# INDUSTRY EXPERT LECTURES IN FINANCE

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| Topic | : Analyse the General Retailer sector using financial metrics and other data to identify the most attractive investment opportunities |
| Presenter | : Tim Clarke |
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## 1. Introduction

The goal of this report is to give investment recommendations for stocks of companies that are preferably undervalued, having a high potential for a capital appreciation or dividend growth. The recommendations are given for stocks that are believed to be out of favour only for a limited period of time or undervalued by the. Following a value and income style, the following recommendations are not necessarily appropriate to achieve short-term trading gains. Instead of achieving a short-term capital appreciation, the identification of attractively priced and financially solid companies will be assumed to be part of the portfolio for several years after the purchase. As the total return of value stocks includes both the capital gain in the stock price and the dividend payment, the downward risk of such stocks is limited. Compound interest is a powerful but often underestimated investment tool. Reinvested income in well established and mature companies being able to face difficult market conditions and changing business cycles has led income stocks to outperform the overall market in the long-term.

For the following fundamental analysis the given Excel spreadsheet was used, complemented by additional data mainly from ft.com, londonstockexchange.com and Sharescope Gold. Balance sheets and income statements were accesses for a more thorough analysis. The overall economic condition and prospects were gathered using a variety of forecasts and specialist knowledge.

## 2. General Retail Sector Overview and Outlook

The KPMG/Ipsos Retail Think Tank (RTT) predicts another year of low growth in 2013. The lack of economic growth and missing consumer confidence will result in deferred discretionary spending which especially affects retailers selling big ticket items. An estimated 0.8% decrease in households' incomes in 2013 adds credibility to this prediction. Operating in this low growth environment, retailers have to focus especially on their costs and a strengthening of their financiers' relationships. David McCorquodale (2012) of KPMG predicts that "2013 will bring increased overheads to retailers' doors, including enhanced pension obligations and rising business rates, which they will be unable to pass on to a consumer already reluctant to part with their cash. These trading conditions will play greatly to the relationship between the retailers and their financiers and an open dialogue between retailer, bank and credit insurer will be vital to survival."[1]

The Centre for Retail Research forecasts a retail growth of only 0.3% in real terms (inflation subtracted) under the assumption of no further upset due to a major Eurozone crisis. Growth in 2014 is estimated at 1.2%-1.4%. However online sales are already included in this forecast. Physical sales on the high street will continue to decline whereas growth is concentrated on online retailers. For the fourth year in succession, total sales in UK shops and stores will fall by -1.9%. Since the beginning of the financial crisis in 2008, the retail sector faced three main problems: (1) Less consumer confidence and hence less consumer spending; (2) Retail balance sheets were focused on continued growth and consumer spending; (3) Rapid growth on online spending mainly at the expense of conventional stores.

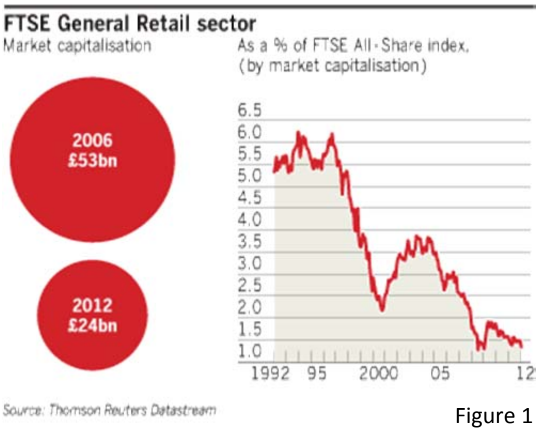



Figure 1

The dropout of multiple retailers (see http://www.retailresearch.org/whosegonebust.php) and an average share price decline of 40% of FTSE listed retailers have caused a massive drop in value of non-food retailers in the FTSE 350 retail index[2] (see Figure 1).

[1] KPMG (2012): 2013 will be another tough year for retailers. Available at: http://www.kpmg.com/uk/en/issuesandinsights/articlespublications/newsreleases/pages/2013-will-be-another-tough-year-for-retailers-warns-kpmg-ipsos-retail-think-tank.aspx (Accessed 20 April 2013)

[2] Barrett (2012): UK retail sector set to shrink further. Available at: http://www.ft.com/intl/cms/s/0/5cf2279e-389d-11e1-9d07-00144feabdc0.html#axzz2RBKMBL7S (Accessed 20 April 2013)

Regarding this difficult business environment in the retail sector and a high risk of bearing financial distress costs in the next years, investment decisions should be made with a low to medium risk.

## 3. Stock Screening

Given a limited word count for this report, a pre-selection of the given sample will be made to be able to analyse selected stocks with a higher probability to perform well over time. Ratio Analysis is used for the evaluation of a firm's performance and its financial health. A comprehensive step-by-step analysis of relevant financial ratios provides a credible picture of a business.[3]

The selection criteria that will be adopted follow basic value style criteria:

- Capitalisation above £250m
- Interest cover of 1.5 or more
- ROCE of at least 12% for last three years
- ROCE trending upwards over last three years
- EPS has increased in four out of the last five years
- Below average PE in subsector
- Net gearing below 100%
- Top quartile in sub-sector for operating margin
- Ideally above average in sub-sector for ROCE, Op. margin, Net Gearing

Due to the consequences of the financial crisis no stock of the sample fulfils the entirety of these criteria. Therefore stocks with the highest degree of fulfilment in each subsector will be picked as they are supposed to possibly outperform their subsector peers.

Table 1 shows the full stock sample, the yellow highlighted cells represent values that are closest to the underlying criteria. Stocks with the highest consensus are red bordered and will be analysed in detail.

[3] Broadbent, M. & Cullen, J. (2003): Managing Financial Resources.3rd edn. Oxford: Butterworth-Heinemann.

**Table 1**

| | Sector | Market Cap. | Subsector | Price | Reported posttax profit (m) | EPS | Norm EPS (p) | Rolling P/E | 3yr av. P/E | Forecast EPS Growth | Rolling PEG | Dividend | Dividend cover | Projected Yield | Op. margin (%) | Gross gearing ex. (%) | Interest cover | ROCE (%) | Quick ratio |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| roup PLC | General Retailers | 6,079.59 | Apparel Retailers | 3.692 | 81 | 29.24 | 26 | 13.17 | 10.4385 | -4.64 | | 13.03 | 2.2 | 3.65 | 13.8 | 74.6 | 21.5 | 19.3 | 2.95 |
| shion PLC | General Retailers | 340.634 | Apparel Retailers | 7.42 | 49.3 | 120.29 | 121 | 8.62 | 6.7112 | -28.67 | | 25.3 | 4.8 | 3.5 | 8.97 | 3.17 | 180 | 59.2 | 0.885 |
| | General Retailers | 6,704.82 | Apparel Retailers | 40.07 | 434 | 255.02 | 217 | 14.29 | 11.5673 | 10.03 | 1.51 | 90 | 2.8 | 2.55 | 17.4 | 321 | 25.6 | 70.4 | 0.898 |
| t International PLC | General Retailers | 2,489.61 | Apparel Retailers | 4.002 | 106 | 16.51 | 14.3 | 18.04 | 14.4348 | 46.43 | 1.12 | 0 | | 2 | 7.47 | 167 | 27 | 33.3 | 0.543 |
| | | | | | | | | | | | | | | | | | | | |
| PLC | General Retailers | 991.582 | Broadline Retailers | 1.013 | 125 | 9.82 | 8.95 | 10.03 | 8.331 | 7.06 | 1.29 | 3.3 | 3 | 3.53 | 7.87 | -208 | 10.8 | 58.6 | 0.146 |
| l Group PLC | General Retailers | 1,204.71 | Broadline Retailers | 1.311 | 72.8 | 10.64 | 22.4 | 17.44 | 8.5489 | -32.77 | | 4.7 | 2.3 | 2.37 | 4.42 | 0 | | 20 | 0.825 |
| ncer Group PLC | General Retailers | 6,079.59 | Broadline Retailers | 3.791 | 490 | 36.47 | 38.1 | 11.45 | 9.8153 | -11.28 | | 17 | 2.1 | 4.48 | 9.53 | 118 | 6.64 | 17.7 | 0.463 |
| PLC | General Retailers | 262.185 | Broadline Retailers | 3.25 | -91.8 | 21.63 | 13 | 35.05 | 17.7552 | -69.75 | | 0 | | 1.85 | 1.93 | 0 | 27.2 | 0.215 | 0.593 |
| | | | | | | | | | | | | | | | | | | | |
| a) Holdings PLC | General Retailers | 206.539 | Home Improvement Retailers | 0.2725 | 13 | 1.86 | 1.99 | 13.63 | 15.2251 | 7.53 | 1.37 | 2 | 0.9 | | 6.74 | 0 | 49.3 | 30.8 | 0.82 |
| PLC | General Retailers | 410.868 | Home Improvement Retailers | 6.69 | 11 | 1.52 | 22.1 | 78.6 | 127.326 | 619.54 | 0.4 | 0 | | 0.3 | 3.37 | 6160 | 4.52 | 19.2 | 0.319 |
| up PLC | General Retailers | 1,678.34 | Home Improvement Retailers | 7.44 | 71.2 | 35.09 | 29.6 | 19.65 | 17.0722 | 13.86 | 1.68 | 14 | 2.5 | 2.12 | 15.6 | 0.261 | 2910 | 55 | 0.503 |
| LC | General Retailers | 6,846.67 | Home Improvement Retailers | 2.727 | 639 | 27.66 | 21.8 | 12.36 | 11.8505 | -20.42 | | 8.84 | 3.1 | 3.34 | 6.34 | 26 | 17.2 | 18.4 | 0.422 |
| PLC | General Retailers | 124.108 | Home Improvement Retailers | 0.5475 | 9.77 | 4.8 | 4.6 | 11.03 | 10.6956 | 10.65 | 0.96 | 1.25 | 3.8 | 2.7 | 8.73 | -231 | 3.27 | 49.6 | 0.552 |
| | | | | | | | | | | | | | | | | | | | |
| | General Retailers | 800.285 | Specialized Consumer Services | 11.55 | 34.3 | 61.14 | 46.7 | 18.49 | 16.3907 | 1.45 | 1.84 | 14.64 | 4.2 | 1.39 | 29.7 | -185 | 3 | 32.7 | 1.58 |
| | | | | | | | | | | | | | | | | | | | |
| | General Retailers | 242.27 | Specialty Retailers | 0.6325 | -32.4 | 1.4 | 15.2 | 20.55 | 17.3739 | 162.57 | 0.33 | 2.9 | 0.5 | 3.44 | 3.06 | 60.7 | 21.9 | 65.2 | 0.386 |
| il PLC | General Retailers | 1,118.29 | Specialty Retailers | 0.276 | -163 | 0.64 | 0.97 | 25.74 | 19.8371 | 90.94 | 0.33 | 0 | | | 0.858 | -128 | 1.9 | 66.9 | 0.401 |
| | General Retailers | 100.073 | Specialty Retailers | 0.0845 | -4.84 | 0.89 | 1.12 | 9.73 | 4.7829 | -2.92 | | 0 | | | 4.22 | 9660 | 1.3 | 9.19 | 3.23 |
| up PLC | General Retailers | 611.721 | Specialty Retailers | 3.506 | 68.4 | 34.1 | 42.8 | 12.14 | 9.2288 | -18.63 | | 22 | 1.5 | 6.27 | 13.8 | -436 | 44.3 | 145 | 0.26 |
| C | General Retailers | 2,278.99 | Specialty Retailers | 4.537 | 148 | 34.1 | 31.9 | 11.87 | 10.9965 | 11.58 | 1.83 | 11 | 3.1 | 2.7 | 3.81 | 65.3 | 12.2 | 18.5 | 0.744 |
| | General Retailers | 362.578 | Specialty Retailers | 0.785 | 25.2 | 6.52 | 5.9 | 11.37 | 9.1552 | 5.55 | 2.43 | 2.18 | 3 | 3.03 | 2.31 | 66.8 | 3.54 | 21.2 | 0.361 |
| PLC | General Retailers | 316.307 | Specialty Retailers | 0.21 | 39.8 | 5.93 | 2 | 10.96 | 5.0423 | -67.96 | 0.94 | 0 | | 1.43 | 1.74 | -171 | 1.66 | 41.1 | 0.25 |
| LC | General Retailers | 913.022 | Specialty Retailers | 6.5 | 84 | 62.7 | 50 | 9.97 | 10.3912 | 10.02 | 1 | 26.9 | 2.3 | 4.62 | 7.07 | 0 | | 82.1 | 0.361 |

## 4. Screening Results

**General Findings:** The majority of companies have a low quick ratio which indicates a low short-term liquidity. Ideally a quick ratio should be 1:1 meaning that a firm is able to meet its current financial obligations with available liquid assets. The retail sector has traditionally a low quick ratio as the business environment is usually stable and companies are able to negotiate favourable credit terms. Therefore a low quick ratio of the analysed companies has to be seen in this context.
An across-the-sample rising P/E ratio in comparison with the 3 year average P/E reflects a slow recovery of market activity. Investors slowly retrieve confidence in the retail sector.
It is hard to find a stock in the retail sector that did not respond to the economic crisis by either falling gearing ratios or efficiency ratios (Dignity PLC as an exception).

**Apparel Retailers: JD Sports Fashion PLC** has a below average market cap (340.934m) in the subsector but features solid financial health, a high dividend yield (3.5%) and has a low price earnings multiple (8.62). Further in-depth analysis will provide a more credible opinion whether JD Sports fits in the value style.

**Broadline Retailers: Debenhams PLC** seems to be most robust stock in the broadline retail subsector. A low debt to equity ratio (-208%) and a good interest cover (10.8) signals financial health, while the forecasted EPS growth is the only positive in compared to subsector peers (7.06%). A well covered yield of 3.53% and a below average P/E ratio of 10.03 in the subsector makes Debenhams an interesting stock.

**Home Improvement Retailers**: In the home improvement retail subsector it is difficult to find suitable stocks. **Carpetright** PLC is highly levered (gross gearing: 6160%) and overvalued with a P/E of 78.6. **Ashley (Laura) Holdings PLC** and **Topps Tiles PLC** have low market caps (206.539£m and 124.108£m). Small cap companies bear a higher risk of financial distress and consequently a high risk for an investor, which disqualifies them from further analysis.

**Speciality Consumer Services**: With a beta of only 0.1895 **Dignity PLC** is an interesting stock in the specialized consumer services sector due to low market correlation and its position as UK's market leader of funeral services. However, with a PEG ratio of 1.84 the stock is overvalued and does not fit in a value style strategy.

**Speciality Retailers**: In the speciality retailing sector large differences concerning leverage and financial health of companies can be spotted. Looking into the balance sheets of **Findel PLC** a total debt of 64£m at year ended 2012 is standing against only 104£m of total equity, which causes a high gross gearing. The interest cover of 1.3 is critically low. This financial situation bears huge risks in the current financial turmoil. The above below subsector P/E of 9.73 could attract high risk taking investors hoping for a turnaround. However, fundamental data indicates not to invest in Findel PLC.

**Halfordsgroup PLC** with a gross gearing of -436% and an interest cover of 44.3 shows a robust financial health and has a high dividend yield of 6.27% with a dividend cover of 1.5. A reasonable P/E ratio of 12.14 and the second highest norm EPS (42.8p) in comparison with the subsector makes Halfords PLC a potential dividend income stock. A ROCE of 145% indicates extraordinary efficiency.

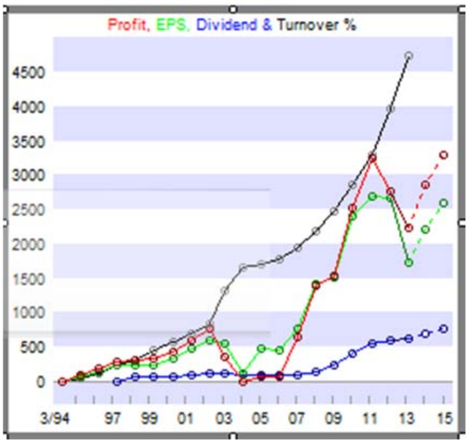
**Darty PLC** has a high forecasted EPS growth of 162.57% with solid financial stability (gross gearing: 60.7%; interest cover: 21.9). A PEG ratio of 0.33 indicates that the stock is undervalued. A detailed analysis of fundamental data and the business model will quality a possible recommendation.

## 5. Detailed Analysis of Investment Alternatives

**Name: JD Sports Fashion PLC**
**Subsector: Apparel Retailers**

| | Stock | Subsector avg.[4] |
|---|---|---|
| **Market Cap.** | **340.634** | **3,903.3665** |
| **P/E** | **8.62** | **13.53** |
| **Yield** | **3.5** | **2.93** |
| **Gross Gearing** | **3.17** | **141.45** |

**Figure 2** Source: Sharescope




JD Sports Fashion Plc is engaged in retail and distribution of sport and athletic inspired fashion, footwear, apparel and accessories. On a five year basis earnings per share growth (34.93%) was among the highest in comparison with the subsector peers. Despite an EPS fall of 16.17% in 2012 and a negative forecasted EPS growth of 28.67% a look at the historical chart development shows an overall positive profit and EPS development in the last 20 years (Figure 2). The fall in profit and consequently EPS can be explained with the acquisition of 200 stores of First Sport from Black Leisure Group.

### Key Investment Ratios

### P/E ratio

With a P/E ratio of 8.62 JD Sports has the lowest multiple of all subsector peers (average of 13.53). This is a first good indicator as it says that investors are willing to pay 8.62 £ for 1 £ of current earnings, whereas the benchmark stocks are more expensive. However cheap

[4] The subsector average is computed by taking the arithmetic mean of the stocks in the Excel sheet and does not match with the complete FTSE subsector averges

stocks are not always good stocks as they bear a higher risk, which is expressed by a low multiple, meaning the market is not willing to pay a high price for the stock. Opposite, companies with a high growth potential will have a high P/E as investors are willing to pay a premium for potential future profits. The rolling P/E shows an increase compared to the 3 year average which indicates increasing investor expectations. The P/E ratio is the best ratio to compare stocks in the same industry, but additional key ratios measuring profitability, cash flows and financial health should be included in the assessment.

**PEG ratio**

The PEG ratio provides a more reliable statement as the P/E ratio as it takes a company's future earnings into account. The ratio indicates whether a stock is overpriced or underpriced. Generally, a PEG ratio below 1 is desired. In this case the PEG ratio does not apply as EPS growth is negative (-28.67%).

**Dividends**

Apart from picking stocks based on expected changes in share prices in the market, future dividend payments determine a good return of a stock. High-growth stocks tend not to pay a dividend to its shareholders and reinvest earnings to sustain a high growth. Many large cap stable companies pay dividends to their shareholders. As the average yield on companies in leading stock market indices in the UK are at least 50% higher than the yield of a ten-year government bond[5], dividend investors are wide-spread.

With a dividend yield of 3.5% JD Sports is the second highest dividend payer after Brown (N) group PLC with 3.65%. To increase the information value of dividends, a look at the dividend cover is helpful to capture a firm's ability to pay its dividend. Here JD Sports proves to be the better pick as the dividend cover of 4.8 is more than double than Brown PLC (2.2). The dividend yield limits the downside risk of the stock by the yield protection and so gives more safety when the market price decreases and so causes losses.

**Profitability Ratios**

[5] Fuller (2012): A reality check for dividend investors. Available at: http://www.ft.com/intl/cms/s/0/8e2e417c-f1bf-11e1-bba3-00144feabdc0.html#axzz2JIera5rR (Accessed on: 22 April 2013)

**Operating Margin**

Profitability ratios describe a company's ability to generate earnings compared to its expenses. Ratios should be higher than the equivalents of direct competitors in the subsector. Figure 3 shows that JD Sports was able to increase its Operating Margin in 4 out of 5 years. The high pressure due to fierce discounting in the subsector probably pulls down the operating margin in 2012 as JD Sports is forced to decrease prices as well.

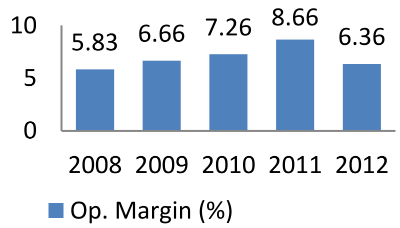



Figure 3

**Return on Capital Employed (ROCE)**

A company has to generate a ROCE which is higher than its cost of capital, meaning the rate at which a company can borrow outside equity, in order to remain on the market in the long-term. The ROCE of JD Sports is decreasing the last 5 years from 80.95% in 2008 to currently 59.2% (see spreadsheet). This numbers situate constantly above 12% in the last three years like proposed by Warren Buffet, however the ROCE is generally trending downwards. The ratios of the three peers show varying numbers across the last five years, but do not decrease on a constant level as JD Sports.

**Cash Flow**

After a consecutive increase in cash reserves of around 400% from years 2008 to 2011, cash reserves of JD Sports fell by 25.93m in 2012. The negative cash flow in 2012 might be a warning sign. However, the company invested 65.15m and paid 29.69m in financing cash flows (for dividend payout and debt issuance) which explains the negative development in the last year.

**Gearing Ratios**

**Gross Gearing**

The Gearing ratio compares owner's equity to borrowed funds. It is a measure of financial leverage and shows to which degree a company's assets are funded by creditors. High gearing is a sign of high risk as a highly leveraged company is vulnerable in the economic downturn due to its obligation to service its debts. Having a look in the balance sheet of 2012, a total debt of 6.73£m stands against total equity of 215£m. Calculating the gross gearing ratio ($\frac{\text{Total debt}}{\text{Total equity}}$), a number of 3.1% results. Subsector peers have an average gross gearing of 185.5%, which shows that their assets are mainly financed with debt.

**Interest Cover**

Interest cover indicates how easily a company can pay interest on outstanding debt. With a cover of 180 JD Sports confirms financial health and outperforms its peers, whose interest cover is around 6 times lower on average.

**Quick ratio**

Keeping the solid long-term financial composition in mind, the quick ratio measures the short-term financial structure of a firm and indicates a corporation's ability to use its quick assets to extinguish its liabilities instantly. Like mentioned in the general findings stocks in the retail sector generally have a low ratio. JD Sport has a ratio of 0.885 which is above average in the whole retail sector. The deviation from 1 could be explained by the recent drop in cash reserves (25.93£m in cash flow statement of year ended 2012) which are a part of the denominator of the quick ratio formula. Contrasting, Brown Group PLC is a positive aberration with a ratio of 2.95. A possible explanation is that the home shopping format of Brown Group PLC requires fewer inventories due to efficient procurement.

## Supportive Information

### News

The newly acquired chain Blacks leisure and the cost of moving warehouses caused high losses in profit. JD executive chairman Peter Cowgill made aware that the recent expansion activity would impact financial results in short-term.[6] Acquisitions of Champions Sports

[6] BBC (2012): JD Sports profits knocked by Blacks Leisure. Available at: http://www.bbc.co.uk/news/business-19632789 (Accessed on: 20 April 20013)

(Ireland) and Sprinter (Spain) and store openings in France and Spain emphasize controlled international growth.[7]

**Directors share dealings**

A buying activity by executive members sends a positive signal to the market and vice versa. Director share dealings reflect what the management of a company really thinks about the opportunities and risks their company faces. However, director deals do not show any interesting signals.

**Analyst recommendations**

The latest investment analyst forecasts on ft.com state that JD Sports will outperform the market.

**Recommendation**

JD Sports PLC offers solid fundamentals and outperforms its subsector peers. Difficult market conditions in retailing and the turnaround of acquired Blacks Leisure chain puts pressure on profits. Increasing overseas presence and especially high investments in multi-channel infrastructure coincide with the future expected retail sector development (strong increase in online sales). The performance history graph (Figure 4) shows a share price recovery starting at the end of year 2011 which is trending upwards. Therefore an investment in JD Sports Fashion PLC is recommended.

**Figure 4** Source: markets.ft.com


[7] JDPLC (2013): Investor Relations. Available at: http://www.jdplc.com/investor-relations/key-financial-information.aspx (Accessed on: 20 April 2013)

**Name: Debenhams PLC**
**Subsector: Broadline Retailers**

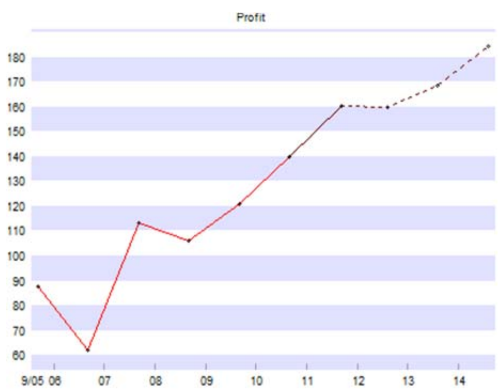
---------------------------------------------------------------------------

| | Stock | Subsector avg. |
|---|---|---|
| **Market Cap.** | **991.582** | **2,134.52** |
| **P/E** | **10.03** | **18.49** |
| **Yield** | **3.53** | **3.06** |
| **Gross Gearing** | **-208** | **-22.5** |

DEBENHAMS

Debenhams PLC operates department stores in the United Kingdom and Ireland and is Britain’s second largest department store. The Company's stores retail men's, women's, and children's clothes, cosmetics, electrical appliances, home furnishings, bicycles, luggage, garden products, flowers, and giftware.

**Figure 5** Source: Sharescope




Given decreasing physical sales on High Street for the benefit of online sales in the next years, Debenhams PLC is the only company in the subsector sample with a positive forecasted EPS growth (7.06%). Figure 5 shows a relatively stable increase in profits. While the revenue over the last five years stayed relatively flat at approx. 2.2£bn, next income grew the last five consecutive years to 125.3m.

With a P/E ratio of 10.03 Debenhams PLC is below average in the subsector. As revenue is stable over the last years and with an EPS growth of 1.5% in the last five years, the low growth expectations are reflected in the price-earnings multiple.

A rolling PEG of 1.29 shows that the stock is currently not undervalued given its earnings performance. A PEG ratio below one would be desirable. As this ratio still outperforms the growth prediction of the subsector peers, it might be a good pick in relative terms.

Debenhams is a solid dividend payer with a current yield of 3.53% and a dividend cover of 3, which is highest in the subsector. However, five year dividend growth is negative (-11.7%).

The operating margin of 7.87% is tending downwards the last five years from 9.31% in 2008. This is a sign of danger as the company might struggle to pay its fixed costs like interest on debt in the future.

With a value of 58.6% ROCE is the highest in the subsector but it does not trend upwards the last three years (decrease from 2011 to 2012).

A quick ratio of 0.146 indicates a bad short-term liquidity which is also due to the high amount of inventory (332m) in relation to only 44m in cash and short term investments.

According to ft.com as of April 12 of 2013, the consensus forecast of 19 investment analysts rate Debenhams PLC as ‘outperform’ from previously ‘hold’. The median estimate represents a 19.98% increase during the next 12 months.

**Recommendation**

Being Britain’s second largest department store and due to increasing online presence, Debenhams PLC is the best investment alternative in the broadline retailing subsector, however the stock is currently not undervalued.

**Name: Halfords PLC**
**Subsector: Speciality Retailers**

| | **Stock** | **Subsector avg.** |
|---|---|---|
| **Market Cap.** | **611.721** | **814.46** |
| **P/E** | **12.14** | **14.04** |
| **Yield** | **6.27** | **3.58** |
| **Gross Gearing** | **-436** | **1139.73** |

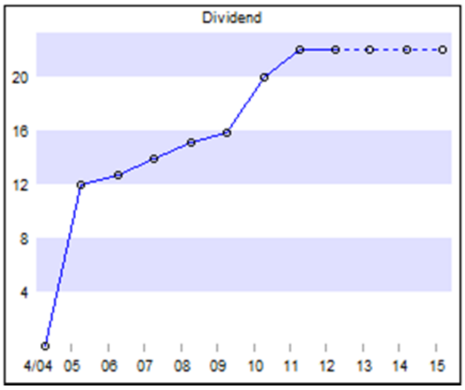
Halfords Group PLC is a holding company with principal activities in retailing of automotive, leisure and cycling products and car servicing and repair. The focus on servicing and repair builds a robust business model even in economic downturns and decreasing new car sales.

Halfords Group PLC has the second highest norm EPS (42.8p) in the subsector which means that the company is among the most profitable in the specialty retailing subsector. This is mainly due to the extraordinary high ROCE of 145 indicating a high efficiency of using the capital employed. Operating margin as second profitability measure is also the highest in the subsector with a value of 13.8%; however the margin decreased by 2.3% compared to previous year.

The P/E ratio of 12.14 is reasonable considering the low growth.

Halfords PLC is the healthiest company concerning gross gearing (-436%) and interest cover (44.3).

**Figure 6** Source: Sharescope




The main reason for investing in this stock is the high dividend of 6.27% which makes Halfords PLC an attractive income stock. The dividend growth rate of the last 5 years is positive (5.83%). Like it can be seen in the historical chart (Figure 6) dividends were rising since 2004. The dividend payment is with a high payout ratio of 70.58% relatively certain. The dividend cover of 1.5 shows that the company uses the majority of its profits for dividend payout.

An extract of the director dealings table (Figure 7) from Sharescope shows solely purchases since 2009. Incorporating the small deal sizes the purchases were probably part of the executive remuneration. However the nonexistence of share sales leaves a positive effect.

| No. | Investor name | Role | Deal Date | Deal type | Deal size | Deal size % | Deal value | Company name | Bene-ficial | Latest |
|---|---|---|---|---|---|---|---|---|---|---|
| 1 | A Findlay | gfd | 31/5/12 | purchase | 2.05k | 0.0010 | £4.96k | Halfords Group PLC | Yes | Yes |
| 2 | A Findlay | gfd | 2/9/11 | purchase | 1.60k | 0.00078 | £4.75k | Halfords Group PLC | Yes | No |
| 3 | A Findlay | gfd | 22/7/11 | purchase | 1.25k | 0.00062 | £4.41k | Halfords Group PLC | Yes | No |
| 4 | Claudia Arney | * | 29/8/12 | purchase | 21.1k | 0.011 | £49.9k | Halfords Group PLC | Yes | Yes |
| 5 | D A R Adams | * | 1/6/12 | purchase | 6.00k | 0.0030 | £14.4k | Halfords Group PLC | Yes | Yes |
| 6 | D H Millard | ch * | 31/5/12 | purchase | 7.50k | 0.0038 | £18.7k | Halfords Group PLC | Yes | Yes |
| 7 | D H Millard | ch * | 3/12/10 | purchase | 7.50k | 0.0038 | £31.4k | Halfords Group PLC | Yes | No |
| 8 | D H Millard | ch * | 18/2/10 | purchase | 10.0k | 0.0048 | £43.1k | Halfords Group PLC | Yes | No |
| 9 | D H Millard | ch * | 29/6/09 | purchase | 15.0k | 0.0071 | £46.5k | Halfords Group PLC | Yes | No |

**Figure 7** Source: Sharescope

**Recommendation**

The share price is not expected to grow significantly within the next years. The financial health and the high profitability limit the downside risk of this stock. An investment is recommended for investors looking for a strong income stock with low risk.

**Name: Darty PLC**
**Subsector: Speciality Retailers**

| | **Stock** | **Subsector avg.** |
|---|---|---|
| **Market Cap.** | **242.27** | **814.46** |
| **P/E** | **20.55** | **14.04** |
| **Yield** | **3.44** | **3.58** |
| **Gross Gearing** | **-128** | **1139.73** |

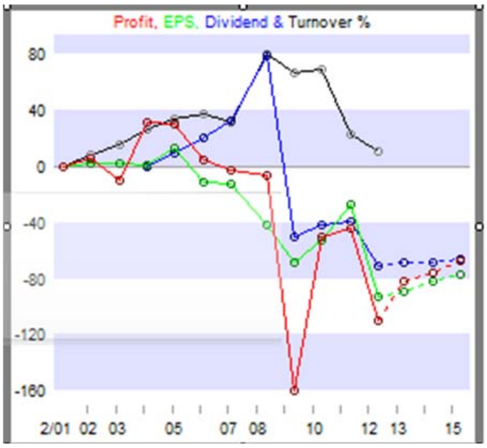


**Figure 8** Source: Sharescope

Former Kesa Electricals PLC was renamed Darty PLC on 31 July 2012 to reflect its biggest brand after the sale of its struggling chain Comet in Britain. Darty PLC is a cross channel service led electrical retailer operating around 500 stores in nine European countries. A negative post tax profit of -32.4£m and the news of closing stores in Spain and France do not indicate an investment opportunity on the first view. The historical chart of the key metrics shows movements without clear directions (Figure 8). The general negative trend in all graphs stops in 2012, forecasted performance is trending upwards.

A closer look at key investment ratios show a positive norm EPS of 15.2p despite the reported -32.4m annual loss. The rolling P/E of 20.55 is above subsector average, but including forecasted earnings of 162.57p per share result in a PEG ratio of 0.33. This indicates that the stock is undervalued given the forecasted EPS growth.

The dividend yield of 3.44% has only a cover of 0.5. Having a look at the blue coloured dividend graph development (Figure

8) there were either no dividend payments (before 2004) or negative dividend growth in the last years (2008-2012).  Capital gains by a potential investment therefore expected due to a share price increase and not by the dividend payments.

The low market price at which the stock is currently traded contains the negative news of the company involved in restructuring and annual losses (Figure 9). An all-time high of 361.5p (13-11-2006) stands against a current share price of 46.25p. Therefore I see high future share price appreciation in the next periods following the finalized restructuring of the company.

**Figure 9** Source: markets.ft.com

A ROCE of 65.2% demonstrates a very efficient use of capital employed. The operating margin is low (3.06%) but is only slightly under the subsector average of 4.61%. The high restructuring costs are an explanation for this low operating margin. Decreasing costs in the future will lead to a predicted increase of the margin again.

Gross gearing is with a value of 60% reasonable and not too high. Long-term debt interest payments are covered well (21.9). The gearing ratios show an overall healthy financial situation. The quick ratio (0.386) is industry related low and has no substantial impact on the recommendation.

The appointment of Eric Knight as of 22 Feb 2013 as a non-executive director as independent advisor shows a positive step towards a new strategic alignment (RNS Number : 5137Y). A positive interim management statement of Feb 2013, reporting a positive growth number of Darty Group (+2.3%) supports a positive development (RNS Number : 9425X).

## Recommendation

The stock is highly undervalued. After an analysis of the overall strategic development and the sound financial condition it is strongly recommended to invest in Darty PLC. Given a low market cap and a failure possibility of the forecasted EPS growth, an investor has to face a medium risk.

## 6. Final Recommendation

All the above analyzed stocks satisfy the investment criteria in respect to risk, financial health and dividend payment/undervaluation. The final results are presented graphically (Figure 9) and highlight the most important characteristics for varying investor preferences.

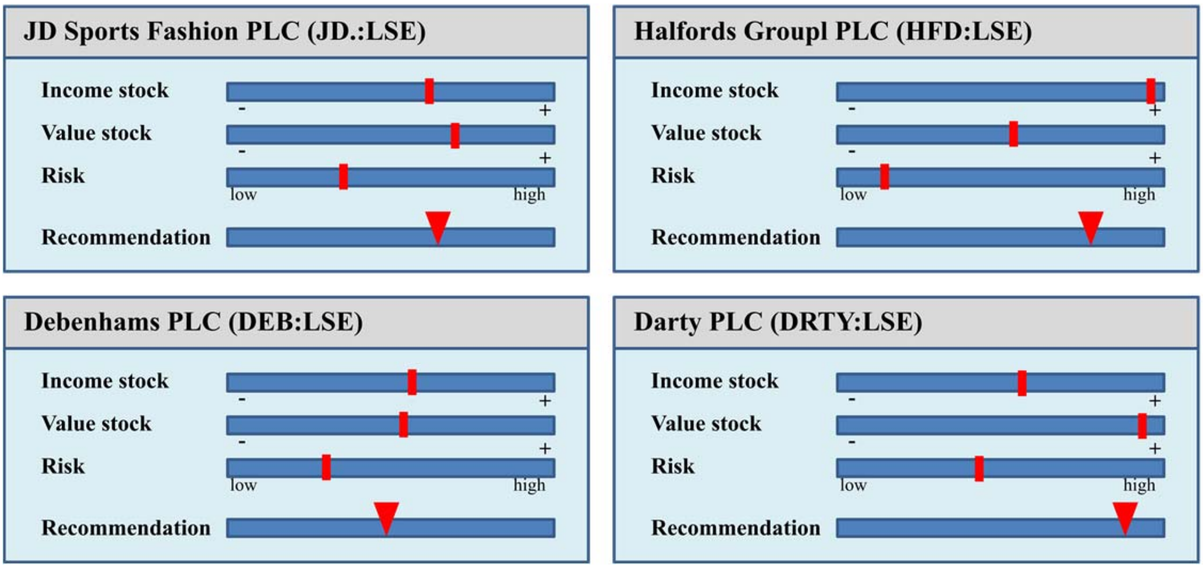



**Figure 9** Source: own Figure

# Appendix

## Glossary

### Market Capitalization[8]

Market Capitalisation is the total dollar market value of all of a company's outstanding shares. It is calculated as: shares outstanding x current market price of one share. Market capitalisation indicates what risk a company bears. Generally, the bigger the market capitalisation the less likely a company fails.

### Norm Earnings-per-Share (EPS)[9]

The portion of a company's profit allocated to each outstanding share of common stock. EPS is an indicator of a company's profitability. However a company is able to manipulate the number depending on assumptions and accounting policies.

It is calculated as[10]: $EPS = \frac{\text{Profit after tax for ordinary equity holders}}{\text{Number of issued ordinary shares}}$.

Norm EPS includes also expected earnings over the next period. This gives a more dynamic view of the company's earnings.

### Price-Earnings Ratio (P/E)[11]

The P/E ratio is one of the most common investment ratios. It is a valuation ratio of a company's current share price compared to its per-share earnings. A rolling P/E includes earnings over longer time periods in order to equate volatile earnings.

[8] Bhattacharya, 2007
[9] Investopedia.com (Accessed on: 20 April 2013)
[10] Weetman, 2006
[11] Bhattacharya, 2007

It is calculated as $P/E = \frac{\text{Share Price}}{\text{Earnings per Share (EPS)}}$.

### Forecasted EPS Growth

Forecasted EPS Growth shows the expectations of analysts for growth in a company's earnings. Stocks with higher earnings-per-share growth rates are generally more desired by the market than stocks with slower earnings-per-share growth rates.

### Rolling PEG

The price/earnings to growth (PEG) ratio is used to determine a stock's value while taking the company's earnings growth into account. It is considered to provide a more complete picture than the P/E.

It is calculated as[12]: $PEG\ ratio = \frac{\frac{\text{P}}{\text{E}}\text{ratio}}{Annual\ EPS\ growth}$

The PEG ratio indicates whether a stock is overpriced or underpriced. Although varying by industry and by company type, generally a PEG ratio below one is desirable.

### Dividend cover[13]

Dividend cover is the percentage of earnings paid to shareholders in dividends. It is also called Dividend Payout Ratio.

It is calculated as: $Dividend\ Cover = \frac{\text{Earnings per Share}}{\text{Dividend per Share}}$

### Projected Yield

[12] Weetman, 2006
[13] Weetman, 2006

An estimation of a year's dividend expressed as a percentage of current stock price. The projected dividend is measured by taking the most recent actual dividend payment and annualizing it.[14]

It is calculated as: $Dividend\ yield = \frac{\text{Dividend per Share}}{\text{Share price}}$ x 100

**Operating Margin**

Operating Margin is a ratio used to measure a company's operating efficiency.[15]

It is calculated as: $Operating\ Margin = \frac{\text{Operating Income}}{\text{Net Sales}}$

The operating margin expresses how much a company makes (before interest and taxes) on each £ of sales. In order to be able to rate the quality of a company, it is best to look at the change in operating margin over time and to compare the company's yearly figures with those of the competitors in the sector. If the operating margin is increasing, the company is earning more per £of sales. Concerning a fundamental analysis it can be said that the higher the margin is, the better.[16]

**Gross Gearing ex.**

Total Debt to Tangible Equity is the ratio of debt to owners' equity, net of goodwill and tangible equity. It is used to measure the leverage of a company and its ability to repay its debt obligations.[17]

It is calculated as: $Gross\ Gearing = \frac{\text{Total Debt}}{\text{Total Shareholder Equity}}$

The higher a company's degree of leverage, the more the company is considered risky. An acceptable level of leverage can be determined by its comparison to ratios of companies in the same industry. A company with high gearing is more vulnerable to downturns in the business cycle as the company has to continue to service its debt no matter its revenue. Especially in the current recession gearing is an important factor.

[14] Bhattacharya, 2007
[15] Thomas, 2005
[16] Investopedia.com (Accessed on: 20 April 2013)
[17] Bhattacharya, 2007

**Interest Cover[18]**

Interest cover determines how easily a company is able to pay interest on outstanding debt.

It is calculated as: $Interest\ Cover = \frac{EBIT}{\text{Interest Expense}}$.

**Return on Capital Employed (ROCE)[19]**

ROCE indicates the efficiency and profitability of a company's capital investments. Capital employed includes all long-term funds.

It is calculated as: $ROCE = \frac{\text{EBIT}}{\text{Total Assets} - \text{Current Liabilities}}$.

The return on capital employed should be higher than the rate at which the company borrows. If this is not the case, any increase in borrowing leads to an increase in shareholders' earnings.

**Quick Ratio[20]**

Quick ratio is an indicator of a company's short-term liquidity. The quick ratio measures the ability of a company to meet its short-term obligations by using its liquid assets. The higher the quick ratio is, the better is the position of the company. Contrary to the current ratio, the quick ratio excludes inventory from the current assets portion. Therefore it is easier to comprehend a company's ability to generate cash from liquid assets like accounts receivable and all marketable securities.

[18] Bhattacharya, 2007
[19] Thomas, 2005
[20] Investopedia.com (Accessed on: 20 April 2013)

It is calculated as[21]: $Quick\ Ratio = \frac{\text{Cash+Marketable Securities+Accounts recievable}}{\text{Current Liabilities}}$

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[21] Weetman, 2006

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