Australian Supermarkets

How low can Australian grocery profits go? Cutting FY17-18 EPS 1-7% & introducing Thesis Map.

Equities

Australia
Retail

Ben Gilbert
Analyst
ben.gilbert@ubs.com
+61-2-9324 2782

Craig Stafford, CFA
Analyst
craig.stafford@ubs.com
+61-2-9324 2277

Apoorv Sehgal
Associate Analyst
apoorv.sehgal@ubs.com
+61-2-9324 2715

How low can Australian grocery profit go?

The Australian grocery market is undergoing structural change; top-line growth is slowing and profits are falling. In this report we introduce Thesis Map to assess: i) How far are we through this structural change; ii) What path the market will take over the next 2-3 years; and iii) What are the earnings implications for MTS, WES and WOW.

Which path will the Australian grocery market follow?

1. Price War (25% probability): Similar to off-shore, all listed retailers lose.
2. Marketing war continues (50%): Soft market growth, clear winners & losers.
3. Converging retailer performance (20%): Coles slows, WW bottoms, IGA steadies.
4. Improving market (5%): Multiple winners, led by a return of food inflation.

3 Key Conclusions:

1. Market growth will remain benign: Price investment will continue at >$400m pa.
2. Clear winners & losers: Small pie for listed players, ex-Aldi mkt will grow 2.5-3.0%.
3. Price war unlikely in 2016: WOW would be the initiator if its strategy does not work.

Reducing forecasts by 1-7% for WOW/WES/MTS

We have cut forecasts by 1-7% for FY17-18 for MTS/WES/WOW to reflect our view that price competition will remain intense (Scenario 2 which assumes c$400m industry price investment pa) but we will not see a price war emerge (Scenario 1). Our new forecasts are 2-11% below sell-side consensus in FY17 but 2-5% ahead of buy-side consensus (See UBS Report). The key risk to our forecasts is a price war which we see as unlikely in 2016. We believe there is however a growing likelihood of a price war in 2017 if WOW fails to gain traction in the turnaround of Australian F&L.

UBS View: Reiterate SELL on WOW and MTS. WES most preferred

We remain negative on the Australian grocery market, but acknowledge that MTS and WOW share prices are factoring a continuation of current trends (pages 18 & 34). This suggests that trends likely need to deteriorate from here for further downside. This would in our view, be driven by a price war, which while not our base case, is becoming increasingly more likely if WW is not able to regain traction. Channel checks to date suggest WW is not regaining momentum, with March quarter LFL likely to be negative.

Figure 1: Earnings changes, price target and rating

	EPS chg.		vs. Consensus		PT		
	FY17e	FY18e	FY17e	FY18e	Was	Is Now	Rating
WOW.au	-5%	-7%	-8%	-14%	20.50	20.00	SELL
WES.au	-1%	-2%	-2%	-2%	41.50	41.50	NEUTRAL
MTS.au	-4%	-5%	-11%	-21%	1.05	1.30	SELL

Source: UBS Estimates, FactSet

UBS Research THESIS MAP | MOST FAVORED | LEAST FAVORED

Wesfarmers

Woolworths
Metcash

PIVOTAL QUESTIONS

Q: Will we see a price war in the Australian grocery market in the next 2-3 years?

Growing risk - no retailer wants a price war. If one occurred it would likely be initiated by WOW, the result of the current strategy proving ineffective. With the above in mind, we expect the competitive backdrop to remain intense, characterised by ongoing structural change. We have cut forecasts for the listed supermarkets by 1-7% to reflect this. In reviewing forecasts we assessed 4-likely paths (Figure 2) the market will follow, with the view one of (or a combination) will play out in the next 2-3 yrs.

Q: Two company specific pivotal questions introduced for MTS, WES and WOW.

For Metcash (page 13), Wesfarmers (page 21) and Woolworths (pages 29).

WHAT'S PRICED IN?

Continuation of current trends: The market is pricing in a continuation of current trends; Coles continues to win (5% of current WES share price attributable to earnings beyond 3yrs), WOW loses share (-15% of current share price) and MTS loses at an accelerating rate (-73% of current share price). We have 3 takeaways from this: i) Market not factoring a price war; ii) Market does not believe MTS (despite recent feedback) or WOW can turn the businesses around in the next 3-yrs; and iii) Industry profitability is expected to remain under pressure, consistent with our UBS Buy-side consensus report.

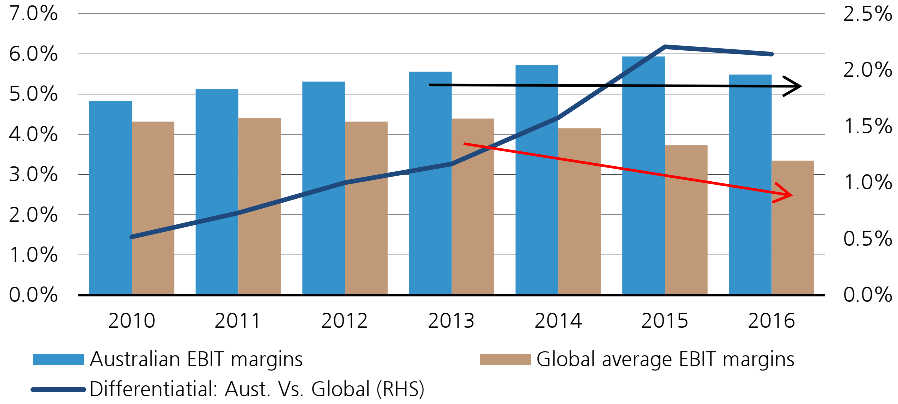
UBS VIEW

Risk weighted to the downside: While a price war is not our base case, the market is challenged, characterised by slowing top-line, ongoing discounting and increased competition. This, in our view, will see retailers needing to invest more for less (falling incremental returns). On balance we continue to see downside risk, with WOW our least preferred name followed by MTS.

EVIDENCE

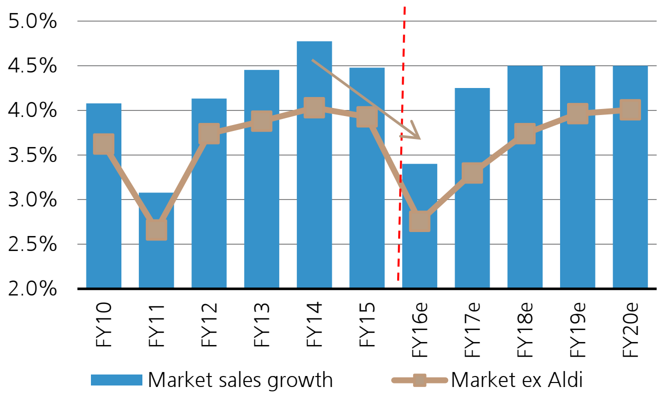
Industry surveys, analysis and discussions: We have drawn on conversations with industry participants, analysed global grocery trends and surveyed suppliers and consumers to draw conclusions on the likely direction the Australian market will go over the next 2-3 years.

Australian Supermarket profitability remains materially above global peers

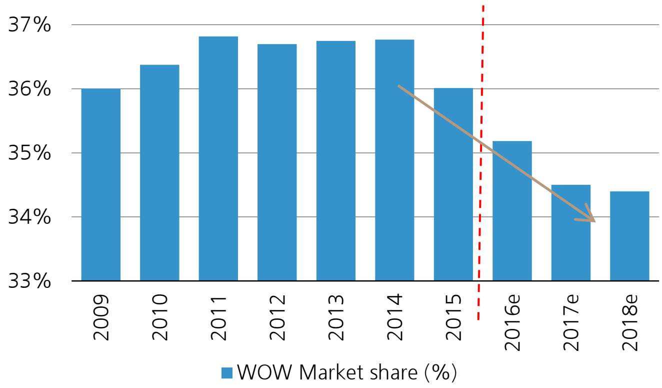


OUR THESIS IN PICTURES

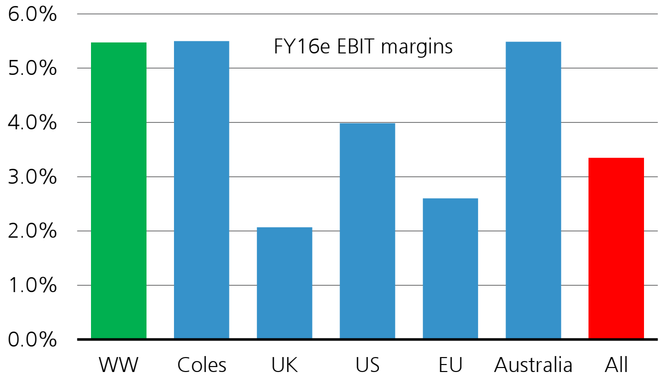
return ↑



Australian market growth has been slowing…



…with the number 1 player (WW) losing share at an accelerating rate…



…yet is still achieving industry leading margins, suggesting there is scope for further re-basing.

The risk is competition increases and we move to level 8-10 on the UBS FMCG Competition Intensity Score…

Grocery Pricing Scenario	Oligopoly	Retailer's Market	Steady Competition	Shopper's Market	Price War
UBS Competition Intensity Score	1-2	3-4	5-6	7-8	9-10
Price leadership	Major leading up	Discounter establishing	A major breaking ranks	Majors begins discounting	All players discounting
Price direction	Robust inflation	Steady inflation	Steady	Steady deflation	Material deflation
Promotional intensity	Selected	Growing	Normal	High	Very high / Irrational
Hard discounters	Not present	Growing	Critical mass	Flexing muscle	Acquiring share
Where are we?	2001-10	2010	2011-13	2014-?	?
EBIT Margins vs. today	Up >200bp	Up >100bp	-50 to +50	-100bp to Flat	Down >200bp

Sources for exhibits above: Company data, ABS, UBS Research

PIVOTAL QUESTIONS

return ↑

Q: Will we see a price war in the Australian grocery market in the next 2-3 years?

UBS VIEW

Unlikely – no retailer wants a price war. If Australia were to experience one it would be initiated by Woolworths, the result of the current strategy not being effective. The above said; we believe the competitive backdrop will remain intense and sector earnings risk is to the downside (Figure 2). The Australian grocery market is only partially through a structural de-base.

EVIDENCE

Global learnings (See UBS report) suggest profitability in Australia is too high, prices need to fall (further) and that discounters will continue to win share. This is consistent with UBS analysis, discussions with industry participants and the retailers' stated strategies. Coles is leading change through its focus on driving the productivity loop (re-investing savings back into price). We expect industry price investment to continue at c$400m pa for FY17-19, driving c30bp of industry deflation per annum.

WHAT'S PRICED IN?

We believe the market is pricing in a continuation of current trends, but not a price war. It assumes WOW remains under pressure (-15% of share price ascribed to future earnings), as does MTS (-73%), whereas Coles continues to win (WES +5%). We attribute 25% probability to a price war, in which case we expect material (>30%) retailer EBIT downgrades (vs. UBSe).

Figure 2: Which path could Australia follow?

			FY17e EBIT vs. UBS			
Scenario	Probability	Market growth	MTS	Coles (WES)	WOW	UBS Comment
1. Price War	25%	2.4%	-57%	-34%	-44%	Coles / WW EBIT margin to c3% vs. Global avg. at c3%
2. Marketing War continues	50%	3.4%	1%	-1%	0%	Market pricing in this scenario for the listed names
3. Trends Stabilise	20%	4.3%	25%	14%	18%	Positive for 'market laggards' and independents
4. Improving Market	5%	5.5%	38%	33%	30%	Inflation returns and mkt growth back to pre-GFC levels
Weighted outcome		3.4%	-7%	-5%	-6%	Downside risk on balance of probabilities

Source: UBS Estimates

What catalysts to look out for:

The signposts to watch in identifying which direction the market will go are 3-fold:

(1) Performance of #1 player: WOW has by its own admission lost its way and needs to regain top-line momentum. If the current plan does not work, we believe WOW will need to be more aggressive, with the obvious lever being price = initiator of price war.

(2) Retailer fresh trends: Fresh is emerging as the key battleground for supermarkets. Winning fresh drives sales, profit and loyalty and is a key differentiator vs. discounters (Aldi). Aldi is however lifting its fresh offer (SKUs, supply-chain and format), which creates a threat to incumbents. A key tipping point in the UK was when discounters lifted share of 'main shops' (led

by fresh participation rates) above 10% in FY14 (to c13%; Source: IGD). Link to UBS Fresh report.

(3) Macro backdrop / New Entrants: A deteriorating macro backdrop increases customer focus on price, driving increased share of sales on promotion and traffic to discounters. This impact would be further exacerbated by a new entrant, Lidl being the most likely. We note when Aldi and Lidl co-locate in markets, traditional grocery EBIT margins are generally 100-200bp lower.

We outline the likely 4 paths the Australian market will follow over the next 2-3 years below:

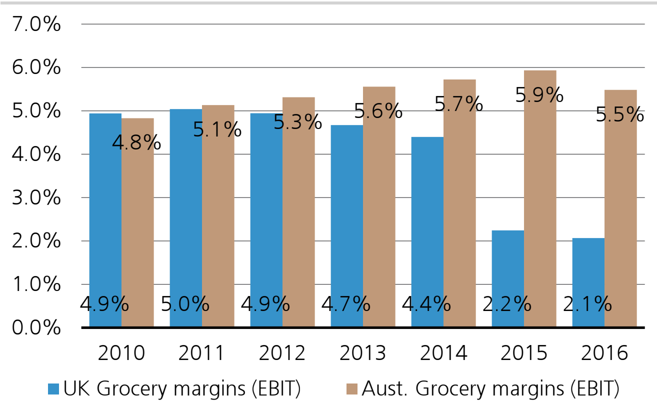
4 paths Australian market could follow in 2016/17:

(1) Price War: Drives 34-57% EBIT downgrades (UBSe Pr. = 25%)

- Definition: Irrational promotional intensity by one (or more) retailers in a bid to win market share and counter the growth of rivals. This investment is matched / exceeded by peers, driving industry profitability lower, at an accelerating rate.

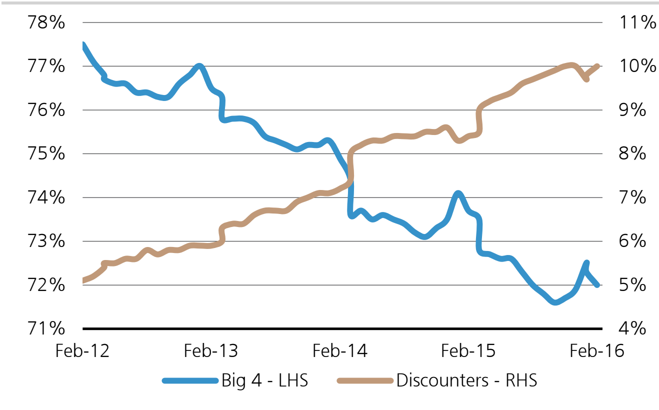
- Evidence = Increasing: Retailer rhetoric around price is increasing, Coles is increasing its investment in EDLP and WW is investing >$700m in price in FY16. Global examples of a 'price war' include the UK, Netherlands and France. Most recently the UK has experienced a material step up in price competition; industry margins have fallen by >200bp (figure 3) and discounter (Aldi, Lidl) share has risen at an accelerating rate (figure 4):

Figure 3: UK Grocery EBIT margins (%)



Source: Company accounts, UBS

Figure 4: UK Grocery market share trends (%)



Source: Kantar, UBS

- Impact = Material: Under a price war we would expect the 3 listed retailers to spend an additional $2b+ on discounts (Hi-Lo, EDLP) in FY17, equivalent to c2% deflation in the grocery market and a material impact to GMs (>200bp).

  This is a worst case outcome, and one we believe all retailers (with the exception of Aldi) are keen to avoid. We outline our assumptions below:

Figure 5: Price War: Sales growth assumptions

	FY17e			
	Low	Mid	High	FY16e
Market Growth	2.1%	2.4%	2.8%	3.4%
Market Growth ex-Aldi	1.0%	1.4%	1.8%	2.8%
Coles	2.9%	3.3%	3.7%	5.4%
Woolworths	0.8%	1.1%	1.5%	1.0%
MTS	-2.9%	-2.5%	-2.2%	-0.7%

Source: ABS, Company reports, UBS Estimates

We estimate the earnings impact to retailers would be material, with margins hit via negative operating leverage and the need to invest (price primarily). We assume retailers would reduce prices on c30% of the range by 10-20%.

Figure 6: Price War: EBIT margins

	FY17e	y/y bp	UBS Comment
Coles	3.2%	-160bp	GM hit c200bp, offsetting c50bp CODB improvement
Woolworths	2.7%	-240bp	Limited cost-out combined with negative operating leverage
MTS	0.8%	-101bp	Impact more muted. Warehouse sales likely to fall >2%

Source: UBS Estimates

- Coles (Wesfarmers): Is best positioned to manage through a price war, albeit as with Asda in the UK would not be immune to its impact. We expect GMs would be hit by c200bp, with CODB margins improving by c50bp as cost-out programs are accelerated. We expect EBIT margins would fall to c3.2% in FY17 vs. current UBSe of 4.7%.

- Woolworths: Would in our view be the (reluctant) initiator, the result of not gaining LFL traction via its current turnaround plan. Given the need to re-invest in the business, we believe the cost-out opportunity would be more limited which coupled with negative operating leverage would see margins nearly halve to c2.7%.

- Metcash: Is worst positioned on face value; however we believe MTS' unwillingness to follow and the cost-out opportunity would mean the impact is more muted. We expect Supa-IGAs would be hardest hit (30-40% volume ex-tobacco), with MTS warehouse sales likely to fall >2%, driving a 100bp decline.

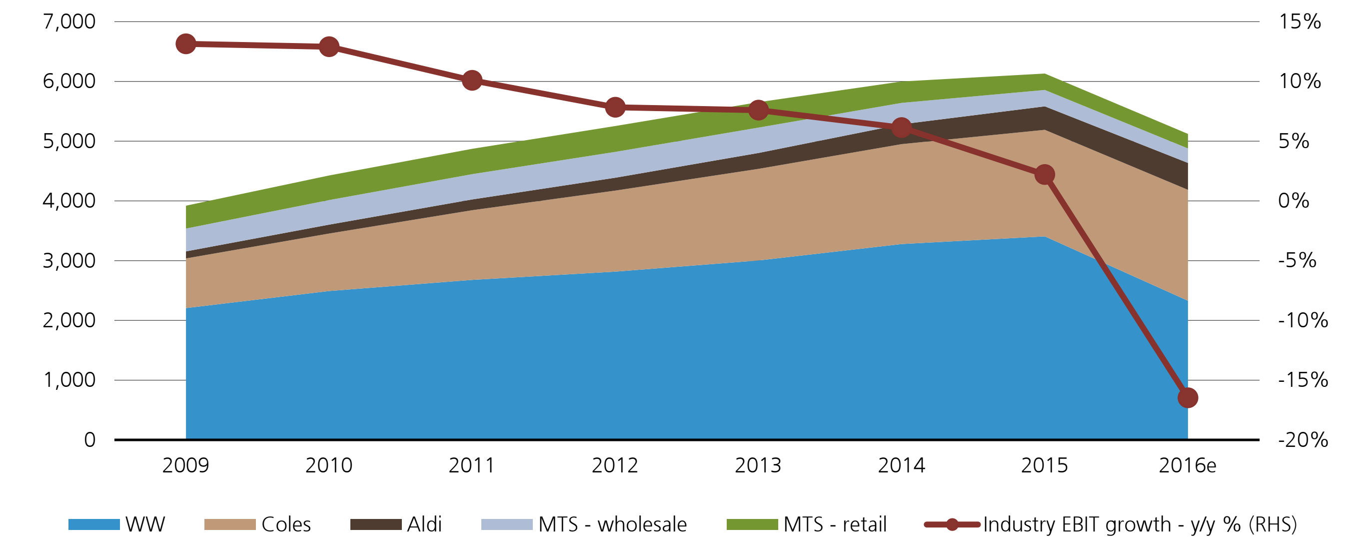
- **UBS View = dependent on WOW turnaround**: For the reason that no listed player wants a price-war (given off-shore experiences), we see it as a less likely outcome, albeit with growing risk. We place a 25% probability on this outcome; the key catalyst would in our view be a lack of traction gained at WW, resulting in the need to invest more, driving a competitive response from peers and ultimately lower industry returns.

(2) 'Marketing war' intensifies: Most likely outcome (UBSe Pr. = 50%)

- Definition: Price investment continues at current rate for the next 3-years ($400m pa), market growth remains benign (3.0-3.8%) and only 2 (of the 4) major players are able to grow above inflation (i.e. negative leverage for 2).

- Evidence = happening: This is the state the market has been in for the past 2-3 years. Coles and Aldi are winning, WW and MTS are losing and price investment growing. The combination of the above has seen slowing top-line growth (deflation, share shift to Aldi) and profit growth across the industry:

Figure 7: Australian FMCG EBIT ($m) trends: Profit growth progressively slowing from 2009…



Source: Company reports, UBS Estimates

- Impact = less material: If the 'marketing war' continues to intensify we would expect the 3 listed retailers to continue spending c$400m pa on price investment (Hi-Lo and EDLP), equivalent to 0.3% deflation in the grocery market and a 30-50bp impact to GMs.

  This is the most likely outcome, and one we believe Coles will continue to drive. We outline our assumptions below:

Figure 8: Marketing War: Sales growth assumptions

	FY17e			
	Low	Mid	High	FY16e
Market Growth	3.0%	3.4%	3.8%	3.4%
Market Growth ex-Aldi	2.0%	2.4%	2.8%	2.8%
Coles	4.0%	4.5%	5.0%	5.4%
Woolworths	1.8%	2.0%	2.3%	1.0%
MTS	-1.6%	-0.6%	0.4%	-0.7%

Source: ABS, Company reports, UBS Estimates

The earnings impact to retailers would be notable, albeit far less than a price war. We believe Coles would be least impacted, followed by MTS and WW.

Figure 9: Marketing War: EBIT margins

	FY17e	y/y bp	UBS Comment
Coles	4.7%	0	Savings reinvested back into business, suggesting flat margins
Woolworths	4.5%	-53	Needs to invest $200m pa to keep up with Coles (UBSe)
MTS	1.8%	2	Unwillingness to invest more + cost-out means impact more muted

Source: UBS Estimates

- Coles (Wesfarmers): Coles have said that any savings across the business will be re-invested back into the customer value proposition (price, service, theatre etc.), suggesting margins will be flat. We estimate this provides a c$140m+ annual pool to invest. Under this scenario we expect Coles' margin to be flat at c4.7% in FY17, in-line with UBSe.

- Woolworths: In our view, the strategy focussed on neutralising price places WW in the position to be hardest hit, because by the time WW neutralise, the competition (Coles) will have taken another step forward. This would require a constant catch-up investment by WW. We estimate WW needs to invest an incremental c$200m in price pa to keep up with Coles; this coupled with expected operating leverage would see FY17 margins fall a further c50bp to 4.5%, in-line with the buy-side (UBS Buy-side consensus report).

- Metcash: Arguably is worst positioned; however we believe MTS' unwillingness to invest more and the cost-out opportunity will mean the impact is more muted. We estimate margins would be flat in FY17.

- **UBS View = most likely:** The most likely outcome, in our view, given this is the path the market is currently taking and allows a progressive closing of the price gap with discounters without a material near-term re-base of margin. We believe it is this scenario the market is pricing in for the listed names.

(3) Trends stabilise (UBSe Pr. = 20%)

- Definition: A cosy oligopoly characterised by: i) Reduced discounting; ii) Converging share trends; and ii) Improving industry profitability. Under this scenario there would be little differentiation, consumers would return to shopping primarily on convenience and share trends would stabilise (i.e. WW accelerate, Coles / Aldi slow). This would be the optimal scenario for the independents.

- Example: There are no examples of this occurring in large developed markets globally, as it essentially requires the market leader(s) to ease-off, allowing the market laggards to regain momentum in a bid to ensure a rational oligopolistic market medium term.

- Impact: We believe the market laggards (WOW, MTS) would benefit most from a more stable environment, as market leaders (Coles, Aldi) would ease back intensity and allow them back into the market.

Figure 10: Trends Stabilise: Sales growth assumptions

	FY17e			
	Low	Mid	High	FY16e
Market Growth	3.8%	4.3%	4.8%	3.4%
Market Growth ex-Aldi	2.8%	3.3%	3.8%	2.8%
Coles	4.4%	5.0%	5.6%	5.4%
Woolworths	2.8%	3.2%	3.6%	1.0%
MTS	-0.8%	0.2%	1.2%	-0.7%

Source: Company reports, UBS Estimates

We estimate the earnings impact to retailers would be favourable. We believe Coles would benefit most, followed by WW and MTS.

Figure 11: Trends Stabilise: EBIT margins

	FY17e	y/y bp	UBS Comment
Coles	5.4%	67	Share growth slows
Woolworths	5.5%	52	Share trends accelerate
MTS	2.2%	45	Regain momentum; consumers shopping on convenience

Source: Company reports, UBS Estimates

- **UBS View:** It is unlikely that the market will stabilise in the next 1-3 years in our view, as this would require Coles surrendering its lead (momentum) and WW regaining share in an orderly fashion, which we see as unlikely. Furthermore Aldi continues to aggressively invest (stores, fresh, marketing) as it looks to win share of main shops which makes this outcome even more unlikely.

(4) Inflation returns and market improves (UBSe Pr. = 5%)

- Definition: Market growth returns to pre-GFC levels (5.5-6.5%) and the retailer is again empowered. This market would be characterised by a return of inflation, elevated population growth (1.6%) and growth in consumption per capita. Major retailers would report growth in-excess of inflation, resulting in margin expansion and accelerating profit growth.

- Example: This type of 'cosy duopoly' has occurred in most major developed markets over the past 15 years and generally results in new competition via a new entrant (discounter). In Australia this was evidenced through FY01-10 when the market recorded c4% sell-item CAGR (inflation), which drove market growth of c6.3% from FY01-10.

  This trend began to reverse in FY11 when inflation eased (c2.1%) and then moved to deflation in FY12 (-0.1%) when Coles began driving market prices lower.

Figure 12: Decade of inflation driven sales growth has come to an end

	FY01-10 CAGR	FY16e	Change
Sell value - Inflation	+4.0%	-2.0%	-6%pt
Market growth	+6.3%	+3.7%	-2.6%pt

Source: ABS, WOW, UBS estimates

- Impact = positive: This scenario would have the largest positive impact on industry earnings, albeit it encourages new entrants (i.e. Costco, Aldi in Australia in the 2000s) given the high top-line, high-return market. We estimate under this scenario market growth would increase to c5.5%, driven primarily by a return to inflation.

Figure 13: Inflation returns: Sales growth assumptions

	FY17e			
	Low	Mid	High	FY16e
Market Growth	5.0%	5.5%	6.0%	3.4%
Market Growth ex-Aldi	4.1%	4.6%	5.2%	2.8%
Coles	6.3%	6.9%	7.6%	5.4%
Woolworths	3.5%	3.9%	4.3%	1.0%
MTS	-1.0%	0.0%	0.9%	-0.7%

Source: ABS, Company reports, UBS Estimates

The earnings impact to retailers would be material, with both top-line and margins to improve. While this would be a positive near-term, it would open the market up to increased competition (i.e. Lidl) in the medium term.

Figure 14: Inflation returns: EBIT margins

	FY17e	y/y bp	UBS Comment
Coles	6.2%	148	Sales growing in excess of inflation, driving margin expansion
Woolworths	6.1%	104	Sales growing in excess of inflation, driving margin expansion
MTS	2.5%	69	

Source: Company reports, UBS Estimates

- **UBS View = least likely:** This is the least likely scenario to play-out, given:

  i) Requires industry participants to collaborate;

  ii) Contrary to stated strategies of all major listed players;

  iii) Consumer would not allow it: The power in the market has shifted to the consumer; a return to consistent annual price increases would see share of discounters accelerate.

What can we learn from overseas?

While our analysis of offshore markets highlights that no single market is the same (See UBS report pages 8-13), there are some consistent themes when the market is disrupted (by incumbents or new discounters):

- Prices adjust: Traditional grocers generally need to lower prices on key lines by 10-20%;
- Margins rebase: The need to rebase prices and invest in differentiation (formats, service and marketing) drives a 100bp+ drop in margin.
- Share prices adversely impacted: Depending on the market, share prices fall materially, only recovering (sometimes only partially) when there are signs of LFL returning.

We summarise the trends of the 4 offshore markets we have previously analysed below:

Figure 15: LFL and Margin impact under various offshore scenarios

	LFL	GM delta	EBIT margin delta	Earnings rebase time horizon
UK	<1%	Unclear	Down >200bp	>3 years
Kroger (US)	<1%	Down c300bp	Down c200bp	>2 years
Safeway (US)	Negative	Down c100bp	Down c500bp	> 2 years
Albert Heijn (Netherlands)	Negative	Unclear	Down c100bp	1-3 years

Source: UBS Estimates

What do we believe will happen?

We believe the existing marketing war is most likely to continue playing out, while the least likely outcome is for inflation returning and market growth rebounding back to pre-GFC levels. On a probability weighted basis, we see downside risk to earnings for the listed names:

Figure 16: Probability weighted outcome

			FY17e EBIT vs. UBS			
Scenario	Probability	Market growth	MTS	Coles (WES)	WOW	UBS Comment
1. Price War	25%	2.4%	-57%	-34%	-44%	Coles / WW EBIT margin to c3% vs. Global avg. at c3%
2. Marketing War continues	50%	3.4%	1%	-1%	0%	Market pricing in this scenario for the listed names
3. Trends Stabilise	20%	4.3%	25%	14%	18%	Positive for 'market laggards' and independents
4. Improving Market	5%	5.5%	38%	33%	30%	Inflation returns and mkt growth back to pre-GFC levels
Weighted outcome		3.4%	-7%	-5%	-6%	Downside risk on balance of probabilities

Source: Company reports, UBS Estimates

Earnings Revisions:

We have made revisions based on our probability weighted expected outcomes:

- **Metcash (MTS.au):** FY17/18 EPS estimates cut 4-5%.
- **Wesfarmers (WES.au):** FY17/18 EPS estimates cut 1-2%.
- **Woolworths (WOW.au):** FY17/18 EPS estimates cut 5-7%.

UBS forecasts sit below Buy-Side (Long-only and Hedge-fund) Consensus:

Figure 17: UBS Buy-side survey results (21-23 March 2016)

	LO	HF	All	UBSe
WW FY17 EBIT margin	4.6%	4.4%	4.5%	4.7%
WW FY20 EBIT margin	4.3%	3.7%	4.0%	4.7%
WW FY20 share	33.5%	32.4%	33.0%	34.2%
Coles FY17 EBIT margin	4.7%	4.5%	4.6%	4.7%
Coles FY20 EBIT margin	4.4%	3.9%	4.2%	4.9%
Coles FY20 share	27.7%	26.4%	27.1%	27.6%
MFG FY17 EBIT margin	1.8%	1.7%	1.8%	1.8%
MFG FY20 EBIT margin	1.4%	1.3%	1.4%	1.5%
MFG FY20 share	13.9%	13.8%	13.9%	13.3%

Source: UBS *LO = Long Only Investor; HF = Hedge Fund Investor

Metcash Limited

Executing better with rate of share loss slowing. LT structural risk remain: SELL unchanged.

Equities

Australia
Food Retailers & Wholesalers

12-month rating	**Sell**
12m price target	**A$1.30**
	Prior: A$1.05
Price	**A$1.74**

RIC: MTS.AX **BBG:** MTS AU

Trading data and key metrics

52-wk range	A$1.82-0.98
Market cap.	A$1.56bn/US$1.19bn
Shares o/s	896m (ORD)
Free float	100%
Avg. daily volume ('000)	5,565
Avg. daily value (m)	A$9.5
Common s/h equity (04/16E)	A$1.35bn
P/BV (04/16E)	1.2x
Net debt / EBITDA (04/16E)	1.1x

EPS (UBS, diluted) (A$)

	From	To	% ch	Cons.
04/16E	0.174	0.174	0	0.189
04/17E	0.167	0.160	-4	0.179
04/18E	0.159	0.150	-5	0.181

Ben Gilbert
Analyst
ben.gilbert@ubs.com
+61-2-9324 2782

Craig Stafford, CFA
Analyst
craig.stafford@ubs.com
+61-2-9324 2277

Apoorv Sehgal
Associate Analyst
apoorv.sehgal@ubs.com
+61-2-9324 2715

Will we see a price war in Australia?

Growing risk – MTS is least likely to initiate a price war and would be hardest hit (Figure 18) given the high level of operating leverage and wholesale model. The above said, recent feedback suggests MTS is executing better and losing share at a slowing rate. While this bodes well for MTS near-term, long-term we believe MTS will lose out from structural change in the industry, creating further earnings risk through FY17/18. The key near-term risk to MTS is an escalation in price intensity in the market.

What will the impact of Aldi's entrance into WA/SA be to MTS?

Material - MTS has the most to lose given its high 25-30% share of SA/WA (vs. East coast c10%). We estimate IGA stands to lose c$87m of sales pa to Aldi, or c1% pa; every 20bp move in EBIT margin (vs. UBSe) = c9% to EPS. However there is an argument that the better offer from the SA/WA IGA/Foodland will mean the rate of share loss is less (vs. East-coast), which we agree with. The key risk is changing consumer shopper habits (more stores, more often) and deflation.

Would a hardware acquisition make sense?

Yes - At the right, we believe price acquiring WOW's Home Timber & Hardware would makes sense given it complements the exiting Mitre 10 business, should be EPS accretive and would drive a valuation re-rate. We estimate a purchase of HTH at 11-13x EBIT would cost MTS $220-325m, with funding most likely via equity raising. Assuming $25m EBIT plus $5m synergies, we estimate the acquisition would be c8% EPS accretive (figure 21) and add c$0.26 / share to valuation (figure 22).

Valuation & Earnings revisions: PT to $1.30; FY17/18 EPS down 4-5%

Our PT has risen materially due to a change in valuation methodology (consistent with WOW) due to adoption of Thesis Map for MTS. We now value MTS using a residual income model. Our EPS has fallen 4-5% to mostly reflect the continuation of the current marketing war (Scenario 2, Figure 18).

Highlights (A$m)	04/13	04/14	04/15	04/16E	04/17E	04/18E	04/19E	04/20E
Revenues	12,977	13,393	13,626	13,478	13,537	13,396	13,347	13,403
EBIT (UBS)	448	394	324	268	248	230	223	221
Net earnings (UBS)	281	234	193	161	149	141	140	143
EPS (UBS, diluted) (A$)	0.325	0.265	0.213	0.174	0.160	0.150	0.145	0.154
DPS (A$)	0.280	0.185	0.065	0.000	0.000	0.080	0.070	0.070
Net (debt) / cash	(759)	(815)	(775)	(349)	(269)	(200)	(123)	(32)

Profitability/valuation	04/13	04/14	04/15	04/16E	04/17E	04/18E	04/19E	04/20E
EBIT margin %	3.4	2.9	2.4	2.0	1.8	1.7	1.7	1.6
ROIC (EBIT) %	19.9	17.1	15.6	15.6	15.1	13.5	12.7	12.3
EV/EBITDA (core) x	7.9	8.3	7.4	6.0	6.0	5.9	5.7	5.5
P/E (UBS, diluted) x	11.4	12.5	10.7	10.0	10.9	11.6	12.0	11.3
Equity FCF (UBS) yield %	7.6	11.4	11.8	2.2	5.2	5.0	6.0	7.0
Net dividend yield %	7.6	5.6	2.8	0.0	0.0	4.6	4.0	4.0

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of A$1.74 on 31 Mar 2016 22:33 EST

UBS Research THESIS MAP a guide to our thinking and what's where in this report

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Will we see a price war in the Australian grocery market in the next 2 years?

Growing risk – No listed retailer wants a price war. We have assessed 4-likely paths and the earnings implications. Our conclusion is earnings risk is weighted to the downside and that Metcash, Woolworths and Coles (in order) are most at risk.

more →

Q: Will Aldi's roll-out into SA/WA have a material impact on earnings over the next 3 years?

Likely. MTS has the most to lose given its high 25-30% share of SA/WA. We estimate IGA stands to lose c$87m of sales pa, or c1% pa; every 20bp move in EBIT margin (vs. UBSe) = c9% to EPS.

more →

Q: Would a hardware acquisition make sense?

Yes, at the right price. We believe an acquisition of WOW's Home Timber & Hardware makes sense given it complements MTS' Mitre 10 business, should be EPS accretive and could see MTS' valuation re-rate.

more →

UBS VIEW

Structurally challenged long term: The turnaround strategy appears sound and is delivering near-term results, however the risks around the long-term sustainability of the MFG business create a high degree of uncertainty. These being: i) Losing share: Which we expect to continue; creating negative leverage; ii) WA/SA impact will be sizeable: We estimate MTS will lose $87m of sales per annum from WA/SA; iii) Cannot afford to invest more: Given the balance sheet is tight and margins are thin.

EVIDENCE

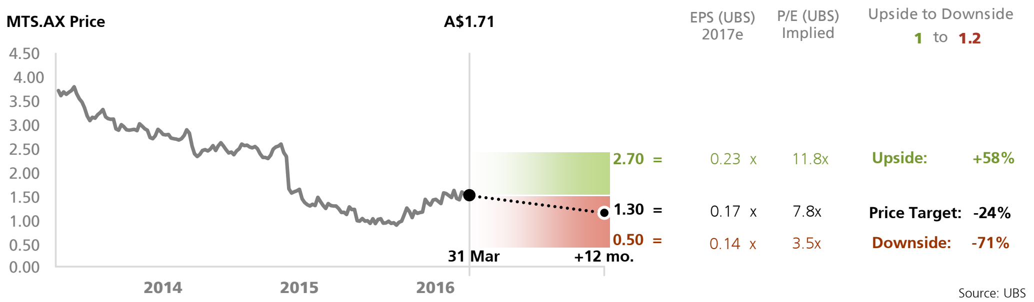
Industry surveys suggest share will fall materially: Recent evidence suggests MTS is executing better and losing share at a reduced rate with LFL sales up 0.6% y/y in 1H16, the best result in 2 years. This was driven by investment (margin fell c60bp to 2.0%) which we view as unsustainable. Looking forward suppliers expect share to fall to c11% and the buy-side to c14% (from c16%), implying 2-25% downside risk to UBS FY20e NPAT.

WHAT'S PRICED IN?

Market not buying the turnaround story, but more confident than 6 months ago: The market is attributing negative 73% of MTS' share price to long-term growth beyond the next 3 years, suggesting it is factoring a material, ongoing decline in earnings.

more →

UPSIDE / DOWNSIDE SPECTRUM



Value drivers	MFG 3yr Sales CAGR	MFG EBIT margin FY19	M10 3yr Sales CAGR	M10 EBIT margin FY19	Asset turn FY19
$2.70 upside	0.0%	2.7%	3.0%	4.1%	4.95x
$1.30 target	-1.4%	1.5%	2.0%	3.1%	4.50x
$0.50 downside	-2.5%	0.9%	1.0%	2.1%	4.05x

more →

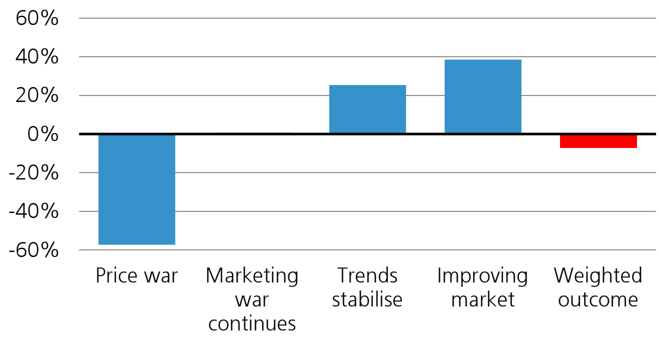
COMPANY DESCRIPTION

Metcash is a marketing and distribution company operating in the food and consumer goods industries. The company operates through 3 divisions: Food & Grocery, Liquor & Hardware.

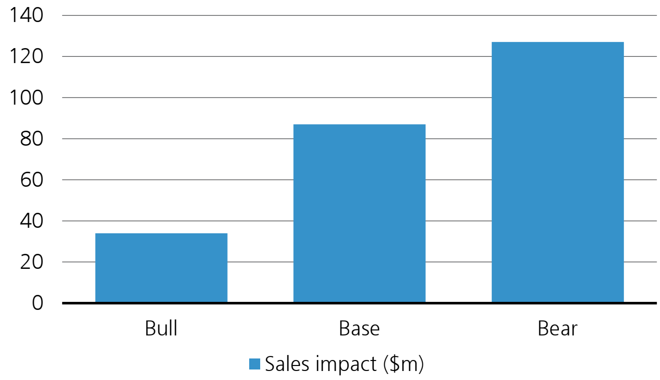
more →

OUR THESIS IN PICTURES

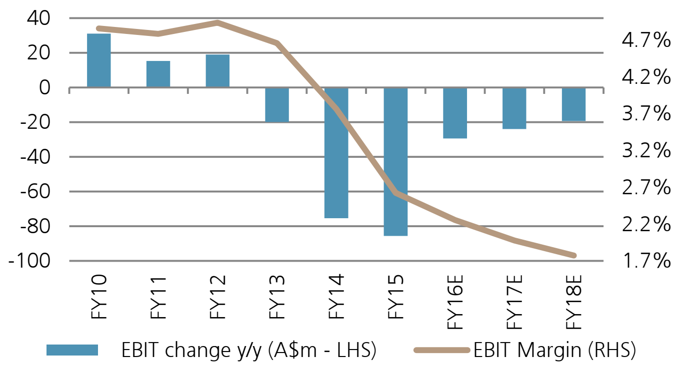
return ↑



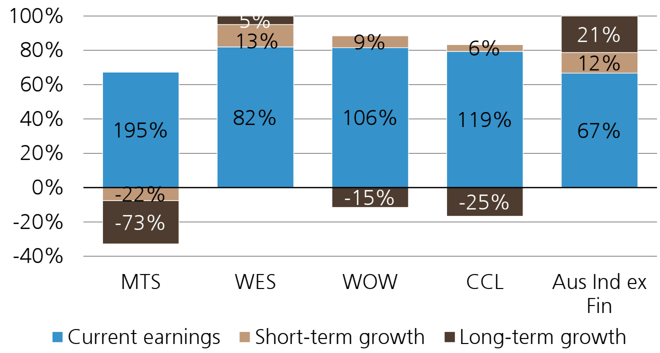
The risk of a price war is growing, with MTS most likely to lose…



…MTS also stands to lose $87m pa (0.9% of sales) from Aldi's entry into SA/WA…



…implying our forecast for a slowing rate of EBIT decline into 2H16 and beyond could prove conservative…



…While the strategy appears sound, the market is not buying MTS' turnaround story.

Sources for exhibits above: Company data, UBS Research, FactSet

PIVOTAL QUESTIONS

return ↑

Q: Will we see a price war in the Australian grocery market in the next 2 years?

UBS VIEW

Growing risk – no retailer wants to initiate a price war. MTS is least likely to initiate a price war and would be hardest hit (Figure 18) given the high level of operating leverage and wholesale model. WOW would be most likely initiate a price war if its current turnaround was unsuccessful. Given recent feedback suggests MTS is executing better (losing share at slowing rate) and Coles LFL has accelerated, this risk is growing (albeit probability still low). Long term, we believe MTS will lose out from structural change in the industry, creating further earnings risk through FY17/18. The key near-term risk to MTS is an escalation in price intensity in the market.

EVIDENCE

Global learnings (See UBS report) suggest that profitability in Australia is too high, prices need to fall further and that discounters will continue to win share. This is consistent with UBS analysis, discussions with industry participants and retailers' stated strategies (Coles) centred on driving the productivity loop (re-investing savings back into price). We expect industry price investment to continue at c$400m pa into the foreseeable future, driving c30bp of deflation per annum.

WHAT'S PRICED IN?

The market is attributing negative 73% of MTS' share price to long-term growth beyond the next 3 years, suggesting a continued decline in earnings at an accelerating rate. This does not reflect a price war; but is not far from it.

Click for full analysis.

Figure 18: Which path could Australia follow?

			FY17e EBIT vs. UBS			
Scenario	Probability	Market growth	MTS	Coles (WES)	WOW	UBS Comment
1. Price War	25%	2.4%	-57%	-34%	-44%	Coles / WW EBIT margin to c3% vs. Global avg. at c3%
2. Marketing War continues	50%	3.4%	1%	-1%	0%	Market pricing in this scenario for the listed names
3. Trends Stabilise	20%	4.3%	25%	14%	18%	Positive for 'market laggards' and independents
4. Improving Market	5%	5.5%	38%	33%	30%	Inflation returns and mkt growth back to pre-GFC levels
Weighted outcome		3.4%	-7%	-5%	-6%	Downside risk on balance of probabilities

Source: UBS Estimates

PIVOTAL QUESTIONS

return ↑

Q: Will Aldi's roll-out into SA/WA have a material impact on earnings over the next 3 years?

UBS VIEW

Yes - MTS Food & Grocery (MFG) has the most to lose from Aldi's roll-out into SA and WA, given its relatively strong position in these markets (c30% share in SA, c25% WA vs. c10% East-Coast). We believe MTS stands to lose c$87m in sales pa medium term, equivalent to c1% of sales, as Aldi rolls out driving industry deflation and changes to consumer shopper habits.

EVIDENCE

We estimate Aldi wins share from IGA at a rate of 1.4-1.6x that of its current share when it enters a new region. However there is an argument for IGA/Foodland stores in SA/WA having a better offer (fresh, theatre, range & execution) than on the east-coast; every 0.1x move in the rate Aldi wins share from IGA = c$6m to sales impact to MFG. Looking forward suppliers (2015 UBS / AFGC Survey) expect share to fall to c11% and the buy-side (2016 buy side survey) to c14% in FY20 (from current c16%), implying 2-25% downside risk to UBS FY20e NPAT.

WHAT'S PRICED IN?

Our Bear scenario sees MFG sales deteriorate a further c0.5% vs. UBSe; given high fixed cost leverage, this combined with a 20bp EBIT margin deterioration (vs. UBSe) would drive c10% EPS deterioration in FY19e (figure 19).

Figure 19: Sales impact to MTS Food & Grocery from Aldi entering SA / WA

MFG (FY16-19 pa)	Bull	Base	Bear
Sales impact ($m)	-34	-87	-127
Sales impact (%)	-0.4%	-0.9%	-1.4%

Source: UBS Estimates

Figure 20: MTS FY19 EPS sensitivity to MFG sales and EBIT margin

FY19		MFG Sales vs. UBSe				
		-1.0%	-0.5%	0.0%	0.5%	1.0%
MFG EBIT margin vs. UBSe	-20	-9.9%	-9.6%	-9.3%	-9.0%	-8.7%
	-10	-5.3%	-5.0%	-4.6%	-4.3%	-4.0%
	0	-0.7%	-0.3%	0.0%	0.3%	0.7%
	10	3.9%	4.3%	4.6%	5.0%	5.4%
	20	8.5%	8.9%	9.3%	9.7%	10.1%

Source: UBS Estimates

PIVOTAL QUESTIONS

return

Q: Would a hardware acquisition make sense?

UBS VIEW

Yes – We believe acquiring Woolworth's Home Timber & Hardware ($21m FY15 EBIT) makes sense for MTS given: i) Synergies: Complements Mitre 10, with synergies from improved buying, marketing and supply-chain; ii) Management expertise: the Mitre 10 team have executed well; and iii) Valuation upside: As hardware is valued at a higher multiple (UBS view) than MTS' grocery business. At the right price, management say they will consider the acquisition.

EVIDENCE

We estimate a purchase of HTH at an 11-13x EBIT multiple would cost MTS $220-325m (figure 20). Funding would most likely be via an equity raising, given MTS has relatively elevated gearing (UBS view) with lease adjusted Net Debt : EBITDAR of 2.3x. Assuming $25m EBIT plus $5m synergies, we estimate the acquisition would be c8% EPS accretive (figure 22) and add c$0.26 / share to valuation (figure 23).

WHAT'S PRICED IN?

Given pressures in Grocery, we estimate the market values MTS' Hardware business (c12x EV/EBIT) at a significantly higher multiple than Grocery (c5x). Therefore expanding Hardware would, in our view, see the Group's valuation re-rate by UBSe c0.4x EV/EBIT (figure 23) or $0.26 per share.

Figure 21: Cost of acquisition sensitivity

		EV / EBIT				
		9x	11x	13x	15x	17x
FY16 EBIT ($m)	15	135	165	195	225	255
	20	180	220	260	300	340
	25	225	275	325	375	425
	30	270	330	390	450	510
	35	315	385	455	525	595

Source: UBS Estimates

Figure 22: FY16 EPS impact sensitivity

		EV / EBIT				
		9x	11x	13x	15x	17x
% Debt funded	0%	9%	9%	8%	8%	8%
	25%	8%	7%	7%	7%	6%
	50%	7%	6%	6%	5%	4%
	75%	6%	5%	4%	3%	2%
	100%	5%	3%	2%	1%	0%

Source: UBS Estimates *assume $25m EBIT

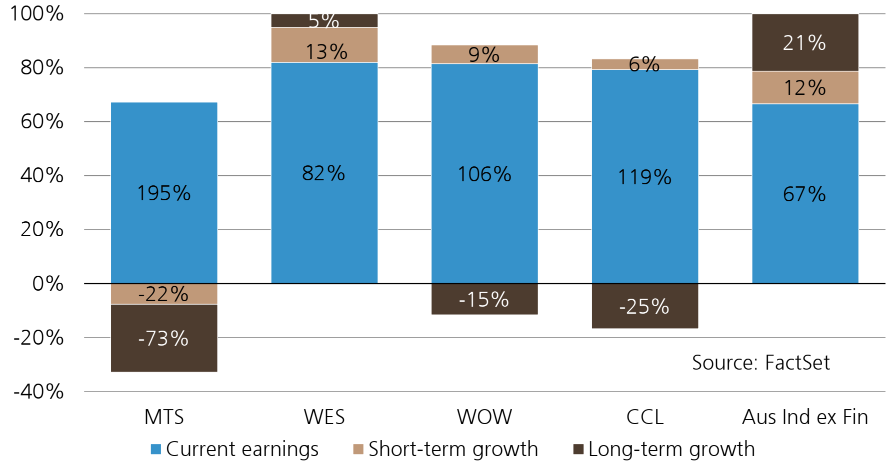
Figure 23: Scenario - MTS SOTP valuation (UBSe for market) after acquisition of WOW HTH and before acquisition (FY16e)

Post-acquisition	EBIT ($m)	Multiple	EV ($m)	Pre-acquisition	EBIT ($m)	Multiple	EV ($m)	Comment
Grocery	184	5.3x	971	Grocery	184	5.3x	971	60% discount to ASX100 Ind-XF
Liquor	59	11.9x	705	Liquor	59	11.9x	705	10% discount to ASX100 Ind-XF
Hardware	63	11.9x	752	Hardware	33	11.9x	395	10% discount to ASX100 Ind-XF
Group	306	7.9x	2429	Group	276	7.5x	2071	Multiple re-rate post acquisition

Source: UBS Estimates

WHAT'S PRICED IN?

return ↑



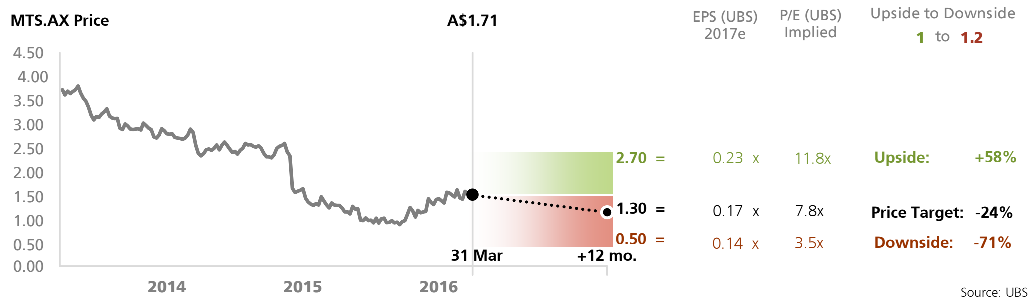
Source: Factset, UBS

Market not pricing in a turnaround

Our residual income analysis suggests the market is attributing -73% of MTS' share price to long-term growth beyond the next 3 years.

UPSIDE / DOWNSIDE SPECTRUM

return ↑



MTS is trading at A$1.71 (as of 31 March).

Value drivers	MFG 3yr Sales CAGR	MFG EBIT margin FY19	M10 3yr Sales CAGR	M10 EBIT margin FY19	Asset turn FY19
$2.70 upside	0.0%	2.7%	3.0%	4.1%	4.95
$1.30 target	-1.4%	1.5%	2.0%	3.1%	4.50
$0.50 downside	-2.5%	0.9%	1.0%	2.1%	4.05

Source: UBS estimates

Risk to the current share price is skewed (1: 1.2) to the downside

MTS is trading at **A$1.71** (as of 31 March 2016).

Upside (A$2.70): Easing of competition.

Base (A$1.30): Share loss accelerates.

Downside (A$0.50): Price war.

COMPANY DESCRIPTION

return ↑

Market Cap	A$1.6b
Shares Outstanding	928m
Industry	Wholesale Distribution
Region	Australia
Website	www.metcash.com

Metcash is a marketing and distribution company operating in the food and consumer goods industries. The company operates through 3 divisions: Food & Grocery (MFG), Liquor & Hardware. MFG division comprises the distribution of dry grocery, perishable and general merchandise supplies to retail outlets. Liquor comprises the distribution of liquor products to retail outlets and hotels. Hardware comprises the distribution of hardware supplies.

Industry outlook

The outlook for the Australian grocery market is deteriorating. We expect market growth of 3.4% y/y through 2016, well below the 20 year average of +6.0%. This reflects increased competitive pressure and an empowered consumer which is in turn putting pressure on industry margins.

Revenues by region (%)

MTS derives >95% of revenue from Australia.

EBIT by product segment

	FY15	FY16e
Grocery	217	184
Liquor	58	59
Hardware	58	33
Total	**332**	**276**

Wesfarmers Limited

Executing well – All factored into the price.

Equities

Australia
Retailers, Broadline

12-month rating	**Neutral**
12m price target	**A$41.50**
Price	**A$41.45**

RIC: WES.AX **BBG:** WES AU

Trading data and key metrics

52-wk range	A$44.97-37.06
Market cap.	A$46.7bn/US$35.7bn
Shares o/s	1,126m (ORD)
Free float	100%
Avg. daily volume ('000)	2,637
Avg. daily value (m)	A$109.2
Common s/h equity (06/16E)	A$24.9bn
P/BV (06/16E)	1.9x
Net debt / EBITDA (06/16E)	1.2x

EPS (UBS, diluted) (A$)

	From	To	% ch	Cons.
06/16E	2.13	2.13	0	2.18
06/17E	2.36	2.33	-1	2.39
06/18E	2.55	2.51	-2	2.60

Ben Gilbert
Analyst
ben.gilbert@ubs.com
+61-2-9324 2782

Craig Stafford, CFA
Analyst
craig.stafford@ubs.com
+61-2-9324 2277

Apoorv Sehgal
Associate Analyst
apoorv.sehgal@ubs.com
+61-2-9324 2715

Will we see a price war in Australia?

Growing risk – We do not believe Coles will initiate a price war, with WOW the only retailer likely to do so, if its turnaround fails to gain traction. In our view Coles is best placed of the listed retailers to manage the structural shift in the industry, given it is driving it. Under 3 of the 4 likely scenarios (Figure 23) we see Coles earnings not at risk. The above said, if Coles continues to win share from WW at an accelerating rate it runs the risk of forcing the #1 player (market share) to do something irrational. We believe UBSe for Coles are ahead of the buy-side for FY17-20.

Can Coles continue to deliver share gains (3-4% LFL) on a 3-5 year view?

We believe Coles will outperform the market and deliver 3-4% LFL growth over FY16-20, driving share up c26bp pa. Coles is well placed to outperform via its market leadership over Woolworths (and IGA) in key areas: EDLP (2,300 SKUs up from 1,900 1H15), fresh and in-store execution (see 19th UBS Supplier Survey). The key will be the extent to which industry pricing remains rational.

How much could Bunnings really be currently worth (Australia + NZ + UK)?

Our base case does not factor in the Bunnings UK/Ireland (via Homebase) opportunity, which presents material upside potential via successful execution. We believe that, on balance, Bunnings management have the capability to execute the UK strategy profitably and ahead of expectations. Under our Bunnings upside scenario, we think Bunnings could be worth $22.8b (vs. base case $17.0b), which could lift WES EV by 10%.

Valuation & Earnings revisions: PT $41.50; FY17/18 EPS estimates down 1-2%

We have moved our EPS estimates modestly to mostly reflect the continuation of the current marketing war (Scenario 2, Figure 18). Our SoTP-derived price target remains $41.50.

Highlights (A$m)	06/13	06/14	06/15	06/16E	06/17E	06/18E	06/19E	06/20E
Revenues	59,832	62,383	62,465	65,005	67,974	71,449	75,656	78,302
EBIT (UBS)	3,696	3,734	3,759	3,689	4,072	4,364	4,750	5,064
Net earnings (UBS)	2,288	2,398	2,440	2,358	2,630	2,831	3,104	3,326
EPS (UBS, diluted) (A$)	1.98	2.09	2.16	2.13	2.33	2.51	2.75	2.95
DPS (A$)	1.80	2.00	2.00	1.98	2.17	2.33	2.56	2.76
Net (debt) / cash	(4,446)	(2,998)	(5,817)	(6,023)	(6,651)	(7,645)	(8,954)	(12,149)
Profitability/valuation	**06/13**	**06/14**	**06/15**	**06/16E**	**06/17E**	**06/18E**	**06/19E**	**06/20E**
EBIT margin %	6.2	6.0	6.0	5.7	6.0	6.1	6.3	6.5
ROIC (EBIT) %	11.0	11.6	11.9	11.2	12.2	12.6	13.2	13.1
EV/EBITDA (core) x	9.8	10.7	10.6	10.6	9.8	9.4	8.7	8.2
P/E (UBS, diluted) x	18.7	20.1	19.9	19.5	17.8	16.5	15.1	14.1
Equity FCF (UBS) yield %	3.7	2.1	3.2	4.2	3.6	3.3	3.1	2.8
Net dividend yield %	4.9	4.8	4.6	4.8	5.2	5.6	6.2	6.7

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of A$41.45 on 31 Mar 2016 22:33 EST

UBS Research THESIS MAP a guide to our thinking and what's where in this report

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Will we see a price war in the Australian grocery market in the next 2 years?

Growing risk – We do not believe Coles will initiate a price war, with WOW the only retailer likely to do so, if its turnaround fails to gain traction. In our view Coles is best placed of the listed retailers to manage the structural shift in the industry, given it is driving it. Under 3 of the 4 likely scenarios (Figure 23) we see Coles earnings not at risk. The above said if Coles continues to win share from WW at an accelerating rate it runs the risk of forcing the #1 player (market share) to do something irrational.

more →

Q: Can Coles continue to deliver share gains (3-4% LFL sales growth) on a 3-5 year view?

Yes - Coles is well-placed to outperform via its market-leading execution. The key will be the extent to which Coles keeps prices rational. We forecast Coles to grow market share at 26bp pa over FY16-20e (vs. 12bp pa over the past 3-years), compared to buy-side consensus for flat growth.

more →

Q: How much could Bunnings really be currently worth (Australia + NZ + UK)?

We are yet to factor the Homebase opportunity into our forecasts. Under our Bunnings upside scenario, we think Bunnings could be worth $22.8b (vs. base case $17.0b), which could lift WES EV by 10%.

more →

UBS VIEW

Good company but fairly priced: WES management leads the market in strategic thinking and approach to taking advantage of structural change across industries, particularly retail. However we believe the company is fairly priced at current levels, given uncertainty over housing (Bunnings), Grocery competition (price war) and Commodities (Resources, Industrials).

EVIDENCE

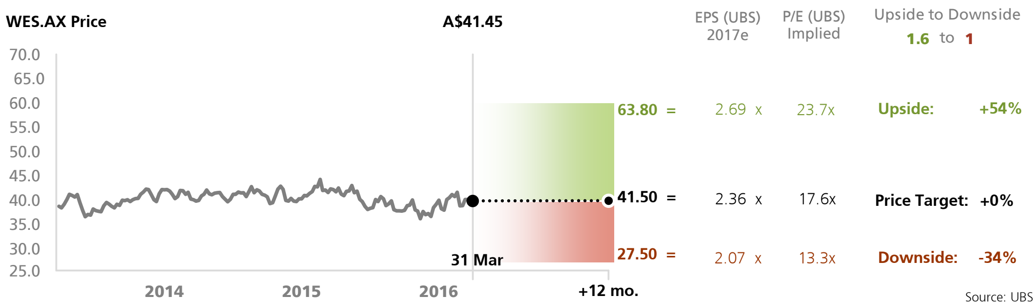
Executing well: Reported results, UBS supplier and shopper surveys and industry channel checks all suggest WES is executing well across the key retail divisions, with this trend to continue into the near-medium term.

WHAT'S PRICED IN?

Market not factoring in a price war: The market is attributing 5% of WES' share price to long-term growth beyond the next 3 years, compared to -15% for WOW and -73% for MTS. This suggests investors are relatively confident in the outlook and are not factoring in a price war.

more →

UPSIDE / DOWNSIDE SPECTRUM



Value drivers	Coles 3yr Sales CAGR	Coles EBIT margin FY19	Bunnings 3yr Sales CAGR	Bunnings EBIT margin FY19	Asset turn FY19
$63.80 upside	6.9%	6.2%	9.0%	11.5%	2.2x
$41.50 target	4.5%	4.7%	8.0%	10.5%	2.0x
$27.50 downside	-0.6%	3.2%	3.0%	9.0%	1.8x

more →

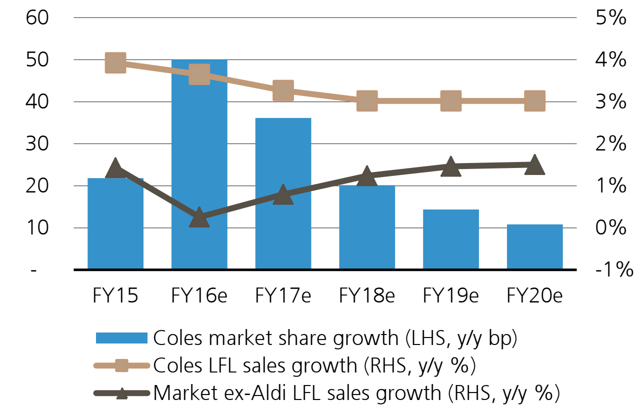
COMPANY DESCRIPTION

WES is the largest conglomerate operating in Australia and NZ. It has 9 divisions, with its biggest two being 1) Food, Liquor & Convenience (Coles), and 2) Home Improvement (Bunnings & Officeworks).

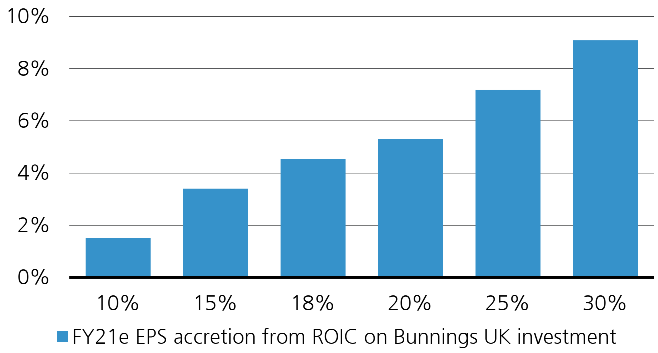
more →

OUR THESIS IN PICTURES

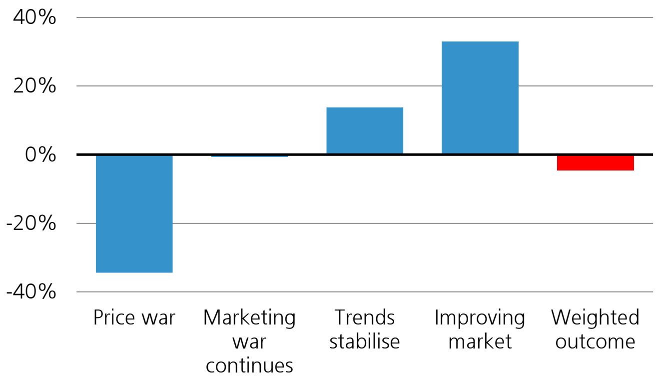
return ↑



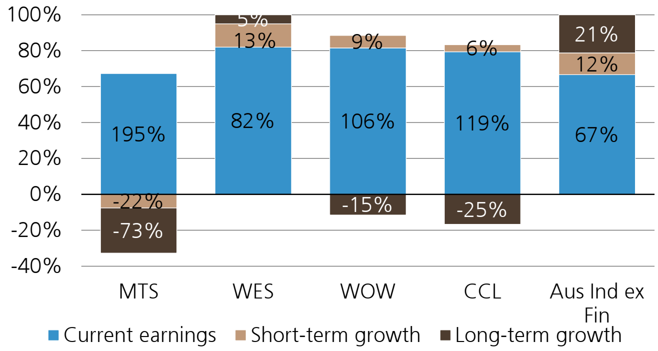
Coles is expected to continue to outperform the market…



…with upside risk from Bunnings UK expansion



…but the key risk to Coles EBIT is a Woolworths-initiated price war



…which is not priced in by the market, with 5% of WES' share price attributable to growth beyond the next 3yrs

Sources for exhibits above: ABS, Company data, UBS Research

PIVOTAL QUESTIONS

return ↑

Q: Will we see a price war in the Australian grocery market in the next 2-3 years?

UBS VIEW

Unlikely – no retailer wants to initiate a price war. In our view Coles is best placed of the listed retailers to manage the structural shift in the industry, given it is driving it. Under 3 of the 4 likely scenarios (Figure 24) we see Coles earnings not at risk. The above said, if Coles continues to win share from WW at an accelerating rate it runs the risk of forcing the #1 player (market share) to do something irrational, albeit we see this probability as low.

EVIDENCE

Global learnings (See UBS report) suggest that profitability in Australia is too high, prices need to continue to fall and that discounters will continue to win share. This is consistent with UBS analysis, discussions with industry participants and retailers' stated strategies (Coles) centred on driving the productivity loop (re-investing savings back into price). We expect industry price investment to continue at c$400m pa into the foreseeable future, driving c30bp of deflation per annum.

WHAT'S PRICED IN?

We believe the market is not pricing in a price-war for Coles (WES) but a continuation of current trends, whereby Coles is able to deliver share gains and maintain margin resulting in mid-high single digit EBIT growth. This is reflected in the residual income model (page 27) whereby 5% of WES' share price attributable to growth beyond the next 3yrs, versus WOW and MTS which are both negative.

Click for full analysis.

Figure 24: Which path could Australia follow?

			FY17e EBIT vs. UBS			
Scenario	Probability	Market growth	MTS	Coles (WES)	WOW	UBS Comment
1. Price War	25%	2.4%	-57%	-34%	-44%	Coles / WW EBIT margin to c3% vs. Global avg. at c3%
2. Marketing War continues	50%	3.4%	1%	-1%	0%	Market pricing in this scenario for the listed names
3. Trends Stabilise	20%	4.3%	25%	14%	18%	Positive for 'market laggards' and independents
4. Improving Market	5%	5.5%	38%	33%	30%	Inflation returns and mkt growth back to pre-GFC levels
Weighted outcome		**3.4%**	**-7%**	**-5%**	**-6%**	**Downside risk on balance of probabilities**

Source: UBS Estimates

PIVOTAL QUESTIONS

return ↑

Q: Can Coles continue to deliver share gains (3-4% LFL sales growth) on a 3-5 year view?

UBS VIEW

Yes. We believe Coles will outperform the market, delivering 3-4% LFL sales growth over FY16-20, driving c26bp pa of share gains. The key, in our view, will be the extent to which Coles keeps prices rational; we believe the catalyst to LFL slowing below 3% would be a Woolworths-initiated price war.

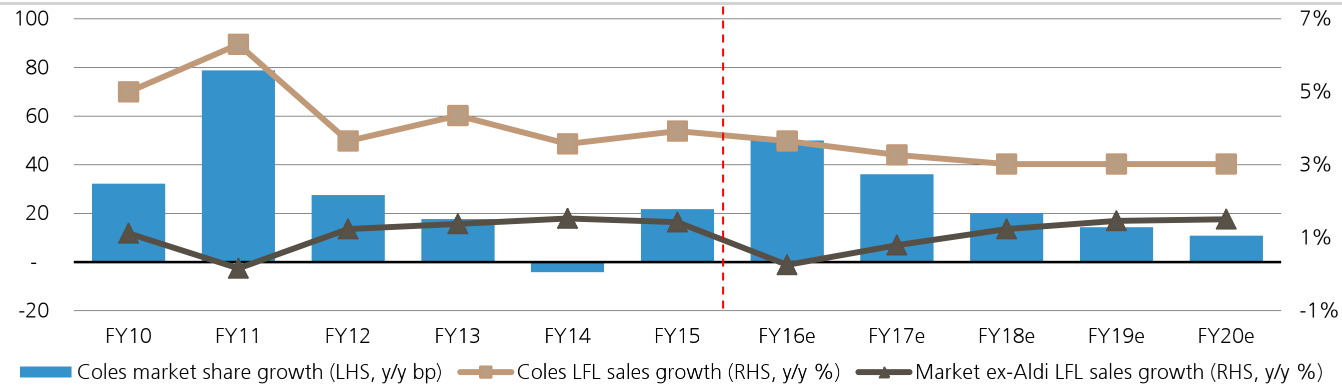
EVIDENCE

Coles LFL accelerated into Q2 (+5%), outperforming in a slowing market. This is underpinned by an industry-leading strategy focussed on a) EDLP: now 2,300 SKUs and expected to increase further, according to suppliers is driving leadership in price perception; b) Fresh: Supplier rate Coles' quality of fresh as superior to WW; and c) In-store execution: Better shelf-availability, compliance and service (see 19th UBS Supplier Survey). Industry feedback suggests this momentum is continuing.

WHAT'S PRICED IN?

We forecast c3% Coles LFL in FY17. Should price intensity in the market step-up and Coles LFL fall to c2% combined with a 50bp EBIT margin decline (fixed cost leverage), WES EPS would fall c5% (vs. UBSe). Buy-side consensus is pricing in flat market share growth (vs. UBSe +26bp pa), implying c2.5% LFL which would drive c2% NPAT downgrade vs. UBS FY20e.

Figure 25: Coles market share and LFL growth vs. Australian Grocery (F&L) Market



Source: WES, Company accounts, ABS, UBS Estimates

Figure 26: WES FY17 EPS Sensitivity to Coles LFL and margin (ex-Convenience)

		Coles FY17 LFL vs. UBSe (%pt)				
		-2.0%	-1.0%	0.0%	1.0%	2.0%
FY17 Coles EBIT margin vs. UBSe	-100	-10.0%	-9.6%	-9.2%	-8.8%	-8.4%
	-50	-5.4%	-5.0%	-4.6%	-4.2%	-3.8%
	0	-0.9%	-0.5%	0.0%	0.5%	0.9%
	50	3.6%	4.1%	4.6%	5.1%	5.6%
	100	8.1%	8.6%	9.2%	9.8%	10.3%

Source: UBS Estimates

PIVOTAL QUESTIONS

return ↑

Q: How much could Bunnings really be currently worth (Australia + NZ + UK)?

UBS VIEW

Upside to WES valuation - Our base case does not factor in Bunnings successfully executing in the UK/Ireland (via Homebase). We believe WES and Bunnings have a high probability of successfully winning profitable share in the UK via the Homebase acquisition. Our rationale is 3-fold: 1) Turnaround opportunity: Industry feedback suggests a) Homebase has been too reliant on Hi-Lo pricing in a market shifting towards EDLP, b) sales densities are low, c) has lower brand power and loyalty than peers, and d) offer stuck in between pure decorator and hardware, focussed too much on female customer; 2) Vulnerable competitor: We understand that B&Q (Kingfisher) does not have deep pockets to step-up price investment against Bunnings; and 3) Sensible management structure: with Peter Davis to head Bunnings UK.

EVIDENCE

Under our base case we value Bunnings at an EV of $17.0b (FY16e EV/EBIT market multiple of c14x), which only factors in Australia & NZ (ANZ). Under an upside scenario, if we assume 10% premium to market multiple for Bunnings ANZ, and assume a market multiple and 25% ROIC in FY21e in the UK (vs. management 5yr target 18%), our total Bunnings EV rises to $22.8b (figure 26), implying 15x EV/EBIT multiple.

WHAT'S PRICED IN?

We have not factored the Homebase opportunity into our forecasts. Under our Bunnings upside scenario above, WES Group valuation (EV) would increase by 10% (figure 27), all else equal. In addition, a 100% Masters store closure could drive a further 1-2% EPS accretion to WES in FY17 (also not in UBSe). Link to Homebase acquisition / Masters closure note.

Figure 27: Bunnings (ANZ + UK) EV ($b) Sensitivity

Bunnings ANZ Premium to Mkt Multiple	ROIC on Bunnings UK investment (FY21e): 10%	15%	20%	25%	30%
30%	23.8	24.6	25.4	26.2	27.0
20%	22.1	22.9	23.7	24.5	25.3
10%	20.4	21.2	22.0	22.8	23.6
0%	18.7	19.5	20.3	21.1	21.9
-10%	17.0	17.8	18.6	19.4	20.2

Source: UBS Estimates Note: UBS base valuation = $17.0b

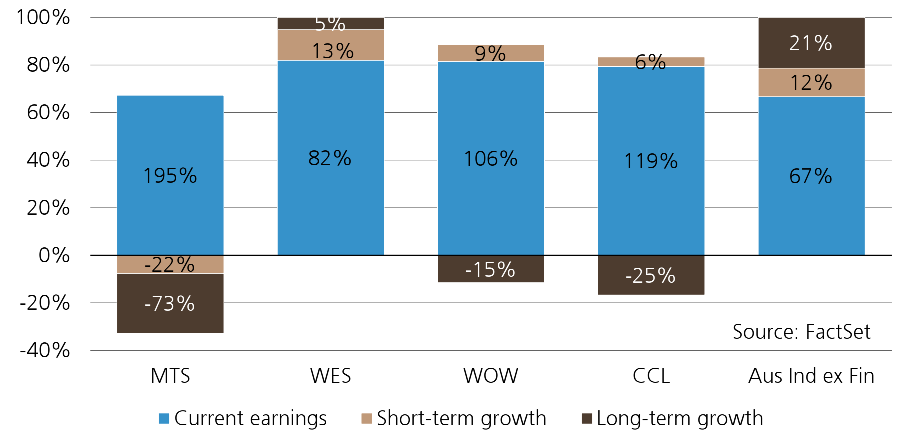
Figure 28: WES Group EV Sensitivity (vs. UBSe)

Bunnings ANZ Premium to Mkt Multiple	ROIC on Bunnings UK investment (FY21e): 10%	15%	20%	25%	30%
30%	12%	14%	15%	17%	18%
20%	9%	11%	12%	14%	15%
10%	6%	8%	9%	11%	12%
0%	3%	4%	6%	7%	9%
-10%	0%	1%	3%	4%	6%

Source: UBS Estimates

WHAT'S PRICED IN?

return



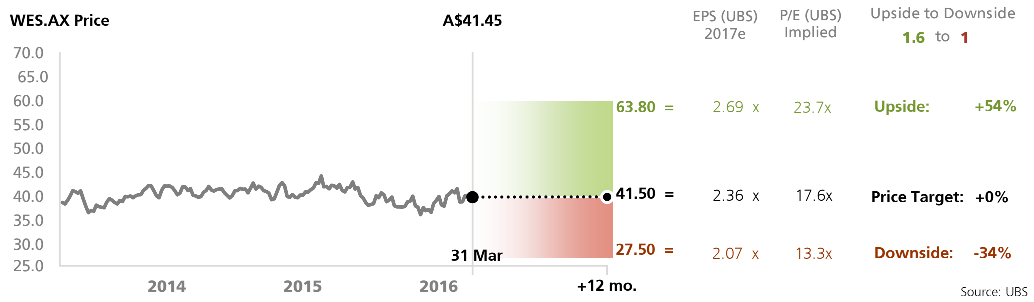
Source: Factset, UBS

Market attributing 5% of share price to long-term growth

The market is more confident in WES' outlook relative to peers WOW and MTS, attributing 5% of the share price to growth beyond the next 3 years. We believe this supports our view that the market is not factoring in a price war.

UPSIDE / DOWNSIDE SPECTRUM

return ↑



WES is trading at A$41.45 (as of 31 March).

Value drivers	Coles 3yr Sales CAGR	Coles EBIT margin FY19	Bunnings 3yr Sales CAGR	Bunnings EBIT margin FY19	Asset turn FY19
$63.80 upside	6.9%	6.2%	9.0%	11.5%	2.2x
$41.50 target	4.5%	4.7%	8.0%	10.5%	2.0x
$27.50 downside	-0.6%	3.2%	3.0%	9.0%	1.8x

Source: UBS estimates

Risk to the current share price is skewed (1.6: 1) to the upside

WES is trading at **A$41.45** (as of 31 March 2016).

Upside (A$63.80): Return to cost-duopoly, Bunnings UK exceeds expectations.

Base (A$41.50): Continuation of current trends.

Downside (A$27.50): Price war in Australian grocery.

COMPANY DESCRIPTION

return ↑

Market Cap	A$47.4b
Shares Outstanding	1.126b
Industry	Conglomerate
Region	Australia
Website	www.wesfarmers.com.au

Wesfarmers is the largest conglomerate operating in Australia and New Zealand. It has nine separate divisions: 1) Resources (coal); 2) Food, Liquor & Convenience (Coles & Bi-Lo supermarkets plus Liquorland, Vintage Cellars & 1st Choice liquor stores); 3) Home Improvement (Bunnings Hardware & Officeworks); 4) Target (discount department store); 5) Kmart (discount department store); 6) Fertilisers & Chemicals; 7) Industrial & Safety distribution; 8) Energy; and 9) Other, including a 50% interest in investment bank Gresham Partners. Wesfarmers acquired Coles Group in November 2007 for $19bn.

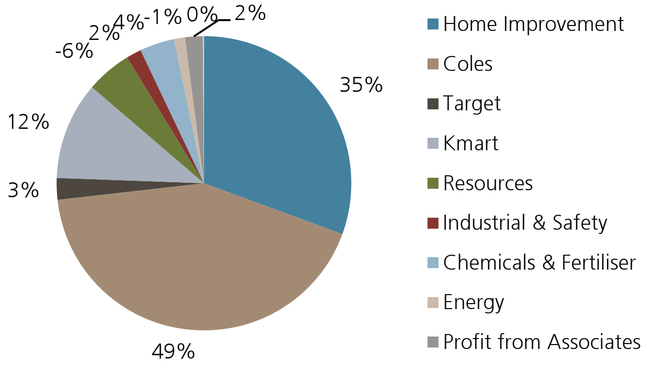
Industry outlook

The outlook for the Australian grocery market is deteriorating. We expect market growth of 3.4% y/y through 2016, well below the 20 year average of +6.0%. This reflects increased competitive pressure and an empowered consumer which is in turn putting pressure on industry margins. We expect the housing market to moderate but remain supportive through 2016.

Revenues by region (%)

WES derives >90% of revenue from Australia.

EBIT by product segment (FY16e)



Key Call: Woolworths Limited

Facing an uphill battle: SELL Unchanged.

Will we see a price war in Australia in the next 2-3years?

Growing risk – No retailer wants a price war. If Australia experienced a price war similar to the UK and Netherlands we believe WOW would be the initiator. Our rational being; Coles and Aldi are winning share and do not want one and MTS cannot afford one. If however WOW is unable to regain momentum in Australian F&L (WW) we expect it would need to invest more, potentially prompting a response from peers, driving prices and margins lower at an accelerating rate. A price war is not our base case, albeit the longer WW remains under pressure, the higher the likelihood becomes.

Can WOW Australian F&L grow share in a slowing market?

Difficult – Recent trading suggests WOW will continue to lose share, with Coles stepping up its intensity, share loss at IGA slowing and Aldi recording double-digit growth. WW continues to lag Coles in key areas: EDLP, fresh, marketing, refurbishments, in-store execution, management calibre and internal culture. LFL is the lifeblood of a retailer, and WW needs to lead (not just improve) in a few areas in order to return to positive LFL momentum. We forecast LFL growth to return positive in Q1 FY17 and improve towards c3% in FY18, although this is not enough to see share rise.

What is the sustainable medium term EBIT margin for Australian F&L?

5% or less - Australia remains one of the most profitable grocery markets globally, suggesting downside risk to WOW EBIT margins, given the need to re-invest over and above peers to regain LFL momentum. In our view WW's margins need to fall further; the question is how far they need to fall to fund the turnaround of Australian F&L (defined as a recovery in LFL sales growth and at least stable market share). We currently forecast a 260bp EBIT margin decline in FY16 to 5.5% (ex-fuel). Every 50bp to EBIT margin (vs. UBSe) drives a c$1.80 impact to UBS' WOW valuation.

Valuation & Earnings revisions: PT to $20.00; FY17/18 EPS estimates cut 5-7%

We have moved our price target and EPS to mostly reflect the continuation of the current marketing war (Scenario 2, Figure 18). We now value WOW using a residual income model.

Equities

Australia
Retailers, Broadline

12-month rating	**Sell**
12m price target	**A$20.00**
	Prior: A$20.50
Price	**A$22.10**

RIC: WOW.AX **BBG:** WOW AU

Trading data and key metrics

52-wk range	A$29.80-21.87
Market cap.	A$28.1bn/US$21.5bn
Shares o/s	1,271m (ORD)
Free float	100%
Avg. daily volume ('000)	3,697
Avg. daily value (m)	A$84.9
Common s/h equity (06/16E)	A$7.41bn
P/BV (06/16E)	3.8x
Net debt / EBITDA (06/16E)	1.1x

EPS (UBS, diluted) (A$)

	From	To	% ch	Cons.
06/16E	1.38	1.38	0	1.37
06/17E	1.38	1.31	-5	1.42
06/18E	1.39	1.29	-7	1.45

Ben Gilbert
Analyst
ben.gilbert@ubs.com
+61-2-9324 2782

Craig Stafford, CFA
Analyst
craig.stafford@ubs.com
+61-2-9324 2277

Apoorv Sehgal
Associate Analyst
apoorv.sehgal@ubs.com
+61-2-9324 2715

Highlights (A$m)	06/13	06/14	06/15	06/16E	06/17E	06/18E	06/19E	06/20E
Revenues	58,674	60,952	60,869	59,326	58,567	61,009	64,739	66,197
EBIT (UBS)	3,653	3,775	3,748	2,702	2,670	2,637	2,826	2,917
Net earnings (UBS)	2,354	2,452	2,453	1,709	1,687	1,666	1,800	1,865
EPS (UBS, diluted) (A$)	1.89	1.96	1.95	1.38	1.31	1.29	1.40	1.45
DPS (A$)	1.33	1.37	1.39	0.92	0.89	0.87	0.94	0.96
Net (debt) / cash	(3,603)	(3,433)	(3,391)	(4,162)	(4,128)	(4,065)	(3,781)	(3,548)

Profitability/valuation	06/13	06/14	06/15	06/16E	06/17E	06/18E	06/19E	06/20E
EBIT margin %	6.2	6.2	6.2	4.6	4.6	4.3	4.4	4.4
ROIC (EBIT) %	28.9	28.1	26.3	20.5	21.9	20.5	21.0	20.9
EV/EBITDA (core) x	9.1	9.8	9.2	8.5	9.2	9.1	8.5	8.1
P/E (UBS, diluted) x	16.4	17.8	16.4	16.0	16.9	17.1	15.8	15.3
Equity FCF (UBS) yield %	2.1	3.6	2.9	3.0	3.8	3.7	4.6	4.7
Net dividend yield %	4.3	3.9	4.3	4.2	4.0	3.9	4.3	4.3

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of A$22.10 on 31 Mar 2016 22:33 EST

UBS Research THESIS MAP a guide to our thinking and what's where in this report

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Will we see a price war in the Australian grocery market in the next 2 years?

Growing risk - No listed retailer wants a price war. We have assessed the 4-likely paths the market will follow. Our conclusion is sector earnings risk is weighted to the downside.

more →

Q: Can WOW Australian F&L maintain share in slowing market?

Unlikely. Recent trading suggests WOW will continue to lose share, with Coles stepping up intensity, share loss at IGA slowing and double-digit growth at Aldi. WW continues to lag Coles in execution.

more →

Q: What is the sustainable medium term EBIT margin for Australian F&L?

5% or less. Australia remains one of the most profitable grocery markets globally, suggesting downside risk to WOW EBIT margins given the need to re-invest to regain LFL momentum.

more →

UBS VIEW

Great company, but turnaround will cost more and take longer: We believe the risk of further earnings and share price downside is high, particularly if WOW is not able to show signs of improvement (e.g. stabilising LFL and market share) in 2H16.

EVIDENCE

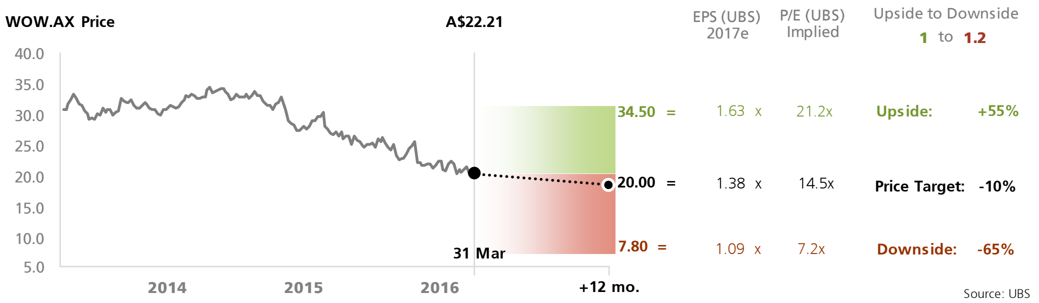
Scenario analysis suggests more valuation downside than upside. We have met with various industry participants, studied offshore markets and analysed various LFL and margin scenarios for WOW over the medium term. On a probability-weighted basis we see downside risk to our LFL and EBIT margin forecasts for Australian F&L, the key share price driver.

WHAT'S PRICED IN?

Continuation of current trends: The share price and consensus earnings tell us 2 different things. The share price implies a continuation of current trends with share and margins to remain under pressure (page 34). In contrast consensus (Sell-side) expects WW EBIT margins (including fuel) to re-base over FY16-18e to 4.5-5.0% (vs. FY15 c8.1%) before improving beyond FY18 driven by a return to positive LFL and market share gains. We estimate -15% of WOW's share price factors in future growth vs. c21% for the Industrials average.

more →

UPSIDE / DOWNSIDE SPECTRUM



Value drivers	Aust. F&L 3yr Sales CAGR	Aust. F&L EBIT margin FY19	Asset turn in FY19
$34.50 upside	+5.0%	6.1%	4.40x
$20.00 target	+3.2%	4.6%	4.00x
$7.80 downside	+1.1%	2.7%	3.60x

more →

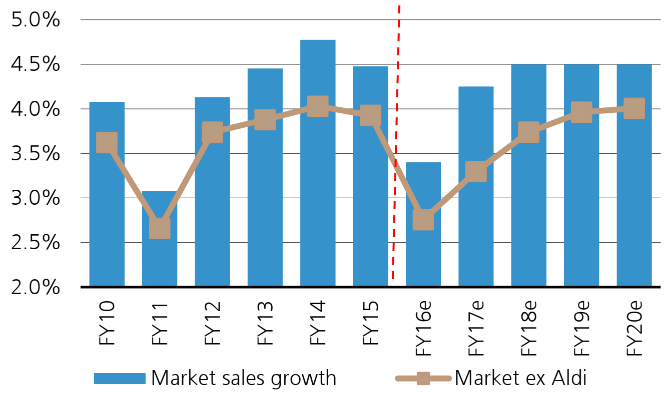
COMPANY DESCRIPTION

Woolworths (WOW) is Australia's largest grocery retailer with c40% market share. The Aust. food & liquor business contributes >80% of WOW's total earnings and includes supermarkets.

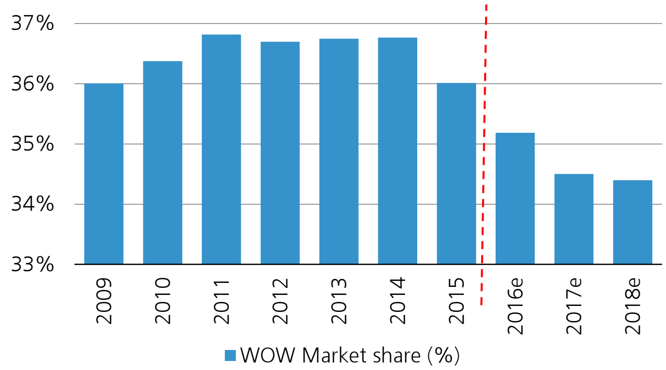
more →

OUR THESIS IN PICTURES

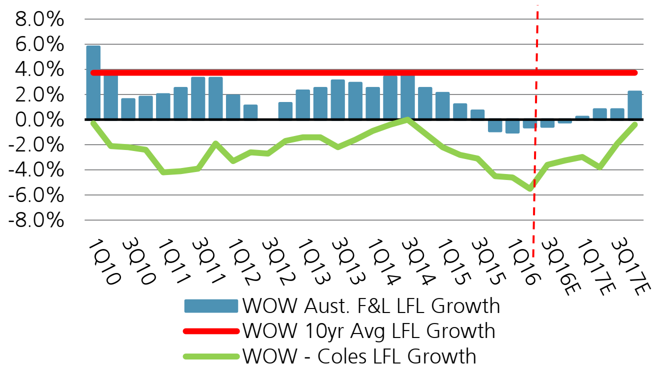
return ↑



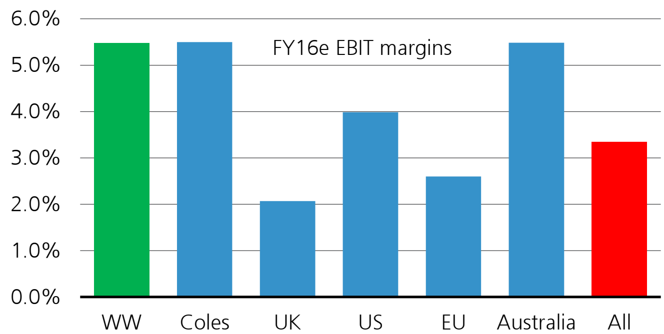
Australian grocery market growth is slowing…



…with WW losing share at an accelerating rate…



…and recording its first quarter of negative LFL sales in >60 quarters, with UBS forecasting a 2H17 recovery…



… while still achieving global leading EBIT margins (FY16e), suggesting the need to re-base further is growing.

Sources for exhibits above: ABS, Company data, UBS Research

PIVOTAL QUESTIONS

return ↑

Q: Will we see a price war in the Australian grocery market in the next 2-years?

UBS VIEW

Growing risk – no retailer wants to initiate a price war. If Australia were to experience one it would be initiated by Woolworths, the result of the current strategy not being effective. We believe the chance of a price war increases the longer it takes WW to turn the business around. Having assessed the 4 likely paths the Australian market will follow (Figure 28) we conclude that earnings risk remains weighted to the downside.

EVIDENCE

Global learnings (See UBS report) suggest that profitability in Australia is too high, prices need to continue to fall and that discounters will continue to win share. This is consistent with UBS analysis, discussions with industry participants and retailers' stated strategies (Coles) centred on driving the productivity loop (re-investing savings back into price). We expect industry price investment to continue at c$400m pa into the foreseeable future, driving c30bp of deflation per annum.

WHAT'S PRICED IN?

Underperformance of the share price and the negative value ascribed to long term growth (page 34) suggest the market expects sales and margin to contract further, particularly relative to WES. We believe the market is factoring in a continuation of current trends, but not a price war.

Click for full analysis.

Figure 29: Which path could Australia follow?

			FY17e EBIT vs. UBS			
Scenario	Probability	Market growth	MTS	Coles (WES)	WOW	UBS Comment
1. Price War	25%	2.4%	-57%	-34%	-44%	Coles / WW EBIT margin to c3% vs. Global avg. at c3%
2. Marketing War continues	50%	3.4%	1%	-1%	0%	Market pricing in this scenario for the listed names
3. Trends Stabilise	20%	4.3%	25%	14%	18%	Positive for 'market laggards' and independents
4. Improving Market	5%	5.5%	38%	33%	30%	Inflation returns and mkt growth back to pre-GFC levels
Weighted outcome		**3.4%**	**-7%**	**-5%**	**-6%**	**Downside risk on balance of probabilities**

Source: UBS Estimates

PIVOTAL QUESTIONS

return ↑

Q: Can WOW Australian F&L maintain share in slowing market?

UBS VIEW

Unlikely. Recent trading suggests WOW will continue to lose share, with Coles stepping up its intensity, share loss at IGA slowing and Aldi continues to record double-digit growth. Poor execution and a slowing market underpin our -0.4% LFL forecast over 2H16, before improving to c1% into FY17 and c3% in FY18. We believe WW management aims to grow LFL at >2% pa.

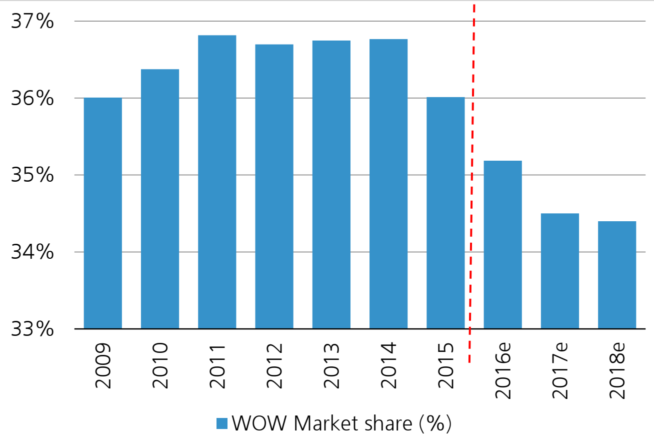
EVIDENCE

Our analysis and industry discussions suggest Woolworths will underperform through FY16/17 as it continues to lag Coles in key areas: EDLP, fresh, marketing, refurbishments, in-store execution, management calibre and culture (see 19th UBS Supplier Survey). LFL is the lifeblood of a retailer, and WW needs to lead in a few areas in order to return to positive LFL momentum.

WHAT'S PRICED IN?

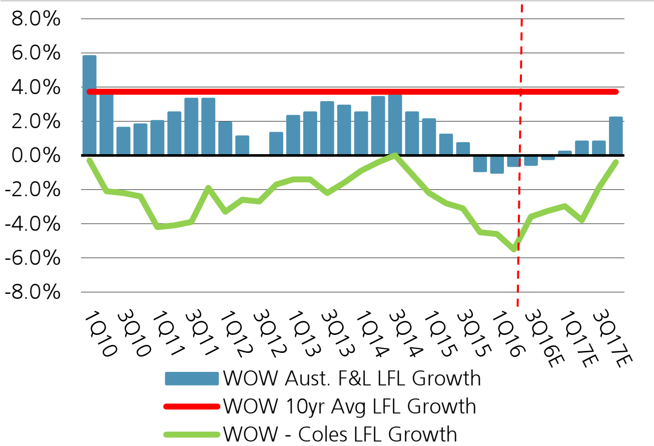
We expect share loss to continue through to FY18 before stabilising into FY19 and beyond. This assumes that the turnaround is successful, but takes 2-3 years to show signs of improvement. We note buy-side (Link to buy-side consensus report) expects share loss, as does the share price (page 36).

Figure 30: Woolworths (Aust. F&L) market share



Source: WOW, UBS Estimates

Figure 31: Woolworths vs. Coles LFL sales growth



Source: WOW, WES, UBS Estimates

PIVOTAL QUESTIONS

return ↑

Q: What is the sustainable medium term EBIT margin for Australian F&L?

UBS VIEW

5% or less – Australia remains one of the most profitable grocery markets globally, suggesting downside risk to WOW EBIT margins, particularly in the event of a price war. In our view WW's margins need to fall further; the question is how far to fund the turnaround of Australian F&L (defined as a recovery in LFL sales growth and at least stable market share). Over the past 10 years WW has grown EBIT margins by ~350bp, equivalent to a ~35bp lift pa. For FY16e, WW EBIT margins will be c5.5% (ex-fuel), ~220bp above the global average.

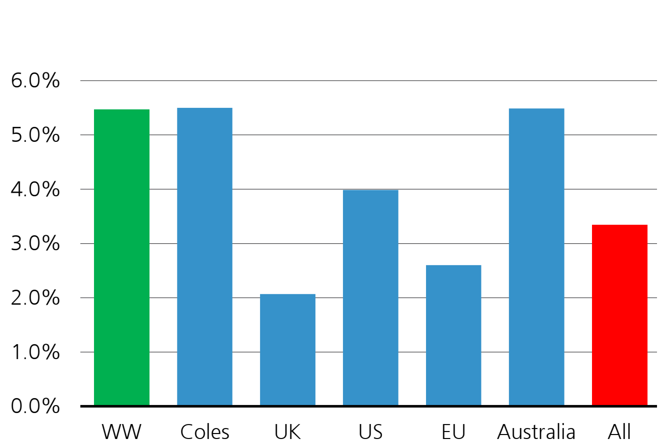
EVIDENCE

Margins are falling, reflecting 1) Need to re-invest in price: To improve price position in the market and better compete against the discounters, 2) Need to re-invest in service: Customer service has deteriorated and staff are being put back into stores; and 3) Focus on the customer: Via a quality fresh offer, every day value (EDLP) and availability of products.

WHAT'S PRICED IN?

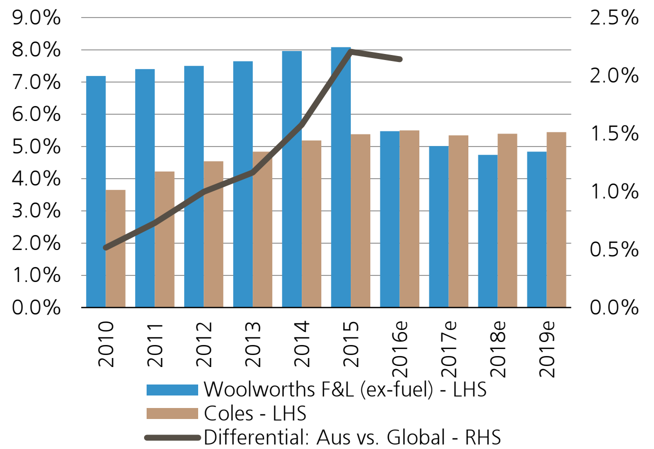
We currently forecast a 260bp EBIT margin decline in FY16 to 5.5% (ex-fuel). Every 50bp to EBIT margin (vs. UBSe) drives c$1.80 to WOW's share price.

Figure 32: WW (FY16e) EBIT margin vs. Global (2015)



Source: Company accounts, UBS Estimates

Figure 33: EBIT margins: WW & Coles vs. Global avg



Source: Company accounts, UBS Estimates

Figure 34: WOW share price sensitivity to PE and EBIT margin (vs. UBSe)

FY16 Aust. F&L EBIT margin vs. UBSe	WOW FY16 PE 14.0	15.0	16.0	17.0	18.0
-200	$12.82	$13.74	$14.65	$15.57	$16.49
-150	$14.52	$15.55	$16.59	$17.63	$18.66
-100	$16.21	$17.37	$18.53	$19.68	$20.84
-50	$17.90	$19.18	$20.46	$21.74	$23.02
0	$19.60	$21.00	$22.40	$23.80	$25.20
50	$21.29	$22.81	$24.33	$25.85	$27.37

Source: UBS Estimates

WHAT'S PRICED IN?

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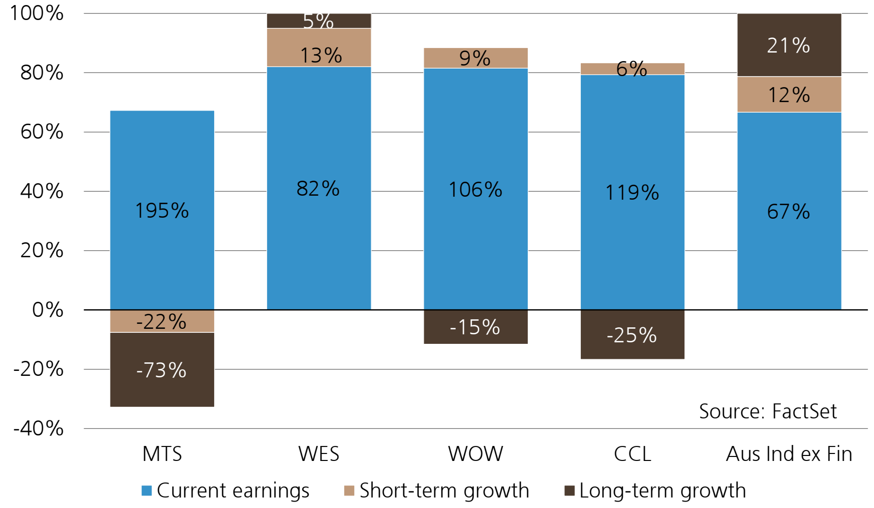

Source: Factset, UBS

Marketing attributing -15% of share price to long-term growth

Our residual income analysis suggests that -15% of the current share price is attributable to earnings beyond the next 3 years.

UPSIDE / DOWNSIDE SPECTRUM

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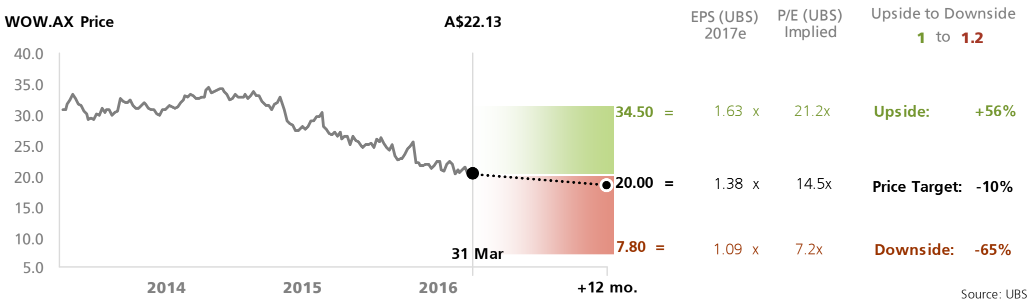

WOW is trading at A$22.13 (as of 31 March)

Value drivers	Aust. F&L 3yr Sales CAGR	Aust. F&L EBIT margin FY19	Asset turn in FY19
$34.50 upside	+5.0%	6.1%	4.40x
$20.00 target	+3.2%	4.6%	4.00x
$7.80 downside	+1.1%	2.7%	3.60x

Source: UBS estimates

Risk to the current share price is skewed (1: 1.2) to the downside

WOW is trading at **A$22.13** (as of 31 March 2016).

Upside (A$34.50): Return to cost-duopoly in Australia.

Base (A$20.00): Continuation of current trends.

Downside (A$7.80): Price war.

COMPANY DESCRIPTION

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Market Cap	$28.5
Shares Outstanding	1.27b
Industry	Consumer Staples
Region	Australia
Website	www.woolworths.com.au

Woolworths (WOW) is Australia's largest grocery retailer with c40% market share. The Aust. food & liquor business contributes 82% of WOW's total earnings and includes supermarkets, and the Woolworths, BWS and Dan Murphy's liquor stores. Big W provides c3% of total earnings, Hotels c8% and New Zealand supermarkets c11%. WOW entered the hardware market via the acquisition of Danks in 2011, but is now unwinding the business.

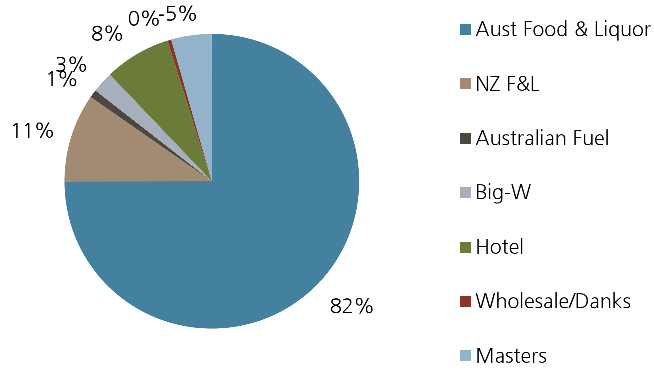
Industry outlook

The outlook for the Australian retail market is on balance positive. Within the retail space we view supermarkets as least attractive, given increased competition, rising costs and changing consumer habits putting pressure on prices. We expect the market to grow at 3.4% y/y over the next 12 months.

Revenues by region (%)

WOW derives c90% of its revenue from Australia, with the residual from NZ.

EBIT by product segment (FY16e)



Valuation Method and Risk Statement

We value WOW and MTS using a residual income model, and WES using SOTP.

The consumer stocks are exposed to the general level of economic growth in Australia and New Zealand. The main drivers of consumer spending are disposable household income, employment growth and interest rates.

Required Disclosures

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12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	48%	36%
Neutral	FSR is between -6% and 6% of the MRA.	39%	28%
Sell	FSR is > 6% below the MRA.	12%	22%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 December 2015.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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UBS Securities Australia Ltd: Ben Gilbert; Craig Stafford, CFA; Apoorv Sehgal.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Metcash Limited[12, 13]	MTS.AX	Sell	N/A	A$1.74	31 Mar 2016
Wesfarmers Limited	WES.AX	Neutral	N/A	A$41.45	31 Mar 2016
Woolworths Limited[4, 13]	WOW.AX	Sell	N/A	A$22.10	31 Mar 2016

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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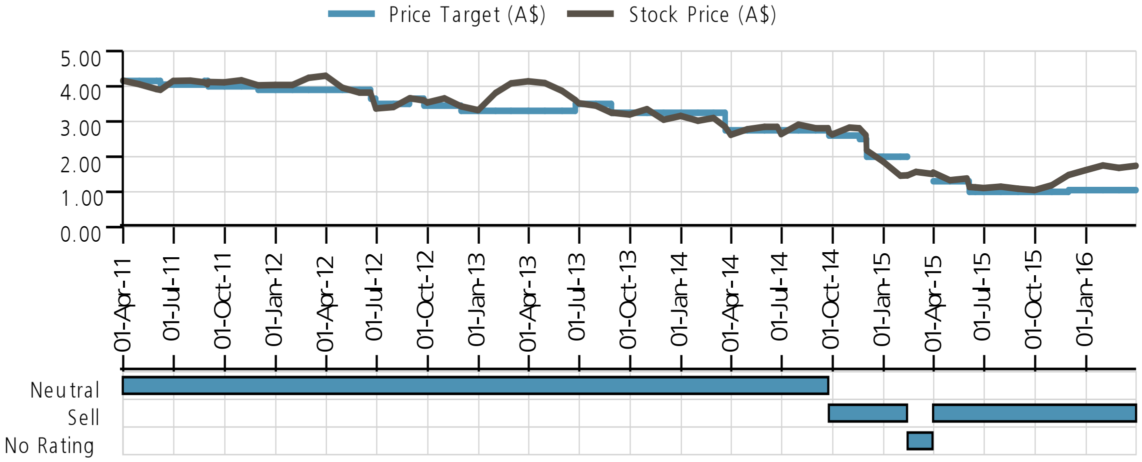
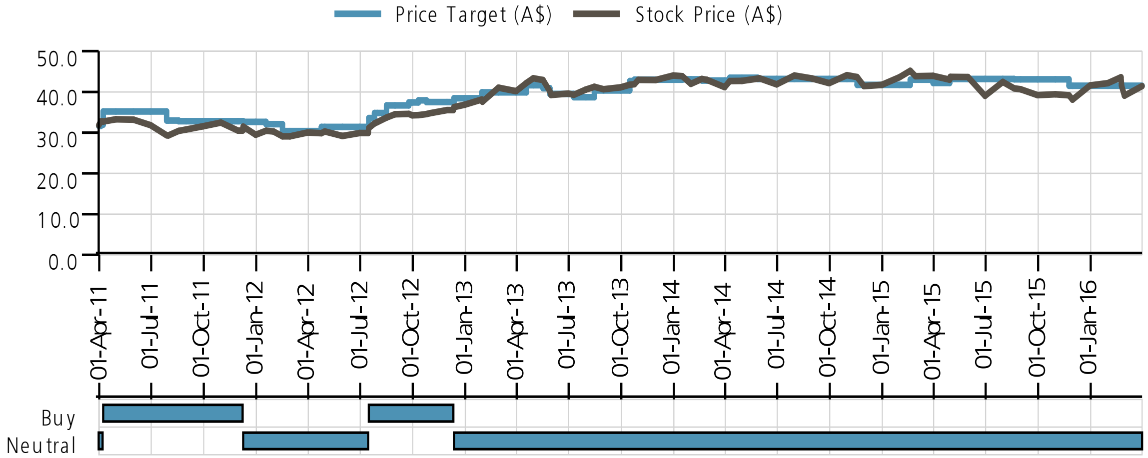
Metcash Limited (A$)



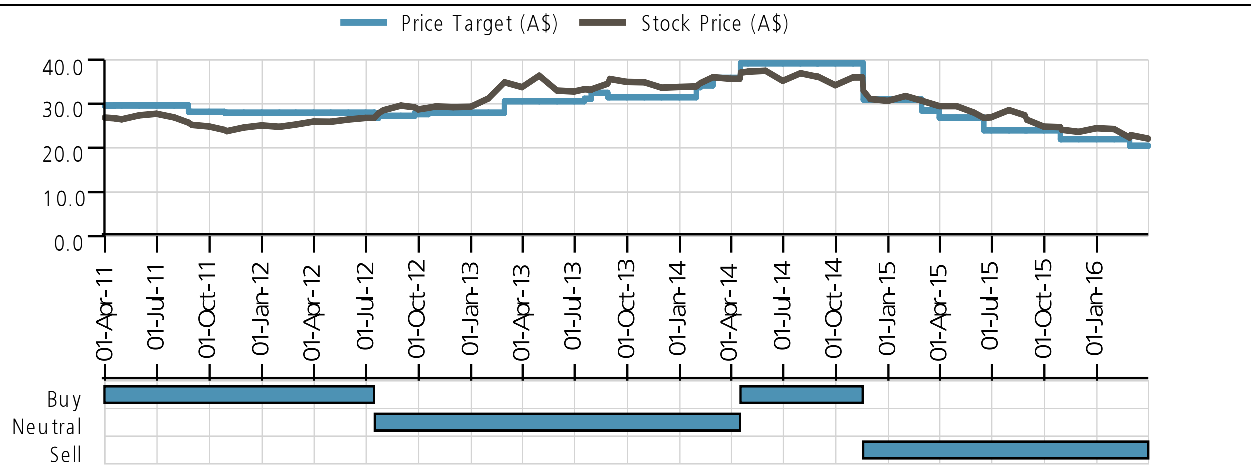
Source: UBS; as of 31 Mar 2016

Wesfarmers Limited (A$)



Source: UBS; as of 31 Mar 2016

Woolworths Limited (A$)



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