WILSONS

Woolworths: calling drinks on Endeavour

Our monthly view on Australian Equities

10 June 2021

Endeavour and Woolworth Demerger

Woolworths (WOW) is in the final stages of calling drinks on its hotel and liquor business, Endeavour Group, representing ~25% of Group earnings. Endeavour consists of 330 hotels and +1300 liquor stores under the Dan Murphy's and BWS brands. In late June, WOW shareholders will vote on whether the proposed demerger will go ahead.

Historically, demergers in Australia have typically created value for both the parent entity and the spin-off. Both companies usually outperform the market in the year post the demerger. We think a similar scenario could play out here with WOW.

WOW, post demerger will consist of ~1200 supermarkets in Australia/NZ and a balance sheet in a net cash position (ex-property leases). This opens the door for capital management and several new investment initiatives designed to provide growth optionality/mitigation against potential technological disruption of the core supermarket business.

The removal of Endeavour (one of the largest gaming machine owners in Australia) from WOW will improve WOW's relative Environmental, Social, Governance (ESG) rank within S&P/ASX 50 companies. This should increase the investor appeal of WOW.

Endeavour as a stand-alone hotel operator and distribution business should benefit from a more focused management and capital allocation policy. The pending recovery in volumes post COVID-19 should provide an earnings recovery into FY23E. We think Endeavour could trade on a premium multiple given the quality of its properties, the relative security of cash flow, and growth prospects.

Woolworths demerger 101

WOW is proposing to separate Endeavour from the Woolworths Group by way of a demerger.

If the demerger proceeds (which we think is very likely), eligible shareholders will own an equal number of shares in two separate ASX-listed companies.

Exhibit 1: Woolworths | Endeavour post demerger

Endeavour Drinks
(25% EBIT of current Woolworths group)

- Dan Murphy, BWS, Pinnacle Drinks, ALH Hotels
- 246 Dan Murphy's stores, 1,384 BWS stores, 332 Hotel venues
- ~70% of EBIT comes from retail (liquor), remainder in Hotels
- Online Penetration (1H21) – 8.5%
- Net debt/(cash) (1H21) – 1,266
- Likely to be an ASX 50 company after demerger

Woolworths Group
(75% EBIT of current Woolworths group)

- Woolworths, Metro, Big W, Countdown (NZ)
- 994 Woolworths Supermarkets, 70 Metro stores, 181 Countdown stores, 179 Big W stores
- 86% of EBIT comes from Australia, remainder in NZ
- Online Penetration (1H21) – 8.3%
- Net debt/(cash) (1H21) – (75)
- Likely to be an ASX 20 company after demerger

Source: Company Data, Refinitiv, Wilsons.

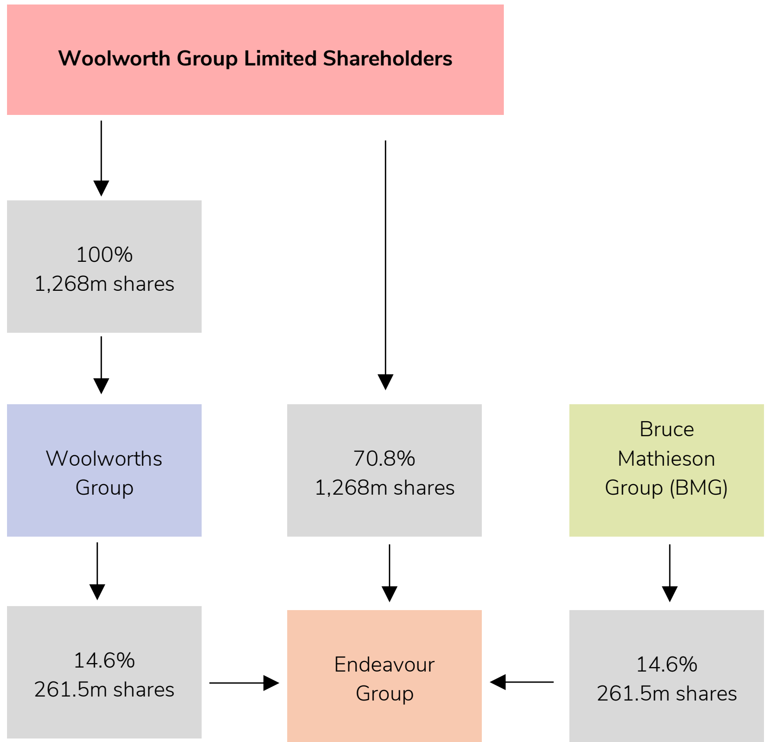
Woolworths intends to hold a 14.6% interest in Endeavour upon implementation of the demerger. Woolworths' long-term joint venture partner BMG will also hold 14.6% interest in Endeavour drinks.

This will go to a shareholder vote on 18 June 2021. The Woolworths Directors unanimously recommend that shareholders vote in favour of the demerger.

The rationale for the demerger:

- Simplified businesses and increased focus for both Endeavour and Woolworths boards.
- Woolworths can prioritise investments in Australian and NZ food to protect its market share from growing competition from Coles and ALDI.
- Endeavour can pursue its own independent strategy and growth agenda, with a funding structure that suits its business.
- Existing shareholders will have the flexibility to choose their level of investments in Woolworths and Endeavour. This allows those concerned about ESG issues with Endeavour to sell down.
- CGT roll-over relief is expected.

Exhibit 2: Woolworths Endeavour Group shareholder structure post demerger.



Source: Company Data, Refinitiv, Wilsons.

Exhibit 3: Timeline of key dates for demerger

18 June	Meeting Resolutions to be considered at the General Meeting
If the demerger is approved	
24 June	First date Woolworths Shares trade on the ASX ex-entitlements under the demerger. Endeavour shares commence trading on the ASX on a conditional and deferred settlement basis
28 June	Separation Date
1 July	Implementation Date – transfer of Endeavour shares to eligible shareholders. Normal trading of Endeavour shares on the ASX commences
26 August	WOW FY21 Results – potential for DPS/capital management surprise.

Source: Refinitiv, Wilsons.

Woolworths investment case

Post demerger, WOW will emerge as a pure-play food retailer with lower earnings cyclicality. The more discretionary aspects of the hotels business will reside within Endeavour.

We would argue that the long-term growth aspects of WOW are marginally lower post demerger; mature supermarkets versus the market consolidation opportunities available within hotels and bottle shops.

In reality, we doubt the market will get focused on the small difference in long-term growth rates. The key growth drivers of WOW will remain unchanged, being;

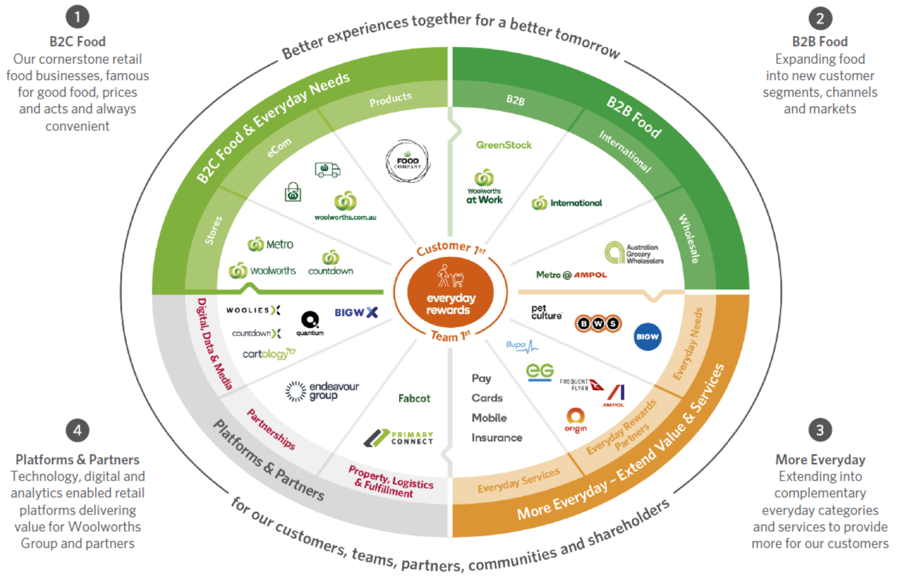
1) population growth (~1.5% p.a.)
2) new sites (1.5-2.0% p.a.)
3) cost and revenue optimisation (1-2% p.a.)

This, coupled with volume and basket size growth, leaves WOW as a low-mid single-digit revenue growth business.

Like many mature, highly cash generative businesses, WOW has several future growth initiatives that, in isolation, are unlikely to move the needle for earnings over the next 3 years, but provide both offensive and defensive strategic learnings and options. These range from e-commerce, small-format metro supermarkets, financial services and food production/wholesaling businesses. We suspect WOW may look to accelerate investment in some of these areas post demerger, with e-commerce a likely beneficiary of more capital.

Overall, we see WOW as a business that can grow core supermarket revenue at around GDP levels, equating to mid-high single-digit earnings growth over the medium term. With strong cash flow generation – dividend payout ratios should be X-Y%.

Exhibit 4: What WOW will look like post demerger



Source: Company Data

Capital management prospects

Most of the debt within WOW today resides within the Endeavour assets. ~$1.5bn net of property leases. Post demerger, the debt will move to Endeavour – leaving WOW in a net cash position of ~$75m as of January 2021 (debt figures we suspect are understated due to the seasonally low Christmas period).

We would argue a supermarket business can support a modest level of gearing. In our view, WOW could return $A1.5-2.0bn of capital to shareholders, leaving WOW with a leverage ratio (ND/EBITDA) of ~3.0x at the low end, up from ~2.7x immediately post the demerger. Coles currently has a leverage ratio of 2.8x.

With ~$A2bn of franking credits, the potential for an off-market buyback or special dividend at the upcoming FY21 results is elevated. The former being more likely in our view. That would equate to a 3-4% reduction in shares on issue or a special dividend of $1.18-$1.58 per share (in addition to franking).

Woolworths trading conditions

Over the last two years, WOW has grown sales faster than COL in all but two of the last eight quarters. This is partly explained by WOW having more neighbourhood/free-standing stores vs COL which customers have preferred in a COVID environment. We expect some normalisation of this in the post-COVID world.

For a long time, WOW has had a superior logistics chain to COL, which has allowed WOW to have higher margins and returns on capital than COL. Looking forward, the market is forecasting ~20% core earnings growth in WOW (ex-Endeavour) vs. 5% for COL between FY20A and FY23E. Looking forward, the market is forecasting ~15% core earnings growth in WOW (ex-Endeavour) vs. 5% for COL between FY20A and FY23E. The key difference being large improvement in Big W earnings, and larger lift in WOW Food EBIT margin.

How we value Woolworths

WOW has rallied ~10% since YTD, performing in line with the market, while outperforming key peer COL by ~20%. WOW's stronger earnings performance, with the prospect of a demerger and capital management, has helped. The average consensus 12-month target price for WOW is $43.73, according to Refinitiv, in line with the current share price.

Historically, WOW has traded on ~20x PER. Today that is closer to 28x. Relative to the market, the PE REL is 1.5x vs 1.2x long-term average. We believe that for the share price of WOW to rerate further from here, the market would need to believe that long-term EBIT margins will step up from the current 5.3% and closer to 6.5% - well ahead of its historic margin.

Exhibit 5: Post demerger WOW will be under-geared at 2.7x leverage

Source: Company Data, Refinitiv, Wilsons. Leverage = Net debt/EBITDA based on FY20A. Net debt includes lease liabilities.

Exhibit 6: WOW has posted higher quarterly sales growth than COL in 6 of the last 8 quarters.

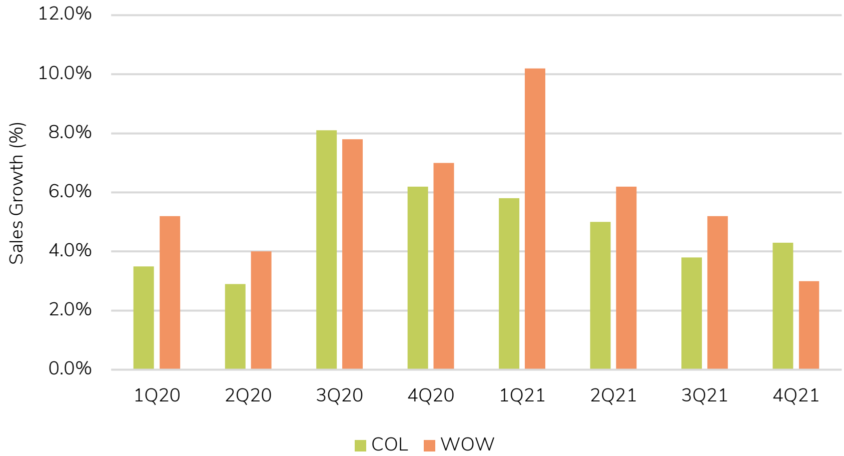
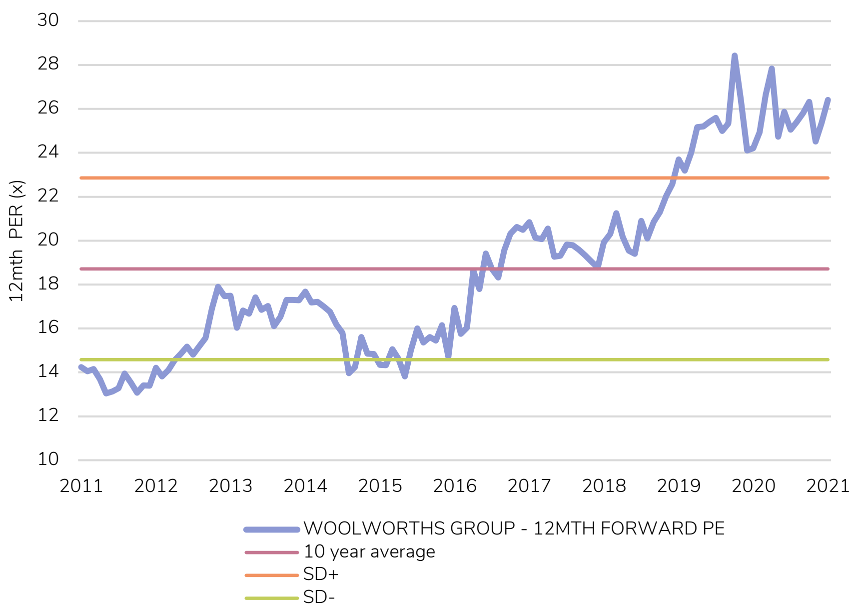


Exhibit 7: WOW multiple has expanded dramatically over the last 3years.



Source: Company Data, Refinitiv, Wilsons.

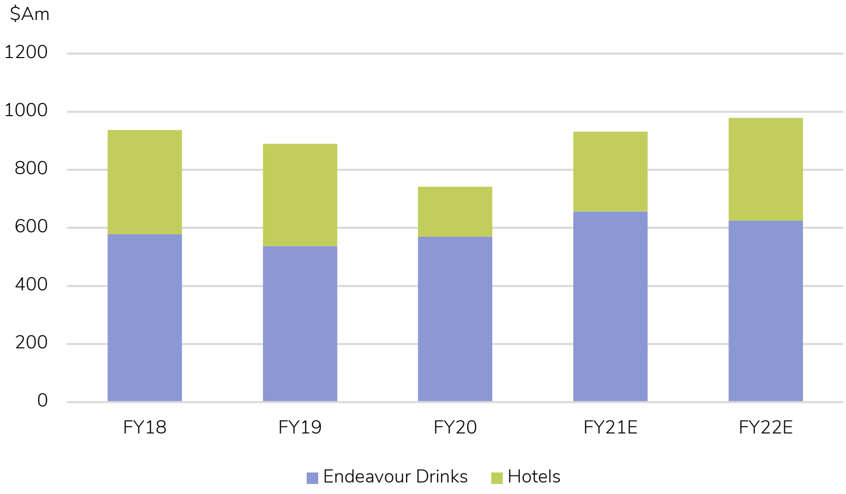
Endeavour investment case

We believe the market will look at three aspects of the Endeavour business;

1. **COVID earnings recovery**
2. **Growth of the asset base – both hotels and distribution**
3. **Enhancing the monetisation of the hotels**

Successful execution of all three aspects should enable Endeavour to generate mid-high single-digit earnings growth through the cycle, with some volatility around hotel earnings. Post demerger, more focused management with greater control over the capital allocation can accelerate growth rates.

Exhibit 8: Endeavour's (consensus EBIT) Hotel earnings should post a strong recovery as COVID-19 restrictions end



Source: Company Data, Refinitiv, Wilsons.

COVID-19 earnings recovery

Hotel earnings were significantly impacted by restrictions around on-premise alcohol consumption in FY20A and FY21A. There was some offset from retail distribution as they saw increased activity from off-premise alcohol consumption.

The Hotel business is typically higher EBIT margin than retail at ~21% vs 7% for retail. As COVID restrictions ease there should be a strong rebound in hotel profitability. Consensus estimates suggest Hotel earnings could more than double from FY20E to FY22E. The below numbers ignore demerger dis-synergies of ~$47m pa.

Endeavour's CAPEX spends historically has been around $340m per year. This has fallen to ~$320m in FY21E. We anticipate CAPEX spending to pick in the coming periods, as ESG concerns under WOW ownership are removed. Gaming machine CAPEX is ~$25m p.a. in the Hotels business, and we could see catch-up CAPEX in our view.

The Group has ~12.5k gaming machines, with around ~11% of the machines renewed annually.

This is at the lower end of the industry average of 10-15% p.a for renewals.

A pick-up CAPEX could slow the strong growth in net operating cash flow that has averaged ~7% pa FY18A -FY20A.

What is Endeavour worth?

There are no pure ASX listed comparable companies (comps) for Endeavour. Offshore comps have significantly different local licences laws to make cross-border comparisons low quality.

1) **COL, MTS and WOW**
2) **Wine Producers - Treasury Wine (TWE), Australian Vintage (AVG); and**
3) **3) Hotels - Redcape (RDC).**

FY1 PER multiples for these businesses range from 10x for AVG to 25x for WOW, implying a per-share valuation for Endeavour of ~$4.00 to $9.00.

Exhibit 9: What could Endeavour be worth? There are three scenarios

	Woolworths		Endeavour		
	WOW (today)	WOW (Ex End.)	Low	Medium	High
Market Cap ($Abn)	55.2	39.0	7.3	11.6	16.2
NPAT FY22E ($Abn)	2.1	1.49	0.61	0.61	0.61
PE (x)	26.5	26.2	12	19	26.5
Implied Share price ($A)	43.53	30.78	4.09	6.47	9.03

Source: Company Data, Refinitiv, Wilsons. No assumption of dis-synergies which are around ~3% of Endeavour's earnings.

Offshore examples of pubs business in the UK suggest very little difference in multiples between pubs and supermarkets.

WOW remains one of the most expensive (PER) supermarket businesses in the world. World-leading margins, duopoly like industry structure, and high returns on capital are all reasons cited for the high valuations of Australian supermarkets. European supermarkets trade at ~14-15x, while Walmart (WMT.US) in the US trades on WOW at 25x.

In our view, Endeavour will trade towards the top end of this multiple range, 22-25x or ~$8.00-9.00 per share given the strong distribution footprint but also acknowledging the potential for COVID-19 recovery in earnings.

Endeavour have guided to dividend payout ratio of 70-75%, which implies a dividend yield of around 2.5~ at upper end of valuation range.

Parent or spin-off? Who performs best after demerging

Over the last ten years, demergers have typically seen the spin-off perform more strongly, by around 2x than the parent entity over a 12- and 24-month period. The longer the timeframe from demerging, the stronger the performance differential.

Exhibit 10: Performance of demergers – spin-offs typically outperform

Demerged Company	Mcap ($Abn)	Parent Entity	Mcap ($Abn)	Announced	Effective	Time (Days)	Performance between announced-effective	12mth Performance		24mth Performance	
								Spin-off	Parent	Spin-off	Parent
Macquarie Atlas Roads		Intoll Group	2.8	30-Oct 09	25-Jan-10	87	5%	144%	21%	155%	
DuluxGroup	0.9	Orica	8.8	3-May-10	12-Jul-10	70	11%	7%	11%	36%	17%
Treasury Wines Estates	2.2	Foster's Group	8.8	26-May-10	10-May-11	349	4%	25%	35%	48%	39%
Echo Entertainment	3.0	Tabcorp	2.3	18-Oct-10	6-Jun-11	231	16%	11%	8%	-37%	10%
Trade Me	1.1	Fairfax Media	1.8	26-Aug-11	13-Dec-11	109	2%	35%	-43%	33%	-29%
Shopping Centres Australia	0.8	Woolworths	35.4	5-Oct-12	26-Nov-12	52	-1%	-6%	3%	13%	-4%
News Corp	9.5	Twenty-First Century Fox	24.4	26-Jun-12	19-Jun-13	358	50%	18%	-2%	18%	9%
Recall	1.4	Brambles	13.8	2-Jul-13	10-Dec-13	161	0%	43%	15%	56%	31%
Orora	1.5	Amcor	12.4	1-Aug-13	18-Dec 13	139	9%	63%	27%	94%	41%
Scentre	16.4	Westfield	14.7	4-Dec-13	25-Jun-14	203	12%	25%	30%	69%	60%
South32	10.9	BHP Billiton	96.8	24-Nov-14	18-May-15	175	-2%	-15%	-29%	31%	-16%
Clydesdale Bank	2.6	NAB	70.9	7-May-15	4-Feb-16	273	-2%	3%	9%	19%	3%
Domain	2.1	Fairfax	1.7	22-Feb-17	16-Nov-17	267	33%	-31%	-9%	-17%	20%
Coles	17.0	Wesfarmers	36.2	16-Mar-18	21-Nov-18	250	15%	8%	24%	34%	57%
United Malt Group	1.2	GrainCorp	1.0	4-Apr-19	20-Mar-20	351	-5%	1%	37%		
Deterra Royalities	2.4	Iluka	2.8	20-Feb-20	13-Nov-20	267	0%	-4%	8%		
Endeavour		Woolworths	55	3-Jul-19	1-Jul-21	729					
Simple Average						209	11%	24%	7%	39%	18%

Source: Company Data, Refinitiv, Wilsons.

Our view on the demerger

We are supportive of the merits of the demerger. The separation logic is sound. Endeavour's earnings prospects, different capital needs and return profile, challenge the logic of a combined supermarket and hotel business. Furthermore, increasing ESG concerns within the ranks of WOW investors could result in inferior investment decisions for Endeavour from the WOW board.

The operational synergies of putting a hotel and supermarket under a single structure never made complete sense to us. This was more an outcome than a desire – consequence of acquiring liquor distribution sites/and function local liquor licencing laws.

We do believe in the synergies between a supermarket and a liquor retailer, given a customer can combine those purchases on a single trip.

However, in a world of rising online sales, this synergy is likely diminishing. In any case, the Australian synergy was always less than what was available globally, given liquor could not be sold inside supermarkets. This revenue synergy is not lost with the demerger, with WOW and Endeavour having a shared services agreement.

Woolworths | high quality, but COVID inflated earnings have crept into the multiple

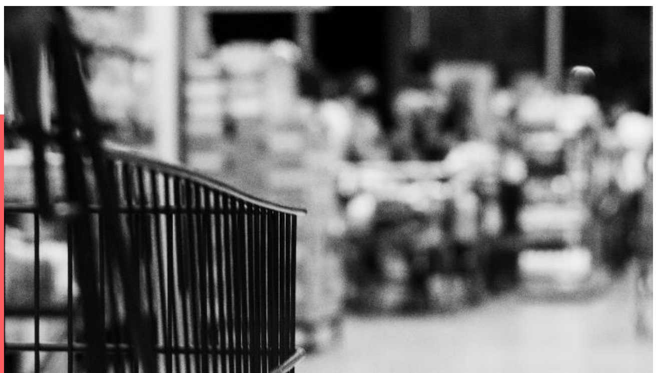
We think WOW now looks relatively expensive, against both its history and the market. WOW is within 2 PER points of an all-time high multiple. Core earnings (EBIT) have boosted by almost $1bn since FY19, a double benefit of no international travel (consumption leakage) and domestic restrictions favouring at-home consumption. High expectations of (franked) capital management, which is likely to be announced in 3QCY21, has helped the share price and likely to support the FY21 Results.

Looking out further, we find it difficult to see how WOW will outperform the market over the next 6-12mths, particularly given both absolute and relative valuations. For that to happen, we need an acceleration of earnings growth and PER multiple expansion. Possible, but not our base case.

Endeavour | potential for earnings to accelerate under focused capital allocation strategy

The Endeavour spin-off to us looks very interesting, with a leading market position, COVID-19 earnings recovery in the Hotels, and management with complete control over capital allocation – set against a backdrop where spin-offs typically perform well.

While not our base case, it would not surprise us to see Endeavour trade on a higher multiple than WOW over FY22E. We also think that Endeavour earnings risks over the medium term could positively surprise relative to the market.



Changes to the Focus List

Adding | Insurance Australia Group (IAG) +3%

IAG is the largest general insurance company in Australia and New Zealand.

IAG has been impacted by a once in a generation bushfire season and a once in a century pandemic that has led to business interruption (BI) and record low interest rates.

We believe that like the banks, IAG has overprovided for the COVID-19 crisis, with a $1.2bn provision. As at Feb 2021, IAG has 500 BI claims, from 76k policies with BI coverage.

Although uncertainty remains on the outcome of current court cases for the insurance industry regarding BI insurance, we believe that BI claims implied in the share price are overstated versus the probable reality.

In the UK, which is more advanced on legal clarification of BI, average claim costs at running ~$A60k (as June 2021). For IAG, the legal standing of BI is likely to be clarified over the next few months and should be a key catalyst.

Premium rates across the insurance industry are growing at the highest rates seen in over 20 years. Recent APRA data on the insurance sector for the March 2021 quarter indicated a strong pickup in premium growth while incurred claims were shrinking.

A recovering economy, coupled with rising rates should also be a supportive backdrop for IAG. As the economy recovers, and growth improves, we should see rising yields, generating higher investment income for companies like IAG.

Removing | Super Retail (SUL) -3%

After a strong period for SUL we have decided to remove the company from the Focus List. We start to move into a period where Like for Like (LFL) sale rates become tougher to maintain (in comparison to a strong period in CY20).

We are also 9-12 months away from when we expect international borders to reopen. When this happens, we expect to see a rotation of wallet spend away from retailers and towards travel. SUL earnings growth will be challenging when this macro headwind occurs.

Increasing | CSL (CSL) +3%

We have lifted our CSL weight by 3% to 7%. CSL's share price has underperformed the market since mid-2020 on concerns that its core blood plasma business would suffer a large earnings hole due to constrained blood collections, particularly in the US. We think the period of underperformance is now behind CSL.

The risks of further blood collection disruptions are falling as vaccinations lift in the US, and COVID-19 unemployment benefits are reduced. Peer blood plasma companies have recently reported higher prices as demand for plasma continues to grow at 7-8%pa, which should also provide earnings offset. Our new 7% weight in the Focus List has CSL overweight relative to market.

Trimming | Macquarie Group (MQG) -3%

We have reduced MQG by 3% to a 3% weighting. MQG has outperformed the market by ~30% since March last year, benefiting from the recovery in both asset markets and activity levels. Multiples have expanded and now around all times highs at 20x PER. MQG PE rel. has also expanded from 0.8 to 1.05x. The long-term is 0.9x. FY22e earnings growth is likely to be subdued given the events in FY21.

While Macquarie's long-term growth prospects continue to appeal, the prospects for such strong outperformance to be maintained has reduced. Our new 3% weight in the Focus List still leaves us fractionally overweight MQG relative to market.

Focus List

Name	Sector	Focus List Weight Old	Focus List Weight New	Classification	EPS CAGR (FY1-FY3)	PE (12mth FWD)	Div Yield (12mth FWD)	ROE (12mth FWD)
Aventus	Real Estate	4.0%	4.0%	Asset Valuation Plays	4%	16.1	5.8%	7.6
News Corporation	Communication Services	3.0%	3.0%	Asset Valuation Plays	27%	46.1	0.7%	5.1
Telstra	Communication Services	4.5%	4.5%	Asset Valuation Plays	8%	25.7	4.8%	11.5
Aristocrat Leisure	Consumer Discretionary	3.5%	3.5%	Cyclical Quality Growth	19%	30.6	1.4%	25.3
Worley	Energy	4.0%	4.0%	Cyclical Quality Growth	39%	29.5	3.7%	5.4
BHP Group	Materials	8.0%	8.0%	Cyclical Quality Growth	-10%	11.5	5.6%	29.5
James Hardie Industries	Materials	3.0%	3.0%	Cyclical Quality Growth	13%	26.8	1.6%	44.0
Macquarie Group	Financials	6.0%	3.0%	Cyclical Quality Growth	7%	18.8	3.7%	13.5
ANZ	Financials	7.0%	7.0%	Cyclical Value	6%	13.8	5.0%	9.9
Insurance Australia Group	Financials	0.0%	3.0%	Cyclical Value	30%	28.5	4.6%	12.0
OZ Minerals Limited	Materials	3.0%	3.0%	Cyclical Value	11%	20.1	1.3%	11.9
NAB	Financials	7.0%	7.0%	Cyclical Value	3%	14.3	4.8%	10.4
Santos Limited	Energy	4.0%	4.0%	Cyclical Value	3%	16.0	1.4%	10.2
Super Retail	Consumer Discretionary	3.0%	0.0%	Cyclical Value	-19%	10.1	4.3%	16.6
Seven Group Holdings	Industrials	4.0%	4.0%	Cyclical Value	10%	14.7	2.5%	14.7
Westpac	Financials	9.0%	9.0%	Cyclical Value	6%	15.1	4.5%	9.4
Northern Star Resources	Materials	3.0%	3.0%	Defensive Growth	37%	22.6	2.1%	22.4
Sydney Airport	Industrials	3.0%	3.0%	Defensive Growth	53%	NULL	2.4%	6.6
Transurban Group	Industrials	4.0%	4.0%	Defensive Growth	18%	NULL	3.9%	6.5
Afterpay	Information Technology	2.0%	2.0%	Secular Growth	131%	NULL	0.0%	4.6
CSL	Health Care	4.0%	7.0%	Secular Growth	11%	45.1	0.8%	26.4
Goodman Group	Real Estate	3.0%	3.0%	Secular Growth	12%	31.3	1.6%	11.4
ResMed	Health Care	2.0%	2.0%	Secular Growth	12%	41.3	0.6%	25.9
Telix Pharmaceuticals	Health Care	2.0%	2.0%	Secular Growth	N/A	N/A	0.0%	N/A
Xero Limited	Information Technology	2.0%	2.0%	Secular Growth	136%	887.4	0.0%	5.2
EML Payments	Information Technology	2.0%	2.0%	Secular Growth	42%	44.1	0.0%	9.9

Source: Company Data, Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures

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