

Findel

Full year results

Outstanding value

Studio, the main customer-facing business for Findel (FDL), is delivering impressive results and improvements across all key performance metrics through its unique digital-first value proposition with integrated consumer credit, which sets it apart from the peers. Despite a recent rebound in the share price the stock remains significantly undervalued for a predominantly online retailer with a strong balance sheet and significant growth opportunities. We forecast a two-year EPS CAGR of 7.3%.

Year end	Revenue (£m)	EBITDA (£m)	PBT* (£m)	EPS* (p)	P/E (x)	EV/EBITDA (x)
03/18**	479.6	46.6	26.8	25.9	9.9	6.0
03/19	506.8	50.9	28.8	26.5	9.7	5.5
03/20e	535.5	53.6	30.0	28.9	8.9	5.2
03/21e	557.6	56.3	31.7	30.5	8.5	5.0

Note: *PBT and EPS are normalised, excl. intangible amortisation, exceptionals and share-based payments. **Rested for IFRS 15 (IFRS 9 not applied retrospectively under GAAP).

Studio: Market disruptor with ambitious growth plans

Studio is unique in its digital-first value offer with integrated consumer credit. The business is delivering year-on-year improvements across all key performance metrics. There are significant opportunities to raise the brand profile, develop the clothing and own brand ranges and, ultimately, position Studio as a market-leading online value retailer. Management has set out ambitious plans to achieve three million active customers and product revenue in excess of £1bn in the medium term.

Strategy delivering robust results

FDL is reaping the rewards of its value-led and digital-first strategy. FY19 group sales grew 5.7% and underlying PBT increased 17.7% to £28.8m (like-for like, taking into account the adoption of IFRS 9 and IFRS 15). This was predominantly driven by Studio's strong performance, with product revenue growth of 7.8% and a 170bp improvement in its product gross margin offsetting the previously flagged impact on Education of lost sales from the Sainsbury 'Active Kids' scheme and ongoing price investment. Core net debt reduced by £16.4m to £57.4m.

No material change to recently upgraded forecasts

Following our recent upgrade in May we leave our FY20 underlying PBT forecast broadly unchanged at £30.0m (previously £29.5m) and introduce an FY21 PBT forecast of £31.7m, representing a 6% y-o-y increase. Our forecasts exclude any impact from IFRS 16: Leases, which FDL will adopt this year.

Valuation: Shares significantly undervalued

Despite a rebound in the share price following the recent upbeat post-close trading update and results, FDL trades on a lowly FY20e P/E of 8.9x. This appears unjustified given the strength of trading for this predominately online retailer, the significant market opportunities and ongoing reduction in core net debt. Our blended DCF and peer valuation increases to 423p (previously 348p), reflecting a sector re-rating and our forecast upgrade in early May, and represents a significant c 60% premium to the current share price.

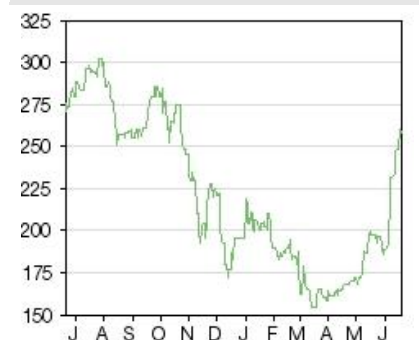
Retail

19 June 2019

Price 258p
Market cap £223m

Core net debt (£m) at 31 March 2019	57
Shares in issue	86.4m
Free float	61%
Code	FDL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	30.6	67.0	(6.2)
Rel (local)	29.5	64.5	(2.8)
52-week high/low	302.00p	154.00p	

Business description

Findel is a multi-channel retailer operating across the business-to-consumer and business-to-business market places. It is a market-leading online value retailer and educational resource supplier in the UK.

Next events

AGM trading statement	July 2019
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Investment thesis

The investment case is primarily centred on Studio, the main customer-facing business, which is making excellent progress in its digital transition. Against a challenging macroeconomic backdrop, Studio is outperforming much of the retail market through its unique digital-first value proposition, delivered through strong supply links with the Far East, combined with the backing of flexible, and increasingly tailored, responsible consumer credit solutions. Personalisation across a large number of items is also a key differentiator for the brand.

Further, the customer redress programme is now materially completed and the Education division is making good progress in executing a turnaround strategy. As such, legacy issues have been successfully resolved giving management greater flexibility to reinvest cash for future growth.

Recent share price performance and upcoming catalysts

The shares have performed strongly since the earnings upgrade in early May and have regained the ground lost towards the end of last year, following the sale of stakes representing 24% of FDL's issued share capital by Toscafund Asset Management and City Financial Investment Company, for reasons unrelated to their views on FDL. Following the recent lapsed mandatory offer, Sports Direct now holds a 36.8% stake in FDL (see page 8).

Despite the recent rally, the shares remain significantly undervalued at the current level, in our view. The company will issue its next trading update with its AGM at the end of July.

Financials: Strategy delivering robust results

FY19 group revenue increased 5.7% to £506.8m and underlying PBT increased 17.7% to £28.8m on a like-for-like basis after taking into account the adoption of IFRS 9 and IFRS 15 in FY19. This robust performance was driven by Studio, which delivered a particularly strong sales performance in the run up to Christmas and has continued to grow its active customer base and the average spend per customer. Product revenue increased 7.8% to £307.2m while ongoing improvements to sourcing contributed to a 170bp rise in the product gross margin. Financial services revenue increased by 8.5% to £117.5m, in line with growth in eligible receivables. Within Education, underlying revenue increased by 0.8% (excluding Active Kids) and the gross margin moved ahead in H2.

Following our recent upgrade in early May, we leave our FY20 underlying PBT forecast broadly unchanged at £30.0m and introduce an FY21 PBT forecast of £31.7m, representing a 6% y-o-y increase. Our forecasts exclude any impact from IFRS 16: Leases, which FDL will adopt this year.

Sensitivities: Relative strength in the value proposition

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. Again, this may favour value suppliers on a relative basis.
- New regulatory intervention, particularly affecting the financial services business.
- As a predominantly online business, Findel could be exposed to cyberattacks. Management is well aware of this, and has taken protective action.

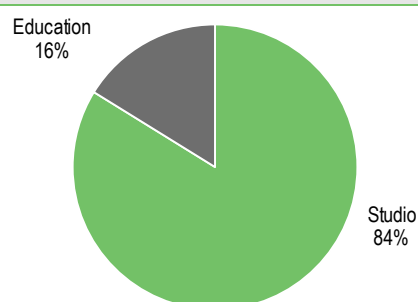
Company description: Studio the jewel in the crown

Findel comprises two businesses. The home shopping retailer Studio Retail (formerly named Express Gifts) accounts for 84% of revenue and 92% of operating profit before central costs (FY19). Studio is increasingly an online business with over 75% of its sales revenue from digital sources, compared with 68% a year ago. The other business is the education supplies operation, Findel Education, which is making good progress in executing a turnaround strategy.

Based in Accrington, Lancashire, Studio evolved from origins in mail order based on a printed catalogue. It trades mainly through the Studio brand, www.studio.co.uk (a second brand, Ace, is effectively identical and accounts for a small and declining element of revenue). The key proposition elements for this increasingly online retailer are low-cost value and personalisation. Its largest category is home and leisure (70% of FY19 sales), although fashion clothing and footwear remains a key growth category, having increased from 23% to 30% of the sales mix over the last three years.

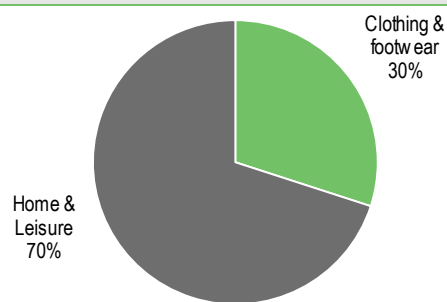
Studio offers its customers outstanding value through strong supply links with the Far East, which have recently also been opened up to the Education business. It is supported by an FCA-approved credit business, which is integral to the proposition.

Exhibit 1: Divisional revenue (FY19)



Source: Findel

Exhibit 2: Studio revenue by category (FY19)



Source: Findel

Strategy: Becoming a leading digital-first and value-led retailer

While each of the two operations has its own clearly defined set of strategic priorities, as below, they both share in common the group's over-arching objective, set out in FY17, to become the UK's leading digital-first and value-led retailer.

This not only applies to Studio, with over 75% of sales online (FY19), but also the Education business, which has streamlined its head office operations and is focused on a rapid transition to online browsing and ordering as part of its turnaround strategy. Since FY17, online ordering levels have increased sharply, from 20% to 66%.

Studio: A market disruptor with ambitious growth plans

Management sees Studio as a disruptor at the value end of the market and has set out ambitious plans to grow the customer base to three million active customers and achieve product revenue in excess of £1bn in the medium term. The three main elements of the strategy are as follows:

- **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.

Education: A turnaround strategy

Two years ago management introduced a change strategy designed to transform the Education business. This has two key pillars:

- **Save schools time and money.** To recruit lost customers and improve retention through an improved product offer, pricing and digital solutions.
- **Improve profitability.** Improve product sourcing and operational efficiency and return the business to a 10% operating margin in the medium term.

History: Focusing on the core operations

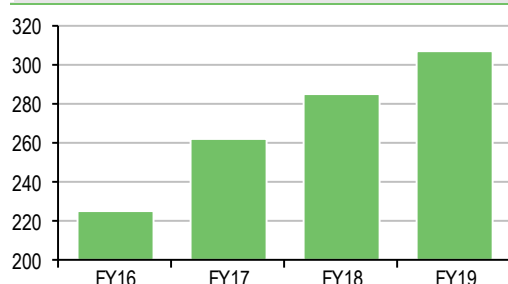
Six years ago, FDL was a mini-conglomerate with five significant divisions. Following the disposals of the healthcare division in April 2013, Kleeneze in March 2015 and Kitbag in February 2016, the company is now focused on home shopping and educational supplies via its two operations: Studio Retail and Findel Education.

Studio was originally a small traditional Christmas-orientated catalogue retailer with a product range of gifts. Its original name, Express Gifts, became outdated as the ranges expanded to include clothing and homewares and, in parallel, the proportion of online sales increased significantly. In line with the company's ambitions to raise the profile of Studio, which has always been its main-customer facing brand, the operation's name was changed to Studio Retail Limited in the third quarter of FY19. Studio is supported by an FCA-approved credit business.

Studio: Significant growth opportunities

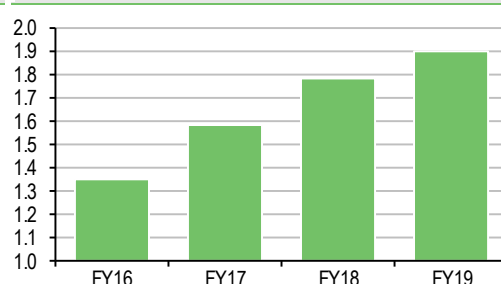
Studio's recent track record demonstrates that the business is both delivering against its strategic priorities and outperforming much of the wider retail market.

Exhibit 3: Product revenue (£m)



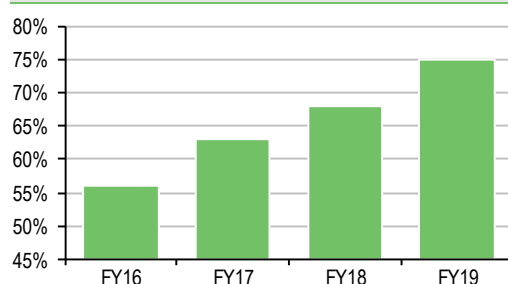
Source: Findel

Exhibit 4: Customer base



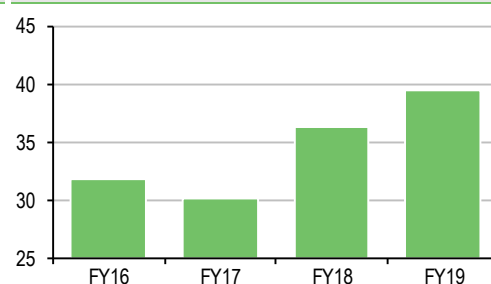
Source: Findel

Exhibit 5: Online penetration



Source: Findel

Exhibit 6: Operating profit (£m)



Source: Findel

In FY19, Studio grew the active customer base by 5% to 1.9 million and average-spend per customer by 3% to £165. This, combined with the ongoing digital transformation and a range of initiatives to raise the brand profile and improve sourcing and IT systems, contributed to product revenue growth of 8% and a 170bp improvement in the retail gross margin. The year-on-year improvement across Studio's key performance metrics is set out in greater detail below.

Exhibit 7: More active customers, each spending more, with wider margins

	FY18	FY19	Change
Active customer base	1.8m	1.9m	4.7%
Spend per customer	£160	£165	3.0%
Clothing as % total sales	29.1%	30.2%	110bp
Product revenue	£285.0m	£307.2m	7.8%
Product gross margin	30.5%	32.2%	170bp
Retail gross profit	£86.9m	£98.9m	14.0%
Online ordering (total)	68%	75%	8pp
Online ordering (new)	86%	92%	6pp
Net promoter score	34.2%	42.8%	8.6pp
Marketing CSR	14.3%	12.9%	(140bp)
Brand awareness (unprompted)	N/A	1%	

Source: Findel

Studio continues to develop its ranges and expand the apparel and footwear proposition, which is 60% own-brand and helps to drive higher customer order frequency. Management sees significant further opportunities to grow Studio's market share (currently just 0.4% of non-food retail) and position the brand as a market-leading online value retailer.

An agile and efficient digital-first approach...

Management is relentlessly focused on Studio's digital transformation such that, between FY16 and FY19, online sales have increased from 56% to over 75%. Studio's age range is broad, with its core customer base aged between 25 and 55 years. A higher and faster accelerating percentage of new customers placed their first orders online, at 92% in FY19, up from 86 last year. For under-25s, new customer online sales are close to 100%. Mobile and tablet are also strong drivers of online sales, up from 51% to 62%, and Studio's first app is currently being developed for launch in summer 2019.










In comparison to traditional catalogue retailing, where product lines and prices are fixed at the time of print, Studio has a more agile approach. The performance of each product line is closely monitored, prices can be changed immediately, sold out items can be rapidly re-stocked or replaced and the 'shop-front' can be reshuffled to promote new goods.

To facilitate Studio's rapid transition to online, management has been focused on developing the front-end offer. In 2016, it moved its websites to IBM's Commerce platform and subsequently introduced Qubit technology, allowing it to personalise the customer experience and increase the versatility of the online shop. Improvements to functionality and website merchandising commenced in the following year and are ongoing, with a revamp of the site undertaken during FY19 to update the look and feel of the site, in conjunction with the recent re-branding exercise (see below).

...with a unique and defensible market position

Studio is unique in its digital-first, value offer with integrated credit.

Exhibit 8: Peer comparison

	DIGITAL 1 st	VALUE	CREDIT
	✓	✓	✓
	✗	✓	✗
	✗	✓	✗
	✗	✓	✗
	✗	✓	✓
	✗	✗	✓
	✓	✗	✓
	✓	✗	✓
	✓	✓	✗

Source: Findel

Management sees the brand as a disruptor at the value end of the market through its offer of 'market leading WOW value'. It aims to deliver consistent low prices across a wide range of quality goods rather than relying on heavy promotional activity. In price comparisons, it repeatedly undercuts the competition on exact or similar items. For example, Studio sells a two-in-one corded stick vacuum for £19.99 (Argos £44.99), a children's play mud kitchen for £64.99 (Argos £100) and women's lace insert tops are two for £8 (Primark £5 each).

Raising the profile of the brand

Studio is reducing its reliance on the traditional means of marketing via printed catalogues and has been proactively expanding its marketing channels to include TV and digital advertising to raise brand awareness, which, at just 1%, is very low and presents a significant opportunity.

The company started sponsoring the fashion segment of ITV's 'This Morning' programme during 2018 and is selectively advertising in prime-time slots. It is able to track web traffic in response to its marketing campaigns, for example recording an additional c 15,000 users on the Studio website immediately after a 10 second TV advert during 'I'm a Celebrity'.

Studio is also sponsoring the new family stand at Accrington Stanley FC, the local football club. This relationship serves to promote the brand both nationally and as a local business and major employer in the region, with over 1,500 employees (rising to c 2,000 during the peak period). In addition, it recently recreated the famous 'Accrington Stanley, who are they?' milk advert from the 1980s featuring Liverpool striker Ian Rush.

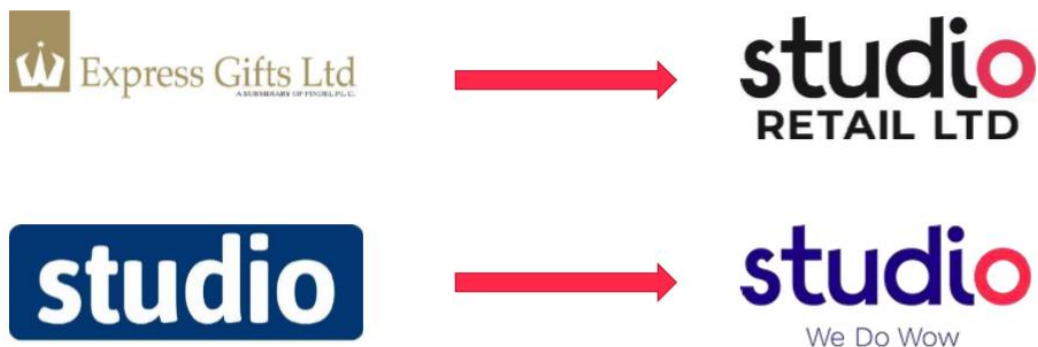
Exhibit 9: Recreating the 1980s 'Accrington Stanley, who are they?' advert



Source: YouTube

Having recently changed the divisional name from Express Gifts to Studio Retail Ltd, the Studio logo has been revamped with the added strap line 'We Do Wow'. A proposal will be put forward at the upcoming AGM to change the name of the group from Findel to Studio Retail Group.

Exhibit 10: Rebranding – Studio taking centre stage



Source: Findel

The focus on promoting Studio and raising brand awareness is expected to help drive further growth in the active customer base, which, over the past three years, has increased from 1.35 million in FY16 to 1.9 million active customers in FY19. Management aims for this to exceed three million in the medium term.

Using data and technology to attract and retain customers

In addition to the recent rebranding and digital marketing drive, a key objective is to develop a deeper understanding of Studio's customers' shopping habits and requirements and to grow key customer groups in line with the business strategy.

The company has started to implement a programme of artificial intelligence (AI) releases, which it believes will help to drive customer numbers beyond the target of three 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.

During FY19, it also began the process of implementing the Salesforce CRM system, enabling it to deliver targeted, data-driven marketing and improve the customer shopping experience. As an example of the latter, the system will be able to identify regular shoppers with good credit ratings and route their telephone calls to a member of the customer services team as a priority. The first phase went live in January and phase two is expected to be fully functional this autumn.

Expansion of own brand and clothing ranges

In recent years sales of clothing and footwear have accelerated particularly fast, growing by 81% between FY15 and FY19, although the category still only represents 30% of total sales.

Management also believes it can increase order frequency from c 2.5x and the average basket value, which, at c £50, is significantly below that of other online peers. It expects frequently purchased categories such as clothing to be the main driver of this as the ranges are expanded, coupled with the support of the flexible credit offer.

Currently, only 68% of Studio's customers buy clothing and own-brand accounts for 60% of those sales. Studio's core female customer typically purchases own-brand items for themselves and branded merchandise for their partners. At 11–12%, the returns rate for clothing is significantly below that of the peers (ranging from 25–40%). Management believes the rate is low because much of the range is a non-critical fit (eg T-shirts and leggings) and customers are required to pay for postage and returns.

As clothing sales continue to accelerate it is anticipated that the company will move away from batch processing in order to accommodate faster fulfilment and also offer a wider range of delivery options. At present, orders of smaller items are charged at £4.99 (even where goods are dispatched in multiple parcels) and larger items at £19.99 (regardless of how many larger items are ordered). Orders typically take two to three days to reach the customer.

Management is also exploring ways in which to develop Home and Leisure, which represents 70% of the sales mix. Within this, Furniture and Garden is the largest category and the company is focusing on opportunities to grow summer season sales. Across all categories, including clothing, own brand represents 74% of all items sold by volume and 52% by value. These higher-margin products will be the main driver of future growth.

Improving the buying process

Although at 32% Studio's product gross margin is low compared with some online retail peers (ASOS 47%, Boohoo 55%, N Brown 52%), figures are not necessarily directly comparable as Studio offers a much broader range beyond apparel.

Management has moved the buying process from a historical focus on catalogue-based timings to a seasonal planning approach, enabling it to improve working capital during FY19. It has also consolidated its overseas buying offices into Shanghai, where it has a team of over 50 employees monitoring the supply chain and securing the best deals. This has been aided by recent steps to streamline the ranges and buy larger volumes of key product lines. Where appropriate, in particular for bulkier items such as garden furniture, orders are being fulfilled directly from the supplier. Management believes these steps will continue to deliver improved value for customers combined with margin improvement.

Fulfilment and distribution

Studio'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 the majority of the c 20,000 stocked lines and around employs c 400 people. The different areas are connected by 3.5km of conveyor belts with a batch order processing system picking c 200,000 items per day (with the capacity to increase this to c 300,000).

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.

Personalisation is a popular and differentiating feature of Studio's offer and the complimentary service takes up c 7,500 sq ft of the facility. The system runs double-checks on order fulfilment, resulting in an accuracy rate exceeding 99%.

From its origins in home delivery, the facility is ideally set up for a transition to high levels of online orders. As previously noted, management has indicated that it is likely to move away from batch processing and is reviewing strategic options to support future growth. In the meantime, it continues to invest in updating legacy systems and operational hardware.

Consumer credit integral to the Studio proposition

The majority of Studio customers have a credit account that allows them to either pay off the balance within a month of receiving their statement or spread the payments over an extended period. Management views the credit proposition not only as an important source of income but also as a means of enhancing customer loyalty and prompting customers to regularly visit the site to manage their accounts.

Two years ago the company implemented Financier, a new credit account management system, for all customer accounts. This allows for improved and clearer 'plain page' statements with simpler account management, and enables proactive management of non-performing accounts. With the system in place, the company has started to trial new tailored credit products, such as 'Interest Saver', which has been well received by customers.

It has also made changes to the application process to encompass new rules on capturing customer income and assessing customers' ability to pay and is developing a new application and decision platform for launch later in 2019.

In FY19, financial services revenue increased by 8.6% to £117m and accounted for 28% of Studio's revenue. The company adopted IFRS 9 for the first time, requiring it to look at expected losses instead of an incurred losses approach under IAS 39. After taking into account the impact of IFRS 9 combined with growth in credit balances from higher retail sales, the FY19 bad debt charge increased to 8.6% of Studio's sales (FY18: 7.8%).

The programme to refund customers for the historical sale of flawed credit and insurance products has now been substantially concluded, with a final additional cost of £2.9m being recognised at year-end. The deadline for PPI claims is August 2019, although FDL has seen a low level of new claims over the last two years as a result of its proactive management of the programme.

Sports Direct: Commercial supply arrangement expected to continue

Sports Direct (SPD) purchased an initial 19.9% stake in FDL in September 2015 and subsequently increased the stake to 29.9%. In March 2019, SPD acquired a further 6.7% stake in FDL, prompting a mandatory offer for the entire issued share capital of FDL at 161p per share, which FDL's board recommended that shareholders reject. The offer attracted minimal acceptances of just under 1%, in our view highlighting ongoing support for the company's strategy and future growth prospects, and has now lapsed. SPD's holding now stands at 36.8%.

Since 2016, the companies have established an arm's length commercial relationship and FDL has trialled the sale of a small range of SPD's branded lines such as Pierre Cardin via Studio. Management has stated that it expects that relationship to continue, although it has not set out plans for further collaborations at this stage.

Studio's market: Appealing to a broad demographic

Studio's customer base is predominantly female (over 80% of the 1.9 million active customers), around a third of whom have children, with the core age range being 25–55 years old. 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 c 50% of customers take credit averaging c £250, 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).

In the UK, online retailing continues to gain market share, representing 17.3% of all retail sales in April 2018, up from 15.6% a year ago, and growing at 11.7% y-o-y against 3.5% for all retail (source: ONS). Hence it represents a favourable tailwind for Studio. We therefore regard both the fact that over 75% of orders are now online, and the accelerated rate of growth of the online share, as significant. Studio's average online order value is slightly higher than the offline equivalent, at c £50. Around 40% of customers buy personalised products at some point during the year; the personalisation process is more cost-effective online. Around half of customers pay their bills online.

The online channel also provides marketing opportunities. Studio 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.

Studio continues to print its traditional catalogue, but the clear objective is to move towards becoming a pure-play online retailer. In line with this strategy, the company has reduced the size and distribution of its catalogues, diverting the spend towards increased digital and online marketing activity, particularly around TV and social media advertising.

Education: Top quality at low prices

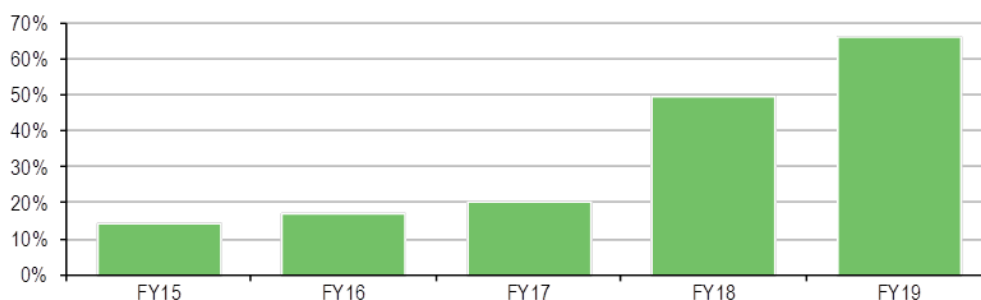
Findel Education is a leading independent educational resources supplier serving primary, secondary and nursery educational establishments in all parts of the UK and over 130 countries internationally. Consolidating a number of smaller businesses, its main areas of operation are stationery essentials, janitorial supplies, furniture and arts & crafts materials.

It offers three separate brand propositions: School, Classroom and Specialist. Within each of these areas it sells a range of well-known brands including Hope, GLS, Philip Harris, Davies Sports and LDA alongside its own-brand, Classmates.

Turnaround strategy: Creating an online value proposition

Since 2017, FDL has embarked on a turnaround strategy to address the decline in Education's market share and improve the overall profitability of the business. Its aim is to achieve a 10% operating margin (FY19: 3.9%), in line with privately owned competitors, over the medium term through scale, cost efficiencies and better sourcing.

Although schools have been slow to move to digital channels for procurement, this has started to change as School Integrated Management Systems (SIMS) have evolved to improve internal processes. FDL has overhauled its own website to seamlessly integrate with several leading SIMS providers and this has been a key driver behind the rapid acceleration in online ordering from 20% to 66% over the past two years.

Exhibit 11: Rapid digital transformation since FY17; online now represents 66% of sales


Source: Findel

Another key element has been to rebase prices across the ranges to compete with peers. In September 2017 the company strengthened its online value proposition by reducing the price of 800 best-selling products on its website by up to 30%, to levels comparable with the lowest in the marketplace. These low prices, only accessible to customers ordering via the website or SIMS, were subsequently extended to over 2,200 products by April 2018 and represent c £4m of gross margin investment.

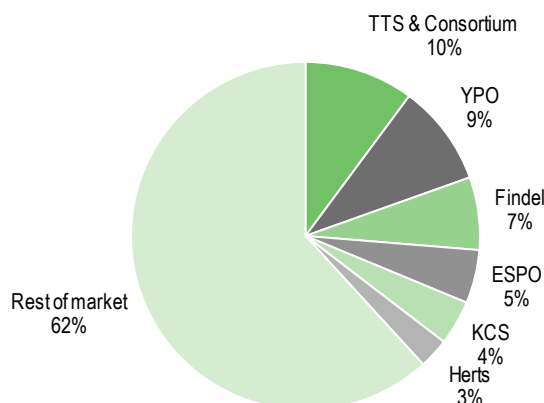
The quality of Classmates own-brand products has also been improved using the group's sourcing capabilities in the Far East to keep prices up to 45% below that of the big-brand equivalents. Classmates products now represent 15% of Education revenue (FY19).

FY19 results clearly demonstrate progress with the strategic turnaround. The UK active customer base grew by 8% following years of decline, supporting underlying revenue growth of 0.8% (excluding Sainsbury Active Kids). Although ongoing investment in prices reduced the gross margin by 50bp, there was a significant improvement in the second half (H1 -250bp vs H2 +230bp) as a result of better stock management and a reduction in provisions.

The cost base has been overhauled, with a further £2.4m of savings delivered in FY19, in addition to £1.3m in FY18. This more than offset the loss from Active Kids and contributed to 9.6% growth in divisional operating profit to £3.2m. Management believes there to be further cost-saving opportunities as the business transitions online.

Education market: Budgets remain under pressure

The UK educational resource market is valued at c £1.2bn (source: BESA, 2018) and is dominated by six large players, which account of c 38% of the market in total. Findel current holds 7% market share. The rest of the market is fragmented and may present opportunities for consolidation.

Exhibit 12: Educational resources market share


Source: Findel, BESA 2018

School funding remains a significant and well-publicised issue in the UK. Schools are typically given a pre-agreed sum per pupil each year to cover three main areas of expenditure: teaching, buildings and educational resources.

According to a report published by the Education Policy Institute in January 2019, almost one in three state secondary schools were in deficit in 2017–18, almost four times greater than in 2014, with the average deficit increasing by c 30% year-on-year to almost £0.5m. In July 2017, Justine Greening, the former 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 6.5% cut in real terms, there will have been a cut of 4.6% between 2015 and 2019.

Expenditure on teaching and buildings is relatively inflexible and it is therefore educational resources, which account for just 5% of budgets, which typically come under the most pressure. This reinforces the need for suppliers, such as FDL, to be able to save schools money. They are also likely to benefit from longer-term demographics, which remain positive, with pupil numbers expected to increase by 0.55 million between 2017 and 2022.

Management

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 Studio Retail, was appointed as chief executive in April 2017. Phil led the development of Studio 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 March 2019 FDL further strengthened its non-executive board with the appointment of Clare Askem, managing director of Habitat. Clare has significant experience of multi-channel retailing, digital marketing and branding. Bill Grimsey, chair of the remuneration committee, will retire in July 2019.

Over the past two years, the company has undertaken a detailed review of departmental structures and created a number of new roles at all levels within the group to support growth and the ongoing transition towards being a pure-play online retailer. This includes the appointment of a new marketing and digital director in August 2018.

Sensitivities

The main sensitivities we see are:

- As a value retail operation across a range of product types, Studio has broad exposure to UK retail demand, an area that continues to be under pressure. Retail sales volumes (excluding fuel) increased by 1.7% over the three months to April 2019, aided by warmer weather, the Brexit deadline extension and a strong UK labour market. However, wider political uncertainties persist and the UK consumer confidence index, at -13, remains in negative territory and four points below its long-running average. Although these challenging conditions may relatively favour value retailers, a significant cutback by customers would not be good for any retailer.
- School funding per pupil was largely frozen in real terms between 2010–11 and 2015–16, but is expected to have fallen by 6.5% in real terms over the four years to 2019–20 (source: IFS). This is the largest cut in school spending per pupil over a four-year period since at least the early 1980s. This results in a challenged market for educational materials.

- Any financial services business is vulnerable to greater regulatory intervention and tighter limits on operating freedom. FDL considered the FCA's review of High Cost Credit last year and believes its plans are in accordance with its provisions. It has also now substantially concluded the programme for customer redress. The recent FCA ruling on 'buy now, pay later' credit, which bans companies from charging backdated interest on purchases, will not have any meaningful impact on FDL.

Financials

In a mixed retail landscape, FDL is reaping the rewards of its digital-first and value-led strategy. Group revenue increased by 5.7% to £506.8m and underlying PBT increased 17.7% to £28.8m in FY19, slightly ahead of our recently upgraded estimate of £28.5m, on a like-for-like basis after taking into account the adoption of IFRS 9 and IFRS 15 in FY19.

Exhibit 13: Results and forecasts by division								
£m	FY18 reported	FY18 (APM*)	FY19	Growth	FY20e	Growth	FY21e	Growth
Revenue								
Studio	393.3	393.3	424.7	8.0%	451.4	6.3%	471.4	4.4%
Education	86.3	86.3	82.1	-4.9%	84.1	2.5%	86.2	2.5%
Total revenue	479.6	479.6	506.8	5.7%	535.5	5.7%	557.6	4.1%
Operating profit								
Studio	36.3	33.9	39.4	16.3%	40.8	3.5%	42.8	4.8%
Studio operating margin	9.2%	8.6%	9.3%	7.7%	9.0%	-0.2%	9.1%	0.0%
Education	2.9	2.9	3.2	9.6%	4.2	31.7%	4.5	5.7%
Central costs	(3.3)	(3.3)	(4.2)	29.3%	(4.5)	5.0%	(4.7)	5.0%
Total operating profit	36.0	33.6	38.4	14.4%	40.6	5.7%	42.6	4.9%
Operating margin	7.5%	7.0%	7.6%	8.3%	7.6%	0.0%	7.6%	0.8%
Interest	(9.1)	(9.1)	(9.7)	5.8%	(10.6)	10.1%	(10.9)	2.7%
PBT (excl. FV movement on derivatives & exceptionals)	26.8	24.4	28.8	17.7%	30.0	4.2%	31.7	5.7%
Source: Findel, Edison Investment Research. Note: *Alternative Performance Measures, adjusting for IFRS 9.								

This robust performance was driven by Studio, which delivered a particularly strong sales performance in the run up to Christmas and has continued to grow its active customer base and the average spend per customer. Product revenue increased 7.8% to £307.2m while ongoing improvements to sourcing contributed to a 170bp rise in the product gross margin. This margin improvement was achieved despite the loss of c £1m of income received in FY18 from Kleeneze (a former subsidiary, sold in 2015).

Financial services revenue increased slightly ahead of product sales, by 8.5% to £117.5m, in line with growth in eligible receivables. An £8.5m increase in the bad debt charge to £36.6m reflected a £2.4m negative impact from the transition to IFRS 9 (adopted for the first time in FY19 and not being applied retrospectively) and growth in product sales. In the prior year FDL took advantage of favourable market rates and accelerated the point of sale of certain receivables, resulting in a £3.5m benefit to the FY18 bad debt charge. While these favourable terms continued through FY19, they may not extend into future periods.

Management's strategy to turn around the Education division is yielding positive results. Despite previously flagged lost sales from the Sainsbury 'Active Kids' scheme and ongoing price investment, underlying revenue increased by 0.8% (excluding Active Kids). Although ongoing investment in prices reduced the gross margin by 50bp, there was a significant improvement in the second half (H1 -250bp vs H2 +230bp) as a result of better stock management and a reduction in provisions.

Individually significant items

Exceptional items totalled £4.2m. This included a £2.9m final charge for the customer redress programme, which is now materially completed, and a £2.5m charge for past service (representing 1.7% of FDL's scheme liabilities) resulting from the recent High Court ruling on the Lloyds Bank defined benefit pension scheme. These are offset by a £1.2m reduction in the onerous lease provision following the subletting of a vacant warehouse in Enfield that had previously been used by the Education division. Management does not expect any individually significant items in FY20.

Strong working capital generation and cash inflow

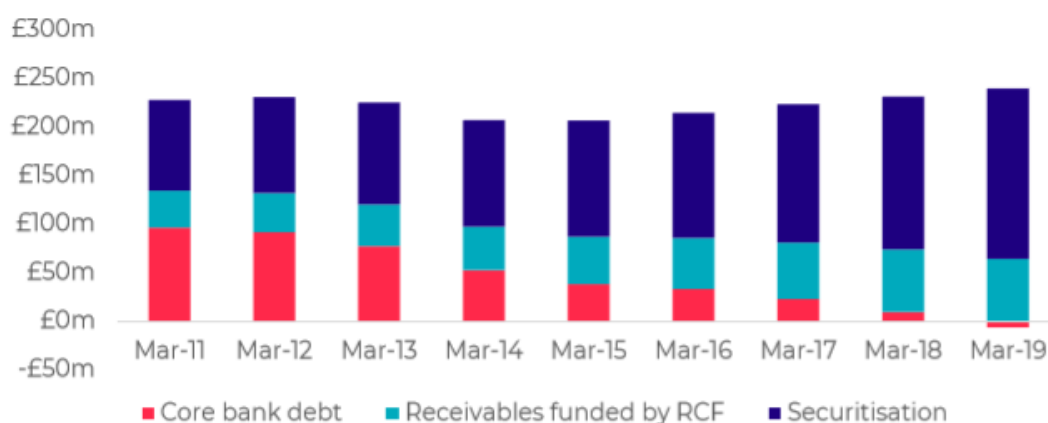
FDL has continued to make significant progress in reducing leverage. Strong free cash flow during FY19 was mainly attributable to working capital efficiencies within Studio, including a c £4m stock benefit driven by more efficient clearance activity and a reduction in the number of SKUs. This contributed to a net cash inflow of £16.4m and further reduction in core net debt to £57.4m.

Exhibit 14: Summary cash flow			
£m	FY18	FY19	Change
EBITDA*	44.0	50.0	6.0
Increase in Express Gifts' receivables*	(1.6)	(6.9)	(5.3)
net of securitisation inflows			
Movement in other working capital	6.9	10.8	3.9
Capital expenditure	(10.6)	(11.5)	(0.9)
Exceptional items	(20.7)	(12.0)	8.7
Pension and other	(2.2)	(1.5)	0.7
Free cash flow	15.8	28.9	
Interest and other	(7.7)	(11.9)	(4.2)
Finance leases and acquisitions	(1.0)	(0.6)	0.4
Net cash inflow	7.1	16.4	9.3
Opening core net debt	(80.8)	(73.7)	
Closing core net debt	(73.7)	(57.4)	
Source: Findel. Note: *Alternative performance measure, FY18 adjusted for IFRS 9.			

Exceptional items totalling £12m in FY19 largely related to cash outflows as part of the customer redress scheme, which has now been substantially concluded. Moving ahead, as the cash impact of exceptional items reduces, management will have greater discretion in its decisions to allocate cash between additional capital expenditure, marketing and customer recruitment, further deleveraging and, potentially in the longer term, dividends.

All debts within business funding good credit receivables

FDL's consumer credit business is substantially funded by a £185m securitisation facility (increased from £170m during the year). For every £100 of credit, £71-73.5 is drawn down from the facility and matched against consumer receivables. The remaining balance is funded from a revolving credit facility (with available funding of £95m to December 2019, followed by £90m to maturity in December 2020). This structure is typical of the home shopping market. As shown below, core net bank debt excluding the element relating to consumer credit has continued to reduce year-on-year since FY11 and finally turned positive in FY19, in line with management's expectations.

Exhibit 15: Debt structure


Source: Findel

Current trading and forecasts

The early part of the financial year is generally a quiet period for FDL and management has stated that the business has been performing in line with its expectations. We make no material changes to our FY20 underlying PBT forecast of £30.0m (previously £29.5m), representing 4.2% growth y-o-y, and introduce our FY21 PBT forecast of £31.7m, representing 5.7% growth y-o-y. We forecast a small net cash outflow of £3.1m in FY20.

Dividend outlook: No plans to reinstate dividend in the near term

FDL does not pay a dividend as it continues to run a substantial deficit of c £100m on its company distributable reserves. While the primary operating subsidiary, Studio Retail Limited, holds potentially distributable reserves of c £85m, management's preference is to hold these reserves at entity level to maintain a strong balance sheet for supplier credit. Its aim over the coming years is to increase the level of distributable reserves, although, as anticipated, progress was affected by IFRS 9 in FY19 (£17.8m net of deferred tax). In the current year, management's choice of approach for the adoption of IFRS 16 will be designed to limit the impact on reserves. Management believes that FDL is two to three years away from having a choice over the dividend policy.

Valuation: Significant headroom

We use a DCF analysis to place a value on the longer-term income stream available to investors and combine this with a peer group comparison of retail companies to take account of market valuations of earnings growth. These metrics identify significant valuation headroom compared with the current share price.

DCF: Returning a valuation of 456p

We make no significant changes to our forecast assumptions for revenue growth of 5% in years four to seven, fading to a terminal growth rate of 2% and a terminal EBITDA margin of 10.5% (FY19: 10.1%). We assume a weighted cost of capital of 6.5% (risk-free rate 3%, risk premium 6%, beta 0.75, cost of debt 3.6% net), resulting in a valuation of 456p/share (previously 418p). Varying the cost of capital and the terminal growth assumption would give the following ranges:

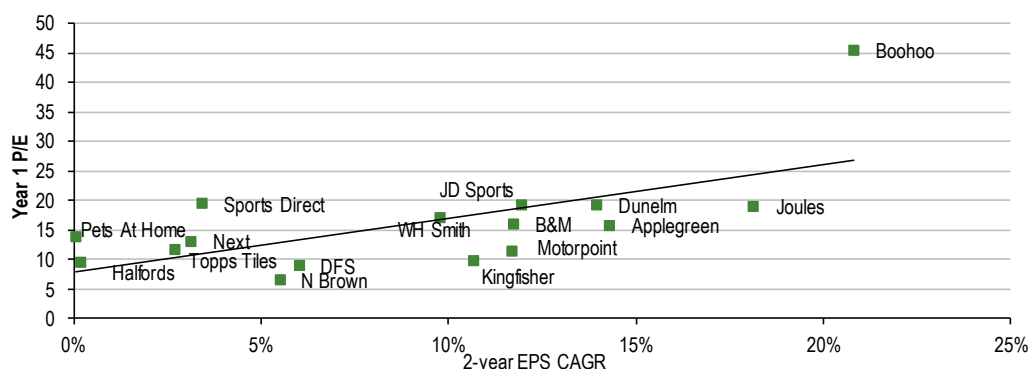
Exhibit 16: DCF assumption scenario analysis (p/share)

		Terminal growth rate				
		0.0%	1.0%	2.0%	3.0%	4.0%
Cost of capital	8.0%	266	291	325	372	443
	7.0%	316	353	404	481	609
	6.5%	347	391	456	558	741
	6.0%	383	439	522	662	941

Source: Edison Investment Research

Peer comparison: Sector re-rating lifts relative valuation

Here we take the common-sense position that higher earnings growth merits a higher P/E ratio than the FY20e 8.9x on which the shares currently trade. We compare P/E ratio 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 one P/E of 14x. This multiple reflects a re-rating of the sector since our last peer comparison in January (which suggested a year one P/E of 11x based on a similar 7% two-year EPS CAGR for FDL).

Exhibit 17: Retail stocks – P/E vs two-year EPS CAGR (2018–20e)


Source: Refinitiv, Edison Investment Research. Note: Trend line on a linear basis. Includes all stocks in FTSE General Retail and AIM super-sector retail indices, negative growth excluded. Valuation at 6 June 2019.

Findel does not pay a dividend so we therefore adjust for the sector yield (weighted between the FTSE General Retail and AIM super-sector retail indices) of 3.9%, as below. This produces a P/E of 13.5x and a comparative share valuation of 389p.

Exhibit 18: Findel comparative share valuation

Findel year one EPS (p)	28.9
Multiple from chart (x)	14
Sector yield	3.9%
Adjusted multiple (x)	13.5
Implied share price (p)	389

Source: Edison Investment Research

Blended valuation: 423p

We therefore determine a blended valuation of 423p, which would put the shares on an FY20e P/E of 14.6x and EV/EBITDA of 8.2x.

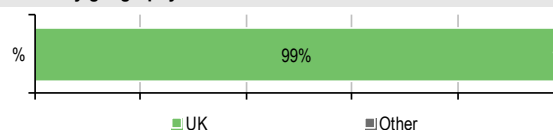
Exhibit 19: Financial summary

	£000s	2018*	2019	2020e	2021e
Year end 31 March		IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue		479,613	506,807	535,542	557,605
Cost of Sales		(281,706)	(298,000)	(311,339)	(320,252)
Gross Profit		197,907	208,807	224,203	237,352
EBITDA		46,594	50,948	53,552	56,313
Operating Profit (before amort. and except.)		38,171	41,510	43,814	45,703
Intangible Amortisation		(1,996)	(2,167)	(2,218)	(2,111)
Operating profit pre exc post intang amortisation		36,175	39,343	41,596	43,593
Exceptionals		0	(4,158)	0	0
Other/share-based payments		(199)	(926)	(1,000)	(1,000)
Operating Profit		35,976	34,259	40,596	42,593
Net Interest		(9,130)	(9,656)	(10,631)	(10,920)
Derivatives, other		(4,701)	4,750	0	0
Profit Before Tax (norm)		26,846	28,761	29,965	31,673
Profit Before Tax (FRS 3)		22,145	29,353	29,965	31,673
Tax		2,081	741	(5,993)	(6,335)
Profit After Tax (norm)		22,399	22,882	24,972	26,338
Profit After Tax (FRS 3)		24,226	30,094	23,972	25,338
Average Number of Shares Outstanding (m)		86.3	86.3	86.3	86.3
EPS - normalised (p)		25.9	26.5	28.9	30.5
EPS - normalised and fully diluted (p)		25.9	26.5	28.9	30.5
EPS - (IFRS) (p)		28.1	34.9	27.8	29.4
Dividend per share (p)		0.0	0.0	0.0	0.0
Gross Margin (%)		41.3	41.2	41.9	42.6
EBITDA Margin (%)		9.7	10.1	10.0	10.1
Operating Margin (before GW and except.) (%)		8.0	8.2	8.2	8.2
BALANCE SHEET					
Fixed Assets		81,675	81,025	90,069	90,349
Intangible Assets		25,175	24,952	23,734	22,624
Tangible Assets		47,596	45,517	50,779	52,169
Investments		8,904	10,556	15,556	15,556
Current Assets		311,878	322,887	329,601	350,074
Stocks		54,375	48,757	58,380	59,749
Debtors		230,802	235,923	243,070	254,474
Cash		26,244	37,603	28,151	35,851
Other		457	604	0	0
Current Liabilities		(81,190)	(76,415)	(80,554)	(82,969)
Creditors		(80,618)	(75,917)	(80,036)	(82,451)
Short term borrowings		(572)	(498)	(518)	(518)
Long Term Liabilities		(273,170)	(282,215)	(271,794)	(268,794)
Long term borrowings		(258,001)	(270,545)	(264,192)	(264,192)
Other long term liabilities		(15,169)	(11,670)	(7,602)	(4,602)
Net Assets		39,193	45,282	67,322	88,660
CASH FLOW					
Operating Cash Flow		11,439	22,356	34,505	37,955
Net Interest		(8,365)	(10,017)	(10,631)	(10,920)
Tax		581	(1,931)	(10,993)	(6,335)
Capex		(10,595)	(11,545)	(16,000)	(13,000)
Acquisitions/disposals		(450)	0	0	0
Financing		0	0	0	0
Dividends		0	0	0	0
Net Cash Flow		(7,390)	(1,137)	(3,119)	7,701
Opening net debt/(cash)		224,974	232,329	233,440	236,559
HP finance leases initiated		0	(283)	0	0
Other		35	309	0	0
Closing net debt/(cash)		232,329	233,440	236,559	228,859

Source: Company data, Edison Investment Research. Note: *Restated for IFRS 15.

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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 Studio Retail 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	36.8
Schroders	19.0
Fidelity International	8.9
Janus Henderson	5.1
Lombard Odier	4.2
Ennismore	3.2
Canaccord	3.1

Companies named in this report

ASOS (ASC), Boohoo (BOO), N Brown (BWNG), Sports Direct (SPD), Provident Financial (PFG), Rank Group (RNK)

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