EDISON

Findel

Interim results

Extraordinary growth continues in peak period

Retail

Product revenue growth of 12% in the last 10 comparable weeks is extraordinary in today's retail climate and it underpins our reiterated 7% earnings growth forecast. With Education responding to turnaround measures, unencumbered by leases, and with the balance sheet strengthening further, Findel should logically be rated as one of the stronger retailers in the sector.

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	10.9	6.5
03/18	479.0	46.6	26.8	25.9	8.6	5.7
03/19e	506.6	51.3	28.5	27.7	8.0	5.2
03/20e	536.4	55.5	30.9	29.8	7.4	4.8

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments. **53 weeks, restated.

Underlying progress strong in Express Gifts

Express Gifts' product sales growth in the 10 weeks to Black Friday (23 Nov) was 12%, an outstanding performance in this retail climate, bringing ytd total revenue growth to 7.7%, which we expect to increase. The Studio platform offers unrivalled value, growing its customer base, from 1.8m to 1.9m y-o-y. However, because of timing, this progress is not apparent from H119 results. Neither is product gross margin progression, but we are confident that FY19 guidance of 125–175bp uplift will be met. H1 financial services revenues grew 8.7% y-o-y, with the number of customers rolling forward a balance up from 52.5% to 58%, demonstrating the attractiveness of the responsibly controlled consumer credit package.

Findel Education responds to turnaround measures

Following FY17's repositioning, the customer base grew by 5% in the 12 months to September, with online order levels increasing from c 20% at September 2017 to c 55% at September 2018. Underlying revenue grew 0.8% y-o-y, although that was obscured by the known loss of Sainsbury's 'Active Kids' and was achieved despite significant investment in price reductions to incentivise online customers.

Balance sheet: Continues to strengthen

Core net debt, close to peak, was down £9.1m y-o-y to £80.9m, despite expansion in credit receivables. During the first half the term of bank and securitisation facilities relating to credit receivables were extended to December 2020, and the securitisation facility limit raised £15m to £185m supporting future planned growth.

Valuation: 62% share price headroom

We make no significant change to forecasts, and therefore in principle our DCF valuation is unchanged at 401p. However, the other metric we consider is against sector ratings in relation to earnings growth. Here we must inevitably recognise that the sector has de-rated in recent months. As a result we value Findel on a peer-comparison basis at 319p, making a blended valuation of average of 360p (previously 428p). This is still a 62% premium to the current share price.

29 November 2018

Price	**222.00p**
Market cap	**£192m**

Core net debt (£m) at 30 September 2018	81
Shares in issue	86.4m
Free float	69%
Code	FDL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(11.3)	(14.7)	44.3
Rel (local)	(12.3)	(7.5)	52.5
52-week high/low		302.00p	153.00p

Business description

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

Next events

Trading statement	Late January

Analysts

Paul Hickman +44 (0)20 3681 2501

Kate Heseltine +44 (0)20 3077 5700

consumer@edisongroup.com

Edison profile page

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Interim results: Underlying growth masked by one-offs

H118 pre-tax profit was slightly higher at £11.6m against £11.4m in H117.

Exhibit 1: Summary of interim results

£m	H118*	H119	Growth
Express	174.8	180.7	3.4%
Education	49.7	47.5	-4.4%
Total revenue	224.5	228.2	1.7%
Operating profit			
Express	15.7	14.7	-6.4%
Express operating margin	9.0%	8.1%	-9.5%
Education	3.3	2.2	-33.9%
Central costs	-3.2	-0.5	-83.1%
Total	15.8	16.3	3.3%
Operating margin	7.0%	7.1%	1.6%
Interest	-4.4	-4.7	5.9%
PBT	11.4	11.6	2.3%

Source: Findel. Note: *Restated.

Express Gifts and Findel Education both posted lower first half profit, which was compensated by lower central costs. However, all three were affected by non-comparable elements, and in particular Express Gifts lower result masks significant underlying growth:

Express Gifts: Product sales growth of 12% in last 10 weeks

Exhibit 2: Express results summary

£m	H118*	H119	Growth
Product	123.5	125.0	1.2%
Financial Services	51.2	55.7	8.7%
Overseas sourcing	0.1	0.0	-74.1%
Total revenue	174.8	180.7	3.4%
Product cost of sales	(82.1)	(83.7)	1.9%
FS cost of sales (bad debts)	(10.0)	(13.9)	39.7%
Sourcing cost of sales	(0.1)	(0.0)	-84.8%
Total cost of sales	(92.3)	(97.7)	5.9%
Gross profit	82.6	83.0	0.5%
Product margin	33.5%	33.0%	-1.4%
Gross profit margin	47.2%	45.9%	-2.7%
Marketing costs	(23.4)	(20.2)	-13.9%
Distribution costs	(17.5)	(17.5)	0.1%
Administration costs	(22.6)	(26.7)	17.7%
EBITDA	19.0	18.7	-1.7%
Depreciation and amortisation	(3.3)	(4.0)	20.5%
Operating profit	15.7	14.7	-6.4%

Source: Findel. Note: *Adjusted.

The H1 results of Express Gifts were affected as expected by the timing of the pre-Christmas marketing campaign compared with last year. In FY17 the campaign was skewed into September but in FY18 reverted to its normal phasing across the half year point. The FY17 timing, which had been adopted to accommodate the introduction of the Financier financial services platform, had accelerated product revenue growth in H117 to 15.8% (full year 9.6%). In H118 growth was 1.2%, but in the comparable 10 weeks leading up to Black Friday, which includes the start of the marketing campaign in both years, growth was 12%. Year-to-date total revenue growth is now 7.7% and we expect it to accelerate further in H2.

Active customers have increased from 1.8 million at H117 to 1.9 million at H118, and online ordering from 66% to 72% on a rolling 12-month basis showing further progress towards the company's stated aim of becoming a digital-first retailer.

Product gross margin reduced 50bp as a result of the known termination in August 2017 of a shared services arrangement with Kleeneze, the former Findel subsidiary. Management still expects a margin improvement for the full year. Marketing costs reduced by £3.2m mainly as a result of the campaign timing differences described above.

Financial services revenues grew year-on-year by 8.7%, with an increase in the number of customers rolling forward a balance increasing from 52.5% to 58%, demonstrating the attractiveness of the personal credit facility. Naturally, accounts are closely controlled, with detailed credit management information having improved through the use of Financier. This greater capability, as well as further products under test, should mean the company is prepared for tightening regulation on the management of personal credit business.

Bad debt costs increased by £4.0m, which included the non-recurrence of a £2.5m benefit in FY17 from a change in strategy to sell on non-performing receivables at an earlier point, as well as a £0.8m current-year impact of IFRS 9, the International Financial Reporting Standard on financial instruments effective 1 January 2018.

After adjusting for the non-comparable items within marketing and administrative costs, total underlying cost increases were 1%, modest compared with total revenue up 3.4% and even more so against the underlying growth.

Findel Education: Growth in customers and underlying sales

Exhibit 3: Education results summary

£m	H118*	H119	Growth
Total revenue	49.7	47.5	-4.4%
Total cost of sales	(31.7)	(31.5)	-0.6%
Gross profit	18.0	16.0	-11.0%
Gross profit margin	36.2%	33.7%	-6.9%
Marketing costs	(2.0)	(1.6)	-18.6%
Distribution costs	(5.2)	(4.8)	-7.8%
Administration costs	(6.8)	(6.6)	-3.0%
EBITDA	4.0	3.0	-25.2%
Depreciation and amortisation	-0.7	-0.8	14.3%
Operating profit	3.3	2.2	-33.9%

Source: Findel. Note: *Adjusted.

There has been no slackening of the very tight conditions affecting schools' budgets and in that context the measures adopted in FY17 have proved vital to reversing the previous business decline. In summary these are:

- **Digital**: increasing online ordering to ease schools' administration and aid customer loyalty.
- **Value**: reducing prices to improve competitiveness.
- **Product:** increasing direct sourcing from the Far East.
- **Profitability**: simplifying the business and reducing costs to target a 10% operating margin.

Underlying revenue grew by 0.8% y-o-y, although that was obscured by previously announced cancellation of Sainsbury's 'Active Kids' lines, and was achieved despite significant investment in price reductions to incentivise online customers

The UK customer base grew by 5% in the 12 months to September, with online ordering levels increasing from c 20% at September 2017 to over 55% at September 2018.

Gross margin slipped 250bp in H1 to 33.7%, although we expected this will narrow by the end of the year as a result of supply chain renegotiations and further range rationalisation. Operating cost savings were achieved in all categories and totalled £0.9m.

Management believes its plans for the division are on track. Although the trading effects of the initiatives will be more clearly seen as the school year progresses, these results are very promising, showing a 100% improvement in operating profit, of which only c 30% is the result of overhead cost savings.

Central costs: Reduction on non-recurrence of exchange loss

Central costs reduced from £3.2m in H117 to £0.5m as a result of the non-recurrence of unrealised foreign exchange losses relating to revaluation of Far East operations.

Balance sheet: Core bank debt eliminated

Core net debt, close to its seasonal peak, was £80.9m at end September, down by £9.1m year-on-year, despite the expansion in Express Gifts' credit receivables.

Findel's revolving bank facility and securitisation facility term were both extended during H1 to December 2020. The securitisation facility limit has also been increased by £15m to £185m to support anticipated growth.

The recent High Court decision on Guaranteed Minimum Pension liabilities is likely to mean an additional liability recognised in H219, which management estimates at 2–3% of total scheme liabilities (£104m at March 2018).

Forecast: No change

Guidance for the full year is unchanged and we make no material change to our forecasts.

The growth in Express Gifts' customer base, as well as the current double-digit revenue growth supports our 8% product sales target. In addition, with the improvement in its credit information, the company is able to selectively service and incentivise its more sustainable credit customers while reducing the risk of compromising quality. One measure of this is that returns, once around 40%, have progressively fallen to single digits. In terms of margin, management is confident of at least achieving its product gross margin guidance for the year of 125–175bp improvement, helped by US dollar cover rates for its purchases that have improved to close to US$1.25/£1 for early 2019 compared with c US$1.40/£1 in the early months of 2018.

Valuation: Blend of DCF and peer comparison

We use a DCF projection to place a value on the longer-term income stream available to investors. We 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.

DCF valuation of 401p: Quantifying future cash flows

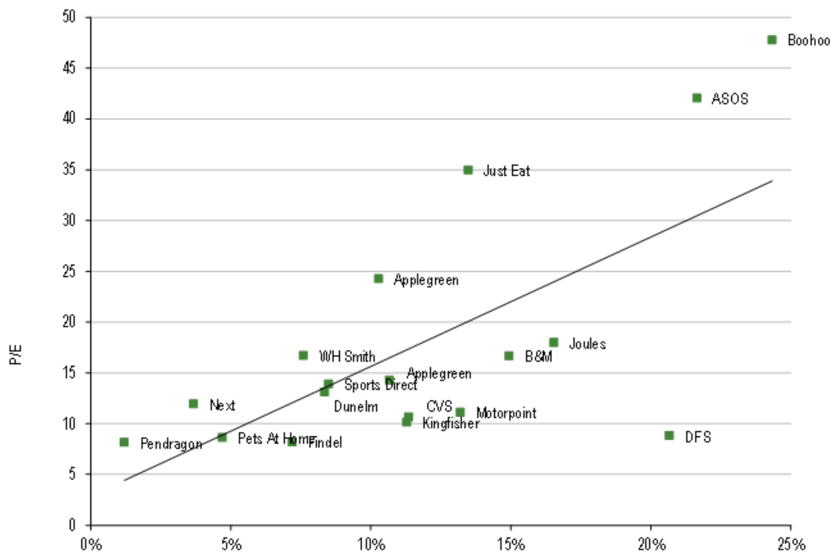
As we make no significant change to our forecast assumptions, our DCF projection does not change. We assume a weighted cost of capital of 6.6% (risk-free rate 3%, risk premium 6%, beta 0.75, cost of debt 3.6% net), resulting in a valuation of 401p/share. We explained our approach in more detail in our June 2018 note Outstanding success with online-led strategy.

Peer comparison valuation of 319p: We reflect sector de-rating

While the recent problems of the retail sector quite largely reflect a residual over-dependence on bricks and mortar, which Findel does not participate in, and while we do not change our forecasts for Findel, we have to reflect the resulting de-rating in terms of a sector comparison.

In this metric we take the common-sense position that higher earnings growth merits a higher P/E ratio than the FY19e 8x on which the shares 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 12x.

Exhibit 4: 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 retail indices, negative growth excluded. Valuation at 26 November 2018.

We adjust for the sector yield (weighted between the FTSE General Retail and AIM Supersector retail indices) of 3.95%. This produces a P/E of 11.5x and a comparative share valuation of 319p:

Exhibit 5: Findel comparative share valuation

Findel Yr 1 (2019e) EPS (p)	27.7
Multiple implied by chart (x)	12.0
Sector yield	3.95%
Adjusted multiple (x)	11.5
Implied share price (p)	319

Source: Edison Investment Research

As a result our valuation is a blend of DCF 401p and peer comparison 319p, an average of 360p (previously 428p). This is still, however, a 62% premium to the current share price.

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Exhibit 6: Financial summary

£'000s	2017	2018	2019e	2020e
Mar	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	457,030	478,959	506,606	536,415
Cost of Sales	(269,182)	(280,230)	(301,615)	(318,370)
Gross Profit	187,848	198,729	204,991	218,045
EBITDA	40,786	46,569	51,287	55,538
Operating Profit (before amort. and except.)	33,300	38,146	42,426	46,577
Intangible Amortisation	(1,959)	(1,996)	(2,552)	(2,387)
Operating profit pre exc post intang amortisation	31,341	36,150	39,874	44,190
Exceptionals	(82,152)	0	0	0
Other/share based payments	(191)	(199)	(1,000)	(1,000)
Operating Profit	(51,002)	35,951	38,874	43,190
Net Interest	(8,920)	(9,130)	(10,345)	(12,244)
Derviatives, other	556	(4,701)	0	0
Profit Before Tax (norm)	22,230	26,821	28,528	30,946
Profit Before Tax (FRS 3)	(59,366)	22,120	28,528	30,946
Tax	1,659	2,081	(5,633)	(6,189)
Profit After Tax (norm)	17,617	22,397	23,895	25,757
Profit After Tax (FRS 3)	(57,707)	24,201	22,895	24,757
Average Number of Shares Outstanding (m)	86.3	86.3	86.3	86.3
EPS - normalised (p)	20.4	25.9	27.7	29.8
EPS - normalised and fully diluted (p)	20.4	25.9	27.7	29.8
EPS - (IFRS) (p)	(66.8)	28.0	26.5	28.7
Dividend per share (p)	0.0	0.0	0.0	0.0
Gross Margin (%)	41.1	41.5	40.5	40.6
EBITDA Margin (%)	8.9	9.7	10.1	10.4
Operating Margin (before GW and except.) (%)	7.3	8.0	8.4	8.7
BALANCE SHEET				
Fixed Assets	79,012	81,687	84,288	84,940
Intangible Assets	26,185	25,175	28,947	28,560
Tangible Assets	44,417	47,596	46,489	47,528
Investments	8,410	8,916	8,852	8,852
Current Assets	301,265	311,918	340,599	366,809
Stocks	57,108	54,180	57,209	70,076
Debtors	212,648	231,037	246,609	258,384
Cash	29,173	26,244	36,459	38,027
Other	2,336	457	322	322
Current Liabilities	(91,789)	(81,190)	(85,158)	(91,249)
Creditors	(91,244)	(80,618)	(84,640)	(90,731)
Short term borrowings	(545)	(572)	(518)	(518)
Long Term Liabilities	(271,785)	(273,170)	(276,172)	(273,672)
Long term borrowings	(253,603)	(258,001)	(264,192)	(264,192)
Other long term liabilities	(18,182)	(15,169)	(11,980)	(9,480)
Net Assets	16,703	39,245	63,557	86,827
CASH FLOW				
Operating Cash Flow	12,281	11,439	29,713	32,181
Net Interest	(9,103)	(8,365)	(10,716)	(12,424)
Tax	148	581	(2,279)	(6,189)
Capex	(11,724)	(10,595)	(12,357)	(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)	4,361	1,568
Opening net debt/(cash)	216,682	224,974	232,329	228,251
HP finance leases initiated	0	0	(283)	0
Other	(1,062)	35	0	0
Closing net debt/(cash)	224,974	232,329	228,251	226,683

Source: Findel, Edison Investment Research. Note: *53 weeks. Forecasts not adjusted for IFRS 9.

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Australia

New Zealand

United Kingdom

United States

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia