Findel

Interim results

Christmas comes early

Retail

Findel's management team is seeing early success from its self-help measures. While strongly positive interim results are partly the result of timing issues, the underlying point is that sales growth from an early Christmas launch has already been banked, improving visibility. The change of strategy at the Education division is also bearing early fruit, and at 66% online, Studio continues to make steady progress to becoming a fully online retailer. Neither that nor management's progress on strategy is reflected in a P/E rating of around 10% of pure-play online retailers.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
03/16	410.6	24.8	23.0	0.0	6.7	N/A
03/17	457.0	22.2	20.4	0.0	7.5	N/A
03/18e	478.1	26.0	25.0	0.0	6.1	N/A
03/19e	506.4	28.5	27.3	0.0	5.6	N/A

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

Underlying improvement boosted by timing

H118 pre-tax profit was sharply higher at £11.9m against £1.9m in H117. The increase was largely driven by Express Gifts, trading as Studio, and included timing issues, particularly management's decision to begin its pre-Christmas campaign in September rather than October. However, a 103% operating profit increase from the Education division also contributed, marking an important early result of the change strategy targeted at restoring Education to a 10% return on sales.

Value offer is gaining share

At a time of deepening uncertainty and challenge for the consumer economy in general and retail in particular, we believe Studio's value offer, combined with its consumer credit services, is well placed to gain market share among its value-conscious customer group. Its outstanding like-for-like revenue growth of +15.8% in H118, combined with improved gross and net margin, indicates that it is doing so.

Taking control of the main drivers

Findel is demonstrating increased control over its destiny with 66% of orders now online, a marked turnaround in the performance of the Education division, and a first half clear of exceptionals. With improved profit visibility for the second half, we make no material change to our forecast of 17% pre-tax profit growth in FY18. However, we believe that the balance of risk has moved to the upside.

Valuation: Double the current price

We slightly adjust our sum-of-the parts valuation from 324p to 312p, mainly as a result of the reduction in the rating of our reference stock, N Brown, net of the positive effect of the scheduled pay-down of the financial services provision. Our valuation equates to an FY18e P/E ratio of 12x. Pure-play online retailers are rated at over 60x, indicating the valuation headroom available to Findel as it identifies more closely with the online model.

29 November 2017

Price	**153p**
Market cap	**£132m**

Net core bank debt (£m) at end September 2017	90
Shares in issue	86.4m
Free float	100%
Code	FDL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(15.0)	(8.4)	(18.7)
Rel (local)	(14.5)	(9.3)	(26.6)
52-week high/low		214.8p	150.5p

Business description

Findel comprises market-leading businesses in the UK online value retailing and education supplies markets. Findel's objective is to develop sustainable growth in a marketplace for value-conscious customers who are rapidly moving their purchases online.

Next events

Trading update	Late January 2018
Post-close update	Early April 2018

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Interim results: Underlying progress flattered by timing

H118 pre-tax profit (before valuation of derivatives) was sharply higher at £11.9m against £1.9m in H117. The increase was largely driven by Express Gifts, with a 103% operating profit increase from the Education division also contributing.

Exhibit 1: Summary of interim results

£m	H117*	H118	Growth
Express	159.5	176.6	10.7%
Education	53.5	49.4	-7.8%
Total revenue	213.0	226.0	6.1%
Operating profit			
Express	5.1	16.1	215.3%
Express operating margin	3.2%	9.1%	5.9%
Education	1.7	3.4	102.8%
Central costs	(0.3)	(3.2)	886.6%
Total	**6.5**	**16.3**	**153.0%**
Operating margin	3.0%	7.2%	4.2%
Interest	(4.6)	(4.4)	4.0%
PBT	**1.9**	**11.9**	**538.1%**

Source: Findel. Note: *27 weeks.

The results included the positive effect of timing differences at Express, discussed below. However, the increase at Education represents significant early success in its change of strategy.

The company has reclassified its results presentation to absorb the now immaterial overseas sourcing operation into Express Gifts and to state central costs separately. The increase in central costs is an allocation issue related to the reorganisation process and we do not expect it to be sustained at this level. We present the results before revaluation of foreign exchange contracts. Those revaluations resulted in a £3.8m charge (H117: £1.4m credit). They relate to foreign exchange contracts that assure expected commercial margins, whose effect are in our forecasts, and we therefore do not believe that they are helpful in understanding the results at mid-year.

Express Gifts – online increases further

Express Gifts improved further on its full-year FY17 performance with like-for-like product revenue up 15.8% (FY17: 15.6%). This was in part the result of Studio starting its pre-Christmas marketing campaign in September this year, rather than October last year.

Exhibit 2: Express results summary

£m	H117*	H118	Growth
Product	110.4	125.3	13.5%
Financial Services	47.4	51.2	8.1%
Overseas sourcing	1.8	0.1	-93.8%
Total revenue	**159.5**	**176.6**	**10.7%**
Product cost of sales	(74.6)	(83.4)	11.8%
FS cost of sales (bad debts)	(16.0)	(10.0)	-37.5%
Sourcing cost of sales	(1.6)	(0.1)	-91.2%
Total cost of sales	(92.1)	(93.6)	1.5%
Gross profit	**67.4**	**83.1**	**23.3%**
Product margin	**32.4%**	**33.4%**	**1.0pp**
Gross profit margin	42.2%	47.0%	4.8%
Marketing costs	(19.9)	(23.4)	17.6%
Distribution costs	(16.3)	(17.5)	7.1%
Administration costs	(26.0)	(26.0)	0.1%
Operating profit	**5.1**	**16.1**	**215.3%**

Source: Findel. Note: *27 weeks.

Online ordering was up from 63% for the full year FY17 to 66.4%, showing further progress towards the company's stated aim of becoming a 100% online operation. The increase was led by new customers, over 80% of whom ordered online, against 71% during the full year FY17. The active customer base was up by 230,000, or 15.7% year-on-year, to reach 1.7 million.

Product gross margin improved 100bp for three reasons: firstly, as a result of a marketing-based approach and reducing dependence on price discounting; secondly, because of an increased mix of apparel, which achieves higher margins; and thirdly, because Showcase items (a selection of high-profile, discounted lines designed to excite customer interest) were on average priced at c 20% gross margin, compared to the prior year period, which was dominated by a laptop offer that was not profitable. Gross margin on financial services fell as a result of lower bad debt provisions; this is essentially a timing difference produced by the company's new provisioning system and is expected to reverse in the second half. Marketing costs were £3.5m higher as a result of bringing forward the pre-Christmas campaign, with high-profile TV advertising targeted at the main customer group (for example, timed during *I'm A Celebrity…*). Distribution costs responded to the increased volumes, while administrative costs were held steady.

In current trading, whereas October was sluggish in common with retailers elsewhere, November has rebounded strongly, with product sales growth of 12% for the 34 weeks to Friday 24 November. Studio appears to be benefiting from the relative trend towards bargain-hunting on small ticket items.

Financial services

The presentation above clarifies the profit, as well as the revenue significance of the financial services operation to the company, which underpins its value retail offer. The healthy 8% increase in revenue supports the growth in product revenue, and the number of new customers who carried over an account balance rose 8.8% in the period, demonstrating the popularity of the facility.

Findel has responded to the sensitivity of managing consumer credit with a range of actions, and has strengthened its team in this area. We would point to the successful implementation of Welcom Software's Financier credit management platform in October, a development noted as having been delayed in the 2017 Annual Report. Management also delivered its new bad debt model early at the year end, and is on track with development work that will result in its being compliant with IFRS 9, the International Financial Reporting Standard on financial instruments effective 1 January 2018. Meanwhile, we note that the disposition of the customer refund provisions made at year end is proceeding to plan with £8.4m having been paid, and that there are no new exceptional items.

Education division

Exhibit 3: Education results summary

£m	H117*	H118	Growth
Revenue	53.5	49.4	-7.8%
Cost of sales	(34.9)	(31.3)	-10.3%
Gross profit	**18.6**	**18.1**	**-2.7%**
Gross profit margin	**34.8%**	**36.6%**	**1.9%**
Marketing costs	(3.1)	(2.0)	35.5%
Distribution costs	(5.9)	(5.2)	11.9%
Administration costs	(8.0)	(7.5)	6.3%
Operating profit	**1.7**	**3.4**	**102.8%**

Source: Findel. Note: *27 weeks.

First half performance at the Education business reflected the early results of the revised strategy announced at the FY17 preliminary results. This targets an operational turnaround focused on four areas:

- **Digital**: increasing online ordering to ease schools' administration and aid customer loyalty. As planned, new websites were rolled out over the summer, linked to price comparison tools. As a result, online ordering is up from c 10% in March 2017 to over 25% in November 2017.
- **Value**: reducing prices to improve competitiveness. Prices were reduced on c 800 items during September by up to 30%.
- **Product:** increasing direct sourcing from the Far East. The benefit of this move is likely to be seen in early FY19.
- **Profitability**: simplifying the business and reducing costs to target a 10% operating margin. Savings have been achieved on the warehouse consolidation of December 2016, and further initiatives worth an annualised £3-4m were identified at year end. Around £1m of those initiatives will be realised in the current year (we therefore estimate c £0.5m is reflected in the first half). Hence the cost benefits to come are substantial.

Management believes that 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.

Balance sheet

Core net debt was £90.0m at end September, a reduction of £4.5m against September 2016. This is as expected ahead of the main trading season.

Forecast

Guidance for the full year is unchanged, and we make no material change to our forecasts. Management advises that as a result of Studio's marketing initiative in September rather than October, second-half revenue growth will likely be commensurately lower: we assume 8.5% to produce 10.6% for the full year.

At the PBT level, last year's split was H1: £1.9m, H2: £20.3m, FY: £22.2m. Against this, in FY18, H1 was £11.9m and we forecast £14.1m in H2 to total £26.0m. Even allowing for the £3.5m marketing cost switch between H1 and H2, and the disparity in bad debt provisioning, this would appear to give better visibility of the full year result. With Studio posting 12% sales growth for the first eight weeks of the second half, we believe that the balance of risk for the full year has moved to the upside.

Valuation

We adjust our sum-of-the parts valuation from 324p to 312p, as a result of a several small factors:

1. Reduction in the provision for financial services product liabilities from £25.5m to £17.1m by the settlement of £8.4m of liabilities since year end. We reflect 90% of the provision in our valuation
2. Reduced rating of our reference stock, N Brown, for FY18. We refer to N Brown as it is the only other listed retailer that is in a progression from mail order to online. We use N Brown's P/E ratio discounted by the dividend yield to reflect the absence of a dividend at Findel. N Brown has recorded good results from its stores, as well as progress in online ordering, but has needed to provide against flaws in past insurance products on a similar basis to Findel. It is currently rated at a year 1 P/E of 12.4x, slightly down on 13.0x at the time of our July note, and its yield is slightly up at 5.2% against 4.9%. As a result, the effective multiple is down from 12.0x to 11.8x.

3. Separate reporting of central costs. These would previously have been split between Express and Education. We apply a P/E multiple of 10x.
4. Reduction in the balance sheet pension deficit from £12.8m to £4.3m.

Exhibit 4: Sum-of-the-parts valuation

	Basis	Metric (£m)	Multiple (x)	Value (£m)
Express (incl securitisation facility)	NOPAT FY18e	31.5	11.8	370.8
Education	EBITDA FY18e	8.8	7.0	61.3
Central costs	FY18e	(6.3)	10.0	(62.5)
Enterprise value				369.6
Core net debt	Dec-16			(80.8)
Pension deficit	Balance sheet			(4.3)
Cash provisions on financial products	90% reflected			(15.4)
Equity value				270.0
# shares (m)				86.4
SOTP value per share (p)				312p

Source: Edison Investment Research

Our valuation would equate to a P/E ratio of 12.0x for FY18e, falling to 11.4x for FY19e, which is close to the current rating of N Brown. That compares with 6.1x and 5.6x currently. However, as we indicate in our July note, Findel is moving closer to its goal of becoming a pure-play online retailer. Online peers ASOS, Boohoo and Gear4music are rated on year 1 P/E ratings of 61-68x earnings, which reflect market expectations of higher sustained profit growth. This indicates the valuation headroom available to Findel as it identifies more closely with the online model.

Exhibit 5: Financial summary

£000s	2016	2017*	2018e	2019e
Year end March	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	410,601	457,030	478,139	506,404
Cost of Sales	(214,621)	(269,385)	(278,341)	(293,270)
Gross Profit	195,980	187,645	199,798	213,134
EBITDA	41,758	40,785	46,748	51,907
Operating Profit (before amort. and except.)	37,264	33,299	39,071	44,400
Intangible Amortisation	(2,348)	(1,959)	(2,031)	(2,495)
Operating profit pre exc post intang amortisation	34,916	31,340	37,040	41,905
Exceptionals	(25,458)	(82,152)	0	0
Other/share based payments	(239)	(191)	(1,000)	(1,000)
Operating Profit	9,219	(51,003)	36,040	40,905
Net Interest	(9,901)	(8,920)	(10,028)	(12,371)
Financial exceptional items	(998)	556	(3,817)	0
Profit Before Tax (norm)	24,776	22,229	26,012	28,534
Profit Before Tax (FRS 3)	(1,680)	(59,367)	22,195	28,534
Tax	91	1,659	(4,654)	(5,992)
Profit After Tax (norm)	19,785	17,616	21,589	23,542
Profit After Tax (FRS 3)	(10,196)	(57,708)	17,541	22,542
Average Number of Shares Outstanding (m)	86.1	86.3	86.3	86.3
EPS - normalised (p)	23.0	20.4	25.0	27.3
EPS - normalised and fully diluted (p)	20.3	20.4	25.0	27.3
EPS - (IFRS) (p)	(11.8)	(66.8)	20.3	26.1
Dividend per share (p)	0.0	0.0	0.0	0.0
Gross Margin (%)	47.7	41.1	41.8	42.1
EBITDA Margin (%)	10.2	8.9	9.8	10.3
Operating Margin (before GW and except.) (%)	9.1	7.3	8.2	8.8
BALANCE SHEET				
Fixed Assets	92,927	79,012	78,462	77,460
Intangible Assets	47,322	26,185	29,311	31,816
Tangible Assets	41,423	44,417	40,741	37,234
Investments	4,182	8,410	8,410	8,410
Current Assets	321,279	301,265	322,404	337,117
Stocks	53,472	57,108	69,060	72,016
Debtors	229,848	212,648	222,521	236,912
Cash	34,405	29,173	29,074	26,441
Other	3,554	2,336	1,748	1,748
Current Liabilities	(76,191)	(91,789)	(89,290)	(93,459)
Creditors	(75,673)	(91,244)	(88,772)	(92,941)
Short term borrowings	(518)	(545)	(518)	(518)
Long Term Liabilities	(259,140)	(271,785)	(277,206)	(272,215)
Long term borrowings	(250,569)	(253,603)	(264,192)	(264,192)
Other long term liabilities	(8,571)	(18,182)	(13,014)	(8,023)
Net Assets	78,875	16,703	34,370	48,903
CASH FLOW				
Operating Cash Flow	8,889	12,280	8,221	27,730
Net Interest	(9,549)	(9,103)	(10,028)	(12,371)
Tax	(2,494)	148	1,146	(5,992)
Capex	(15,940)	(11,724)	(10,000)	(12,000)
Acquisitions/disposals	11,115	1,168	0	0
Financing	0	0	0	0
Dividends	0	0	0	0
Net Cash Flow	(7,979)	(7,231)	(10,661)	(2,633)
Opening net debt/(cash)	206,551	216,682	224,975	235,636
HP finance leases initiated	0	0	0	0
Other	(2,152)	(1,062)	0	0
Closing net debt/(cash)	216,682	224,975	235,636	238,269

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

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