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Lewis Group

ANCHOR STOCKBROKERS

1H24 Results – Investing for the future

- Lewis announced 1H24E HEPS of 372c, down 6.6% on 1H23. The result is ahead of expectations given stronger growth from interest earned off its debtors book and the inclusion of R22.7m from an insurance claim for business interruption dating back to 2021. The result has a greater than anticipated shift from cash (-14%) to credit sales (+20%), with the latter now 64% of total sales (60% in FY23, 51% in FY22). This has surpassed the guidance range issued in the FY23 results of 59-63%. We anticipate it reaching 67% for FY24E, outside the FY24E and medium term guidance ranges.
- The implication of higher credit sales is a larger debtors book - we now forecast for this book to grow 17% in FY24E. Apart from the greater funding required for the book, it also requires additional credit provisions – new loans are provided for at 25% on origination. These two factors will drive a lower 2H24E result than expected. In addition, Black Friday has disappointed with sales down 5% on the prior period – load shedding disruptions playing a role.
- The ongoing investment in the debtors book is benefiting interest income and will continue to do so more meaningfully in the medium term. New business is being written at a 25.25% interest rate compared to the average yield in 1H24 of 22.5% (21.6% in FY23), indicating a further 2.75% uplift over time, a strong tailwind to revenue growth despite the challenging operating environment. We forecast growth of 23% in FY24E and 17% in FY25E.
- We forecast the debtors charge to rise 62%, to 16.4% of gross debtors (guidance is 12-16%) - FY23 was a historically low charge given the release of provisions. We see the charge rising 7% in FY25E (15.8% of gross debtors), given the higher base and a decline in performing book provisions. While a 25% provision is raised on new business, it declines on good performing credit after 6 months. We believe the book is conservatively provided for and in the absence of IFRS 9, provisions would be lower given the high coverage in the satisfactory book - 171% coverage of its arrears (143% in 1H23). Currently 52% of the book is collected on debit order positively impacting arrears.
- The operating environment remains challenging. Whilst no details of the loadshedding costs were provided, it remains a headwind with lower levels of activity. All Lewis stores are operational during loadshedding. Cash sales remain under pressure and therefore UFO sales will continue to be constrained. We anticipate 3.8% sales growth in FY24E (4.8% in 1H24), supported by circa 40 new stores in the year – like for like sales was 1.9% in 1H24. We anticipate an improvement in FY25 (+6.8%) given the new stores, an improvement from UFO and some relief on consumers affordability.
- Costs remain well contained (+4.2%) but operating margins (pre impairments) declined from 15.5% to 14.8% - we anticipate adjusted margins of 12% in FY24E, bottom of the 12-16% guidance range, rising to 15.4% in FY25E.
- We revise our FY24E HEPS from 740c to 622c given higher debtors costs (R1168m vs R944m) and higher funding costs (R157m vs R131m). Our gross profit expectation remains broadly in line with other revenue revised up from R3406m to R3472m. FY24E reflects heavy investment in the debtors book with the returns flowing through over the subsequent years. Our revised FY26E HEPS forecast of 1267c is only 7% off our prior forecast.
- The mid-point of our DFCF valuation declines from R58 to R54 per share given lower free cash flow in the near future. We still envisage a fairly consistent dividend payout ratio (fwd 8.7% dividend yield) and ongoing share buy backs of around 7% in FY24E. The stock trades on an attractive 18m fwd P/E of 4.4x.

Date: 06 December 2023

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Price (06/12/2023):	R39.40
Market cap	R2246mn
Shares in issue	54mn

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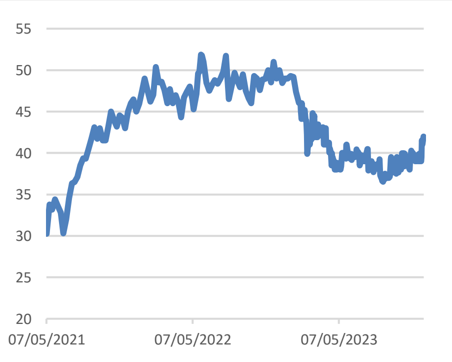
Price performance - ZAR



Source: FactSet

Figure 1 Financial summary

Year Ending	FY2020 A	FY2021 A	FY2022 A	FY2023 A	FY2024 F	FY2025 F	FY2026 F
Income Statement							
Merchandise Sales	3,686	3,931	4,383	4,443	4,610	4,925	5,285
Sales growth (%)	*4.7%*	*6.7%*	*11.5%*	*1.4%*	*3.8%*	*6.8%*	*7.3%*
Gross profit	1,512	1,642	1,775	1,806	1,899	2,044	2,209
growth %	*4.2%*	*8.6%*	*8.1%*	*1.8%*	*5.2%*	*7.6%*	*8.1%*
Finance income	1,312	1,271	1,280	1,334	1,634	1,913	2,101
growth %	*5.1%*	*-3.1%*	*0.7%*	*4.2%*	*22.5%*	*17.0%*	*9.9%*
Insurance income	666	707	776	854	973	1,024	1,076
growth %	*2.9%*	*6.2%*	*9.7%*	*10.1%*	*13.9%*	*5.2%*	*5.1%*
Ancillary income	790	817	818	825	865	931	998
growth %	*9.3%*	*3.4%*	*0.2%*	*0.9%*	*4.8%*	*7.6%*	*7.2%*
Total revenue	4,280	4,437	4,649	4,819	5,371	5,911	6,384
growth %		4%	5%	4%	11%	10%	8%
EBITDA	629	1,039	996	960	942	1,138	1,296
EBITDA Margin (%)	*17.1%*	*26.4%*	*22.7%*	*21.6%*	*20.4%*	*23.1%*	*24.5%*
EBIT	254	696	668	609	544	761	908
EBIT Margin (%)	*6.9%*	*17.7%*	*15.2%*	*13.7%*	*11.8%*	*15.4%*	*17.2%*
Recurring EBIT	276	726	767	703	553	761	908
Recurring EBIT Margin (%)	*7.5%*	*18.5%*	*17.5%*	*15.8%*	*12.0%*	*15.4%*	*17.2%*
Profit before tax	273	604	674	567	447	637	787
Net profit	182	433	483	411	329	468	578
Net profit post minorities	182	433	483	411	329	468	578
Headline Earnings	205	463	561	510	338	468	578
Basic EPS (ZAc)	232	576	731	695	605	945	1,267
Headline EPS (ZAc)	260	617	849	863	622	945	1,267
% growth	*-30.8%*	*137.0%*	*37.7%*	*1.7%*	*-28.0%*	*52.1%*	*34.0%*
DPS (ZAc)	185	328	413	413	363	520	697
Payout ratio (%)	*78.9%*	*56.9%*	*56.5%*	*59.4%*	*60.0%*	*55.0%*	*55.0%*
Balance Sheet							
Cash and Cash equivalents	1,193	447	308	183	306	360	331
Current asset (ex – cash)	4,368	4,588	4,739	5,175	5,980	6,571	6,949
Net Fixed assets	1,018	1,021	396	426	491	534	584
Intangible assets	308	297	258	175	187	200	214
Investments	228	254	266	257	249	283	324
Other assets	273	218	940	916	937	982	1,025
Total assets	**7,388**	**6,823**	**6,907**	**7,133**	**8,150**	**8,930**	**9,428**
Debt	922	0	81	368	1,000	1,300	1,350
Current liabilities	1,052	1,295	1,305	1,252	1,399	1,450	1,536
Other liabilities	705	656	805	820	838	897	953
Total liabilities	**2,679**	**1,951**	**2,190**	**2,440**	**3,237**	**3,646**	**3,839**
Shareholders' equity	4,710	4,873	4,717	4,693	4,781	5,052	5,358
Minorities	0	0	0	0	0	0	0
Total shareholders' equity	**4,710**	**4,873**	**4,717**	**4,693**	**4,781**	**5,052**	**5,358**
BVPS (ZAR)	*6,124*	*6,812*	*7,523*	*8,218*	*9,277*	*10,636*	*12,239*
ROE (%)	*4.3%*	*9.7%*	*11.7%*	*10.8%*	*7.1%*	*9.5%*	*11.1%*

Year Ending	FY2020 A	FY2021 A	FY2022 A	FY2023 A	FY2024 F	FY2025 F	FY2026 F
Cash Flow							
Reported net profit	**182**	**433**	**483**	**411**	**329**	**468**	**578**
Change in net working capital	-256	-139	-156	-239	-671	-554	-307
Dividends paid	-196	-147	-254	-241	-226	-206	-273
Other adjustments	920	661	618	596	1,042	898	855
Cash flow from operations	**650**	**808**	**691**	**526**	**474**	**607**	**853**
Net Capex	-104	-119	-67	-125	-152	-133	-143
Capex/sales (%)	*2.8%*	*3.0%*	*1.5%*	*2.8%*	*3.3%*	*2.7%*	*2.7%*
Other investing cash flows	96	23	102	51	-11	-3	-3
Cash flow from investing	**-8**	**-96**	**34**	**-74**	**-163**	**-136**	**-145**
Equity raised/(bought back)	-123	-136	-408	-310	-276	-182	-175
Net inc/(dec) in borrowings	0	0	0	0	633	300	50
Other financing cash flows	469	-1,323	-551	-547	-547	-538	-616
Cash flow from financing	**347**	**-1,459**	**-959**	**-856**	**-189**	**-417**	**-737**
Net cash flow	**989**	**-747**	**-234**	**-403**	**123**	**54**	**-29**
Free cash flow	**179**	**610**	**582**	**441**	**0**	**282**	**1,087**
Repayment of lease liabilities		**-254**	**-297**	**-305**	**-320**	**-329**	**-339**
Net free cash flow	**179**	**355**	**285**	**136**	**-319**	**-47**	**748**
Valuation Summary							
Valuation Metrics							
Share Price (ZAc)	1,782	3,050	4,160	4,160	4,160	4,160	4,160
P/E (Underlying) (x)	6.8	4.9	4.9	4.8	6.7	4.4	3.3
P/BV (x)	0.3	0.4	0.6	0.5	0.4	0.4	0.3
EV/Sales (x)	0.8	0.8	0.7	0.7	0.7	0.6	0.6
EV/EBITDA (x)	5.0	3.0	3.1	3.2	3.3	2.7	2.4
EV/EBIT (x)	12.3	4.5	4.7	5.1	5.7	4.1	3.4
FCF Yield (%)	8.0	15.8	12.7	6.0	-14.2	-2.1	33.3
Dividend Yield (%)	10.4	10.8	9.9	9.9	8.7	12.5	16.8

Net debt	567	359	723	1130	1686	1982	2113
Gearing ratio	12%	7%	15%	24%	35%	39%	39%
Net debt (excluding lease liabilities)	-271	-447	-227	185	694	940	1019
Gearing ratio (excluding lease liabilities)	-6%	-9%	-5%	4%	15%	19%	19%

Source: Company data, FactSet, ASB estimates

Debtors Book

The debtors book has maintained its quality despite a deteriorating affordability environment. This can be attributed to increased debit order penetration, now at 52% of the book, 80% on new applications from formally employed customers, and more vigilant credit management. Debit order collections has freed up capacity to focus on arrears and ensuring higher collection rates. It also ensures better quality repeat business which is around 45% of new sales. Provisions as a % of gross debtors remains at 36% since FY23, collection rates are modestly higher at 80% while satisfactory paid accounts by value increased from 73.8% to 74.7%, the highest in recent history.

Total arrears have declined from 27.8% in FY23 to 26.7% - this was as high as 42% in FY18. NPA's (non-performing accounts) have declined from 11.4% of total gross debtors in FY23 to 11.3% (FY23 has been restated due to Insurance accounting changes). Credit application decline rates are fairly stable at 34.8%.

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 177% coverage (173% in FY23) of the problematic book. We have excess provisions of R1002m which represents a general provision of 16% (15% in FY23) of the gross debtors book. With higher interest rates, the discount rate for future collections as per IFRS 9 is considerably higher and therefore provisions are further inflated. In the absence of IFRS 9 we would see a decline in provisions and therefore a considerably lower debtors cost in the income statement.

In 1H24 provisions of R2310m are adequate to cover:

- All the NPAs totalling R724m.
- All the arrears in Slow Payers – totalling R558m
- All the arrears in Satisfactory Paid – R628m

We therefore believe the book is adequately provided for.

Figure 2 Provision coverage of the "problematic book"

Stress test provision levels	F17	F18	F19	F20	F21	F22	F23	1H24
Non performing accounts	1484	1452	1285	1261	1238	971	688	724
Slow payers > 3m in arrears	483	460	412	383	382	364	350	367
Satisfactory paid >3m in arrears	233	211	196	196	216	222	214	217
Problematic book	2200	2123	1894	1839	1836	1557	1252	1308
Total group provisions	1561	1620	2323	2534	2424	2300	2163	2310
% coverage	71%	76%	123%	138%	132%	148%	173%	177%
Excess provisions/general provision	-639	-503	429	695	588	744	911	1002
% of gross debtors	-11%	-9%	8%	12%	10%	13%	15%	16%

Source: Company data, ASB estimates

Despite the high levels of provisions, provision coverage levels of circa 36% is likely to persist given the strong growth in the debtors book and the raising of provisions on origination. As a consequence, the debtors costs will rise considerably in FY24E as the debtors book grows on the back of the robust credit sales. Our estimated 17% rise in the debtors book with consistent provision coverage implies a further circa R368m of provisions. We forecast a R449m increase in the debtors charge in FY24E to account for this as well as a buffer for any deterioration in collection rates and bad debt recoveries.

Other revenue

The other revenue categories are accelerating in growth on the back of rising credit sales. Growth was 1% in FY21, 2.8% in FY22 and 4.9% in FY23. 1H24 saw a 13.4% rise and we anticipate 15.2% growth for FY24E. Accelerating credit sales is positive for ancillary income, although there is a delay as extended warranty products only kick in after the manufacturers 12-month warranty lapses. There is therefore an acceleration in growth projected for the next two years. Insurance income growth will follow that of credit sales – overall profitability from insurance will improve as lapse rates decline given a better quality customer base. Lastly finance income will improve continually over the next few years as the debtors book reprices – it's an average 32-month fixed interest rate book which has credit at considerably lower rates (20.5% 32 months ago) rolling off whilst new business is done at consistently higher rates and values. The yield enhancement from the book was 80bp in FY23 to 21.6%, an additional 90bp in 1H24. New business is currently done at 25.25%. A 100bp enhancement to yield equates to R46m of PAT, 14% uplift on our FY24E PAT forecast.

Competition

Shoprite's furniture segment achieved 2% like for like sales (5.1% in total) for the 52 weeks ended 2 July 2023. Credit sales remain at considerably lower levels than Lewis, at 14.9% (up from 13.4%). It opened a net 8 stores in the period. Trading profit declined 50.7%.

JD Group (part of Pepkor Holdings) reported like for like sales down 2.1% (down 1.2% in total) for the 12 months ended 30 September 2023. Credit sales remained stable at 11%. It opened 49 new stores and stated its intention to optimise its brands.

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