FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | RETAIL | GENERAL MERCHANDISE RETAILER
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The Warehouse Group
Noel Leading Strong Trading

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RESEARCH INSIGHTS

The Warehouse Group (WHS) released a strong trading update, albeit not overly surprising given recent retail sales data trends. Year to date, group sales are effectively flat on the prior year period, however, growth has been led by lower margin divisions, Noel Leeming and Torpedo7. In addition, online penetration has accelerated, with additional fulfilment costs also impacting margin. Whilst consumer activity has surprised to the positive to date, we retain a cautious view of the near term outlook.

NZX Code	WHS
Share price	NZ$2.11
Issued shares	345.2m
Market cap	NZ$728m
Avg daily turnover	65.7k (NZ$152k)

Financials: Jul/	19A	20E	21E	22E
NPAT* (NZ$m)	74.1	74.0	34.9	64.7
EPS* (NZc)	21.5	21.4	10.1	18.8
EPS growth* (%)	25.6	-0.2	-52.8	85.6
DPS (NZc)	17.0	10.0	6.0	14.0
Imputation (%)	100	100	100	100

*Based on normalised profits

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	4.9	4.7	6.7	4.7
EV/EBIT	7.6	7.1	13.9	7.8
PE	9.8	9.8	20.9	11.3
Price / NTA	1.5	1.4	1.4	1.5
Cash div yld (%)	8.1	4.7	2.8	6.6
Gross div yld (%)	11.2	6.6	3.9	9.2

Surging sales but weighted to lower margin divisions

Group sales for the year to date are effectively flat, following a surge in retail activity as New Zealand entered Alert Level 2. The key standouts are Noel Leeming and Torpedo7, with sales up +32% across both brands for the quarter to date, and +7% for the financial year to date. Whilst strong sales performance has reduced the level of discounting expected in the market, growth was led by low margin brands, weighing on group gross margin.

We suspect an element of the recent sales success represents a pull forward of demand, with sales performance concentrated in brands linked to favourable category trends; work from home, home entertainment, and sporting goods. However, should economic conditions worsen, we see scope for a pull towards value benefiting The Warehouse.

Online sales surged but higher cost to serve and product mix weigh on margin

Online penetration accelerated, particularly during Alert Level 3 where work from home requirements and home entertainment purchases saw a surge in demand at Noel Leeming. Year to date online sales represent 11.8% of group sales (7.8% in FY19), although it has ticked lower since retail doors reopened (9.3% penetration in the last seven weeks).

Whilst the online channel provided a positive sales offset to bricks & mortar disruption, high fulfilment costs, the accelerated nature of online adoption, and product mix weighed on margins.

Outlook uncertain but balance sheet in good condition

Beyond FY20 the outlook for WHS and the retail sector remains highly uncertain. The company's recent consumer survey suggests a slowdown in consumer activity is likely, particularly as government wage subsidies roll off and the economic realities become clearer. Whilst we expect to see lower sales in FY21E, recent performance alleviates concerns around discounting activity, and with NZ $330m of undrawn bank facilities, WHS's balance sheet is well placed to weather a level of further disruption.

The Warehouse Group (WHS)

Priced as at 09 Jul 2020 (NZ$)	2.11

Research Insights

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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	3,117.4	3,001.4	3,054.9
Normalised EBITDA	**151.1**	**173.0**	**168.7**	**114.9**	**162.8**
Depreciation and amortisation	(59.6)	(60.6)	(58.3)	(59.4)	(64.1)
Normalised EBIT	**91.4**	**112.4**	**110.4**	**55.5**	**98.7**
Net interest	(9.2)	(8.9)	(7.5)	(6.9)	(8.6)
Associate income	0	0	0	0	0
Tax	(23.0)	(29.3)	(28.8)	(13.6)	(25.2)
Minority interests	0.2	0.1	0.1	0.1	0.1
Normalised NPAT	**59.0**	**74.1**	**74.0**	**34.9**	**64.7**
Abnormals/other	(31.8)	(6.8)	(16.3)	0	0
Reported NPAT	**27.3**	**67.3**	**57.7**	**34.9**	**64.7**
Normalised EPS (cps)	17.1	21.5	21.4	10.1	18.8
DPS (cps)	16.0	17.0	10.0	6.0	14.0

Growth Rates	2018A	2019A	2020A	2021A	2022A
Revenue (%)	0.5	2.6	1.5	-3.7	1.8
EBITDA (%)	-9.1	14.5	-2.5	-31.9	41.7
EBIT (%)	-15.2	22.9	-1.8	-49.7	77.8
Normalised NPAT (%)	-13.4	25.6	-0.2	-52.8	85.6
Normalised EPS (%)	-13.2	25.6	-0.2	-52.8	85.6
Ordinary DPS (%)	0.0	6.3	-41.2	-40.0	>100

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**151.1**	**173.0**	**168.7**	**114.9**	**162.8**
Working capital change	(23.6)	57.0	(4.6)	9.8	(4.4)
Interest & tax paid	(23.4)	(35.2)	(36.3)	(20.5)	(33.8)
Other	3.9	3.2	3.2	3.2	3.2
Operating cash flow	**107.9**	**198.0**	**131.1**	**107.4**	**127.7**
Capital expenditure	(70.2)	(61.3)	(65.0)	(65.0)	(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**	**66.1**	**42.4**	**12.7**
Dividends paid	(55.8)	(52.3)	(34.5)	(20.7)	(48.3)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**11.4**	**86.7**	**31.6**	**21.7**	**(35.6)**

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	324.6	255.9	260.4	250.6	255.1
Fixed assets	353.9	346.7	353.3	359.0	409.9
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**	**652.2**	**648.1**	**703.4**
Net debt/(cash)	162.3	76.2	44.6	54.5	111.8
Lease liability	163.4	172.5	187.1	187.1	192.7
Other liabilities	101.6	90.7	90.7	90.7	90.7
Shareholder's funds	460.4	473.4	516.8	502.7	500.8
Minority interests	0.9	0.7	0.1	0.1	0.1
Total funding sources	**725.2**	**641.0**	**652.2**	**648.1**	**703.4**

* 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)	5.9	4.9	4.7	6.7	4.7
EV/EBIT (x)	9.7	7.6	7.1	13.9	7.8
PE (x)	12.3	9.8	9.8	20.9	11.3
Price/NTA (x)	1.6	1.5	1.4	1.4	1.5
Free cash flow yield (%)	5.2	18.8	9.1	5.8	1.7
Net dividend yield (%)	7.6	8.1	4.7	2.8	6.6
Gross dividend yield (%)	10.5	11.2	6.6	3.9	9.2

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	10.0	12.7	14.8	8.1	11.5
Interest cover EBITDA (x)	16.5	19.5	22.6	16.7	18.9
Net debt/ND+E (%)	26.1	13.9	7.9	9.8	18.2
Net debt/EBITDA (x)	1.1	0.4	0.3	0.5	0.7

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	8.9	10.8	10.4	5.3	8.9
Return on equity (%)	12.8	15.7	14.3	6.9	12.9
Return on funds employed (%)	10.4	13.8	14.3	7.1	12.2
EBITDA margin (%)	5.0	5.6	5.4	3.8	5.3
EBIT margin (%)	3.1	3.7	3.5	1.8	3.2
Capex to sales (%)	2.3	2.0	2.1	2.2	3.8
Capex to depreciation (%)	118	101	111	110	179
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	94	79	47	59	75

Operating Performance	2018A	2019A	2020E	2021E	2022E
Divisional revenue (NZ$m)					
Red Sheds	1,716.6	1,705.7	1,674.0	1,612.0	1,641.7
Blue Sheds	263.8	268.6	261.3	259.5	263.4
Noel Leeming	880.5	924.6	994.5	941.9	956.0
Torpedo7	163.4	172.5	187.1	187.1	192.7
Total revenue	**2,994.6**	**3,071.4**	**3,117.4**	**3,001.4**	**3,054.9**
Gross profit (NZ$m)	**991.2**	**1,028.6**	**969.2**	**945.6**	**989.6**
Gross margin (%)	**33**	**33**	**31**	**32**	**32**
Divisional EBIT (NZ$m)					
Red Sheds	71	85	84	53	75
Blue Sheds	11	17	15	11	12
Noel Leeming	31	38	49	27	37
Torpedo7	(1.4)	(7.0)	(7.3)	(8.2)	(0.8)
Total EBIT	**91**	**112**	**110**	**56**	**99**
EBIT margins (%)					
Red Sheds	4.2	5.0	5.0	3.3	4.6
Blue Sheds	4.0	6.2	5.9	4.1	4.6
Noel Leeming	3.5	4.1	4.9	2.9	3.8
Torpedo7	-0.9	-4.1	-3.9	-4.4	-0.4
Group	**3.1**	**3.7**	**3.5**	**1.8**	**3.2**

Earnings changes

We lift our FY20E earnings assumptions on the back of recent trading. Operating leverage is amplified in FY20 by wage subsidies and favourable rent negotiation outcomes. Beyond FY20, the outlook becomes very opaque, particularly in the near-term as government subsidies roll off and economic uncertainty is heightened. In FY21E, we have lifted our gross margin assumptions across the group as better than expected sales to date alleviates concerns around discounting activity, driving higher gross margin and earnings assumptions.

Given the level of current uncertainty, we do not expect WHS to pay a dividend in 2H20 or 1H21. However, recent trading has been better than expected and the balance sheet appears in good shape. We see scope for an earlier resumption of dividend payout than previously forecast and we reinstate dividends from 2H21.

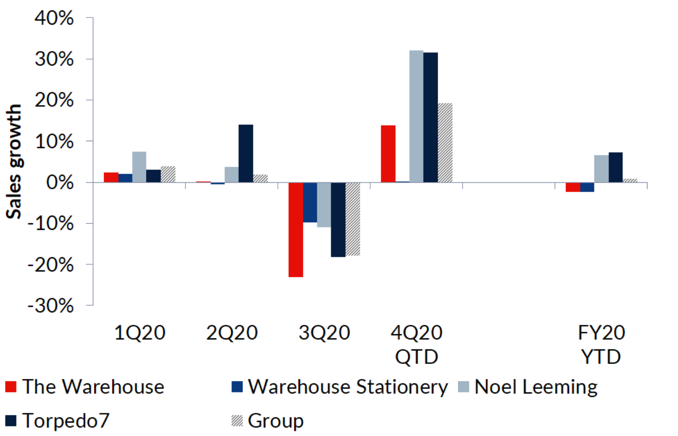
Figure 1. Earnings changes (NZ$m)

	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales	2,858.5	3,117	9%	2,999.7	3,001	0%	3,038.6	3,054.9	1%
EBIT	82.5	110.4	34%	44.4	55.5	25%	94.6	98.7	4%
Normalised profit	53.9	74.0	37%	26.7	34.9	31%	61.8	64.7	5%
Underlying EPS	15.6	21.4	37%	7.7	10.1	31%	17.9	18.8	5%
DPS	10.0	10.0	-	-	6.0	n/a	13.5	14.0	4%

Source: Forsyth Barr analysis

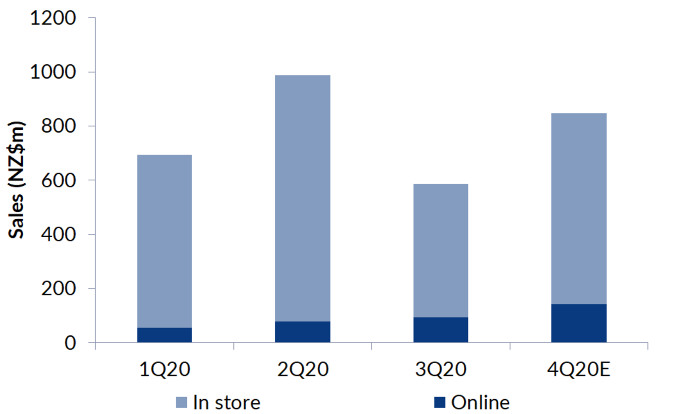
Recent trading shows a rebound

Figure 2. FY20 quarterly sales growth



Source: Company reports, Forsyth Barr analysis

Figure 3. FY20 quarterly sales by channel



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. 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.

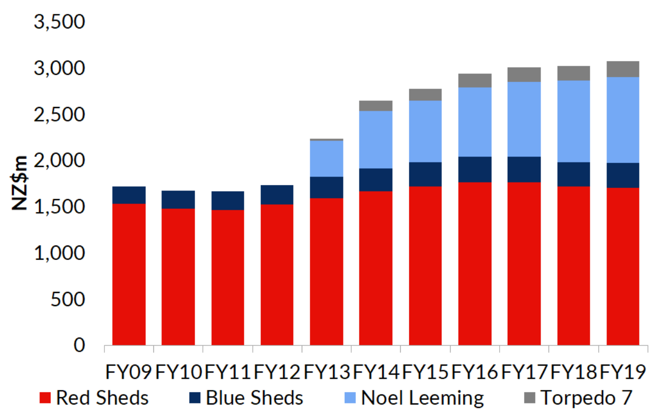
Financial structure

- **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

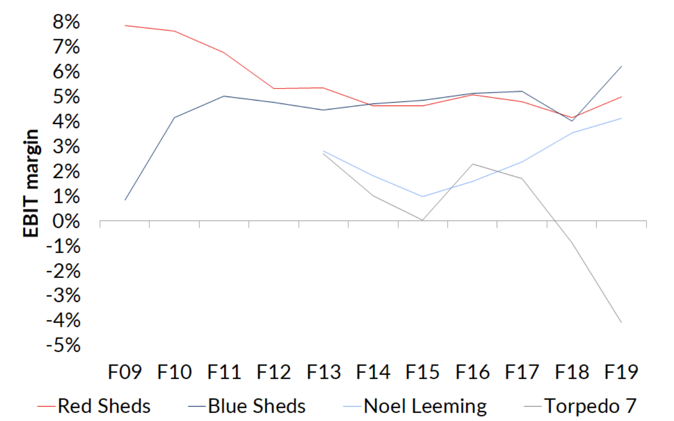
- **Competitive environment:** Particularly with the expansion of Kmart in New Zealand and the entry of Amazon into Australia.
- **Consumer sentiment and cost inflation:** Deterioration in economic conditions or general consumer sentiment. Cost inflation, particularly rising wages and rent.

Figure 4. Divisional revenue (NZ$m)



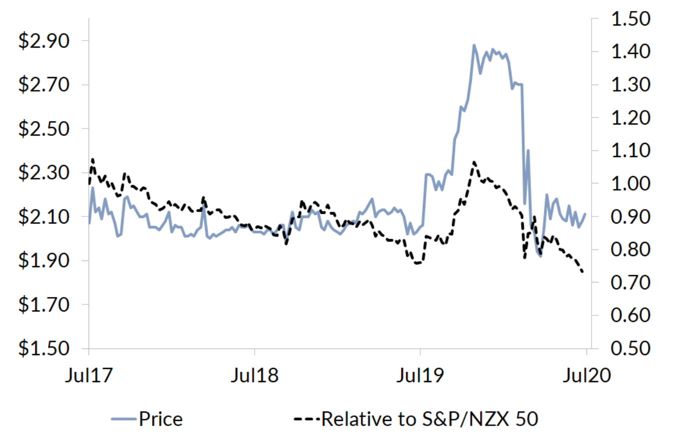
Source: Forsyth Barr analysis

Figure 5. Divisional EBIT margin (%)



Source: Forsyth Barr analysis

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

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

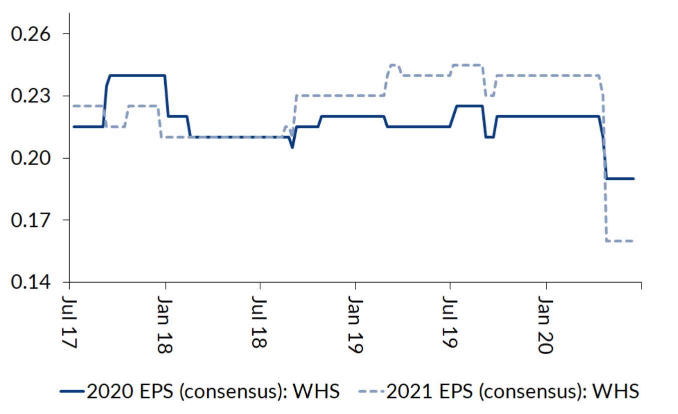
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. 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$2.11**	**NZ$728**	**9.8x**	**20.9x**	**4.8x**	**7.0x**	**7.3x**	**14.5x**	**2.8%**
BRISCOE GROUP *	BGP NZ	NZ$3.20	NZ$711	17.8x	19.1x	7.4x	7.3x	10.5x	10.2x	4.0%
COSTCO WHOLESALE CORP	COST US	US$316.32	US$139,663	37.4x	34.5x	20.9x	19.2x	27.5x	25.1x	0.9%
TARGET CORP	TGT US	US$117.70	US$58,852	20.8x	20.4x	10.4x	10.5x	17.6x	17.5x	2.4%
REJECT SHOP/THE	TRS AT	A$7.48	A$286	>50x	>50x	19.8x	16.6x	>75x	44.2x	0.3%
WALMART INC	WMT US	US$124.44	US$352,408	24.3x	23.8x	12.3x	12.4x	19.6x	18.6x	1.8%
KATHMANDU HOLDINGS *	KMD NZ	NZ$1.20	NZ$851	16.8x	19.3x	12.2x	9.3x	18.6x	13.4x	2.5%
MICHAEL HILL INTL *	MHJ NZ	A$0.35	A$134	14.0x	39.1x	4.2x	5.7x	9.3x	19.3x	8.2%
			Compco Average:	**21.8x**	**26.0x**	**12.5x**	**11.6x**	**17.2x**	**21.2x**	**2.9%**
EV = Current Market Cap + Actual Net Debt			**WHS Relative:**	**-55%**	**-20%**	**-62%**	**-40%**	**-58%**	**-32%**	**-1%**

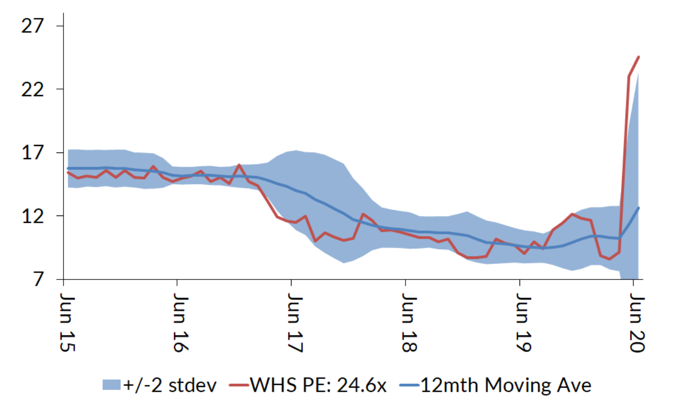
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (WHS) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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