EDISON

Gear4music

AGM update

Focusing on the European opportunity

Retail

Gear4music (G4M) confirms that trading is on track for the first four months of FY18. The return to a more normal second half-weighted revenue split has already been flagged. Significant development of the offer and the platform is underway as the company focuses on the international opportunity. Given this focus, the market's expectation of the time the company is likely to take to build European market share may be too cautious, which would imply upside for the share price.

Year end	Revenue (£m)	EBITDA (£m)	PBT* (£m)	EPS* (p)	P/E (x)	EV/EBITDA (x)
02/16	35.5	1.7	0.6	3.1	264.5	99.8
02/17	56.1	3.7	2.7	11.6	70.7	47.1
02/18e	79.7	4.1	2.4	10.0	82.0	42.0
02/19e	102.1	5.1	3.3	13.3	61.7	33.5

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

AGM trading update: In line with expectations

Trading has been in line with management's expectations, with strong growth continuing in the UK as well as internationally. The new European distribution centres should contribute in the second half. Development continues on the mobile platform, building the software team, expanding options for order and delivery, and international capabilities, including potential expansion beyond Europe. The product range as well as investment in these initiatives, is benefiting from the funds raised in the May placing.

No change to forecast, lower H1 split confirmed

We are not changing our forecasts. We expect FY18 revenue to be closer to the historical split between H1 and H2 than in FY17, when H1 was boosted by the effect of investment of the funds raised at IPO. We expect the first/second half split to be 37:63 compared with 39:61 in FY17. H118 revenue growth is likely to be numerically lower because of the abnormally high H117 comparative. H118 will also reflect the costs of fully establishing the new European distribution centres and UK head office, which, in addition to the operational gearing effect of revenue, is likely to lead to first half operating profit below trend.

Valuation: Share price implies slower market gains

G4M is valued on P/E and EV/EBITDA multiples that are close to those of Boohoo and ASOS, at the upper end of the range of pure-play online retailers. The market is clearly focusing on the European opportunity, which implies continued outperformance. We have little doubt that G4M can grow its European market share. The question is how long this will take. In the UK it will have taken six years to grow UK market share from 1% to 6% in FY18e. According to our analysis, the current share price implies that mainland Europe takes eight years to reach the same level. However, if European market share were to reach 6% in six years, that would be equivalent to a share price valuation of 962p. This scenario is a plausible upside case given the strategic focus of G4M's investment and resources, although it is also true that there is significant competition in mainland Europe.

28 July 2017

Price	**820.0p**
Market cap	**£171m**

Net cash* (£m) at end February 2017 *Before placing	0.4
Shares in issue	20.9m
Free float	64%
Code	G4M
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	13.1	56.0	564.0
Rel (local)	12.6	52.1	496.3
52-week high/low		850.0p	122.5p

Business description

Gear4music is the largest dedicated, UK-based online retailer of musical instruments and music equipment. It sells branded instruments and equipment, alongside its own brand products, to customers ranging from beginners to professionals, in the UK and into Europe and the rest of the world.

Next events

Interim results	September 2017

Analysts

Paul Hickman +44 (0)20 3681 2501

Neil Shah +44 (0)20 3077 5715

consumer@edisongroup.com

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Gear4Music is a research client of Edison Investment Research Limited

AGM statement

The first four months of the year have seen two milestone events. Firstly, the May 2017 placing, which was oversubscribed, raised £4.2m of additional growth capital. Secondly, in June, the company completed on its new freehold office.

Trading performance has been in line with management's expectations. We would point to the fact that G4M reports strong growth continuing in the UK as well as internationally, and we believe that the company's niche market, pure-play online status and independent market drivers will help protect it from general UK retail malaise.

While the new European distribution centres contribute to the scope of G4M's northern European proposition, we still expect that the operations will gather pace in the second half, meaning that evidence of their revenue contribution is likely to be seen more clearly then.

Developments taking place in the current period include:

- Development of the mobile platform: significant functionality is being added under the direction of the company's new chief technology officer, which should benefit the second half.
- Having acquired its dedicated software provider in January 2017, G4M is in the process of building the team to enhance the scope of its capabilities in developing the bespoke platform.
- G4M is progressing on configuring the customer proposition, in terms of expanding the options for order and delivery.
- The company continues to develop its European capabilities, including marketing and delivery capabilities. With two centres in northern Europe the next physical presence will probably be in a southern country. Plans continue for potential expansion beyond Europe.
- G4M continues to develop the range of products available to customers and its own brands. Management believes that investment in stock is the most commercial use of short-term funds and the balance sheet effect of this is likely to be apparent in the interim results.

Financials

Trading is in line with management's expectations after four months. We are not changing our forecasts at this early point in the year.

FY17 revenue was skewed to the first half (39% of the year) mainly because the benefit of the funds raised at IPO towards the end of FY15 was effectively felt then. Revenue in FY16 and earlier had followed a pattern of around 35% in H1. In FY18 we expect the seasonality to be more in keeping with the earlier pattern at 36.6%. H118 growth is therefore likely to be numerically lower because of the one-off nature of the H117 comparative.

In H2 we expect growth to be accentuated as investments in infrastructure including European distribution centres, the increased UK warehouse space, social media marketing, product range expansion and system developments, all contribute later in the year.

Exhibit 1: H1/H2 revenue split

	FY15	H116	H216	FY16	H117	H217	FY17	H118	H218	FY18e	FY19e	FY20e
£m	24.2	12.5	23.0	35.5	21.6	34.5	56.1	29.2	50.6	79.7	102.1	127.3
Growth %	37.1	42.5	48.6	46.4	73.0	50.1	58.2	35.0	46.5	42.0	30.1	24.7
% annual revenue		35.2	64.8	100.0	38.5	61.5	100.0	36.6	63.4	100.0		

Source: G4M, Edison Investment Research

As we have previously discussed, H118 will reflect the costs of fully establishing the new European distribution centres and UK head office, which, in addition to the operational gearing effect of revenue, is likely to lead to H1 operating profit below trend.

Valuation

Multiples compared against online peers

G4M is valued on P/E and EV/EBITDA multiples that are close to those of Boohoo and ASOS, which are at the upper end of the range of pure-play online retailers:

Exhibit 1: Comparable valuation multiples for pure-play retailers

Name	Year end	Market cap (£m)	Year 1 P/E (x)	Year 2 P/E (x)	Year 1 EV/ EBITDA (x)	Year 2 EV/ EBITDA (x)	Year 1 EV/ Sales (x)	Year 2 EV/ Sales (x)
Boohoo	02/2017	2,577	77.8	62.6	50.9	36.6	5.3	4.0
Gear4music	02/2017	161	81.8	61.3	42.9	31.6	2.0	1.6
ASOS	08/2016	4,725	57.4	44.8	26.8	21.1	1.9	1.5
Zalando	12/2016	9,130	43.6	33.9	21.2	16.7	1.5	1.3
Yoox Net-A-Porter	12/2016	3,076	37.4	27.4	14.4	11.0	1.3	1.1
AO World	03/2017	570	N/A	N/A	N/A	43.7	0.7	0.6
Koovs	03/2016	67	N/A	N/A	N/A	0.0	2.3	0.9
Average (excl G4M)			54.0	42.2	28.3	21.5	2.2	1.6

Source: Bloomberg, Edison Investment Research. Note: Calendarised to February year end.

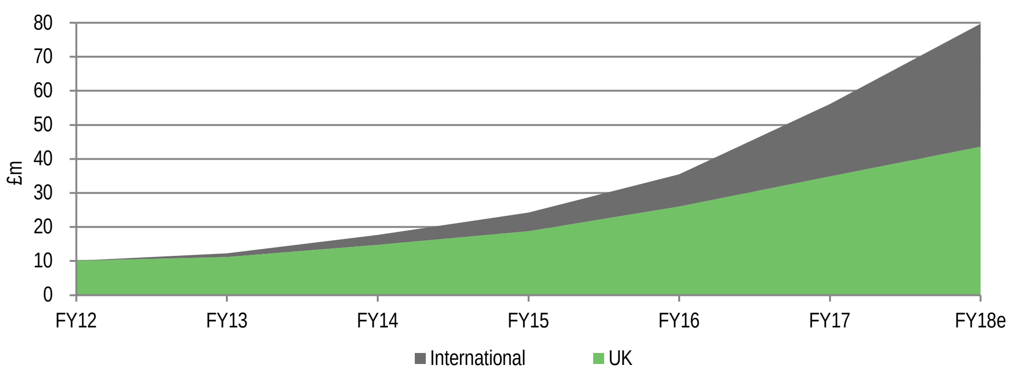
The market is clearly focusing on the European opportunity, which implies continued outperformance if G4M wins market share in the same way as in the UK. That is consistent with G4M's strategy of investing in the European market opportunity, not only through the local distribution hubs that have already been opened in Sweden and Germany, but also in terms of investment in the country websites, Europe-wide marketing and the functional support for a much bigger marketing and distribution operation.

European market share profile

We have little doubt that G4M can grow its European market share, currently 1%, in the same way as it has done in the UK, where in FY12 it too had only 1% of the market. The question is how long this will take. In the UK it will have taken six years, until the current year FY18, to grow UK market share from 1% to 6% (ie our FY18 forecast of £43.6m UK revenue against the UK market of £790m).

While UK revenue is now showing a pattern of substantial growth (34% in FY17 and 27% in FY18e), initial growth in Europe is much more dramatic (125% in FY17: we forecast 70% in FY18). However, that is in the context of a European market that is around five times the size of the UK market, according to management's market estimates.

Exhibit 3: UK vs international revenue

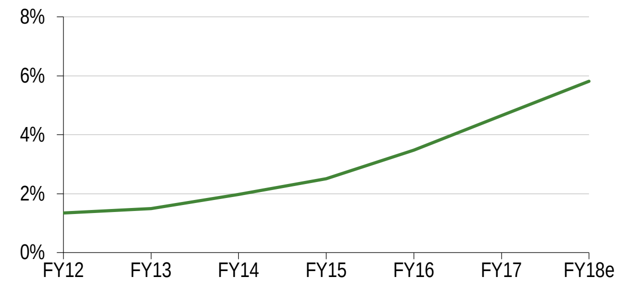


Source: G4M

Share price implies slower market share growth in Europe

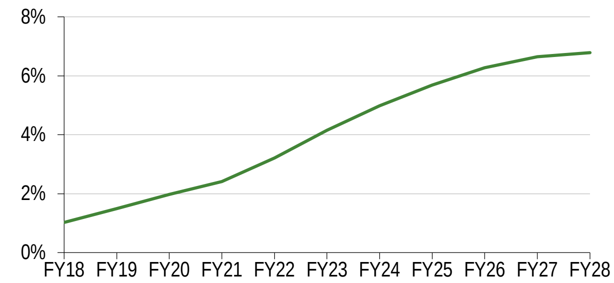
We have adapted our DCF valuation model to mirror assumptions on European share growth that give best fit with the current share price. We use our existing DCF assumptions (10-year period, weighted cost of capital of 8.7%, terminal growth 2%, terminal EBITDA margin 10%). Above 6% market share, we fade growth towards our 2% terminal assumption, for both the UK and Europe.

Exhibit 2: UK market share history



Source: G4M

Exhibit 3: Mainland Europe market share assumption



Source: G4M

While the UK takes six years (including our current year forecast) to achieve market share of 6%, the current share price implies that mainland Europe takes eight years to reach the same level, in FY26. It may be a reasonable assumption that it takes this longer time, because of the scale of the market and because of the scale of online competition in Europe.

However, if European market share were to reach 6% in six years (ie by FY24), that would be equivalent to a share price valuation of 962p. This scenario is a plausible upside case given the strategic focus of G4M's investment and resources.

In a 'blue sky' case in which European market share reaches 6% one year earlier (ie by FY23), our valuation would be 1,215p.

Exhibit 6: Financial summary

£000	2016	2017	2018e	2019e	2020e
Year end: February	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT					
Revenue	35,489	56,128	79,728	102,116	127,347
Cost of Sales	(26,303)	(40,983)	(58,615)	(74,875)	(93,382)
Gross Profit	9,186	15,145	21,114	27,242	33,965
EBITDA	1,688	3,650	4,092	5,133	6,649
Operating profit (before amort. and except).	903	2,655	2,648	3,590	4,747
Amortisation of acquired intangibles	0	0	0	0	0
Exceptionals	(606)	0	0	0	0
Share-based payments	(8)	(39)	(73)	(66)	(83)
Reported operating profit	289	2,616	2,575	3,524	4,663
Net Interest	(283)	20	(289)	(265)	(264)
Joint ventures & associates (post tax)	0	0	0	0	0
Exceptionals	0	0	0	0	0
Profit Before Tax (norm)	620	2,675	2,360	3,325	4,482
Profit Before Tax (reported)	6	2,636	2,286	3,259	4,399
Reported tax	(49)	(322)	(283)	(532)	(717)
Profit After Tax (norm)	571	2,353	2,076	2,793	3,765
Profit After Tax (reported)	(43)	2,314	2,003	2,727	3,682
Minority interests	0	0	0	0	0
Discontinued operations	0	0	0	0	0
Net income (normalised)	571	2,353	2,076	2,793	3,765
Net income (reported)	(43)	2,314	2,003	2,727	3,682
Basic average number of shares outstanding (m)	18.2	20.2	20.7	20.9	20.9
EPS - basic normalised (p)	3.1	11.7	10.0	13.4	18.0
EPS - normalised (p)	3.1	11.6	10.0	13.3	18.0
EPS - basic reported (p)	(0.2)	11.5	9.7	13.1	17.6
Dividend per share (p)	0.00	0.00	0.00	0.00	0.00
Revenue growth (%)	46.4	58.2	42.0	28.1	24.7
Gross Margin (%)	25.9	27.0	26.5	26.7	26.7
EBITDA Margin (%)	4.8	6.5	5.1	5.0	5.2
Normalised Operating Margin	2.5	4.7	3.3	3.5	3.7
BALANCE SHEET					
Fixed Assets	4,477	7,102	14,067	15,124	16,255
Intangible Assets	3,238	5,537	6,432	6,971	7,465
Tangible Assets	1,239	1,565	7,634	8,153	8,790
Investments & other	0	0	0	0	0
Current Assets	11,194	16,035	24,687	28,821	34,099
Stocks	6,906	11,686	15,060	19,068	23,307
Debtors	740	1,348	1,915	2,452	3,058
Cash & cash equivalents	3,548	3,001	7,712	7,301	7,734
Other	0	0	0	0	0
Current Liabilities	(6,022)	(10,000)	(14,940)	(18,028)	(21,511)
Creditors	(5,188)	(7,379)	(10,722)	(13,710)	(17,096)
Tax and social security	0	0	0	0	3
Short term borrowings	(834)	(2,621)	(4,219)	(4,319)	(4,419)
Other	0	0	0	0	0
Long Term Liabilities	(290)	(1,415)	(4,368)	(4,154)	(3,804)
Long term borrowings	(127)	(24)	(4,278)	(4,064)	(3,714)
Other long term liabilities	(163)	(1,391)	(90)	(90)	(90)
Net Assets	9,359	11,722	19,445	21,763	25,039
Minority interests	0	0	0	0	3
Shareholders' equity	9,359	11,722	19,445	21,763	25,042
CASH FLOW					
Op Cash Flow before WC and tax	1,688	3,656	4,092	5,133	6,649
Working capital	(1,416)	(3,618)	(598)	(1,558)	(1,459)
Exceptional & other	(607)	28	(73)	(66)	(83)
Tax	0	(104)	(283)	(532)	(717)
Net operating cash flow	(335)	(38)	3,137	2,978	4,390
Capex	(1,509)	(2,195)	(7,680)	(2,601)	(3,034)
Acquisition: deferred payments	0	0	(409)	(409)	(409)
Net interest	(130)	(47)	(289)	(265)	(264)
Equity financing	9,535	0	4,100	0	0
Dividends	0	0	0	0	0
Other	0	0	0	0	0
Net Cash Flow	7,561	(2,280)	(1,140)	(297)	683
Opening net debt/(cash)	4,974	(2,587)	(356)	784	1,081
FX	0	0	0	0	0
Other non-cash movements	0	49	0	0	0
Closing net debt/(cash)	(2,587)	(356)	784	1,081	398

Source: Gear4music accounts, Edison Investment Research

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 12, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia