Why Woolworths takeover speculation won’t go away

PETER FAY | 6 OCT, 8:55 AM |
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If we turn back the clock to late June, speculation was rife that private equity group Kohlberg Kravis Roberts was sizing up Woolworths and that a takeover bid for the Australian retailer was imminent. That came at a time when the stock was underperforming and dissatisfaction with the previous chief executive, Grant O’Brien, had reached fever pitch leading to his resignation.

This takeover talk caused a spike in the share price of over 5 per cent, driving it from $26.38 to a high of $27.80 the day these rumours were circulated.

Fast-forward to today, and this speculation has died down. The sellers have re-entered the market and short interest in this stock is at all-time highs. In fact, last week the stock hit a three-year low of $24.11.

The continued deterioration in Woolworths’ (ASX:WOW) price and uncertainty over future management means the factors leading to the takeover speculation are still firmly in place. And to highlight why Woolworths may be on the radar of foreign firms, we need look at Woolworths’ plunging share price in conjunction with the Australian dollar’s drop.

Woolworths’ shares have dropped from a closing high $38.49 in April 2014 to Monday’s closing price of approximately $25.88. This is a fall of around 32 per cent from its high. At the same time, the Australian dollar has fallen to around US70c from US90c when Woolworths was trading at $39 back in April last year. So in US dollar terms, the market cap of Woolworths has dropped from $US44 billion to around $US23bn. That’s a 48 per cent discount from the highs and may well attract buyers.

The rumoured suitor KKR has history in this area, having made two unsuccessful bids for Coles in 2006, before withdrawing from the race unexpectedly and handing Wesfarmers the prize. At the time, Coles was maligned for bad management and its underperformance. Wesfarmers imported experienced top-level management and was able to turn around the struggling supermarket and it proved to be a great buy. Last week KKR demonstrated that it has a keen eye on the Australian market, taking a 10 per cent stake in OZ Minerals, while its affiliate Thorpe Holdings acquired 5.01 per cent.

Another possible suitor is the mega-retailer Walmart. It certainly has the balance sheet and has previously shown its willingness to buy non-US assets by purchasing the UK grocery chain ASDA. Walmart could be attracted by the healthy margins provided by the Australian

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supermarkets. Currently, the US chain operates at just above a 3 per cent profit margin, while ASDA operates at around 3.8 per cent. In contrast, Coles' profit margin sits at 4.5 per cent and Woolworths at a comparatively massive 7.9 per cent. While these margins are likely to come down significantly due to competitive pressures from Coles and Aldi, they should still remain higher than those offered by their US and UK counterparts.

O'Brien's resignation will effectively be completed by November, when he takes his accrued leave. As yet, a new chief executive hasn't been named. When announced, the CEO will likely need a prolonged period before earning the faith and loyalty of the shareholders. This means that the coming 12 months are likely an ideal time for any potential bidders to strike.

Realistically, a forthcoming monster takeover bid should still be considered a long shot. Any subsequent bid would likely face many hurdles, including approval from the Foreign Investment Review Board and likely a hostile board. This being said, Woolworths looks to be a good inclusion in the portfolio of those seeking diversification from the mining and banking sectors. As it is largely consumer staples oriented, it also provides a defensive element at a time when there is significant downward pressure on Australian shares.

All up, the takeover speculation, a solid dividend yield of over 5.5 per cent (fully franked) and the possibility of a buyback if the stock continues to be sold off, make it worth a look.

Peter Fay *is director of Dealing Services at Invast Australia.*

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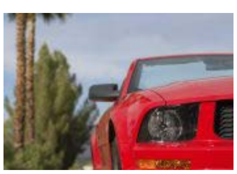

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Richard

WOW margins are the highest in the world and heading south for a long time. The important metric to look at here is Sales/sq.metre - Coles still has some considerable way ahead to get to WOW Sales/sq.metre so why get involved in that brawl now? Wait until Coles and Woolies have equalised, then assess the effect of the discount retailers on overall market share and what effect the China Free trade agreement will have on supply costs (i.e., WOW wont be able to push fruit and veg suppliers around anymore).

Perhaps then - when WOW's share price has a "1" handle - will KKR consider a bid.