Gear4music Holdings

Market share gains and margin boost

January trading statement

Retail

Gear4music's (G4M) Christmas trading statement shows it continuing to take share in its niche markets to generate revenue growth far above the level of general consumer demand. We expect the company to over-achieve our margin expectation, and upgrade our FY17e earnings per share forecast by 20%, although we expect margins to normalise in FY18. While the share price has risen by a factor of four since we initiated in May 2016, it still stands at a discount to larger UK pure-play e-tail peers.

Year end	Revenue (£m)	EBITDA (£m)	PBT* (£m)	EPS* (p)	P/E (x)	EV/EBITDA (x)
02/15	24.2	0.8	(0.6)	(4.1)	N/A	N/A
02/16	35.5	1.7	0.6	3.1	161.3	57.9
02/17e	56.0	3.2	2.4	9.2	54.3	30.7
02/18e	79.1	4.1	2.9	11.5	43.5	24.0

Note: *PBT and EPS are normalised and diluted, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Strong pre-Christmas trading

G4M has reported strong trading in the pre-Christmas period, with September to December revenue growing by a robust 55% year-on-year. This was against a much stronger H2 base than in H1, where growth had been 73%. We forecast H217 revenue at £34.4m, which is 97% of the preceding full year. Both sales and margins were boosted by a significant investment in stock at pre-referendum rates, and margins benefited from an increasing mix of own-brand products, while overheads were controlled below expected levels. As a result, we upgrade our FY17 EPS forecast by 20%.

FY18 forecast maintained

Prospects for the upcoming year remain encouraging. We expect gross margin to normalise given the new exchange rate environment. We continue to expect growth in the cost base, given further development of the online platform, expansion of the management structure, and the full-year costs of the new hubs in Sweden and Germany. The unknown factor in FY18 is the level to which general reductions in discretionary consumer spending may affect the company's niche markets, and to what extent these may be countered by further share gains. As a result, we are not upgrading our forecasts for FY18 and FY19 materially at this stage.

Valuation: Still discounted to pure-play peers

G4M's share price has risen by a factor of four since we initiated in May 2016. Yet it still stands at a significant discount to larger, pure-play online peers: in fact a discount level of 20% would indicate a share price of 536p. This puts G4M on much higher multiples than UK small-cap peers, but we see this as justified by its higher growth characteristics. Indeed, taking into account relative growth, reflected by the PEG ratio, the shares could be priced at 651p, a calendar 2017 P/E of 58.6x. While our DCF forecast, assuming 9% terminal EBITDA margin, would indicate a share price of 395p, scenario analysis suggests that the market is assuming 10-11%. This is high in, but not outside the range of, comparable achieved margins.

6 January 2017

Price	**500p**
Market cap	**£101m**

Net cash (£m) at 31 August 2016	0.9
Shares in issue	20.2m
Free float	42%
Code	G4M
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	17.1	80.2	247.2
Rel (local)	10.2	76.6	201.4
52-week high/low		502.5p	99.5p

Business description

Gear4music is the largest dedicated, UK-based online retailer of musical instruments and music equipment. It sells branded instruments and equipment, alongside its own brand products, to customers ranging from beginners to professionals, in the UK and into Europe and the rest of the world (RoW).

Next events

Trading statement	Early March 2017
Final results	May 2017

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Edison profile page

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An excellent Christmas and a positive New Year

Strong pre-Christmas trading

G4M has reported strong trading in the pre-Christmas period. Revenue for September to December grew by 55% year-on-year, reflecting excellent growth of 29% in the UK and spectacular growth of 129% in Europe. Active customer numbers were ahead 53% year-on-year at December 2016, at 324,000, showing that the sales growth is volume-based and represents clear market penetration. The headline is lower than the 73% growth achieved in H1, but that was against a comparatively soft base in early FY16. That situation was transformed later in FY16, mainly because of a strong competitive position driving accelerated European growth, the introduction of seven-day delivery, improvements to the marketing platform and other use of cash following the June 2015 IPO. Revenue was further boosted from June 2016 as a result of the pricing advantage, which the company realised by contracting for product at sterling prices that reflected currency rates before the Brexit vote of June 2016.

Gross margins heightened

The cost advantage from contracted purchases reflecting pre-referendum exchange rates has not only provided a competitive advantage, but is also likely to have boosted gross margins. Margins will also have been strengthened by the relative mix of own-brand products, where we understand revenue is now growing at rates comparable with other brands.

Bright prospect to year end

Going into January, activity levels remain strong and management is confident of the sales outlook for the final two months of the financial year, despite the fact that the comparative is relatively strong, with seven-day delivery being fully rolled out in the corresponding period in early 2016. Revenue should start to benefit from the new European centre in Sweden, which started shipping in November, and did not contribute materially to the pre-Christmas sales period.

The company is still progressing on other projects in its platform development pipeline, such as improvements in its mobile site and enhancements to its marketing capabilities. We understand that overheads including such costs have been controlled below the levels assumed in our forecast, although to some extent these may be timing differences and not permanent reductions.

Steady outlook for FY18

Prospects for the upcoming year remain encouraging. We understand that interest in the company’s product ranges remains high based on e-tail data and customer feedback, and to date the competitive position remains favourable, so that we are comfortable with our existing forecast of 41% revenue growth, while our gross margin expectations remain unchanged.

Although specific priorities will be announced at year end, we continue to expect management to further develop its online platform, incurring planned costs in the process. The full-year cost burden of the two European centres (the other is scheduled to open in Germany before financial year end) is already reflected in our forecasts, although the full sales benefit of those facilities is in the medium term. These are mainly property and people costs, although there will clearly be an investment in working capital as well. In addition, G4M continues to expand its operating management structure in preparation for higher volumes of business.

The unknown factor in FY18 is the level to which general reductions in discretionary consumer spending may affect the company’s specialised market in the UK and mainland Europe, and to what extent these may be countered by further market share gains. As a result, we are not upgrading our forecasts for FY18 and FY19 materially at this stage.

Forecast revisions

We do not currently expect a materially higher FY17e revenue total than our existing forecast, although the strong performance for the first 10 months clearly brings a large measure of assurance to our expectation. However, as a result of the margin positives in H217, both on cost of sales and overhead control, we upgrade our forecast operating margin by 70bp to 4.1%. As a result, we upgrade our FY17 PBT and EPS forecasts by 20%.

As explained above we remain confident in our FY18 sales growth expectation of 41%, given the strong fundamentals, increasing market share, a lack of unexpected competition, and continued initiatives in developing the platform. We currently hold our forecast operating margin at 3.7% in both FY18 and FY19 assuming a normalisation of purchase costs as well as overhead spend. As a result, we are only forecasting slight increases in our EPS for both years.

As a result of our FY17 upgrade we forecast year-end cash levels to increase by £0.4m throughout the forecast period FY17e-19e.

Exhibit 1: Forecast changes

£'000	FY17e			FY18e			FY19e		
	Old	New	Chg (%)	Old	New	Chg (%)	Old	New	Chg (%)
Revenue	55,936	56,040	0.2	78,905	79,083	0.2	98,081	98,312	0.2
EBITDA	2,816	3,213	14.1	4,045	4,062	0.4	5,068	5,091	0.5
Normalised operating profit	1,913	2,310	20.7	2,888	2,905	0.6	3,661	3,684	0.6
Operating margin	3.4%	4.1%	0.7%	3.7%	3.7%	0.0%	3.7%	3.7%	0.0%
Profit Before Tax (norm)	1,991	2,388	19.9	2,882	2,904	0.8	3,653	3,680	0.7
EPS	7.7	9.2	19.9	11.4	11.5	0.8	14.4	14.5	0.7
Net cash	2,283	2,692	17.9	2,154	2,556	18.6	2,917	3,336	14.3

Source: Edison Investment Research

Valuation

G4M's share price has performed spectacularly, growing by a factor of four since we initiated in May 2016. We examine valuation based on peer comparisons, taking into account relative growth rates, and DCF techniques.

Peer comparison on earnings multiples

Exhibit 2: Significant discount to pure-play online retailers

	Share price	Market cap	P/E (x)			EV/Sales (x)			EV/EBITDA (x)		
Calendarised	p	£m	2016	2017e	2018e	2016	2017e	2018e	2016	2017e	2018e
G4M	502.5	101.3	35.5	40.8	35.7	2.9	1.9	1.3	33.4	25.0	19.9
ASOS	5041.0	4206.5	78.5	61.2	47.2	2.6	2.1	1.7	39.6	30.0	23.6
Boohoo	133.0	1496.8	75.4	59.7	46.2	5.4	4.0	3.2	48.5	36.9	28.7
AO World	180.2	757.9	N/A	N/A	72.0*	1.1	0.9	0.7	N/A	79.9*	31.4
Average			77.0	60.4	46.7	3.0	2.3	1.9	44.1	33.5	27.9
Discount			(53.9%)	(32.4%)	(23.6%)	(3.4%)	(19.9%)	(30.2%)	(24.3%)	(25.3%)	(28.7%)
N Brown	203.4	576.8	8.9	9.0	8.6	0.0	0.9	0.9		7.2	6.6
Findel	191.0	165.0	8.5	7.7	7.0	0.9	0.8	0.8	8.7	8.2	6.7
Average of whole group			42.8	34.4	27.3	2.0	1.8	1.5	32.3	20.6	19.4
Premium/(discount)			(17.1%)	18.9%	30.8%	46.8%	6.4%	(10.3%)	3.3%	21.5%	2.5%

Source: Bloomberg, Edison Investment Research. Note: *Outlier, excluded. Prices as at 4 January 2017.

The primary comparison on the UK market is with profitable online retailers ASOS and Boohoo (AO World is also a good comparator in terms of its business model but is not profitable in calendar

2017 according to consensus forecasts). Against these, G4M trades at calendar 2017 discounts of 33% on P/E and 25% on EV/EBITDA measures. We see a discount of around 20% as appropriate to G4M's smaller size and liquidity, and therefore regard this discount as excessive. Pricing G4M at an average 20% discount on P/E and EV/EBITDA (CY17 multiples of 48.4x and 26.8x respectively) would put the shares at 536p.

Small-cap online retailers N Brown and Findel trade at much lower multiples and, when these are taken into account, G4M trades at a 19% P/E and 22% EV/EBITDA premium to the wider peer group for calendar 2017. However, we do not see those companies as a close comparison. Both have adapted from a previous mail order business model, and neither is seeing comparable rates of growth to pure-play online peers, with EPS growth in FY17 of less than 10%.

Growth-adjusted earnings comparison

This metric reflects a comparison with peers where consensus forecasters expect FY17 earnings growth of above 10%. In these cases there is a growth component clearly included in the valuation, which is reflected in the PEG (P/E to earnings growth) ratio. Taking into account its CY17e P/E of 40.8x against forecast EPS growth in the same year of 35.2%, G4M has a PEG of 1.2, which is half that of ASOS and Boohoo (2.5 and 2.2 respectively). Allowing for a 20% discount to these larger peers would suggest a PEG of 1.9 leading to a CY17 P/E of 66.6x and thus a share price of 740p for G4M. Based on our slightly lower two-year (to CY19e) EPS growth forecast of 30.9%, the PEG calculation would indicate a 58.6x P/E and thus a share price of 651p.

Reverse DCF valuation

We model DCF valuation on a reverse basis to examine the assumptions that the current market price is currently discounting in relation to the scale and shape of the long-term cash flow.

Our DCF model fades revenue growth from FY19e (+24.3%) by 3% in FY20e and then by c 2% each year to terminal growth of +2%. In the table below we show the effect of a faster or slower step down in FY20e, given that the remaining years then spread the declining growth rate to still achieve the terminal growth of +2%.

The terminal EBITDA margin may reasonably be placed in a range of 7-11% based on the experience in other online retailers. ASOS, which is a mature online apparel retailer, achieved 10.1% in its financial year ended August 2012, although this reduced to 7.0% in the most recent reported year FY16. Boohoo posted 10.7% in its financial year to February 2012, 9.3% in FY16, and is forecast to hit 11.5% in FY17 (source: Bloomberg consensus). Looking further afield, the Italian online retailer YOOX NET-A-PORTER achieved 9.7% in calendar 2013 and is forecast to make 8.1% in 2016.

Exhibit 3: Scenarios for terminal EBITDA margin and revenue growth fade

		------Step-down in growth rate, FY19-FY20------				
		1.0%	**2.0%**	**3.0%**	**4.0%**	**5.0%**
Terminal EBITDA margin	11.0%	570	553	535	518	502
	10.0%	495	480	465	450	436
	9.0%	421	408	395	383	371
	8.0%	346	335	325	315	305
	7.0%	271	263	255	247	240

Source: Edison Investment Research

Assuming the step down of 3% in growth rate (ie a relatively benign flattening of growth after the end of our explicit three-year financial forecast), the current share price signals a terminal EBITDA margin of between 10% and 11%. This is high in the range suggested by other retailers, above, but is not above the range. Our previous assumption of 9% would suggest 395p.

We also model below scenarios for terminal growth rate and WACC. This table, which is based on a terminal margin of 9%, suggests that the current share price is equivalent to WACC of 7- 8% (against our assumption of 9%) using our usual assumption of 2% terminal growth; or alternatively terminal growth rate of c 4% on a WACC of 9%.

Exhibit 4: Scenarios for terminal growth rate and WACC

		Terminal growth rate				
		0.0%	1.0%	2.0%	3.0%	4.0%
WACC	12.0%	217	229	243	260	282
	11.0%	247	262	281	305	335
	10.0%	284	305	330	364	408
	9.0%	330	359	395	443	511
	8.0%	390	430	483	557	668
	7.0%	468	526	608	730	934

Source: Edison Investment Research

Valuation conclusion: Supported by peers, assumes high margin

Pricing G4M's shares on a discount to larger pure-play online peers certainly justifies the current share price: in fact, our chosen discount level of 20% would indicate a level of 536p. This puts G4M on much higher multiples than UK small-cap peers, but we feel this is justified by G4M's higher growth characteristics. In fact, taking into account relative growth reflected by PEG ratios, the shares could be priced at 651p, which would put them on a P/E of 58.6x.

While our DCF forecast using our assumption of 9% terminal EBITDA margin would indicate a share price of 395p, scenario analysis suggests that the market is assuming a terminal margin of 10-11%. While high in the range of achieved margins among peers, this is not outside the range.

Exhibit 5: Financial summary

	£'000	2015	2016	2017e	2018e	2019e
Year end: February		IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue		24,240	35,489	56,040	79,083	98,312
Cost of Sales		(17,483)	(26,303)	(41,059)	(58,294)	(72,428)
Gross Profit		6,757	9,186	14,981	20,788	25,884
EBITDA		842	1,688	3,213	4,062	5,091
Normalised operating profit		376	903	2,310	2,905	3,684
Amortisation of acquired intangibles		0	0	0	0	0
Exceptionals		(165)	(606)	0	0	0
Share-based payments		0	(8)	(92)	(116)	(137)
Reported operating profit		211	289	2,218	2,789	3,546
Net Interest		(1,008)	(283)	78	(1)	(4)
Joint ventures & associates (post tax)		0	0	0	0	0
Exceptionals		0	0	0	0	0
Profit Before Tax (norm)		(632)	620	2,388	2,904	3,680
Profit Before Tax (reported)		(797)	6	2,296	2,788	3,543
Reported tax		111	(49)	(519)	(581)	(736)
Profit After Tax (norm)		(521)	571	1,869	2,323	2,944
Profit After Tax (reported)		(686)	(43)	1,777	2,207	2,807
Minority interests		0	0	0	0	0
Discontinued operations		0	0	0	0	0
Net income (normalised)		(521)	571	1,869	2,323	2,944
Net income (reported)		(686)	(43)	1,777	2,207	2,807
Basic average number of shares outstanding (m)		12.7	18.2	20.2	20.2	20.2
EPS - basic normalised (p)		(4.1)	3.1	9.3	11.5	14.6
EPS - diluted normalised (p)		(4.1)	3.1	9.2	11.5	14.5
EPS - basic reported (p)		(5.4)	(0.2)	8.8	11.0	13.9
Dividend (p)		0.00	0.00	0.00	0.00	0.00
Revenue growth (%)		37.1	46.4	57.9	41.1	24.3
Gross Margin (%)		27.9	25.9	26.7	26.3	26.3
EBITDA Margin (%)		3.5	4.8	5.7	5.1	5.2
Normalised Operating Margin		1.6	2.5	4.1	3.7	3.7
BALANCE SHEET						
Fixed Assets		3,755	4,477	5,450	6,087	6,724
Intangible Assets		2,764	3,238	3,977	4,556	5,095
Tangible Assets		991	1,239	1,473	1,531	1,629
Investments & other		0	0	0	0	0
Current Assets		6,458	11,194	15,817	20,817	25,754
Stocks		5,326	6,906	10,948	15,604	19,360
Debtors		216	740	1,169	1,649	2,050
Cash & cash equivalents		916	3,548	3,700	3,564	4,344
Other		0	0	0	0	0
Current Liabilities		(5,842)	(6,022)	(8,999)	(12,429)	(15,196)
Creditors		(4,522)	(5,188)	(8,065)	(11,495)	(14,262)
Tax and social security		0	0	0	0	0
Short term borrowings		(1,320)	(834)	(934)	(934)	(934)
Other		0	0	0	0	0
Long Term Liabilities		(4,660)	(290)	(90)	(90)	(90)
Long term borrowings		(4,570)	(127)	0	0	0
Other long term liabilities		(90)	(163)	(90)	(90)	(90)
Net Assets		(289)	9,359	12,177	14,384	17,191
Minority interests		0	0	0	0	0
Shareholders' equity		(289)	9,359	12,177	14,384	17,191
CASH FLOW						
Op Cash Flow before WC and tax		842	1,688	3,213	4,062	5,091
Working capital		1,012	(1,416)	(1,300)	(1,706)	(1,390)
Exceptional & other		(304)	(607)	14	(116)	(137)
Tax		0	0	0	(581)	(736)
Net operating cash flow		1,550	(335)	1,927	1,659	2,828
Capex		(953)	(1,509)	(1,900)	(1,794)	(2,044)
Acquisitions/disposals		0	0	0	0	0
Net interest		(185)	(130)	78	(1)	(4)
Equity financing		0	9,535	0	0	0
Dividends		0	0	0	0	0
Other		(377)	0	0	0	0
Net Cash Flow		35	7,561	105	(136)	780
Opening net debt/(cash)		4,694	4,974	(2,587)	(2,692)	(2,556)
FX		0	0	0	0	0
Other non-cash movements		(315)	0	0	0	0
Closing net debt/(cash)		4,974	(2,587)	(2,692)	(2,556)	(3,336)

Source: Company accounts, Edison Investment Research

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