Debenhams: Lease Nightmares

Analyst: James Armstrong

Debenhams – Notes and Models

Recommendation: Short (Coverage Initiated)

Price: 73p **/ Price Target**: 45p **/ Forecast Return**: -38%
Ticker: DEB LN **/ Market Cap**: £900m **/ 3m Average Daily Volume (USD):** $3.1m
Valuation Metric: PE FY18e **/ Current Multiple:** 16x **/ Target Multiple:** 10x

Investment Thesis:

- **Medium term trend of declining EBITDAR margins combined with barely growing revenues.**
- **Still opening UK stores despite average outstanding lease length of 22 years and consistently declining footfall. Online offer less profitable and cannibalises store sales. 1m sq. ft. of surplus space.**
- **"Designers at Debenhams" range was pioneering in the 1990's but the brand is now seen as dated and surpassed by more agile rivals H&M, New Look, Primark and Next. Inferior customer ratings compared to rivals.**
- **Balance sheet worries, lease adjusted net debt to EBITDAR ratio expected to rise to 5x in FY18, close to ratio of 5.3x prior to previous rights issue in FY09.**

Setting out the Short Case

Debenhams has been a consistently weak retailer since the 2008 recession, with sales barely growing and declining margins resulting in an EBIT that has declined in four of the last five years despite a moderately favourable UK consumer environment. The company has a horrendous balance sheet with a high net debt position resulting from its private equity ownership prior to floating in 2006. The off balance sheet operating leases also average 22 years in length. CEO Michael Sharp will be stepping down in 2016 following pressure from investors.

The stock appears cheap on under 10x FY15 earnings and a 4.7% dividend yield. However, we see profits nearly halving in the next four years, with potential for a cut to the dividend and a further rights issue as the lease-adjusted net debt to EBITDAR ratio rises to 5x from 4.5x today. We therefore initiate with a Short recommendation and a price target of 45p, providing 38% downside.

Business Model and Position in the Market

Debenhams has two main business segments:

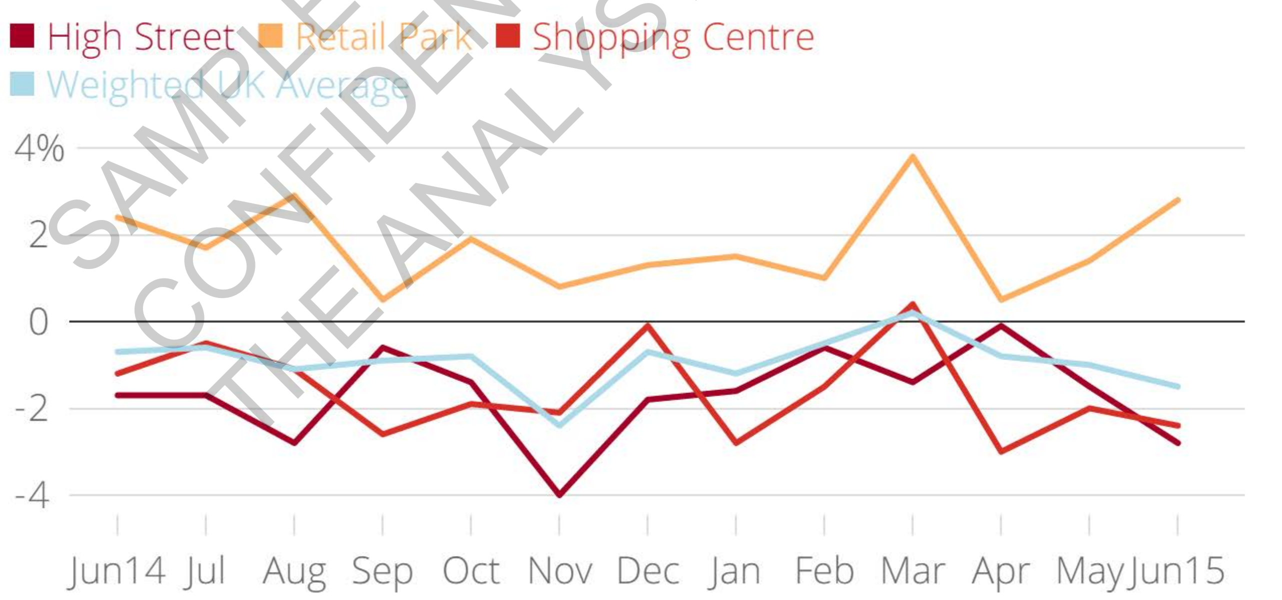
- **178 own-run department stores**, with 161 in the UK and 11 in Ireland branded as Debenhams and then a further six in Denmark branded as Magasin. These stores are all rented on long operating leases with an average outstanding lease of 22.8 years. A range of clothing, home and furniture is sold. 27% of products sold are core Debenhams own brands, 17% are "Designers at Debenhams" products, sold on the same basis as the core own brands but where a royalty fee is paid to the designer. 32% of products are bought-in international brands and the remaining 24% are concession brands, where the concession pays rent to Debenhams for the space utilised.

- **68 franchised department stores** in other international markets – weighted towards the Middle East. Franchisees are responsible for all store costs and must buy stock from Debenhams on a "cost-plus" basis.

Debenhams' key market is the UK, responsible for around three quarters of revenues and profits. Debenhams has a 4.7% share of the UK clothing & apparel market of around £40bn. The market is expected to grow by 3.9% in 2015 to £43bn (Conlumino). Volume growth year-to-date is running at 7%, reflecting BRC Nielsen Shop Price Index figures which show non–food deflation of 2.3% in July 2015 (the 27th consecutive month of deflation across food and non-food combined). This deflation reflects both falling commodity prices and increasing price competition from low end retailers. There is little sign of these trends changing in the medium term.

Around 20% of the fashion & apparel sales are now online and overall retail footfall continues to decline at around 1.5%per annum; the decline is faster on high streets and shopping centres than on retail parks.

Exhibit 1: Shopping footfall in the UK



Source: BRC/Springboard

In the mid-1990s, the Designers at Debenhams range was cutting edge and allowed people to buy designer clothes at an affordable price for the first time. It was popular amongst younger consumers.

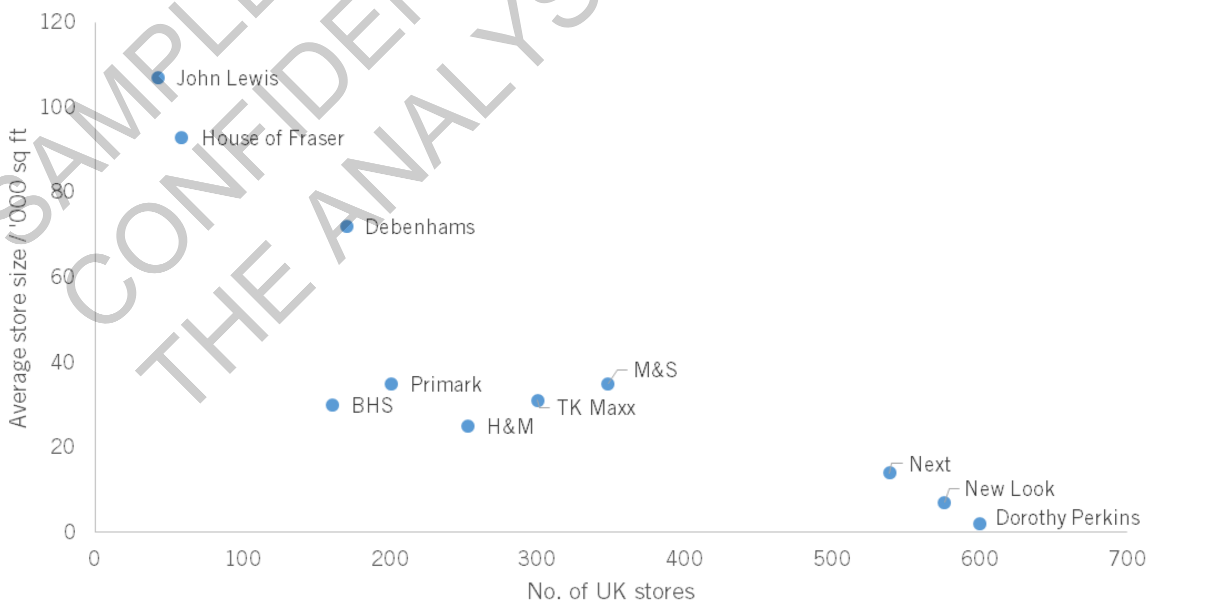
Times have changed. Primark, H&M and a host of other fashion retailers barely existed in the UK at that time, and have since provided a dramatic explosion in choice for young consumers to purchase affordable clothes. Meanwhile the core Debenhams customer has changed. Debenhams say their core customers is female, aged 25 – 54. We beg to differ, and based on conversations with people in this age group and our store visits, view their core customer as being over 35. Debenhams customers have aged with the brand and the company struggles to attract enough new younger customers to sustain it in the long term.

Whereas Debenhams and other traditional department stores rely on new seasons of clothes twice per year, Zara (one of the pioneers of fast fashion retailers) can get a product from conception to the shop floor in under a month, allowing it to respond quickly to the latest changes in fashion trends. Other retailers, including H&M, followed this fast fashion trend. Debenhams will inherently be months behind in comparison simply as a consequence of its traditional department store business model. It also means that they lack flexibility to deal with unusual weather conditions and like other retailers will traditionally blame the weather for a profit warning.

Working out Debenhams' position in the market is difficult. It says that offers are a part of the company's DNA, indicating that it is aiming for a more cost-conscious consumer than say John Lewis. Meanwhile it wants to reduce the perception of being always on sale. It neither markets itself as a high-end or as a value retailer and is suffering from the Tesco problem of being "stuck in the middle".

Space addiction

Exhibit 2: Store number vs average store size for a range of UK retailers



Source: Company websites and annual reports

Exhibit 3: Debenhams space expansion

	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16e	FY17e	FY18e
Trading space '	10,266	10,704	11,046	12,250	12,443	12,521	12,597	12,766	12,803	13,090	13,170	13,250
% growth		4.3%	3.2%	10.9%	1.6%	0.6%	0.6%	1.3%	0.3%	2.2%	0.6%	0.6%

Source: Company reports, The Analyst Estimates (FY17 & FY18)

Debenhams has 171 stores in the UK & Ireland, compared to rivals John Lewis at 43 stores and 59 for House of Fraser. This is despite Debenhams stores being around three quarters their size. More worrying, Debenhams continue to open new space, with eight new stores over the next four years, five of which are opening this autumn. Combined with declining retail footfall this appears to be a strange strategy. Counter to this is that Next have grown space from 5.7m sq ft in FY10 to 7.1m sq ft in FY15, however this is because Next have been closing smaller stores in poor locations and moving to larger new stores in better locations. M&S do not plan to open any more stores with general merchandise.

Debenhams may be doing this because the cash flow economics of opening a new store are favourable in the short term. A rent free period of two years can often be obtained on a 20 year lease. The profit and loss cost of the lease in the first two years is much higher than the cash cost, therefore with many stores openings over the last 20 years the company have built up a £341m non-current liability relating to lease incentives. As a lease progresses the liability unwinds, therefore if the average lease length continues to fall whilst few new stores are opened then the overall £341m will start to unwind in the cash flow statement.

Stronger Competitors Still Expanding

John Lewis, seen as the strongest of the department stores, has 43 stores in the UK and plans to open five stores across the UK in the next five years – Birmingham (2015), Leeds (2016), Chelmsford (2016), Westfield White City (2017) and Oxford (2017). These are all places where John Lewis are currently not present and Debenhams, which has stores in all of these locations, is likely to be a big loser from this.

Primark and H&M continue to open new stores in the UK & Ireland, with the total between them growing from 373 in 2010 to 454 in 2014. These value operators continue to take share from the incumbents. TK Maxx had 229 stores in 2009 in the UK & Ireland, reached 291 stores in 2014 and is aiming for 309. Although TK Maxx is known mainly for its clothing, it also has an extensive Home section and in fact stocks a broadly similar range of products as a full range Debenhams department store.

Poor Reviews

Exhibit 4: Customer ratings of Debenhams and other similar retailers (five is top)

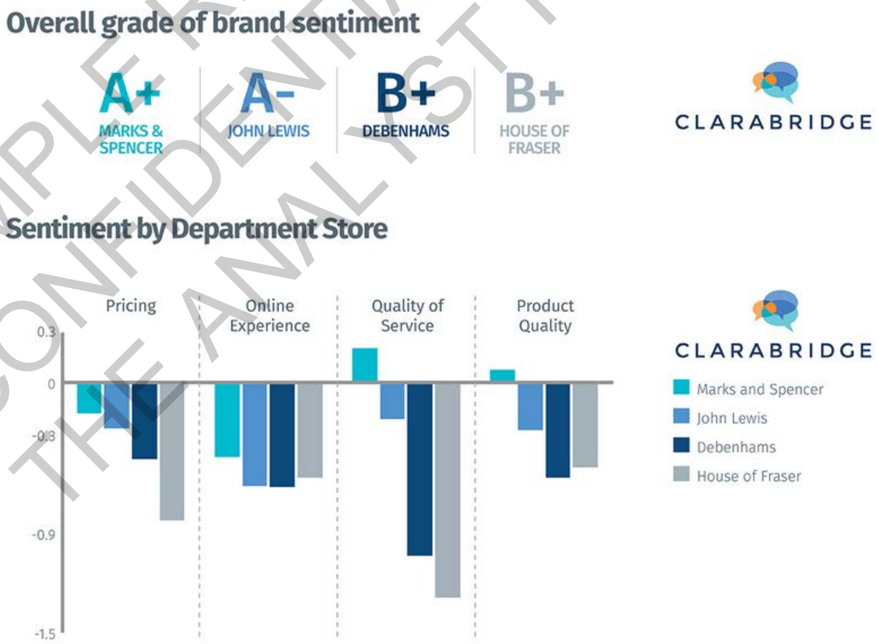
Store	TrustPilot Rating	Review Centre rating
BHS	1.4	1.6
Debenhams	1.7	1.5
H&M	3.9	1.6
House of Fraser	2.1	1.8
John Lewis	4.2	2.1
M&S	2.9	1.8
New Look	3.2	2.7
Next	3.7	2.7
Primark	4.2	3.7
TK Maxx	4.6	2.2

Source: TrustPilot and Review Centre websites

Reviews on Trustpilot and The Review Centre show Debenhams' weak position in comparison to other department stores for customer satisfaction.

Clarabridge brand ratings and sentiment (produced in May 2015 using Facebook comments) confirm the review comments.

Exhibit 5: Brand sentiment of UK department stores



Source: Clarabridge Sentiment of the Week, 19 May 2015

Online Offering

Exhibit 6: Comparison of online offer with rivals

		Asos	Debenhams	House of Fraser	John Lewis	M&S	Next	Zalando
Standard delivery	**Cost**	Free on orders over £20. Otherwise £3	Free on orders over £30, otherwise £3.49	Free on orders over £50, otherwise £3.50	Free on orders over £50, otherwise £3.50	Free on orders over £50, otherwise £3.50	N/A	Free
	Time to deliver	4 working days	5 working days	5 working days	5 working days	5 working days	N/A	4 working days
	Delivery days	Mon - Sat	Mon - Fri	Mon - Fri	Mon - Sat	Mon - Sat	N/A	Mon - Sat
Same day delivery	**Cost**	N/A	N/A	N/A	N/A	N/A	£4.99	N/A
	Time to deliver	N/A	N/A	N/A	N/A	N/A	Order by midday	N/A
	Delivery days	N/A	N/A	N/A	N/A	N/A	Mon - Fri	N/A
Next day delivery	**Cost**	Free on orders over £100. Otherwise £5.95	£3.99	£6	£6.95	£3.99	£3.99	£5.95
	Time to deliver	Order before 12am Mon-Fri, 5pm Sat-Sun	Order by 9pm Sun-Fri, 6pm Sat	Order by 7pm	Order by 8pm	Order by 10pm	Order by 12am	Order before midday
	Delivery days	Mon - Sun	Mon - Sun	Mon - Sun	Mon - Sat	Mon - Sun	Mon - Sun	Mon - Fri
Click and collect in store	**Cost**	N/A	Free	Free	Free on orders over £30, otherwise £2	Free	Free	N/A
	Time to deliver	N/A	Next day from midday, order by 7pm	Next day from midday, order by 12am	Next day from 2pm, order by 8pm	Next day from midday, order by 5pm	Next day from midday (2pm on Sun), order by 12am	N/A
	Delivery days	N/A	When open	When open	When open	When open	Mon - Sun	N/A
Click and collect elsewhere	**Cost**	Free on orders over £20	N/A	£3.50	£3.50	N/A	N/A	£nil
	Time to deliver	4 working days, from Collect+ store or Boots	N/A	Order by 7pm, from Collect+ store	Order by 2pm, from Collect+ store	N/A	N/A	From ParcelShop stores
	Delivery days	Mon - Sat	N/A	Mon - Sat	When open	N/A	N/A	N/A
Nominated day	**Cost**	£5.95	£3.99	£6	£6.95	£3.99	N/A	N/A
	Time to deliver	Order up to 10 days in advance	Order by 9pm (6pm on Saturday)	Order by 7pm	Order by 7pm	Next day, order before 10pm	N/A	N/A
	Delivery days	Mon - Sun	Mon - Sun	Mon - Sun	Mon - Fri	Mon - Sun	N/A	N/A
Evening next day	**Cost**	£7.95	£6.99	£8	N/A	N/A	£4.99	N/A
	Time to deliver	Order before 12am	Order by 12am	Order by 12am	N/A	N/A	Next day 6pm to 10pm, order before 11pm	N/A
	Delivery days	Mon - Fri	Mon - Sun	Mon - Sun	N/A	N/A	Mon - Fri	N/A

Source: Company websites

For Debenhams, online comprises 14% of sales, compared to 33% for John Lewis and 40% for Next, and management acknowledges that their offer has been behind rivals. Comparing with rivals we note the following observations:

- Standard delivery is free up to £30. There was a previous announcement that this was to be raised back to £50 in September after cutting from this amount earlier in 2015. However this change does not appear to have been implemented. Debenhams is confused about whether to be at ASOS' level (£20) or John Lewis and M&S (£50).

- The cut off time for next day delivery is 9pm, later than John Lewis (8pm) but still behind M&S (10pm) and Next (11pm). It is also £3 cheaper than John Lewis.

- Click & collect pick up is available from midday if the order is made by 7pm the previous evening, soon to move to 9pm. This will put it ahead of John Lewis and M&S but still behind House of Fraser and Next.

In website reviews the site was noted as being dated and not easy to navigate. However the site has been updated and we see it as tidy and easy to navigate. It appears from a consumer point of view that Debenhams has a good online offer, soon to be better than John Lewis.

From a financial point of view, the growth online has been a problem for Debenhams. Online sales are less profitable than store-based sales. Of growth in online sales, 60% is believed to be incremental and 40% is thought to cannibalise store-based purchases. Online costs are largely variable whereas store costs are largely fixed. Also, pricing online is more transparent, adding to the value sensitivity of consumers and impacting the potential operating margins for Debenhams.

Overall, the online offer has improved and is good for consumers, but is margin dilutive for the company.

Store Visits

We visited the following three stores in the Debenhams estate:

- **Clapham** – This is a high street store opposite Clapham Junction railway station with new Sports Direct and Joe & Juice concessions and appears to be fully refurbished. The refurbished store is significantly more pleasant than the old store, however it still feels far too big for the location, with four large floors of stock. The Sports Direct concession is on the third floor and though smaller than a typical Sports Direct outlet it did have the same heavy discounting policy across the range. This was the busiest part of the store away from the ground floor, perhaps due to the signage outside the shop which gives as much indication of the existence of the Sports Direct concession as for the whole Debenhams store. Though the Sports Direct arrangement clearly is good for using surplus space it does rather enhance customer perception that Debenhams is a promotional retailer that is always on sale – despite management attempts to change this. Despite there being no official discounting event on we still observed many racks across the store with reduced price items.

- **Croydon** – This is another large store in the Centrale Shopping Centre alongside fellow department stores House of Fraser and Next and includes a new Mothercare concession. This was by far the worst of the three stores visited and desperately requires modernising. The whole Centrale and neighbouring Whitgift shopping centres have a classic second rate shopping centre feel of being in dated 1970s buildings, having empty shops and containing many low-end retailers. The Mothercare concession was less distinctive than the Sports Direct concessions, comprising only a few shelves within the children's section and was not publicised at the entrance of the store. There was discounting across the store, with a particularly depressing furniture clearance that reminded us more of a second hand office furniture shop than a modern department store.

Exhibit 7: Clapham store – Excessive Sports Direct branding on the outside, heavy discounting on the inside

[redacted]

Source: The Analyst Lens

Exhibit 8: Croydon store

[redacted]

Source: The Analyst Lens

- **Oxford Street (Flagship store)** – The store was recently fully refurbished, extending into the upper floors previously occupied by the head office and including four food/drink options. The store is impressive and is on a level above the Clapham and Croydon stores but was much quieter than the M&S and John Lewis stores on the same street. It was strange that the menswear section is on the first floor but womenswear is on the second floor – we would expect these floors to be the opposite way round.

Overall, two of the three stores visited are in a good condition and the newly refurbished stores should not become dated for a number of years. The stores are however over-spaced, especially in the Home sections. Despite their being no official discounting event happening there were still a number of items on sale in each store – in comparison to Next where there was no discounting at all. All stores were lacking customers in comparison to other shops in the same location.

Discounting Addiction

Debenhams have in the last 18 months attempted to reduce their need for discounting events, and claim that they took 17 promotional days out of the calendar for FY15. Our email inbox this autumn suggests that the habit is proving difficult to break.

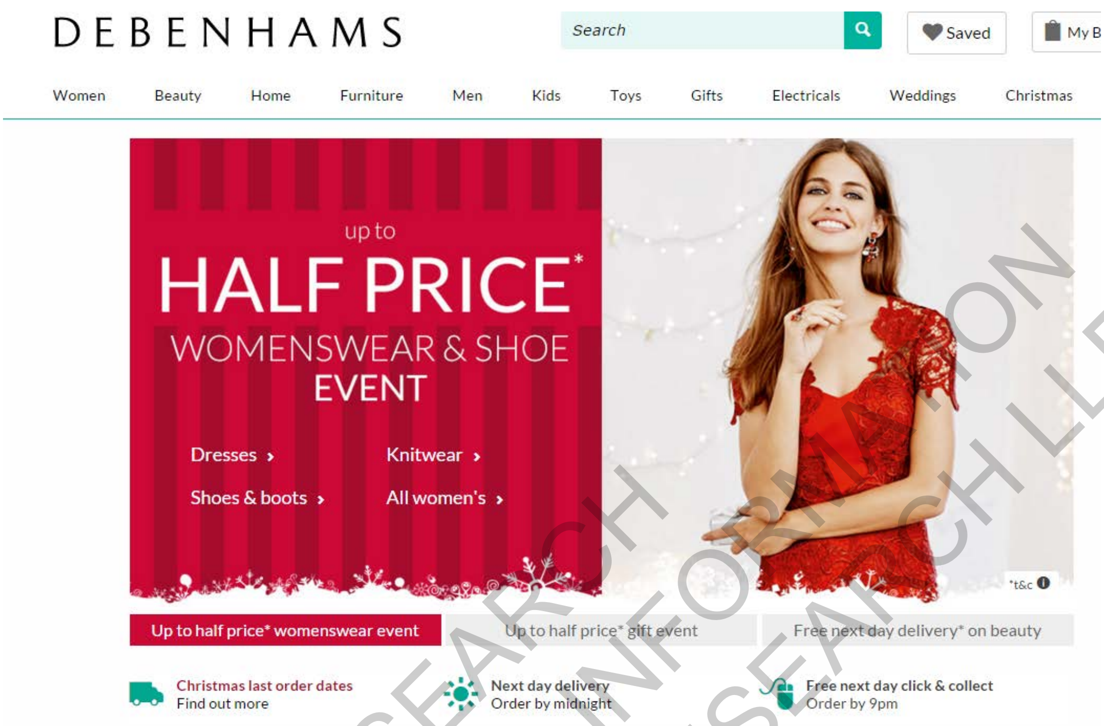
Exhibit 9: Gmail inbox this autumn with Debenhams promotions

Debenhams	Inbox	**TODAY ONLY! 40% OFF offers inside + Spectacular in store now** - e.debenhams.com/?qs=c363476b7da2372665adcec9e1913aa5dae73a4304c6bc808a35d9a6a070961b316128c063df1003 FOUND	Nov 10
Debenhams	Inbox	**Go, go, go! Up to 25% OFF all departments ONLINE NOW...** - e.debenhams.com/?qs=69fd498a07179ec827e7533a688fc88618d0ead1224b7510c47107f4948b8356495e2a05808b35d7 FOUND	Nov 9
Debenhams	Inbox	**Get ready for your 6am start** - e.debenhams.com/?qs=921a0782d2a7ef1158c71012b25e616aa90ba5b5e7df82d9d0add11456ad5f0d8275ceaaaf95e6f3 FOUND	Nov 8
Debenhams	Inbox	**FOUND IT! Our Christmas TV ad is here** - e.debenhams.com/?qs=c361a10d37761c0b52987cd09158b58e957b5080a6ec74951f1c8f9a2be0b93fed378c7f991f0f17 FOUND	Nov 6
Debenhams	Inbox	**FOUND IT | Introducing the Debenhams MasterCard** - e.debenhams.com/?qs=0d70d5b11d61f6bfa33ddbcca65158a69bf78012737179997b3b968ee76ef2385194c66a61248c17 FOUND	Nov 3
Debenhams	Inbox	**FOUND IT! Your top 10 Christmas gift ideas** - e.debenhams.com/?qs=d562df36c3505bea424227d337936e4175a666a326181dbed6ed63355af5cf7f4f19cc834479ba FOUND	Oct 28
Debenhams	Inbox	ENDS TODAY! Up to 70% OFF in our Blue Cross Sale - e.debenhams.com/?qs=569dd829e71d1f942fec31f90c541fd187e1e853564da27533ba2c8eb1b97b231d8f9340c67b14ac ENDS	Oct 25
Debenhams	Inbox	**20% OFF coats, boots, knitwear & designer handbags** - e.debenhams.com/?qs=cb57411e9828a415993003410f0c42b3e2722594cd5c4cd2a51aff61ac4048cc01278add16859796 WINTER	Oct 20
Debenhams	Inbox	**Up to 70% OFF + time to get your home ready for winter** - e.debenhams.com/?qs=28087549c42c5ba0b84a8cf107e5dfcfd90da47b723ab9384861612de5c82c31988203f64b4da7de Mid	Oct 16
Debenhams	Inbox	**Sale now on! Up to 70% OFF in our Blue Cross Sale** - e.debenhams.com/?qs=857bb298422184e89c66c8424272c05a7b61beaecebf74c4facf7955b73ac2164295488a0c5ee92d Mid	Oct 13
Debenhams	Inbox	Time to re-boot - e.debenhams.com/?qs=7eae9802c1f6417565e9986e3e2778d5a209b7b0f5eb96cf07365417d86cb6248211855171f98ff Best	Oct 6
Debenhams	Inbox	**ONLINE NOW! Up to HALF PRICE Mid Season Sale** - e.debenhams.com/?qs=69a959d73f6f67361216803241e908cbdca3a9f73e03411f38bb655a9dd6e4a205dbe7adcfadc8f4 mid	Sep 30
Debenhams	Inbox	**ENDS TODAY! Up to 25% OFF every department** - e.debenhams.com/?qs=1219130a12a4ad7be13de44e71ab08093da24b5b4da18890ebf8729fb66bcd7e5624390ce3fc09a7 ENDS	Sep 27
Debenhams	Inbox	**TODAY ONLY! 30% OFF women's coats & jackets** - e.debenhams.com/?qs=853424d8b013c6c6509f055c88bb27d2c3aa6a0bda6a5a980e5ade067b8f8beeb3d3540d8a9d52fc NEW	Sep 23
Debenhams	Inbox	ONLINE NOW! Up to 25% OFF all departments - e.debenhams.com/?qs=4c5bc93a293d875b40220d97862222414279193094bf199b43287b0040e4886093bd7833895d47ec NEW	Sep 22
Debenhams	Inbox	**Get ready for a Spectacular week** - e.debenhams.com/?qs=67a3661191ab99b9efc2718bec6a16738a43aaf04f80bb4af147035832c9704743797ec3dfda177e NEW	Sep 21
Debenhams	Inbox	**The Autumn fashion wrap-up** - e.debenhams.com/?qs=cb9a65a0ff88a9731eba006e2084f38744d3e48361500000b52443e193eac9361b038cb0df4948bb THE	Sep 16
Debenhams	Inbox	**3 smart looks for you this season** - e.debenhams.com/?qs=34a27a29b9e9b75b5ccbd8633f37c3c3966163fa2d8506ba21035053190c254631afe0991622e846 HAMMOND	Sep 8
Debenhams	Inbox	**Men's Monochrome | No-nonsense style** - e.debenhams.com/?qs=a8b8455a11653c801ce66d62f045d6f0a337c3a63be0c9b195981d61f3f616a8e72633ba73c4d631 A	Sep 2
Debenhams	Inbox	**ENDS TODAY! 20% OFF home** - e.debenhams.com/?qs=c2f527fa962e61eb19fb579823aae2b54413242a079e304359e394f6a1b0c4e6ec470e2d4e054286 MUST	Aug 31

Source: Gmail inbox

The website today also suggests that the traditional 'Boxing Day' sales have started over a week early.

Exhibit 10: Debenhams website, 18 December 2015



Source: Debenhams website

Whilst the percentage of full price sales has risen in FY15, our perception as customers remains that Debenhams is always on sale.

Declining Business Economics

Exhibit 11: Margins declining

	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16e	FY17e	FY18e
Revenue	1,774	1,839	1,916	2,120	2,210	2,230	2,282	2,313	2,323	2,386	2,408	2,432
EBITDAR	447	431	446	479	483	470	457	446	458	444	426	407
Margin	25.2%	23.4%	23.3%	22.6%	21.9%	21.1%	20.0%	19.3%	19.7%	18.6%	17.7%	16.7%

Source: Company reports, The Analyst estimates

EBITDAR margins, a sensible comparator for retailers, have been on a downward trend since 2007. This is despite the higher margin own-bought sales mix (non-concessions) improving in the UK from 69.5% in FY07 to 78.3% in FY14. The decline is the result of overall price deflation, growing price competitiveness of the market and weaker economics of the online business against the store based business. We see little sign of this trend changing. Whilst online economics will improve, they still cannibalise sales from the stores and remain less profitable than a store-based sale. Clothing price deflation continues and competitors are still opening stores.

The strategy now is to bring in more concessions to use surplus space, therefore concession sales must grow as a percentage of the total, adding another push to the downside. The company highlight slightly under 10% of space as being surplus but this amount will grow as footfall declines further, therefore the percentage of concession sales will continue growing, adding further downside to EBITDAR margins.

Competitors M&S and House of Fraser are suffering from the same trend, however quality operator Next has managed to grow EBITDAR margins from 25% in FY10 to 28% in FY15 thanks to the superiority of its highly profitable online offering.

Debenhams' average remaining length of operating leases has fallen from 30.5 years in FY07 to 22.8 years in FY14, but this level is still extremely high compared to Next at nine years. Equally concerning is that rent per sq ft has risen from £14.90 in FY07 to £16.70 in FY15 despite declining footfall in that period, a reflection that the long average leases are not allowing them to gain much benefit from cutting rental payments at lease expiry and also indicating that their leases contain upwards-only rent reviews. We have the following information regarding Debenhams lease transactions in recent years:

- In 2005, there was a £495m sale and leaseback of 23 stores. Two of these were for 35 year leases, the rest on 30 year leases all starting in 2004. Annual rent payments were £27.9m in 2004, with fixed 2.5% annual increases until 2019 when there is an upwards-only rent review that is repeated every five years.

- In 2005, Debenhams took over the leases on four former Allders stores. Included in this is the Clapham store, where the lease expires in 2035. Rent was £1.25m per annum at inception with guaranteed annual uplifts and full rent reviews every five years.

- In 2011, long leases on nine stores were sold and leased back on an operating lease basis. The new leases were for 25 years. Debenhams received a £36.6m cash inflow as a result of the transaction, £24m of which came from lease incentives on the new operating leases.

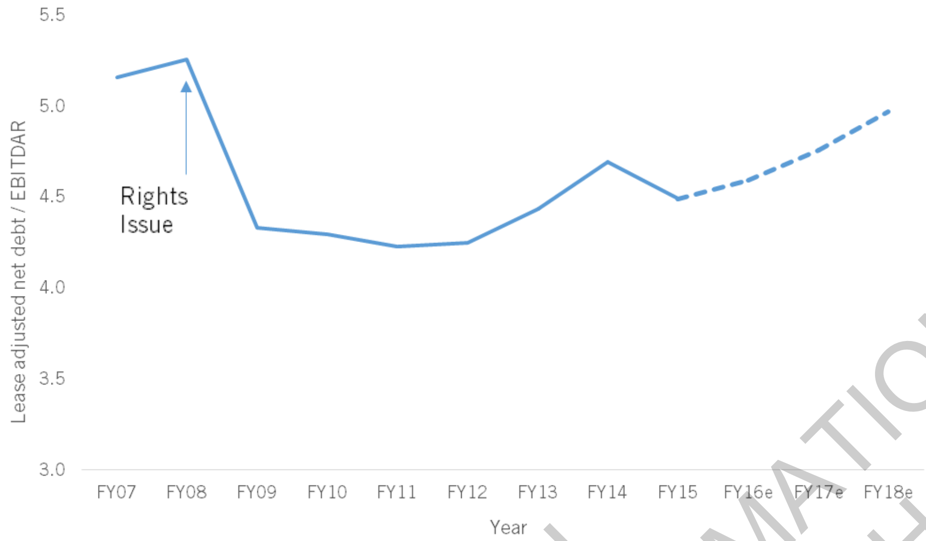
- In 2012, the lease on the Chatham store was put on the market with Smith Price. The lease for £1.5m p.a. expires in 2026 and contains upwards-only rent reviews.

- In 2015, LaSalle Investments bought the freehold on the Canterbury store, with expiry in 2034. Rent is £1.33m p.a. with fixed annual 2.5% uplifts until 2019 when there is a full upwards-only rent review.

- The store and delivery facilities on Princes Street in Edinburgh are on the market with KLM Property, with remaining leases through to 2054, and annual rent of £1.3m. Rent reviews are every year on the main store, with the next review in 2015.

Whilst this is only a snapshot of the leases, we are confident that Debenhams has upwards-only rent positions on the majority of its stores and model operating lease expenses growing from £214m in FY15 to £226m in FY18.

Exhibit 12: Lease adjusted net debt to EBITDAR ratio



Source: Company reports, The Analyst estimates

The simple net debt to EBITDA ratio has fallen from around 3.7x prior to the rights issue in FY09 to around 1.3x, a level at which the company has been broadly stable for the past three years, suggesting reasonable health of the company. However when we capitalise the leases at 8x annual lease expenses we get a lease adjusted net debt to EBITDAR ratio of 4.5x. We expect rising operating lease costs combined with falling EBITDAR to result in the ratio rising to 5x by FY18, slightly below the 5.3x that it reached prior to the last equity raise in FY09.

The dividend payment of £42m in FY15 was twice covered by free cash flow, however as business profitability declines, and the £341m of other non-current liabilities starts to unwind, we expect this cover to disappear by FY18. The dividend is being kept constant in FY15 and we expect it to come under threat from both the lack of cash flow cover and growing leverage of the business.

Exhibit 13: Debenhams balance sheet at year end FY15.

Balance sheet item	At Y/E FY15 / £m
Intangibles	932
PPE	675
Net debt	(320)
Working capital	(114)
Net other liabilities	(326)
Other	5
Net assets on balance sheet	853
Off balance sheet operating leases	(4,713)
Net assets including operating leases	(3,861)

Source: Debenhams FY15 financial statements

The balance sheet is also extremely concerning for a company with declining earnings:

- The £932m of intangible assets mainly comprises goodwill. The only asset of value here is the Debenhams brand.
- £675m of PPE mainly comprises store and warehouse fittings along with delivery vehicles. There is only £1.6m of freehold property, with all of the stores now on operating leases following sale and leaseback transactions in 2005 and 2011.
- Negative working capital of £114m, whilst a good position for a company quickly growing sales, is of no benefit for a company with flat sales.
- £326m of net other liabilities is largely comprised of lease incentives, which as we discussed earlier give the business a cash boost when growing store numbers but will start to unwind when the store network in the UK stops expanding in the next two years.

Bank debt has little in the way of assets to be secured against and there are few assets available which could be sold to raise further cash.

Debenhams want the international operations to rise from 17% of the business today to 30%. The 70 franchised stores are a strong asset, with franchisees buying product from Debenhams on a cost-plus basis and taking the risk of fixed costs on the store. Whilst the economics are good, the growth in franchised stores has slowed and although further stores are due to open in the next few years we expect this to be balanced out by other stores closing. Franchisees are probably seeing declining value of the Debenhams brand due to its perception of having heavy discounting and a dated offering in the UK.

Debenhams is at serious risk of requiring a dividend cut and/or an equity raise in the next three years.

Risks to Short Recommendation

We see the following key risks to our Short recommendation:

- **Takeover offer** – A domestic operator is unlikely to buy Debenhams due to the operating lease liabilities. The only risk here is from a Far East operator looking to acquire a UK brand which can then be taken back to the home country, along the lines of the Fosun International stake in Thomas Cook.
- **BHS is in an even worse state** – With 171 stores, BHS has suffered from underinvestment for a number of years and the loss-making chain was sold by Arcadia for £1 in 2014 to Retail Acquisitions. There are rumours that 52 of these stores will be closed. These closures could provide a short term uplift to Debenhams, although conversely if the new owners decide to invest in the offer then competition could increase.
- **Improving consumer confidence** – This is now at the highest level since the 2008/2009 recession as wages begin to rise, interest rates remain low and energy prices decline.

Overall we view the risks to the downside as outweighing risks to the upside. Consumers with more confidence will visit the stores with the better offer, benefiting winners Primark, Next, John Lewis and the other fast-fashion retailers more than Debenhams.

Conclusion

We model revenues increasing by between 0.6% and 0.8% in FY17 and FY18, all from international and online growth. We expect higher revenue growth in FY16 due to the five new UK stores opening in Autumn 2015. However we also expect EBITDAR margins to continue declining from 19.5% in FY15 to 18.1% in FY18 as price competition grows stronger and the percentage of sales from lower margin concessions increases. This combines with a rising rent bill from leases with upwards only rent reviews to give a fall in underlying net income and free cash flow from £93m and £85m respectively in FY15 to £55m and £34m respectively in FY18. We sit 45% below consensus with FY18 net income earnings of £99m.

We value the business at 10x FY18 estimated earnings, giving a valuation of 45p per share. We therefore initiate with a Short recommendation and a target price of 45p, giving 38% downside.

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