS

Equity Research

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South Africa Retail Sector

Consumer spending recovering slowly

INDUSTRY UPDATE

South Africa Food Retail
NEUTRAL
Unchanged

South Africa General Retail
POSITIVE
Unchanged

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Consumer recovering but only slowly: The South African consumer is recovering slowly from the excessive borrowing over the last decade. But structural change suggests that credit extension is unlikely to return to previous unsustainable growth rates, resulting in retailers having slower earning growth than previous years. But it won't be an average return – we believe those retailers with a strategic competitive edge will take market share from those without.

More space growth leading to profitability pressure: We expect the food and general retail sector to come under increasing profitability pressures in the next few years, with the food retailers having a much harder time relatively. Real food growth is declining and the entrance into South Africa of new players such as Choppies and Massmart will in our view add increasing pressure onto the current undifferentiated large three. According to Urban Studies, during the last 20 years South Africa has moved into 6th place in the world in number of shopping centres and 7th place in shopping centre floor space, despite being 29th in GDP and 89th on a GDP per capita basis, according to the IMF.

Will the middle class recover in time to save the majority of retailers? The rise of the middle class has saved retail in the past decade, albeit this has been credit driven. Since 2001, South Africa has seen a substantial rise in the middle income Living Standard Measure (LSM) groups. The LSM groups are socio-demographic groups which take into account not only income but access to facilities and use of household appliances. LSMs 5-8 have seen a rise over the 13 years of 114% on average. This is evidence of a consumer that is getting wealthier and moving towards a more affluent lifestyle, in addition to becoming more urbanised. Urban Studies (20 Years of Shopping Centre Success, June 2015) estimates that South Africa's population is now 64% urbanized and will move towards 70% in the next seven years.

South Africans are getting wealthier but slow growth and rising interest rates are now slowing spending: There has also been significant wealth growth of the South African population. More of the population is paying tax and more of them are moving into higher tax brackets. Over the 10-year period from 2003 to 2013, the number of taxpayers has increased from 3.1m to 5.0m. Over this period the R150,000 per annum to R1,000,000 per annum taxable earnings brackets have seen 383% growth in the number of individual personal taxpayers, from 558,611 in 2003 to 2,695,424 in 2013.

We recommend staying with the quality retailers that have a strategic point of difference. We are Overweight Woolworths, Mr Price and Foschini. We are Underweight Lewis Group, Shoprite and Truworths.

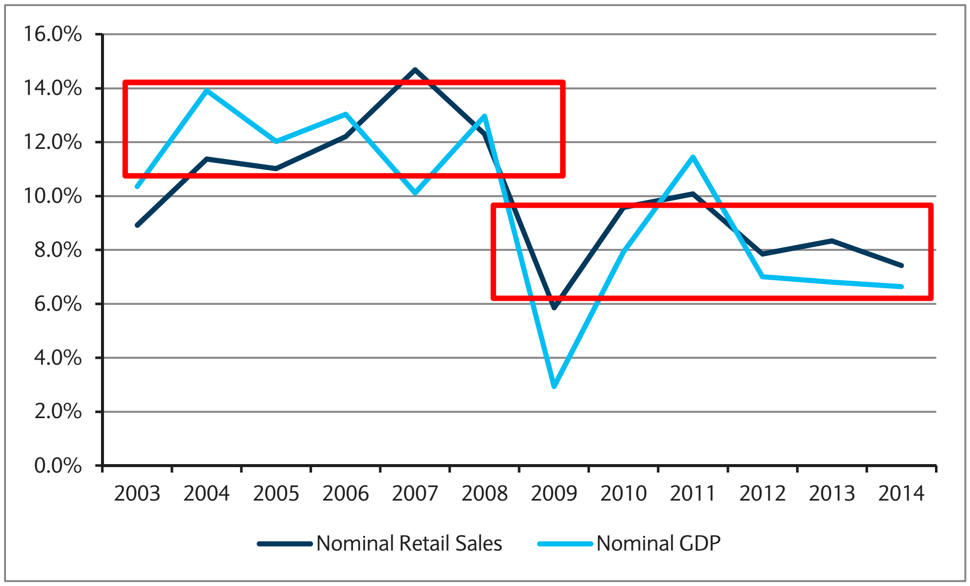
Overview: South African retail in 6 pictures

Consumption and retail spending set for lower growth

Consumer spending 60% of GDP and previous high GDP growth was buoyed by higher consumption. Going forward we expect consumption and retail spending to be at a new lower level of growth, down from 10-14% to 6-8%.

FIGURE 1

Nominal retail sales and GDP growth



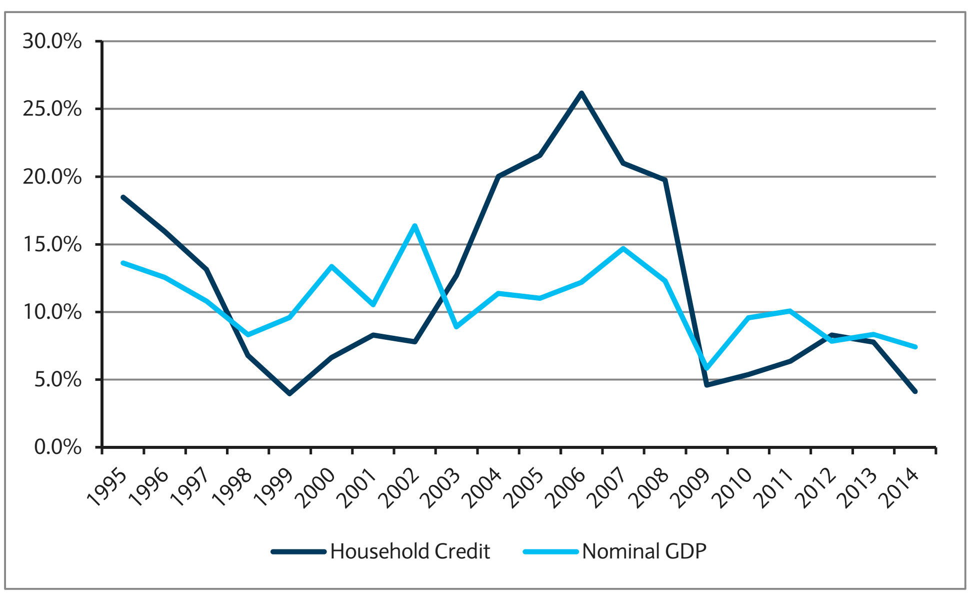
Source: SARB, Stats SA, Barclays Research

Higher spending driven by consumer credit extension

Higher consumption and retail spending were driven by higher than GDP consumer credit extension between 2003 and 2008. This rate of growth in consumer borrowing was unsustainable and we see consumer credit growth sustainably lower at 4-6% per annum.

FIGURE 2

Consumer credit and nominal GDP growth



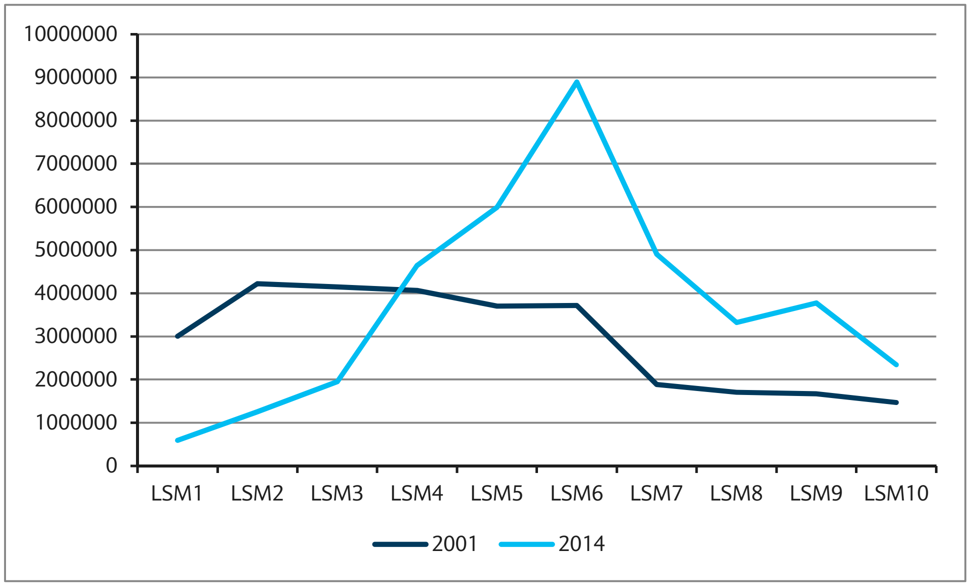
Source: SARB, Barclays Research

Consumption also driven by growth of the middle class

The growth in the South African consumer middle class has provided a buoy for spending and has allowed more consumers to access more credit. Growth in government employment, which due to spending constraints is slowing down, was a main driver of this increase in the middle class.

FIGURE 3

Population per LSM 2001 and 2014



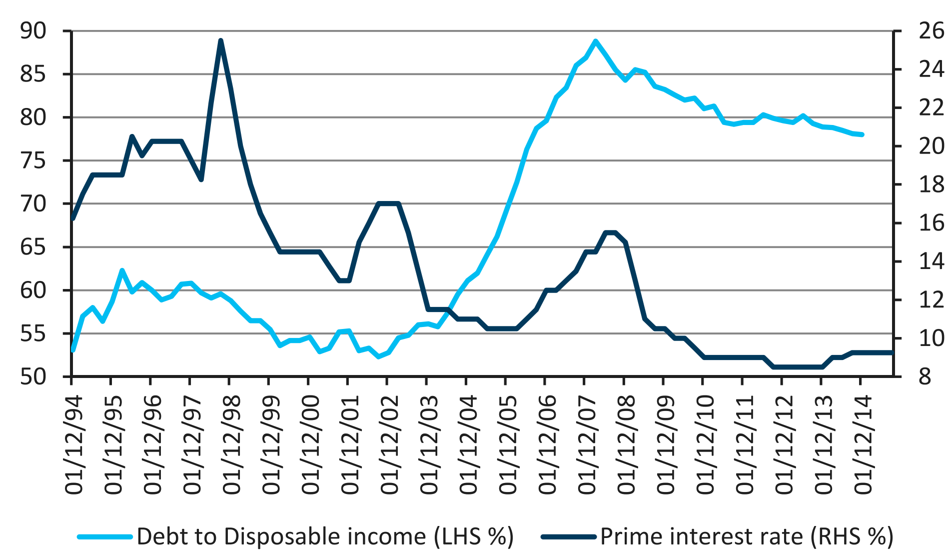
Source: SAARF, Barclays Research

Lower interest rates meant higher borrowing

In addition to higher employment and growing incomes, lower interest rates meant higher borrowing capacity for consumers, leading to historically high debt to disposable income levels.

FIGURE 4

South African household debt to disposable income and prime interest rate



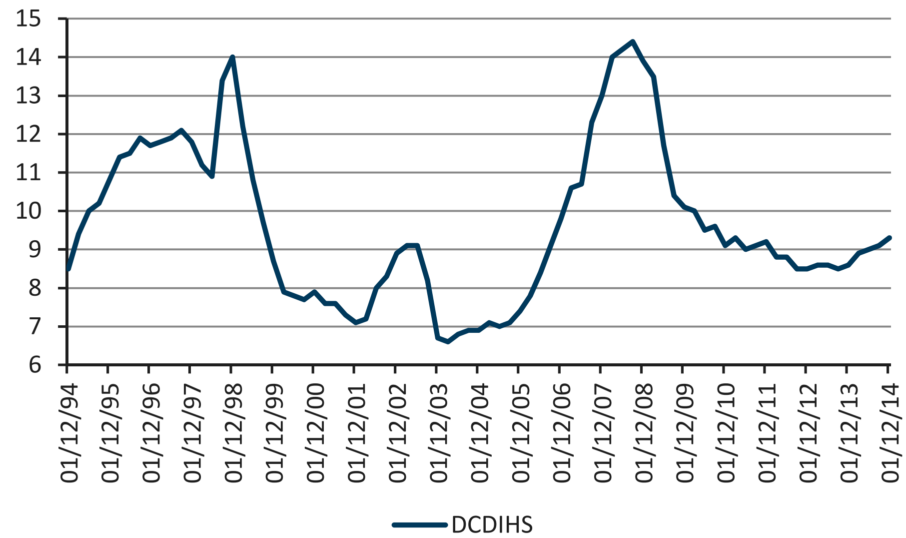
Source: SARB, Barclays Research

Rising interest rates will slow consumption growth

South Africa is now in a rising interest rate cycle which, although the consumer is slowly recovering from over indebtedness, will slow the recovery and result in lower growth over the next few years.

FIGURE 5

South African Household cost of debt to disposable income



Source: SARB, Barclays Research

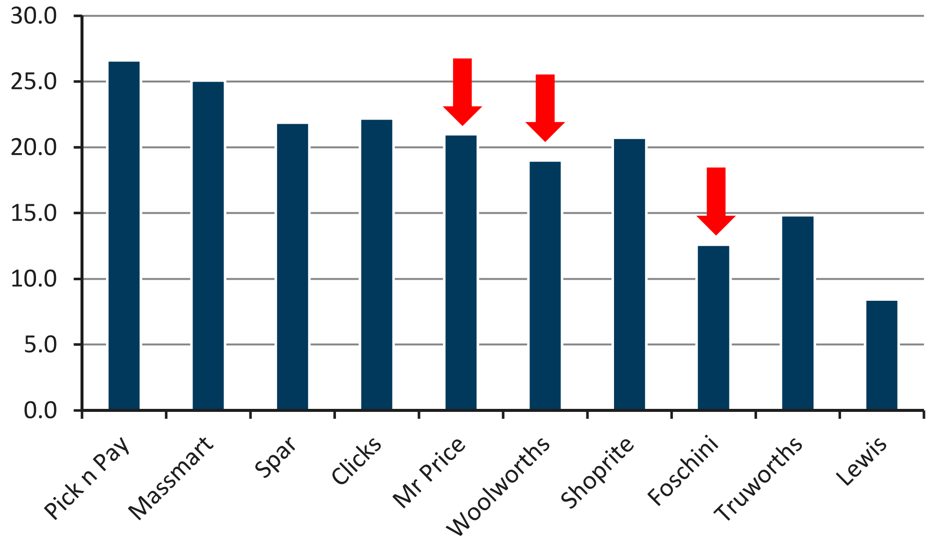
With the growth in the middle class set to slow, and interest rates rising but the consumer slowly reducing high debt levels as credit growth slows, we expect retail spending to grow only marginally and not above nominal GDP. Our expectation is for retail spending growth of 5-8%.

Stick with the quality

We believe that retailers that can take market share, become more operationally efficient or have plans for product or geographic growth will be the medium- to long-term winners. The next few years will continue to see market share move to those retailers that have better management teams and stronger propositions. Therefore, we recommend staying with quality and with retail stocks that have strong strategic growth plans (Woolworths and Mr Price), rely less on credit growth as they have a product offering that is well priced (Mr Price), are delivering value through operational efficiencies and strategic market positioning (Foschini) or has a defensive market positions (Woolworths).

FIGURE 6

Retail stock forward PER



Source: Barclays Research estimates

Retail recovery slow but positive

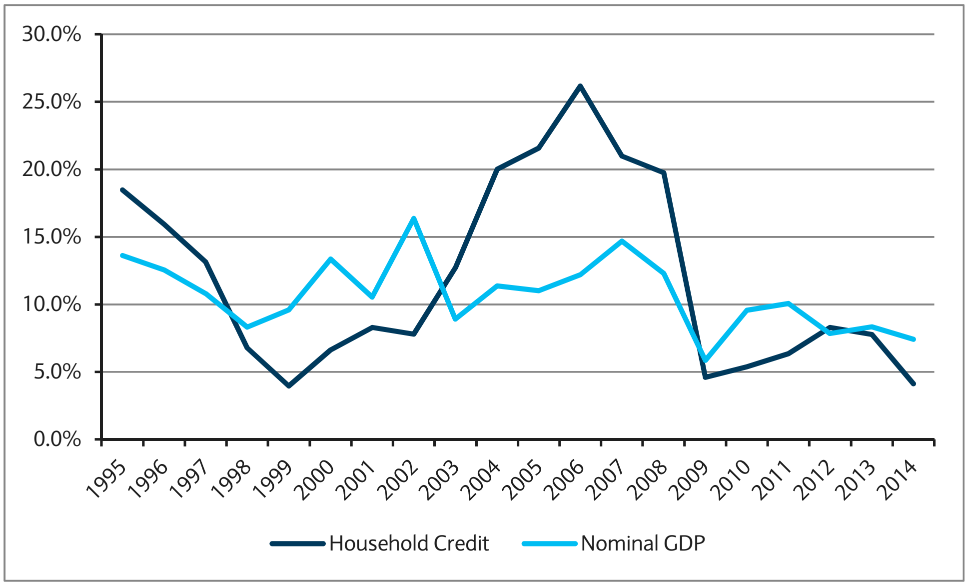
We are now going to discuss the retail landscape in more details, looking at the growth of the middle income class and the growth in retail space.

Structural change in consumer credit provision

We believe that a structural change has taken place with regard to consumer credit provision. Credit growth cannot sustainably grow faster than nominal GDP, in our view. Retail spending growth has been distorted by artificial support from higher than normal credit growth which was never going to be sustainable, as highlighted by the chart below. Although growth across income bands may differ, with lower income groups' spending power growing much slower, we believe the average will revert to nominal GDP levels.

FIGURE 7

Household credit and nominal GDP growth (% per annum)



Source: SARB, Barclays Research

Consumer recovering despite slow credit growth

We believe that consumer credit will be a facilitator but not a driver of credit. However, the consumer is recovering slowly from the credit overload from the 2003-2008 period. The damage to consumer balance sheets was exacerbated by the 205% increase in the gross unsecured lending book since 2009, a much more expensive form of debt than either mortgages or secured lending which had taken place previously.

The consumer is still recovering despite the slowdown in growth of consumer credit. Another driver of retail spending, and one which has made retail more resilient than expected, has been the growth of the middle income consumers, earning between R150,000 and R500,000 per annum.

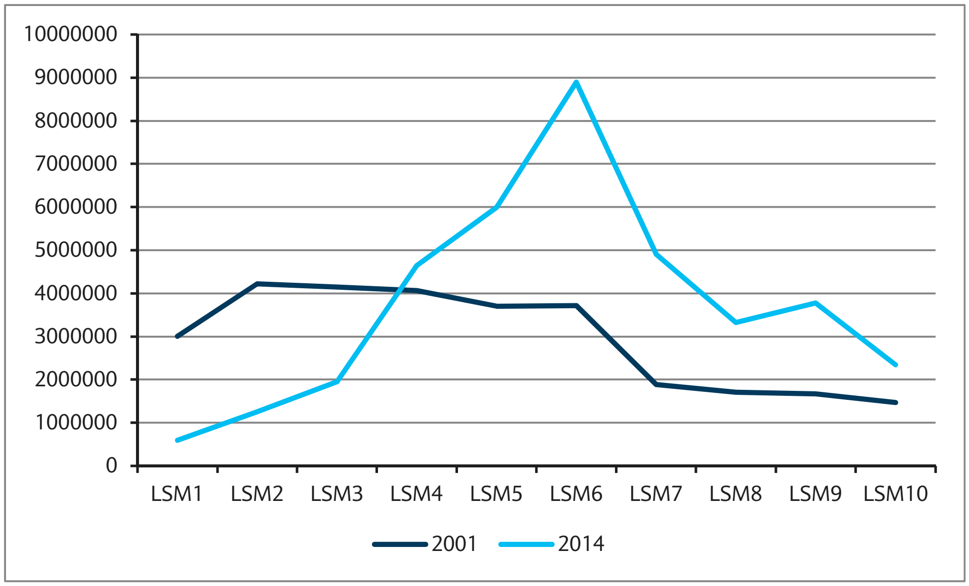
LSM changes in South Africa

More of the population moving into higher LSM groups

Since 2001, South Africa has seen a substantial rise in the middle income Living Standard Measure (LSM) groups. The LSM groups are socio-demographic groups which take into account not only the income but the access to facilities and the use of household appliances. LSMs 5-8 have seen a rise in number of people over the last 13 years of 114% on average. This is evidence of a consumer that is getting wealthier and moving towards a more affluent lifestyle in addition to becoming more urbanised. Urban Studies (20 Years of Shopping Centre Success, June 2015) estimates that South Africa's population is now 64% urbanised. Moving into urban areas is a reason for some of the movement of the population up the LSM groups, as they would have access to more services and higher sources of income.

FIGURE 8

Adult population across LSM demographic groups



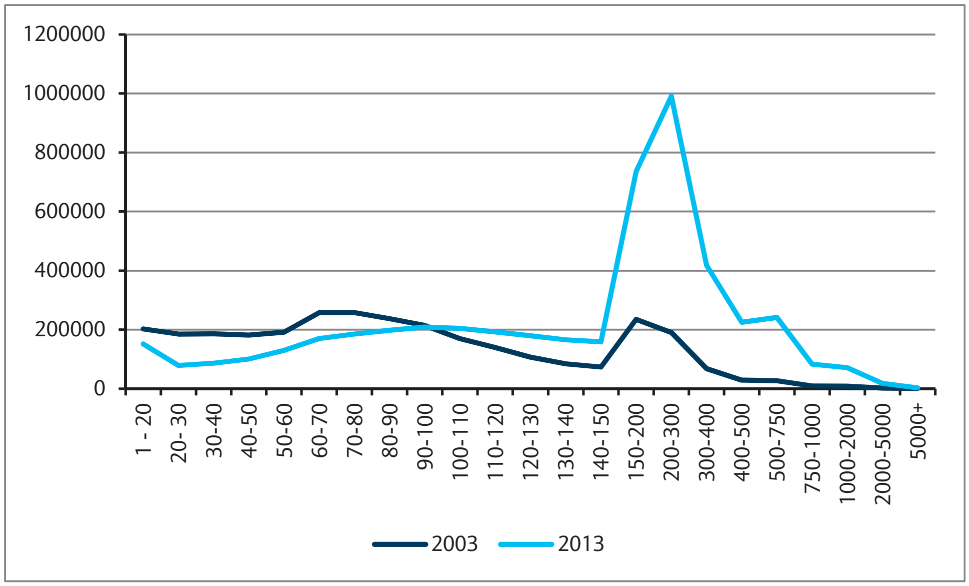
Source: SAARF, Barclays Research

South African consumers are getting wealthier

The chart below shows that there has also been significant wealth growth of the South African population. More of the population is paying tax and more of them are moving into higher tax brackets. Over the 10-year period from 2003 to 2013 the number of taxpayers has increased from 3.1m to 5.0m. The R150,000 per annum to R1,000,000 per annum taxable earnings brackets have seen over the 10-year period to 2013 a 383% growth in number of individual personal taxpayers in those brackets, from 558,611 in 2003 to 2,695,424 in 2013. A large source of this rise has been due to the government adding jobs to the civil service, which has contributed towards the growth in the middle class in South Africa.

FIGURE 9

Number of personal taxpayers by income group, 2003 and 2013

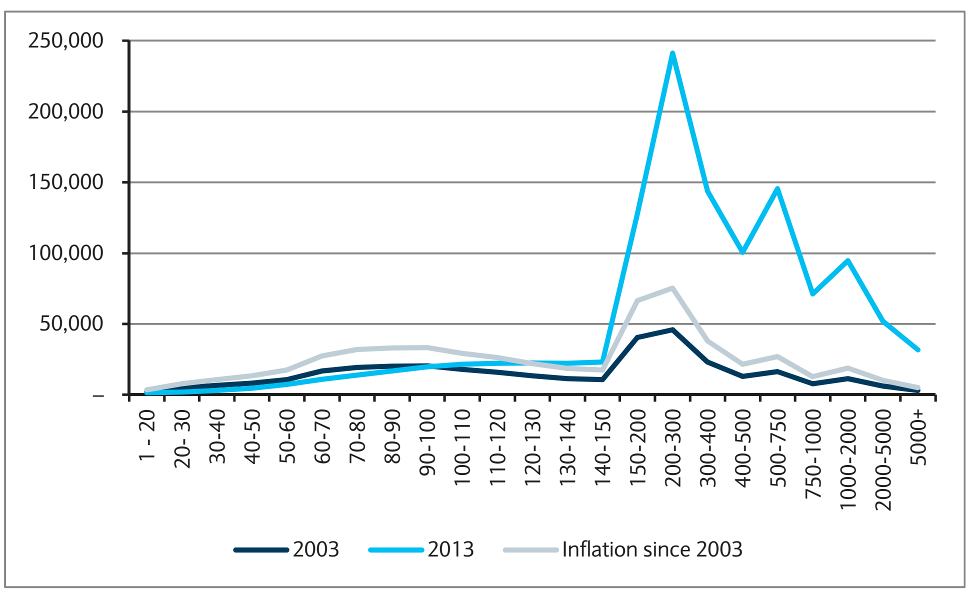


Source: SARS, Barclays Research

Personal taxation paid, an indication of earnings, has also grown significantly in the middle income and upper income bands. The 248% increase in taxation paid, despite tax rates falling marginally over the 10-year period, or 112% higher than inflation growth, has benefited the retail industry, with more people becoming wealthier in real terms and able to borrow against earnings and therefore increase their spending. According to Stats SA total household spending has increased by 137% between 2006 and 2014, or 91% higher than inflation, although some of this will have been credit driven.

FIGURE 10

Personal taxation paid by income group 2003 and 2013 (population by income group ZAR000s)



Source: SARS, Barclays Research

Urban Studies estimates that R85bn is expected to be added to consumer spending by 2021

The growth in employment, which has been driven largely by government hiring programmes, is slowing due to a lack of funds. Growth in employment in unproductive sectors has limited opportunity to grow above productive areas in the economy. Despite this slowdown in employment growth and the expectation of rising interest rates, we see an underpinning of consumption, as consumers slowly repair their balance sheets.

Another factor is the rise of the black consumer, which now accounts for 57% of total consumption by households. In addition, Urban Studies estimates that the middle market will grow by a further 1.2m households over the next six years to 2021, as urbanisation increases and earnings grow. This will add an estimated R40bn in additional consumer spending to the economy. The upper income households are expected to grow by 400,000-500,000 by 2021, adding a further R45bn in consumer spending to the economy.

Space saturation in South Africa retail equals lower returns

Slow but steady growth for retail spending into the headwinds of increasing competition and rising interest rate

For clothing and general merchandise retailers, this means that as the consumer recovers from the debt overhang, there is some leverage for growth in spending. Food retailers may also benefit to some degree as consumers become wealthier and start to trade to higher priced foods, such as fresh foods and less basic commodities. But not all food retailers will benefit equally in our view, with Woolworths reaping the greatest benefit. Shoprite at the lower end, due to the over indebtedness of the consumer in that market, will we expect fare worst.

Interest rates won't be the only headwind to retail spending. Both the food and clothing sectors will become more competitive as foreign retailers enter the market. In food, Choppies is expanding and adding pressure onto the current players, in particular Shoprite. In clothing foreign entrants like H&M and Cotton On will increase the pressure and diminish the aspirational qualities of the local retailer brands. Weaker retailers will therefore continue to lose market share to those that are on trend with value, fashion and price.

Volume growth stagnation a concern for mainstream food retailers

In addition to extra competition, some retailers are having to face diminishing returns on space in some areas. In 1994, the population of South Africa was 38.3m and LSM 1-4 represented over 80% of households with an average annual income of R30,000. According to Urban Studies there were only 36 shopping centres over 30,000 sq meters, with most located in metropolitan areas with total shopping centre floor area was just over 4m square meters and only 54% of the population was urbanised.

From 1994 to 2014 the population has increased by 42% to 54.0m, with only 22% of all households now within LSM 1-4 and almost 80% of households now in LSM 5-10. Shopping centres of more than 30,000 square meters now number 160, according to Urban Studies, and total shopping centre space has increased in the same period to 23m square meters, a 7.5% compound annual increase and more than 2,000 shopping centres are in country areas.

Some of the growth in space has come from traditional high streets, although less so with food retailers, due to the longer-term rentals signed by these retailers. Space growth by food retailers has increased 61% in the last 10 years against real food sales growth of 85%. However, it is the latest trend that worries us, in that for the big four food retailers real retail sales per square meter have stalled, indicating lower volumes, for the second time in the last four years.

FIGURE 11

Food retail sales and space growth

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total 04-14
Total space	0.8%	9.4%	-1.0%	7.0%	6.9%	4.5%	4.4%	8.6%	3.1%	5.3%	60.8%
Total sales	12.7%	13.3%	14.3%	18.6%	16.6%	5.5%	8.0%	9.1%	9.2%	7.7%	195.2%
Real sales growth 2004-2014											85.1%

Source: Companies, Barclays Research

We believe that the dynamics for food retailing is coming under pressure. Costs are rising faster than sales in many areas, unwinding the leverage model of food retailing, which in good times has low net profit margins.

FIGURE 12

Food retail productivity growth

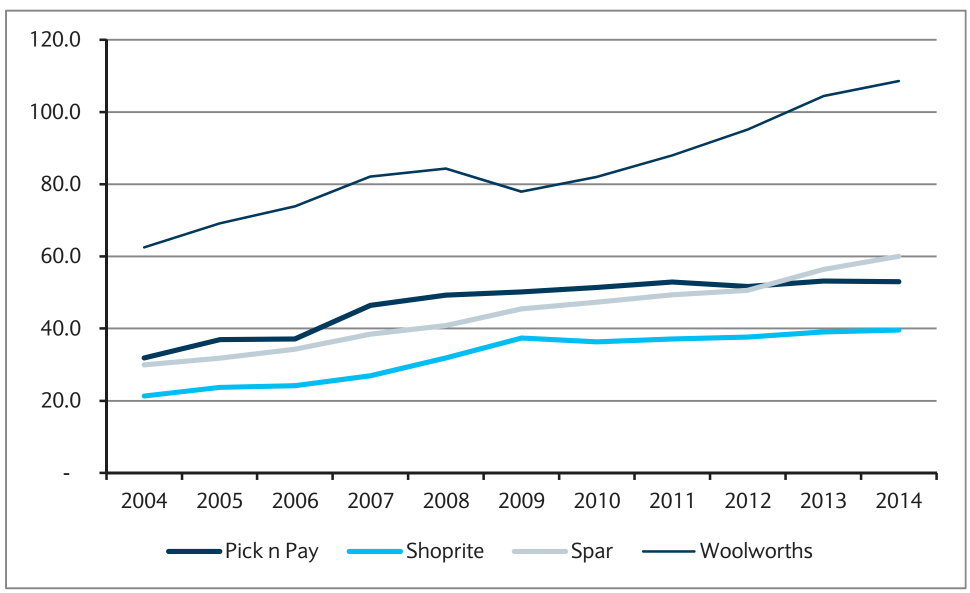
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Sales per square meter	27.8	31.1	32.2	37.2	41.2	44.9	45.4	46.9	47.1	49.9	51.0
Food inflation	1.5%	3.8%	6.8%	12.7%	15.6%	3.6%	1.6%	11.0%	7.0%	3.5%	7.2%
Real sales per square meter	27.4	29.9	30.1	33.0	35.6	43.4	44.7	42.2	44.1	48.2	47.6

Source: Companies, Barclays Research

Our particular concern is for Shoprite, which has the lowest sales per square meter, on our estimates. Shoprite management does not provide total space per format, but through field research and property company lease agreements, we have estimated the total space for Shoprite. We believe that Shoprite is most vulnerable to stagnation in volume growth. Shoprite management admit that about 30% of new stores opening turnover is cannibalised from its existing stores. This all points to saturation of the formal retail food market and hence the legal battles in trying to prevent Massmart entering the food retail market.

FIGURE 13

Retailer sales per square meter



Source: Companies, Barclays Research Estimate

As could be expected, due to the small size of store and higher value per basket, Woolworths has the highest sales per square meter followed by Spar and Pick n Pay.

Spar store numbers also reducing

Spar is also concerning in that it has been moving to bigger stores against the trend of convenience, with more Superspars opening and normal Spars and Kwikspars declining in numbers. Although overall space has increased, and some of the growth in Superspars is through conversions, it would seem to indicate that there is a critical weakness in the competitiveness of the smaller Spar formats, which would in our view be as a result of the franchise model.

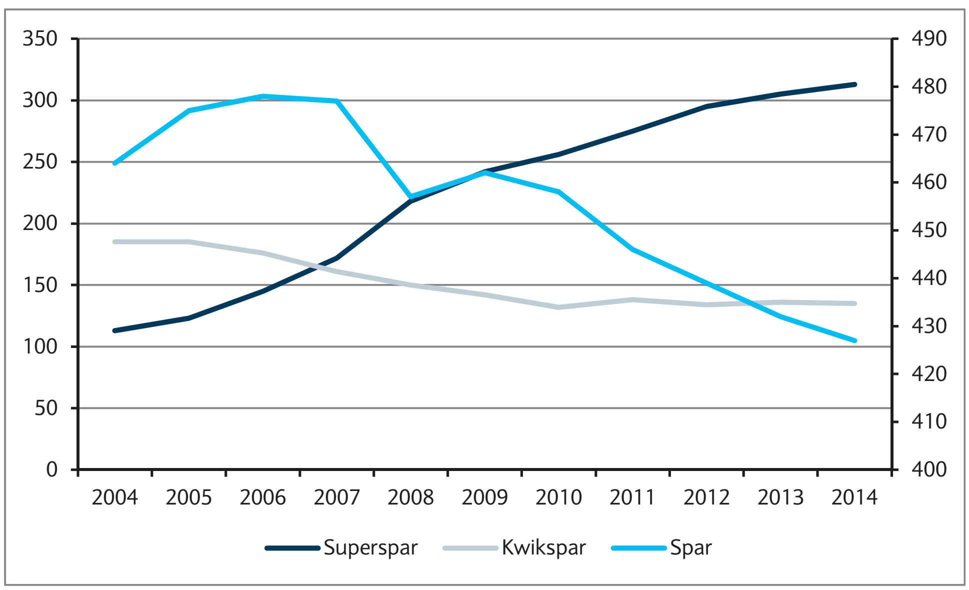
FIGURE 14
Spar space by format

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Superspar	248,600	270,600	319,000	378,400	479,600	532,400	563,200	605,000	649,000	671,000	688,600
Spar	371,200	380,000	382,400	381,600	365,600	369,600	366,400	356,800	351,200	345,600	341,600
Kwikspar	17,831	17,831	16,964	15,518	14,458	13,687	12,723	13,301	12,916	13,108	13,012
Savemore	-	-	-	-	-	-	-	-	5,100	8,400	8,400
TOTAL	637,631	668,431	718,364	775,518	859,658	915,687	942,323	975,101	1,018,216	1,038,108	1,051,612

Source: Company, Barclays Research Estimates

The chart below highlights the dramatic fall in the smaller store formats, and may indicate why the group has decided to move offshore.

FIGURE 15
Spar store numbers by format



Source: Company, Barclays Research

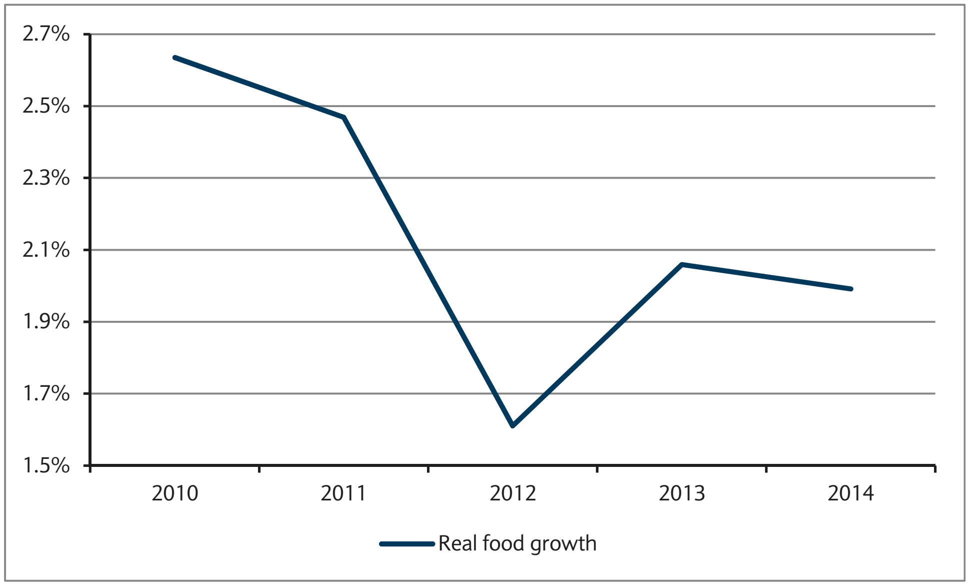
Conclusion

Slow growth the norm

We believe that the food and general retail sector will come under increasing profitability pressures in the next few years relative to the previous decade, with lower sales and earnings growth. The food retailers will we expect have a much harder time relatively, despite the rise of the middle class. Real food growth is declining and the entrance into the South Africa food market of new players such as Choppies and also Massmart will in our view add increasing pressure onto the current largely undifferentiated main three retailers in Pick n Pay, Shoprite and Spar.

FIGURE 16

South Africa real food growth



Source: Stats SA, Barclays Research

Lots of retail space and more to come

According to Urban Studies, during the last 20 years South Africa has moved into 6th place in the world as regards the number of shopping centres and 7th place as regards shopping centre floor space, despite according to the IMF being 29th in GDP and 89th on a GDP per capita basis.

Retail space costs has a role to play, as cheaper space means more space availability in a country with less consumer spend. But this would indicate that either retail rentals or retailers' profit margins may come under pressure going forward, depending on the rate of growth of the consumer middle class. With current economic growth at low levels, the growth in consumer wealth is being pushed out, signalling in our view trouble ahead.

Stay with the quality

We recommend staying with the quality retailers that have a strategic point of difference.

We are Overweight Woolworths, Mr Price and Foschini.

We are Underweight Lewis Group, Shoprite and Truworths.

VALUATIONS

FIGURE 17

Barclays forecasts and price targets – Financial Years

Stock	Rating	EPS FY2015 ZARc	EPS Growth %	EPS FY2016 ZARc	EPS Growth %	Divi yield FY2015E	Div yield FY2016E	Target price ZAR	Market Cap ZARm
Clicks	OW	385	14.2%	453	17.7%	2.6%	2.9%	100.00	22,266
Pick n Pay	EW	175	16.7%	225	28.6%	2.1%	2.7%	56.00	28,313
Shoprite	UW	743	6.5%	795	7.0%	2.1%	2.3%	151.00	99,903
Spar	EW	862	17.8%	960	11.4%	3.3%	3.7%	187.00	33,970
Foschini	OW	890	9.5%	1027	15.3%	3.8%	4.4%	184.00	30,634
Lewis	UW	875	-4.1%	924	5.6%	5.3%	6.0%	76.00	7,602
Massmart	EW	597	14.6%	714	19.6%	3.3%	3.5%	166.00	32,405
Mr Price	OW	865	21.0%	1046	21.0%	2.4%	3.1%	272.00	62,957
Truworths	UW	569	0.0%	555	-2.4%	5.3%	5.6%	70.00	35,883
Woolworths	OW	397	5.9%	446	12.3%	2.9%	3.1%	104.00	99,899

Source: Barclays Research Estimates. Prices as of 13 July 2015

FIGURE 18

Barclays earnings forecasts and ratings – Calendar Years

Stock	EPS CY2015 ZARc	EPS Growth %	EPS CY2016 ZARc	EPS Growth %	Dividend yield CY2015	Target price ZAR	Current price ZAR	Price upside/ downside	Target price PER 1 Yr fwd	Current price PER 1 Yr fwd
Clicks	407	15%	472	15.8%	2.7%	100.00	90.30	10.7%	24.6	22.2
Pick n Pay	216	29%	261	20.5%	2.0%	56.00	57.59	-2.8%	25.9	26.6
Shoprite	769	10%	835	8.6%	2.2%	151.00	173.00	-12.7%	18.1	20.7
Spar	895	15%	989	10.5%	3.4%	187.00	195.75	-4.5%	20.9	21.9
Foschini	993	14%	1151	16.0%	4.2%	184.00	145.07	26.8%	16.0	12.6
Lewis	912	3%	918	0.7%	5.8%	76.00	77.50	-1.9%	8.3	8.4
Massmart	597	15%	714	19.6%	3.3%	166.00	149.67	10.9%	27.8	25.1
Mr Price	1001	21%	1190	18.9%	3.5%	272.00	249.75	8.9%	22.9	21.0
Truworths	561	-2%	566	0.9%	5.3%	70.00	84.00	-16.7%	12.4	14.8
Woolworths	427	-1%	504	18.1%	2.9%	104.00	95.80	8.6%	20.6	19.0

Source: Barclays Research estimates. Note: Pricing 13 July 2015; for full disclosures on each covered company, including details of our company-specific valuation methodology and risks, please refer to *http://publicresearch.barcap.com*.

FIGURE 19

Stock price performance of the South African retailers – end June 2015

	Clicks	Pick n Pay	Shoprite	Spar	Foschini	Lewis	Massmart	Mr Price	Truworths	Woolworths
1 month	4.3%	0.8%	4.3%	-1.1%	-2.2%	1.1%	-0.5%	2.0%	-1.0%	2.9%
3 month	-1.7%	16.3%	2.3%	-2.4%	-12.0%	27.9%	0.0%	-5.3%	-2.7%	14.0%
6 month	11.0%	9.3%	-0.1%	14.2%	19.3%	33.8%	5.0%	4.8%	11.1%	27.4%
12 months	141.6%	98.7%	109.1%	148.1%	142.6%	152.8%	113.6%	136.2%	114.5%	125.7%
3 year	67.3%	31.0%	11.5%	62.1%	24.2%	40.8%	-11.1%	120.0%	-4.1%	95.5%
5 year	164.8%	32.5%	102.8%	130.9%	145.2%	68.1%	27.1%	450.2%	60.1%	310.0%

Source: INet, Barclays Research (Prices as at 30 June 2015)

ANALYST(S) CERTIFICATION(S):

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Materially Mentioned Stocks (Ticker, Date, Price)

Foschini Group Ltd. (TFGJ.J, 13-Jul-2015, ZAR 145.07), Overweight/Positive, F/J

Lewis Group Ltd. (LEWJ.J, 13-Jul-2015, ZAR 77.50), Underweight/Positive, D/F/J/L

Mr Price Group Ltd. (MPCJ.J, 13-Jul-2015, ZAR 249.75), Overweight/Positive, F/J/K/M

Shoprite Holdings Ltd. (SHPJ.J, 13-Jul-2015, ZAR 173.00), Underweight/Neutral, D/J/K/L/M

Truworths International Ltd. (TRUJ.J, 13-Jul-2015, ZAR 84.00), Underweight/Positive, J/K/M

Woolworths Holdings Ltd. (WHLJ.J, 13-Jul-2015, ZAR 95.80), Overweight/Positive, D/J/K/L/M

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Spar Group Ltd. (SPPJ.J)		
South Africa General Retail		
Foschini Group Ltd. (TFGJ.J)	Lewis Group Ltd. (LEWJ.J)	Massmart Holdings Ltd. (MSMJ.J)
Mr Price Group Ltd. (MPCJ.J)	Truworths International Ltd. (TRUJ.J)	Woolworths Holdings Ltd. (WHLJ.J)

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