THE INTELLIGENT INVESTOR
VALUE INVESTING EXPERTS

Myer float on the stand

[Weighing up the pros and cons of the Myer offer]

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Introduction

*'Ground floor: Perfumery,
Stationery and leather goods,
Wigs and haberdashery,
Kitchenware and food,
Going up ...'*

So begins the theme song to *Are you being served?*, the iconic—and occasionally smutty—British department store comedy of the 1970s and 80s. To many shoppers, the Australian department store group Myer is also iconic. It's a chain of stores you'll almost certainly recognise, and have visited at least once. So it's no wonder that the sharemarket float of this business is attracting attention, particularly because it's the first sizeable new listing for some time.

Before we ride the analytical elevator, though, let's deal with something you may want to know upfront: Are Myer shares 'going up'?

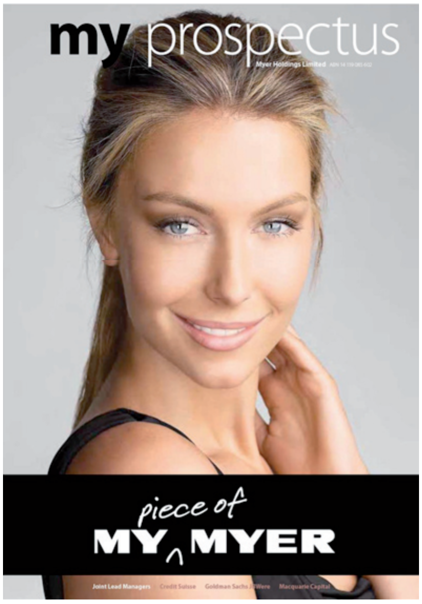
In the short term, the question isn't hard to answer. While it was a very different story a year ago, the sharemarket has staged a remarkable recovery, rising more than 48% from its March lows. Retail businesses are back in favour, Myer is a high quality brand name, and the marketing of this float is very slick. The photo of former Miss Universe and Myer brand ambassador Jennifer Hawkins on the cover of the prospectus won't hurt.

Assuming the sharemarket remains buoyant, the Myer Holdings float is likely to 'get away', as your stockbroker might say. The fact that those very same stockbrokers will be paid a 1% commission for every application form lodged will also help ensure 'success' (for the sellers, at least). It's likely that the final pricing, which won't be known until institutions bid for shares in late October, will ensure a small-to-decent 'stag profit' [see Shoptalk] on listing (although Myer shares aren't particularly underpriced).

To bet on making a 'stag profit', though, is speculation pure and simple. If the market or consumer confidence takes a dive in the meantime, or the vendors get the pricing wrong, then Myer shares could list at a discount to the price you'll pay. If you're willing to take this risk—a bet on a quick return—then understand you are speculating rather than investing.

The focus of this special report is much longer term. It will try and determine whether Myer is an attractive business to own for a long period. Even more importantly, it will assess whether the shares are available at a reasonable price in the float. We're avowed long-term investors at The Intelligent Investor, and we believe a hard-nosed business and financial analysis is the only way to address these two issues.

If this approach resonates with you, then we hope you enjoy this report. A prospective investment needs to jump plenty of hurdles to attract us so, on that note, let's release Myer from the starting gate.



SHOPTALK

STAG PROFIT—a profit made on a new listing on the sharemarket. If a stock with an issue price of $1.00 lists on the market at $1.10, it has provided its initial investors with a 10% 'stag profit'.

History and background

Old companies never die, they just return to the sharemarket 25 years later. So it will be with Myer, with the 2009 float marking the second time shares in the company have been publicly traded. Founded in 1900 by Sidney Myer, The Myer Emporium Limited was already a substantial business before it merged with GJ Coles & Coy. With brands such as Myer, Grace Bros, Target, Fosseys, Country Road and Red Rooster, the 1985 merger valued The Myer Emporium at $1.1bn. Coles Myer Limited was born.

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Fifteen years later the Myer department store business had lost its way. In 2002 Dawn Robertson was hired as Myer's new chief executive and, in 2004, she ditched the New South Wales-based Grace Bros brand. But little seemed to work, and despite some recovery in margins towards the end of Robertson's stewardship (see Table 1), the sales and profit performance of the 61-store chain wasn't up to scratch. In 2005, Coles Myer chief executive John Fletcher took the decision to cut the business loose.

TABLE 1: MYER UNDER COLES MYER

	2002*	2003*	2004	2005	2006
REVENUE ($M)	3,243.0	3,240.0	3,030.7	3,095.8	3,174.0
EBIT ($M)	–21.6	25.2	71.9	43.2	73.0
EBIT MARGIN (%)	–0.7%	0.8%	2.4%	1.4%	2.3%

* Including Megamart

In June 2006, Myer—and, importantly, the company's flagship Melbourne property—was sold to a consortium of 'private equity' firms, including TPG and Blum Capital, as well as the Myer family (who were no doubt pleased to see their legacy free of the lumbering Coles Myer bureaucracy). The purchase price was $1.4bn, considerably higher than expected at the time, and other bidders, such as **Harvey Norman**, missed out. Everyone was keen to know: Could the new owners turn around this chronically underperforming department store chain?

'Private equity firms are essentially large private investment funds ... If you lived through the 1980s, combine the terms 'corporate raider' and 'leveraged buyout' and you get something pretty close. Of course, these days they prefer to go by the more legitimate-sounding 'private equity' moniker.'

The private equity modus operandi

After many attempts, the turnaround of Myer looked a Herculean ask. But, before examining what happened under Myer's new ownership, let's shine some light into the sometimes secretive world of 'private equity'.

Private equity firms are essentially large private investment funds. They occasionally buy businesses from owners like Coles Myer, but takeovers of listed companies have become more frequent. If you lived through the 1980s, combine the terms 'corporate raider' and 'leveraged buyout' and you get something pretty close. Of course, these days they prefer to go by the more legitimate-sounding 'private equity' moniker.

But the term itself is something of a misnomer. Typically much less equity than debt is used to fund acquisitions—60/40 or 70/30 debt/equity funding splits are common, and sometimes even higher. These are aggressive leverage ratios, equating to debt to equity ratios of 150% and 233% respectively. Few listed companies choose to operate with such high debt levels.

Let's illustrate with a fictitious example, although you can skip down a few paragraphs if mathematical gymnastics give you migraines. Assume a private equity firm, Smash Capital, bids $1,000m for Grab Bros Limited, a long-established but underperforming retailer with earnings before interest

TABLE 2: TYPICAL PRIVATE EQUITY FUNDING EXAMPLE

	TAKEOVER (YEAR 1)	CAPITAL RESTRUCTURE (YEAR 1)	FLOAT (YEAR 3)
VALUE OF EQUITY ($M)	1,000	480	1,080
VALUE OF DEBT ($M)	200	720	720
ENTERPRISE VALUE ($M)	1,200	1,200	1,800
EBIT ($M)	120		180
ENTERPRISE VALUE/EBIT MULTIPLE (X)	10		10

and tax (EBIT) of $120m and debt of $200m. Grab's total enterprise value—the equity plus the debt—costs Smash $1,200m. The enterprise value multiple paid is therefore 10 times, as you can see from Table 2.

Under private equity ownership, though, a company's capital structure changes significantly. Smash decides to use a typical 60/40 debt/equity funding split. So it funds the $1,200m acquisition with $720m of debt (which is used to pay off Grab's $200m of existing debt) and $480m of equity (from Smash's own investors). This is a debt-to-equity ratio of 150%.

Under Smash's control, Grab begins cutting costs, overhauls its retailing 'supply chain' [see Shoptalk], and launches a more aggressive store rollout program. Within three years, EBIT has grown 50% to $180m. Smash then decides to sell Grab back to the public in a sharemarket float. As Grab now has a three year record of decent profit growth, and is apparently better managed than before, new shareholders are happy to pay the same enterprise value multiple of 10 times, or $1,800m.

Grab floats with the same $720m of debt, which necessarily means its equity is worth $1,080m. As Smash contributed only $480m of equity three years earlier, it has made 2.25 times its invested capital, or an average annual return of 31%. Using 'other people's money', including a lot of debt, is how private equity firms usually achieve such attractive returns.

In reality, this return wouldn't excite many private equity firms. Many more than double their money on each investment. Indeed, TPG, Blum and the Myer family will make out like bandits from the Myer float, as we'll see a little later. But using significant amounts of debt is only one of the strategies private equity employs to extract high returns. Before we turn to Myer itself, let's look at some of these techniques using an international example.

SHOPTALK

SUPPLY CHAIN—the system of transportation, warehousing and logistics used to move a retailer's merchandise from its suppliers to its stores

The lessons from Debenhams

Debenhams is a UK-based mid-market department store group. Its key competitors include retailers such as Marks & Spencer and John Lewis. In 2003, a private equity consortium consisting of TPG (who now control Myer) and CVC Capital Partners bid £1.7bn for the listed Debenhams, which then had debt of about £100m. The bid was financed with about £1.2bn of debt and £600m of equity.

Debenhams was the sort of target private equity firms love. They typically favour established brand name businesses with strong cash flows, as extracting cash is essential. Debenhams, like a lot of companies, certainly had some fat to cut—its executive chefs and chauffeurs, for example, were dismissed soon after new chief executive Rob Templeman took charge. As with most private equity acquisitions, management bought a stake in the business. 'Alignment of interests' between management and investors is another important ingredient that is baked into the private equity cake.

DEBENHAMS

Templeman began overhauling the business. In the first year, £30m of slow-moving stock that was sitting in Debenhams' warehouses was marked down heavily and sold. This generated cash and reduced the company's investment in working capital. Agreements with suppliers were also renegotiated so that they weren't paid until 60 days after delivery. Debenhams' cash flow began improving.

Debenhams also increased its store rollout program, providing the company with a more obvious 'growth profile'. But capital expenditure on new stores and refurbishments (on a per-store basis) was cut back, preserving still more of the company's precious cash flow. By 2005, cash was pouring into the business, Debenhams was rolling out ten stores a year, and margins had jumped.

Templeman's next move was straight out of the private equity textbook.

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Like many retailers, Debenhams owned some of its stores and, in 2005, he sold and leased back 23 properties, realising another £495m of cash. This move allowed TPG and CVC to refinance Debenhams' debt and, by mid-2005, they had paid themselves almost £1bn in distributions (after putting in equity of only £600m 18 months earlier). Debenhams itself was now loaded to the gills with £1.9bn of debt.

By 2006, TPG and CVC decided to re-float Debenhams on the London Stock Exchange at 195p a share. The company's market capitalisation was £1.7bn, the same price it was acquired for three years earlier. But this time Debenhams owned little property and had debt of £1.2bn (that is, total enterprise value was £2.9bn compared with its earlier £1.8bn). In short, the retailer was a shadow of its former self.

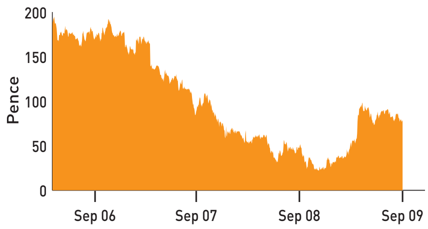
While TPG and CVC retained 30% of the listed company's stock—and Templeman remained chief executive—the wheels soon fell off. Debenhams made mistakes with its menswear range, gained a reputation for always being on sale, and was criticised for underinvestment in stores. Three profit warnings were announced in the 18 months following the float and, when the global financial crisis hit, Debenhams' high debt levels spelt trouble.

By Christmas 2008, Debenhams' share price had slumped to less than 25p, and it was close to breaching banking covenants. But better than expected Christmas trading and the sharemarket recovery from March 2009 came to the rescue, and in June it raised £323m at 80p a share. Despite the company's near-death experience, Templeman apparently likes living on the edge. Last month, he remarked 'We're conscious that our balance sheet is not optimal' and indicated acquisitions were now on the agenda.

The private equity strategies of cash maximisation, high leverage and management ownership can generate strong returns from a business in the short to medium term. But the Debenhams experience suggests that these strategies don't necessarily make for a sustainable business over a longer period. Indeed, Australian retail floats from private equity vendors also have a patchy record. While **JB Hi-Fi** has been a standout performer, aided by its exposure to a growth market, others like **Pacific Brands** and Repco bombed. Plenty of other non-retail private equity floats, such as **Emeco** and **Boart Longyear**, have performed much worse.

Finally, the fact that TPG, CVC and Templeman retained stakes in the listed Debenhams was of little comfort. By the time Debenhams listed, TPG and CVC had almost tripled their original investment, while Templeman made a reported profit of £41m from the float. Having already squeezed blood from the Debenhams stone—and become rich in the process—it mattered little to them when more pressure crushed it to pieces.

CHART 1: DEBENHAMS SHARE PRICE (UK)



'The private equity strategies of cash maximisation, high leverage and management ownership can generate strong returns from a business in the short to medium term. But the Debenhams experience suggests that these strategies don't necessarily make for a sustainable business over a longer period.'

Myer under private equity ownership

The TPG, Blum Capital and Myer family consortium ('the TPG consortium') acquired Myer in June 2006 with equity of about $450m (and debt of about $950m). The first task was to appoint management, and **Woolworths** proved a fertile hunting ground for talent. The company appointed former director of supermarkets Bill Wavish as executive chairman before poaching Bernie Brookes, Woolworths' marketing director, for the chief executive's role.

With the release of the prospectus, the reason became clear—each man will own 11.8m shares and options worth up to $58m following Myer's listing. While Brookes's salary was $1.1m a year at Woolworths, he will make $1.7m a year as chief executive of the listed Myer, but his stake in the company dwarfs his annual remuneration. Consistent with the private equity modus operandi, 400 other management staff also acquired equity in the company to ensure 'alignment of interests'.

Brookes soon discovered Myer's dirty little secret under Coles's ownership—it

BERNIE BROOKES | MYER CEO

had squirrelled away dead stock in 24 warehouses around the country. As had been the experience at Debenhams, Myer launched a massive clearance sale, reducing inventory by 25% and raising cash of $150m. The reduction of Myer's investment in working capital had begun.

It wasn't long before suppliers soon noticed the change in ownership. Over the course of the TPG consortium's three year ownership period, Brookes moved payment terms for trade creditors out from 42 days to 59 days (see Chart 2). In other words, suppliers now aren't paid until almost two months after they deliver inventory. Brookes admitted in an interview that Myer had been quite 'ogre-ish' with its suppliers in the early days, but had more recently tried to help them out during the global financial crisis.

You'll recall that the TPG consortium also acquired the flagship Melbourne store along with the Myer business in 2006. In 2007, the property was sold for a net $425m and leased back for $19m a year, implying that the net cost of the Myer business itself was slightly less than $1bn. Myer still retains small properties in Dubbo, Bendigo and Wagga Wagga, but intends to sell these when property market conditions are more favourable.

So far, so similar to Debenhams. Thanks to the property sale, inventory clearance and squeezing of suppliers, Myer began spitting out copious quantities of cash, which allowed $560m to be returned to the new owners in 2007. But, with the listed Debenhams now beginning to falter, the TPG consortium was anxious to avoid a repeat at Myer.

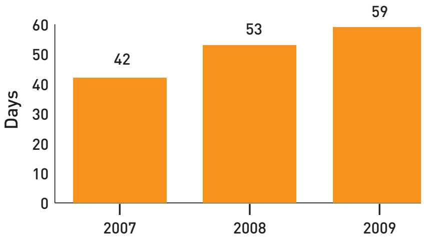
Brookes made two significant changes. First, he lifted the amount of capital expenditure sharply. Over the five years to 2006, Coles had spent an average of only $53m a year on capital expenditure. Following its acquisition, Brookes proposed lifting Myer's capital expenditure to $70m a year.

But he soon realised even this figure wouldn't be sufficient. A successful turnaround would require greater spending on stores, information technology, and the company's supply chain. TPG was sensitive to criticism it had starved Debenhams of capital, and it didn't want to jeopardise the future float of Myer by holding back spending this time. Indeed, the Myer prospectus highlights—in the Chairman's letter no less—that the TPG consortium has spent more than $400m on capital expenditure during its ownership.

The second lesson was perhaps even more important. Debenhams had floated with too much debt just prior to the global financial crisis, and investors wouldn't tolerate the same thing at Myer. In 2009, Myer reported debt of close to $900m but, with that clearly too aggressive for a listed company, part of the float proceeds will be put towards debt reduction. Myer will list with net debt of just under $400m, which represents a more reasonable (but hardly conservative) net debt-to-equity ratio of 53%.

Despite the higher capital expenditure, the TPG consortium will do very well from the Myer float. After committing equity of $450m in 2006, the consortium was paid distributions of $560m in 2007. They'll receive up to an additional $1,900m if Myer shares are sold at the top end of the price range. In that case, the TPG consortium will walk away with almost $2.5bn from a $450m investment. Not bad for three years' work.

CHART 2: CREDITOR PAYMENT TERMS



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The Myer Holdings float

Of course, the history of Myer is important. But it's the float of Myer Holdings, the listed company, that prospective shareholders are interested in. Let's turn now to the key details of the float itself.

Key float details

Like most large floats, Myer Holdings shares are being offered in a price range, with the final price to be set by institutional investors on 30 October. The indicative price range is $3.90 to $4.90 and, depending on the number of

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shares issued, Myer's market capitalisation on listing will be between $2.3bn and $2.8bn. Conscious of the enormous profit made by the TPG consortium, institutional investors will probably demand a favourable price to take stock. This is why a 'stag profit' on listing is likely (although there are never any guarantees).

You can see some of the key valuation statistics (which we'll discuss in more detail in the 'Valuation' section) and relevant dates in Table 3.

TABLE 3: MYER FLOAT: IMPORTANT INFORMATION

PRICING STATISTICS		
INDICATIVE PRICE RANGE PER SHARE ($)	3.90	4.90
INDICATIVE MARKET CAPITALISATION ($M)	2,282	2,768
NET DEBT ($M)	392	392
ENTERPRISE VALUE ($M)	2,674	3,160
EARNINGS BEFORE INTEREST AND TAX ($M)*	261	261
ENTERPRISE VALUE/EBIT MULTIPLE (X)*	10.2	12.1
PRICE-EARNINGS RATIO (X)*	14.3	17.3
DIVIDEND YIELD (%)*	5.3	4.3
KEY DATES#		
PROSPECTUS RELEASED	28-Sep-09	
RETAIL OFFER OPENS	6-Oct-09	
RETAIL OFFER CLOSES	23-Oct-09	
FINAL PRICE AND ALLOCATIONS ANNOUNCED	30-Oct-09	
LISTING DATE	2-Nov-09	

* based on 2010 pro forma forecast # subject to change

Of particular interest is that the TPG consortium might retain up to 15% of the stock after listing. While this gives it some flexibility, we expect the consortium will sell all of its shares to the public. Whether it retains a stake or sells out completely, though, the Debenhams experience illustrates that it's unlikely to make much difference to the subsequent performance of the business.

As the offer is not underwritten, the TPG consortium is pulling out all stops to ensure adequate demand for the shares. And it's to this marketing strategy that we'll turn next.

The marketing of Myer

When considering any float, one of the more important things to remember is that you're not just buying stock—the vendors (and their various 'helpers') are selling it to you. Everything the TPG consortium has done over the past three years of ownership has been to one end—the eventual sale of the Myer business. Private equity firms generally have n o interest in owning businesses, or parts thereof, for the long term (unlike *The Intelligent Investor*). Rather, they run them to sell.

Importantly, they also choose the time of sale. At the moment, sharemarket conditions are buoyant and Myer's competitor David Jones commands a premium market rating. Both those factors provide very favourable tailwinds which will help ensure the issue achieves an extremely attractive price for the TPG consortium.

Myer's strong brand is also being flogged mercilessly. There's no 'general public' offer; most shares will go to the 140,000 members of the company's loyalty program, MYER one, who registered to receive the prospectus, as well as brokers' clients. Even the prospectus looks like one of the company's catalogues, with the image of Jennifer Hawkins gracing the cover and sprinkled liberally throughout its pages. Unfortunately Bernie Brookes, the

'The new issue market ... is ruled by controlling stockholders and corporations, who can usually select the timing of offerings or, if the market looks unfavorable, can avoid an offering altogether. Understandably, these sellers are not going to offer any bargains ... Indeed, in the case of common stock offerings, selling shareholders are often motivated to unload only when they feel the market is overpaying.'

—Warren Buffett, Berkshire Hathaway letter to shareholders, 1992

man shareholders should really be eyeing off, isn't photogenic enough to appear before page 13.

Using Jennifer Hawkins on the float roadshow also says a great deal. While Hawkins is obviously a smart businesswoman (as well as a shareholder in Myer), her presence is more about marketing than hard-nosed analysis. One of *The Intelligent Investor*'s analysts, who lives in her street (in a much less salubrious property), has sworn on a stack of prospectuses that he has never seen her reading a balance sheet. We have our doubts about whether she's qualified to know if Myer shares are good buying.

It's MYER one members who will make this float successful. They've had it drilled into them that 'Myer is my store'; now they are being asked to buy 'My piece of Myer'. It's all emotive stuff, but don't confuse it for hard-nosed business and financial analysis. And it's to this analysis we'll turn now.

Myer—a retailer reborn?

There's no doubt that the Myer retailing operation is much more smartly managed than it was under Coles's ownership. Brookes has implemented a completely new supply chain, reducing the number of warehouses from eight to four. The number of suppliers has been reduced by 15%, while it now takes an average of 24 days to get inventory from factory to market (down from 43 days). A new merchandising system has been implemented and selling space per store lifted from 66% to 69%. All this has helped improve returns and remove unnecessary expense.

Brookes's self-imposed 50-month turnaround phase is now nearing completion ahead of schedule. But it's important to remember that you're not buying Myer's past; you're buying its future. It's therefore vital to think about what that future might hold.

Myer's business

The Myer department store business currently has 65 stores Australia-wide. A department store is just as its name suggests—it needs to provide a wide range of merchandise to suit many different customers. Myer's departments include womenswear, menswear, youth fashion, accessories, beauty and cosmetics, homewares, electrical, and general merchandise. Apparently 'wigs and haberdashery' do not require their own departments these days.

Despite the layman's familiarity with retail businesses such as Myer, don't confuse familiarity with ease of management. 'Retail is detail' goes the old industry saying, and there are literally hundreds of things that management must focus on at once. Buying mistakes—such as Debenhams made in menswear in 2006—are but one example of the things that can go wrong.

There are also myriad external factors that affect retailing. Myer in particular is on the frontline of consumer confidence. In the 2009 financial year, for example, the company's same-store sales [see Shoptalk] fell almost 2% as Australia narrowly avoided a recession. Interest rates, household debt levels, unemployment, and house prices can all have a bearing on retail spending.

Department store retailing is also extremely competitive and potentially subject to changes in customer preferences over time. Myer not only competes with its slightly more upmarket listed competitor **David Jones** (a company which we'll examine in more depth later), but with discount department stores such as Big W, Target, Kmart, as well as hundreds of specialty stores. Myer's mid-market positioning is risky because in tough times, consumers are likely to 'trade down' to discount department stores. Conversely, in buoyant times, they tend to 'trade up' to David Jones or specialty boutiques. Indeed, some people argue that the department store model is a dinosaur because consumers now prefer a more intimate shopping experience.

'Despite the layman's familiarity with retail businesses such as Myer, don't confuse familiarity with ease of management. 'Retail is detail' goes the old industry saying, and there are literally hundreds of things that management must focus on at once.'

SHOPTALK

SAME-STORE SALES —sales from stores that have been in existence for at least a year (also known as 'comparable store sales', or 'like-for-like sales'). Same-store sales growth measures the performance of existing stores by removing the sales uplift from the opening of new stores.

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Whatever the case, though, Myer's future growth and prosperity will be influenced by many external factors over which it has absolutely no control. Indeed, now that the turnaround phase is largely complete, external factors will have a much greater bearing on future profitability.

Board and management

There is no doubt that chief executive Bernie Brookes is an excellent retailer (as his Woolworths pedigree might indicate) and that he's been an asset to Myer thus far. The prospectus makes a big deal out of the fact that he will retain 90% of his Myer stock after listing, which implies he'll sell about $6m worth into the float. Brookes has agreed not to sell more shares until 18 months after listing.

Myer has also been keen to keep other senior managers, with $6m of retention payments promised to certain management staff between 2010 and 2012. In total, directors, management and employees will own about 8% of the stock after listing.

The listed company's board will be rather different than under the TPG consortium's ownership. Bill Wavish decided not to take on the chairman's role at the listed Myer because of the 'extended commitment' required post-float. Fellow director Howard McDonald, the former chief executive of Just Group, will take on the chairman's role instead. McDonald has agreed to retain 100% of his 2m shares in Myer following the float, but the fine print at the back of the prospectus notes that he will also receive a $1.9m sign-on fee. Presumably if Myer 'does a Debenhams', Brookes's $6m share sale and McDonald's $1.9m incentive will help cushion the blow.

Also, John Lovering, the current chairman of Debenhams, stepped down as a Myer director in January 2009. His departure conveniently ensured that there would be no mention of the word 'Debenhams' anywhere in the Myer prospectus. Upon listing, Myer will have a compact five member board that between them own 14.2m shares (with Brookes accounting for 11.8m).

See Appendix 1 (page 16) for detailed financial information and forecasts for Myer Holdings

Growth strategies

Myer's 50-month turnaround phase is approaching completion. Perhaps more than any other, Chart 3 illustrates the success of Brookes's strategies over the past three years. But Brookes is not alone—the highly respected chief executive of David Jones, Mark McInnes, has also had great success turning around that business since taking on the top job in 2003.

As Myer keenly points out, though, its future is about growth. In the prospectus, the company identifies four main growth strategies that we'll now consider in turn—same-store (or 'comparable store') sales growth, new store openings, gross margin improvement, and reductions in the cost of doing business. Through these initiatives, 'Myer believes it has scope to grow its margins to world's best practice levels'. This statement implies Myer can achieve earnings before interest and tax (EBIT) margins above 10%, a level that David Jones has already reached.

Interestingly, Myer has yet to achieve any momentum on three of these four growth strategies. While this is presumably because Brookes has focused on Myer's 'turnaround phase' rather than its post-listing 'growth phase', it suggests that different skills will be required—and new risks faced—in future.

CHART 3: EARNINGS BEFORE INTEREST AND TAX MARGINS (%)

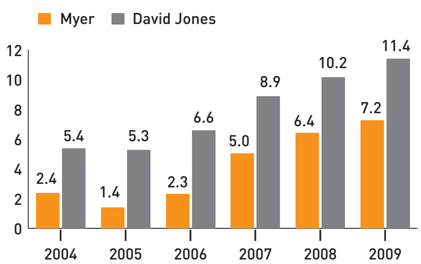
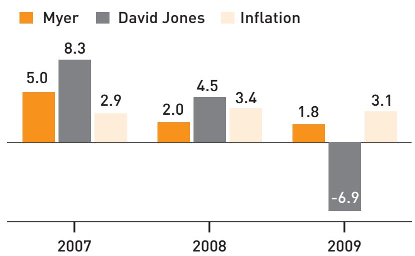


CHART 4: SAME STORE SALES GROWTH (%)



1. Comparable store sales growth

Increasing sales from existing stores is very important for retail businesses. As a retailer's costs typically rise with inflation, it's important that same-store sales grow at least that fast. But same-store sales haven't grown significantly over the past three years, as you can see from Chart 4 and have actually underperformed inflation. Indeed, Myer's same-store sales growth has also marginally underperformed David Jones's (which admittedly produced much more volatile sales results). This is in spite of Myer spending almost double what David Jones spent on capital expenditure between 2006 and 2009.

According to David Jones's 2009 results presentation, both retailers lost market share to discount department stores (such as Target and Big W) between 2006 and 2009 as consumers tightened their belts. But whereas David Jones's market share fell from 11.9% to 11.7%, Myer's fell from 20.8% to 19.2%. This seems consistent with Myer's relatively poor sales performance over recent years.

Of course, we've already indicated it's the future that matters, and Myer has grand plans now the turnaround phase is nearing completion. Its program of store 'refreshments', which involve improving visual merchandising, is already largely complete. Full store refurbishments are now on the agenda, with ten full refurbishments planned over the next two years. Also nearing completion is the major refurbishment of its flagship Melbourne store (accounting for 7% of total sales) which, after numerous delays, is expected to be progressively opened over 2010. Full refurbishments can have a significant sales impact, with its Sydney store the best-performing one in the chain following its 2008 renovation.

Myer also plans to introduce new brands and concessions (retail stores with their own sales staff within Myer premises) to drive growth. It also plans better utilisation of its MYER one loyalty program database, with membership having grown from 1.1m members in 2006 to 3.1m members in 2009.

But, while these growth initiatives will help lift same-store sales, it's the economy and consumer confidence that will make the most difference. If the economy recovers nicely, then Myer's forecast of 3% sales growth in 2010 looks conservative. If it falters, refurbishments, new brands, and better marketing will make much less difference.

2. New store openings

Under Coles's ownership, Myer didn't open stores. With an ancient supply chain it simply wasn't able to cope. After overhauling Myer's supply chain, Brookes now believes it could support up to 100 stores over the long term (compared with 65 currently). Twelve new store leases have already been signed, with three under negotiation, which will take the number of Myer stores to 80 by July 2014. So far, so impressive.

But store openings are a high-risk form of growth, particularly for a mature retailer. Two-thirds of the new stores Myer expects to open are in areas with below average household income, which seems anomalous for a department store that focuses on 'medium to higher income earners'. Cannibalisation of existing stores must also be a real risk.

It's also notable that the company is only opening one new store in 2010 (at Top Ryde in New South Wales). Myer's new store opening program won't ramp up until 2011, so any problems won't show up until well after the prospectus forecast period.

3. Gross margin improvement

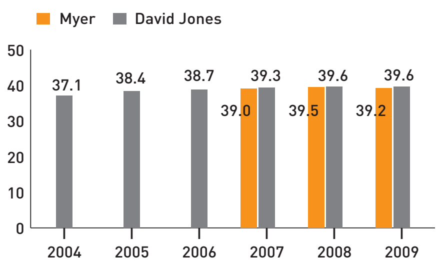
A retailer's gross profit is the difference between its sales and the cost of that merchandise, before taking into account the 'cost of doing business' (see below). In other words, it represents the difference between what a retailer pays its suppliers for merchandise, and how much it sells that merchandise for.

As you can see from Chart 5, both Myer and David Jones make gross profit margins of slightly less than 40%. This means they mark up the average item they buy by about 65% (100%/(100% minus 40%)) to produce this level of gross profit. Next time you buy a pair of jeans or a dress from a department store, remember that you're paying an average of 65% more than it cost the retailer to buy.

But whereas David Jones has had reasonable success lifting its gross profit margin since Mark McInnes became chief executive in 2003, Myer has had less success over a shorter period. Once again, though, it has big plans for improvement here.

Increasing the number of private label brands—such as Miss Shop, Vue,

CHART 5: GROSS MARGINS (%)



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Blaq and Reserve—is one way Myer hopes to improve its gross margin. Brookes hopes to lift private label brands from 15% to 20% of sales over time. For comparison, 50% of Debenhams sales are private label, although Australian consumers have typically been more reluctant to buy department store brands. While Brookes is taking the softly, softly approach, too much private label merchandise might alienate customers and damage the brand.

Using more direct sourcing—buying from suppliers directly instead of through wholesalers—is another way Myer hopes to lift gross margin. Target has been particularly successful at sourcing low-cost merchandise directly from Asian suppliers, helping it achieve an EBIT margin of 9.4% in 2009. Finally, 'shrinkage'—theft by customers and staff—is a big problem for most retailers. In 2010 Myer will install a closed circuit television (CCTV) system in an attempt to reduce the amount of stock that walks out the door.

4. Reductions in the cost of doing business

While gross profit is the difference between the sale price and the cost price of merchandise, a retailer's 'cost of doing business' (CODB) is all the other expenses required to sell that merchandise. These costs include staff, rent, information technology and marketing expenses, and the idea is to minimise them as a percentage of sales. Out of the four areas Myer intends to focus on, this is the only one where it has achieved significant progress since 2006, as you can see from Chart 6.

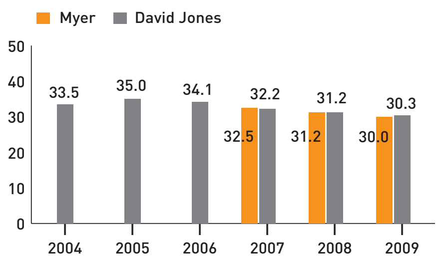
But even here, Myer's cost control isn't quite as good as it might seem. Myer chooses to focus on its 'cash' cost of doing business, which excludes depreciation expense. Failing to include depreciation—a cost that is increasing because of significant capital expenditure—makes the improvement in this ratio look better than it actually is. There's no sleight of hand in David Jones's CODB figures, which include depreciation and are therefore a better reflection of total costs.

Cutting costs might seem an easy way to improve margins at a department store, but management needs to walk a fine line. Trimming staff levels might work in the short term, but risks damaging customer loyalty if they can't find service when they want it. Anecdotally, there are fewer customer service staff at Myer than before, a point perhaps confirmed by the 13% decline in selling expenses in 2009.

Myer expects to make further savings in 2010 thanks to the introduction of a new point-of-sale system (which was meant to be ready from August 2008). The company has also been cutting advertising expenses in favour of direct marketing to MYER one customers. This represents another longer term risk—direct marketing targets existing customers, but does little to build the brand with prospective ones.

On the whole, Myer's 'growth phase'—the one new shareholders will participate in—looks higher risk than its 'turnaround phase'. While store refurbishments and cost savings should drive sales and profit in 2010, its longer term store rollout program in particular looks questionable. Compared with David Jones, Myer's performance still isn't up to scratch, and yet investors are being asked to pay a similar price. With that in mind, let's turn our attention to the issue of valuation.

CHART 6: COST OF DOING BUSINESS (%)



'Increasing the number of private label brands—such as Miss Shop, Vue, Blaq and Reserve—is one way Myer hopes to improve its gross margin. Brookes hopes to lift private label brands from 15% to 20% of sales over time.'

Valuation

A retailer's key financial ratios—such as sales growth, gross margins, and the cost of doing business—tend to get a lot of attention. Perhaps that's not surprising, because they are the variables that feed straight into earnings. While we'll consider earnings-based valuations shortly, balance sheet analysis—which tends to play second fiddle—tells you a great deal about any business (and particularly a new float).

Balance sheet analysis

Table 4 lines up the balance sheets of Myer and David Jones. They aren't all that different until you get to the 'property' line, which is a dead giveaway of Myer's private equity heritage. We saw earlier that the TPG consortium sold Myer's Melbourne store in 2007, leaving it with just $29m worth of property in Dubbo, Wagga Wagga and Bendigo (which is classified on the balance sheet as 'held for sale').

While Myer was selling, though, David Jones was buying. In 2006, David Jones bought back its flagship Sydney and Melbourne properties after selling them in 2000. Ownership of flagship properties provides security of tenure, redevelopment flexibility, and increases a retailer's ability to raise emergency funds if necessary (as the properties can be mortgaged). Furthermore, it reduces the risk of the retailer being held hostage by landlords that want to profiteer from rent increases.

Jumping down another line, Myer's balance sheet also contains 'Intangibles' of $909m compared with just $38m for David Jones. While most of Myer's intangibles relate to goodwill and the Myer brand, $128m relates to capitalised software—a questionable 'asset' in anyone's language. If Myer was to write down its intangible assets by only $250m, it would be in breach of its banking covenants.

Finally, turning to the 'Borrowings' line, Myer has net debt (borrowings minus cash) of almost $400m compared with David Jones's net debt of less than $100m. These represent net debt-to-equity ratios of 53% and 13% respectively. All retailers have significant 'operating leverage' built into their businesses because they must meet lease commitments whatever their profitability. Given Myer's lack of tangible assets, we consider a 53% net debt-to-equity ratio to be aggressive.

Myer's balance sheet has much less property, a much greater proportion of intangible assets, and much more debt than its listed competitor. As this implies that the company is higher risk, it should trade on a lower multiple of earnings than David Jones.

TABLE 4: 2009 BALANCE SHEET ANALYSIS

	MYER (PRO FORMA) ($M)	DAVID JONES (ACTUAL) ($M)
ASSETS		
CASH	25	14
RECEIVABLES	33	26
INVENTORY	355	245
FIXED ASSETS	371	340
PROPERTY	29	384
INTANGIBLES	909	38
OTHER	132	81
TOTAL ASSETS	**1,854**	**1,128**
LIABILITIES		
PAYABLES	469	244
BORROWINGS	417	102
OTHER	230	94
TOTAL LIABILITIES	**1,116**	**440**
EQUITY	**738**	**688**

Earnings-based valuation

Of course, the balance sheet will be glossed over in the sales spiel. Instead, the vendors and the brokers whose job it is to sell you the float will quote the prospective price-earnings ratio or, if they think you're sophisticated, the enterprise value to earnings before interest and tax multiple. The EV/EBIT multiple, as it is usually abbreviated, is usually a more appropriate comparative measure, as it adjusts for different capital structures by removing the distorting effect of debt.

Investors often believe they're getting a good deal when a float is priced at a discount to a comparable listed business. In this case, the obvious comparable business is, naturally enough, David Jones. You can see the comparable multiples, depending on Myer's final price—and the current David Jones's share price—in Table 5 (overleaf).

If Myer is priced at $3.90, the low end of the range, then its price-earnings ratio and EV/EBIT multiples will be 13.8 and 10.2, which represent discounts of 21% and 16% to David Jones's figures respectively. At $4.90, the top end of the range, Myer would be priced at only a minor discount to David Jones. As we've argued, a strong case can be made that Myer should trade at a decent discount given its weaker balance sheet.

What this analysis fails to consider, though, is whether David Jones itself is currently expensive. Chart 7 shows David Jones's average prospective price-earnings ratio over each of the past six years, based on the earnings per share actually achieved in that year. What the chart indicates is that David Jones's current prospective price-earnings ratio of 17.5 is well above average. And, with the company already producing a 'world-class' 2009 EBIT margin of 11.4%, there's arguably less potential for strong profit growth than back in 2003 and 2004. Our conclusion is that David Jones shares look expensive.

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TABLE 5: 2010 EARNINGS MULTIPLES

	MYER*			DAVID JONES
EARNINGS PER SHARE ($)	0.283	0.283	0.283	0.33
ISSUE / SHARE PRICE ($)	3.90	4.40	4.90	5.77
PRICE-EARNINGS RATIO (X)	**13.8**	**15.5**	**17.3**	**17.5**
EBIT ($M)	261	261	261	243
MARKET CAPITALISATION ($M)	2,282	2,525	2,768	2,868
NET DEBT ($M)	392	392	392	88
ENTERPRISE VALUE ($M)	**2,674**	**2,917**	**3,160**	**2,956**
EV/EBIT MULTIPLE (X)	**10.2**	**11.2**	**12.1**	**12.2**

* assuming the higher earnings per share figure from the prospectus

For comparison, we also considered the historical EV/EBITDA multiples of selected internationally listed department stores, including JC Penney, Marks & Spencer, Nordstrom, Macy's, and Debenhams. The average multiple is considerably lower than Myer's, even at the bottom end of the float price range.

Retail is a business that tends to lead the economic cycle. This often means that the share prices of retailers are ascribed premium multiples in the early stages of an economic recovery. During the dark days of March 2009, David Jones's share price was trading on a prospective price-earnings ratio of less than 7. Now that investors are more confident in the future of retail businesses, they are prepared to pay a multiple of more than twice that. It's this optimism that is helping the TPG consortium sell Myer for a premium price.

CHART 7: DAVID JONES AVERAGE PRICE-EARNINGS RATIOS

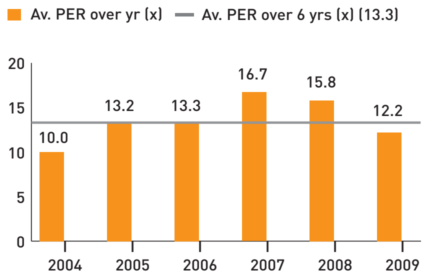

TABLE 6: INTERNATIONAL EV/EBITDA MULTIPLE COMPARISON

	JC PENNEY	MARKS & SPENCER	NORDSTROM	MACY'S	DEBENHAMS	MYER
EV	8,410	8,105	8,740	15,900	1,617	2,673
EBITDA	1,310	1,177	946	2,490	268	301
EV/EBITDA (X)	6.4	6.9	9.2	6.4	6.0	8.9

Note: Figures expressed in home currency, and are historical EBITDA multiples rather than prospective.
Source: Yahoo Finance and company reports

Optimism, though, is not the savvy investor's friend. Cyclical businesses like David Jones and Myer shouldn't be acquired when the recovery—if it indeed occurs—has been largely factored into the price. Rather, they should be purchased when investors have deserted them and Jennifer Hawkins is nowhere to be seen.

Based on the analysis in this section, a more realistic valuation range for Myer might be an EV/EBIT multiple of between 6 and 8. This would equate to a share price of between $2.00 and $3.00, well below the indicative price range of the float.

'The future is never clear, and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values.'

—Warren Buffett

Conclusion

The arguments in favour of buying Myer look oh-so convincing. The company's margins remain well below 'world-class', with the implication being that this achievement is simply a matter of time. And, after a moribund period under Coles's ownership, it now has a store rollout program the envy of some smaller retailers. These days, even mature businesses can be packaged up and sold as growth stocks.

The Myer float is likely to 'get away'—the clever marketing campaign, combined with investor hunger for big 'name' floats, will work its magic. There will probably even be a small stag profit on listing, enough to keep the punters on speaking terms with their broker, anyway.

We even expect Myer to achieve its 2010 prospectus forecasts. After the Debenhams experience, the TPG consortium won't want another failed float soiling its record. Indeed, there's a good chance that Bernie Brookes and his team will drive Myer harder for a few years yet. For the long-term investor, though, none of this guarantees good returns from Myer shares.

All investments involve risk, so successful investors look for two things that keep the odds stacked in their favour. First, they prefer to buy underappreciated businesses and, second, they only buy them when they are available at attractive prices. Indeed, they do exactly what the TPG consortium did when it bought Myer back in 2006. Three years on, TPG has made substantial profits and is moving on to the next underappreciated business. Do you really want to buy its cast-off?

Myer Holdings fails to clear two important investment hurdles. Not only is it a poorer quality and higher risk business than its major competitor, it's not available at a sufficiently attractive price. Notwithstanding the likelihood of a small stag profit, our recommendation for long-term investors is a clear **AVOID**.

Disclosure: The author, James Greenhalgh, owns shares in Harvey Norman.

TABLE 7: RECOMMENDATION GUIDE

BUY	Up to $2.00
LONG TERM BUY	Up to $2.60
HOLD	Up to $3.40
TAKE PART PROFITS	Above $3.40
SELL	Above $4.20

See Appendix 1 on the next page for detailed financial information and forecasts for Myer Holdings

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APPENDIX 1: MYER FINANCIALS AND 2010 FORECAST

	2007	2008	2009	2010F
INCOME STATEMENT				
REVENUE ($M)	3289	3320	3261	3360
COST OF GOODS SOLD ($M)	–2006	–2008	–1983	–2029
GROSS PROFIT ($M)	1283	1312	1278	1331
COST OF DOING BUSINESS ($M)	–1068	–1037	–977	–1001
EBITDA ($M)	215	275	301	330
DEPRECIATION AND AMORT. ($M)	–50	–62	–65	–69
EBIT ($M)	165	213	236	261
INTEREST ($M)	–83	–78	–82	–38
NPBT ($M)	82	135	154	223
TAX ($M)	–29	–40	–45	–63
NPAT ($M)	53	95	109	160
EPS (C)	N/a	N/a	N/a	28.3
CASH FLOW				
OPERATING CASH FLOW ($M)	244	269	306	347
CAPEX ($M)	–119	–150	–126	–140
FREE CASH FLOW ($M)	125	119	180	207
BALANCE SHEET				
ASSETS				
CASH ($M)	220	139	185	25
INVENTORY ($M)	367	345	356	355
FIXED ASSETS ($M)	238	295	372	371
PROPERTY ($M)	372	29	29	29
INTANGIBLES ($M)	862	897	909	909
OTHER ($M)	138	151	137	165
TOTAL ASSETS ($M)	2197	1856	1988	1854
LIABILITIES				
PAYABLES ($M)	443	437	468	469
BORROWINGS ($M)	943	873	879	417
OTHER ($M)	297	250	260	230
TOTAL LIABILITIES ($M)	1683	1560	1607	1116
EQUITY ($M)	516	297	380	738
GENERAL				
NO. OF STORES	61	65	65	66
SAME–STORE SALES (%)	5%	2%	–1.8%	3.0%
GROSS MARGIN (%)	39.0%	39.5%	39.2%	39.6%
EBIT MARGIN (%)	5.0%	6.4%	7.2%	7.8%
CASH COST OF DOING BUSINESS (%)	32.5%	31.2%	30.0%	29.8%
INVENTORY TURNS (X)	4.07	3.87	3.94	
CREDITOR DAYS (X)	42	53	59	
NET DEBT TO EQUITY RATIO (%)	140.1%	247.1%	182.6%	53.1%

Detailed financial information and forecasts for Myer Holdings

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VALUE INVESTING EXPERTS