Debenhams: Cash Flow and Dividend Worries

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Debenhams – Notes and Models

Recommendation: Short (No Change)

Price: 80p **/ 2 Year Price Target**: 42p **/ Forecast Return**: -48%
Ticker: DEB LN **/ Market Cap**: £982m **/ 3m Average Daily Volume (USD):** $3m
Valuation Metric: PE FY18e **/ Current Multiple:** 19x **/ Target Multiple:** 10x

Investment Thesis:

- **Structurally-challenged retailer with stagnant revenues and falling margins, entering a more difficult period for UK consumers.**
- **Free cash flow inflated by working capital, lease incentive inflows and low cash tax totaling £105m since H1'14, representing 36% of total free cash flow in that period.**
- **We estimate profits to fall 40% from FY15 to FY18, dividend to be uncovered from FY17 onwards.**
- **Valuation at 10x FY18 earnings with dividend cut likely as lease adjusted net debt to EBITDA multiple approaches 5x.**

We update our Short thesis on Debenhams following the recent H1'16 report. Results in the period are not as good as the headline figures suggest and cash flows have been inflated through working capital, lease incentives and cash tax paid running below the accounting tax expense. These positive cash movements are non-recurring and in combination with weakening trading we see the FY17 dividend being uncovered by free cash flow and susceptible to a cut. We would therefore continue to short the shares based on a 42p price target which is 10x FY18 estimated earnings.

Recent Results & Cash Flow Concerns

The recent H1'16 results were Michael Sharp's last set of figures before leaving the company. The headlines look OK, but if we dig a little deeper into sales and cash flow the results are not so good for the incoming chief executive – who has yet to be identified:

- UK in-store sales increased by 0.1%, the first such increase in four years. However, this refers to gross transaction value ("GTV"), which is the total of all sales made by both Debenhams and concession partners – **this is not revenue! Overall GTV for the whole company increased by 1.6%, but revenue by only 0.1% - so in fact UK store revenues likely fell in the period.** This difference comes from the rising proportion of sales by concession partners as surplus space in UK stores is allocated to them, and this difference will continue for the foreseeable future. Concession space operates at a lower margin than own-utilised space, therefore we expect margins in the medium term to fall.

- EBIT margins in the period were actually flat on H1’15 at 7.5%, suggesting a good result. However this has been achieved through a dramatic reduction in the levels of discounting. This step can only be achieved once. We expect core pricing will need to be reduced further to compete with rivals and, combined with the rising proportion of concessions sales, margins will once again resume their downward trend.

- Free cash flow performance appears impressive at £126m vs £94m in H1’15, and the company announced a 2.5% dividend increase. However, we need to look carefully at the reasons for this increase:

  - £11.2m one-off cash inflow from closing forex contracts – this is non-recurring.
  - £15m working capital inflow.
  - £9m inflow from lease incentives
  - £16m benefit from cash tax being lower than the accounting tax expense.

  The “sustainable” free cash flow for the half is therefore £74m, not £126m.

- Looking at these movements in more depth since H1’14, we see that of the £289m of free cash flow since H1’14, only £185m (64%) of it has come from underlying trading and can therefore be deemed sustainable in the long term.

Exhibit 1: Influences on Free Cash Flow

Source of cash movement	H1'14	H2'14	H1'15	H2'15	H1'16	Total
	£m	£m	£m	£m	£m	£m
Working capital	-14	25	13	-8	15	**31**
Other non current liabilities	5	6	-1	9	9	**28**
Tax charge per accounts	-17	-2	-17	-3	-17	
Tax paid	-16	-5	1	1	-2	
Net tax impact on cash flow	1	-3	18	3	16	**35**
Derivative contracts					11	**11**
Total impact on free cash flow	**-8**	**28**	**30**	**4**	**51**	**105**
Actual free cash flow in period	51	28	94	-10	126	289
Of which from underlying trading	**59**	**1**	**64**	**-14**	**74**	**185**

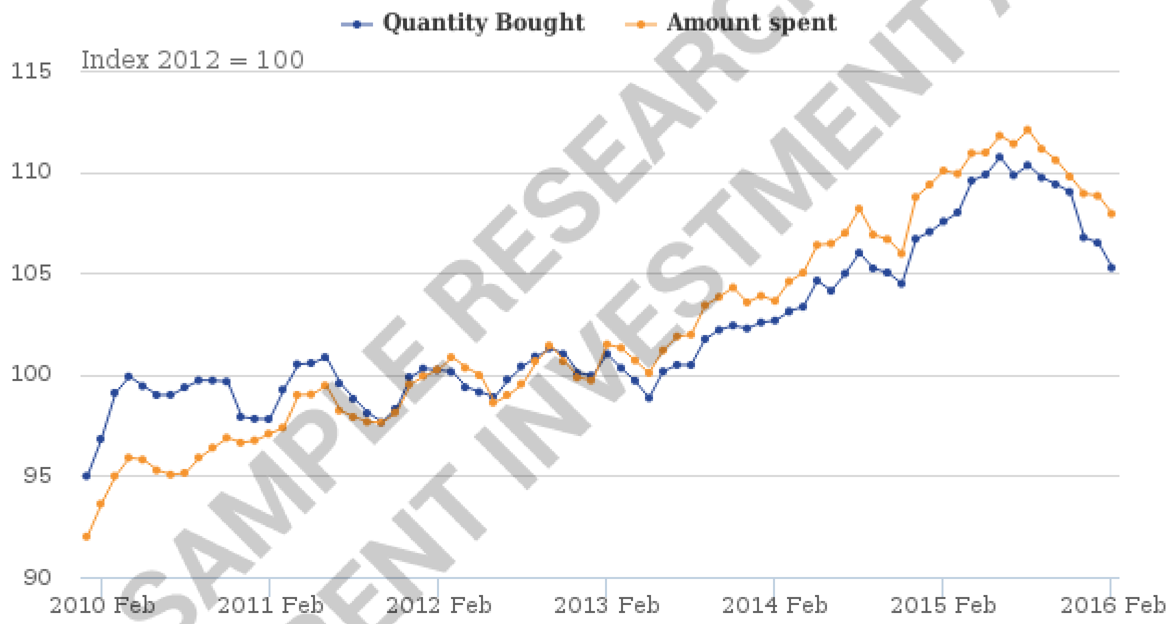
Source: Company figures

So, in summary, business performance was weaker than at first glance in what has been a buoyant environment in recent years for UK consumers and the improvement in the debt position has come largely from one-off cash flow items rather than sustainably good business performance.

Poor Trading Conditions

The consumer environment is now weakening and, in particular, spending on clothing is falling after two years of growth in 2014 and 2015. M&S, Next and N Brown have already warned of the tough environment with strong price competition. The weakest operators have had a stay of execution in recent years but their luck is now running out. BHS, with around 160 UK stores, is today filing for administration as its department store model has failed to keep up with changing consumer trends. Austin Reed, the menswear retailer, is also expected to appoint administrators shortly. We expect that Debenhams will also suffer in the next few months.

Exhibit 2: ONS Textile, Clothing & Footwear Stores sales and volumes (seasonally adjusted)



Source: ONS

Estimates and Dividend Issues

We forecast flat revenues for the next three years, which combined with an EBIT margin falling from 5.8% to 3.5% means that we expect EBIT to fall from £134m in FY15 to £81m in FY18. This translates to profit after tax falling from £93m to £51m over the same period.

Free cash flow is likely to plummet, and we see free cash flow conversion falling well-below 100%. Capex of around £130m in FY16 is higher than D&A of approximately £110m and we expect this trend to continue as the business still needs to invest heavily in bringing its store estate up to date. The company will no longer get a working capital benefit going forward as stock levels cannot be reduced further and supplier payables cannot be stretched any further. Meanwhile there should be no further inflows of lease incentives for the next two years as no new stores will be opened in that time.

We estimate free cash flow of £35m in FY17 and £23m in FY18. The dividend would then be uncovered in both years and we see the lease adjusted net debt to EBITDAR ratio increasing from around 4.5 to 4.9x. This would be slightly below the level reached in FY08 before the last rights issue. The prospect of a dividend cut in the next two years is therefore very real.

Conclusion

We value the business at 10x FY18e earnings, the low multiple due to the horrendous balance sheet and 22 years of off-balance sheet lease liabilities which gives the company little leeway if the business deteriorates further.

Clients may ask why we dropped our Short recommendation on N Brown after the recent warning and yet retain our recommendation on Debenhams. **The big difference compared to N Brown is the much greater vulnerability of the Debenhams dividend.** At present the Debenhams dividend is covered by free cash flow but N Brown is not. However, we see the Debenhams dividend being uncovered by FY17. N Brown's debt is more than covered by its customer loan book and it can therefore continue to finance an uncovered dividend from more debt. Debenhams does not have this ability.

We therefore retain our Short recommendation with a slightly reduced price target of 42p, giving 48% downside from here.

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