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"Other operating revenue" spoiling retailers

Summary

Not a few retailers are struggling business due to slow recovery in consumer spending. In profitability analysis of this sector, someone compares profit margins based on raw data but this does not reflect true earnings power of retail business, as 'other operating revenue' such as property income would inflate profit margin in some cases. The analysis based on real profit from retail business shows correlation between other revenue and profitability, and examines store sales policy, private brand goods sale as well as store sales growth. A retailer with higher other revenue is more likely to weaken operating profit margin from core business, as higher margin of rent from tenant than retail business is likely to encourage a retailer to develop a large store (shopping center), and private brand goods are often selling at lower price for gathering customers.

Japan's GDP (flash) 4Q CY2015 was released on February 15th, showing weak personal consumption expenditures of -0.8% QoQ that were down after slight improvement in 2 quarters. Negative real earnings growth and concern over increasing cost of social security of aging society would cause reluctant spending. In such difficulties, convenience stores are performing well, developing values such as utility payment, parcel handling, eat-in, coffee, premium products and etc. and delivering to customers. Conversely, many of retailers are in the middle of recovery from slump hit by consumption tax hike 2 years ago.

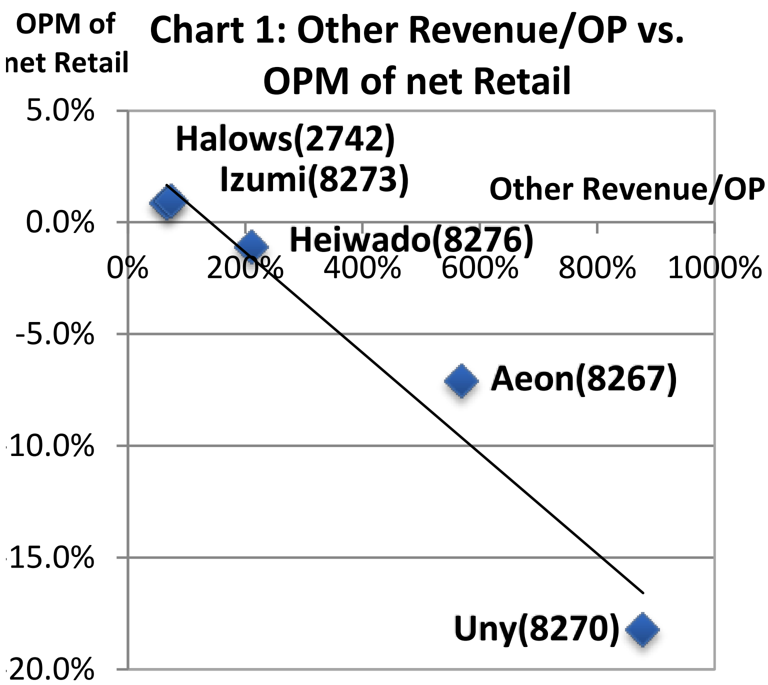
In this research, I would like to analyze real marketing or earning power of retailers of super market and home center sector that have been straggling for many years, and highlight "other operating revenue" of an accounting item. The item is income from non-core business and mostly from property income that GMS and HC operators lease their site to tenants. Diversification of business is not always a bad thing, but would weaken core retail business in some cases. In analyzing financial statements of retailers, we should keep it in mind to distinguish between profit margin of retail and that of other business such as property income from tenant, as some companies include other revenue in operating profit and others do not. For the company that puts it together in operating profit (OP), OP on income statement and OP margin looks higher than that for the company that booked the item as non-operating income. I focus on the relationship between "other revenue" and OP margin from net retail business, Total Liability/Total Assets, Private brand products sales/total sales.

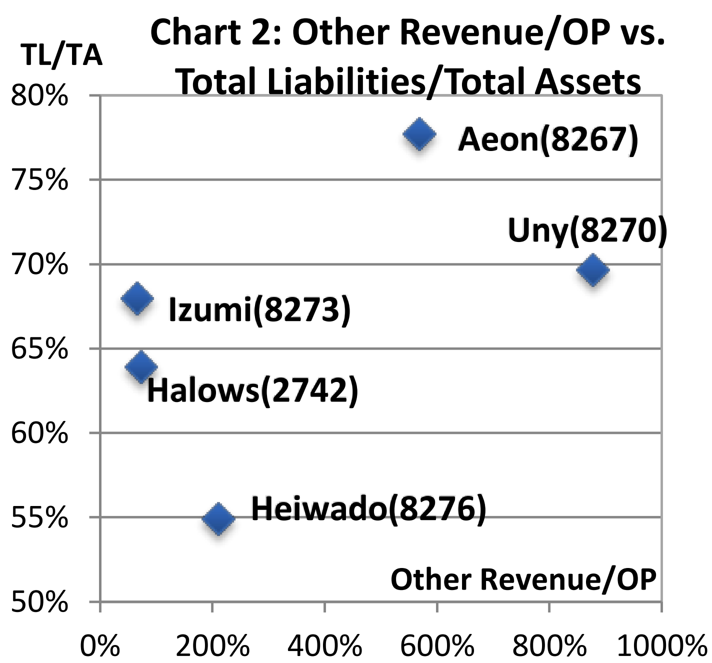
Super Market (GMS and regional super market)

The table shows an example of GMS and regional super market operators. Net OP from retail of net retail is outstandingly negative for 3 companies, Aeon, Uny and Heiwado, but other revenue for the other 2 companies consist of more than half of OP. As mentioned earlier, diversification is not always a bad thing for particularly a large retail conglomerate, but the issue should be a lower OP margin from real retail business which is likely to lead losing money due to lower profitability from core business, although raw profit margin looks to be graded ‘A’ in normal days. Following analysis will examine correlation between other revenue and profitability from retail (see Chart 1). Apparently a convenience store operator FamilyMart (8028) recently merged Uny that have been in trouble, earning higher other revenue but lower real profit margin from core business.

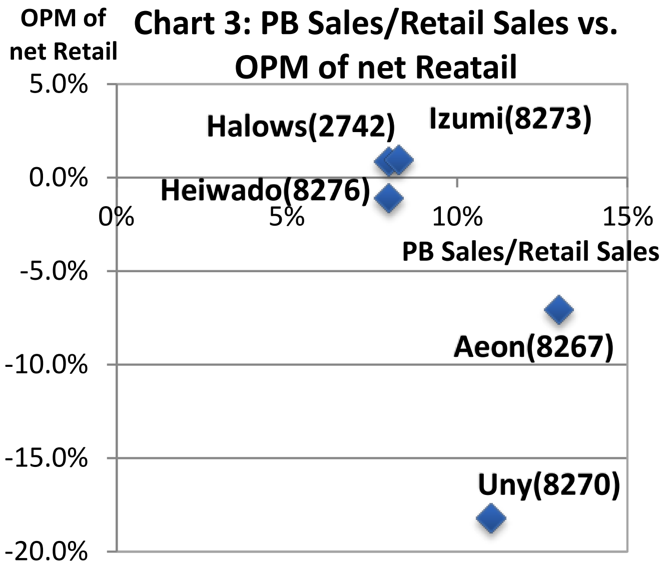
	Aeon (8267)	Uny (8270)	Izumi (8273)	Heiwado (8276)	Halows (2742)
(a) net Sales from Retail	5,345,504	631,058	443,874	301,360	76,154
(b) Operating Profit	80,851	14,797	11,072	3,027	2,723
(c) Other Revenue (mainly rent income from tenant)	459,959	129,910	7,324	6,386	1,999
(d) net OP from Retail =(b)-(a)	(379,108)	(115,113)	3,748	(3,359)	724
Other Revenue/OP =(c)/(b)	569%	878%	66%	211%	73%
OPM of net Retail =(d)/(a)	-7.1%	-18.2%	0.8%	-1.1%	1.0%
Total Liabilities/Total Assets	78%	70%	68%	55%	64%
Private Brand products (exc. Premium products) Sales/Retail Sales	13%	11%	8%	8%	8%
Existing Store Sales (YoY) Fiscal Year to Month	-0.5%	0.9%	1.9%	1.7%	2.2%

(Note) Other Revenue of Aeon excludes revenue from Financial Servivces.
(Note) Data is based on 3Q FY2015
(Note) Private Brand Sales ratios are estimated.
(Note) Store Sales of Aeon are data of Aeon Retail.
(Note) Store Sales of Heiwado and Halows are average of monthly sales.





As the “other operating revenue” mostly comes from property income leasing to tenants, for retailers it would be a great motivation to develop large outlets and lease the sites to tenants. Raw “operating profit’ is becoming large as they develop more new outlets. Aggressive store-opening plan is often shown as capital structure such as total liability/total assets of relying on more debt financing. Chart 2 shows relationship between other revenue between total liabilities/total assets. Aeon, Izumi and Halows maintain aggressive store opening policy, whereas Uny and Heiwado are likely to decrease opening large stores these days although all the companies had opened numbers of stores. Of course, hiring leverage is not necessarily bad for companies, but point is collecting cash flows or return on the investment. Property income would often relatively higher margin and easier than that from retail business, and not a few operators tend to increase large new stores and employ higher leverage. Consequently, they are more likely to focus on developing new large stores or shopping malls than raising profit margin from selling goods.



Meanwhile many of them are strengthening private brand goods most of which have been sold at lower prices (PB goods mean low price goods and exclude premium goods at this time). PB goods can contribute to profit if a retailer delivers customers value and prices them reasonably high enough. However, many retailers use them to gather customers as bait and the earning power is decreasing. All companies on Chart 3 are expanding private brand goods sale and a company with higher PB sales ratio makes lower profit margin. Seriously higher PB sale ratio of Aeon and Uny that are selling more low price PB goods, but their existing store sales are lower of -0.5% and 0.9% YoY (see the bottom of Table on page 1). This means that the 2 GMS cannot deliver value to customers well and attract them with low price goods. Hence, they are more likely to be in trouble and have less room to lower sale prices of goods. Hiroshima based 2 regional super markets Izumi and Halows are likely to follow similar strategy of the 2 GMS, expanding outlets aggressively but fortunately have more room to increase private brands goods sale to gather more customers at lower prices, whereas Heiwado has diverted from aggressive store opening and lower PB sales ratio but real OPM is low.

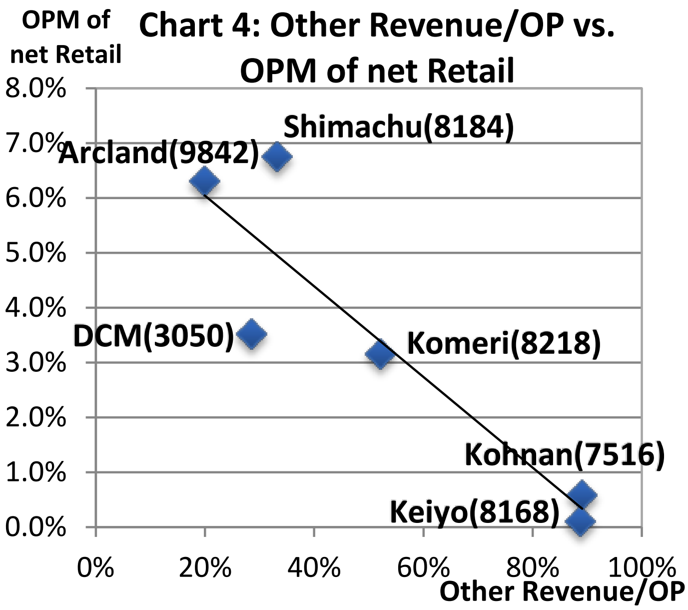
Home Center

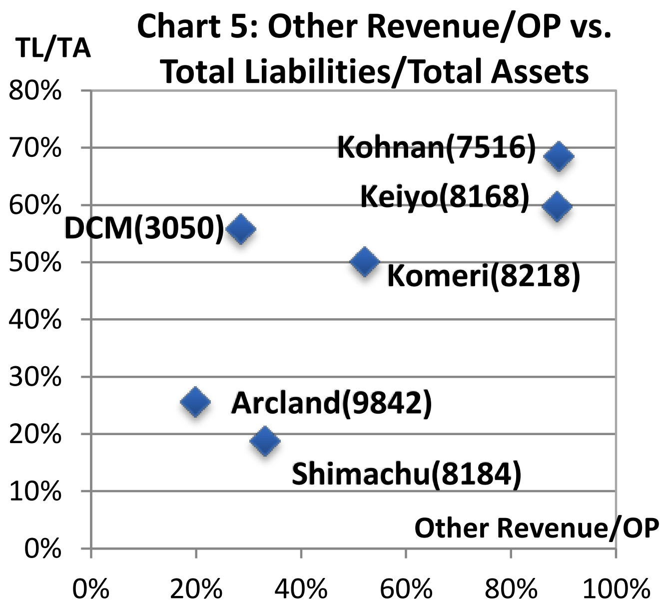
Home Center sector is clearer relationship on effect of other revenue. The table shows samples of major HC operators. In computing OP margin from real retail business, other revenue should be considered propertly, as Arcland, Shimachu and Keiyo do not include it in operating profit, whereas Komeri, DCM and Kohnan do (see below table).

	Komeri (8218)	DCM (3050)	Kohnan (7516)	Arcland (9842)	Shimachu (8184)	Keiyo (8168)
(a) net Sales from Retail	246,857	328,256	218,966	59,646	37,665	119,395
(b) Operating Profit	16,287	16,164	11,673	3,761	2,544	118
(c) Other Revenue (rent income from tenant)	8,492	4,609	10,401	-	-	-
Rent income that does not include in OP				936	1,264	932
(d) net OP from Retail =(b)-(a)	7,795	11,555	1,272	3,761	2,544	118
Other Revenue/OP =(c)/(b)	52%	29%	89%	20%	33%	89%
raw OPM =(b)/((a)+(c))	6.4%	4.9%	5.1%	6.3%	6.8%	0.1%
OPM of net Retail =(d)/(a)	3.2%	3.5%	0.6%	6.3%	6.8%	0.1%
Total Liabilities/Total Assets	50%	56%	68%	26%	19%	60%
Private Brand products Sales/retail Sales	40%	10%	40%	0%	0%	33%
Existing Store Sales (YoY) Fiscal Year to Month	-0.4%	-5.4%	5.3%	-4.6%	-6.8%	-7.4%

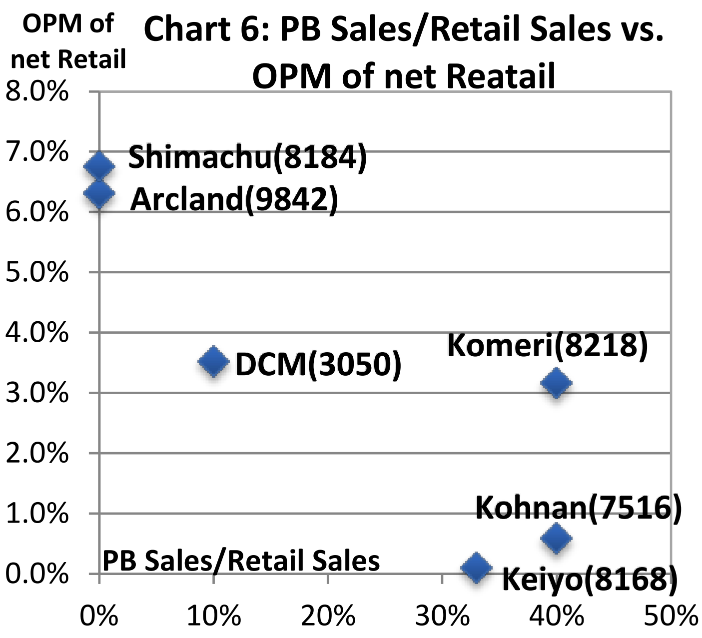
(Note) All data is based on 3Q FY2015, but data of Shimachu is 1Q FY2016.
(Note) OP of Arcland, Shimachu and Keiyo does not include Other Revenue.
(Note) Private Brand Sales ratios are estimated.
(Note) Store Sales of Shimachu are average of monthly sales (YoY) from March 2015.

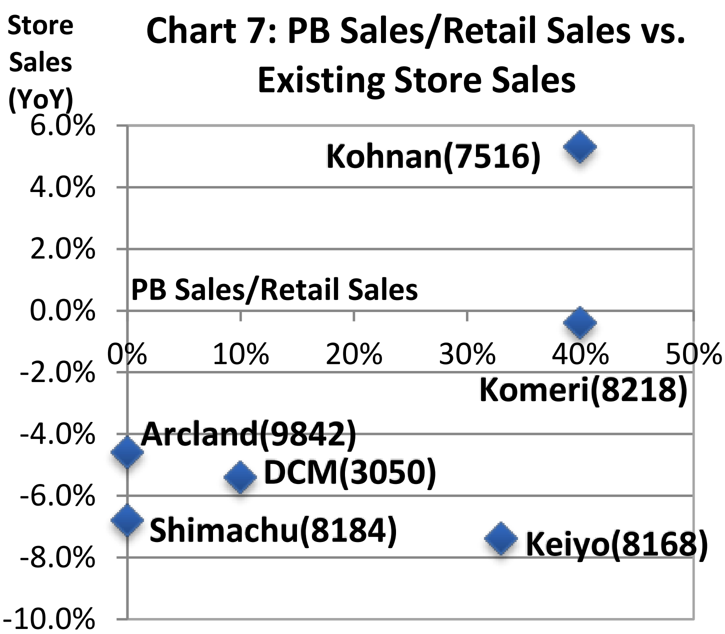
Chart 4 also shows negative correlation between other revenue to OP and OP margin of net retail business. Kohnn and Keiyo heavily rely on other revenue from property income and earn soggy profit margin in core business. Arcland and Shimachu make relatively higher margins from mostly core HC business, whereas DCM and Komeri are in the middle. The relationship between other revenue to OP and total liabilities to total assets are shown on Chart 5. The financial leverage remains higher for Kohnan and Keiyo that has not collected sufficient return or cash flows from past investment, whereas Arceland and Shimachu has collected well cash flows from past investment and maintained slower store opening for a few years.





PB goods sale seems to have negative correlation with OP margin of net retail business on Chart 6. Shimachu and Arcland earn higher OP margin from core business with low PB goods sale. Other peers make lower profitability, selling more private brand goods at lower prices. Keiyo and Kohnan are using PB goods as bite for gathering customers into stores, whereas Komeri has median profit margin with the highest PB sale ratio. Regarding store sales, Chart 7 shows relationship with PB goods sales. Generally, more PB goods are sold, existing store sales grow at higher rate. Keiyo that has higher PB sale but the lowest store sales growth has been in trouble for years. Arcland and Shimachu suffer declining store sales but are likely to prefer profitability to current sales. Kohnan is improving from soggy store sales for past a few years but remains lower profitability and insufficient return from past investment as mentioned earlier. DCM has improved profitability for this fiscal year (but still lower) without pulling PB goods sale higher. Komeri seems to try to balance sales growth and profitability. The home center operator tries to sell balancing high margin professional goods and lower price of PB goods gathering customers. Although the company plans to continue increasing PB goods sale, I wonder if it is possible, as Kohnan has given up further increase PB sale due to losing customers who prefer national brands a few years before. Earnings would decrease further if store sales move lower as real OP margin from retail business is lower at 3.2%. In case, investors who look at raw OP margin of the 2nd highest of 6.4% in raw OPM in HC sector might react negatively.





Conclusion

Some correlation would be proved on the above analysis although sample companies for super market and home center sector are limited number. This is not always the case, as mentioned earlier. However, key ratios should be kept in mind as check marks (other revenue/OP, financial leverage and PB sale). Once store sales in monthly basis deteriorated, profits would unexpectedly decline as OP is inflated particularly for a company that includes other revenue in OP.

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