

The Warehouse Group

RESEARCH INSIGHTS#

1Q20 Sales Check Out

The Warehouse Group (WHS) has started FY20 well, illustrating signs of execution on its transformation programme, reporting 1Q20 sales growth of +4.0% on the prior period. Growth was broad based and ahead of expectations across three of the four key brands. We see some upside risks to our forecasts with 1Q20 sales growth ahead of our full year run rate; however, note that the important Christmas selling season is to come. FY20 guidance is expected to be provided at the end of 2Q20.

Solid start to the year

WHS reported 1Q20 group revenue of NZ\$695m, up +4.0% on the prior comparable period and ahead of our FY20 run rate. Margin commentary is also positive, particularly against the backdrop of rising cost pressures with gross margins in Red Sheds performing well relative to the prior year. Whilst the strong start is positive, 1Q represents ~20% of full year revenue with the key Christmas quarter to come.

Divisional insights

- **Red Sheds:** An encouraging start with 1Q20 same store sales (SSS) up +3.1%, ahead of expectations, and positive commentary around gross margin expansion. Margin improvement is being driven by a mixture of better price realisation and buying discipline. On a category basis, general merchandise is the main driver of growth.
- **Blue Sheds:** 1Q20 sales increased +2.1% on the prior year period. Relatively benign SSS growth of +0.6% is suppressed by a number of store-within-a-store conversions (Blue Shed integrated into a Red Shed) which are considered new stores. Warehouse Stationary stores that have been integrated into a Red Shed are seeing strong sales growth, leveraging Red Sheds higher foot traffic, and at better margins.
- **Noel Leeming:** A key standout for the quarter with sales benefitting from the timing of the Rugby World Cup and a new Apple product launch. SSS increased +6.1%, with particularly strong growth in the TV and Computer Accessories categories as consumers bought streaming technology ahead of the Rugby World Cup.
- **Torpedo7:** Slight decline in SSS, down -0.6%, with total sales benefitting from additional store openings (up +3.0%). We suspect continued store expansion combined with limited SSS growth is likely to be weighing on margins.
- **TheMarket:** Early signs for TheMarket are encouraging with customer traffic ~+30% ahead of expectations and continued growth in brands available through the platform. However, build out of ecommerce platforms can take a long time and we expect customer acquisition costs will be an earnings drag for a number of years.

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\$2.88
Issued shares	345.2m
Market cap	NZ\$994m
Average daily turnover	30.4k (NZ\$106k)

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	6.4	6.2	5.5	5.1
EV/EBIT	9.9	9.4	8.4	7.7
PE	13.4	13.1	11.3	10.4
Price / NTA	3.1	2.8	2.6	n/a
Cash dividend yield (%)	5.9	6.1	6.4	7.3
Gross dividend yield (%)	8.2	8.4	8.9	10.1

*Historic and forecast numbers based on underlying profits

Guy Hooper

guy.hooper@forsythbarr.co.nz

+64 4 495 5255

The Warehouse Group (WHS)

Priced as at 08 Nov 2019: NZ\$2.88

July year end

Research Insights						Valuation Ratios											
Forsyth Barr Research Insights focuses on qualitative rather than quantitative assessments of an equity investment.						2018A	2019A	2020E	2021E	2022E							
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/EBITDA (x)	7.7	6.4	6.2	5.5	5.1						
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.						EV/EBIT (x)	12.7	9.9	9.4	8.4	7.7						
						PE (x)	16.9	13.4	13.1	11.3	10.4						
						Price/NTA (x)	2.2	2.1	2.0	1.8	1.7						
						Free cash flow yield (%)	3.8	13.7	3.6	4.6	5.3						
						Net dividend yield (%)	5.6	5.9	6.1	6.4	7.3						
						Gross dividend yield (%)	7.7	8.2	8.4	8.9	10.1						
						Imputation (%)	100	100	100	100	100						
						Pay-out ratio (%)	94	79	79	72	76						
						Capital Structure											
						2018A	2019A	2020E	2021E	2022E							
						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						
						Key Ratios											
						2018A	2019A	2020E	2021E	2022E							
						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						
						Operating Performance											
						2018A	2019A	2020E	2021E	2022E							
						Divisional revenue (NZ\$m)											
						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						
						Total revenue	2,995	3,071	3,121	3,165	3,181						
						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						
						Divisional EBIT (NZ\$m)											
						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)						
						Total EBIT	91	112	115	131	142						
						EBIT margins (%)											
						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						
						Group	3.1	3.7	3.7	4.1	4.5						
Profit and Loss Account (NZ\$m)						2018A	2019A	2020E	2021E	2022E							
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							
						Growth Rates											
						2018A	2019A	2020E	2021E	2022E							
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							
						Cash Flow (NZ\$m)											
						2018A	2019A	2020E	2021E	2022E							
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							
						Balance Sheet (NZ\$m)											
						2018A	2019A	2020E	2021E	2022E							
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

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

- **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.
- **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

- **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.
- **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.

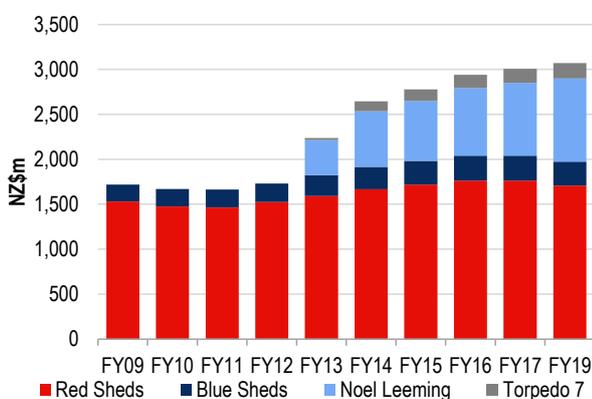
Financial structure

- **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.
- **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

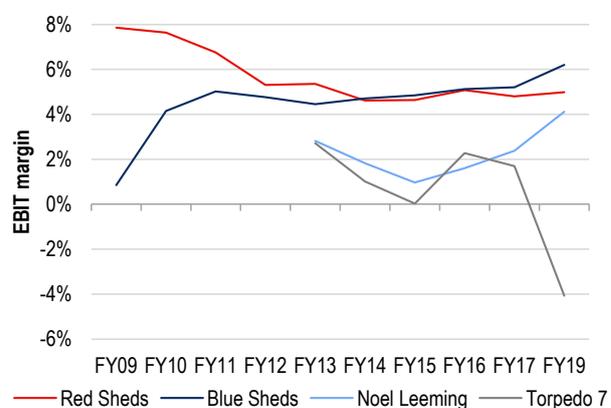
- **Competitive environment:** Particularly with the expansion of Kmart in New Zealand and the entry of Amazon into Australia.
- **Consumer sentiment and cost inflation:** Deterioration in economic conditions or general consumer sentiment. Cost inflation, particularly rising wages and rent.

Figure 1. Divisional revenue (NZ\$m)



Source: Forsyth Barr analysis, company reports

Figure 2. Divisional EBIT margin (%)



Source: Forsyth Barr analysis, company reports

Figure 1. Substantial Shareholders

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

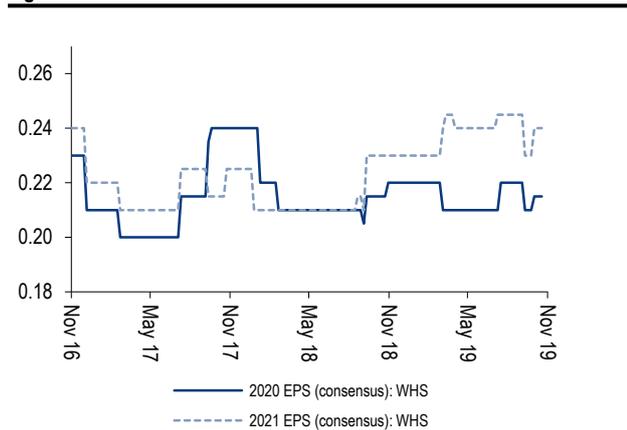
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 2. International Compco's

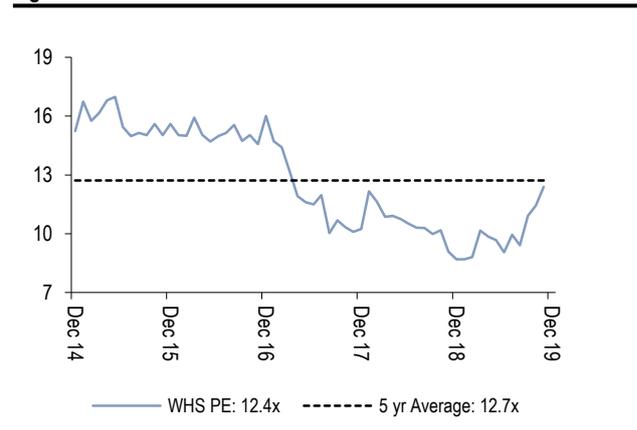
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld	
<i>(metrics re-weighted to reflect WHS's balance date - July)</i>											
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E	2021E
The Warehouse Group	WHS NZ	NZ\$2.88	NZ\$994	13.1x	11.3x	6.1x	5.4x	9.3x	8.2x	6.4%	
Briscoe Group *	BGP NZ	NZ\$3.70	NZ\$822	12.7x	12.9x	7.8x	7.9x	8.3x	8.5x	6.1%	
Hallenstein Glasson Holdings	HLG NZ	NZ\$6.25	NZ\$369	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Kathmandu Holdings *	KMD NZ	NZ\$3.10	NZ\$914	11.4x	9.7x	6.7x	5.5x	8.1x	6.6x	6.1%	
Michael Hill Intl *	MHJ NZ	A\$0.75	A\$291	10.2x	10.0x	5.1x	4.9x	7.4x	7.2x	6.9%	
Restaurant Brands NZ *	RBD NZ	NZ\$11.84	NZ\$1,477	29.4x	25.7x	14.5x	13.3x	21.8x	19.5x	0.0%	
Costco Wholesale Corp	COST US	US\$305.21	US\$134,188	35.5x	33.1x	19.2x	17.7x	25.4x	23.2x	1.0%	
Target Corp	TGT US	US\$110.59	US\$56,504	17.3x	16.0x	9.8x	9.5x	15.0x	14.3x	2.6%	
Reject Shop/The	TRS AT	A\$2.69	A\$78	<0x	25.8x	1.0x	0.9x	n/a	n/a	0.9%	
Walmart Inc	WMT US	US\$120.23	US\$341,968	23.9x	22.8x	12.2x	11.9x	18.3x	17.8x	1.9%	
Compco Average:				20.1x	19.5x	9.5x	8.9x	14.9x	13.9x	3.2%	
WHS Relative:				-35%	-42%	-36%	-40%	-37%	-41%	+102%	

EV = Current Market Cap + Actual Net Debt

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

Figure 3. Consensus EPS Momentum


Source: Forsyth Barr analysis

Figure 4. 12 Month Forward PE


Source: Forsyth Barr analysis

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