FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | RETAIL | GENERAL MERCHANDISE RETAILER

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The Warehouse Group

1H20 Result — Transformation Delivers; Outlook Uncertain

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RESEARCH INSIGHTS

The Warehouse Group (WHS) maintained positive momentum into 1H20 as it executes on its transformation programme, reporting improved operating margins alongside same store sales (SSS) growth across the majority of its business. The near term outlook is increasingly uncertain in light of the evolving coronavirus (COVID-19) situation in New Zealand, and possible wider economic implications. We have made negative revisions to our earnings forecasts to reflect this uncertainty, cutting our FY20 normalised NPAT forecast -8% to NZ$70m (below guidance) as we assume a slow down in activity.

NZX Code	WHS
Share price	NZ$2.04
Issued shares	345.2m
Market cap	NZ$704m
Avg daily turnover	56.9k (NZ$135k)

Financials: Jul/	19A	20E	21E	22E
NPAT* (NZ$m)	74.1	70.2	85.1	96.8
EPS* (NZc)	21.5	20.3	24.6	28.0
EPS growth* (%)	25.6	-5.2	21.1	13.7
DPS (NZc)	17.0	17.5	18.5	21.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	4.8	4.7	4.1	3.7
EV/EBIT	7.3	7.4	6.3	5.6
PE	9.5	10.0	8.3	7.3
Price / NTA	1.5	1.4	1.3	1.2
Cash div yld (%)	8.3	8.6	9.1	10.3
Gross div yld (%)	11.6	11.9	12.6	14.3

Transformation programme delivering margin gains

WHS reported a robust 1H20 against a challenging retail backdrop, as it delivered on cost out and pricing initiatives, driving improved operating earnings. Torpedo7 was the only laggard, which reported another drop in earnings as the company continues to invest in additional stores. WHS maintained its low debt levels, enabled by improved terms of trade, with gearing sitting at 13% (25% in the prior comparable period). Helping debt levels was lower capex in 1H20, with the company dropping its full year capex guidance to NZ $70m to NZ$90m from NZ$100m to NZ$120m. Execution challenges relating to recent projects, in combination with an element of near-term uncertainty, are contributing to the slower capex spend although we expect to see it lift again in FY21.

Among the challenges was disruption to its fulfilment operations which materially impacted online sales for both Blue and Red Sheds. This issue is expected to be resolved with online sales growth expected to return in 1H21; however, the timing is disappointing with the wider retail online channel likely to experience a boost amid COVID-19 concerns.

Near-term outlook highly uncertain; Lower earnings assumptions

WHS issued first time FY20 normalised NPAT guidance of NZ$75m to NZ$77m, with the rather large caveat that this is subject to normal trading and does not factor in any impact from COVID-19. We understand recent trading has been steady, with strong uplifts in technology and cleaning products, which likely contains an element of demand pull through. Whilst the company notes it has seen limited impact to date from COVID-19, and has not experienced any material disruption to its supply chain, we expect to see some slow down in economic activity. Recognising that the near term outlook is highly uncertain and evolving rapidly, we have lowered our same store sales assumptions in FY20 and cut our normalised NPAT forecast -8% to NZ$70m (-8% below the guidance mid point) to reflect the uncertainty.

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The Warehouse Group (WHS)

Priced as at 17 Mar 2020 (NZ$)	2.04

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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.
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.

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	2,994.6	3,071.4	3,070.7	3,145.4	3,184.2
Normalised EBITDA	**151.1**	**173.0**	**166.3**	**191.8**	**214.8**
Depreciation and amortisation	(59.6)	(60.6)	(59.9)	(65.3)	(72.2)
Normalised EBIT	**91.4**	**112.4**	**106.4**	**126.5**	**142.7**
Net interest	(9.2)	(8.9)	(8.7)	(8.2)	(8.1)
Associate income	0	0	0	0	0
Tax	(23.0)	(29.3)	(27.4)	(33.1)	(37.7)
Minority interests	0.2	0.1	0.1	0.1	0.1
Normalised NPAT	**59.0**	**74.1**	**70.2**	**85.1**	**96.8**
Abnormals/other	(31.8)	(6.8)	(16.3)	0	0
Reported NPAT	**27.3**	**67.3**	**53.9**	**85.1**	**96.8**
Normalised EPS (cps)	17.1	21.5	20.3	24.6	28.0
DPS (cps)	16.0	17.0	17.5	18.5	21.0

Growth Rates	2018A	2019A	2020A	2021A	2022A
Revenue (%)	0.5	2.6	0.0	2.4	1.2
EBITDA (%)	-9.1	14.5	-3.9	15.3	12.0
EBIT (%)	-15.2	22.9	-5.3	18.9	12.7
Normalised NPAT (%)	-13.4	25.6	-5.2	21.1	13.7
Normalised EPS (%)	-13.2	25.6	-5.2	21.1	13.7
Ordinary DPS (%)	0.0	6.3	2.9	5.7	13.5

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**151.1**	**173.0**	**166.3**	**191.8**	**214.8**
Working capital change	(23.6)	57.0	(0.7)	(6.2)	(3.2)
Interest & tax paid	(23.4)	(35.2)	(36.1)	(41.3)	(45.8)
Other	3.9	3.2	3.2	3.2	3.2
Operating cash flow	**107.9**	**198.0**	**132.8**	**147.5**	**169.1**
Capital expenditure	(70.2)	(61.3)	(85.0)	(105.0)	(115.0)
(Acquisitions)/divestments	29.5	3.7	0	0	0
Other	0	(1.4)	0	0	0
Funding available/(required)	**67.2**	**139.0**	**47.8**	**42.5**	**54.1**
Dividends paid	(55.8)	(52.3)	(60.4)	(63.9)	(72.5)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**11.4**	**86.7**	**(12.6)**	**(21.4)**	**(18.4)**

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	324.6	255.9	256.5	262.7	265.9
Fixed assets	353.9	346.7	371.8	411.5	454.4
Intangibles	0	0	0	0	0
Right of use asset	0	0	0	0	0
Other assets	46.7	38.5	38.5	38.5	38.5
Total funds employed	**725.2**	**641.0**	**666.8**	**712.7**	**758.8**
Net debt/(cash)	162.3	76.2	88.8	97.5	94.6
Lease liability	163.4	172.5	193.2	200.9	204.9
Other liabilities	101.6	90.7	90.7	90.7	90.7
Shareholder's funds	460.4	473.4	487.1	524.3	573.3
Minority interests	0.9	0.7	0.1	0.1	0.1
Total funding sources	**725.2**	**641.0**	**666.8**	**712.7**	**758.8**

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

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	5.7	4.8	4.7	4.1	3.7
EV/EBIT (x)	9.5	7.3	7.4	6.3	5.6
PE (x)	11.9	9.5	10.0	8.3	7.3
Price/NTA (x)	1.5	1.5	1.4	1.3	1.2
Free cash flow yield (%)	5.4	19.4	6.8	6.0	7.7
Net dividend yield (%)	7.8	8.3	8.6	9.1	10.3
Gross dividend yield (%)	10.9	11.6	11.9	12.6	14.3

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	10.0	12.7	12.3	15.5	17.7
Interest cover EBITDA (x)	16.5	19.5	19.1	23.5	26.6
Net debt/ND+E (%)	26.1	13.9	15.4	15.7	14.2
Net debt/EBITDA (x)	1.1	0.4	0.5	0.5	0.4

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	8.9	10.8	10.0	11.3	12.1
Return on equity (%)	12.8	15.7	14.4	16.2	16.9
Return on funds employed (%)	10.4	13.8	13.6	15.2	15.9
EBITDA margin (%)	5.0	5.6	5.4	6.1	6.7
EBIT margin (%)	3.1	3.7	3.5	4.0	4.5
Capex to sales (%)	2.3	2.0	2.8	3.3	3.6
Capex to depreciation (%)	118	101	142	161	159
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	94	79	86	75	75

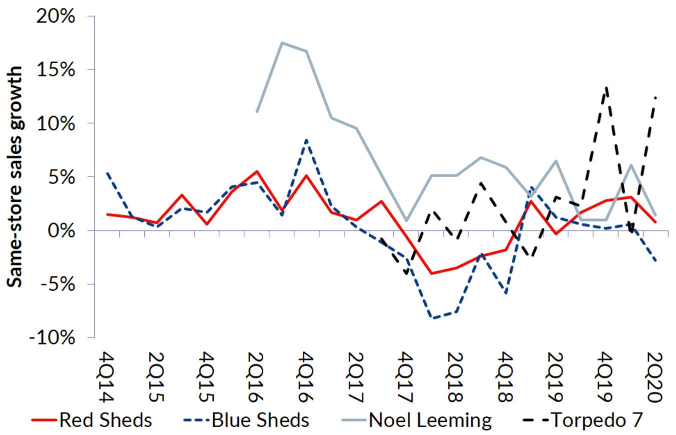
Operating Performance	2018A	2019A	2020E	2021E	2022E
Divisional revenue (NZ$m)					
Red Sheds	1,716.6	1,705.7	1,680.1	1,713.7	1,721.5
Blue Sheds	263.8	268.6	263.2	268.5	271.2
Noel Leeming	880.5	924.6	933.8	961.8	985.9
Torpedo7	163.4	172.5	193.2	200.9	204.9
Total revenue	**2,994.6**	**3,071.4**	**3,070.7**	**3,145.4**	**3,184.2**
Gross profit (NZ$m)	**991.2**	**1,028.6**	**1,044.4**	**1,061.7**	**1,071.1**
Gross margin (%)	**33**	**33**	**34**	**34**	**34**
Divisional EBIT (NZ$m)					
Red Sheds	71	85	90	98	107
Blue Sheds	11	17	16	16	14
Noel Leeming	31	38	37	42	46
Torpedo7	(1.4)	(7.0)	(6.5)	(1.9)	0.1
Total EBIT	**91**	**112**	**106**	**127**	**143**
EBIT margins (%)					
Red Sheds	4.2	5.0	5.4	5.7	6.2
Blue Sheds	4.0	6.2	5.9	5.8	5.3
Noel Leeming	3.5	4.1	4.0	4.4	4.6
Torpedo7	-0.9	-4.1	-3.4	-1.0	0.0
Group	3.1	3.7	3.5	4.0	4.5

1H20 result summary

Divisional summary

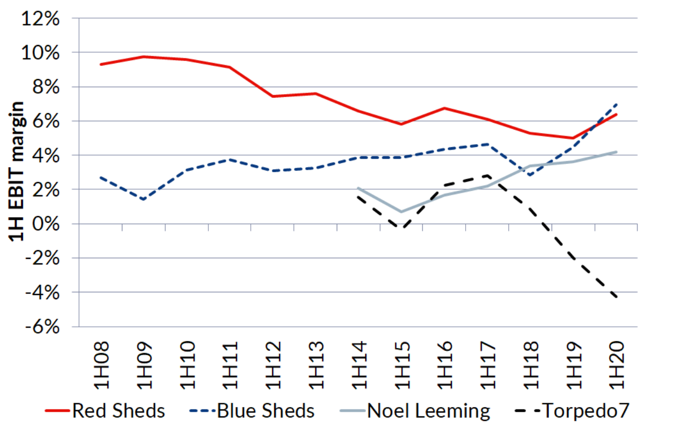
- **Red Sheds:** A tough 2Q20 offset a promising 1Q20, as same store sales growth slowed and a pull through of December sales into the November promotional led Black Friday period weighed on margins. 1H20 gross profit increased +8% on the prior period as improved terms of trade and less discounting activity lifted gross margin +160bps to 38.8%. We expect gross margin improvement to continue although note downside risk should the suppressed New Zealand dollar continue.
- **Blue Sheds:** Experienced a same store sales decline in 1H20 (-1.2%). We suspect underlying sales growth was positive, weighed down by classification of integrated stores within a Red Shed as "new" stores. Three additional stores were integrated in 1H20, taking the total to 13.
- **Noel Leeming:** Same store sales slowed in 2Q20, having benefited from a Rugby World Cup driven uplift in 1Q20. Within the business Tech Solutions, Protection, and Store Services delivered strong growth, all reporting 1H20 revenue up >+20% on the prior comparable period.
- **Torpedo 7:** Continues to be a drag on earnings as the cost of doing business increased +19% on the prior comparable period reflecting continued store investment. Same store sales growth was a group highlight, up +7.1% in 1H20.
- **Ecommerce:** Online sales disappointed amid fulfilment related disruption for Red and Blue Sheds, both reporting a decline in online sales. Total group online sales lifted +7% (7.9% of group sales) on the prior comparable period, with Noel Leeming and Torpedo7 both achieving >+30% growth. Early signs appear encouraging for TheMarket, with reasonable site traffic and now offering more than two million products, however, we expect it will continue to be an earnings drag for a number of years.

Figure 1. Quarterly same store sales growth



Source: Company reports, Forsyth Barr analysis

Figure 2. 1H EBIT margin



Source: Company reports, Forsyth Barr analysis

Earnings changes

WHS has guided to FY20 normalised NPAT of NZ$75m to NZ$77m, however, this is subject to no material change in trading conditions. Noting that the near-term earnings outlook is highly uncertain in light of the rapidly developing COVID-19 situation in New Zealand, we currently assume a short term slow down in economic activity and therefore have lowered our earnings assumptions below the stated guidance range. We cut our FY20 normalised NPAT forecast -8% to NZ$70m (-8% below the guidance mid-point), reflecting lower SSS assumptions.

Figure 3. Earnings changes (NZ$m)

	FY20E			FY21E			FY22E		
	Old	New	%chg	Old	New	%chg	Old	New	%chg
Sales	3,121.2	3,070.7	-1.6%	3,165.2	3,145.4	-0.6%	3,181.0	3,184.2	0.1%
EBIT	114.9	106.4	-7.4%	131.0	126.5	-3.4%	141.6	142.7	0.8%
Normalised profit	76.1	70.2	-7.7%	88.4	85.1	-3.7%	96.0	96.8	0.8%
Underlying EPS (cps)	22.0	20.3	-7.7%	25.6	24.6	-3.7%	27.8	28.0	0.8%
DPS (cps)	17.5	17.5	0.0%	18.5	18.5	0.0%	21.0	21.0	0.0%

Source: Forsyth Barr analysis

Figure 4. 1H20 result summary (NZ$m)

	1H19	1H20 (pre IFRS 16)	Change	1H20	Comments
Profit and Loss Account					
Sales	**1,640.5**	**1,683.4**	**+2.6%**	**1,683.4**	**Driven by Noel Leeming**
Cost of Sales	(1107.3)	(1117.3)	+0.9%	(1117.3)	
Gross Profit	533.2	566.1	+6.2%	566.1	Gross margin up +110bps to 33.6%
SG&A Costs	(442.5)	(469.3)	+6.1%	(402.5)	
Total EBITDA	90.8	96.8	+6.6%	163.6	Cost of doing business margin up reflecting TheMarket losses and wage inflation
D&A	(30.3)	(28.9)	-4.7%	(76.0)	Lower store count
EBIT	**60.5**	**67.9**	**+12.3%**	**87.6**	**EBIT margin 4.0% (1H19 3.7%)**
Net Interest	(5.1)	(3.3)	-34.9%	(23.7)	Material reduction in net debt
Profit Before Tax	55.4	64.6	+16.7%	63.9	
Tax	(15.0)	(12.6)	-16.0%	(12.4)	Effective tax rate 29.5%
Normalised Profit	**39.6**	**46.2**	**+16.7%**	**45.7**	**FY20E Normalised NPAT guidance of NZ$75m–$77m**
Reported Profit	37.4	30.4	-18.6%	29.9	Post tax abnormal of NZ$15m a business transformation cost
Underlying EPS	10.8c	8.8c	-18.6%	8.7c	
DPS	9.0c	10.0c	+11.1%	10.0c	
Balance Sheet Summary					
Operating Cashflow	54.0	60.0	+11.1%	101.0	
Inventory	542.8	581.3	+7.1%	581.3	Lift in inventory given an early Chinese New Year and T7 expansion
Fixed Assets	267.1	271.2	+1.5%	271.2	
Working Capital	241.4	168.3	-30.3%	168.3	Enabled by improved credit terms
Net Debt	153.1	68.6	-55.2%	68.6	Working capital release and lower capex. Gearing of 12.6% (1H19 24.5%)
Shareholders Equity	478.6	364.5	-23.8%	364.5	
Divisional Analysis					
Red Sheds Sales	929.5	938.8	+1.0%	938.8	Same store sales growth of +1.6%
Blue Sheds Sales	132.8	133.8	+0.8%	133.8	Same store sales decline -1.2%
Noel Leeming Sales	487.3	512.8	+5.2%	512.8	Same store sales growth of +3.4%
Torpedo7 Sales	89.9	98.4	+9.4%	98.4	Same store sales growth of +7.1%
Other	1.0	(0.4)	-140.6%	(0.4)	
Total Sales	**1,640.5**	**1,683.4**	**+2.6%**	**1,683.4**	
Red Sheds EBIT	46.6	59.8	+28.4%	n/a	EBIT margin 6.4% (1H19 5.0%)
Blue Sheds EBIT	5.9	9.3	+57.3%	n/a	EBIT margin 7.0% (1H19 4.5%)
Noel Leeming EBIT	17.6	21.4	+22.1%	n/a	EBIT margin 4.2% (1H19 3.6%)
Torpedo7 EBIT	(1.8)	(4.2)	+135.3%	n/a	
Other EBIT	(7.8)	(18.4)	-136.1%	n/a	
Total EBIT	**60.5**	**67.9**	**+12.3%**	**87.6**	**Cost control across the group**

Source: Company reports, 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.

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.

Earnings and cashflow 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. WHS is carrying good momentum in its Red Sheds business into FY20.
- **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.

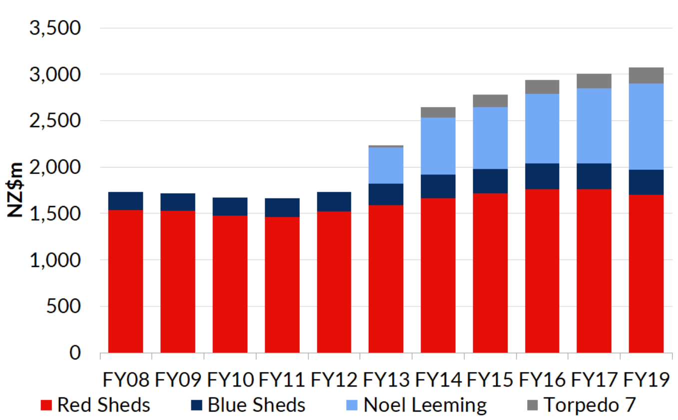
Financial structure

- **Balance sheet analysis:** Gearing is around 13% with WHS having reduced its debt through its transformation process, enabled by improved terms of trade. 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.

Risk factors

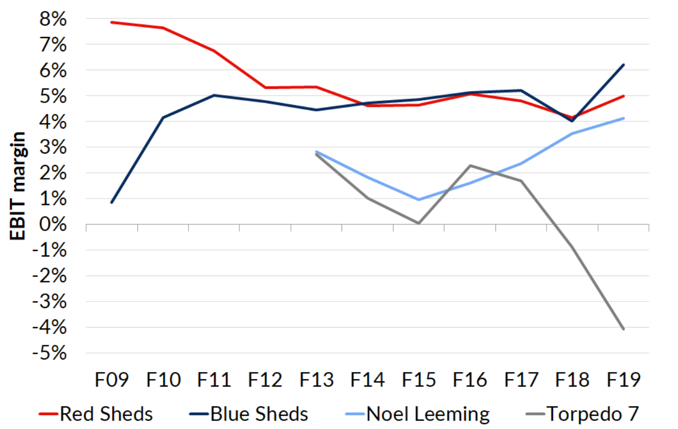
- **Competitive environment:** Particularly with the expansion of Kmart in New Zealand and the entry of Amazon into Australia.
- **Consumer sentiment and cost inflation:** Deterioration in economic conditions or general consumer sentiment. Cost inflation, particularly rising wages and rent.

Figure 5. Divisional revenue (NZ$m)



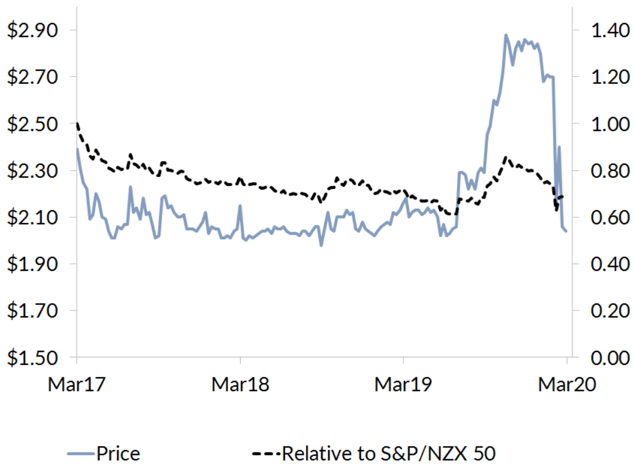
Source: Company reports, Forsyth Barr analysis

Figure 6. Divisional EBIT margin (%)



Source: Company reports, Forsyth Barr analysis

Figure 7. Price performance



Source: Forsyth Barr analysis

Figure 8. Substantial shareholders

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

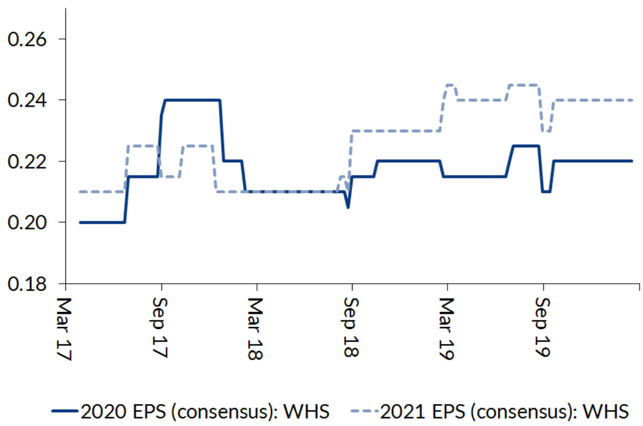
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 9. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash 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$2.04**	**NZ$704**	**10.0x**	**8.3x**	**4.7x**	**4.1x**	**7.3x**	**6.2x**	**9.1%**
Briscoe Group *	BGP NZ	NZ$3.15	NZ$700	11.3x	11.3x	5.1x	5.0x	6.5x	6.5x	7.1%
Kathmandu Holdings *	KMD NZ	NZ$1.82	NZ$537	6.7x	5.8x	4.0x	3.3x	4.8x	4.0x	10.4%
Michael Hill Intl *	MHJ NZ	A$0.40	A$155	5.9x	5.8x	3.0x	2.9x	4.5x	4.4x	13.0%
Restaurant Brands NZ *	RBD NZ	NZ$8.20	NZ$1,023	21.9x	18.2x	10.9x	8.3x	16.1x	12.6x	0.0%
COSTCO WHOLESALE CORP	COST US	US$290.44	US$128,111	33.5x	31.2x	18.8x	17.3x	24.5x	22.5x	1.0%
TARGET CORP	TGT US	US$96.85	US$48,483	14.5x	13.5x	8.1x	8.1x	12.6x	12.0x	3.0%
REJECT SHOP/THE	TRS AT	A$2.50	A$72	<0x	24.3x	3.3x	3.1x	n/a	n/a	1.8%
WALMART INC	WMT US	US$109.16	US$309,621	21.1x	20.6x	11.5x	11.0x	17.4x	16.4x	2.1%
			Compco Average:	**16.4x**	**16.3x**	**8.1x**	**7.4x**	**12.4x**	**11.2x**	**4.8%**
EV = Current Market Cap + Actual Net Debt			**WHS Relative:**	**-39%**	**-49%**	**-42%**	**-45%**	**-41%**	**-45%**	**89%**

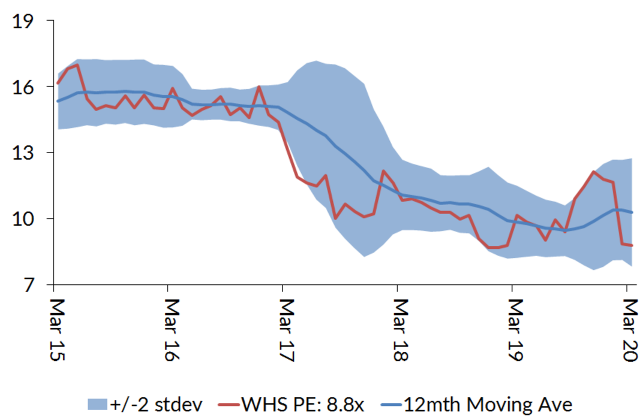
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (WHS) companies fiscal year end

Figure 10. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 11. One year forward PE (x)



Source: Forsyth Barr analysis

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