RETAIL THERAPY. **WHAT THE NEXT DECADE HOLDS FOR SA CLOTHING RETAIL**

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ABOUT **THE AUTHOR**

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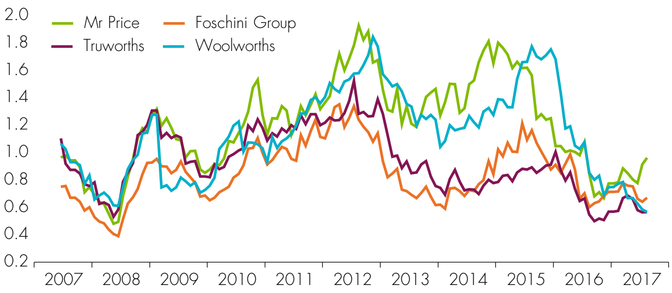
KEY TAKEOUTS:

- IS THE RETAIL SALE A BARGAIN?
- SOUTH AFRICANS ARE GETTING RICHER MORE SLOWLY
- UP TO 50% OF RETAIL SALES ARE ON CREDIT
- GLOBAL RETAILERS ARE CHANGING THE LANDSCAPE

I love a good bargain, but there is always the risk of buying something because it's cheap and not because it adds any value to my life. Today, I'll be discussing a clothing sale of a different kind and unpacking the longer-term value in making a purchase.

In recent months, the price earnings (P/E) multiples of apparel retail stocks relative to the FTSE/JSE Shareholder Weighted All Share Index (SWIX) have tumbled to levels that look temptingly cheap compared with their 10-year history.

COMPANY PEs RELATIVE TO FTSE/JSE SHAREHOLDER WEIGHTED ALL SHARE INDEX



Source: FactSet

ARE RETAIL STOCKS TRULY CHEAP AND A GOOD BUY?

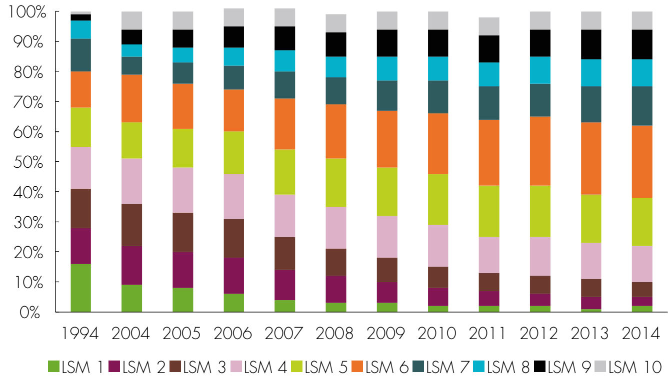
Before jumping to any conclusions, a key question needs to be answered: Will the next 10 years of retail look as good as the past 10 years?

I don't think they will. Here are four things that I expect to be different in the coming decade for South African apparel retailers:

1. South Africans are becoming richer at a slower pace

In the mid-1990s, as South Africans marked the birth of a new democracy, there were also economic reasons to celebrate. South African living standards were improving as a result of growing employment and the roll-out of social grants. The Living Standards Measure (LSM) is a marketing research tool commonly used by retailers as an indication of South Africans' income levels and spending power. The target market for listed national retailers is LSM 6-10. In 1994, 30% of the population was categorised as LSM 6-10. Ten years later, this segment had doubled to represent 60% of South Africans. All retailers were lifted by this rising tide. However, this tide is now receding as the pace of growth in employment and social grant payouts wanes, making growth in the retail sector going forward more of a challenge.

IMPROVING LIVING STANDARDS OF SOUTH AFRICANS (1994 – 2014)

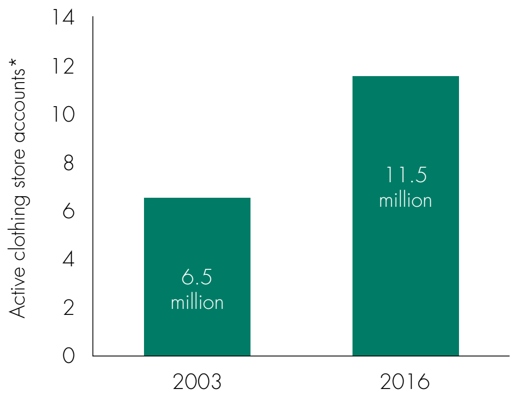


Sources: Renaissance Capital, South African Advertising Research Foundation

2. Store credit will grow at a pedestrian pace

When I graduated and started my first job in 2005, I had no credit card or overdraft facility. However, I opened store credit accounts with Truworths and Foschini. Both clothing accounts came with the option to pay off debt over six months at no interest cost. This was a common thing for not only a young graduate to do, but an increasing number of South Africans. Between 2003 and 2016, driven by growing income levels, the number of store accounts held with national retailers nearly doubled in thirteen years!

EXPLOSIVE GROWTH IN CLOTHING ACCOUNTS



*includes Truworths, TFG, Woolies, Edcon & Mr Price

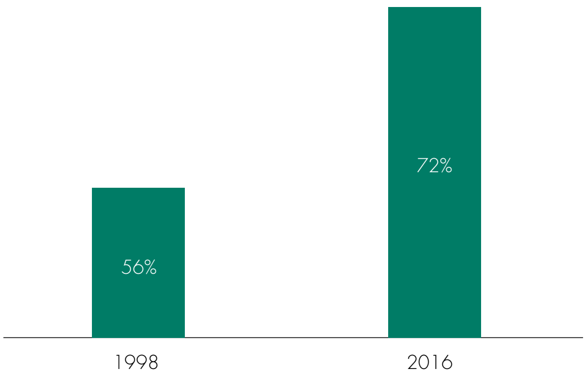
Sources: Deutsche Bank, company reports

The 11.5 million store accounts in 2016 includes the decline in the number of accounts over the previous three years. New credit regulations make it more difficult to open an account, while credit cards and personal loans have also become more accessible, with income thresholds as low as R4 000 a month. At the same time, most store accounts now carry interest charges similar to credit card rates. Some banks also offer close on three years to pay credit card balances, whereas store accounts have to be paid back within 12 months – making the monthly instalments much higher. All the while, as the economy slows, the pool of creditworthy customers has stopped growing. This presents a tougher environment for the likes of Truworths, The Foschini Group and Edcon, with between 30% and 50% of sales being made on credit.

3. **Saturated market offers less "flag-planting" opportunities**
   National retailers have opened, on average, four new stores every month over the past 10 years. Over the past 20 years, national apparel chains have consolidated the retail sector, squeezing out independent retailers by launching new brands or acquiring independent ones. For instance, in 2014 Truworths bought Naartjie and Earth Child. The Foschini Group, on the other hand, has bought Markham, Fabiani and Sportscene, and launched DonnaClaire, Exact and The Fix. Once brands sit within a national chain, their countrywide roll-out is swift... but this trend is running out of steam. In 1998, national retailers held 56% of the SA market share, in 2016 they held 72%. The opportunities for consolidation are dwindling.

GROWTH OPPORTUNITIES DRY UP IN A SATURATED MARKET

NATIONAL RETAILERS' MARKET SHARE OF TOTAL CLOTHING SALES*



*excludes Pick n Pay Clothing & Stuttafords

Sources: SARB, company reports

4. **Global entrants will make retail more competitive (point: margins may come down)**
   Over Christmas 2011, Sandton City customers could shop at Zara for the first time, with Inditex having opened its first South African store in November. The Spanish retailer now has eight stores countrywide. In the same year, Australian retailer Cotton On opened its doors on our shores. Today, Cotton On has upwards of 180 stores in South Africa. The most recent entrant, Swedish retail giant H&M, has opened 10 stores in under two years and is by no means content with that number. Up to this point, South Africa has been dominated by local retailers. Global retailers are changing the local retail landscape by bringing faster access to fashion trends, world-class stores and cutting-edge online platforms often at the same price points or cheaper than the local retailers. Competition is heating up as standards for local retailers rise.

SO WHAT DO WE HANG OUR HAT ON?

The next decade of apparel retail is not going to look the same as the past 10 or 20 years. The post-Apartheid consumer tide has receded. The store credit explosion is over. Global players are raising consumers' expectations of retailers.

Clothing retailers enjoyed a golden decade, but history is unlikely to repeat itself. Only those with the most innovative customer strategies and razor-sharp operations management will thrive this time around. At Old Mutual Equities, relentless research underpins our every investment decision. A disciplined and structured approach to fundamental analysis is essential in identifying and exploiting market inefficiencies – and ultimately extracting alpha. We invest extensively in systems to support our comprehensive research – tracking the long-term history of each share to determine its response under different scenarios. Based on this research we continue to take a "wait and see" approach to the SA retail sector, while holding a position in The Foschini Group, which we believe is well placed to navigate the changing retail landscape.