Myer 09/02/2010 **FAT-AUS-461**

MYR AUD $3.25 Core **MED.** **B**

Myer is MyStock

The short term fog hovering over Myer will dissipate. Our long term view on the stock is positive and we now believe the stock is cheap enough to justify adding it to the Fat Prophets Portfolio.

"After an over-hyped listing process, we believe the valuation has reduced to a compelling level for investors"

Turning to the charts, Myer Holdings reached a high of $3.98 during mid November 2009. Prices have since retraced lower, forming a down-trend as evident from the series of lower highs and lower lows.

Since finding support at $3.12, Myer Holdings has seen an increase in support, with a minor rally evident from the daily chart despite the weakness in the broader market. Should prices break above the recent high of $3.41, we could be in for a swift move higher towards the $3.55 - $3.65 range. These levels also coincide with the current downtrend, thus a break above the trend line would spark substantial gains in the coming months.

Myer released its second quarter sales data last week, and although it showed a patchy result across Christmas, we believe the prognosis is good. After seeing Woolworths report modest sales growth for the same period, the emerging pattern of the 2009 Christmas season is becoming similar for other retailers, including Myer.

The retail environment has been tossed about by two significant factors that have distorted the market – government cash stimulus payments and rising interest rates.

The government doled out $20 billion in stimulus payments from December 2008 to March 2009, and about $10 billion of income tax cuts kicked in from July 2009 to add fuel to the spending fire. With the low interest rates prevailing throughout the GFC, combined with relatively few Australians losing their jobs during the crisis, consumers generally felt very comfortable and unafraid of spending. At least one economist estimates that up to 40% of the stimulus payments were spent in the retail sector providing much needed revenue growth.

As retailers geared up for Christmas 2009, the outlook was cautiously positive. However, promotions normally timed to blend in to the last week of Christmas were brought forward into November. Like sheep, every retailer followed, fearful of missing crucial high-season sales. The Australian Bureau of Statistics (ABS) reported November retail sales had lifted 1.4%, far ahead of market forecasts. As December played out, promotions disappeared and so did consumers. The traditional post-Christmas sales did a roaring trade as consumers hunted for the now traditional January bargains. The ABS statistics confirm this and show December retail sales actually fell 0.7% on the November total.

Retailers have perhaps been hoist by their own petard and must now think smarter about how to attract profitable sales in a less stop-start manner.

Of course, Myer has been as guilty of this as any retailer, chasing market share and ensuring no excess inventory would go stale on the racks.

Myer's second quarter sales release mirrored this experience. The company said November and January sales were strong but December was negative compared to the same months in 2008. Total sales for the second quarter were flat on the prior comparable period, while first quarter sales had risen 5.2%. The net result for the full six month period was total sales growth of 2% and comparable store sales growth of 1.2%.

As the cash stimulus works its way out of Myer's sales results over the next half year, the distortion of the comparisons will die down.

Interest rates have also created some artificiality amongst the numbers although the effect is unquantifiable. Throughout 2009, residential mortgage rates were as low as they have been for many years and as the commercial banks have haphazardly raised them, vaguely in concert with the Reserve Bank increases, the impact on household spending will gradually become evident.

So, in our view there have been several major distortions to the retail market over the last year and a half. As the effects wear off, the focus should return to the more fundamental aspects of the industry.

In that regard, Myer is in good shape. The new management team has done a good job of sorting out the historical problems that plagued Myer under its previous conglomerate ownership.

Doing the basics right

At the back of the store, Myer has invested in a new point-of-sale system that will be functional early in 2010. Halving the number of Distribution Centres to four has significantly reduced supply chain costs for the company. Simplification of the merchandising system has improved inventory management. An upgraded store security system has lowered 'shrinkage' through theft.

Myer's loyalty store card program (MYER one) has 3.1 million members who collectively account for about 63% of sales. It also provides the company with a highly targeted audience for promotions and marketing that is very cost-effective.

The store network is also undergoing a progressive improvement and expansion – a common and essential element of growth in a retail company. Again, the previous owners had somewhat neglected this key factor, leaving some low hanging fruit for the new team to harvest. But it is easier said than done, of course.

Under a new long term plan, Myer will refresh its existing network of 65 stores and expand progressively towards 80 stores over the next three years. The principal store in Melbourne's central business district is undergoing a major rebuild, while refurbishments in Sydney, Castle Hill, Blacktown and Doncaster have already added sales to the group. New stores are under construction at Top Ryde (NSW) and Robina (QLD) and more refurbishments will commence at the Eastland, Marion and Canberra stores.

Guidance reaffirmed

Chief executive of Myer, Bernie Brookes, reaffirmed the company's profit guidance for the 2010 financial year. He said Myer was on track to achieve full year pro forma operating profit (EBIT) of $261 million, a 10.1% increase over the previous year.

He said that operating profit margins were increasing, indicating the on-going improvement in the management of the company's cost base.

Valuation now cheap

The fixation with short term sales results has probably led some investors to become pessimistic about the stock. Since listing at $4.10 per share in November last year, a price we thought too demanding (see FAT 448), the stock has declined to a level that puts it on a PE ratio of 11.8 times FY10 earnings and a fully franked net yield of 6.3% (gross yield of 9.0%). That represents a 16% PE discount to rival David Jones, which happens to be on a similar yield to Myer.

Myer has a conservative balance sheet with gearing of 34% and net debt to operating profit (EBITDA) of just 1.3 times.

Summary

After an over-hyped listing process, we believe the valuation has reduced to a compelling level for investors.

Much of the short term noise over sales results overlooks the very strong position Myer's new management has put the company into. Much of the early hard work to repair previous damage has been done and the company has a sensible long term growth plan in place.

Economic conditions are not punitive for Australian households and consumer confidence justifiably remains high. Unemployment appears to have peaked and residential mortgage rates, though rising, are not hampering discretionary spending.

In our view, the time is right to add Myer to the Fat Prophets Portfolio and we recommend Members buy it around $3.25 per share.

DISCLAIMER

Snapshot MYR

Myer

Myer is a major Australian department store retailer. Its history dates back to 1900 when Sidney Myer opened the first store in Bendigo. With 65 stores and total sales in excess of $3.2 billion, Myer offers a comprehensive range of retail brands across a wide range of price points designed to appeal to all Australians.
Over the last three years, Myer has undergone a major transformation and has invested over $400 million to reinvigorate every aspect of its business.

Market Capitalisation:$1,878m

	FY1	FY2
Price to Earnings	11.7	10.7
Dividend Yield (%)	6.5	7.2
Price to Book	4.9	
Return on Equity (%)	28.6	