

The Warehouse Group

3Q20 Sales Checkout

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RESEARCH INSIGHTS

The Warehouse Group (WHS) benefited from a surge in demand prior to the move to Alert Level 4, partially offsetting the sales hole as store doors were temporarily closed. The outlook for WHS and the retail sector remains opaque, with the full extent of the impact of lockdown policies unclear, and consumer appetite for bricks & mortar shopping through lower Alert Levels uncertain. In addition, the deteriorating economic outlook may weigh on medium-term growth.

NZX Code	WHS	Financials: Jul/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$2.18	NPAT* (NZ\$m)	74.1	53.9	26.7	61.8	EV/EBITDA	5.0	5.8	7.7	5.0
Issued shares	345.2m	EPS* (NZc)	21.5	15.6	7.7	17.9	EV/EBIT	7.8	9.9	17.9	8.4
Market cap	NZ\$753m	EPS growth* (%)	25.6	-27.3	-50.5	n/a	PE	10.2	14.0	28.2	12.2
Avg daily turnover	64.2k (NZ\$149k)	DPS (NZc)	17.0	10.0	0.0	13.5	Price / NTA	1.6	1.5	1.5	1.5
		Imputation (%)	100	100	100	100	Cash div yld (%)	7.8	4.6	0.0	6.2
		*Based on normalised profits					Gross div yld (%)	10.8	6.4	0.0	8.6

3Q20 – A burst of activity before lockdown

WHS experienced a strong ramp in sales ahead of COVID-19 Alert Level 4, with group sales for the period to 25 March surging +19% against the prior year period. Panic buying in grocery and a lift in technology spend as consumers positioned to work from home drove the strong result. However, sales fell away as the country entered lockdown, with WHS announcing 3Q20 sales of NZ\$586.3m, down -18% on the prior year period. Red Sheds and Torpedo7 experienced the biggest drop in quarterly sales, down -23% and -18% on the prior year respectively, with Noel Leeming and Blue Sheds down -11% and -10% respectively.

Although online penetration has increased materially, it is not a significant offset to door closures, representing 16% of suppressed 3Q20 sales (versus 8% of total sales in 1H20).

Reduced cost base lowers earnings impact

WHS has significantly reduced its fixed cost base through Government wage subsidies (group wage subsidy of NZ\$67m), temporary salary reductions, and possible rent relief from landlords. However, these are temporary reductions which are likely to roll off through 4Q20. We, therefore, expect the negative earnings impact from COVID-19 to be larger in FY21E.

A tough outlook

We have made significant negative revisions to our earnings forecasts to reflect store closures and reduced trading capacity through lower Alert Levels.

When New Zealand shifts to Alert Level 2, and store doors re-open, we expect elevated discounting across the retail sector as companies look to clear higher than usual stock levels. This is likely to weigh on gross margin in FY20E and FY21E, with further pressure from FX headwinds in FY21E as hedging rolls off.

Post COVID-19, and once the economic implications of New Zealand's lockdown measures become apparent, we expect the weaker economic backdrop to weigh on sales recovery. Through the Global Financial Crisis (GFC), both Red Sheds and Blue Sheds delivered negative same store sales growth (SSS).

The Warehouse Group (WHS)

Priced as at 08 May 2020 (NZ\$)

2.18

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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	Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Sales revenue	2,994.6	3,071.4	2,858.5	2,999.7	3,038.6	EV/EBITDA (x)	6.1	5.0	5.8	7.7	5.0
Normalised EBITDA	151.1	173.0	140.8	103.7	158.6	EV/EBIT (x)	10.0	7.8	9.9	17.9	8.4
Depreciation and amortisation	(59.6)	(60.6)	(58.3)	(59.4)	(64.1)	PE (x)	12.8	10.2	14.0	28.2	12.2
Normalised EBIT	91.4	112.4	82.5	44.4	94.6	Price/NTA (x)	1.6	1.6	1.5	1.5	1.5
Net interest	(9.2)	(8.9)	(7.4)	(7.2)	(8.6)	Free cash flow yield (%)	5.0	18.2	9.0	1.7	1.5
Associate income	0	0	0	0	0	Net dividend yield (%)	7.3	7.8	4.6	0.0	6.2
Tax	(23.0)	(29.3)	(21.0)	(10.4)	(24.1)	Gross dividend yield (%)	10.2	10.8	6.4	0.0	8.6
Minority interests	0.2	0.1	0.1	0.1	0.1	Capital Structure	2018A	2019A	2020E	2021E	2022E
Normalised NPAT	59.0	74.1	53.9	26.7	61.8	Interest cover EBIT (x)	10.0	12.7	11.1	6.2	11.0
Abnormals/other	(31.8)	(6.8)	(16.3)	0	0	Interest cover EBITDA (x)	16.5	19.5	19.0	14.5	18.5
Reported NPAT	27.3	67.3	37.6	26.7	61.8	Net debt/ND+E (%)	26.1	13.9	8.0	11.4	18.3
Normalised EPS (cps)	17.1	21.5	15.6	7.7	17.9	Net debt/EBITDA (x)	1.1	0.4	0.3	0.6	0.7
DPS (cps)	16.0	17.0	10.0	0	13.5	Key Ratios	2018A	2019A	2020E	2021E	2022E
Growth Rates	2018A	2019A	2020A	2021A	2022A	Return on assets (%)	8.9	10.8	8.2	4.3	8.6
Revenue (%)	0.5	2.6	-6.9	4.9	1.3	Return on equity (%)	12.8	15.7	10.9	5.4	12.4
EBITDA (%)	-9.1	14.5	-18.6	-26.3	52.9	Return on funds employed (%)	10.4	13.8	10.9	5.8	11.7
EBIT (%)	-15.2	22.9	-26.6	-46.2	>100	EBITDA margin (%)	5.0	5.6	4.9	3.5	5.2
Normalised NPAT (%)	-13.4	25.6	-27.3	-50.5	>100	EBIT margin (%)	3.1	3.7	2.9	1.5	3.1
Normalised EPS (%)	-13.2	25.6	-27.3	-50.5	>100	Capex to sales (%)	2.3	2.0	2.3	2.2	3.8
Ordinary DPS (%)	0.0	6.3	-41.2	-100.0	n/a	Capex to depreciation (%)	118	101	111	110	179
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Imputation (%)	100	100	100	100	100
EBITDA	151.1	173.0	140.8	103.7	158.6	Pay-out ratio (%)	94	79	64	0	75
Working capital change	(23.6)	57.0	17.2	(11.8)	(3.2)	Operating Performance	2018A	2019A	2020E	2021E	2022E
Interest & tax paid	(23.4)	(35.2)	(28.4)	(17.6)	(32.7)	Divisional revenue (NZ\$m)					
Other	3.9	3.2	3.2	3.2	3.2	Red Sheds	1,716.6	1,705.7	1,535.1	1,627.2	1,634.7
Operating cash flow	107.9	198.0	132.8	77.6	126.0	Blue Sheds	263.8	268.6	263.2	263.2	265.9
Capital expenditure	(70.2)	(61.3)	(65.0)	(65.0)	(115.0)	Noel Leeming	880.5	924.6	886.7	922.1	945.2
(Acquisitions)/divestments	29.5	3.7	0	0	0	Torpedo7	163.4	172.5	172.5	186.3	191.9
Other	0	(1.4)	0	0	0	Total revenue	2,994.6	3,071.4	2,858.5	2,999.7	3,038.6
Funding available/(required)	67.2	139.0	67.8	12.6	11.0	Gross profit (NZ\$m)	991.2	1,028.6	921.2	929.7	991.5
Dividends paid	(55.8)	(52.3)	(34.5)	0	(46.6)	Gross margin (%)	33	33	32	31	33
Equity raised/(returned)	0	0	0	0	0	Divisional EBIT (NZ\$m)					
(Increase)/decrease in net debt	11.4	86.7	33.3	12.6	(35.6)	Red Sheds	71	85	65	48	66
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Blue Sheds	11	17	20	12	16
Working capital	324.6	255.9	238.7	250.5	253.7	Noel Leeming	31	38	36	20	39
Fixed assets	353.9	346.7	353.3	359.0	409.9	Torpedo7	(1.4)	(7.0)	(8.8)	(8.4)	(1.0)
Intangibles	0	0	0	0	0	Total EBIT	91	112	82	44	95
Right of use asset	0	0	0	0	0	EBIT margins (%)					
Other assets	46.7	38.5	38.5	38.5	38.5	Red Sheds	4.2	5.0	4.3	2.9	4.0
Total funds employed	725.2	641.0	630.5	647.9	702.1	Blue Sheds	4.0	6.2	7.8	4.6	5.9
Net debt/(cash)	162.3	76.2	42.9	63.6	111.8	Noel Leeming	3.5	4.1	4.0	2.2	4.1
Lease liability	163.4	172.5	172.5	186.3	191.9	Torpedo7	-0.9	-4.1	-5.1	-4.5	-0.5
Other liabilities	101.6	90.7	90.7	90.7	90.7	Group	3.1	3.7	2.9	1.5	3.1
Shareholder's funds	460.4	473.4	496.7	493.5	499.4						
Minority interests	0.9	0.7	0.1	0.1	0.1						
Total funding sources	725.2	641.0	630.5	647.9	702.1						

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

Earnings changes

We have made significant downgrades to our near-term earnings outlook. The revenue impact of COVID-19 is captured in FY20E, however, temporary cost relief masks the underlying earnings hit, which becomes more apparent in FY21E.

- We lower our FY20E revenue assumption, reflecting seven full weeks of store closures, including three weeks at Alert Level 3 (where online channels are open). We also assume Alert Level 2 lasts for the remainder of 2H20E, with social distancing limitations and consumer caution towards the Bricks & mortar channel impacting sales.
 - Our FY20E earnings changes capture the impact of wage subsidies, partial rent relief, and temporary salary reductions.
- In FY21E we assume a partial recovery in sales, although expect activity to remain subdued given the weaker economic outlook. Same store sales (SSS) at both Red Sheds and Blue Sheds declined through the Global Financial Crisis (GFC).
 - In addition, elevated discounting levels in combination with FX headwinds are likely to weigh on gross margin.

WHS removed its FY20E guidance given the high levels of uncertainty. We assume no dividends are paid in 2H20E or FY21E.

Figure 1. Earnings changes (NZ\$m)

	FY20E			FY21E			FY22E		
	Old	New	%chg	Old	New	%chg	Old	New	%chg
Sales	3,070.7	2,858.5	-6.9%	3,145.4	2,999.7	-4.6%	3,184.2	3,038.6	-4.6%
EBIT	106.4	82.5	-22.5%	126.5	44.4	-64.9%	142.7	94.6	-33.7%
Normalised profit	70.2	53.9	-23.3%	85.1	26.7	-68.7%	96.8	61.8	-36.2%
Underlying EPS	20.3	15.6	-23.3%	24.6	7.7	-68.7%	28.0	17.9	-36.2%
DPS	17.5	10.0	-42.9%	18.5	-	-100.0%	21.0	13.5	-35.7%

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. The near-term outlook for WHS and the wider retail sector is opaque, with the full extent of the impact of lockdown policies unknown and a deteriorating economic backdrop.

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.

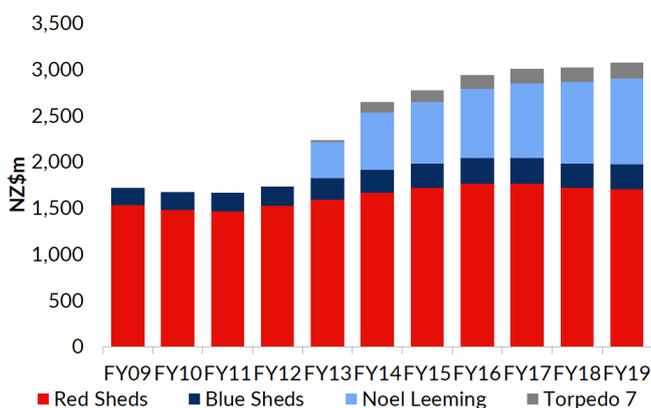
Financial structure

- **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

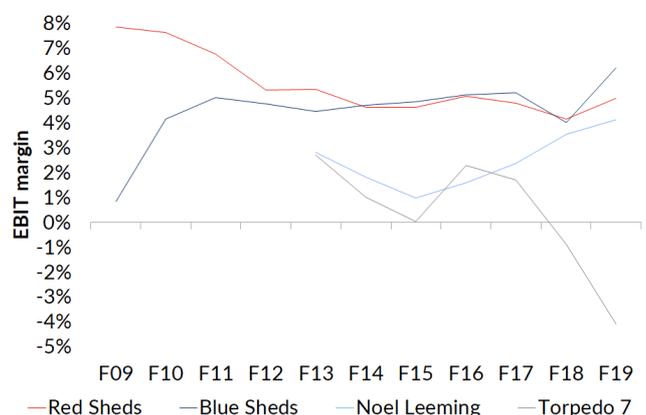
- **Competitive environment:** Particularly with the expansion of Kmart in New Zealand and the entry of Amazon into Australia.
- **Consumer sentiment and cost inflation:** Deterioration in economic conditions or general consumer sentiment. Cost inflation, particularly rising wages and rent.

Figure 2. Divisional revenue (NZ\$m)



Source: Forsyth Barr analysis

Figure 3. Divisional EBIT margin (%)



Source: Forsyth Barr analysis

Figure 4. Price performance



Source: Forsyth Barr analysis

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

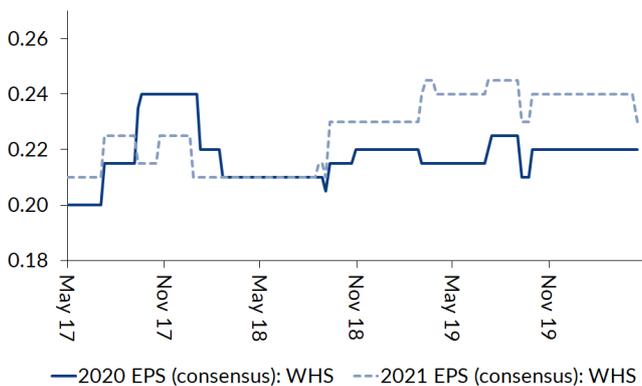
Figure 6. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect WHS's balance date - July)										
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
The Warehouse Group	WHS NZ	NZ\$2.18	NZ\$753	14.0x	28.2x	5.9x	8.0x	10.0x	18.7x	0.0%
Briscoe Group *	BGP NZ	NZ\$3.19	NZ\$709	17.7x	19.1x	7.4x	7.2x	10.5x	10.2x	4.0%
Kathmandu Holdings *	KMD NZ	NZ\$0.74	NZ\$525	>50x	13.0x	17.3x	6.2x	>75x	9.1x	4.1%
Michael Hill Intl *	MHJ NZ	A\$0.33	A\$126	13.2x	36.9x	4.0x	5.4x	8.8x	18.4x	8.7%
Restaurant Brands NZ *	RBD NZ	NZ\$12.00	NZ\$1,497	>50x	>50x	21.2x	18.3x	45.7x	39.9x	0.0%
COSTCO WHOLESALE CORP	COST US	US\$304.95	US\$134,660	35.3x	32.8x	19.7x	18.2x	25.7x	23.7x	1.0%
TARGET CORP	TGT US	US\$112.00	US\$55,981	18.9x	18.2x	10.1x	10.3x	15.8x	15.5x	2.6%
REJECT SHOP/THE	TRS AT	A\$2.90	A\$111	16.0x	19.0x	3.4x	3.5x	n/a	n/a	3.2%
WALMART INC	WMT US	US\$128.00	US\$362,714	24.7x	24.1x	12.6x	12.5x	19.9x	18.8x	1.7%
Compc Average:				21.0x	23.3x	12.0x	10.2x	21.1x	19.4x	3.1%
WHS Relative:				-33%	21%	-51%	-22%	-52%	-4%	-100%

EV = Current Market Cap + Actual Net Debt

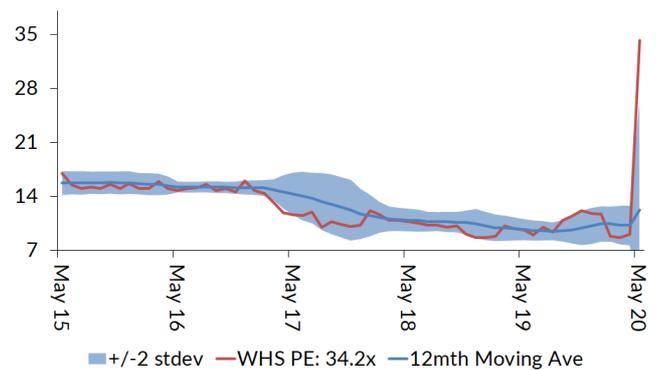
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compc metrics re-weighted to reflect headline (WHS) companies fiscal year end

Figure 7. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 8. One year forward PE (x)



Source: Forsyth Barr analysis

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Figure 9. Earnings Changes (NZ\$m)

	FY20E			FY21E			FY22E		
	Old	New	%chg	Old	New	%chg	Old	New	%chg
Sales	3,070.7	2,858.5	-6.9%	3,145.4	3,044.9	-3.2%	3,184.2	3,082.6	-3.2%
EBIT	106.4	82.5	-22.5%	126.5	30.2	-76.2%	142.7	91.7	-35.8%
Normalised profit	70.2	53.9	-23.3%	85.1	15.6	-81.7%	96.8	59.7	-38.3%
Underlying EPS	20.3	15.6	-23.3%	24.6	4.5	-81.7%	28.0	17.3	-38.3%
DPS	17.5	10.0	-42.9%	18.5	-	-100.0%	21.0	13.0	-38.1%

Source: Forsyth Barr analysis