Lewis Group – Capitalising on change

Date: 06 December 2021

- Lewis Group has undergone significant positive change in six years as it transforms back to a retail revenue driven business, instead of financial services. Of its revenue earned in FY14, we estimate 58% was from financial services – in FY21 its 45%. Credit sales now accounts for 50.6% of total sales, compared to 72% in FY14.
- Its acquisition of Beares in FY15 and UFO in FY18, as part of management's diversification strategy, expanded its target market to higher income segments whilst reducing its ratio of credit sales. Club subscriptions have been terminated, ancillary services are more transparent and optional. As a further protection to customers, a centralised call centre now engages with all customers before a store finalises a credit transaction. These reforms have addressed certain legacy issues.
- The retail business model has remained consistent, with the stores driving sales, deliveries and collections. Sales are being enhanced with an online channel (currently 5% of sales) which is gaining momentum and collections are moving swiftly towards debit orders (25% of collections) which is positively impacting arrears.
- Debtors management has improved significantly since FY17 with arrears declining 5%, total provision coverage rising from 28% to 42% (resulting from the IFRS9 implementation in FY19), provision coverage of non-performing accounts at 88% from 73% and our debtors charge forecast of 11.2% in FY22E compared to 19%. Arrears remain stubbornly high at 37%, a reflection of the credit risk in its target market. The number of satisfactory paid accounts is rising (75.2% from 68.4% in FY17), good for repeat business which is circa 45% of credit sales.
- The group has no debt, apart from financial lease obligations. Operating cash flow post interest and tax was R808m in FY21 (1H22 R532m). This has facilitated a strong dividend payout as well as an aggressive share buyback programme since FY18. Its dividend payout ratio has remained above 50% since FY08 (55% in FY22E). To date it has acquired and cancelled a third of its shares in issue – in FY22E it has already acquired 6m shares, approximately R215m in value. This combined with the 1H22 dividend, equates to an estimated 12% return to shareholders in FY22E to date. The stock is on a forward 9.1% dividend yield.
- We anticipate modest headline earnings growth of 6% and 11% in FY22E and FY23E impacted by a low repo rate, a depressed cost base in FY21 and store interruptions due to COVID-19 and civil unrest. Post the buyback it translates into HEPS growth of 24% and 23%. This puts the stock on an attractive 18-month forward PE of 4.9x. We value the stock on a DFCF basis, deriving a fair value range of R65.68 to R72.75.

ZARmn (to March)	FY20	FY21	FY22E	FY23E	FY24E
Revenue	4,280	4,437	4,670	5,089	5,658
EBITDA	629	1,039	1,155	1,288	1,428
Normalised earnings	205	463	493	547	610
Normalised HEPS (ZAc)	260	617	764	935	1,119
PE Ratio	6.8	7.5	6.0	4.9	4.1
Dividend (ZAc)	185	328	420	514	615
Dividend yield	10.4%	7.1%	9.1%	11.2%	13.4%

Source: Company data, Chronux Research estimates

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Price (06/12/2021):	R46.00
Market cap	R3036m
Shares in issue	66mn

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Price performance - ZAR

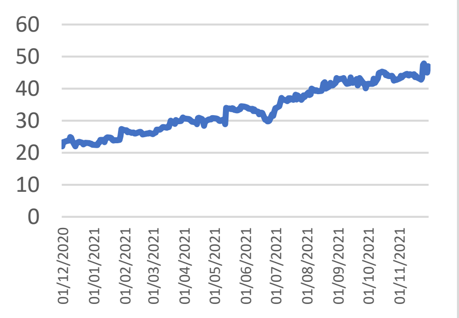

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Figure 1 Financial summary – R'mn

Year Ending	FY2018A	FY2019A	FY2020A	FY2021A	FY2022F	FY2023F	FY2024F
Income Statement							
Merchandise Sales	2,865	3,520	3,686	3,931	4,336	4,701	5,084
Sales growth (%)	*9.9%*	*22.9%*	*4.7%*	*6.7%*	*10.3%*	*8.4%*	*8.1%*
Gross profit	1,187	1,451	1,512	1,642	1,747	1,909	2,084
growth %	*7.3%*	*22.2%*	*4.2%*	*8.6%*	*6.4%*	*9.2%*	*9.2%*
Finance income	1,362	1,248	1,312	1,271	1,276	1,347	1,552
growth %	*-6.2%*	*-8.4%*	*5.1%*	*-3.1%*	*0.4%*	*5.6%*	*15.3%*
Insurance income	671	647	666	707	774	856	943
growth %	*-18.4%*	*-3.5%*	*2.9%*	*6.2%*	*9.4%*	*10.6%*	*10.2%*
Ancillary income	659	722	790	817	873	978	1,078
growth %	*-7.2%*	*9.6%*	*9.3%*	*3.4%*	*7.0%*	*12.0%*	*10.2%*
EBITDA	465	522	629	1,039	1,155	1,288	1,428
EBITDA Margin (%)	*16.2%*	*14.8%*	*17.1%*	*26.4%*	*26.6%*	*27.4%*	*28.1%*
EBIT	379	443	254	696	741	831	925
EBIT Margin (%)	*13.2%*	*12.6%*	*6.9%*	*17.7%*	*17.1%*	*17.7%*	*18.2%*
Profit before tax	393	464	273	604	694	765	847
Net profit	264	310	182	433	493	547	610
Net profit post minorities	264	310	182	433	493	547	610
Headline Earnings	261	308	205	463	493	547	610
Basic EPS (ZAc)	307	377	232	576	764	935	1,119
Headline EPS (ZAc)	303	376	260	617	764	935	1,119
% growth	*-24.3%*	*24.3%*	*-30.8%*	*137.0%*	*23.9%*	*22.5%*	*19.6%*
DPS (ZAc)	200	234	185	328	420	514	615
Payout ratio (%)	*71.1%*	*61.1%*	*78.9%*	*55.0%*	*55.0%*	*55.0%*	*55.0%*
Balance Sheet							
Cash and Cash equivalents	608	205	1,193	447	131	181	221
Current asset (ex – cash)	4,996	4,425	4,368	4,588	4,756	5,071	5,602
Net Fixed assets	302	299	1,018	1,021	1,141	1,280	1,435
Intangible assets	305	310	308	297	297	297	297
Investments	471	276	228	254	264	264	264
Other assets	102	274	273	218	216	225	236
Total assets	**6,785**	**5,789**	**7,388**	**6,823**	**6,804**	**7,318**	**8,054**
Debt	532	0	922	0	0	200	300
Current liabilities	594	783	1,052	1,295	1,511	1,564	1,669
Other liabilities	211	130	705	656	739	783	817
Total liabilities	**1,336**	**913**	**2,679**	**1,951**	**2,250**	**2,547**	**2,787**
Shareholders' equity	5,449	4,876	4,710	4,873	4,554	4,716	5,268
Minorities	0	0	0	0	0	0	0
Total shareholders' equity	**5,449**	**4,876**	**4,710**	**4,873**	**4,554**	**4,716**	**5,268**
BVPS (ZAR)	*5,878*	*6,080*	*6,124*	*6,812*	*7,350*	*8,428*	*10,139*
ROE (%)	*4.8%*	*6.0%*	*4.3%*	*9.7%*	*10.4%*	*11.8%*	*12.2%*

Cash Flow

Reported net profit	**264**	**310**	**182**	**433**	**493**	**547**	**610**
Change in net working capital	102	151	-256	-139	85	-267	-430
Dividends paid	172	-168	-196	-147	-279	-284	-317
Other adjustments	123	235	920	661	551	829	1,062
Cash flow from operations	**661**	**528**	**650**	**808**	**849**	**825**	**925**
Net Capex	-32	-79	-104	-119	-134	-146	-158
Capex/sales (%)	*1.1%*	*2.2%*	*2.8%*	*3.0%*	*3.1%*	*3.1%*	*3.1%*
Other investing cash flows	-59	-48	96	23	-7	3	3
Cash flow from investing	**-91**	**-127**	**-8**	**-96**	**-141**	**-142**	**-154**
Equity raised/ (bought back)	-164	-105	-123	-136	-450	-250	-100
Net inc/(dec) in borrowings							
Other financing cash flows	-593	-671	469	-1,323	-575	-383	-632
Cash flow from financing	**-757**	**-776**	**347**	**-1,459**	**-1,025**	**-632**	**-730**
Net cash flow	**-187**	**-375**	**989**	**-747**	**-316**	**51**	**40**
Free cash flow	**407**	**439**	**179**	**610**	**905**	**658**	**603**

Valuation Summary

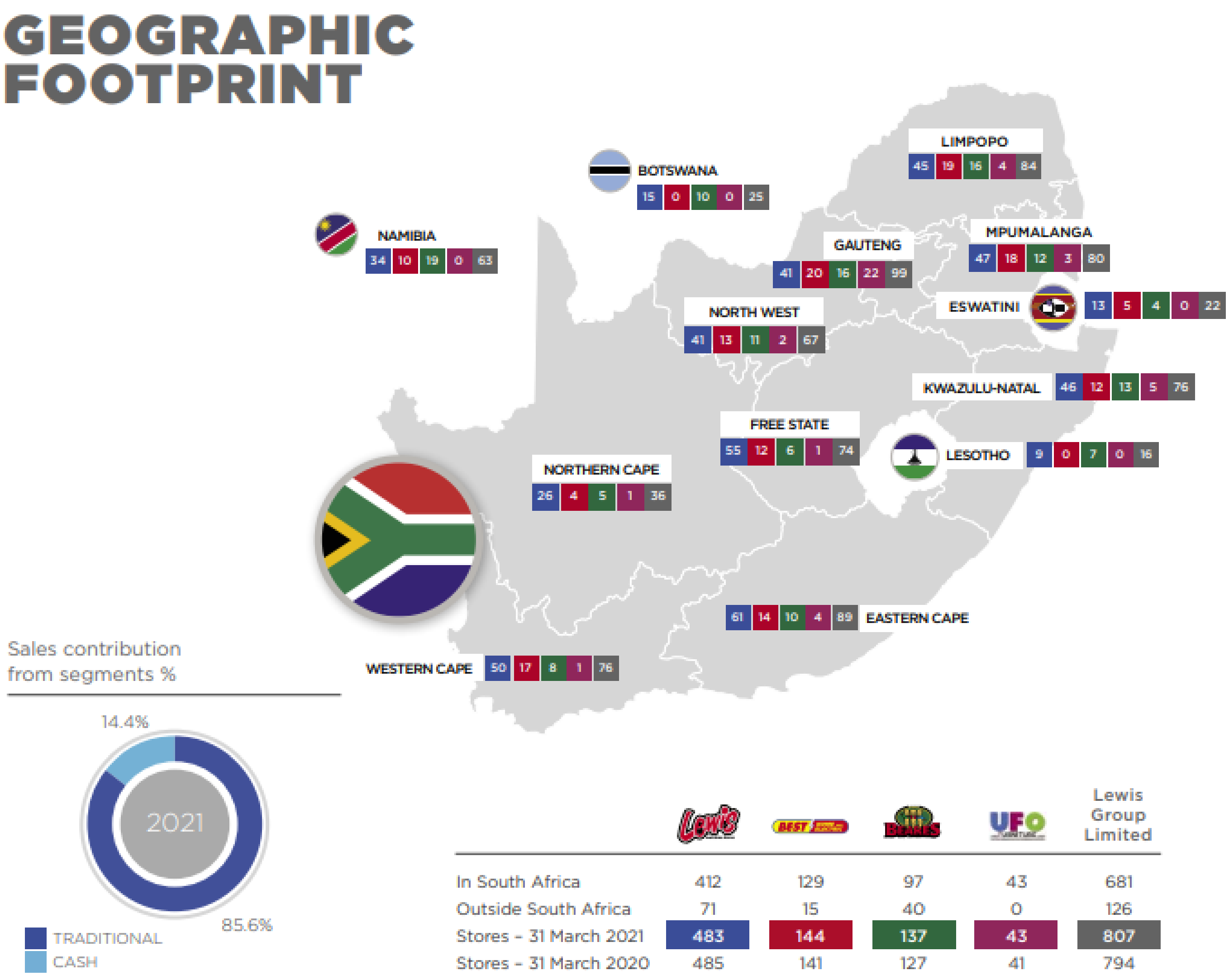
Valuation Metrics							
Share Price (ZAc)	4,220	3,110	1,782	4,600	4,600	4,600	4,600
P/E (Underlying) (x)	13.9	8.3	6.8	7.5	6.0	4.9	4.1
P/BV (x)	0.7	0.5	0.3	0.7	0.6	0.5	0.5
EV/Sales (x)	1.2	1.0	0.9	0.9	0.8	0.7	0.7
EV/EBITDA (x)	7.4	6.6	5.5	3.3	2.9	2.6	2.4
EV/EBIT (x)	9.0	7.7	13.5	4.9	4.6	4.1	3.7
FCF Yield (%)	12.2	13.2	5.4	18.3	27.5	20.0	18.3
Dividend Yield (%)	4.7	7.5	10.4	7.1	9.1	11.2	13.4

Source: Company data, Chronux Research

Company Overview

Founded in 1934 and listed on the JSE since 2004, Lewis Group has been a very focused business since inception. Traditionally a furniture retailer focused on the lower income market it has transitioned more recently to the mid and upper income markets through its acquisition of Beares and UFO. It offers credit to buyers as its primary target market is unable to afford the large ticket price items. Its financial services offering is further augmented with insurance, providing cover to those taking credit. We split the business into its two primary components, Retail (cash and credit) and Financial Services (credit granting and insurance). Management refers to its credit providing retail operations as the "Traditional" segment while UFO is its "Cash" segment.

Figure 2 Group store presence across Southern Africa – March 2021



	Lewis	Best Home	Beares	UFO	Lewis Group Limited
In South Africa	412	129	97	43	681
Outside South Africa	71	15	40	0	126
Stores – 31 March 2021	483	144	137	43	807
Stores – 31 March 2020	485	141	127	41	794

Source: Company data, Chronux Research

Figure 3 The group covers a broad target market across its four brands

BRAND PROFILES

Brand	Target market*	Retail channel	Product offering	
Lewis	LSM 4-7	412 stores in SA 71 stores outside SA Average store size 317 m²	Focus mainly on credit sales of household furniture, homeware, electrical appliances and home electronics. On average 90% of merchandise deliveries are completed within 24 hours of the sale.	Traditional retail
BEST HOME AND ELECTRIC	LSM 4-7	129 stores in SA 15 stores outside SA Average store size 130 m²		
BEARES	LSM 7-9	97 stores in SA 40 stores outside SA Average store size 366 m²		
UFO FURNITURE	LSM 9+	43 stores in SA Average store size 648 m²	Cash sales of exclusive and luxury household furniture, including lounge, dining room and bedroom ranges.	Cash

** Based on Living Standards Measure*

Source: Company data, Chronux Research

In 1H22, 10 net new stores were opened, 2 of which were outside of SA, bringing the total store count to 817 at 30 September 2021.

The furniture retail market (particularly furniture on credit) has undergone significant change in the past decade with the challenges faced by Ellerines and Steinhoff. Well established brands like Ellerines and Joshua Doore are no more and have left a gap in the market for the Lewis Group to exploit. The primary competition for the Lewis brand is OK Furniture (Shoprite Holdings) and Russells (Pepkor Holdings). Beares primary competitors are Bradlows (Pepkor Holdings), OK Furniture and House & Home (Shoprite Holdings).

OK Furniture has 301 stores in SA and 41 stores in Botswana, Namibia and Eswatini where the Lewis Group is also present. House & Home has 39 stores in SA and 4 outside of SA. This compares to the 774 across Lewis, Best Home and Electric and Beares. Credit sales are also limited across the Shoprite furniture stores.

JD Group (part of Pepkor Holdings) also has a limited credit sales offering with only 10% credit sales across its portfolio of stores. Russells has 245 stores in SA and Bradlows 228.

The group is headed by Johan Enslin, who joined the group as a salesman in 1993 and rose through the ranks from a store manager to the regional controller and ultimately the CEO. His knowledge of furniture retail is unsurpassed.

Jacques Bestbier, the CFO, joined the group in 2012. A Chartered Accountant, he has a background in short term insurance, banking and retail.

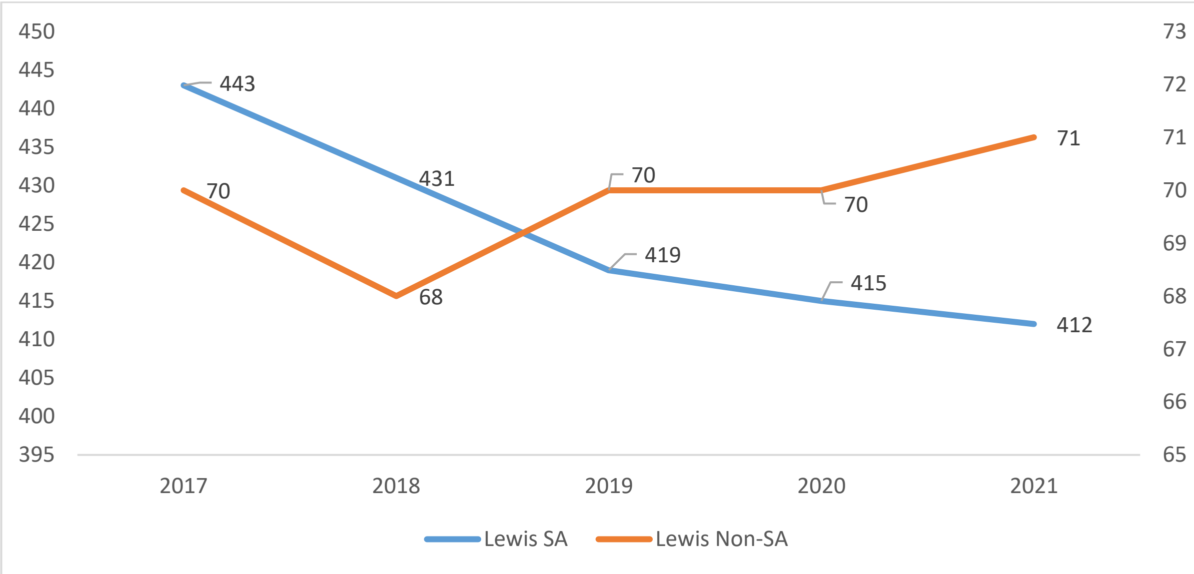
Retail

Traditional Retail

Traditional sales accounts for 86% of group sales, a relatively stable level over the past three financial years. The split between credit and cash sales is an estimated 59:41 in 1H22, below the 66:34 in FY20. Affordability constraints has pushed the ratio lower, but it is currently at an exaggerated low given the excess cash COVID-19 has placed in consumers hands.

Lewis

Figure 4 Lewis store footprint – 31 March 2021



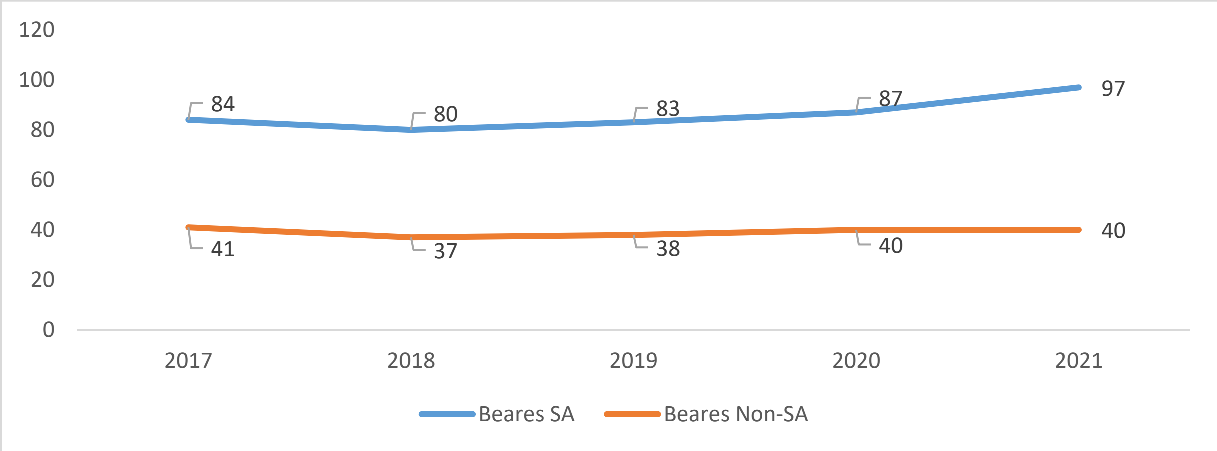
Source: Company data, Chronux Research

The founding brand, Lewis, is the largest furniture chain in SA and focuses on the LSM 4-7 market. It sells a range of household furniture, electrical appliances and home electronics. It currently has 483 stores spread nationwide, including 71 outside of SA, namely, Namibia 34, Botswana 15, Eswatini 13 and Lesotho 9. The non-SA portfolio has remained stable over the past 5 years while the SA footprint has declined by 7%. This reflects a mature market at this end of the income group and stresses the importance of customer loyalty and repeat business. To enhance profitability of the stores, management has over the past 10 years been downsizing its stores to its smaller circa 250m2 format. This has allowed the group to position itself in higher traffic areas and reduce property expenses. Approximately 50% of Lewis stores are in the smaller format, a number which is unlikely to grow considerably given landlord resistance. The average lease is 5 years.

Lewis stores are located mainly on the main streets of town centres, 70% of which are in rural areas. Stores carry a basic range of popular items for its location and can ensure delivery of an item in 24hrs, 95% of the time. Electronic catalogues in the stores showcase the full product offering which is readily available as there are storage facilities located nearby (in lower rental zones) that store the full product range. As a result, Traditional brands have no distribution warehouses. Deliveries are made by the store utilising its own fleet of vehicles. The result is a very personal transaction with customers.

Beares

Figure 5 Beares store footprint – 31 March 2021



Source: Company data, Chronux Research

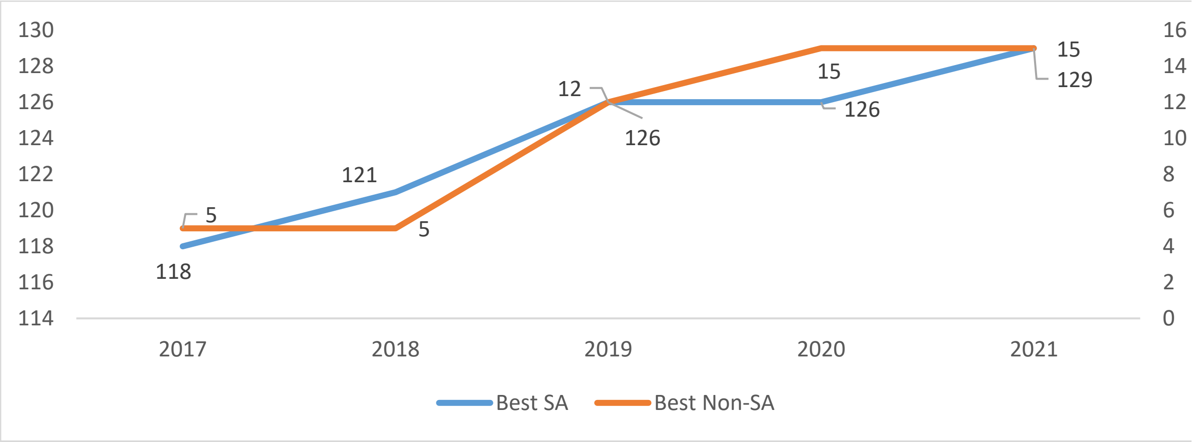
Beares was acquired from Ellerines in 2014 and has a history going back over 80 years. Its target market is in LSM 7-9 (although some customers are in LSM 9+) and it is also predominantly credit sales based, although at 8-10% lower than the other Traditional brands. It currently has 137 stores, 97 nationwide in SA and 40 outside of SA, Namibia being dominant with 19. Growth opportunities remain in SA whilst the non-SA market is saturated. Management has a medium to long term target of 140-160 SA stores.

It has a similar business model to Lewis with regards distribution and credit sales; however, its furniture range is more upmarket. It is an aspirational brand for the groups Traditional customers, positioning it well to retain Lewis credit customers as they migrate up the income curve. Stores average 366m2 and are located in high traffic areas.

Management launched a homeware brand a few years ago. This brand focuses primarily on home decorations, e.g., linen, curtains, bedding, tableware and small electrical appliances. It's a call centre driven operation with online functionality as well. It offers clients a credit facility to do "online" shopping. The business has now been integrated into the Beares brand with deliveries originating from Beares stores. This offers customers an additional channel to acquire from Beares and with time it will increase its product range and penetration. It has been the framework for the group's online offering.

Best Home and Electric (Best)

Figure 6 Best Home and Electric store footprint – 31 March 2021



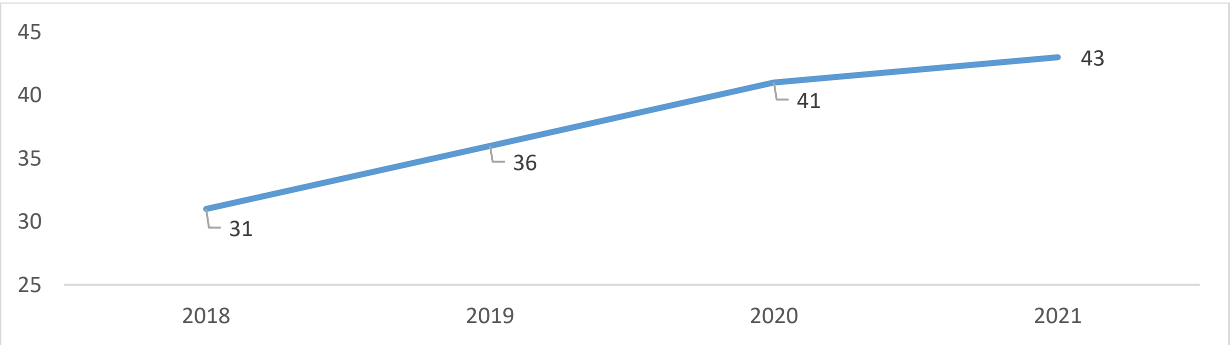
Source: Company data, Chronux Research

Best was established in 2008 and sells home appliances, sound and vision equipment and selected lines of furniture, largely on credit. It has 144 stores, 15 of which are outside of SA – 10 in Namibia and 5 in Eswatini. There is still scope for expansion in and outside of SA. It has the smallest stores, averaging 130m2, located in high traffic areas with high trading densities.

Cash Retail

United Furniture Outlets - UFO

Figure 7 UFO store footprint – 31 March 2021



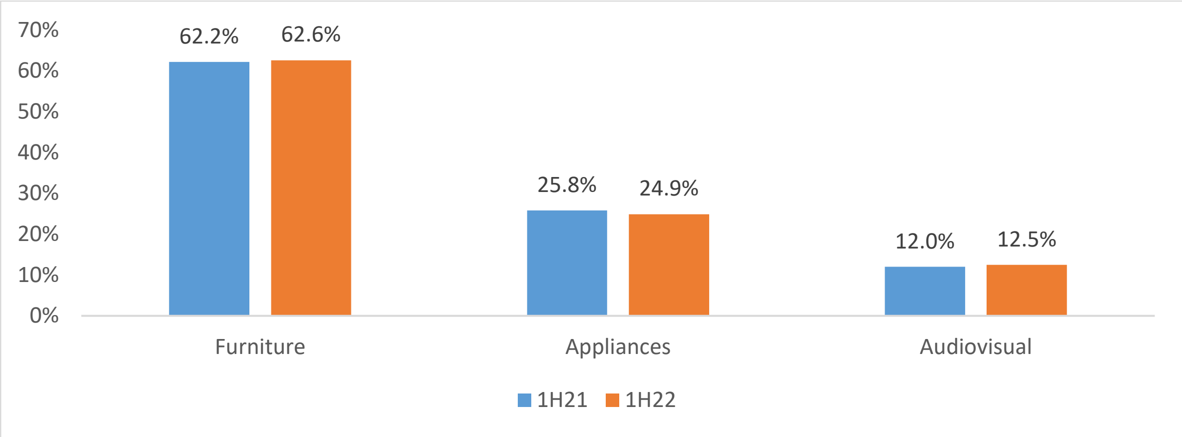
Source: Company data, Chronux Research

The final brand in the group is United Furniture Outlets (UFO), a luxury brand cash furniture retailer targeting the LSM 9+ market. UFO was established in 2004 and acquired by Lewis Group in 2018 for R324m. It has 43 stores, all located in SA, predominantly in Gauteng (22 stores). Expansion outside of SA is not currently envisaged but remains an opportunity once the SA expansion has progressed. It only recently entered the Eastern and Western Cape and therefore there is still scope for considerable expansion.

UFO stores are located in malls and shopping centers and therefore expanding the footprint is more challenging than with traditional stores. Stores are considerably bigger, averaging 648m2 with product displays on the floor allowing customers to view and inspect. It offers no credit facilities to customers.

Merchandise

Figure 8 Sales split by merchandise category



Source: Company data, Chronux Research

Product is sourced locally and offshore - approximately 30% is currently imported. Imports come predominantly from China, Malaysia and South America. The group has strong relationships with local suppliers, supporting the industry extensively and ensuring good purchasing terms. Approximately 75% of furniture is designed internally and therefore exclusive to the group's brands. This allows flexibility in ensuring the correct pricing points for its target market. New product ranges are introduced regularly to ensure a freshness of the offering. The aim is to provide a quality, value for money offering to all income segments.

- Furniture – bedroom suites, beds, base sets, mattresses, lounge and dining room suites, wall units and kitchen units. Furniture accounts for 63% of sales.
- Appliances – Fridges, freezers, stoves, washing machines, microwaves and smaller electrical appliances. Brands such as Defy, Russel Hobbs, KIC, LG and Kelvinator are popular. 25% of sales.
- Audio visual – mainly TV's, audio equipment and laptops. Brands include Hisense, Sinotec, LG and Panasonic. 12% of sales.

All local merchandise is delivered by manufacturers directly to stores, eliminating the need for distribution warehouses. In the case of imports, independent logistic companies will deliver the goods to the stores. The use of storage facilities close to its retail stores limits the buildup of obsolete stock and thereby reduces the need to have excessive mark downs.

There are further additional products and services that customers can choose from such as extended warranties (beyond the standard one-year product warranty), fabric protection (one in 3 customers elect this for their furniture) and an inhouse delivery service.

Customers

As indicated in figure 3, the group caters for all LSM groups from 4 to 9+. Those in the 9+ category are predominantly cash only customers (mainly UFO but also some Beares customers). Traditional retail stores are located close to where its customers live and work. This provides ease of access for shopping but also for making payment. The bulk of collections are done in the stores. The result is a store manager that has regular engagement with its customers, assisting with sales and collection efforts. Credit granting is centralized to ensure consistency in the granting process and ensuring that subjectivity is removed from the store manager.

Credit customers are loyal with approximately 45% of sales going to repeat customers. This endorses the quality of the product, the service levels and the overall customer experience. All credit customers are credit scored monthly to determine the appropriate preapproved credit limits. At 30 September 2021 there were 581k active credit customers.

Financial Services

Credit is provided to customers off the groups own balance sheet and insurance through its wholly owned insurer, Monarch Insurance Company Limited (Monarch), providing credit life and other protection policies. Credit is granted centrally with the use of external credit bureaus and internal score cards. Applications are made in store and decisions taken from head office. For existing customers preapproved limits are updated monthly and these are made available to the customers on their statements.

Collections are made at the stores via cash payments. During COVID-19 this became challenging, and management put in place collection facilities at national food retail chains and expanded its use of debit order collections. Debit order collections is gaining traction amongst its customers with approximately 25% of collections through this channel (this will continue to increase). The use of debit order collections decreases the need for the customer to come to the store which could negatively impact sales. Therefore, marketing campaigns have been intensified. Promotional flyers are sent to mobile phones, e-mailed to customers, included in monthly statements and delivered to homes, ensuring the customer is aware of the latest offers and Lewis is top of mind. We would expect a higher ratio of debit order collections to be positive for arrears.

Store managers are proactive in managing arrears, either calling the customer into the branch or visiting the customer at home.

Monarch

Monarch operates in a highly regulated industry. Its dominant product is standard credit life which covers the outstanding balance for death or permanent disability and up to 12 months installments due for temporary disability or loss of employment. Enhanced benefits can be acquired that will cover all outstanding debt.

Goods insurance is also offered. This covers accidental damage or theft. A standard policy will cover the outstanding balance in the event of damage or theft whilst enhanced benefits cover the full outstanding balance or provides replacement of goods.

Credit life fees were capped in August 2017 by the National Credit Act (NCA). This had a material impact on insurance revenue – insurance revenue was 48% of credit sales in FY17 and it declined to 32% in FY19.

Credit Provider

In SA, lending and credit life insurance is regulated by the National Credit Regulator (NCR) and therefore interest rates, initiation fees, service fees and insurance premiums are capped. Credit is also offered in its stores outside of SA – in Namibia credit sales are approximately 65% of total sales and rates are also capped (currently lower than SA). Current regulated SA limits are as follows:

- Finance rates – repo rate plus 17%. This is currently 20.75%. Lewis prices most of its sales at this maximum rate.
- Initiation fee – R165 (plus VAT totalling R189.75) per credit agreement, plus 10% of the amount in excess of R1000. It is capped at R1050. Lewis applies this rate to most credit sales.
- Monthly service fee – R60 plus VAT – totalling R69 per month. The service fee is waived on contracts below R2000.
- Credit life insurance premium – capped at R4.50 per R1000 of the contract value.

A standard monthly installment on an item purchased will include the following:

- Interest at 20.75% on the outstanding balance.
- Initiation fee
- Service fees
- Optional delivery charge
- Standard credit life cover. This is full repayment of the outstanding balance upon death or disability. Temporary disability or loss of employment provides cover for 12 months of instalments. The client is not obliged to take this credit life if they can prove they have a policy from another insurer that provides the same benefits. This cover is in line with the NCA minimum requirements.
- Standard goods cover - damage or loss or theft of goods – the outstanding balance is settled in full. The customer is not obliged to take this cover if they can prove they have a policy from another insurer that provides the same benefits.

The finance terms differ by brand and by product, the average being 32-33 months (for the past seven years) with the maximum being 36 months.

Optional ancillary services

- Delivery services
- Extended warranty on selected products
- Masterguard (fabric protection on furniture)
- Top up credit life to include full repayment if temporary disabled or loss of employment. Priced at R1.00 per R1000 of the contract value in addition to the R4.50 credit life premium.
- Damage or loss or theft of goods top up insurance – the customer can choose to have the outstanding balance settled or the goods replaced.

The group has had certain aspects of its credit practices challenged in its past, including compulsory delivery fees and club subscription fees. NCR matters were either settled or the court ruled in the groups favour. These are highly contentious matters that have incurred some reputational damage to the group, despite the outcome. Two cases brought on by Summit Financial Partners in 2016 on behalf of 28 existing or previous Lewis customers at the time, remain unresolved – the quantum of both claims is R85 000 plus interest.

We take comfort from the fact that positive changes have been implemented resulting in no new issues in the past four years. These changes include making the delivery fee optional and the termination of the club magazine. In addition, before any agreement is confirmed in the store, the customer speaks with a compliance call centre consultant who goes through salient terms and conditions again, in a language of the customer's choice, to ensure the customer fully understands the agreement. Credit provision and credit life policies have always been priced within the NCA limits and there has always been a five-business day cooling off period (the customer can cancel the contract and request a refund).

We acknowledge that the total cost of the item after the average 32-month period is significantly higher compared to its initial cash sales price. Whilst all the pricing is within NCA guidelines and all costs are repeatedly disclosed and confirmed, the morality of these charges is often questioned. Having covered the SA micro finance sector since the late 90's the question of morality is always raised. With a debtors book that is 37% in arrears, the cost of providing furniture retail credit is high. With a client base that has no transport and little disposable cash, buying many of these items would never be an option without the credit terms and delivery service offered. These are two key points to consider. A service is being offered and is being priced to reflect the risk. Transaction Capital and Capitec are two of the best performing financial services companies on the JSE, attracting demanding valuations. In their histories both have had similar questions asked about their businesses.

Management of the Debtors book

Arrears are high at 37% of the gross debtors book of R5.8bn in 1H22. Management is able to reduce this to 22% of Non-Performing Accounts (NPAs), still an excessive number and a reflection of the risk and hence the pricing. It is extremely costly to have the resources to chase 37% of your customers for payment. There is no restructuring of loans by the group. The following steps are in place to manage arrears down:

- All new customers are reminded regularly about ensuring their accounts are up to date.
- If the customer can't come into the branch debit orders can be implemented.
- The store will contact the customer or pay them a visit.
- Credit life policies will pay out in the event of death, disability or job loss.

The vast majority of arrears are collected internally. NPAs are classified when customers have paid less than 55% of amounts due over the contract period. When it is uneconomical to collect the debt and all internal processes have been exhausted, such accounts are written off. There are two write off cycles per year in which these decisions are made. At this stage the book is handed over to collection agencies.

Lewis has a unique classification of its debtors book with three different categories of performance. Within each category arrears data is provided. The categories are:

- Satisfactory paid – customers that have paid more than 70% of amounts due over the contract period. These are the lowest risk customers from which repeat sales are generated and therefore the rising trend in Figure 11 is very positive.
- Slow payers – customers that have paid between 55% and 70% of amounts due over the contract period.
- NPAs – customers that have paid less than 55% of amounts due over the contract period. This is clearly the highest risk category and attracts the greatest provisions.

Of importance, the criteria for these categories have remained static for the past three years. In FY19 NPAs were consolidated – prior to this they were split further into two categories covering all accounts less than 65% of amounts due over the contract period. The change does not hinder a historic trend analysis as accounts below 55% were clearly identified.

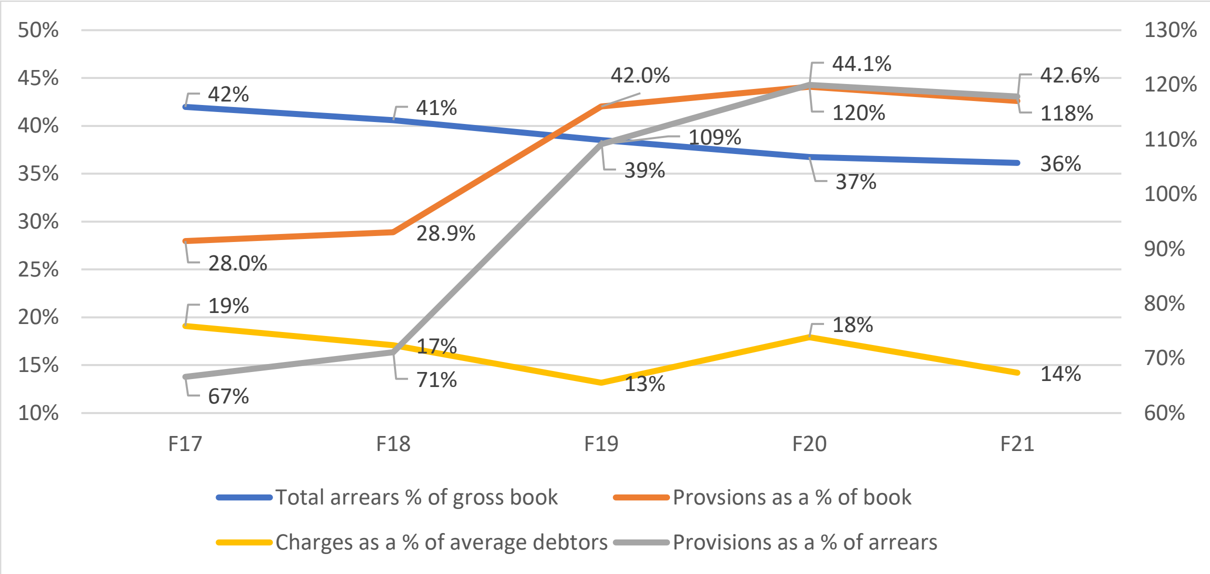
Figure 9 Profile of the debtors book and provisioning (*Note: IFRS9 was implemented in FY19*)

R'm	F17	F18	F19	F20	F21	1H22
Gross Debtors	5581	5478	5528	5747	5691	5787
Provisions	1561	1620	2323	2534	2424	2444
	4020	3858	3205	3213	3267	3343
Provisions as a % of gross debtors	28.0%	29.6%	42.0%	44.1%	42.6%	42.2%
Arrears	2343	2277	2129	2112	2056	2160
1 month	302	295	289	348	296	286
2 month	250	241	233	262	242	236
3 month	216	207	198	215	208	204
>3 month	1576	1535	1409	1286	1311	1434
>3 month arrears % of gross debtors	28%	28%	25%	22%	23%	25%
Total arrears % of gross debtors	42%	42%	39%	37%	36%	37%
Provisions as a % of arrears	67%	71%	109%	120%	118%	113%
Non performing accounts (NPAs)	1484	1452	1285	1261	1238	1281
% of gross debtors	26.6%	26.5%	23.3%	21.9%	21.8%	22.1%
Provisions for NPA	1081	1143	1117	1079	1071	1129
Provisions coverage %	73%	79%	87%	86%	87%	88%
Stress test provision levels						
Non performing accounts	1484	1452	1285	1261	1238	1281
Slow payers > 3m in arrears	483	460	412	383	382	395
Satisfactory paid >3m in arrears	233	211	196	196	216	225
Problematic book	2200	2123	1894	1839	1836	1901
Total group provisions	1561	1620	2323	2534	2424	2444
% coverage	71%	76%	123%	138%	132%	129%
Excess provisions/general provision	-639	-503	429	695	588	544
% of gross debtors	-11%	-9%	8%	12%	10%	9%
Income statement charge						
Increase (decrease) in provisions	27	59	-99	211	-110	21
Bad debts written off	1039	959	895	878	982	295
Bad debts recovered		-61	-63	-78	-59	-42
	1066	957	733	1010	813	273
Charges as a % of average gross debtors	19.1%	17.3%	13.2%	17.9%	14.2%	9.5%
Bad debt write off rate		17%	16%	16%	17%	10%
Bad debt recovery rate (% of ave write offs)		6%	7%	9%	6%	11%

Source: Company data, Chronux Research

It must be noted that interim data is not directly comparable with year end data as the company has a comprehensive bad debt write off review in March. This will impact provision and write off data. We focus on full year numbers below. We also highlight the implementation of IFRS9 in FY19 which had a material impact on provision levels.

Figure 10 Credit quality trends – declining arrears and rising provision coverage



Source: Company data, Chronux Research

We focus on the book across all three categories. Total arrears were 36% of the gross book in FY21, a significant number. This falls to 23% when analyzing arrears >3 months. This is a closer reflection of the NPA's at 22% of gross debtors. Arrears and NPA's have been on a declining trajectory over the past five years, the latter falling from 27% to 22%. This would reflect better credit granting criteria as well as improved collections, the growing use of debit orders having a positive impact. The credit applications decline rate has remained fairly stable at 38% over the period. Provisions in the NPA category (consistently defined) currently cover 87% of NPAs which is also up considerably from 73% in FY17. We would like to see this figure closer to 100%. We do, however, need to consider the bad debt and VAT recovery rates. Disclosure limits a full five-year review of the bad debt recovery rate, but for FY20 it ran at 9% and FY21 at 6%. We can't accurately quantity the VAT recovery on write offs (as it applies only to the original contract amount and not accrued interest), however management has guided towards a 11-12% recovery rate. On this basis coverage is at 100% or higher and adequate.

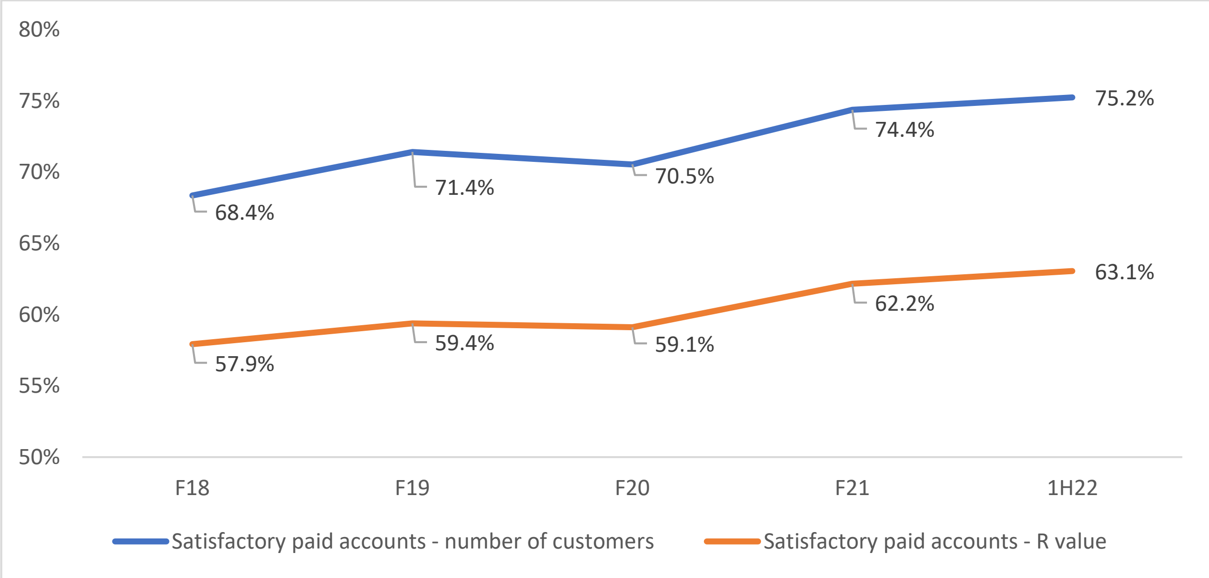
Another test for adequacy of provisions is to look at coverage levels across the arrears in the three categories of the book. We assume that NPAs should be fully provided for as well as >3 month arrears in the other two categories (we define this as the problematic book). Total provisions provide 132% coverage of the problematic book. We have excess provisions of R588m which represents a general provision of 10% of the gross debtors book. IFRS9 resulted in significantly higher provision coverage - in FY17 there was only 71% provision coverage of the problematic book we define above.

In FY21 provisions of R2423m are adequate to cover:

- All the NPAs totalling R1238m
- All the arrears in Slow Payers – totalling R568.2m
- All the arrears in Satisfactory Paid – R592.2m

We therefore believe the book is adequately provided for. We gain further comfort that the credit management practices have not changed in recent years. 1H22 results provide no reason for concern, with collection rates rising and satisfactory paid accounts increasing as a % of the book to new highs, as per the chart below.

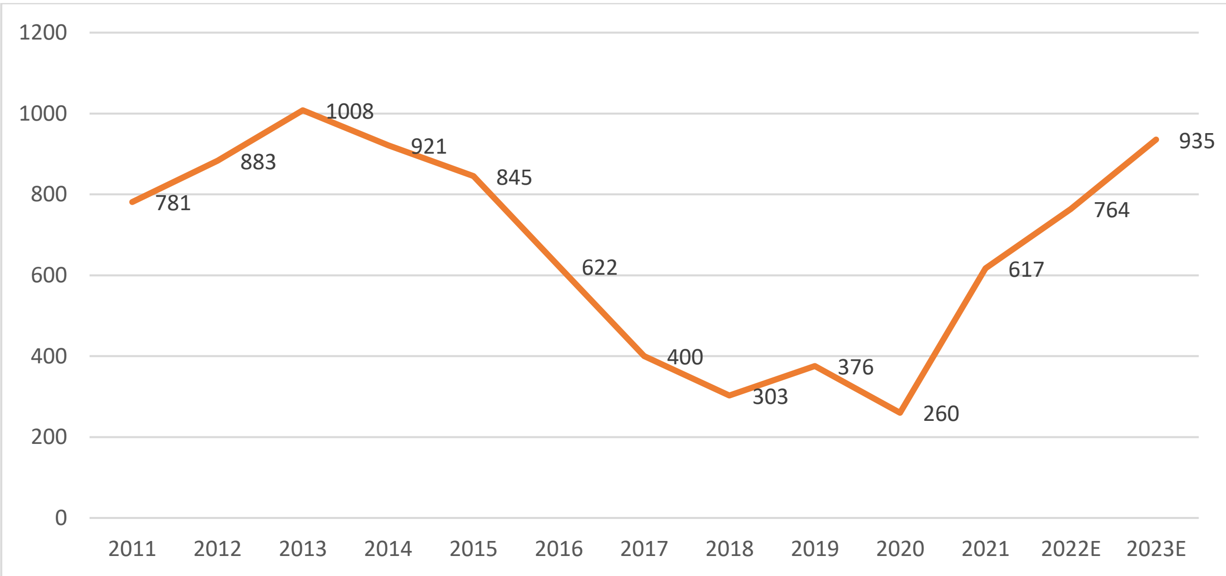
Figure 11 Quality of the book is improving with increasing satisfactory paid accounts



Source: Company data, Chronux Research

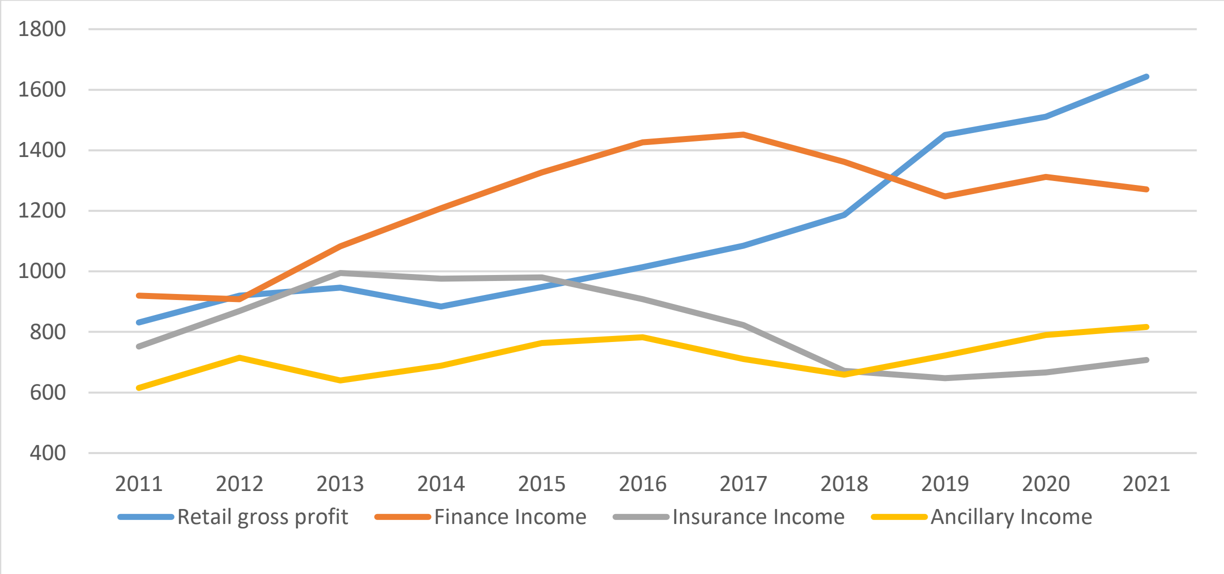
Financial Results

Figure 12 HEPS - ZAc



Source: Company data, Chronux Research

Figure 13 The four sources of revenue (R'm) – retail once again dominant



Source: Company data, Chronux Research

The Group has undergone significant change in the past 10 years, not in its retail offering but in the financial services business. As per the chart above, in FY11 the gross profit earned from the retail operations was less than finance income earned and only modestly more than insurance income. In FY21 the picture is significantly different. In FY11 finance charges earned amounted to R920m, ten years later this is R1271m. Insurance premiums earned has gone from R752m to R707m over the same period and ancillary services from R615m to R817m. Retail gross profit has been a consistent performer over the period and is now the dominant revenue source for the group.

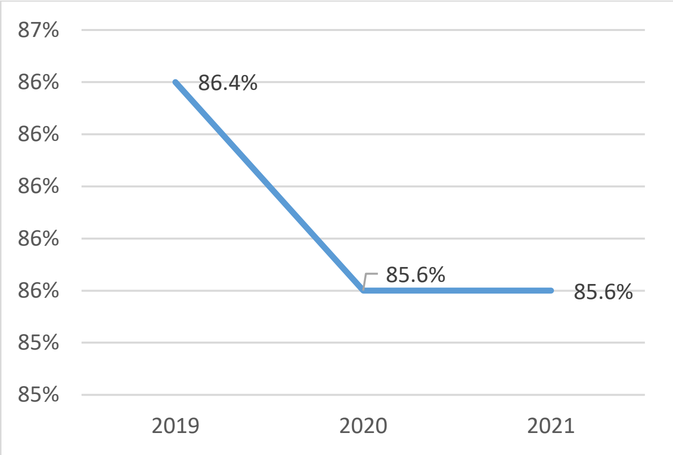
The net effect from the relative decline in the financial services business has been a decline in HEPS – it's fallen from 781cps in FY11 (1008cps in FY13) to 617c in FY21 as per figure 12 above. What has changed:

- Credit sales as a % of total sales has declined from 71% in FY11 to 57% in FY21, stripping out UFO. During COVID-19 consumers have had excess cash and this has also temporarily contributed to higher cash purchases in the group. This is also impacted by affordability constraints in its target market, driven by weak economic growth over the period. The credit applications decline rate has gone from 32% to 38% (edging up to 39% in 1H22) further highlighting consumer strain.
- The acquisition of UFO, a cash retailer.
- The acquisition of Beares – it has a lower credit sales ratio than Lewis.
- Credit life pricing caps introduced in August 2017.
- A declining repo rate.

Whilst negative from a financial perspective it has been positive for the Group's risk assessment and quality of earnings. Provisions as a % of gross debtors has risen from 17% in FY11 to 43%, the implementation of IFRS9 in FY19 having a material impact. The past three years have seen a more stable business, more reflective of its future and its core competency of retailing.

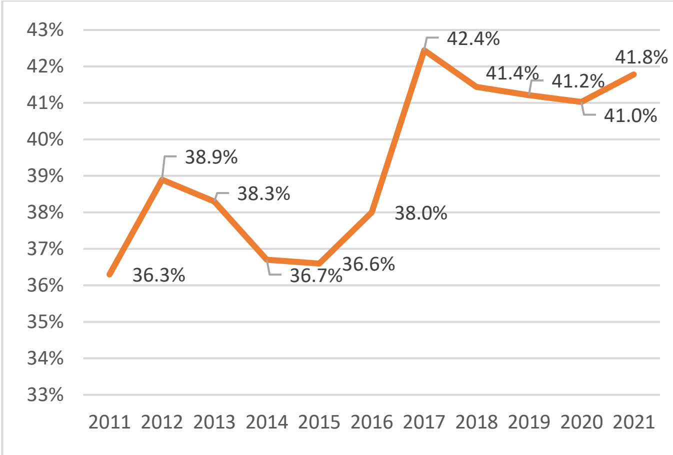
Merchandise sales and GP margins

Figure 14 Traditional vs Cash sales



Source: Company data, Chronux Research

Figure 15 Group GP margin



Source: Company data, Chronux Research

Consistent growth has come from the Traditional brands, a 6.6% sales CAGR over the past four years, approximately 2.5% above inflation. Management has noted that furniture inflation from the factory floor is approximately 1.5-2% p.a. and has been well maintained for the Group as buying power has been enhanced with the addition of Beares (and the absence of Ellerines and Joshua Doore) and it imports directly from manufacturers. In FY21 purchase inflation was well managed as the Group never cancelled any orders during COVID-19 and was rewarded with good pricing. Inflation going forward is anticipated at 2-2.5%p.a.

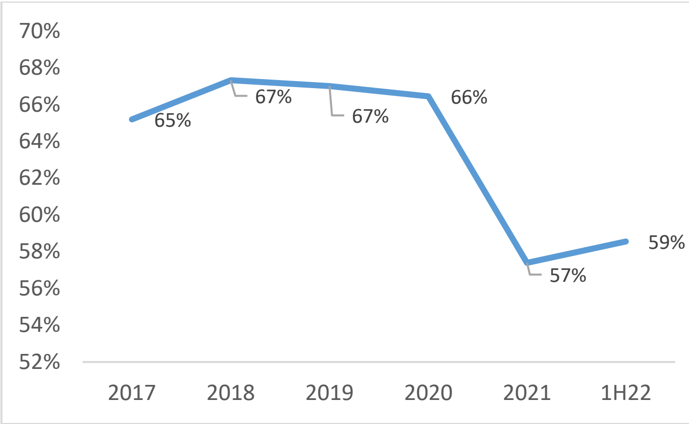
Assuming purchase inflation is passed on to customers, volume growth is approximately 4-5%, highlighting that there is still growth in the industry, particularly in the higher LSM categories. The demise of many of Lewis's competitors (following the African Bank Investments and Steinhoff fallouts) has been a tailwind for volume growth. We see growth in volumes around 4% in the medium term as the market has adjusted to the new competitive landscape and economic growth improves. We anticipate 10% sales growth from Traditional in FY22E (exaggerated by a low 1H21 base given COVID-19 – 1H22 sales were up 21.2%), followed by 8.5% in FY23E (some base effect from civil unrest losses in 1H22). We forecast 12% and 8% growth from Cash retail in FY22E and FY23E. **Our group sales are therefore forecast to grow at 10.3% and 8.4% in FY22E and FY23E.**

No segmental disclosure is provided for GP margins. The group margins have been between 41% and 42.4% the past five years. The addition of UFO in FY18 had little impact on the GP margin %. **We forecast a 40.3% (40.2% in 1H22) margin in FY22E and 40.6% in FY23E** as we see no competitive pressure on margins or on the ability to adequately pass on purchase/manufacturing inflation. Management is guiding 40-42% in FY22E and 41-43% in the medium term (3-5 years).

Other revenue

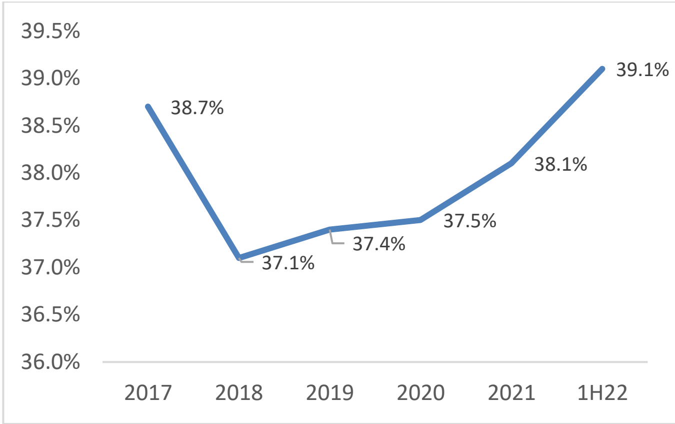
Finance income

Figure 16 Credit sales % of Traditional sales



Source: Company data, Chronux Research

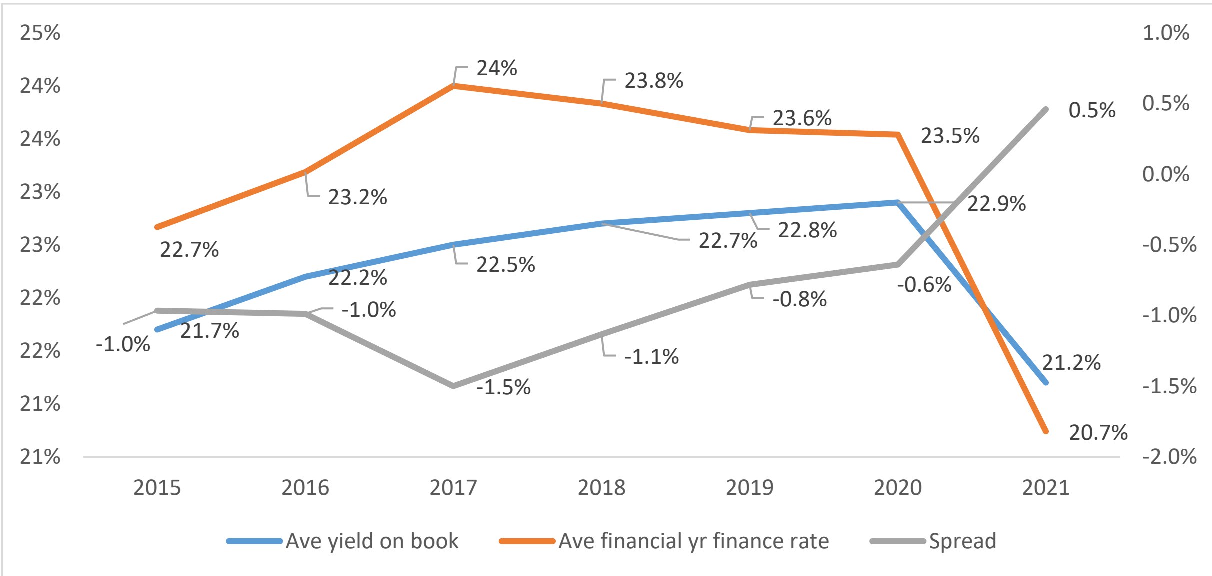
Figure 17 Credit application decline rate



Source: Company data, Chronux Research

Finance income is a function of credit sales, decline rates and the repo rate. Credit sales should recover in FY22E given the COVID-19 impact on store closures in FY21 and the increased access to cash by its customers during lockdown. At a group level, management is guiding towards credit sales recovering from 50.6% of total group sales in 1H22 to 52-56% in the short to medium term. Decline rates have increased to 39.1% in 1H22 and have been rising gradually, despite no significant changes made to credit granting criteria. This points to deteriorating customer affordability and hence the propensity to take on credit. The sharp fall in the repo rate in 2020 will have a lingering negative impact on finance income given average credit is for 32 months at fixed interest rates.

Figure 18 Ave yield on the debtors book vs the ave finance rate in the financial year



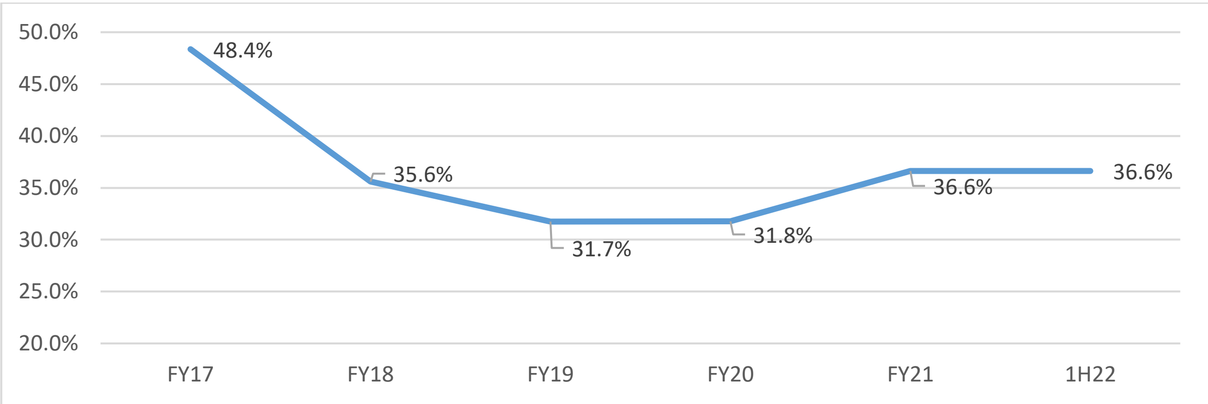
Source: Company data, Chronux Research

In the above chart we plot the disclosed average yield on the debtors book against the average finance rate in the financial year. The latter is a function of the repo rate plus 17% and is a weighted rate in a particular financial year. The yield on gross debtors tracks the general direction of the repo rate (finance rate), however, the spread to the finance rate varies depending on whether repo is rising or falling. The average spread over the seven-year period equates to -0.8%. This is a function of the book duration and fixed interest rates. As is evident in the chart when rates rise the spread widens because the book is priced at a lower repo rate and when rates fall the spread narrows. The sharp drop in the repo rate in 2020 is working its way through the book as seen in the sharp decline in yields from 22.9% to 21.2% in FY21. This has declined further to 20.3% in 1H22. We model for yields to decline further in FY22E and bottom in FY23E. We therefore forecast a 0% increase in finance revenue in FY22E and 6% growth in FY23E. We see a sharp increase of 15% in FY24E given the rising repo rate outlook.

The recent 0.25% repo rate hike would be welcomed just ahead of Black Friday and Christmas sales. We calculate a R5.5m revenue boost for every 0.25% rate hike, given our credit sales estimate of R2.2bn in FY22E.

Insurance Income

Figure 19 Insurance income as a % of credit sales



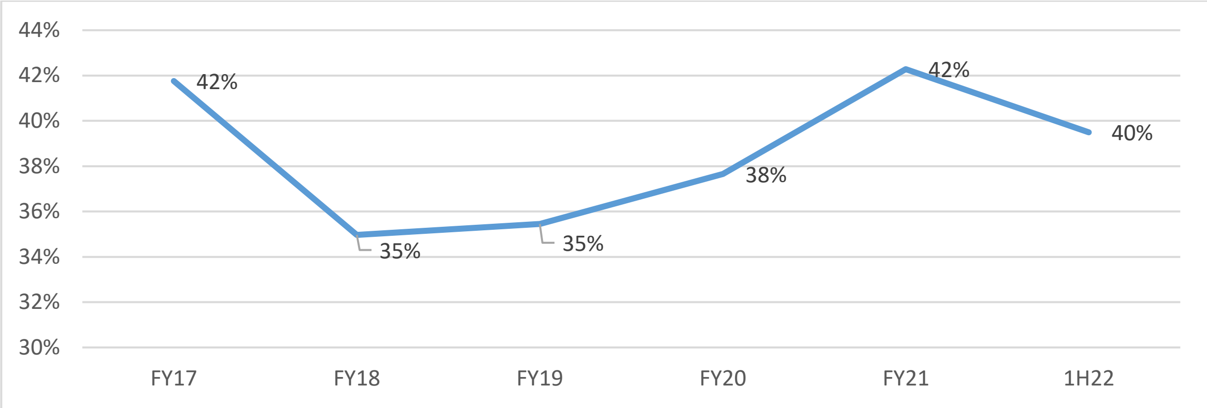
Source: Company data, Chronux Research

This would track credit sales and therefore we express insurance revenue as a % of credit sales as per the graph above. With credit life rates capped in August 2017 the sharp drop in revenue is evident from FY17 to FY18. This falls further into FY19 with the full impact of the repricing (these are also 32-month policies). It stabilizes and then rises again into FY21 as credit sales dropped 8% in FY21.

We estimate the ratio to decline to 35% in FY22E and remain fairly stable going forward. It was 36.6% in 1H22. **We forecast insurance income growth of 9% and 11% in FY22E and FY23E.**

Ancillary Services Income

Figure 20 Ancillary service income as a % of credit sales



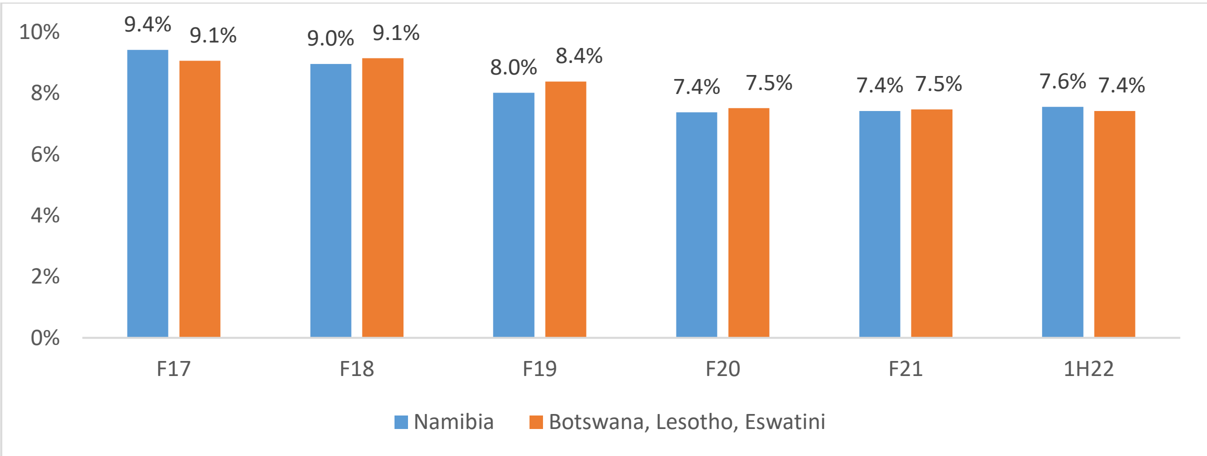
Source: Company data, Chronux Research

This includes product add ons (retail related revenue) as well as monthly service fees (financial services revenue). A break down of its composition is unfortunately not disclosed. As with insurance, income should track credit sales. As per the chart above it also suffered a sharp decline in FY18, largely due to a decrease in service fees following a reduction in the size of the debtors book. It also got distorted in FY21 by the decline in credit sales but has started to normalise in 1H22.

We estimate the ratio to decline to 39.5% in FY22E and to remain relatively stable thereafter. **We forecast ancillary income growth of 7% and 12% in FY22E and FY23E.**

Total Revenue

Figure 21 Total revenue contribution by non-SA operations – slower growth than SA



Source: Company data, Chronux Research

Our trends noted above are at a group level, incorporating the non-SA operations. Disclosure on these operations is limited, apart from a revenue breakdown. The revenue is merchandise sales (not retail gross profit) plus other income. Revenue growth rates have been slower than SA, given challenges in all the countries. Namibia's economy is under pressure and its interest rates are also at lows, capped at a lower rate than SA, around 12% for credit finance. Eswatini has its own political challenges whilst

Lesotho has had minimal economic growth over the past 5 years. Despite these challenges the businesses remain profitable with better credit quality than in SA.

Based on our retail and other income estimates, we have total revenue (retail gross profit plus other income) rising by 5% in FY22E, with 9% growth in FY23E.

Costs (excluding debtors costs)

Costs declined by 2.9% in FY21 given cost savings arising from COVID-19. Transport and marketing costs both declined during the lockdown period. Cost growth (including depreciation and amortisation) rebounded in 1H22, up 16.9%. Management is guiding for costs to grow by 8-12% in FY22E given the base effect. Staff costs represent 43% of operating costs, transport and travel is 8% and marketing 6%. There is little scope to cut staff costs as store manager commissions will rise with greater sales and there is further store expansion (15-20 stores) planned. Marketing and transport costs will rise with increased sales. **There is a strong cost containment culture in the group and therefore we believe operating costs will grow at 10% in FY22E, only 8% up on FY20**. Management is guiding for 3-5% cost growth in the medium term.

Tax

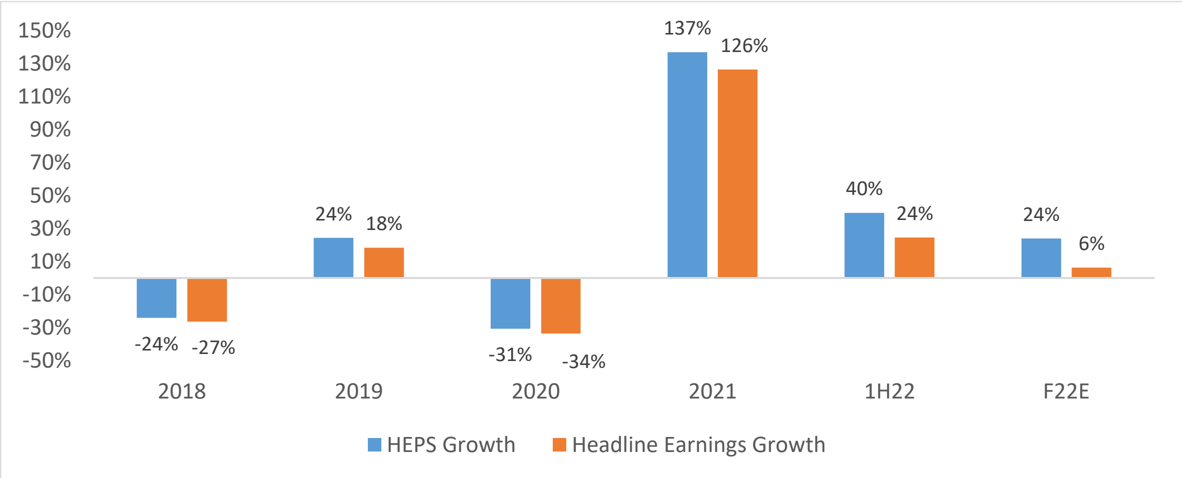
The group's effective tax rate (28.4% in FY21) is marginally higher than the SA statutory tax rate of 28% and is likely to remain at these levels. The tax rates outside of SA are marginally higher.

Headline Earnings and DPS

We forecast headline earnings to rise 6% and 11% in FY22E and FY23E. Both years are negatively impacted by the low growth in finance income given the low repo rate. FY22E is further impacted by the 10% cost growth off a low base.

We forecast HEPS to rise by 24% and 23% in FY22E and FY23E given the aggressive share buyback programme. We believe management will maintain its 1H22 dividend policy of a 55% payout ratio. This equates to a FY22E DPS of 420c and 514c in FY23E.

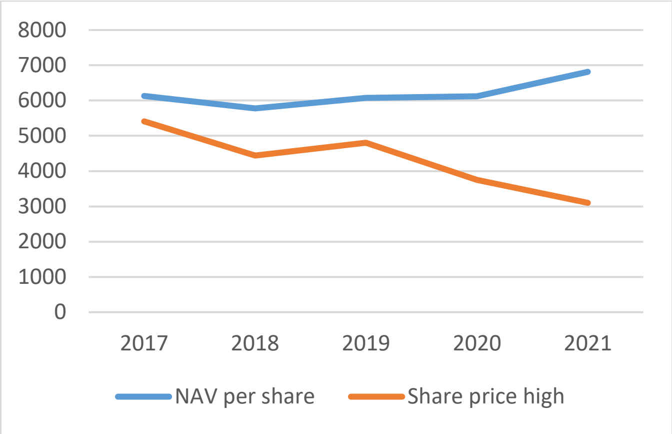
Figure 22 HEPS vs Headline Earnings growth – positive impact of share buy backs



Source: Company data, Chronux Research

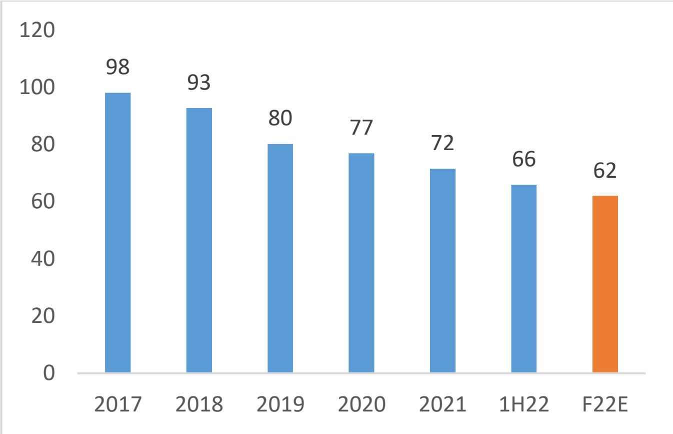
Balance Sheet Management

Figure 23 Deep discount to NAV - ZAc



Source: Chronux Research

Figure 24 Shares in issue - million



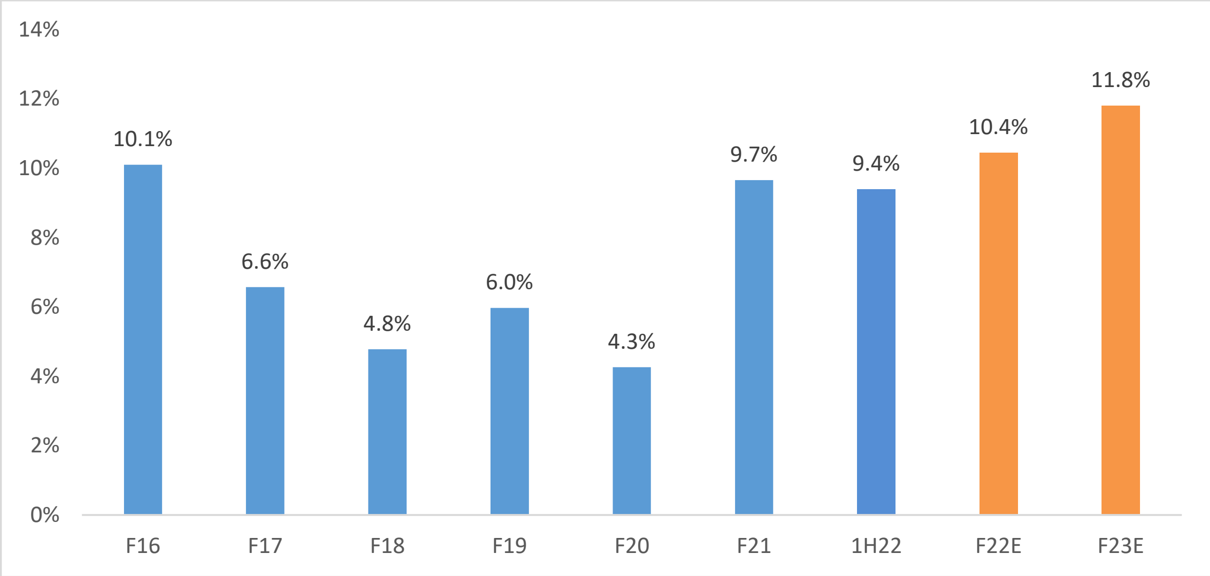
Source: Chronux Research

Apart from lease liabilities of R806m in FY21, the group has no short or long term borrowings on the balance sheet. Short term debt of R922m (in FY20) was repaid in FY21. This means its R5.7bn debtors book is funded with internal cashflow. Operating cash flow post interest and tax was R808m in FY21 (1H22 R532m). It had R447m (R390m on 1H22) of cash on hand in FY21, resulting in a robust balance sheet. Added to this the group had a 55% dividend payout ratio in FY21 and managed to buy back 5.36m shares in issue (7% of FY20 shares in issue). This trend remains intact in 1H22 with a 55% payout ratio, no additional debt and 6m shares acquired up to early November 2021.

The company has been consistently buying back shares and cancelling them, accumulating 23.34m of shares in the past four years to early November 2021. Since listing it's acquired 34.5% of shares in issue. Pre FY17 the stock traded at a premium to its NAV, but derated significantly given the regulatory impact on its financial services businesses, the reputational damage caused by litigation, a declining repo rate and the sharp decline in its HEPS as a consequence. As evidenced in Figure 23 (using the highest share price in the financial year), the stock has been trading at a significant discount to NAV making it a prime candidate for share buybacks. We support the decision to buy back shares particularly as it retains a high dividend payout and has assumed no bank debt.

Management has confirmed it would not pursue buybacks should it need to raise debt to do so. Its dividend payout ratio of 55% is its priority. Debt would be considered for growth in its debtors book or acquisitions. We see a sound enough balance sheet to maintain the buy backs through to FY23E and management has obtained shareholder approval.

Figure 25 ROE – headline earnings as a % of average shareholder funds



Source: Company data, Chronux Research

Its ROE in FY16 was 10.1%, compared to 9.7% in FY21. Over this period its gearing ratio has declined from 25.5% to 7.4% (0% excluding IFRS 16), masking the improved profitability as measured by ROE. We have the ROE rising to 10.4% in FY22E and 11.8% in FY23E. Management is targeting a 15% ROE in the medium to long term.

Valuation

Figure 26 DFCF valuation assumptions

WACC Assumptions	
Risk free rate	9.5%
Beta	1.0
Market risk premium	6.5%
Marginal tax rate	29.0%
Pre-tax cost of debt	0.0%
Cost of equity	16.0%
Target debt/value ratio	0.0%
Target equity/value ratio	100.0%
WACC	16.0%
Growth Rate assumption	
Sustainable long term growth rate	4.0%

Source: Chronux Research estimates

Figure 27 DFCF sensitivity to WACC and growth rate

		WACC				
		-1%	-0.50%	0%	0.5%	1.0%
Terminal Growth	3.0%	7248	6978	6728	6497	6281
	3.5%	7350	7069	6809	6568	6345
	4%	7462	7167	6896	6646	6414
	4.5%	7584	7275	6991	6730	6488
	5%	7719	7393	7094	6821	6569

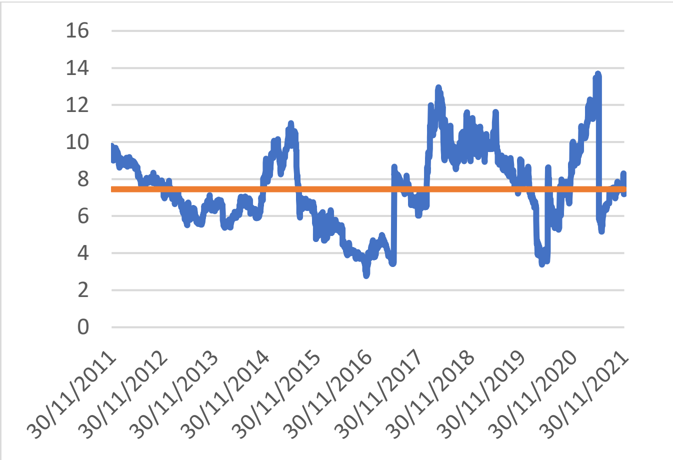
Source: Chronux Research estimates

We value the group on a DFCF basis, applying a WACC of 16.0%, a risk premium of 6.5%, a beta of 1.0 and a sustainable long-term growth rate of 4%, as highlighted in the table above. The lack of gearing negatively impacts its WACC. Applying some sensitivities to WACC and terminal growth rates leads to a valuation range of R65.68-72.75/share. This remains at a discount to our FY22E NAV/share of R73.50. Applying the midpoint of the valuation range (R69.22), values the stock on a 12-month forward P/E of 8.2x.

Based on our HEPS forecasts, the stock trades on a 12M forward P/E of 5.5x, a 27% discount to its 10-year historical average of 7.5x as highlighted in the chart below. This average P/E reflects a five-year period of consistent negative HEPS growth (FY14 up to and including FY18) with the P/E dropping below 4x. With circa 23 % HEPS growth p.a over the next two years, the discount to its historic average appears unjustified.

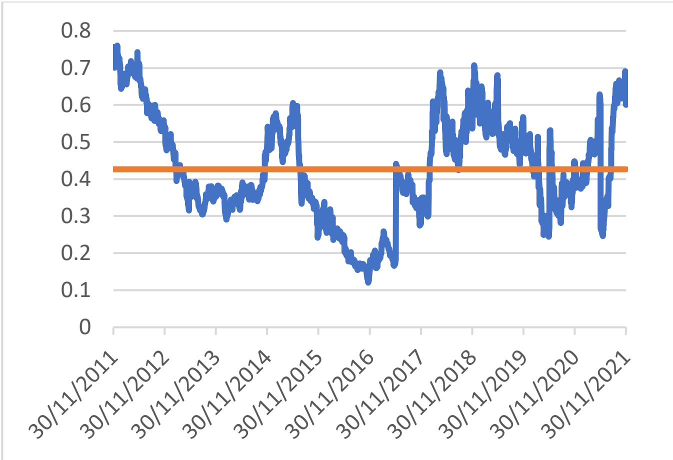
Our FY24E HEPS of 1119c will surpass the 1008c reported in FY13, after which time the stock rallied to a high of R100 per share. Over the pursuing period the company has faced numerous challenges and has spent the last six years on a journey to transform the business into one that focuses on a far broader target market, is less reliant on credit sales/financial services and is optimising shareholder returns through effective balance sheet management. Reputational and financial risk have declined considerably over the transformation period. Given these changes and our strong HEPS growth recovery over the next two years, we would anticipate a strong rerating in the stock.

Figure 28 Lewis P/E – average 7.5x



Source: FactSet, Chronux Research

Figure 29 Lewis/ALSI – P/E Rel – ave 0.43x



Source: FactSet, Chronux Research

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.
- A sharp devaluation of the rand will have a negative impact on the pricing of its imports which accounts for 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 is currently successfully claiming 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 buy back 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.

Disclaimer: