Sponsored Research

Lewis Group

ANCHOR STOCKBROKERS

Up for the challenge

Date: 02 June 2022

- Lewis produced an impressive set of FY22 results beating our HEPS expectations by a considerable margin – 849c vs 764c. Revenue was broadly in line with the beat coming from strong cost containment (up only 6.5% on FY20). The quality of the debtors book continues to improve, driving debtors costs (credit losses) down from 14% to 12% of gross debtors. The full year dividend of 413c was modestly short of our 420c estimate, equating to a historic yield of 8%.
- As anticipated credit sales (+17%) grew stronger than cash sales (+6%) given robust cash sales during COVID-19. Credit sales as a % of total sales remains historically low at 51.4% with management guiding towards a medium-term target of 52-56%. As affordability pressures face consumers, credit will grow as an enabler of sales. GP margins declined from 41.8% to 40.5% given rising shipping costs and supply constraints and we forecast it to remain at these lower levels in FY23E.
- The impact of rising credit sales is not immediately felt in the other revenue categories which are credit sales dependent. Other revenue only experienced 2.8% growth. Finance income (+0.7%), the biggest component, is still negatively impacted by the low interest rates levied in 2020/1 and this will take time to work through the book (ave duration of 32.7 months). We have the yield beginning to rise in FY23E. Ancillary income includes extended warranty insurance that only kicks in after 12 months - this grew an insignificant 0.2%. Insurance income (+9.7%) is more reflective of credit sales growth but also requires upfront policy charges. We have other revenue rising 6% and 10% in FY23E and FY24E.
- The debtors book quality continues to improve, benefiting from 35% of collections via debit orders - management is targeting 50% in two years. This will ensure debtors costs remain well managed with elevated collection rates – 79% vs 76.3% pre COVID-19. The higher the quality of the book the greater the potential for resales. Total provisions to debtors declined from 42.6% to 40.4% but is more a reflection of a better book as the provision coverage of arrears and non-performing accounts increased.
- Management's outlook for FY23E is cautious for the various market prevailing reasons that are impacting consumer affordability and the sales outlook. Credit sales coupled with high stock levels should position the group for market share gains. Pepkor Holdings' furniture credit sales appetite is considerably lower with a 12% credit sales mix.
- We make minor adjustments to our FY23E (930c, +10%) and FY24E (1132c, +22%) HEPS despite the higher base reported in FY22. This is a result of a lower forecast operating margin for FY23E. FY24E benefits from rising other revenue growth and improved gross and operating margins. We anticipate a dividend payout ratio of 53%, equating to a 493c DPS, a forward dividend yield of 9.8%. Share buy backs continue and already 48% of its latest buy back mandate has been completed. R353m was spent on share buy backs in FY22, which added to the circa R270m dividend payment equates to a shareholder return of around 20%.
- Lewis is trading on an attractive forward 12m P/E of 5.4x and an EV/EBITDA of 3.1x. We have ROE's rising from 11.7% to 12.7% in FY24E – management is targeting 15% in 5 years which would be positive for the stocks rating. In our DFCF valuation we calculate a fair value range of R66.94-R80.32, a mid-point of R73.

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Price (02/06/2022):	R50.19
Market cap	R3154mn
Shares in issue	62.84mn

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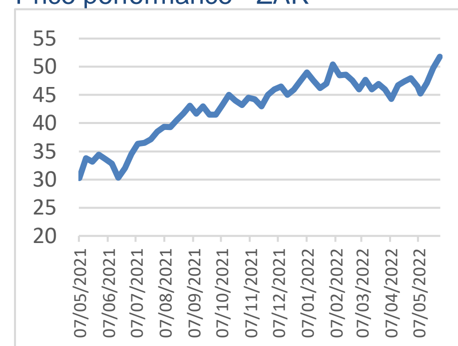
Price performance - ZAR



Source: FactSet

Figure 1 Financial summary

Year Ending	FY2019 A	FY2020 A	FY2021 A	FY2022 A	FY2023 F	FY2024 F	FY2025 F
Income Statement							
Merchandise Sales	3,520	3,686	3,931	4,383	4,778	5,187	5,638
Sales growth (%)	*22.9%*	*4.7%*	*6.7%*	*11.5%*	*9.0%*	*8.6%*	*8.7%*
Gross profit	1,451	1,512	1,642	1,775	1,935	2,127	2,340
growth %	*22.2%*	*4.2%*	*8.6%*	*8.1%*	*9.0%*	*9.9%*	*10.0%*
Finance income	1,248	1,312	1,271	1,280	1,357	1,490	1,650
growth %	*-8.4%*	*5.1%*	*-3.1%*	*0.7%*	*6.1%*	*9.8%*	*10.8%*
Insurance income	647	666	707	776	833	921	1,026
growth %	*-3.5%*	*2.9%*	*6.2%*	*9.7%*	*7.4%*	*10.6%*	*11.4%*
Ancillary income	722	790	817	818	859	947	1,051
growth %	*9.6%*	*9.3%*	*3.4%*	*0.2%*	*5.1%*	*10.2%*	*11.0%*
EBITDA	522	629	1,039	1,095	1,165	1,338	1,496
EBITDA Margin (%)	*14.8%*	*17.1%*	*26.4%*	*25.0%*	*24.4%*	*25.8%*	*26.5%*
EBIT	443	254	696	668	807	933	1,047
EBIT Margin (%)	*12.6%*	*6.9%*	*17.7%*	*15.2%*	*16.9%*	*18.0%*	*18.6%*
Profit before tax	464	273	604	674	769	907	1,022
Net profit	310	182	433	483	559	658	741
Net profit post minorities	310	182	433	483	559	658	741
Headline Earnings	308	205	463	561	559	658	741
Basic EPS (ZAc)	377	232	576	731	930	1,132	1,275
Headline EPS (ZAc)	376	260	617	849	930	1,132	1,275
% growth	*24.3%*	*-30.8%*	*137%*	*37.7%*	*9.6%*	*21.7%*	*12.6%*
DPS (ZAc)	234	185	328	413	493	623	727
Payout ratio (%)	*61.1%*	*78.9%*	*56.9%*	*56.5%*	*53.0%*	*55.0%*	*57.0%*
Balance Sheet							
Cash and Cash equivalents	205	1,193	447	308	115	219	242
Current asset (ex – cash)	4,425	4,368	4,588	4,739	4,988	5,380	5,804
Net Fixed assets	299	1,018	1,021	1,144	1,365	1,581	1,784
Intangible assets	310	308	297	258	258	258	258
Investments	276	228	254	266	282	299	317
Other assets	274	273	218	193	201	223	243
Total assets	**5,789**	**7,388**	**6,823**	**6,907**	**7,210**	**7,961**	**8,648**
Debt	0	922	0	81	0	0	0
Current liabilities	783	1,052	1,295	1,305	1,389	1,462	1,540
Other liabilities	130	705	656	805	854	900	947
Total liabilities	**913**	**2,679**	**1,951**	**2,190**	**2,243**	**2,362**	**2,488**
Shareholders' equity	4,876	4,710	4,873	4,717	4,949	5,436	6,150
Minorities	0	0	0	0	0	0	0
Total shareholders' equity	**4,876**	**4,710**	**4,873**	**4,717**	**4,949**	**5,436**	**6,150**
BVPS (ZAR)	*6,080*	*6,124*	*6,812*	*7,523*	*8,728*	*9,938*	*11,244*
ROE (%)	*6.0%*	*4.3%*	*9.7%*	*11.7%*	*11.6%*	*12.7%*	*12.8%*

Cash Flow

Reported net profit	**310**	**182**	**433**	**483**	**559**	**658**	**741**
Change in net working capital	151	-256	-139	-156	-169	-331	-354
Dividends paid	-168	-196	-147	-254	-275	-320	-372
Other adjustments	235	920	661	632	703	834	928
Cash flow from operations	**528**	**650**	**808**	**705**	**818**	**841**	**943**
Net Capex	-79	-104	-119	-67	-129	-145	-152
Capex/sales (%)	*2.2%*	*2.8%*	*3.0%*	*1.5%*	*2.7%*	*2.8%*	*2.7%*
Other investing cash flows	-48	96	23	102	-13	-19	-20
Cash flow from investing	**-127**	**-8**	**-96**	**34**	**-142**	**-164**	**-173**
Equity raised/(bought back)	-105	-123	-136	-408	-250	-100	0
Net inc/(dec) in borrowings							
Other financing cash flows	-671	469	-1,323	-551	-620	-474	-750
Cash flow from financing	**-776**	**347**	**-1,459**	**-959**	**-869**	**-572**	**-747**
Net cash flow	**-375**	**989**	**-747**	**-220**	**-193**	**104**	**24**
Free cash flow	**439**	**179**	**610**	**680**	**657**	**612**	**709**
Repayment of lease liabilities			**-254**	**-297**	**-320**	**-350**	**-375**
Net free cash flow	**439**	**179**	**355**	**384**	**337**	**262**	**334**

Valuation Summary

Valuation Metrics							
Share Price (ZAc)	3,110	1,782	3,050	5,019	5,019	5,019	5,019
P/E (Underlying) (x)	8.3	6.8	4.9	5.9	5.4	4.4	3.9
P/BV (x)	0.5	0.3	0.4	0.7	0.6	0.5	0.4
EV/Sales (x)	1.0	1.0	0.9	0.8	0.8	0.7	0.6
EV/EBITDA (x)	6.9	5.7	3.5	3.3	3.1	2.7	2.4
EV/EBIT (x)	8.2	14.3	5.2	5.4	4.5	3.9	3.5
FCF Yield (%)	14.0	5.7	11.3	12.2	10.7	8.3	10.6
Dividend Yield (%)	7.5	10.4	10.8	8.2	9.8	12.4	14.5
Net debt			359	723	892	986	963
Gearing ratio			7%	15%	18%	18%	16%

Source: Company data, FactSet, ABS estimates

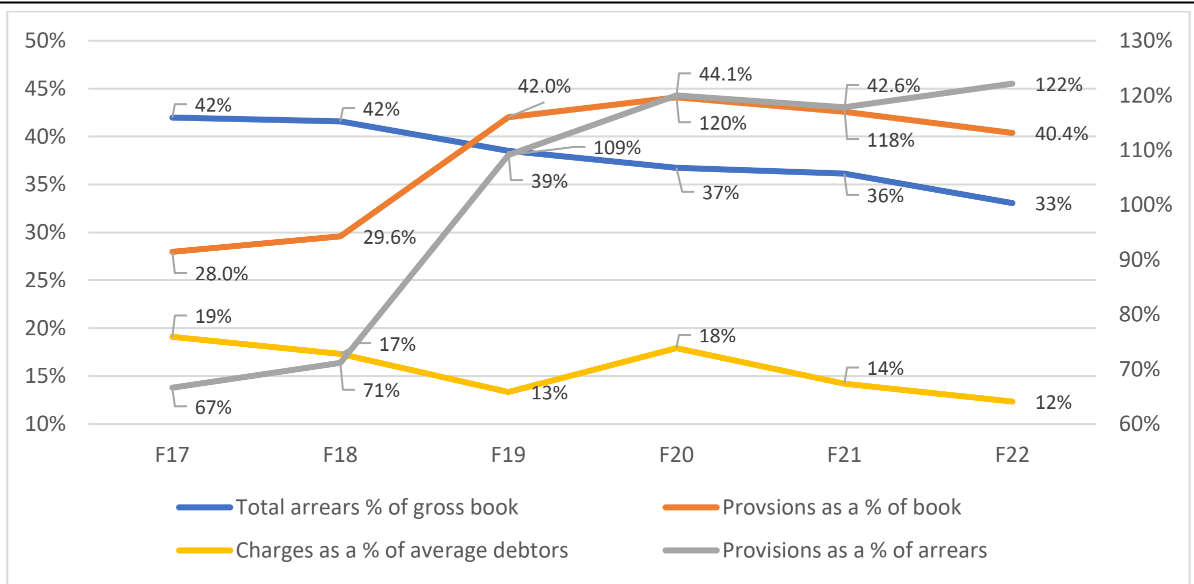
Debtors Book

The debtors book has shown further improvement in credit quality as highlighted by the following trends:

- Satisfactory paid accounts (customers have paid more than 70% of amounts due over the contract period) have risen in value from 62.2% in FY21 to 68.6%. As per the chart below this was 57.9% in FY18. By number, the value is 79%.
- Collection rates have risen to 79% from 76.3% in FY19
- Total arrears have declined from 36% to 33% in FY22.This was as high as 42% in FY18

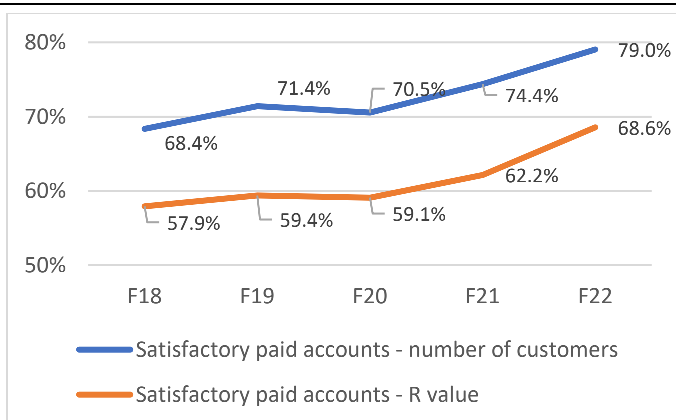
Whilst provisions as a % of the gross book has declined from 42.6% in FY21 to 40.4%, we are not alarmed as the quality of the book is better and therefore warrants lower provisions. Provisions as a % of total arrears rose from 118% to 122%. Pepkor Holdings recently announced that its furniture credit book provisions decreased to 33% from 40% a year earlier, given improved quality and a continued positive collections performance.

Figure 2 Credit quality trends – declining arrears and rising provision coverage



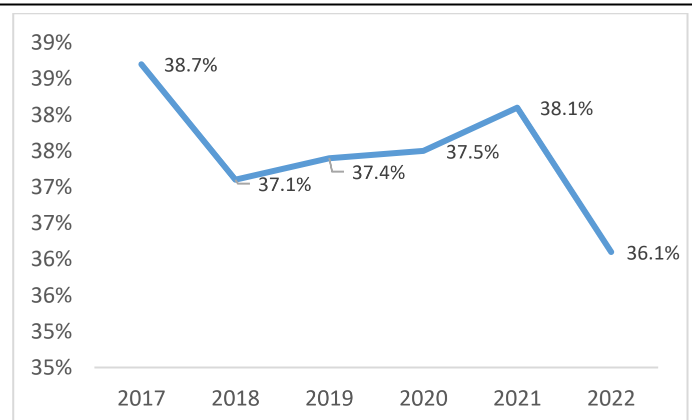
Source: Company data, ABS Research

Figure 3 Satisfactory paid accounts



Source: Company data, ABS Research

Figure 4 Credit application decline rates



Source: Company data, ABS Research

A further test for adequacy of provisions is to look at coverage levels across the arrears in the three categories (satisfactory paid, slow payers, non-performing) of the book. We assume that NPAs should be fully provided for as well as >3-month arrears in the other two categories (we define this as the problematic book). Total provisions provide 148% coverage of the problematic book. We have excess provisions of R744m which represents a general provision of 13% (10% in FY21) of the gross debtors book.

In FY22 provisions of R2300m are adequate to cover:

- All the NPAs totalling R971m
- All the arrears in Slow Payers – totalling R531m
- All the arrears in Satisfactory Paid – R593m

We therefore believe the book is adequately provided for.

Figure 5 Provision coverage of the "problematic book"

Stress test provision levels	F17	F18	F19	F20	F21	F22
Non performing accounts	1484	1452	1285	1261	1238	971
Slow payers > 3m in arrears	483	460	412	383	382	364
Satisfactory paid >3m in arrears	233	211	196	196	216	222
Problematic book	2200	2123	1894	1839	1836	1557
Total group provisions	1561	1620	2323	2534	2424	2300
% coverage	71%	76%	123%	138%	132%	148%
Excess provisions/general provision	-639	-503	429	695	588	744
% of gross debtors	-11%	-9%	8%	12%	10%	13%

Source: Company data, ABS estimates

The sharp drop in the credit decline rate (from 38.1% to 36.1%) is counter cyclical and worthy of monitoring going forward. Management attributes this to attracting lower risk customers and not amending any credit criteria. With repeat sales at approximately 45% from existing clients, as the book improves so should the credit quality of future business. Management went on to add that the debt/income ratios of new customers is below the average of its existing customers and hence better quality.

Earnings Revision

The strong FY22 HEPS was only 9% short of our current FY23E forecast. Revenue was broadly in line with our expectations, although UFO disappointed in the mix due to civil unrest closures and shipping delays given much of its product is imported. The better performance came largely from cost containment. We make the following changes to our earnings outlook:

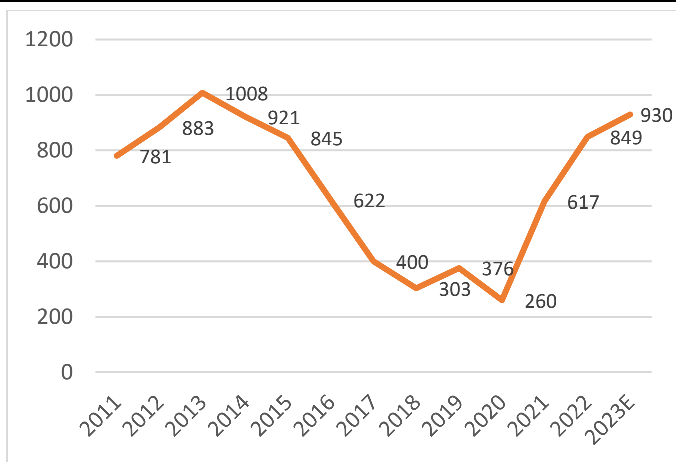
- Merchandise total sales grew by 11.5% in FY22. This contrasts with Pepkor Holdings' furniture retail business which achieved 8.1% over the same period. We marginally increase our current FY23E merchandise sales forecast from R4701m to R4782m (+9%). We anticipate the credit sales mix to rise from 51.4% to 54.5%, reflecting a more difficult operating environment requiring credit as an enabler for sales.
- We reduce the GP margin from 40.6% to 40.5%, which is in line with FY22.
- Other income (Ancillary, Insurance and Finance) was up a very modest 2.8% in FY22E.

- o Finance income is the largest component and in value terms has bottomed out (R1280m vs R1271m in FY21). This is due to the lower fixed interest rate book which currently has an average term of 32.7 months. We calculate the average SA finance rate (repo + 17%) in FY20 was 23.5% which dropped to 20.7% in FY21 and FY22. As the book matures the yield is therefore declining. Management disclosed the ave yield was 19.6% in FY22 (dragged a bit lower by the Rest of Africa operations), down from 21.2% in FY21 and 22.9% in FY20. With new business now done at 21.75%, and rising further given rate hikes, the yield on the book should rise towards circa 22%, an approximate potential 2% widening over the next few years. On our estimated credit sales of R2.6bn it equates to an annual post tax earnings benefit of R38m, 7% of FY22 headline earnings.
- o Ancillary income showed little growth (+0.2%) despite the 17% growth in credit sales. Whilst in the long term it will track credit sales, there is a lag. This is particularly true for the extended warranty cover which only kicks in after a product is one year old as the first year is covered by the manufacturers warranty. Management discloses Ancillary income in two categories. The first is "At a point in time" and would include delivery fees as an example – this was up 7%. The second category is "Over time" and this was down 2% indicating the lagged effect – this would include monthly service charges and extended warranty revenue. We anticipate 5.1% growth in FY23E and 10.2% in FY24E.
- o Insurance income also tracks credit sales. It was up 9.7%, responding quicker to the credit sales growth. There are some upfront costs in the policy which would result in a lag but to a lesser degree. We forecast 7.4% and 10.6% growth in FY23E and FY24E.

- We have operating costs growing 6.9% in FY23E - management is guiding towards 4-8%. Given the inflationary environment we would rather be towards the upper end of guidance. Forecast risk is high as demonstrated by the FY22 results.
- We forecast debts costs at 12.3% and 13% of gross debtors in FY23E and FY24E. FY22 saw an impressive decline in debtors costs, and we don't see this as repeatable in the short to medium term (despite rising debit order collections). It declined from 14% in FY21 to 12%. Managements medium term target is 12-15%.
- The adjusted EBIT margin in FY22 was 17.7% (15.2% post impairments of right of use assets and goodwill). We revise our FY23E EBIT margin estimate down from 17.7% to 16.9% given higher cost growth, rising debtor costs and the lagged impact on other revenue. Management is guiding towards 14-18% in FY23E. We have it rebounding to 18% in FY24E when UFO is anticipated to recover, and other income bounces back following robust credit sales growth.

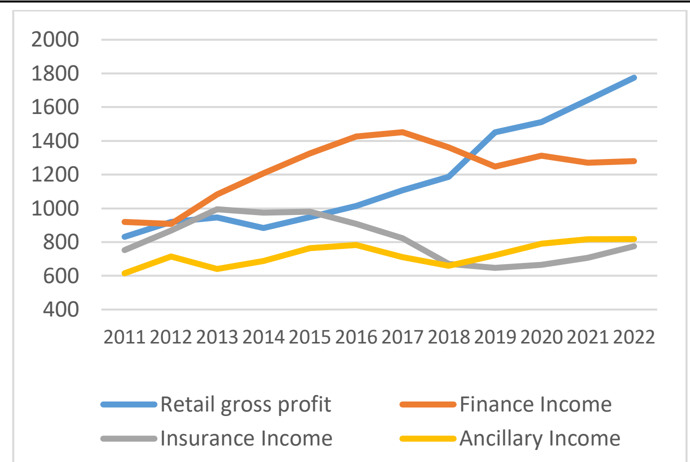
Because of the above changes, we revise our FY23E HEPS from 935c to 930c, up 10% on FY22. We revise FY24E from 1119c to 1132c, up 22%. We model for a 53% dividend payout ratio in FY23E resulting in a 493c dividend, up 19%.

Figure 6 HEPS – ZAc



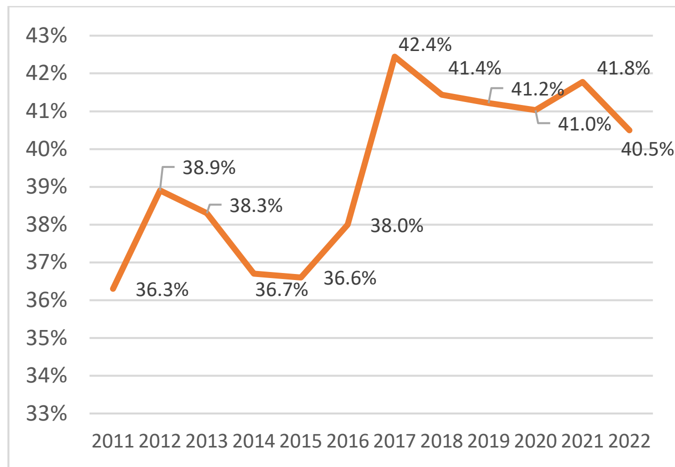
Source: Company data, ABS Research

Figure 7 Revenue sources R'm



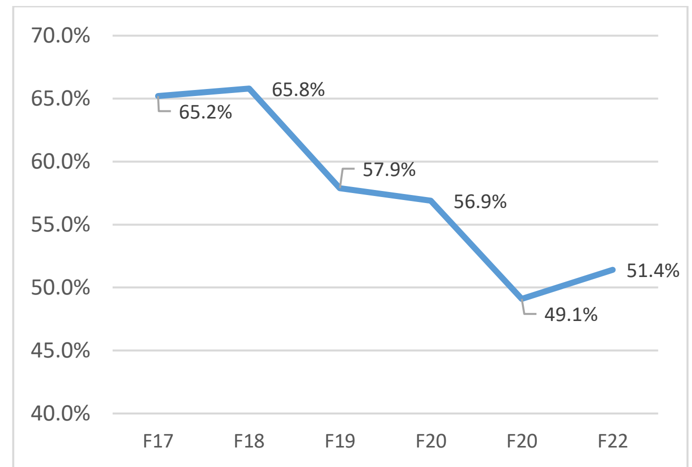
Source: Company data, ABS Research

Figure 8 GP Margin



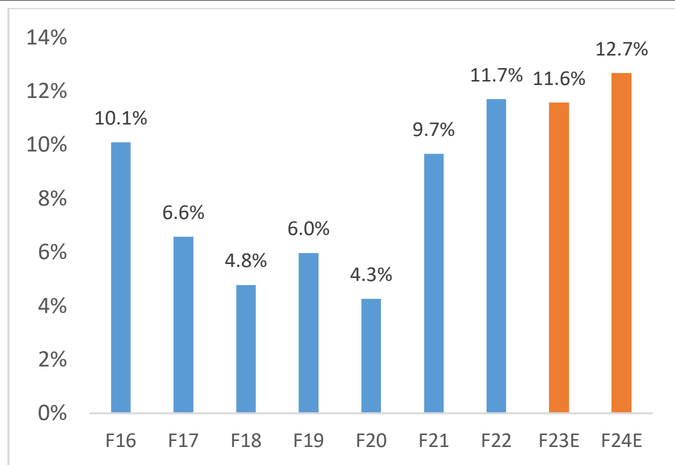
Source: Company data, ABS Research

Figure 9 Credit sales mix



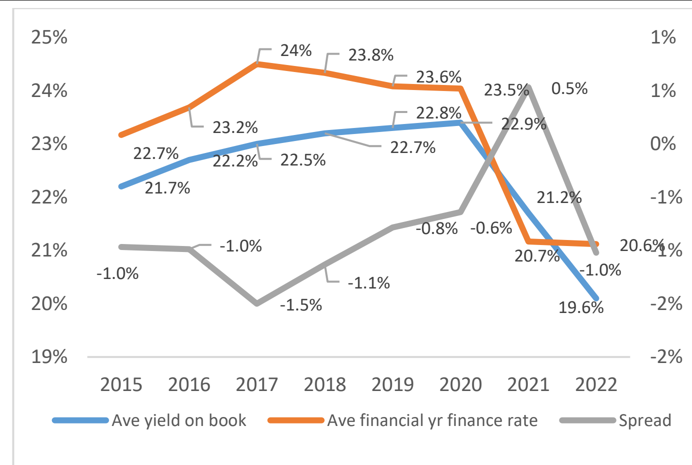
Source: Company data, ABS Research

Figure 10 ROE - %



Source: Company data, ABS Research

Figure 11 Yield vs ave finance rate (repo + 17%)



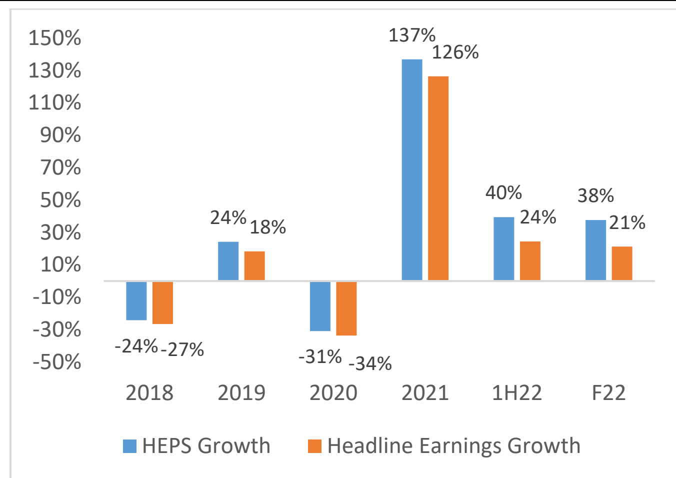
Source: Company data, ABS Research

Share Buybacks

The company continues to buy back shares - by FY22, 26.1m shares have been acquired since 2018, with 8.8m (ave price of R40.34) in FY22, the biggest annual purchase. In total 37.2% of shares since listing have been bought back (ave price R31.82). The benefit to HEPS has been significant as per the chart below. FY22 headline earning rose by 21% and HEPS by 38%.

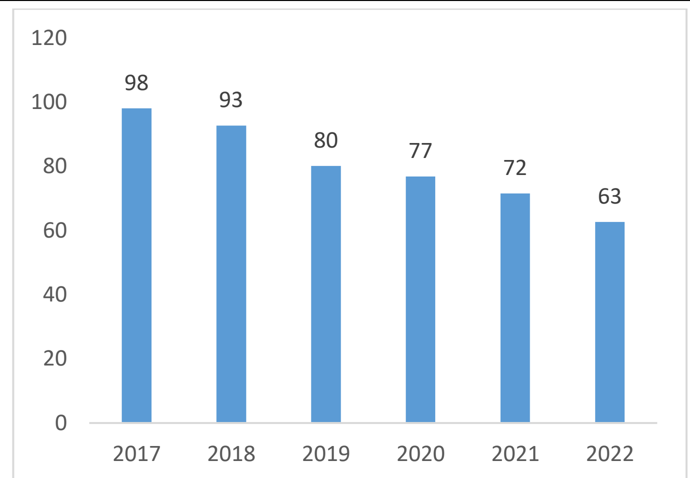
We believe buybacks will continue at current share price levels given the significant discount to NAV and strong cash generation. We forecast for a further 6m shares to be cancelled in FY23E. The group received the authority from shareholders to purchase a further 10% in October 2021 – 48% of this mandate has already been purchased.

Figure 12 HEPS vs Headline earnings growth



Source: Company data, ABS Research

Figure 13 Shares in issue - million



Source: Company data, ABS Research

Updated Valuation

Figure 14 DFCF valuation assumptions

WACC Assumptions	
Risk free rate	9.9%
Beta	1.0
Market risk premium	6.5%
Marginal tax rate	28.0%
Pre-tax cost of debt	6.5%
Cost of equity	16.4%
Target debt/value ratio	15%
Target equity/value ratio	85%
WACC	14.6%
Growth Rate assumption	
Sustainable long term growth rate	4.0%

Source: ASB estimates

Figure 15 DFCF sensitivity to WACC and growth rate

		WACC				
		-1%	-0.50%	0%	0.5%	1.0%
Terminal Growth	3.0%	7832	7359	6928	6536	6177
	3.5%	8064	7562	7107	6694	6316
	4%	8321	7785	7303	6865	6468
	4.5%	8606	8032	7517	7053	6633
	5%	8923	8306	7755	7260	6814

Source: ASB estimates

We update the risk-free rate from 9.5% to 9.9% and use a debt/equity of 15:85 given the right of use assets. This results in a revised WACC of 14.6%. Our valuation range equates to R66.94-R80.32 /share, a mid-point valuation of R73. By contrast the NAV per share in FY22 was R75.27.

Net capex of R67m in FY22 came in lower than our estimates. We have it rising to R129m in FY23E – this compares to R119m in FY21.

Based on our HEPS forecasts, the stock trades on a very attractive 5.4x forward P/E, a 3.1x EV/EBITDA. The stock has traded on an average 10-year P/E of 7.4x, suggesting upside of 32% or a price of R68,80. We expect the rerating to be driven by rising ROE's – we have it forecast at 12.7% in FY24E after reaching a low of 4.8% in FY18. Management is targeting 15% in five years. Apart from this potential rerating the annual return to shareholders is significant (circa 20%) given the high dividend yield and ongoing share buyback.

Risks

- A slow to little recovery in the SA economy will impact sales but also its customers affordability and hence the quality of the debtors book. At present management is coping with rising inflation (maintain GP margins) and supply issues whilst the debtors book quality is at its best.
- A sharp devaluation of the rand will have a negative impact on the pricing of its imports which accounts for circa 30% of its stock procurement
- A further COVID-19 induced lockdown
- Further civil unrest that leads to store damage, stolen or damaged stock and lost trading days. Whilst the company remains insured for such events (it has successfully claimed damages from SASRIA), the future shopping patterns of the locals in the affected areas is impacted well after the event. The company has separate insurance cover for business interruption losses to mitigate.
- A sharp rerating of the stock would hinder the share buyback opportunities which are providing an underpin to our HEPS growth forecasts. This could be mitigated by a higher dividend payout ratio.
- Further reputational and financial damage resulting from the ongoing legal proceedings with Summit Financial Partners

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