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Lewis Group

ANCHOR STOCKBROKERS

Coping with a difficult environment

- Lewis announced 19% growth in HEPS, bolstered by continued share buybacks (headline earnings up 4%) and strong credit sales (+16%). It maintained an interim dividend of 195c. Cost control was admirable with 6.9% growth in operating costs (excl depreciation). Cash sales declined across all brands as consumers affordability is constrained – this was more than offset by credit sales, its enabler for sales during difficult times, a key competitive advantage. Credit quality improved further despite the environment. UFO disappointed due to lower cash sales and rampant logistics costs given shipping and transport challenges.
- Merchandise sales was up 4.3% whilst other revenue rose 3.5%. Credit sales/total sales rose from 51.4% in FY22 to 56.5%, a level its likely to maintain in the short term given pressure on cash sales. Store rollouts continue with a net 16 additional envisaged for FY23E. Other revenue lags the strong credit sales. Finance income (+1.7%), the biggest component, is starting to show a rising yield (as a % of debtors) as anticipated and will continue to improve into FY25E as interest rates rise and the book rolls over. Ancillary income includes extended warranty insurance that only kicks in after 12 months - this declined 0.6% but we estimate it to rise in 2H23E. Insurance income (+4.2%) is more reflective of credit sales growth but also requires upfront policy charges. We have other revenue rising 5% and 6% in FY23E and FY24E.
- The quality of the debtors book continues to improve, driving debtors costs down 2% to 9.1% of ave gross debtors. We see this rising to 12% for the full year. Debit orders now account for 42% of collections, enabling collection rates to improve from 79% in FY22 to 81.7%. Satisfactory paid customers are now 78.8% of total customers, 69.2% in value. Non- performing accounts (NPA) declined from 22.1% to 16.6% in value - this impacted the overall provision coverage (declined from 40.4% in FY22 to 38.7%) as NPA's attract 88% provision coverage compared to 21% in satisfactory paid. Provisions cover all arrears by 118% (122% in FY22). Management commented that collections continued to perform well post interim period end.
- September and October were difficult trading months with Black Friday and the festive season needed to restore growth. We reduce our FY23E and FY24E sales growth from 9% and 8.6% to 4.2% and 7.6% respectively. Logistic challenges resulted in GP margins declining in 1H23 but should be maintained at 40.5% for the full year. Operating cost growth for the full year will rise – we estimate 8.4%. The growth in the debtors book as well as increased inventory levels resulted in R432m of short term debt ((R81m in FY22). We anticipate debt to be a feature of results in the medium term as credit sales accelerate and management maintains its buyback programme and dividend policy. Management guides to gearing of 20-25%.
- We revise our FY23E HEPS down from 930c to 856c (+1%) and FY24E from 1132c to 1068c (+23%) due to a slower sales outlook and higher borrowing costs. FY24E should benefit from improved UFO results and rising debtors book yields. The buyback programme will continue and a further 10% of shares are expected to be cancelled in FY23E and FY24E. We anticipate a dividend payout ratio of 53%, equating to a 426c DPS, a forward dividend yield of 8.4%.
- Lewis is trading on an attractive forward 12m P/E of 5.3x and an EV/EBITDA of 3.3x. We have ROE's rising from 11.7% to 13.2% in FY25E – 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 R65.70-R78.11, a mid-point of R71, down from R73.

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Price (25/11/2022):	R50.75
Market cap	R2984mn
Shares in issue	58.8mn

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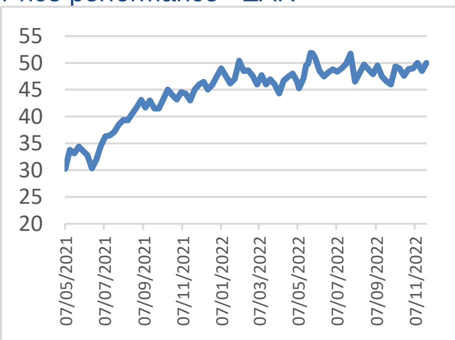
Price performance - ZAR



Source: FactSet

Figure 1 Financial summary

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	4,568	4,913	5,295
Sales growth (%)	*22.9%*	*4.7%*	*6.7%*	*11.5%*	*4.2%*	*7.6%*	*7.8%*
Gross profit	1,451	1,512	1,642	1,775	1,850	1,990	2,171
growth %	*22.2%*	*4.2%*	*8.6%*	*8.1%*	*4.2%*	*7.6%*	*9.1%*
Finance income	1,248	1,312	1,271	1,280	1,315	1,399	1,508
growth %	*-8.4%*	*5.1%*	*-3.1%*	*0.7%*	*2.8%*	*6.4%*	*7.8%*
Insurance income	647	666	707	776	859	908	964
growth %	*-3.5%*	*2.9%*	*6.2%*	*9.7%*	*10.8%*	*5.6%*	*6.1%*
Ancillary income	722	790	817	818	844	894	946
growth %	*9.6%*	*9.3%*	*3.4%*	*0.2%*	*3.2%*	*6.0%*	*5.8%*
EBITDA	522	629	1,039	1,095	1,049	1,188	1,289
EBITDA Margin (%)	*14.8%*	*17.1%*	*26.4%*	*25.0%*	*23.0%*	*24.2%*	*24.3%*
EBIT	443	254	696	668	667	831	921
EBIT Margin (%)	*12.6%*	*6.9%*	*17.7%*	*15.2%*	*14.6%*	*16.9%*	*17.4%*
Profit before tax	464	273	604	674	653	780	857
Net profit	310	182	433	483	476	565	622
Net profit post minorities	310	182	433	483	476	565	622
Headline Earnings	308	205	463	561	507	565	622
Basic EPS (ZAc)	377	232	576	731	804	1,068	1,309
Headline EPS (ZAc)	376	260	617	849	856	1,068	1,309
% growth	*24.3%*	*-30.8%*	*137.0%*	*37.7%*	*0.9%*	*24.8%*	*22.5%*
DPS (ZAc)	234	185	328	413	426	588	720
Payout ratio (%)	*61.1%*	*78.9%*	*56.9%*	*56.5%*	*53.0%*	*55.0%*	*55.0%*
Balance Sheet							
Cash and Cash equivalents	205	1,193	447	308	204	224	174
Current asset (ex – cash)	4,425	4,368	4,588	4,739	5,022	5,093	5,346
Net Fixed assets	299	1,018	1,021	396	440	510	584
Intangible assets	310	308	297	258	243	228	213
Investments	276	228	254	266	258	273	290
Other assets	274	273	218	940	955	1,003	1,044
Total assets	**5,789**	**7,388**	**6,823**	**6,907**	**7,122**	**7,331**	**7,650**
Debt	0	922	0	81	200	300	400
Current liabilities	783	1,052	1,295	1,305	1,484	1,531	1,573
Other liabilities	130	705	656	805	828	859	887
Total liabilities	**913**	**2,679**	**1,951**	**2,190**	**2,512**	**2,690**	**2,861**
Shareholders' equity	4,876	4,710	4,873	4,717	4,548	4,640	4,790
Minorities	0	0	0	0	0	0	0
Total shareholders' equity	**4,876**	**4,710**	**4,873**	**4,717**	**4,548**	**4,640**	**4,790**
BVPS (ZAR)	*6,080*	*6,124*	*6,812*	*7,523*	*8,151*	*9,279*	*10,645*
ROE (%)	*6.0%*	*4.3%*	*9.7%*	*11.7%*	*11.0%*	*12.3%*	*13.2%*

Year Ending	FY2019 A	FY2020 A	FY2021 A	FY2022 A	FY2023 F	FY2024 F	FY2025 F
Cash Flow							
Reported net profit	**310**	**182**	**433**	**483**	**476**	**565**	**622**
Change in net working capital	151	-256	-139	-156	-112	-31	-219
Dividends paid	-168	-196	-147	-254	-244	-272	-321
Other adjustments	235	920	661	618	696	678	803
Cash flow from operations	**528**	**650**	**808**	**691**	**816**	**940**	**885**
Net Capex	-79	-104	-119	-67	-110	-138	-143
Capex/sales (%)	*2.2%*	*2.8%*	*3.0%*	*1.5%*	*2.4%*	*2.8%*	*2.7%*
Other investing cash flows	-48	96	23	102	5	-2	-2
Cash flow from investing	**-127**	**-8**	**-96**	**34**	**-104**	**-140**	**-145**
Equity raised/(bought back)	-105	-123	-136	-408	-391	-300	-250
Net inc/(dec) in borrowings	0	0	0	0	119	100	100
Other financing cash flows	-671	469	-1,323	-551	-545	-583	-643
Cash flow from financing	**-776**	**347**	**-1,459**	**-959**	**-816**	**-781**	**-790**
Net cash flow	**-375**	**989**	**-747**	**-234**	**-104**	**20**	**-50**
Free cash flow	**439**	**179**	**610**	**680**	**650**	**805**	**691**
Repayment of lease liabilities			**-254**	**-297**	**-300**	**-309**	**-318**
Net free cash flow	**439**	**179**	**355**	**384**	**350**	**496**	**372**
Valuation Summary							
Valuation Metrics							
Share Price (ZAc)	3,110	1,782	3,050	5,075	5,075	5,075	5,075
P/E (Underlying) (x)	8.3	6.8	4.9	6.0	5.9	4.7	3.9
P/BV (x)	0.5	0.3	0.4	0.7	0.6	0.5	0.5
EV/Sales (x)	1.0	1.0	0.9	0.8	0.8	0.7	0.7
EV/EBITDA (x)	7.0	5.8	3.5	3.3	3.5	3.1	2.8
EV/EBIT (x)	8.2	14.3	5.2	5.4	5.5	4.4	4.0
FCF Yield (%)	13.8	5.6	11.2	12.1	11.0	15.6	11.7
Dividend Yield (%)	7.5	10.4	10.8	8.1	8.4	11.6	14.2
Net debt	-205	567	359	723	974	1084	1265
Gearing ratio	-4%	12%	7%	15%	21%	23%	26%
Net debt (excluding lease liabilities)	-205	-271	-447	-227	-4	76	226
Gearing ratio (excluding lease liabilities)	-4%	-6%	-9%	-5%	0%	2%	5%

Source: Company data, FactSet, ABS estimates

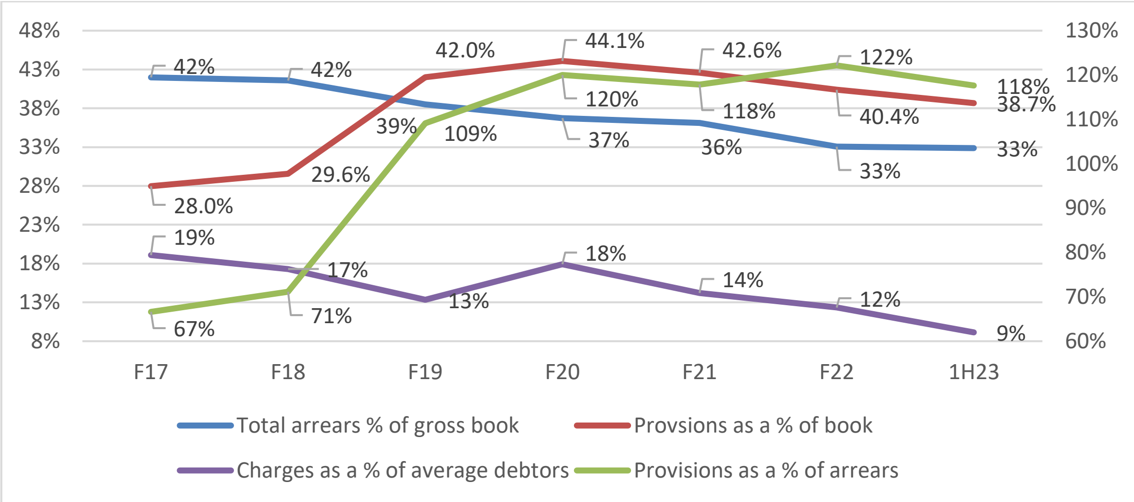
Debtors Book

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 68.6% in FY22 to 69.3%. As per the chart below this was 57.9% in FY18. By number, the value is 78.8%.
- Collection rates have risen from 79% in FY22 to 81.7%.
- Total arrears have declined from 33.1% in FY22 to 32.9%. This was as high as 42% in FY18

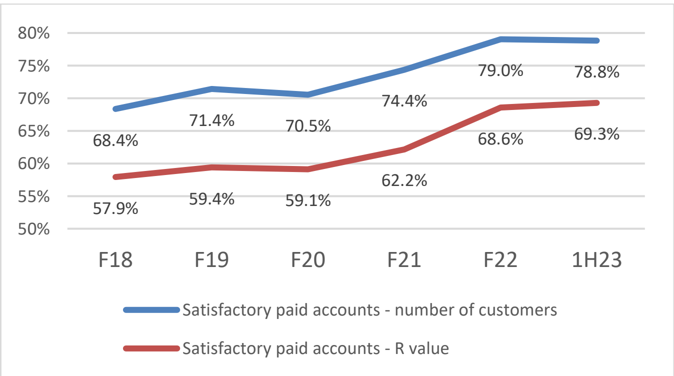
Whilst provisions as a % of the gross book has declined slightly from 40.4% in FY22 to 38.7%, we are not alarmed as the quality of the book is better and therefore warrants lower provisions. With lower non-performing accounts (NPA) the portfolio provision coverage will decline as NPA's have higher coverage ratios than satisfactory paid accounts (88.1% vs 20.7%). NPA's have declined from 17% of total gross debtors in FY22 to 16.6% whilst satisfactory accounts increased from 68.6% to 69.2%. Provisions as a % of total arrears declined from 122% to 118%, a level it was at in FY21.

Figure 2 Credit quality trends



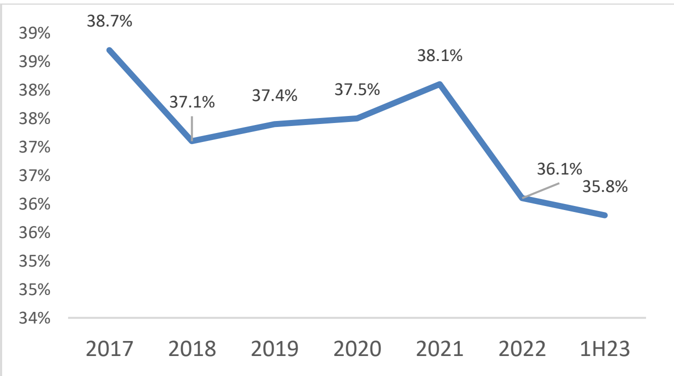
Source: Company data, ABS Research

Figure 3 Satisfactory paid accounts



Source: Company data, ABS Research

Figure 4 Credit application decline rates



Source: Company data, ABS Research

As per Figure 4 above, credit application decline rates fell further from FY22. The decline is driven by a better risk profile of customers as evidenced by higher satisfactory paid customer numbers. Granting criteria has not changed. With circa 45% of new business coming from existing clients, the improved profile of the book should result in lower rejection rates. However, intuitively one would not expect this to decline further given affordability challenges facing consumers and the trend would need to be monitored closely. The decline rate is up on the 33% achieved in 2H22.

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 144% coverage (148% in FY22) of the problematic book. We have excess provisions of R702m which represents a general provision of 12% (13% in FY22) of the gross debtors book.

In 1H23 provisions of R2282m are adequate to cover:

- All the NPAs totalling R977m
- All the arrears in Slow Payers – totalling R556m
- All the arrears in Satisfactory Paid – R602m

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	1H23
Non performing accounts	1484	1452	1285	1261	1238	971	977
Slow payers > 3m in arrears	483	460	412	383	382	364	381
Satisfactory paid >3m in arrears	233	211	196	196	216	222	222
Problematic book	2200	2123	1894	1839	1836	1557	1580
Total group provisions	1561	1620	2323	2534	2424	2300	2282
% coverage	71%	76%	123%	138%	132%	148%	144%
Excess provisions/general provision	-639	-503	429	695	588	744	702
% of gross debtors	-11%	-9%	8%	12%	10%	13%	12%

Source: Company data, ABS estimates

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