Smart Company Analysis

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The Company: Mr Price Group Ltd

Changing market dynamics putting impressive track record to test

Our call

Overvalued

Intellidex estimate of fair value:	*R227.82*
Spot price:	*R255.50*
Potential move:	*-10.8%*

Share price graph and Intellidex's previous calls

Background

Mr. Price Group Ltd. is a fashion value retailer. It retails apparel, homeware and sportswear through owned and franchised stores and online channels in Africa and Australia. Merchandise is predominantly own-branded and targeted at young customers in the mid to upper LSM categories.

Sensitivity analysis: discounted cash-flow valuation

Wacc \ Terminal growth	4.0%	6.0%	8.0%
9.3%	31 020	44 012	96 983
11.3%	22 261	27 295	38 432
12.3%	19 384	**22 782**	29 308
14.3%	15 609	17 427	20 398
15.3%	14 199	15 572	17 697

This reflects the sensitivity of our forecasts to assumptions of the terminal growth rate and the weighted average cost of capital (WACC). The highlighted cell shows our target price in cents.

Investment thesis

Investors love a good story and Mr Price has provided one. For the past two decades it has consistently delivered, paying a growing dividend each year, bar two occasions where it remained flat. Its operating margin has expanded from 5% to 18% during the same period. This has seen it growing the bottom line by an average of 23.7% annually.

Because of its consistent performance its share price has attracted a premium valuation, which means it is priced for perfection and investors believe this consistence will endure. Its attractiveness is enhanced by a huge cash pile and no leverage.

However, the market landscape is changing. Mr Price will have to contend with increasing competition, which will put pressure on margins. For the past two decades its bottom line has grown more in line with the operating profit (rather than revenue). Its operating profit has grown faster than the top line because expenses rose slower than revenue, leading to margin expansion. Whereas the revenue growth rate since FY10 averaged 10.3%, expenses grew at 9.2%. It is amazing how such a small difference can make a big difference at the bottom line. By ensuring gradual expansion of margins, on average the bottom line growth rate has almost doubled the revenue growth rate. In context, Mr Price's headline earnings growth rate has averaged 18.9% in the same period, while the rate is 10.3% for its top line.

However, FY17 reminded us that this model breaks down if sales fall or remain static because expenses are sticky. Revenue fell 1.6% and the bottom line tanked 13.8%. Similarly, the share price fell sharply, highlighting the downside risk of a premium market valuation.

The market valuation of Mr Price shows that investors expect average earnings to continue growing close to 20% a year in the foreseeable future. In order for this to happen margins ought to keep expanding, but we do not believe it is possible. Margin-expansion cannot go on forever. This is a logical premise of markets: cost efficiencies cannot be extracted into perpetuity. And Mr Price's margins are already above those of global peers. Furthermore, the market that Mr Price operates in has relatively low barriers to entry and new entrants/competition will erase abnormal profits, as we are beginning to witness. Despite the low base effect created in FY17, it has been followed by single-digit growth rates in both FY18 and 1H19.

Our thesis is that as Mr Price struggles to expand margins, its bottom line will start to grow more in line with its slower revenue growth rate, divorcing from its traditional relationship where the bottom line grows faster than the top line. As such the market will eventually downwardly rerate the counter.

Overall, we see the top line maintaining upper single-digit to lower double-digit growth in the foreseeable future. We do not see margins improving markedly from current levels.

We expect Mr Price to experience average annual revenue and earnings growth of 10% and 11% respectively in the short to medium term. We see both metrics gradually falling to a sustainable growth rate of 6% in the terminal year of our model. We assume that its adjusted pre-tax operating margin will stabilise at around 18%.

Using a discount rate of 12.3%, we obtain a target price of R227.82/ share, which translates to downside potential of 10.8%.

Analysis of results

Retail sales – revenue excluding other income – grew 6.6% to R9.7bn, helped by product inflation of 4.5% and volume growth of 2.9%. Comparable sales grew 3.9%. Other income, which primarily includes financial services and cellular sales, climbed 24.7% to R801m.

Cash sales, which make up 83.4% of total sales, rose 7.5% while credit sales edged up 2.2%. SA sales increased 6.2% while non-SA sales grew 11.4%.

The gross profit margin improved to 42.6% from 42% primarily due to less discounting than the base period.

The apparel segment grew its revenue 6.2% to R7.3bn, propelled by online sales growth of 31.6%. The operating margin widened to 16.9% from 16.1%. The home division grew revenue 7.2% to R2.4bn and its operating margin improved to 14.3% from 13.4%. Financial services and cellular revenue climbed 23.5% to R673m.

Macroeconomic analysis

Mr Price has dominated its market segment for decades largely because of its low prices. Its strategy is to order large quantities of stock and push higher sales volumes of predominantly own-branded merchandise, which keeps both input and output prices low.

However, the encroachment of international competitors has changed the stakes and presents real substitutes for consumers. Furthermore, online trading is becoming more widespread, increasing competition and market access to offshore competitors. The online space is still developing in SA and though it presents opportunities it also significantly increases competition.

However, management says independent research shows that consumers' perception of Mr Price's apparel and fashion has improved relative to competitors, further enhancing its price positioning.

The bulk of Mr Price's revenue comes from SA, where the economic outlook remains grim. Intellidex has recently revised its expected growth rate for 2018 downwards to 0.7% (from 1% in October) following a slew of disappointing economic data.

The slowdown in the economy is linked to slowing wage growth. Stats SA data show a high and pronounced correlation between slowing wage growth – arguably the single most important factor in driving consumer spending – and the slowdown in retail sales. Between 2005 and 2017 wages grew at an average of 10% annually compared with clothing sales growth of 16.4%. However, 2017 recorded the slowest wage growth rate of 7.6% and retail sales grew at only 5.6%. More recently in September, retail sales grew a meagre 0.7% (below the 2% we expected). This suggests a bear outlook for retail without any recovery in the economy and employment prints.

On consumer indebtedness, the TransUnion SA Consumer Credit Index fell sharply in Q2 to 51 points from 55 in Q1. (The reading ranges from 0 to 100, with readings above 50 indicating improving credit health for consumers). The reading has been above 50 and trending upwards since the beginning of 2017, but the decline in Q2 of 2018 is a cause for concern.

Bull Factors

- Less affected by the cyclical nature of retail due to its low price strategy
- Not heavily dependent on credit to drive sales due to its affordable offering
- Highly cash-generative with net cash position on its balance sheet
- New, larger distribution centre should boost margins
- Faster-growing online sales

Bear Factors

- Recovery of consumer spending remains constrained by high unemployment, high indebtedness and threat of higher administered costs
- Intense industry competition
- Poor economic and retail sales performance in SA

Key statistics

Share details – JSE Code: **MRP**
Sector: **Apparel retailer**

Market cap: **R66.5bn**
Net debt:equity ratio**: net cash**
Price:earnings ratio: **23.0**
Forward PE ratio (FY19): **19.9**
Dividend yield: **2.8%**
Forward dividend yield**: 3.2%**
Risk: **Medium to high**

12-month high: **R296.11**
12-month low: **R202.00**
Ave monthly volume: **31.3-million**
Financial year-end: **31 March 2019**
Latest event**: Interim results**
Date announced: **22 Nov 2018**

RESULTS IN BRIEF	1H19	Change	1H18	FY18
Revenue(R'm)	10 539.0	7.8%	9 778.0	21 347.0
Operating profit (R'm)	1 693.0	10.9%	1 526.0	3 732.0
Operating margin (%)	16.1%	2.9%	15.6%	17.5%
Attributable earnings (R'm)	1 279.0	12.4%	1 138.0	2 781.0
HEPS (cents)	494.3	11.6%	442.9	1 100.1