EDISON

Findel

Final results

Outstanding success with online-led strategy

Retail

Findel (FDL) is seeing outstanding success with its online-led value retail strategy. FY18's 21% PBT growth includes a strong Black Friday and Christmas campaign. However, underlying independent market share growth puts FDL on the right side of a difficult sector. Also, considering that customer redress has been bottomed out, Education has been stabilised and that core net bank debt (excluding receivables-related debt) is close to net positive, most of the negatives in the investment case have been removed. FDL appears to have turned the corner and our revised valuation suggests significant valuation headroom.

Year end	Revenue (£m)	EBITDA* (£m)	PBT* (£m)	EPS* (p)	P/E (x)	EV/EBITDA (x)
03/17	457.0	40.8	22.2	20.4	13.3	7.6
03/18	479.0	46.6	26.8	25.9	10.5	6.6
03/19e	508.8	52.1	28.5	27.5	9.9	5.9
03/20e	538.6	55.7	30.9	29.8	9.1	5.5

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Outstanding year confirms online-led strategy

The outstanding FY18 results reflect the Phil Maudsley team's pragmatic strategy. Free of exceptionals, PBT grew 21% to £26.8m. This success was the direct result of Express Gifts' performance, particularly its strong Black Friday and pre-Christmas marketing campaign. Our forecasts average a more cautious 7% EPS growth over the next two years, but the direction of travel is clear.

Success in neutralising threats

Two significant threats have been neutralised over the last year. The £26m provision for customer redress is on track with only £9m left to pay out in the next few months, and the profit declines at Findel Education have been stabilised with several learnings borrowed from the winning formula in the retail business.

Core bank position approaches the black

FDL's nominally large net debt position mostly results from its securitisation of its consumer receivables book, but net core bank debt excluding receivables-related debt is now in single figures. Underlying free cash generation has improved from £22m to £32m, setting the scene for optionality on utilisation between investment, marketing and customer growth, deleveraging and ultimately, dividends.

Valuation: Significant headroom

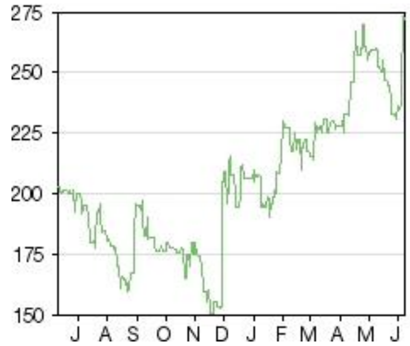
In our view, despite the recent share price rise, a FY19e P/E of 9.9x, does not yet fully recognise FDL's independent growth characteristics or the effective removal of the negatives in its investment case. Our revised valuation approach uses two metrics: a DCF projection to value on the longer-term income stream; and relative valuations to price growth among peer retailers. The first values the shares at 401p, the second at 455p. We therefore define a blended valuation of 428p, implying an unstretched FY19e P/E of 15.5x and EV/EBITDA of 8.5x.

8 June 2018

Price	**272p**
Market cap	**£235m**

Core net debt (£m) at 31 March 2018	73.8
Shares in issue	86.4m
Free float	69%
Code	FDL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	5.0	20.9	34.2
Rel (local)	2.9	12.5	29.1
52-week high/low		273.0p	150.2p

Business description

Findel plc is a multi-channel retailer operating across the business-to-consumer and business-to-business market places. It is a market leader in the home shopping and educational supplies sectors in the UK.

Next events

AGM statement	August 2018

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Edison profile page

Findel is a research client of Edison Investment Research Limited

Investment summary

Company description: Increasingly retail focused, online led

Findel comprises two businesses. Its primary operation is the retailer Express Gifts, trading as Studio (93% of operating profit before central costs and 82% of revenue in FY18). Express is increasingly an online-led value retailer with 68% of its sales revenue from digital sources. Its other business is the education supplies operation, Findel Education, which is executing a turnaround strategy (7% of operating profit and 18% of revenue). Part of that strategy has overlap with Express, for example Far East sourcing, increased digital ordering and a value-led model.

Financials: Outstanding 21% PBT growth confirms strategy

Phil Maudsley was appointed CEO a year ago and Findel has completed a highly successful FY18 in which the strategy under his team began to work on several fronts. With no exceptionals, 52-week group revenue was up 5.9% to £479.0m, operating profit was up 15.4% to £36.0m, and adjusted PBT up 21% to £26.8m.This success was the result of the strength of Express's performance, both total revenue and operating margin, and particularly its high profile TV-led pre-Christmas marketing campaign, resulting in strong incremental sales. Meanwhile Education was stabilised and there was a small increase in central costs. Core net debt (total bank debt less cash) was down by £7.1m to £73.8m and excluding receivables-related debt, was down £13.2m to £9.1m. We make no material changes to our FY19 profit forecast, which represents 6% EPS growth, and we introduce our FY20 forecast with 8% EPS growth. Recognising the challenged consumer backdrop, we are cautious in our assumptions but the direction of travel is clear, in our view.

Valuation: More appropriate metrics show value of 428p

We have revised our valuation approach to use two metrics: a DCF projection to place a value on the longer-term income stream available to investors; and relative valuations for growth among peer retailers. Our DCF, which takes account of the securitisation of receivables only to the extent that it hedges working capital outflows in the medium term, results in a valuation of 401p. Our peer valuation is 455p. We therefore define a blended valuation of 428p. While this is significantly higher than our previous 312p, in our view it does recognise FDL's independent market share gains as well as the effective removal of the negatives in its investment case. These are not yet, we believe, fully assimilated by the market, despite the 17% share price rise since the preliminary results. Our valuation would put the shares on an unstretched FY19e PE of 15.5x and EV/EBITDA of 8.5x.

Sensitivities: A value-driven UK retailer

The main sensitivities we see are:

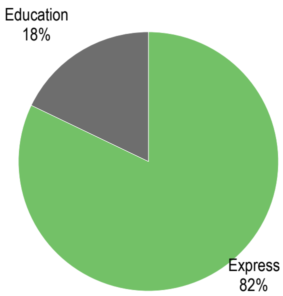
- UK retail demand and consumer hardship, although a cost squeeze may favour value retailers on a relative basis.
- A continuing tough educational market, with budget pressure affecting spending ability.
- New regulatory intervention, particularly affecting the financial services business.
- Particularly as an online business, Findel could be exposed to cyberattacks. Management is well aware of this, and has taken protective action.

Company description: Increasingly online led

Findel comprises two businesses. The home shopping retailer Express Gifts, trading as Studio, accounted for 82% of FY18 revenue and 93% of operating profit before central costs. Express is increasingly an online business with 68% of its sales revenue from digital sources. The other business is the education supplies operation, Findel Education, which is executing a turnaround strategy.

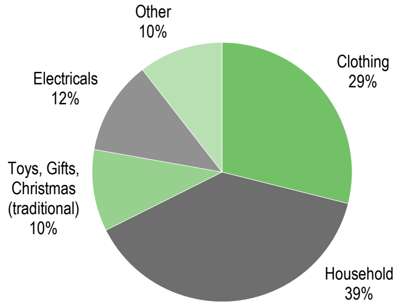
Based in Accrington, Lancashire, Express evolved from origins in mail orders based on a printed catalogue. It trades mainly through its Studio brand, www.studio.co.uk (a second brand, Ace, is effectively identical). The key proposition elements are low-cost value and personalisation. Its largest category is household goods (39% of FY18 sales), although the fastest growing in the last two years is fashion clothing (29% of FY18 sales). Express maintains strong customer value using strong supply links with Far East, which have recently also been opened up to the Education business. It incorporates an integrated FCA-approved credit business.

Exhibit 1: Findel: divisional revenue (FY18)



Source: Findel

Exhibit 2: Express Gifts: category split of revenue (FY18)



Source: Findel

Strategy: Business-specific approach

Findel has specific strategies for each of its business:

Express Gifts: a growth and expansion strategy. Management has streamlined its strategy into three pillars (there were previously eight):

- **Improve retail profitability**. This is to be achieved by growing the customer base, range development and product sourcing to build margins with a constant focus on costs to underpin the value proposition.
- **Maximise financial services opportunity.** This entails utilising new products and systems to develop payment options for customers, in turn increasing the headroom for sales.
- **Build strong foundations.** The emphasis is to invest in technology and business infrastructure to support growth, backed up by people and processes developed to provide modern and professional customer service.

Findel Education: a turnaround strategy. A year ago management introduced a change strategy designed to turn round the Education business. This has four pillars:

- **Return this business to an operating profit of 10% operating margin.** The impetus was to stabilise margins consistent with a sustainable business model.
- **Provide everything a customer needs at everyday low prices**. A combination of range and value.
- **Make teachers' budgets go further while saving time.** Responding to budget constraints combined with manpower shortages in the education sector.

- **Support schools/academies in taking a far more commercial approach.** This reflects the need to bring processes and tools up to date, to be competitive and reflect contemporary needs.

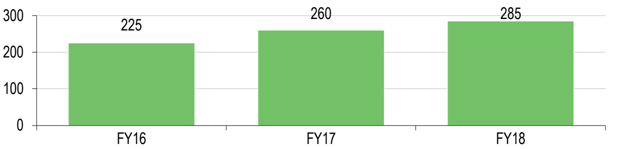
History: A process of focus

Five years ago Findel was a mini-conglomerate with five significant divisions. Following the disposals of the Healthcare division in April 2013, Kleeneze in March 2015 and Kitbag in February 2016, the company is now focused on two operations: Express Gifts and Findel Education. Express Gifts was originally a catalogue mail order retailer with a product range of gifts as the name suggests. The name has become historical as the range has been expanded and in parallel the proportion of online sales has increased to its current 68% (FY18). In FY17 management adopted an explicit strategy to become the UK's leading digital first, value retailer.

Express: Online retailer with sophisticated fulfilment

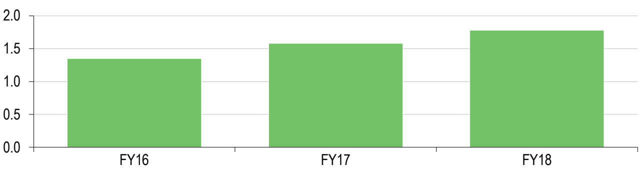
Express Gifts trades principally through its retail brand Studio (about 20% of sales are via a legacy but identical brand, Ace). Studio's move to being an online platform is central to management's current strategy.

Exhibit 3: Product sales (£m)



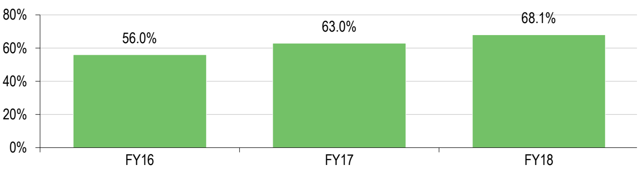
Source: Findel

Exhibit 4: Customer base (m)



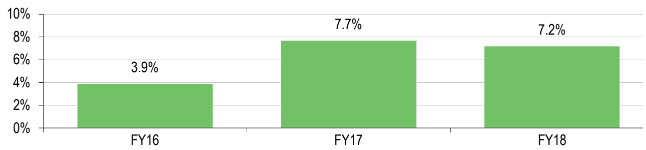
Source: Findel

Exhibit 5: Online sales %



Source: Findel

Exhibit 6: Bad debt as % of revenue

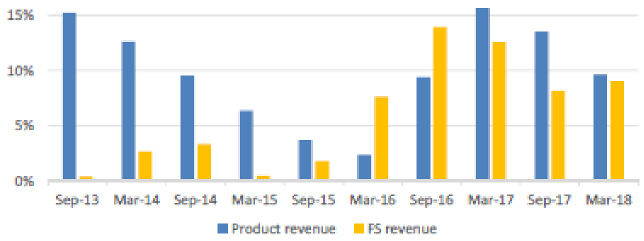


Source: Findel

Retail profitability improved

Product sales for the year grew by 9.6% on a 52-week basis to £285.1m. Customer numbers, up 13% at 1.8 million, benefited from a focus on promoting showcase products, and increased digital marketing and TV advertising. The decision to rework and bring forward the pre-Christmas marketing campaign drove a spike in H1 results but was key to the increased profit increase in the year as a whole. Marketing activity has also positively influenced the established customer base. Management sees further potential for growing both retention and average spend.

Exhibit 7: Express Gifts – revenue growth: Product and Financial Services (FS)



Source: Findel

Online penetration grows relentlessly

Management now describes Express as a 'digital first' value retailer, and is managing the process consistent with online orders moving close to 100% in the future. It is relentlessly growing its online penetration. Online customers in FY18 increased from 63% to 68% (the figure was higher at 72% in Q3 due to the seasonal peak). A higher and faster accelerating percentage of new customers placed their first orders online, at 84%, up from 71%. For the under-25 customer group, the online proportion is 97%. Mobile and tablet are strong drivers of online sales, up from 37.5% to 47.4%. Express's age range is broad, with its core customer base aged between 25 and 55 years.

Technologies that Express has adopted include IBM's Commerce platform and Qubit technology, allowing it to personalise the customer experience and increase the versatility of the online shop. In FY18 Express continued to improve functionality and website merchandising, and introduced Aura, which enhances the mobile experience through product recommendations. Further digital developments in FY19 include a programme of artificial intelligence (AI) releases through the year. Management believes there is a role for AI to help drive customer numbers beyond the two-year target of two million. It aims to use social proofing (the social and psychological phenomenon in which individuals mirror the behaviour of others) throughout the customer shopping experience.

Improving the buying process

Although at c 30% Express's gross margin is low compared with some online retail peers (Amazon 33%, ASOS 50%), figures are not necessarily comparable as Express offers financial services as well as product (also ASOS sells apparel only). Management intends to move the buying process from an historical focus on the catalogue to a view across the entire season that will be reflected in the pricing architecture. Management believes this focus will allow it to sharpen its buying prices with resulting improved value for customers combined with margin improvement.

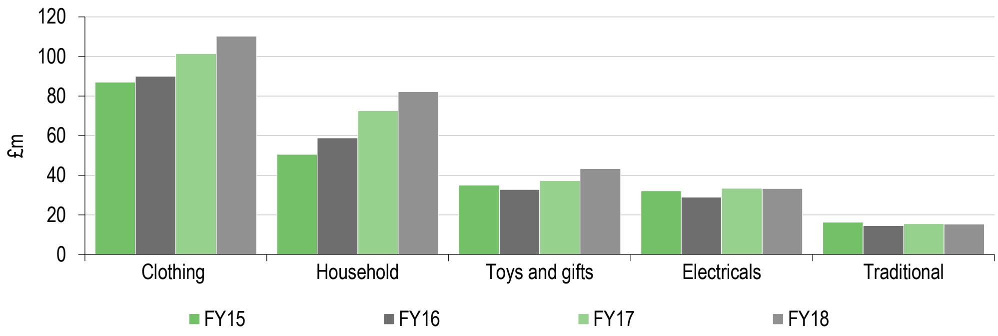
Downward pressure on costs

Management has worked hard to mitigate the cost impact of sterling's depreciation. Actions included a reduction in stock lines to streamline the buying process, and achieving added efficiencies in Far East sourcing. These mitigated the FY18 exchange rate impact on product gross margin to 40bp, while maintaining the value offer for customers. In FY19, a new seasonal planning process is being introduced, while the move of the Far East sourcing centre to management in Shanghai rather than Hong Kong should help to disintermediate sourcing, relieving cost pressure on margins while avoiding significant customer price increases.

Range development

Over two years the clothing and household categories have accelerated such that they dominate the product range, leaving gifts, electricals and other ranges comparatively flat. Clothing and household goods now jointly account for 68% of revenue. Clothing (including footwear) has accelerated particularly fast (new customer numbers are one-third over two years to take total customers to 1.8 million in FY18), and now represents 29% of total sales. Management is convinced it has further potential.

Exhibit 8: Clothing and household dominate range and growth



Source: Edison Investment Research. Note: Based on company presentations (52-week basis).

One of the issues the company faces is that it takes c 18 months to grow a new customer to profitability. Clothing is a particularly progressive category as its customers are more frequent users than in other categories, creating the potential to contract the recruitment period, while clothing also smoothes seasonal peaks in sales and recruitment.

Express's market: Wide and progressive

Of Express's 1.8 million active customers, c 84% are female, of whom around a third have children, with the core market being 25-55 year olds. Experian profile analysis has shown that approximately half of customers are from households with an annual income below £30k. At this level consumers have an acute interest in matching quality and value; this group also has an active interest in credit that operates on a fair and professional basis. It is therefore not surprising that a c 50% of customers take credit averaging c £360, which they pay off in an average of nine months (although customers have flexibility to match payments to their budgets and could take longer than this).

The online channel continues to gain share within the UK retail market, representing 17.3% of all retail sales in April 2018, up from 15.6% a year ago, and growing y-o-y at 11.7% against 3.5% for all retail (source: ONS). Hence it represents a favourable tailwind for Express. We therefore regard both the fact that 68% of orders are now online, and the accelerated rate of growth of the online share, as significant. The average online order value is slightly higher than the offline equivalent, at c £50. Around 40% of customers buy personalised products; the personalisation process is more cost-effective online. Around half of customers pay their bills online.

The online channel also provides marketing opportunities. Express can track customer visits providing valuable information on dwell times, conversion rates, failed searches, complementarities and other customer statistics available for data analytics. That should result in better product selection, range structures, assortment mix, marketing approaches and therefore sales.

Express continues to print its traditional catalogue, but the clear objective is to move towards a high mix of online sales. In line with this strategy, the company has increased marketing activity, particularly around TV and social media advertising, and has led the effort with 'showcase' promotional products such as the computer tablet priced at £19.99, which sold c 60,000 units in FY16. It has also opened a Philippines call centre operation, which is now being consolidated.

Financial services

Around 30% of Express's revenue is from financial services in which consumer credit is offered to customers and over the past two years management has been successful in rebalancing product sales against financial services income, with an aim of stimulating product growth without customer detriment. In FY17 financial services income grew 7%. In FY18, the company implemented its new credit account management system, Financier, for all customer accounts, bringing improved and clearer 'plain page' statements with simpler account management, enabling proactive management of non-performing accounts. The company is trialling additional tailored financial services products in FY19.

As part of its working capital management, FDL sells non-performing receivables to specialist third parties. This market has been particularly attractive over the last year and management believes leading players may be looking to list in coming months. FDL has taken the opportunity to slightly accelerate such sales, generating an estimated £2m of cash and profit.

The customer redress programme is proceeding to plan and within current provisions, and is due to be completed in the coming months.

Fulfilment and distribution

Express's main distribution facility is housed in a modern warehouse at Accrington, near Manchester. The facility, which consolidates an operation once spread between seven warehouses, manages around 3,000 stock keeping units and employs c 200 people. Different areas are connected by 3.5km of conveyor belts. The order processing system currently picks c 200,000 items per day, with the capacity to increase this to c 300,000. The Klug software relies on barcode identification and is capable of bringing together a typical basket of five to six items within a session. This may include goods such as clothing, cutlery or pencils, which go through a personalisation process to inscribe or embroider a name on the product; this is a popular and differentiating feature of Express's offer. Personalisation operations take up c 7,500sq ft of the site. The system incorporates a double-check on order fulfilment, as a result of which the unit has a record of over 99% accuracy.

From its origins in home delivery, the fulfilment structure is ideally established for a transition to high levels of online orders. Express is now focusing on adapting its front-end offer more specifically to the online marketplace. As part of its platform development, it has moved its websites to IBM's Commerce platform, which includes new account management features and cyber security compliant with the EU's General Data Protection Regulation (GDPR), effective from May 2018.

FDL plans to update its warehouse technology over the next two years. It has already implemented projects to ensure it is compliant on the GDPR. Because FDL already has comprehensive data on its customers and their shopping preferences, it is in a strong competitive position. Management recognises this and will invest to protect and enhance this asset.

Sports Direct: Commercial supply arrangements being trialled

Indications are that a positive commercial relationship is gradually emerging from Findel's relationship with Sports Direct, its 29.9% shareholder. A number of menswear ranges are being trialled in Studio's spring/summer collection, with the potential for additional opportunities for Sports Direct brands further into the future. In addition supply chain opportunities are being investigated.

Education: Strategies to optimise a difficult market

Findel Education is a leading independent educational resources supplier, serving educational establishments in all parts of the UK. Consolidating a number of smaller businesses, its main areas of operation are stationery essentials, science, art and craft and early years. Its well-known brands include Hope, GLS, Philip Harris, Davies Sports and LDA.

In support of its turnaround strategy highlighted above, Education has taken decisive action in the last year:

- It rebased pricing, offering reductions of up to 30% against catalogue prices on many key items when ordering online. By doing so it created a strong incentive for schools and nurseries to shift ordering away from traditional catalogue channels in favour of Findel's upgraded websites.
- It added online tools, developed to help teachers save time by automatically comparing prices against the competition to demonstrate best prices and encouraging switching to Findel's ranges to save money.
- Sourcing arrangements with Far East suppliers have been firmed up, enabling a growing range of products to be manufactured at industry-competitive prices. This is expected to mitigate the margin impact of price reductions in the next few months.
- The cost base has been overhauled with additional savings realised, in pursuit of the strategic objective of 10% operating margin.

The educational supplies market: Continued pressure

As is well known, school funding is under pressure.

A March 2018 report by the Education Policy Institute found that the average local authority maintained secondary school deficit rose 28% over a seven-year period to £374,990 in 2016-17, while primary school deficits rose 40% to £107,962 in the same period. It concluded that schools were unlikely to be able to achieve the scale of savings necessary without also cutting staff.

In July 2017, Justine Greening, education secretary announced that an extra £1.3bn would be injected into schools over the next two years; however, the Institute for Fiscal Studies said this only meant that instead of a real terms cut of 6.5%, there will have been a cut of 4.6% between 2015 and 2019.

There are three main areas of expenditure: teaching, buildings and resources. The first two have inflexible features and therefore the latter is where the most pressure exists in practice. As a result, school resources spending across the five major educational resources suppliers reduced by 6.3% in FY17 (source: BESA market data). However, long-term fundamentals remain positive with pupil numbers expected to increase by 0.55 million between 2017 and 2022.

Findel Education's strategy for operational turnaround focuses on four key themes:

- **Digital:** increasing the level of online ordering to improve admin and loyalty rates. In FY17 only 18% of sales were through digital channels, below peers. By FY18 the goal of delivering 50% of volume sales through digital channels within 24 months has already been achieved (39% by value). All websites were successfully re-platformed during FY18. The e-procurement tools WebFMS and WebFlow are proving to be a success, and customer advocacy of the company's solutions is positive with up to 80% of administration time being saved in schools, according to management. In FY19 there are plans to deliver further easy procurement solutions, and new WebFMS solutions will be rolled out across the marketplace.
- **Value**: making products price-competitive. A major synergy with Express is being exploited to drive significant product sourcing from the Far East. Price reductions were made in September 2017 on the best-selling 800 products, and this was expanded to 2,000 products in January 2018. The result has been H2 demand decline of 2% compared with 10% in H1.
- **Product**: the company identified that direct Far East sourcing was too low at 7% in FY17. In response it has established a new Far East supply chain using its Shanghai resourcing office. A new big brand alternative Classmates range of 500 products was launched in April 2018 at a value price 40% lower than the competitive equivalent. Management now plans to expand this to 1,100 products.

- **Profitability**: major systems and warehouse benefits of £3m (c 10% of total costs) have been realised during FY17 and FY18, business simplification has delivered £1.3m of annualised cost benefits during FY18 with a further £1.3m to be delivered during FY19. In FY19 the company will invest over £2.5m in value, while digital transformation and simplification of processes expected to reduce the cost base. The objective remains to deliver a minimum 10% operating margin.

Management: Reflecting forward strategic direction

Ian Burke, chairman, was appointed effective from January 2017. He had served in a number of high-profile consumer-facing roles, including Rank Group (as CEO and chairman) and as CEO of Thistle Hotels, with previous experience at Holiday Inn Worldwide and Gala Clubs. Phil Maudsley, managing director of Express Gifts, was appointed as chief executive in April 2017. Phil led the development of Express Gifts for over 20 years, and has been responsible for its transformation to a leading online retailer. Stuart Caldwell, previously group financial controller, was appointed CFO in July 2017. We believe these management changes indicate where the group's strategic emphasis now lies.

In February 2018 FDL strengthened its non-executive board with the appointment of Elaine O'Donnell, a former partner at Ernst & Young with over 20 years' experience operating in a senior advisory capacity across a range of industry sectors and situations.

Significant management changes have been made to strengthen the organisation over the last year, with Express Gifts making key appointments in HR, finance and IT. The Far-East sourcing office has received additional investment and its leadership has moved from Hong Kong to Shanghai. Management transfers have also been made from Express Gifts to Education to accelerate its development of Far Eastern buying, commercial and digital marketing.

Sensitivities

- As a value retail operation across a range of product types, Express has broad exposure to UK retail demand, an area that is currently under pressure. UK retail sales volumes (excluding fuel). Although labour costs per hour increased by 3.7% in Q417, which is technically higher than consumer price inflation of 2.5% in the same period, it masks continued hardship among many consumers. A shortage of disposable income may relatively favour value retailers, but a significant cutback by customers would not be good for any retailer.
- School funding per pupil has been frozen in cash terms between 2015–16 and 2019–20, resulting in a real-terms cut of 6.5% (source: IFS). This is the largest cut in school spending per pupil over a four-year period since at least the early 1980s. According to a survey of 1,500 headteachers by the lobbying campaign Worth Less?, despite the introduction of the national funding formula in April 2018, school leaders have reported that budgets are still in crisis, with 60% of schools removing teaching posts and 80% cutting the numbers of assistants and support staff. This environment results in a challenged market for educational materials.
- Any financial services business is always vulnerable to greater regulatory intervention and tighter limits on operating freedom. Express has considered the FCA's review of High Cost Credit and believes its plans are in accordance with its provisions. Management also believes that its provision for customer redress is adequate, with the actual repayment process now due to complete within a few months.

- Like any business, but particularly as an increasingly online one, the company could be exposed to cyber attacks. Management is well aware of this, and for example the move to IBM's Commerce platform includes cyber security compliant with forthcoming EU standards.

Financials

FY18 was a very successful year financially as well as more generally. In a report that was completely clear of exceptionals, 52-week group revenue was up 5.9% to £479.0m, with Express Gifts up 8.9% and the much smaller Findel Education down 6.2%. Operating profit was up 15.4% to £36.0m, and adjusted PBT up 21% to £26.8m. Core net debt was down by £7.1m to £73.8m, and excluding receivables-related borrowings is only £9.5m.

Exhibit 9: Results and forecasts

	FY17*	FY18	Growth	FY19e	Growth	FY20e	Growth
Revenue							
Express	365.3	393.4	7.7%	426.6	8.5%	454.4	6.5%
Education	91.7	85.6	-6.7%	82.2	-4.0%	84.2	2.5%
Total	457.0	479.0	4.8%	508.8	6.2%	538.6	5.9%
Operating profit**							
Express	30.2	36.3	20.4%	40.2	10.7%	43.1	7.2%
Express operating margin	8.3%	9.2%	1.0%	9.4%	0.2%	9.5%	0.1%
Education	2.7	2.9	8.9%	3.1	5.7%	3.8	24.2%
Central costs	(1.7)	(3.3)	94.0%	(3.4)	3.0%	(3.6)	5.0%
Total**	31.2	36.0	15.4%	39.9	11.0%	43.4	8.7%
Operating margin	6.8%	7.5%	0.7%	7.8%	4.5%	8.1%	2.7%
Interest	(8.9)	(9.1)	2.4%	(11.3)	24.3%	(12.4)	9.5%
PBT	22.2	26.8	20.7%	28.5	6.4%	30.9	8.4%

Source: Findel, Edison. Note: *53 weeks. **Pre-exceptional, but after amortisation and share-based payments.

This success is the result of the strong performance at Express, both total revenue and operating margin. Meanwhile, Education was stabilised and there was a small increase in central costs.

The performance at Express stems principally from its strong growth in customers, up 13% to 1.8m, despite a difficult retail market, with product sales up 9.6% on a 52-week basis. Currency-related cost rises led to a relatively small 40bp impact on gross profit to 30.5%. There was a strong 23% increase in new credit take-up driving growth in financial services income of 9% on a 52-week basis. Collections from customers performed well and receivables were successfully managed leading to a reduction in the bad debt charge from 7.7% to 7.2% of total revenue. Costs of distribution actually reduced by c £0.8m with a change in carrier to Hermes, while marketing costs increased broadly in line with product sales, and administrative costs increased by 6.1% due to the investments in business support and structure.

Performance at Education improved in H2 due to the strategic pricing changes implemented last September and, while full-year revenue declined overall by 6.2%, cost-saving initiatives helped to move profit operating forward by £0.2m.

Together, fundamental underlying factors delivered operating profit growth of 15% to £36.0m. This is encouraging for the new financial year, despite the dour consumer backdrop.

Improvement in underlying cash generation

There is significant underlying progress in FDL's efforts to reduce leverage.

Exhibit 10: Cash flow			
£m	FY17	FY18	Change
EBITDA*	40.6	46.4	5.8
Increase in Express Gifts' receivables net of securitisation inflows	(7.1)	(4.0)	3.1
Movement in other working capital	1.7	6.9	5.2
Capital expenditure	(11.7)	(10.6)	1.1
Exceptional items	(8.2)	(20.7)	(12.5)
Pension and other	(2.0)	(1.6)	0.4
Free cash flow	13.3	16.4	3.1
Interest	(9.1)	(8.3)	0.8
Business disposals and finance leases	0.6	(1.0)	(1.6)
Net cash inflow	**4.8**	**7.1**	**2.3**

Source: Findel. Note: *After share-based payments.

Taking out exceptionals (which in FY18 were mainly the cash effect of refunds on flawed financial products provided in FY17 and timing differences of c £6m), free cash generation improved from £21.5m to £31.5m. This sets the scene for an outlook where management has increased discretion over how it utilises free cash, with optionality between additional capital investment, marketing and customer growth, further deleveraging and potentially in the long-term, dividends.

Balance sheet: On the verge of underlying net cash

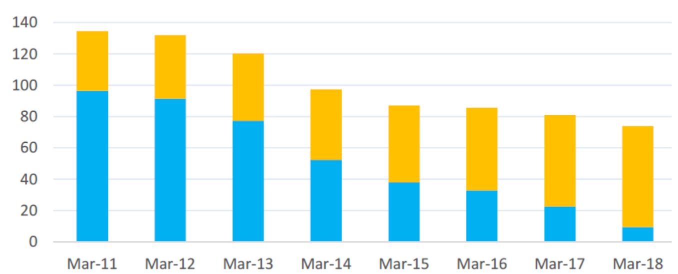
Allowing for the inclusion in the debt structure of Findel's substantial consumer credit business, the balance sheet is increasingly strong. The consumer lending business is funded by a £170m securitisation facility (increased in FY18 by £15m). For every £100 of credit, £71 is drawn down from the facility and matched against customer receivables, which are appropriately provisioned on a formula basis consistent with IAS39. The other £29 is funded from bank facilities, in a structure typical of the home shopping market. This means other (core) net bank debt at March 2018 was £9.5m, down from £22.7m in March 2017:

Exhibit 11: Net debt and core element						
	FY17			FY18		
£m	Total	Receivables related	Core bank	Total	Receivables related	Core bank
External bank debt	110	58.2*	51.8	100	64.3*	35.7
Total cash	-29.1		-29.1	-26.2		-26.2
Net bank debt	80.9	58.2	22.7	73.8	64.3	9.5
Securitised loan	142.5	142.5		157.5	157.5	
Finance leases	1.6			1.0		
Net debt	**225.0**	**200.7**	**22.7**	**232.3**	**221.8**	**9.5**

Source: Findel, Edison Investment Research. Note: *Defined as securitised loan x 29/71.

On the same basis, core net bank debt excluding the element that relates to consumer credit (ie the £29 above) has continuously reduced over the last six years:

Exhibit 12: Reduction in net bank debt (£m)



Source: Findel. Note: Yellow area represents bank funding receivables. Blue area represents other bank debt.

Management expects the balance excluding the securitisation element to turn positive from FY19.

Forecasts: No material change

We make no material changes to our FY19 profit forecast, which represents 6% EPS growth, and we introduce our FY20 forecast with 8% EPS growth. Recognising the challenged consumer backdrop, we are cautious in our assumptions but the direction of travel is clear, in our view.

Exhibit 13: Changes in forecasts

	EPS (p)			PBT (£m)			EBITDA (£m)		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
03/18e	25.4	25.9	2.0%	26.5	26.8	1.3%	47.2	46.6	-1.4%
03/19e	27.3	27.5	1.0%	28.5	28.5	0.1%	51.9	52.1	0.3%
03/20e	N/A	29.8	N/A	N/A	30.9	N/A	N/A	55.7	N/A

Source: Edison Investment Research

We forecast a small net cash inflow of £4.1m in FY19.

Dividend outlook: No change soon

FDL does not pay a dividend as it has a shortfall of £95.5m on its company distributable reserves. Management's ambition over the next years is to increase the level of distributable reserves within the primary operating subsidiary, Express Gifts Limited, to enable it to remit dividends to Findel. While Express's reserves improved slightly in FY18, management expects the FY19 adoption of IFRS 9 Financial Instruments to have an impact on the distributable reserves of Findel of c £21m, and the FY20 adoption of IFRS16 Leases also to have an adverse impact. FDL is therefore some years from reinstating dividends, although underlying progress is being made.

Valuation: Revised approach highlights headroom

We have revised our valuation approach, which previously largely relied on comparison with a single peer. Findel is a relatively small retail company that, while not originally an online concept, now has 68% of its retail sales through online channels and has an operational procurement and fulfilment structure that is appropriate. With a declared strategy to move to an online-led model, growth is likely to be sustained and may accelerate. We therefore use a DCF projection to place a value on the longer-term income stream available to investors. We also consider the valuation in relation to a peer group of retail companies to take account of market valuations of earnings growth. Our revised approach highlights significant valuation headroom.

DCF valuation of 401p: Quantifying future cash flows

Our DCF projection extends our published forecasts, using similar revenue growth and margin assumptions for three years, extending that to 10 years on a formula basis. In the last three years we fade revenue growth to a perpetuity, or terminal, rate of 2%. We assume terminal EBITDA margin of 10.5% (2018: 9.7%) and capex investment at 2.2% of revenue, consistent with the three years of our forecast. Recognising the partial funding of the consumer credit activity, we model the working capital component of free cash flow in our detailed model as the company does, offsetting increases in receivables to the extent they are funded by securitisation: however, for our longer-term cash flow we drop out this cover as essentially it is a time-shift mechanism. Consistent with this, we take as current net debt the bank borrowings excluding the securitisation borrowings and associated cash, as these are secured against the opening receivables asset in our DCF forecast and therefore are not relevant to the future cash flow of the business.

We assume a weighted cost of capital of 6.6% (risk-free rate 3%, risk premium 6%, beta 0.75, cost of debt 3.6% net), resulting in a valuation of 401p/share. Varying the cost of capital and the terminal growth assumption would give the following ranges:

Exhibit 14: DCF assumption scenario analysis – terminal growth and cost of capital (p)

		Terminal growth rate				
		0.0%	1.0%	2.0%	3.0%	4.0%
Cost of capital	8.0%	206	234	271	324	402
	7.0%	258	299	356	442	584
	6.6%	284	332	401	507	696
	6.0%	330	392	485	640	951

Source: Edison Investment Research

Varying our revenue growth and margin assumptions affects the valuation as follows (in each case we assume that in the last three years of the forecast, revenue growth fades to the terminal 2%):

Exhibit 15: DCF assumption scenario analysis – medium term growth, terminal margin (p)

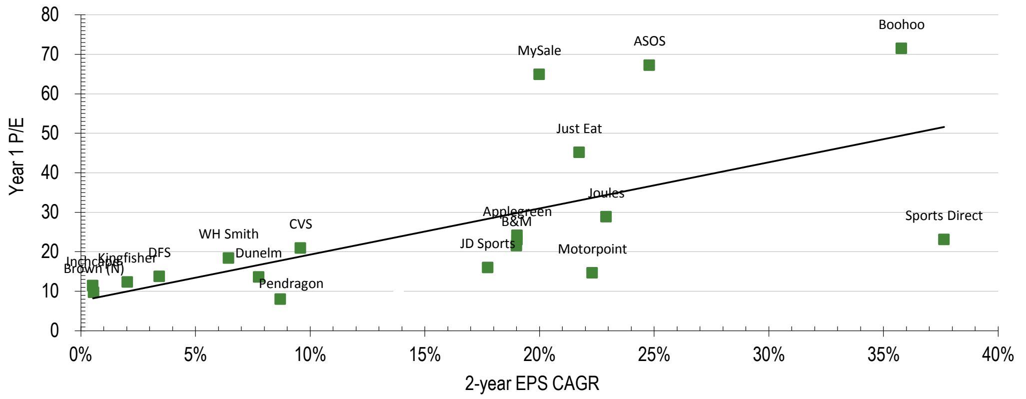
		Year 4-7 growth				
		4.0%	4.5%	5.0%	5.5%	6.0%
Terminal EBITDA margin	9.0%	238	244	251	257	264
	10.0%	333	342	351	359	369
	10.5%	381	391	401	411	421
	12.0%	524	537	550	564	578

Source: Edison Investment Research

Comparative valuation of 455p: Putting a price on growth

Here we take the common-sense position that higher earnings growth merits a higher P/E ratio than the FY19e 9.9x on which the shares currently trade. We compare P/E with two-year compound earnings growth forecasts (CAGR). Based on the chart below, we would expect Findel's 7% two-year compound EPS growth to command a year 1 P/E of 17x.

Exhibit 16: Retail stocks: P/E vs two-year EPS CAGR (2017-19e)



Source: Bloomberg, Edison Investment Research. Note: Trend line on a linear basis. Includes all stocks in FTSE General Retail and AIM supersector retail indices, negative growth excluded. Valuation at 5 June 2018.

Below we adjust for the fact that Findel does not pay a dividend:

Exhibit 17: Findel comparative share valuation

Findel Yr 1 (2019e) EPS (p)	27.5
Multiple implied by chart (x)	17
Sector yield	2.91%
Adjusted multiple (x)	16.5
Implied share price (p)	455

Source: Edison Investment Research

We adjust for the sector yield (weighted between the FTSE General Retail and AIM Supersector retail indices) of 2.9%. This produces a P/E of 16.5x and a comparative share valuation of 455p:

Blended valuation: 428p

We therefore determine a blended valuation of 428p, which would put the shares on a FY19e P/E of 15.5x and EV/EBITDA of 8.5x. It is significantly higher than our previous valuation of 312p as a result of our use of revised metrics.

Exhibit 18: Financial summary

£'000s	2017*	2018	2019e	2020e
Mar	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	457,030	478,959	508,789	538,585
Cost of Sales	(269,182)	(281,176)	(295,870)	(313,548)
Gross Profit	187,848	197,783	212,919	225,037
EBITDA	40,786	46,569	52,061	55,722
Operating Profit (before amort. and except.)	33,300	38,146	43,308	46,741
Intangible Amortisation	(1,959)	(1,996)	(2,416)	(2,383)
Operating profit pre exc post intang amortisation	31,341	36,150	40,891	44,358
Exceptionals	(82,152)	0	0	0
Other/share based payments	(191)	(199)	(1,000)	(1,000)
Operating Profit	(51,002)	35,951	39,891	43,358
Net Interest	(8,920)	(9,130)	(11,345)	(12,424)
Derviatives, other	556	(4,701)	0	0
Profit Before Tax (norm)	22,230	26,821	28,546	30,935
Profit Before Tax (FRS 3)	(59,366)	22,120	28,546	30,935
Tax	1,659	2,081	(5,766)	(6,249)
Profit After Tax (norm)	17,617	22,397	23,780	25,686
Profit After Tax (FRS 3)	(57,707)	24,201	22,780	24,686
Average Number of Shares Outstanding (m)	86.3	86.3	86.3	86.3
EPS - normalised (p)	20.4	25.9	27.5	29.8
EPS - normalised and fully diluted (p)	20.4	25.9	27.5	29.8
EPS - (IFRS) (p)	(66.8)	28.0	26.4	28.6
Dividend per share (p)	0.0	0.0	0.0	0.0
Gross Margin (%)	41.1	41.3	41.8	41.8
EBITDA Margin (%)	8.9	9.7	10.2	10.3
Operating Margin (before GW and except.) (%)	7.3	8.0	8.5	8.7
BALANCE SHEET				
Fixed Assets	79,012	77,019	81,987	82,623
Intangible Assets	26,185	25,174	28,895	28,512
Tangible Assets	44,417	47,596	48,843	49,862
Investments	8,410	4,249	4,249	4,249
Current Assets	301,265	312,458	340,659	366,127
Stocks	57,108	53,091	56,941	69,026
Debtors	212,648	232,666	246,788	259,097
Cash	29,173	26,244	36,480	37,553
Other	2,336	457	451	451
Current Liabilities	(91,789)	(81,190)	(91,216)	(92,402)
Creditors	(91,244)	(80,618)	(90,698)	(91,884)
Short term borrowings	(545)	(572)	(518)	(518)
Long Term Liabilities	(271,785)	(268,606)	(272,215)	(272,637)
Long term borrowings	(253,603)	(258,001)	(264,192)	(264,192)
Other long term liabilities	(18,182)	(10,605)	(8,023)	(8,445)
Net Assets	16,703	39,681	59,215	83,711
CASH FLOW				
Operating Cash Flow	12,281	11,439	33,210	31,746
Net Interest	(9,103)	(8,365)	(11,345)	(12,424)
Tax	148	581	(5,766)	(6,249)
Capex	(11,724)	(10,595)	(12,000)	(12,000)
Acquisitions/disposals	1,168	(450)	0	0
Financing	0	0	0	0
Dividends	0	0	0	0
Net Cash Flow	(7,230)	(7,390)	4,099	1,073
Opening net debt/(cash)	216,682	224,974	232,329	228,230
HP finance leases initiated	0	0	0	0
Other	(1,062)	35	0	0
Closing net debt/(cash)	224,974	232,329	228,230	227,157

Source: Company data, Edison Investment Research. Note: *53 weeks.

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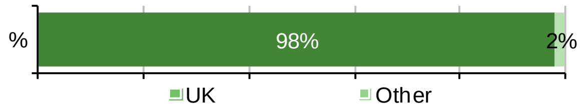
Revenue by geography



Management team

Chairman: Ian Burke

Ian Burke joined the board on 12 January 2017. He has spent the majority of his career in the leisure industry and is chairman of the Rank Group, having previously overseen the growth of that business as chief executive. He is also chairman at VetsPartners Holdings. Previously, he has served as chief executive of Thistle Hotels and has also held the position of managing director at both Holiday Inn Worldwide and Gala Clubs.

Chief executive: Phil Maudsley

Philip Maudsley joined the group in 1987 as general manager of a manufacturing subsidiary. He became managing director of the Home Shopping division in 1994 and was appointed to the board on 6 April 2004. He was appointed managing director of Express Gifts in 2010 before being appointed as group chief executive officer in April 2017.

Chief financial officer: Stuart Caldwell

Stuart Caldwell joined the group finance team in October 2010 and held the post of Acting CFO from April 2017 before his appointment to the board on 13 July 2017. He is a qualified chartered accountant and a fellow of the Association of Corporate Treasurers. After qualifying within the profession, he held a number of roles with Provident Financial before moving to Findel.

Principal shareholders	(%)
Sports Direct	29.9
Schroders	22.5
Toscafund	18.3
Fidelity	9.4
River & Mercantile	4.5
Merrill Lynch	3.5
Janus Henderson	3.0

Companies named in this report

Amazon (AMZN), ASOS (ASC), Sports Direct (SPD), Provident Financial (PFG), Rank Group (RNK)

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