EDISON

Gear4music Holdings

Interim results

Ready to rock

Retail

While revenue and customer KPIs continue to grow robustly, Gear4music (G4M) is preparing the next stage of expansion. The first half saw the start of the planned investment associated with the May placing, the new head office structure, and the move to positive contribution in the two European hubs. It ends with the launch of the US$ website opening a new front in a larger market, and the company strongly positioned for the key pre-Christmas season.

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	259.9	98.9
02/17	56.1	3.7	2.7	11.6	69.9	46.3
02/18e	81.4	4.1	2.4	10.0	81.3	42.2
02/19e	102.1	5.2	3.3	13.3	60.9	33.8

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

H1 results: Strong trading, reloading for next stage

After a first half focused on expected investment and positioning for the next stage of expansion, G4M reported strong interim revenue growth of 44% y-o-y to £31.2m with pre-tax profit at break-even. Margin pressures have been well managed and, as planned, significant investment has been laid down ahead of the key second-half trading period. KPIs are ahead across the board and the two European hubs have ended the period profit-positive.

Market share growth progress and prospects

From UK origins, G4M has progressively developed strategies to penetrate wider markets. Its development to date has been marked by phases in which fund-raising rounds for investment have preceded step changes in expansion. The May fund-raise of £4.2m (net) is associated with the current investment stage, including key management hires and the new headquarters, and G4M has now announced the launch of its US$ website, opening a new front in a significantly larger market.

Forecasts: Stable with margin pressures reducing

Given the strong customer KPIs, we expect H218 revenue growth at similar rates to H1. We expect currency-based margin pressures to abate, while administrative costs should settle from 24.9% in H1 to 22.6% for the year, in keeping with FY17. As a result, we leave our profit forecast unchanged, in line with guidance.

Valuation: Pricing market share gains

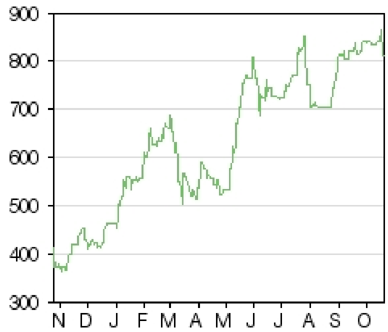
The share price reflects the strong growth expectations associated with significant market share gains. Short-term P/E and EV/EBITDA multiples remain top of the range of currently profitable pure-play online retailers, against peers that are more established in international markets outside Europe. G4M's current share price implies seven years to reach market share of 6% in mainland Europe. Achieving that one year earlier would imply 1094p. Alternatively, overlaying a 1% share of the US market developed over the next 10 years would be equivalent to a share price of 949p. The two combined would be equivalent to a share price of 1258p.

23 October 2017

Price	**812.5p**
Market cap	**£170m**

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	(1.8)	(0.4)	118.1
Rel (local)	(5.0)	(1.2)	101.6
52-week high/low		865.0p	363.5p

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

Trading statement	Early January 2018
Pre-close	Early March 2018
Preliminary results	May 2018

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Edison profile page

Gear4music Holdings is a research client of Edison Investment Research Limited

Interim results: Strong trading, reloading for next stage

Expected investment and positioning for further expansion

After a first half focused on expected investment and positioning for the next stage of expansion, G4M has reported interim results with strong revenue growth of 44% y-o-y to £31.2m and pre- and post-tax profit at break-even levels.

Exhibit 1: H118 results

£000s	H117	H118	Growth
Revenue	21,609	31,219	44.5%
Gross profit	5,754	7,811	35.7%
Gross margin (%)	26.6%	25.0%	(1.6)pp
EBITDA	1,366	746	(45.4%)
EBITDA margin	6.3%	2.4%	(3.9)pp
Operating profit	916	57	(93.8%)
Operating margin (%)	4.2%	0.2%	(4.0)pp
PBT	994	(40)	(104.0%)
PAT	778	33	(95.8%)

Source: G4M, Edison Investment Research. Note: EBITDA, operating profit and PBT are before exceptional costs, share-based payments and non-recurring interest charges.

Underlying momentum was strong both in the core UK market, up 30%, and particularly in the strategic focus market of Europe, up 70%, including maiden full trading periods at the two new distribution centres in Sweden and Germany. The company's own branded products grew by 61%, faster than other branded products (41%), to reach a level of 24% of total sales.

Margin pressure mitigated

Gross margin eased 1.6 percentage points to 25.0% as the company managed cost increases. Its own-brand products are purchased in US dollars, against which the GB pound was 8% weaker in the period. Purchases of other brand products, although mainly negotiated in GB pounds, are also inevitably affected by sterling weakness. These pressures were mitigated in part through investment in the customer proposition and in part by the higher margin associated with relatively stronger growth of its own products.

Operating costs reflect European footprint

Operating costs totalling £7.8m rose from £4.9m at H117, an increase from 22.5% to 24.9% of revenue. That overall increase was largely accounted for by the two European hubs, at 2.2 percentage points of the total 2.4 point increase.

Exhibit 2: Operating costs

Operating cost analysis	H117	% of revenue	H118	% of revenue
£000s				
Marketing costs	1,760	8.1%	2,538	8.1%
UK labour costs	1,730	8.0%	2,612	8.4%
Depreciation and amortisation	450	2.1%	689	2.2%
European hub costs			701	2.2%
Other costs	926	4.3%	1,243	4.0%
Total	**4,866**	**22.5%**	**7,783**	**24.9%**

Source: G4M, Edison Investment Research

Investment in necessary management

As flagged in the full-year results and at pre-close, the first half, which included the £4.2m fund-raise in May 2017, was a period of investment into the proposition and infrastructure that increased operational costs. During the period, needed hires were made, particularly in the sales and buying functions, and the half also bore the full-period costs of senior hires in the second half of FY17. Marketing costs continued at 8.1% of revenue, and depreciation and amortisation rose as a result of continued investment into the software platform.

Performance indicators: Progression across the board

Customer KPIs demonstrate underlying progression across the board:

Exhibit 3: Customer KPIs

	H116	FY16	H117	FY17	H118
Unique visitors (m)	4.41	10.1	5.6	12.6	7.1
y-o-y growth			27%	25%	27%
UK conversion rate (%)	2.45	3.08	3.20	3.64	3.59
Change y-o-y (ppts)			0.75	0.56	0.39
European conversion rate (%)	0.86	1.21	1.49	1.82	2.14
Change y-o-y (ppts)			0.63	0.61	0.65
Total conversion rate (%)	1.79	2.28	2.38	2.75	2.84
Change y-o-y (ppts)			0.59	0.47	0.46
Average order value (£)	115.67	115.74	125.64	124.02	131.66
y-o-y growth			9%	7%	5%
Active customers	187,840	226,000	272,340	340,000	390,790
y-o-y growth			45%	50%	43%
Proportion of repeat customers (%)	28.4	25.5	28.2	23.7	25.8
Change y-o-y			(0.2)	(1.8)	(2.4)
Trustpilot rank	9.5	9.5	9.5	9.6	9.6
Change y-o-y			0.0	0.1	0.1
E-mail subscriber database	325,937	306,000	601,011	650,000	725,594
y-o-y growth			84%	112%	21%

Source: G4M reports and presentations

Unique visitors to the website continue to grow at a substantial and consistent rate, reflecting the bias to new users, also apparent in the reduced proportion of repeat customers. G4M achieves payback on customer acquisition costs from the first transaction, on average.

Conversion rates continue to move upwards, as they have in every half-year reporting period over the past two years. They grew particularly strongly in Europe, and the convergence of European with UK rates represents a sizeable opportunity. Similarly, average order value continues to increase year-on-year, and at £132 indicates that customers are using the website for purchases of serious value. G4M maintains its high-quality Trustpilot score of 9.6, achieved for FY17. And the email database continues to grow significantly at 21%, on top of the transformative 84% a year ago.

European hubs – one year in

The Swedish hub near Stockholm opened in November 2016 and the German one near Dusseldorf in February 2017. It is therefore nearly a year since the physical move to continental Europe was launched. In May, we noted that the German centre was at an early stage of trading and was likely to remain inefficient during H118. However, by August 2017 both the centres were making positive contributions to central costs, a promising position to be in ahead of the busier second half. With half-year costs of £0.7m and assuming similar gross margin to the rest of the business, it could be inferred that run-rate annual revenue from the centres is currently £5-6m, or some 7% of revenue.

This profitable position is significant in that it indicates that the process of setting up the international centres has been successfully executed. This is no small achievement for a business that was previously purely UK-based. It is an important result for a business that targets international markets. It has been a significant learning phase for management that reduces the risks associated with further international expansion. It puts the international operation in a strong position ahead of the busy second-half trading period.

Investment in the balance sheet

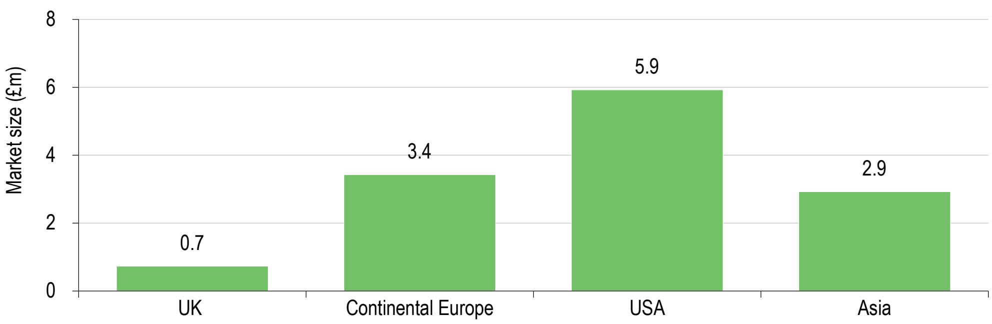
Having raised £4.2m net cash in May 2017, G4M has invested in stock as planned, supporting continuing revenue growth. Stock increased from £9.3m at August 2016 to £13.0m at 31 August 2017, although the 39% increase is lower than the rate of increase in revenue, and we forecast a further increase to £15.5m by year-end. This should be partly mitigated by a reduction in receivables, which was inflated at August by prepaid stock on water, cash-in-transit and funds lodged with payment providers, as well as property-related prepayments. We forecast receivables reducing from £2.3m at interim to £2.0m at year-end.

The company also invested £5.6m in its UK Head Office freehold in York, although this was debt-financed via term loans of £5.5m. As a result, net debt was £3.7m against net cash of £0.9m at August 2016.

A measured approach to market share growth

From its origins in the UK G4M has progressively developed strategies to penetrate wider markets, and currently has delivery available to over 190 countries. At IPO, management identified the UK and continental European as the major strategic growth areas and identified their market sizes. With FY17 results, the equivalent markets in the US and Asia were also identified:

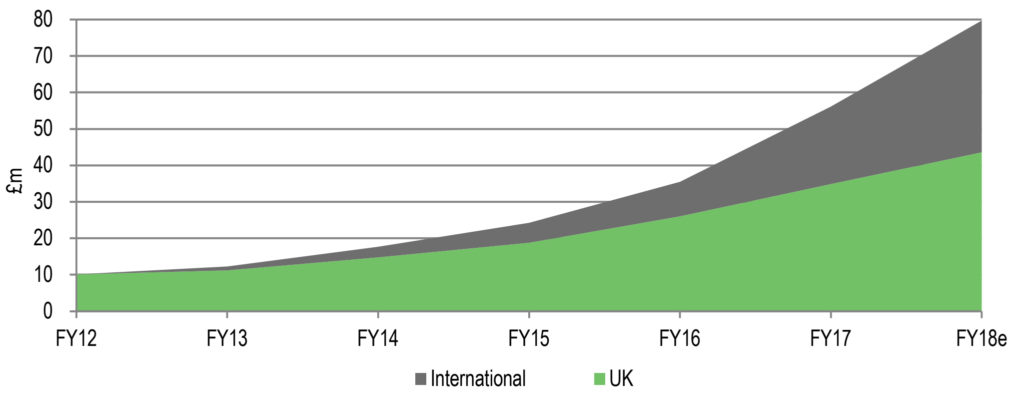
Exhibit 3: Musical instrument and equipment markets



Source: G4M May 2017 presentation, Edison. Translated at US$/£1.30.

The company's successful incursion into Europe is the result of a consistent strategy of investing in the European market opportunity, including 18 individual native language websites that look and feel local to European nationals, the local distribution hubs in Sweden and Germany, and the functional support for a much larger marketing and distribution operation.

Exhibit 5: Cumulative UK and international revenue



Source: G4M, Edison

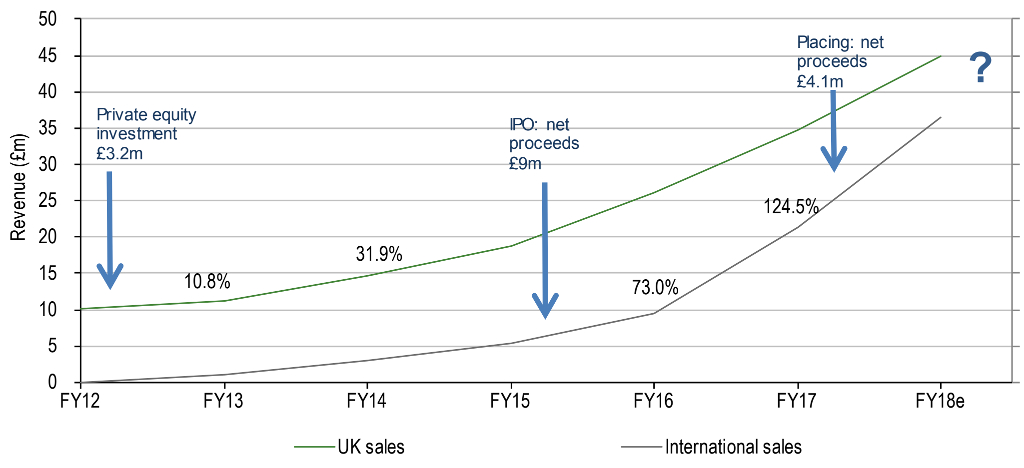
These actions have resulted in international revenue (largely European to this point) taking the lead in terms of rate of growth, while UK growth remains substantial.

A pattern of investment and step changes in growth

G4M's development to date has been marked by phases in which fundraising rounds for investment have preceded step changes in revenue growth.

- In March 2012, private equity invested £3.2m in the business. In the following financial year, FY14, UK revenue growth accelerated from 10.8% to 31.9%.
- In June 2015, the company raised £9m at IPO, using half of the funds to pay down loan notes and releasing the remainder for investment in the business with a key aim of international expansion and citing the European market. In the following financial year, FY17, international (largely European) growth accelerated from 73.0% to 124.5%.
- In May 2017, the company raised £4.2m net in a placing combined with a smaller warrant exercise. Reasons given, as well as investment in bespoke platforms, supply chain, infrastructure (including the new HQ) and marketing initiatives, also covered "investment in international expansion, including an acceleration of translation activities and additional multilingual resource". The company has now announced the launch of its US$ website.

Exhibit 6: Phasing of funding rounds against revenue growth rates, UK and international



Source: G4M, Edison

Although it would be simplistic to assume a causal relationship, what has been apparent in the company's record is a measured use of investment to prepare for phases of expansion, driven by market share. With this perspective, it would be logical to regard the company as being at the front end of further phases of expansion, where over time it could develop a share of a much larger market.

Forecasts: Stable picture with margin pressures reducing

Given the strong customer KPIs, we expect second-half revenue to grow by similar rates to the first, both in the UK and internationally. We also expect foreign exchange pressures on margins to reduce in the second half, taking into account the lead times between contracting for stock and its impact on cost of sales. This should add to the characteristically stronger underlying second-half gross margin trend to lift it to 25.8% in the full year from 25.0% in H1. As sales accelerate and the European hubs become more efficient, administrative costs (excluding depreciation and amortisation) should settle from 24.8% in H1 to 22.6% for the full year, more in keeping with the 22.3% achieved in FY17. As a result, we leave our profit forecast unchanged. Our net debt forecast of £3.9m is also unchanged.

Valuation

Multiples price in strong growth

The shares reflect the strong growth expectations associated with significant market share gains both in the UK and newer geographies where G4M trades. Short-term P/E and EV/EBITDA multiples are top of the range of pure-play online retailers that are currently profitable (AO World and Koovs are not):

Exhibit 7: Comparable valuation multiples for pure-play retailers

Company name	Share price (p)	Market cap (£m)	Year end	Year 1 P/E (x)	Year 2 P/E (x)	Year 3 P/E (x)	Year 1 EV/ EBITDA (x)	Year 2 EV/ EBITDA (x)	Year 3 EV/ EBITDA (x)	Year 1 EV/sales (x)	Year 2 EV/sales (x)	Year 3 EV/sales (x)
Gear4music	812.5	170	Feb	78.9	60.2	45.1	41.5	33.2	25.5	2.1	1.7	1.3
Boohoo	195.5	2,247	Mar	72.4	55.9	41.6	41.1	30.1	22.1	3.9	2.9	2.1
ASOS	5502	4,590	Aug	56.7	45.1	36.4	26.3	20.8	16.2	1.8	1.5	1.2
Zalando	41.566	9,244	Dec	55.9	42.5	31.0	25.2	19.4	15.3	1.7	1.4	1.2
Yoox Net-A-Porter	32.34	3,895	Jan	48.9	35.5	30.8	18.5	14.1	11.0	1.7	1.5	1.2
AO World	112	514	Mar	N/A	N/A	N/A	N/A	42.1	19.2	0.6	0.6	0.5
Koovs	27	47	Mar	N/A	N/A	N/A	N/A	N/A	N/A	1.6	0.6	0.3
Average (excl G4M)				**58.5**	**44.7**	**35.0**	**27.8**	**25.3**	**16.8**	**1.9**	**1.4**	**1.1**

Source: Bloomberg, Edison Investment Research. Note: Calendarised to February year end. Prices at 19 October 2017.

We believe this reflects the fact that peers such as Boohoo and ASOS are more established in terms of their penetration of international markets beyond Europe, and that G4M therefore has a greater market opportunity.

Our valuation approach: Discounting market share gains

The investment case for G4M is based on its ability to continue to win market share in a fragmented market sector both in the UK and internationally.

Our DCF projection indicates, under consistent assumptions, the current share price implies that, from its current year level of 1%, G4M takes seven years to reach a market share of 6% in mainland Europe, equivalent to that which we forecast in the UK for the full year FY18 (the current market share for the 12 months to August 2017 is 5.2%). It will have taken six years to build this level of market share in the UK, from insignificant levels. If G4M takes less than seven years to develop the same market share in Europe (at constant profitability ratios), then there is a share price opportunity. For example, if it achieves it one year earlier, that would be equivalent to a share price valuation of 1110p on our current analysis.

The prospect of faster European share growth is supported by G4M's adoption of European expansion as a major strategic focus. The company is specifically organised around this strategy, and is better resourced and experienced than it was eight years ago. In addition, it has the benefit of the May 2017 fund-raise, which secured £4.2m of additional growth capital specifically aimed at accelerating expansion. We therefore believe it is reasonable to expect that G4M will develop its market share over this time frame.

However, this scenario is not without risk. There is more organised online competition in mainland Europe, and management has the additional task of setting up operations in different geographies, although with the successful set-up of the Swedish and German hubs now confirmed, much of this learning is already behind it.

With the launch of the US$ website, the dimensions of the longer term market prospects potentially expand, producing an overlay to the scenario. If, instead of faster share gains in Europe, G4M develops a share of the US musical instrument and equipment market rising to, say, 1% over the next 10 years, this would be equivalent to a share price of 967p. In a more positive scenario in which G4M is able to achieve both the faster European growth described above and also a 1% US market share over 10 years, that would be equivalent to a share price of 1274p.

Exhibit 8: Financial summary

	£000	2016	2017	2018e	2019e	2020e
Year end: February		IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue		35,489	56,128	81,410	102,116	127,347
Cost of Sales		(26,303)	(40,983)	(60,399)	(74,931)	(93,328)
Gross Profit		9,186	15,145	21,011	27,186	34,019
EBITDA		1,688	3,656	4,092	5,150	6,664
Operating profit (before amort. and except).		903	2,655	2,648	3,589	4,746
Amortisation of acquired intangibles		0	0	0	0	0
Exceptionals		(606)	0	0	0	0
Share-based payments		(8)	(39)	(64)	(65)	(81)
Reported operating profit		289	2,616	2,584	3,525	4,664
Net Interest		(283)	20	(288)	(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	2,360	3,325	4,482
Profit Before Tax (reported)		6	2,636	2,296	3,261	4,400
Reported tax		(49)	(322)	(283)	(532)	(717)
Profit After Tax (norm)		571	2,353	2,077	2,793	3,765
Profit After Tax (reported)		(43)	2,314	2,012	2,729	3,683
Minority interests		0	0	0	0	0
Discontinued operations		0	0	0	0	0
Net income (normalised)		571	2,353	2,077	2,793	3,765
Net income (reported)		(43)	2,314	2,012	2,729	3,683
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	17.7
Dividend per share (p)		0.00	0.00	0.00	0.00	0.00
Revenue growth (%)		46.4	58.2	45.0	25.4	24.7
Gross Margin (%)		25.9	27.0	25.8	26.6	26.7
EBITDA Margin (%)		4.8	6.5	5.0	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	13,718	14,730	15,811
Intangible Assets		3,238	5,537	6,094	6,612	7,083
Tangible Assets		1,239	1,565	7,623	8,119	8,728
Investments & other		0	0	0	0	0
Current Assets		11,194	16,035	21,225	24,340	28,712
Stocks		6,906	11,686	15,426	19,008	23,200
Debtors		740	1,348	1,955	2,452	3,058
Cash & cash equivalents		3,548	3,001	3,844	2,880	2,454
Other		0	0	0	0	0
Current Liabilities		(6,022)	(10,000)	(10,925)	(12,970)	(15,495)
Creditors		(5,188)	(7,379)	(7,957)	(9,901)	(12,329)
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	18,029	20,758	24,502
Minority interests		0	0	0	0	3
Shareholders' equity		9,359	11,722	18,029	20,758	24,505
CASH FLOW						
Op Cash Flow before WC and tax		1,688	3,656	4,092	5,150	6,664
Working capital		(1,416)	(3,618)	(3,769)	(2,134)	(2,370)
Exceptional & other		(607)	28	(64)	(65)	(81)
Tax		0	(104)	(283)	(532)	(717)
Net operating cash flow		(335)	(38)	(25)	2,419	3,496
Capex		(1,509)	(2,195)	(7,680)	(2,573)	(2,999)
Acquisition: deferred payments		0	0	(409)	(409)	(409)
Net interest		(130)	(47)	(288)	(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)	(4,208)	(827)	(176)
Opening net debt/(cash)		4,974	(2,587)	(356)	3,852	4,680
FX		0	0	0	0	0
Other non-cash movements		0	49	0	0	0
Closing net debt/(cash)		(2,587)	(356)	3,852	4,680	4,856

Source: G4M, Edison