

# The Warehouse Group

## RESEARCH INSIGHTS<sup>#</sup>

### FY19 — Points on the Board

The Warehouse (WHS) reported an encouraging FY19 result, lifting earnings across Red Sheds, Blue Sheds, and Noel Leeming, exhibiting operating improvements from its transformation programme. Going forward we expect Group store EBIT margin to continue to improve, offsetting macro and cost headwinds. However, customer acquisition costs relating to its new online platform, TheMarket, will likely provide an earnings drag for a number of years.

#### What's changed?

- Earnings:** We have lowered our FY20E/FY21E/FY22E Normalised NPAT -4%/-7%/-6% as a result of higher expected operating losses from TheMarket

#### Transformation programme unlocking margin gains

WHS reported FY19 underlying NPAT of NZ\$74.1m, up +26% on the prior period and in line with expectations. Margin improvements across Red Sheds, Blue Sheds, and Noel Leeming are encouraging and exhibit signs of execution on the company's transformation programme. Torpedo7 delivered a higher than expected operating loss as a result of deterioration in its cost of doing business margin, with ongoing store expansion. Additionally, costs associated with the development of TheMarket of -NZ\$6.0m also weighed on earnings. Group online sales displayed strong growth, up +18%, and now represent 7.8% of total sales.

#### Debt reduction enabled by improved supplier terms; capex lift guided

WHS reported a material reduction in net debt, driven by a release of working capital following the negotiation of improved supplier terms, which we view as sustainable and more aligned to retailing peers. Inventory levels also fell, with a reduction in stock keeping units following the shift to an everyday low pricing model. Gearing fell to 14% from 25% in the prior period. WHS guided to elevated capex through FY20–FY22 (NZ\$100m to NZ\$120m per year) as it invests in its store network, information and digital systems, and logistics.

#### Transformation gains to offset macro headwinds

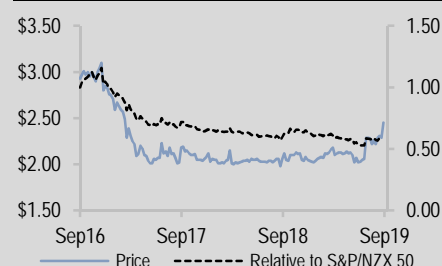
WHS has not provided FY20 guidance at this stage given the importance of the peak Christmas trading period; however, it highlighted a number of macro headwinds in unfavourable currency movements and ongoing cost inflation. We expect improvements in the underlying business will continue, offsetting headwinds and providing earnings growth. WHS signalled an FY20 operating loss from its recently launched ecommerce platform, TheMarket, of NZ\$14m to NZ\$17m. We expect TheMarket could take circa five years to reach breakeven although expect FY20 to represent the peak of negative earnings with a focus on both customer and merchant acquisition as it builds out its offering.

#### Investment View

WHS operates The Warehouse, Warehouse Stationery, Noel Leeming, Torpedo7, and TheMarket. Material business transformation is underway which brings considerable moving parts and a wide range of outcomes. This follows underwhelming returns in recent years. We retain a cautious stance with material risk at this stage of the transformation around execution, 'cost-in', and time to see results; but there are some initial encouraging signs.

NZX Code	WHS
Share price	NZ\$2.45
Issued shares	345.2m
Market cap	NZ\$846m
Average daily turnover	52.7k (NZ\$113k)

#### Share Price Performance



Financials: July	19A	20E	21E	22E
NPAT* (NZ\$m)	74.1	76.1	88.4	96.0
EPS* (NZc)	21.5	22.0	25.6	27.8
EPS growth* (%)	25.6	2.7	16.1	8.6
DPS (NZc)	17.0	17.5	18.5	21.0
Imputation (%)	100	100	100	100
Valuation (x)	19A	20E	21E	22E
EV/EBITDA	5.6	5.3	4.8	4.4
EV/EBIT	8.6	8.1	7.2	6.7
PE	11.4	11.1	9.6	8.8
Price / NTA	1.8	1.7	1.5	n/a
Cash dividend yield (%)	6.9	7.1	7.6	8.6
Gross dividend yield (%)	9.6	9.9	10.5	11.9

\*Historic and forecast numbers based on underlying profits

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<sup>#</sup>Forsyth Barr RESEARCH INSIGHTS targets selected smaller cap stocks or those under transitional coverage and focuses on qualitative rather than quantitative assessments. We do not provide investment ratings or target prices on these stocks.

**The Warehouse Group (WHS)**

Priced as at 25 Sep 2019: NZ\$2.45

July year end

<b>Research Insights</b>						<b>Valuation Ratios</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Forsyth Barr Research Insights focuses on qualitative rather than quantitative assessments of an equity investment.						EV/EBITDA (x)	6.7	5.6	5.3	4.8	4.4
We do not provide valuation, target prices or investment ratings for companies in the Research Insights series. It is targeted at selected smaller cap stocks with typically higher risk attributes, or those under transitional coverage.						EV/EBIT (x)	11.0	8.6	8.1	7.2	6.7
Our earnings and cashflow forecasts, together with key valuation and ratios provided on this page should assist investors in determining the relative valuation merits of the company.						PE (x)	14.3	11.4	11.1	9.6	8.8
						Price/NTA (x)	1.8	1.8	1.7	1.5	1.4
						Free cash flow yield (%)	4.5	16.2	4.2	5.4	6.3
						Net dividend yield (%)	6.5	6.9	7.1	7.6	8.6
						Gross dividend yield (%)	9.1	9.6	9.9	10.5	11.9
						Imputation (%)	100	100	100	100	100
						Pay-out ratio (%)	94	79	79	72	76
						<b>Capital Structure</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
						Interest cover EBIT (x)	10.0	12.7	12.7	16.2	17.5
						Interest cover EBITDA (x)	16.5	19.5	19.5	24.6	26.7
						Net debt/ND+E (%)	26.1	13.9	17.0	14.7	13.9
						Net debt/EBITDA (x)	1.1	0.4	0.6	0.5	0.4
						<b>Key Ratios</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
						Return on assets (%)	8.9	10.8	10.5	11.4	11.9
						Return on equity (%)	12.8	15.7	15.4	16.2	16.2
						Return on funds employed (%)	10.4	13.8	14.5	15.3	15.4
						EBITDA margin (%)	5.0	5.6	5.6	6.3	6.8
						EBIT margin (%)	3.1	3.7	3.7	4.1	4.5
						Capex to sales (%)	2.3	2.0	3.2	3.5	3.8
						Capex to depreciation (%)	118	101	164	162	160
						<b>Operating Performance</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
						<b>Divisional revenue (NZ\$m)</b>					
						Red Sheds	1,717	1,706	1,714	1,723	1,722
						Blue Sheds	264	269	271	275	278
						Noel Leeming	880	925	953	977	986
						Torpedo7	163	172	183	190	194
						Other	(30)	(0)	0	0	1
						<b>Total revenue</b>	<b>2,995</b>	<b>3,071</b>	<b>3,121</b>	<b>3,165</b>	<b>3,181</b>
						Gross profit (NZ\$m)	991	1,029	1,052	1,064	1,069
						Gross margin (%)	33.1	33.5	33.7	33.6	33.6
						<b>Divisional EBIT (NZ\$m)</b>					
						Red Sheds	71	85	92	100	107
						Blue Sheds	11	17	16	16	14
						Noel Leeming	31	38	40	44	44
						Torpedo7	(1)	(7)	(4)	(1)	0
						Other	(20)	(20)	(30)	(27)	(25)
						<b>Total EBIT</b>	<b>91</b>	<b>112</b>	<b>115</b>	<b>131</b>	<b>142</b>
						<b>EBIT margins (%)</b>					
						Red Sheds	4.2	5.0	5.4	5.8	6.2
						Blue Sheds	4.0	6.2	6.0	5.7	5.2
						Noel Leeming	3.5	4.1	4.2	4.5	4.5
						Torpedo7	-0.9	-4.1	-2.0	-0.7	0.1
						<b>Group</b>	<b>3.1</b>	<b>3.7</b>	<b>3.7</b>	<b>4.1</b>	<b>4.5</b>
						<b>Profit and Loss Account (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Sales revenue							2,995	3,071	3,121	3,165	3,181
Normalised EBITDA							151	173	176	199	217
Depreciation and amortisation							(60)	(61)	(61)	(68)	(75)
Normalised EBIT							91	112	115	131	142
Net interest							(9)	(9)	(9)	(8)	(8)
Associate income							-	-	-	-	-
Tax							(23)	(29)	(30)	(34)	(37)
Minority interests							0	0	0	0	0
Normalised NPAT							59	74	76	88	96
Abnormals/other							(32)	(7)	(20)	-	-
Reported NPAT							27	67	56	88	96
Normalised EPS (cps)							17.1	21.5	22.0	25.6	27.8
DPS (cps)							16.0	17.0	17.5	18.5	21.0
						<b>Growth Rates</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Revenue (%)							0.5	2.6	1.6	1.4	0.5
EBITDA (%)							-9.1	14.5	1.7	13.0	9.0
EBIT (%)							-15.2	22.9	2.3	14.0	8.1
Normalised NPAT (%)							-13.4	25.6	2.7	16.1	8.6
Normalised EPS (%)							-13.2	25.6	2.7	16.1	8.6
DPS (%)							0.0	6.3	2.9	5.7	13.5
						<b>Cash Flow (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
EBITDA							151	173	176	199	217
Working capital change							(24)	57	(5)	(4)	(1)
Interest & tax paid							(23)	(35)	(39)	(42)	(45)
Other							4	3	3	3	3
Operating cash flow							108	198	136	156	173
Capital expenditure							(70)	(61)	(100)	(110)	(120)
(Acquisitions)/divestments							30	4	-	-	-
Other							-	(1)	-	-	-
Funding available/(required)							67	139	36	46	53
Dividends paid							(56)	(52)	(60)	(64)	(72)
Equity raised/(returned)							-	-	-	-	-
Increase/(decrease) in net debt							(11)	(87)	25	18	19
						<b>Balance Sheet (NZ\$m)</b>	<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
Working capital							325	256	261	264	266
Fixed assets							354	347	386	428	473
Intangibles							-	-	-	-	-
Other assets							47	38	38	38	38
Total funds employed							725	641	685	731	777
Net debt/(cash)							162	76	101	94	96
Other non current liabilities							102	91	91	91	91
Shareholder's funds							460	473	493	546	591
Minority interests							1	1	0	0	0
Total funding sources							725	641	685	731	777

\* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

## FY19 result summary

Figure 1. FY19 result summary (NZ\$m)

	FY18A	FY19A	Change	Comments
<b>Profit and Loss Account</b>				
Sales	2,994.6	3,071.4	+2.6%	Sales growth gaining momentum in 2H19
Cost of Sales	(2,003.4)	(2,042.7)	+2.0%	
Gross Profit	991.2	1,028.6	+3.8%	Gross margin of 33.5% (+40bps on FY18)
SG&A Costs	(840.1)	(855.6)	+1.8%	
Total EBITDA	151.1	173.0	+14.5%	
Depreciation & Amort.	(59.6)	(60.6)	+1.6%	Capex of \$62m, slightly behind guidance
EBIT	91.4	112.4	+22.9%	
Net Interest	(9.2)	(8.9)	-3.1%	Debt reduction skewed towards final quarter
Profit Before Tax	82.3	103.5	+25.8%	
Tax	(23.0)	(29.3)	+27.1%	Effective tax rate of 28.3%
Normalised Profit	59.0	74.1	+25.6%	Includes -\$6m investment cost relating to TheMarket
Reported Profit	27.3	67.3	+146.9%	Includes restructuring cost of -\$16m, Torpedo7 impairment of -\$5m
Underlying EPS (cps)	17.1	21.5	+25.6%	
DPS (cps)	16.0	17.0	+6.3%	Fully imputed (80% pay-out of Normalised NPAT)
<b>Balance sheet and cashflow Summary</b>				
Operating Cashflow	107.9	198.0	+83.5%	
Inventory	523.8	517.8	-1.2%	SKU reduction as part of shift to EDLP model
Fixed Assets	353.9	346.7	-2.0%	Capex guidance of NZ\$100m to NZ\$120m FY20-FY22
Working Capital	324.6	255.9	-21.2%	Change in payables key driver
Net Debt	162.3	76.2	-53.1%	NWC release with increased payables from changes in supplier terms
Shareholders Equity	479.4	481.3	+0.4%	
<b>Divisional Analysis</b>				
Red Sheds Sales	1,695.8	1,075.7	0.6%	Same store sales (SSS) up +1.5%. General Merchandise a standou
Red Sheds EBIT	71.4	85.1	19.1%	5.0% EBIT margin (+80bps on FY18)
Blue Sheds Sales	263.8	268.6	1.8%	SSS up +1.4%. 6 store-within-store integrations completed in FY19
Blue Sheds EBIT	10.6	16.7	57.4%	6.2% EBIT margin (+220bps)
Noel Leeming Sales	880.5	924.6	5.0%	SSS up +2.8%. Home Appliances a standout category
Noel Leeming EBIT	31.2	38.1	22.3%	4.1% EBIT margin (+60bps)
Torpedo7 Sales	163.4	172.5	5.6%	Four additional stores (now at 18)
Torpedo7 EBIT	(1.4)	(7.0)	-385.6%	Higher operating costs due to store expansion
Total Sales	2,994.6	3,071.4	2.6%	
Total EBIT	91.4	112.4	22.9%	EBIT margin 3.7% (+60bps)

Source: Company reports, Forsyth Barr analysis

## Earnings changes

We have made net negative revisions to earnings assumptions. We have lifted our forecasts across Red Sheds, Blue Sheds, and Noel Leeming on the back of a higher FY19 base and signalling of continued margin gains. However, this is offset by a higher than expected operating loss from its recently launched ecommerce platform, TheMarket. WHS has guided to an operating loss from TheMarket of NZ\$14m to NZ\$17m in FY19; we expect it will take a number of years to reach breakeven.

Figure 2. Earnings changes (NZ\$m)

	2020E			2021E			2022E		
	Old	New	%chg	Old	New	%chg	Old	New	%chg
Sales	3,063.3	3,121.2	1.9%	3,081.3	3,165.2	2.7%	3,106.3	3,181.0	2.4%
EBIT	120.0	114.9	-4.2%	138.1	131.0	-5.1%	146.9	141.6	-3.7%
Normalised profit	79.3	76.1	-4.0%	94.8	88.4	-6.8%	101.5	96.0	-5.5%
Underlying EPS (cps)	22.9	22.0	-3.6%	27.3	25.6	-6.3%	29.3	27.8	-5.0%
DPS (cps)	16.0	17.5	9.4%	16.5	18.5	12.1%	22.0	21.0	-4.5%

Source: Forsyth Barr analysis

## Investment summary

The Warehouse Group (WHS) is a multi-business retailer which operates four retail chains having undergone a period of change following a suite of acquisitions and investments. The current phase is reducing complexity and driving flexibility in the model through a material business transformation. Recent signs are encouraging but it is early days.

### Earnings and cash flow outlook

- n **Red Sheds:** Is the key contributor to profit and is the main area of focus in the business transformation. Following a very disappointing FY17, FY18 was a year of transition, with FY19 the first 'clean' year to assess changes.
- n **NZDUSD and hedging:** All market participants are affected by FX movements, but given price conscious consumers we don't expect retailers to be able to pass on the full impact of unfavourable FX movements.

### Business quality

- n **Strategic change:** Details of the new strategy have been released by CEO, Nick Grayston over the past 18 months. The focus is on leveraging the existing asset base, optimising the model and reducing complexity. WHS itself acknowledges there is a significant range of outcomes in its internal financial modelling of the strategic plan.
- n **Competitive positioning:** While WHS faces strong competition from existing retailers, possible new entrants, and online retailers, it has a market leading store footprint and three very strong brands.

### Company description

The Warehouse Group is a major listed retailer in NZ with a general merchandise chain of 92 stores (The Warehouse) and a stationery chain of 66 stores (Warehouse Stationery). The company acquired Noel Leeming for NZ\$65m in December 2012 and pure-play online retailer, Torpedo7 in April 2013 for up to NZ\$33m. Noel Leeming is a leading consumer electronics and appliances retailer.

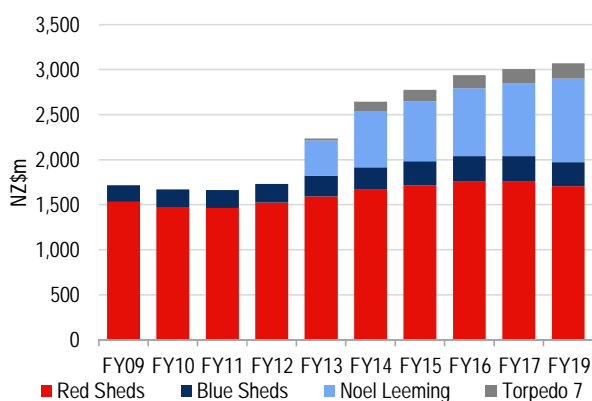
### Financial structure

- n **Balance sheet analysis:** Gearing is around 25% and WHS is looking to reduce debt through its transformation process. Operating cash flow shows the benefit of an improved working capital position, while capital expenditure is on improving the businesses systems and operations.
- n **Dividends:** We expect dividend growth to be relatively modest in the near-to-medium-term given the reinvestment into the business that is underway.

### Risks factors

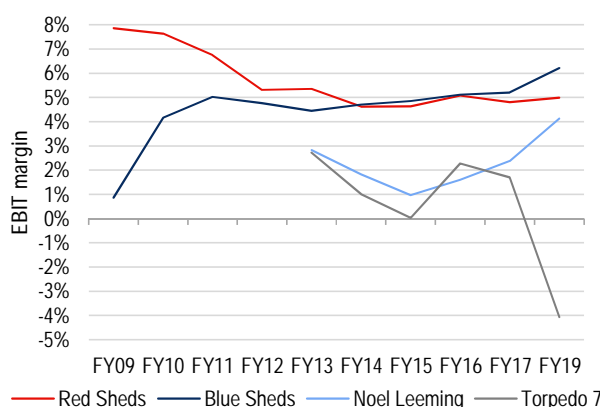
- n **Competitive environment:** Particularly with the expansion of Kmart in New Zealand and the entry of Amazon into Australia.
- n **Consumer sentiment and cost inflation:** Deterioration in economic conditions or general consumer sentiment. Cost inflation, particularly rising wages and rent.

Figure 3. Divisional revenue (NZ\$m)



Source: Forsyth Barr analysis, company reports

Figure 4. Divisional EBIT margin (%)



Source: Forsyth Barr analysis, company reports

**Figure 5. Substantial Shareholders**

Shareholder	Latest Holding
Stephen Robert Tindall	27.0%
The Tindall Foundation	21.3%
James Pascoe	19.7%
Foodstuffs	9.9%

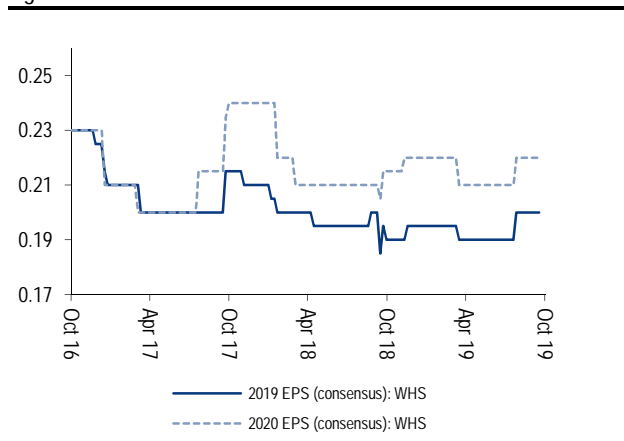
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

**Figure 6. International Compcos**

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect WHS's balance date - July)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
The Warehouse Group	WHS NZ	NZ\$2.45	NZ\$846	11.1x	9.6x	5.2x	4.6x	8.0x	7.0x	7.6%
Briscoe Group *	BGP NZ	NZ\$3.70	NZ\$822	12.7x	12.9x	7.8x	7.9x	8.3x	8.5x	6.1%
Hallenstein Glasson Holdings	HLG NZ	NZ\$5.96	NZ\$352	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Kathmandu Holdings *	KMD NZ	NZ\$3.08	NZ\$698	12.1x	11.2x	7.2x	6.8x	8.5x	8.0x	5.8%
Michael Hill Intl *	MHJ NZ	A\$0.60	A\$233	9.1x	9.0x	4.4x	4.3x	6.6x	6.6x	8.7%
Restaurant Brands NZ *	RBD NZ	NZ\$11.15	NZ\$1,391	27.8x	24.4x	13.8x	12.7x	20.8x	18.8x	0.0%
Costco Wholesale Corp	COST US	US\$287.88	US\$126,607	33.8x	31.7x	18.2x	16.8x	23.8x	21.7x	1.0%
Target Corp	TGT US	US\$107.36	US\$54,853	16.8x	15.8x	9.6x	9.4x	14.7x	14.1x	2.6%
Reject Shop/The	TRS AT	A\$1.98	A\$57	15.9x	9.5x	1.9x	1.7x	n/a	n/a	3.9%
Walmart Inc	WMT US	US\$118.71	US\$337,446	23.6x	22.7x	12.1x	11.8x	18.1x	17.8x	1.9%
Compcos Average:				19.0x	17.1x	9.4x	8.9x	14.4x	13.6x	3.8%
WHS Relative:				-41%	-44%	-44%	-48%	-44%	-48%	+101%
EV = Current Market Cap + Actual Net Debt										

EV = Current Market Cap + Actual Net Debt

Source: \*Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (WHS) companies fiscal year end

**Figure 7. Consensus EPS Momentum**


Source: Forsyth Barr analysis

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