EDISON

Appreciate Group

In line FY20 but significant COVID-19 adjustment

Trading update

Financial services

Trading for the first 11 months of the year ending 31 March 2020 (FY20) was in line with expectations until COVID-19 began to have an impact in the final weeks of the financial year and, we expect, far more significantly in the current financial year. The end-FY20 free cash balance was £30m and actions are underway to mitigate the impacts of COVID-19 while maintaining investment for medium-term digital based growth.

Year end	Billings* (£m)	Revenue (£m)	Adj. PBT** (£m)	EPS*** (p)	DPS (p)	P/E (x)	Yield (%)
03/19	426.9	110.4	12.5	4.8	3.20	7.1	9.4
03/20e	433.5	118.1	11.5	3.5	1.00	9.6	2.9
03/21e	341.0	88.0	3.2	1.4	1.00	24.8	2.9
03/22e	437.3	112.6	9.3	4.0	2.75	8.5	8.1

Note: *Billings is a non-statutory measure of sales defined as the face value of voucher sales and the amount of value loaded onto prepaid cards, less any discount given to customers. **PBT is adjusted for exceptional items. ***EPS is fully diluted on a statutory basis.

FY20 progress interrupted by pandemic

Based on unaudited data, APP expects FY20 revenues of c £118m and adjusted PBT (before non-cash impairment charges of £2–3.0m) and exceptional costs of c £0.5m) of c £11.5m. By slowing customer redemptions and deferring earnings recognition, COVID-19 reduced FY20 profitability by c £0.3m. The FY21 impact will be significantly greater, with customer activity substantially reduced (Corporate activity currently down 70% year on year and Christmas Savings orders down 10%). Despite end-FY20 free cash of c £30m (excluding customer funds held in trust), the previously declared interim DPS was cancelled, one of the steps to preserve cash while maintaining investment for medium-term growth. A decision on the final DPS will be taken with the full-year results. The board remains positive about the longer-term prospects and the benefits of the strategic growth plan but is not providing near-term guidance. As explained in this report, our forecasts are sharply reduced but allow for a gentle recovery in H221. Given the level of uncertainty, our earnings and dividend forecasts warrant a high degree of caution.

Maintaining progress with strategic plan

FY20 saw further progress with the strategic business plan aimed at enhancing long-term growth by accelerating digitalisation, improving efficiency, broadening customer appeal and deepening market penetration. Core functions were relocated to APP's new fit-for-purpose HQ in central Liverpool and good progress was made with rationalising the brand architecture and implementing technology upgrades. Trials of new consumer-facing digital products, Select and Giftli, targeting currently untapped areas of the market, have enabled the design of an enhanced proposition for a full launch later this year.

Valuation: Uncertainty weighing on forecasts

COVID-19 adds uncertainty to near-term forecasting and impedes reliable anticipation of the benefits of the strategic business plan. Our modified discounted cash flow (DCF) valuation falls to 64p, which would represent 19x forecast calendar 2021 EPS. At 64p our assumed FY22 DPS represents a yield of more than 4%.

12 May 2020

Price	**34p**
Market cap	**£64m**

Net cash (£m) at 31 March 2020 (unaudited)	30.0
Shares in issue	186.3m
Free float	99.9%
Code	APPS
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(14.6)	(45.6)	(47.5)
Rel (local)	(15.6)	(30.7)	(36.5)
52-week high/low		70.5p	32.5p

Business description

Appreciate Group is a specialised financial services business and is the UK's leading provider of multi-retailer redemption products to the corporate and consumer markets. Consumers can access these products directly through its market-leading Christmas Savings offering. Corporate customers use these products to supply a range of incentive and reward products, often tailor made.

Next events

FY20 results announcement	TBC*

*Originally schedule 17 June 2020 but deferred in line with FRC and FCA guidance.

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FY20 broadly in line but pandemic forces material adjustments

Near-term demand substantially reduced

At the end of March 2020, APP announced that in response to the spread of COVID-1, and following government guidance, it had closed all its offices and fulfilment locations, ceasing the delivery of physical product to focus on digital opportunities. A number of new digital products have been launched, albeit in the face of a substantial near-term reduction in customer demand. APP says that in the short term, demand in the Corporate and Other Consumer (together c 50% of total FY19 billings) areas is approximately 70% below last year. In Christmas Savings (the other c 50% of FY19 billings) the order book normally begins to build in around September of the preceding year (ie September 2019 for Christmas 2020), completing around the end of March. For Christmas 2020 (FY21) the order book is currently c 10% below the prior year level. Typically, net cancellations result in some attrition in the order book, once built, over subsequent months, but positively APP says that cancellation rates are currently running at similar levels to previous years and the company is making efforts to reassure customers their savings remain safe, segregated and protected within the Park Prepayment Protection Trust. Nevertheless, the potential for customer financial stress over coming months poses the risk of increased cancellations.

While customers are continuing to redeem products online and at retail outlets that remain open, the lockdown has seen many outlets close with the result that redemption rates have slowed overall. This has deferred revenue and profit recognition into subsequent periods and was the reason for the negative £0.3m COVID-19 impact on FY20 earnings. Conversely, the delay in customer redemptions has a positive impact on cash flow, particularly in relation to APP's own prepaid vouchers.

In addition to the COVID-19 impact on the near-term operational result, the recent reduction in interest rates (the Bank of England reduced base rate by 0.50% to 0.25% on 11 March 2020, and again to 0.10% around a week later) will have a material impact on net interest income, typically around 12% of underlying PBT. APP earns interest on corporate cash balances as well as the customer cash balances that are held in trust. Total cash balances fluctuate throughout the year but are normally at their highest level in or around October as Christmas approaches, peaking in FY19 at c £236m.

Exceptional items mostly non-cash

APP expects adjusted PBT to be c £11.5m before exceptional items, which are expected to amount £2.5–3.5m, predominantly non-cash. The exceptional items comprise a non-cash impairment of the Valley Road site and goodwill relating to the brand engagement agency FMI acquired in 2016 and exceptional redundancy costs of c £0.5m.

The commercial property market has taken a knock from COVID-19 as a result of a near-term slowdown in rents collected and a weakening of longer-term occupational demand expectations. With transaction volumes having substantially dried up, there is a dearth of supporting evidence for valuations and a statement of material uncertainty has become widespread industry practice. Against this background, sale of the Valley Road site, substantially vacated by the relocation of core activities in modern fit-for-purpose accommodation in central Liverpool that was nearing completion has been postponed. A currently held for sale asset, Valley Road had a 30 September 2019 value of £5.0m and in our revised forecasts we have assumed a non-cash impairment of £2.0m.

Goodwill relating to FMI was £882k at 30 September 2019 and we have assumed a full impairment.

The redundancy charge follows a management restructuring in Q420 to streamline operations.

Focus on cash to support continuing investment for growth

APP started the current year with cash of c £30m and no debt. In addition to cancelling the payment of the previously declared DPS of 1.05p (representing a £2.0m cash outflow previously scheduled for early FY21), the company has taken a number of measures to conserve cash and reduce costs were possible including delaying discretionary spend or capital projects, cancelling annual pay reviews, reviewing all bonus schemes and postponing the leadership team's incentive awards.

Looking further ahead, management remains confident of the group's growth plan and we note that on 2 April it was announced that CEO, Ian O'Doherty, had acquired 40,000 shares at 34p each. The board has reviewed several financial scenarios of the likely impact of COVID-19 on the business and in each case projects positive free cash at end-FY21. Between balance sheet dates, free cash is sometimes lower, particularly in August/early September, as stocks are built ahead of Christmas shipments. To ensure adequate resources to facilitate an acceleration medium and long-term growth, as well as investment in the continued switch to digital, the group has commenced a bank financing exercise and will provide an update on the progress of this with the full year results.

Revised estimates

The exact impact of the COVID-19 pandemic on near-term financial performance remains highly uncertain and APP continues to feel it inappropriate to provide forward-looking financial guidance at this stage. With this caveat we have revised our forecasts, attempting to model a steady recovery in trading activity from the end of September 2020 (ie H221) and a resumption of growth in FY22, from a lower base and amidst a less supportive overall economic backdrop. Given the potential for materially worse or even better outcomes than we have modelled, we prefer to view our forecasts as illustrative.

Exhibit 1: Forecast revisions

	Billings (£m)			Revenues (£m)			Adj. PBT (£m)			Diluted EPS (p)			DPS (p)		
	New	Old	Change	New	Old	Change	New	Old	Change	New	Old	Change	New	Old	Change
03/20e	433.5	442.9	-2.1%	118.1	114.7	3.0%	11.5	11.8	-1.9%	3.5	5.1	-30.7%	1.00	3.2	-68.8%
03/21e	341.0	462.7	-26.3%	88.0	120.3	-26.9%	3.2	13.4	-76.3%	1.4	5.8	-76.3%	1.00	3.4	-70.1%
023/22e	437.3	N/A	N/A	112.6	N/A	N/A	9.3	N/A	N/A	4.0	N/A	N/A	2.75	N/A	N/A

Source: Edison Investment Research

Our main income statement forecasting assumptions include:

- **Billings.** For FY21 Corporate and Other Consumer billings, we assume the current c 70% drop in activity is sustained through to the end of June (end-Q121), with only a modest improvement in Q221 (-60%), ahead of a stronger recovery in Q321 (-20%) and Q421 (flat year on year). For Christmas Savings, we assume the current 10% decline in the order book versus FY20 is sustained through the year. These assumptions represent a c 50% drop in H221 group billings, recovering to a c 21% drop for the year as a whole. For FY22 we assume relatively modest marginal growth from the end-FY21 point of recovery, although comparing FY22 with FY21 on a full-year basis the growth is more substantial. Our assumptions indicate FY22 billings at a similar level to FY20, with a stronger recovery in Corporate. We expect the positive impact of a lifting of the lockdown to be reinforced by new card and digital product innovations as previously, but dampened by a likely weaker economic environment and a continuation of the trend of sales agent attrition in Consumer.

Exhibit 2: Billings assumptions

£m	2019	2020e	2021e	2022e	H119	H219	H120	H220	H121	H221e
CORPORATE										
Multi & single retailer redemption billings	191.0	200.6	138.0	216.6	70.2	120.8	77.3	123.3	27.1	110.9
Year on year change	**8.1%**	**5.0%**	**-31.2%**	**57.0%**	**-0.7%**	**14.0%**	**10.1%**	**2.0%**	**-65.0%**	**-10.0%**
Other billings	3.8	3.4	.8	3.7	3.1	.7	2.8	.6	.3	.5
Total Corporate billings	**194.8**	**204.0**	**138.8**	**220.3**	**73**	**122**	**80**	**124**	**27**	**111**
Year on year change	**8.1%**	**4.7%**	**-32.0%**	**58.7%**	**-1.0%**	**6.4%**	**9.3%**	**1.9%**	**-65.9%**	**-10.1%**
CONSUMER										
Christmas Savings	213.6	209.3	188.4	197.8	33.3	180.3	36.3	173.0	32.7	155.7
Year on year change	**-0.1%**	**-2.0%**	**-10.0%**	**5.0%**	**7.7%**	**-1.5%**	**9.0%**	**-4.0%**	**-10.0%**	**-10.0%**
Other consumer billings	8.6	10.3	7.6	11.4	2.0	6.6	3.0	7.3	1.1	6.6
Year on year change	**10.3%**	**20.0%**	**-26.0%**	**48.6%**	**-2.9%**	**15.0%**	**50.0%**	**10.9%**	**-65.0%**	**-10.0%**
Total multi & single retailer redemption billings	222.2	219.6	196.0	209.2	35.3	186.9	39.3	180.3	33.7	162.3
Year on year change	**0.2%**	**-1.1%**	**-10.8%**	**6.7%**	**7.0%**	**-1.0%**	**11.3%**	**-3.5%**	**-14.2%**	**-10.0%**
Other billings	9.9	9.9	6.2	7.8	0.4	9.5	0.8	9.1	0.1	6.1
Total Consumer billings	**232.1**	**229.5**	**202.2**	**217.0**	**35.7**	**196.4**	**40.1**	**189.4**	**33.8**	**168.4**
Year on year change	**-0.2%**	**-1.1%**	**-11.9%**	**7.3%**	**13.8%**	**-2.4%**	**12.5%**	**-3.6%**	**-15.8%**	**-11.1%**
GROUP BILLINGS	**426.9**	**433.5**	**341.0**	**437.3**	**109.0**	**317.9**	**120.2**	**313.3**	**61.1**	**279.9**
Year on year change	**3.4%**	**1.6%**	**-21.3%**	**28.2%**	**3.4%**	**0.8%**	**10.3%**	**-1.5%**	**-49.1%**	**-10.7%**

Source: Edison Investment Research

- **Revenues.** Our assumed revenues track billings but allow for an increasing proportion of own-branded multi-retailer redemption product through FY21 and FY22, reported on a net basis (for a detailed explanation of revenue and profit recognition see our July 2019 Outlook note).
- **Administrative costs.** We expect lower administrative costs in FY21 and modest growth in FY22 reflecting as a fall away of some of the (estimated c £2m) strategic business plan implementation costs in FY20 as well as the current attention to cost containment.
- **Net finance income.** We expect net finance income to be materially reduced by lower bank deposit rates.
- **Profit before tax.** Before exceptional charges, our assumptions indicate a decline in adjusted PBT from £11.5m in FY20 to £3.2m in FY21 and £9.3m in FY22. As noted above, we have assumed aggregate pre-tax exceptional charges on £3.4m in FY20.

Sensitivity to alternative billing assumptions

FY21 billings remain difficult to predict and will be significantly determined by the duration of the lockdown and the speed of recovery of the UK economy and consumer confidence. Our modelled adjusted PBT for FY20 would increase/decrease by 36% if group billings were 5% higher/5% lower than assumed and would increase/decrease by 73% if group billings were 10% higher/lower than assumed.

Strategic plan to support medium-term performance

Although our modelling extends to end-FY22 this does little more than capture our best guess at the immediate bounce from a challenging FY21. Looking further ahead, we still expect the implementation of the strategic plan to bring income statement benefits derived from faster than otherwise growth and increased efficiency. APP's previous guidance of income statement benefits of £2–5m pa after FY21 (ie first benefits in FY22) has been withdrawn given the current uncertain operating environment, but nevertheless provides an indication of the scope for medium-term benefits that, depending on market conditions, may accelerate growth or provide an offset to a more challenging trading environment.

The board is yet to decide on the final dividend for FY20

As noted above, payment of the interim DPS of 1.05p (scheduled for April 2020) has been cancelled. The board will decide on the final DPS in respect of FY20 at the time of the results. We have assumed only 1p final DPS, a low pay-out of FY20 earnings but conserving cash for the more challenging FY21. We have similarly assumed a 1p full year DPS for FY21 (a c 70% pay-out) before increasing to 2.75p in FY22 (c 1.5x covered by earnings).

Based on these DPS assumptions, our modelling suggests a decline in free cash in with a further decline in FY22 offset by the c £3.0m sales of the Valley Road site. We have not factored borrowing into our modelling but as noted above, this is a possibility to manage seasonal cash flows.

Valuation

In our December 2019 update, our estimated modified DCF valuation was 87p, which equated to a 2020 calendar year P/E ratio of 16.0x.

Given the near-term reduction in earnings and cash flow that we assume above, our DCF value is also reduced and similarly uncertain depending on the duration of the pandemic lockdown and the shape of the recovery.

At 64p our revised DCF value is equivalent to 34x calendar 2020 EPS and c 19x calendar 2021 EPS with the prospect of the strategic investment plan supporting performance over the medium-term. At 64p, our assumed FY21 DPS of 2.75p would represent a yield of 4.3%.

Exhibit 3: Financial summary

Year end 31 March	£'000s	2015	2016	2017	2018	2019	2020e	2021e	2022e
PROFIT & LOSS									
Consumer billings		196,796	208,352	216,771	232,635	232,096	229,544	202,238	216,961
Corporate billings		176,091	176,679	187,741	180,151	194,805	203,975	138,769	220,292
Total Billings		372,887	385,031	404,512	412,786	426,901	433,519	341,006	437,253
Revenue		85,769	100,556	119,637	111,054	110,394	118,116	87,950	112,550
Cost of sales		(59,193)	(72,030)	(89,944)	(79,628)	(79,117)	(84,807)	(62,884)	(80,248)
Gross profit		26,576	28,526	29,693	31,426	31,277	33,309	25,066	32,302
Gross margin as % billings		7.1%	7.4%	7.3%	7.6%	7.3%	7.7%	7.4%	7.4%
Distribution costs		(2,761)	(2,909)	(2,940)	(3,002)	(2,934)	(2,818)	(2,217)	(2,842)
Administrative expenses excluding depreciation & amortisation		(14,914)	(15,176)	(16,348)	(15,702)	(16,007)	(18,916)	(18,070)	(18,672)
EBITDA		8,901	10,441	10,405	12,722	12,336	11,575	4,779	10,788
Depreciation & amortisation		0	0	0	(1,405)	(1,394)	(1,484)	(1,930)	(1,928)
Operating profit before exceptional items		8,901	10,441	10,405	11,317	10,942	10,091	2,849	8,860
Exceptional items		0	0	0	0	(1,210)	(3,382)	0	0
Operating profit		8,901	10,441	10,405	11,317	9,732	6,709	2,849	8,860
Net Interest		1,245	1,457	1,470	1,270	1,572	1,443	327	419
Profit Before Tax & exceptional items		10,146	11,898	11,875	12,587	12,514	11,534	3,176	9,279
Profit before tax		10,146	11,898	11,875	12,587	11,304	8,152	3,176	9,279
Tax		(2,284)	(2,177)	(2,361)	(2,398)	(2,422)	(1,549)	(603)	(1,763)
Profit after tax (IFRS)		7,862	9,721	9,514	10,189	8,882	6,603	2,573	7,516
Average number of shares (m)		182.5	183.7	183.9	185.3	186.0	186.3	186.3	186.3
Fully diluted average number of shares (m)		184.7	187.2	187.2	185.9	186.1	187.3	187.3	187.3
Basic EPS - IFRS (p)		4.3	5.3	5.2	5.5	4.8	3.5	1.4	4.0
Fully diluted EPS - IFRS (p)		4.3	5.2	5.1	5.5	4.8	3.5	1.4	4.0
Dividend per share (p)		2.40	2.75	2.90	3.05	3.20	1.00	1.00	2.75
Pay-out ratio		55.7%	52.0%	56.1%	55.4%	67.0%	28.2%	72.4%	68.2%
BALANCE SHEET									
Non-current assets		13,924	13,749	14,399	14,868	12,606	14,283	14,853	15,429
Goodwill		1,320	1,320	2,202	2,185	2,168	1,286	1,286	1,286
Other intangible assets		3,168	3,036	2,682	2,278	2,295	3,417	4,117	4,820
Property, plant, & equipment		8,143	8,003	7,688	7,684	6,216	2,455	2,325	2,198
Retirement benefit asset		1,293	1,390	1,827	2,721	1,927	1,923	1,923	1,923
Other non-current assets		0	0	0	0	0	5,202	5,202	5,202
Current assets		107,095	119,496	129,322	142,423	153,475	160,880	140,421	161,805
Inventories		3,186	2,182	2,632	3,808	4,574	2,000	2,000	3,286
Trade & other receivables		11,309	8,860	9,236	10,917	12,582	14,089	11,594	14,867
Monies held in trust		65,728	75,219	83,018	86,992	99,251	111,685	101,040	119,212
Cash & equivalents		26,333	32,735	34,236	40,311	36,868	30,139	22,820	24,440
Other current assets		539	500	200	395	200	2,966	2,966	0
Current liabilities		(121,545)	(128,164)	(133,789)	(142,604)	(148,818)	(152,047)	(131,449)	(148,842)
Trade & other payables		(77,688)	(83,135)	(87,201)	(94,592)	(89,952)	(86,704)	(78,431)	(83,078)
Tax payable		(671)	(262)	(424)	0	(580)	0	0	0
Provisions		(43,186)	(44,767)	(46,164)	(48,012)	(58,286)	(65,344)	(53,018)	(65,764)
Non-current liabilities		(2,907)	(1,881)	(1,118)	(662)	(553)	(5,819)	(5,819)	(5,819)
Deferred tax liability		(273)	(181)	(194)	(662)	(553)	(553)	(553)	(553)
Retirement benefit obligation		(2,634)	(1,700)	(924)	0	0	0	0	0
Net assets		(3,433)	3,200	8,814	14,025	16,710	17,296	18,005	22,573
Minorities		0	0	0	0	0	0	0	0
Shareholders' equity		(3,433)	3,200	8,814	14,025	16,710	17,296	18,005	22,573
CASH FLOW									
Operating Cash Flow		14,106	12,184	9,603	10,540	6,874	4,135	(2,679)	5,449
Net interest		1,176	1,339	1,539	1,267	1,497	1,567	327	419
Tax paid		(2,132)	(2,490)	(2,258)	(2,537)	(1,576)	(2,129)	(603)	(1,763)
Capex		(597)	(1,126)	(717)	(1,020)	(1,152)	(3,721)	(2,500)	(2,502)
Acquisitions/disposals		41	52	(875)	1	0	0	0	2,966
Dividends paid		(4,198)	(4,380)	(5,052)	(5,370)	(5,668)	(5,961)	(1,863)	(2,950)
Other		0	0	305	0	345	323	0	0
Net cash flow		8,396	5,579	2,545	2,881	320	(5,786)	(7,319)	1,619
Opening net (debt)/cash		14,842	23,238	28,817	31,362	34,243	34,563	28,777	21,458
Closing net (debt)/cash		23,238	28,817	31,362	34,243	34,563	28,777	21,458	23,078
Overdraft		3,095	3,918	2,874	6,068	2,305	1,362	1,362	1,362
Closing net (debt)/cash as per balance sheet		26,333	32,735	34,236	40,311	36,868	30,139	22,820	24,440

Source: Appreciate Group data, Edison Investment Research forecasts

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