Gear4music Holdings

Robust finish and forward momentum

Year-end trading statement

Retail

Gear4music Holdings (G4M) finished the year in robust style, with 43% revenue growth. While marginally below our forecast, this represents good momentum going into FY19, where we only forecast 27%. While continued investment in scale means costs remain at planned levels, resulting in a pause in FY18 earnings growth, prospects for further market share gains remain bright and we see the current share price as below fair value.

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	201.8	76.7
02/17	56.1	3.7	2.7	11.6	54.3	37.1
02/18e	80.1	3.7	1.7	7.3	86.7	37.1
02/19e	102.1	5.0	3.1	12.5	50.3	27.4

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

Strong revenue growth, momentum sustained

G4M has traded strongly throughout FY18, with a 39% increase in active customers and a 3.25% conversion rate. Against an atypical base in FY16, 41.7% revenue growth for September-December 2017 was a very satisfactory result. In January and February 2018, growth has remained consistent at a robust 41.3%, representing acceleration against 38.7% in the previous year. This provides good momentum going into FY19.

Investment in scale continues

Having raised £4.2m net cash in May 2017, G4M has continued to develop its platform, build the management structure, and expand stock range and availability. The European distribution centres that opened last year have scaled up, marketing activities continue to develop, and FY18 bears the costs of moving into the freehold office in York as well as the financing costs of the freehold base.

Forecasts: FY18 pause, confident in FY19e

Reflecting operational gearing in the business, combined with management's commitment to investing for scale, a shading of FY18 revenue against our forecast is likely to have a disproportionate effect on earnings. Management guides to EBITDA similar to FY17 and we reduce our FY18e forecast from £4.1m to £3.7m. However, we do not expect a significant implication for FY19e, where we remain confident in our forecast, based on sales growth well below the current level.

Valuation: Upside on both our metrics

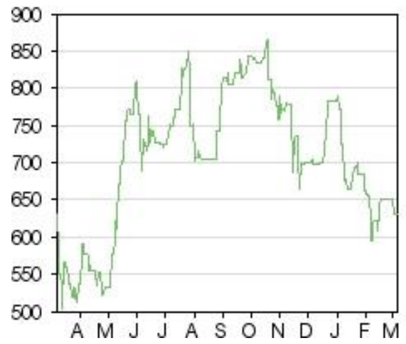
G4M stands at a P/E discount and a slight EV/EBITDA premium to online retail peers. Adjusted to the average for both, G4M would be valued at 707p. On a DCF basis, we estimate that G4M's current share price implies around nine years to reach market share of 6% in mainland Europe, starting in FY19. It took six years to build that market share in the UK and if G4M can replicate that in Europe, the appropriate share price valuation would be 831p, or if it took seven years, 726p. On both metrics, therefore, we see share price upside.

6 March 2018

Price	**631p**
Market cap	**£132m**

Net debt (£m) at August 2017	3.7
Shares in issue	20.9m
Free float	64%
Code	G4M
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	1.6	(10.5)	(3.7)
Rel (local)	4.2	(8.1)	(1.7)
52-week high/low		865.0p	502.5p

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

Preliminary results	May 2018

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Edison profile page

Trading update: A good finish to a strong year

G4M has continued to trade strongly throughout FY18:

Exhibit 1: Consistent sales growth

£000	Mar-Aug	Sept-Dec	Jan-Feb	FY
FY18				
UK	17,900	18,763	7,595	44,258
Europe and RoW	13,319	15,801	6,722	35,842
Total	31,219	34,564	14,317	80,100
FY17				
UK	13,784	15,019	6,062	34,865
Europe and RoW	7,825	9,365	4,073	21,263
Total	21,609	24,384	10,135	56,128
Growth in FY18				
UK	29.9%	24.9%	25.3%	26.9%
Europe and RoW	70.2%	68.7%	65.0%	68.6%
Total	44.5%	41.7%	41.3%	42.7%
FY16				
UK	9,584	11,608	4,824	26,016
Europe and RoW	2,909	4,082	2,482	9,473
Total	12,493	15,690	7,306	35,489
Growth in FY17				
UK	43.8%	29.4%	25.7%	34.0%
Europe and RoW	169.0%	129.4%	64.1%	124.5%
Total	73.0%	55.4%	38.7%	58.2%

Source: G4M

Substantial and broadly based growth

Growth has been substantial strong and broadly based, built on a significant 39% increase in active customers. Europe continues to run ahead of growth rates in the more mature UK market, with Scandinavia making a particular contribution. We understand that sales through mobile devices has been a recent success and look forward to further detail at the final results in May.

From a seasonal standpoint, triple-digit European growth in the first half and third quarter of FY17, driven by the competitive advantage around sterling's devaluation in mid-2016, was something of a one-off, although it was utilised by management to drive strategic advantage in opening up these new target markets. Against that background, growth of 41.7% in September-December 2017 was a more than satisfactory result, albeit slightly lower than first-half growth largely as a result of slight flattening of the UK growth rate, still strong at 24.9%.

Early 2018 momentum remains strong

Moving into January and February 2018, growth has remained consistent with the previous period at a very robust 41.3%. Internationally, the dramatic growth seen earlier in the year (70% in H1) reduced very slightly to 65%, which indicates that market share gains are continuing strongly. In the UK, growth remained consistent at 25.3%, which is very pleasing considering that this is a characteristically weak period and UK retail sales volumes had been much lower than expected in January at 1.6% volume and 4.4% value year-on-year (source: ONS). In total, the last two months' growth of 41.3% remains very consistent with the previous four-month period, reinforced by the greater weighting of international sales, now 47% of the total against 40% for the same period in the previous year. This final two months, in fact, is ahead of 38.7% growth in the previous year.

In short, G4M's top-line performance has been excellent, and momentum is being sustained. Sales expansion has been strong and market share continues to be won, particularly in the newer markets of Europe where so much strategic focus has been concentrated. If there is any disappointment, it is that the pick-up in the final two months was not greater, despite the weakening of growth in the final two months of FY17. As a result, revenue for the year was 1.6% below our forecast at £81.4m.

Current developments: Positive indications

Among other positive indicators for G4M as it finishes its FY18 year are:

- Conversion across all websites has increased from 2.75% to 3.25% year-on-year. This is a high-quality score in a key conversion rate, which provides evidence of the quality and effectiveness of the company's online marketing.
- Mobile ordering is seeing good traction, we understand. In H118, the company reported a 61% increase in mobile visitors to 3.8m. We look forward to further updates.
- Progress on consumer credit. In the UK, G4M offers retail point-of-sale credit through an agreement with an external credit provider. The company is changing its provider and plans to roll out the product in Europe.

Investment in scale

G4M continues to invest for future scale. Having raised £4.2m net cash in May 2017, the company has continued to develop its platform and build the management structure. We noted increased stock investment in the first half, intended to improve range and availability. Although the European distribution centres in Sweden and Germany were both opened by the beginning to this financial year, stock investment and operational costs there have continued to support revenue growth as expected. Marketing activities, which were running at 8% of revenue at interim, are continuing to develop, and FY18 bears the costs of moving into the freehold office in York as well as its financing costs.

Forecasts: Confident in FY19 revenue growth

As a result of the significant operational gearing in the business, combined with management's unchanged commitment to investing for scale, the marginal shading of FY18 full-year revenue against our forecast is likely to have a disproportionate effect on earnings. However, we do not expect that to affect FY19 or FY20 significantly, where we believe our forecasts remain prudent.

Exhibit 1: Changes to forecasts

	FY18e	FY18e	Change	FY19e	FY19e	Change	Growth	FY20e	FY20e	Change	Growth
£000	Old	New	%	Old	New	%	%	Old	New	%	%
Revenue	81,410	80,100	(1.6)	102,116	102,113	(0.0)	27.5	127,347	127,282	(0.1)	24.6
EBITDA	4,092	3,652	(10.8)	5,150	4,953	(3.8)	35.6	6,664	6,669	0.1	34.7
Normalised operating profit	2,648	2,160	(18.4)	3,589	3,391	(5.5)	57.0	4,746	4,747	0.0	40.0
Operating margin	3.3	2.7	(17.1)	3.5	3.3	(5.5)	0.6	3.7	3.7	0.1	0.4
Profit before tax (norm)	2,360	1,720	(27.1)	3,325	3,127	(6.0)	81.8	4,482	4,483	0.0	43.4
EPS (p)	10.0	7.3	(27.1)	13.3	12.5	(6.0)	72.2	18.0	18.0	0.0	43.4
Net cash/(debt)	(3,852)	(3,509)	8.9	(4,680)	(4,367)	6.7	(24.5)	(4,856)	(4,541)	6.5	(4.0)

Source: Edison

In the second half of FY18, revenue was very slightly lower than our forecast, mainly because the rate of growth in the final two months did not increase, despite a relatively weaker base in the previous year. We reduce our EBITDA forecast to £3.6m, flat compared with FY17 and in line with management's guidance. We also include gross margin slightly lower at 25.6% against our previous forecast of 25.8%, and translational currency differences.

At this stage, we remain very confident in our FY19 revenue forecast of £102.1m. It represents 27% growth against FY18, significantly lower than the growth actually experienced in January and

February. A 3% trim to our EBITDA forecast is the result of our assuming that a 0.2 percentage point reduction in gross margin carries on through FY19. We expect net debt slightly lower than our previous forecast as a result of working capital requirements at lower levels.

Valuation: Upside on both our metrics

We retain our valuation approach, referring both to peer multiples and our DCF projections:

Peer group valuations

Short-term P/E and EV/EBITDA multiples now stand at a significant discount to the average P/E of pure-play online retailers, while close to their average EV/EBITDA multiples. On an EV/sales basis, G4M stands at a significant discount in both years:

Exhibit 2: Comparative peer valuations

	Year end	Market cap (m)	EV/sales FY19e (x)	EV/sales FY20e (x)	P/E FY19e (x)	P/E FY20e (x)	EV/EBITDA FY19e (x)	EV/EBITDA FY20e (x)
ASOS	August	5,896	1.9	1.5	65.2	52.1	30.3	23.7
Boohoo	February	1,955	2.3	1.7	48.6	37.8	25.8	19.1
Yoox Net-A-Porter	December	5,085	1.8	1.5	63.8	45.6	22.3	16.8
Zalando	December	10,549	1.4	1.2	63.5	49.4	27.4	21.5
Average			**1.8**	**1.5**	**60.3**	**46.2**	**26.5**	**20.3**
G4M	February		1.3	1.1	50.4	35.2	27.3	20.3
Premium/(discount)			(28.2%)	(28.2%)	(16.4%)	(23.9%)	3.3%	0.0%

Source: Bloomberg, Edison. All calendarised to February.

Adjusted to the average of the peer group for the FY19e and FY20e years on a P/E basis, G4M would be valued at 793p per share, or 622p on an EV/EBITDA basis, an average of 707p.

DCF valuations

On a reverse DCF basis, we estimate that, under consistent assumptions, G4M's current share price (which is now about 25% lower than it was in October 2017) implies around nine years to reach market share of 6% in mainland Europe starting in FY19, equivalent to that which it currently enjoys in the UK (we previously estimated six to seven years). It effectively took six years to build this level of market share in the UK, from insignificant levels. Therefore, if G4M takes less than nine years to develop this market share (at constant economic ratios), then there is a share price opportunity. For example, if it achieves it in seven years, that would be equivalent to a share price valuation of 726p, or if in six years, 831p.

European expansion is now a major strategic focus for G4M, which is also better organised, resourced and experienced than it was when it began to build its share of the UK market. In addition, it has the benefit of the May 2017 placing, which raised £4.2m of additional growth capital specifically aimed at accelerating expansion. On the other hand, it is true that there is more organised online competition in mainland Europe. G4M needs to negotiate the enhanced risks of setting up operations in different geographies, although it has made significant progress with its centres in Germany and Sweden.

Exhibit 4: Financial summary

£000s	2016	2017	2018e	2019e	2020e
Year end: February	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT					
Revenue	35,489	56,128	80,100	102,113	127,282
Cost of Sales	(26,303)	(40,983)	(59,555)	(75,766)	(94,326)
Gross Profit	9,186	15,145	20,545	26,347	32,956
EBITDA	1,688	3,656	3,652	4,953	6,669
Operating profit (before amort. and except).	903	2,655	2,160	3,391	4,747
Amortisation of acquired intangibles	0	0	0	0	0
Exceptionals	(606)	0	0	0	0
Share-based payments	(8)	(39)	(64)	(65)	(82)
Reported operating profit	289	2,616	2,096	3,326	4,665
Net Interest	(283)	20	(440)	(264)	(264)
Joint ventures & associates (post tax)	0	0	0	0	0
Exceptionals	0	0	0	0	0
Profit Before Tax (norm)	620	2,675	1,720	3,127	4,483
Profit Before Tax (reported)	6	2,636	1,656	3,062	4,401
Reported tax	(49)	(322)	(206)	(500)	(717)
Profit After Tax (norm)	571	2,353	1,513	2,626	3,765
Profit After Tax (reported)	(43)	2,314	1,449	2,562	3,684
Minority interests	0	0	0	0	0
Discontinued operations	0	0	0	0	0
Net income (normalised)	571	2,353	1,513	2,626	3,765
Net income (reported)	(43)	2,314	1,449	2,562	3,684
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	7.3	12.6	18.0
EPS - normalised (p)	3.1	11.6	7.3	12.5	18.0
EPS - basic reported (p)	(0.2)	11.5	7.0	12.3	17.7
Dividend per share (p)	0.00	0.00	0.00	0.00	0.00
Revenue growth (%)	46.4	58.2	42.7	27.5	24.6
Gross Margin (%)	25.9	27.0	25.6	25.8	25.9
EBITDA Margin (%)	4.8	6.5	4.6	4.9	5.2
Normalised Operating Margin	2.5	4.7	2.7	3.3	3.7
BALANCE SHEET					
Fixed Assets	4,477	7,102	13,718	14,751	15,853
Intangible Assets	3,238	5,537	6,094	6,612	7,083
Tangible Assets	1,239	1,565	7,623	8,139	8,770
Investments & other	0	0	0	0	0
Current Assets	11,194	16,035	20,625	23,779	28,158
Stocks	6,906	11,686	14,515	18,135	22,333
Debtors	740	1,348	1,924	2,452	3,057
Cash & cash equivalents	3,548	3,001	4,187	3,192	2,769
Other	0	0	0	0	0
Current Liabilities	(6,022)	(10,000)	(10,841)	(13,112)	(15,666)
Creditors	(5,188)	(7,379)	(7,873)	(10,044)	(12,500)
Tax and social security	0	0	0	0	3
Short term borrowings	(834)	(2,621)	(2,969)	(3,069)	(3,169)
Other	0	0	0	0	0
Long Term Liabilities	(290)	(1,415)	(5,988)	(5,343)	(4,526)
Long term borrowings	(127)	(24)	(4,728)	(4,491)	(4,141)
Other long term liabilities	(163)	(1,391)	(1,260)	(851)	(385)
Net Assets	9,359	11,722	17,514	20,075	23,820
Minority interests	0	0	0	0	3
Shareholders' equity	9,359	11,722	17,514	20,075	23,823
CASH FLOW					
Op Cash Flow before WC and tax	1,688	3,656	3,652	4,953	6,669
Working capital	(1,416)	(3,618)	(2,911)	(1,978)	(2,346)
Exceptional & other	(607)	28	(64)	(65)	(82)
Tax	0	(104)	(206)	(500)	(717)
Net operating cash flow	(335)	(38)	471	2,409	3,524
Capex	(1,509)	(2,195)	(7,680)	(2,595)	(3,025)
Acquisition: deferred payments	0	0	(409)	(409)	(409)
Net interest	(130)	(47)	(440)	(264)	(264)
Equity financing	9,535	0	4,193	0	0
Dividends	0	0	0	0	0
Other	0	0	0	0	0
Net Cash Flow	7,561	(2,280)	(3,865)	(858)	(174)
Opening net debt/(cash)	4,974	(2,587)	(356)	3,509	4,367
FX	0	0	0	0	0
Other non-cash movements	0	49	0	0	0
Closing net debt/(cash)	(2,587)	(356)	3,509	4,367	4,541

Source: G4M, Edison

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