Debenhams plc (market cap: £164m) Ticker: DEBLN

Isin	Issue Size	Rating M / S&P	Coupon	Min Piece	Maturity	Offer	YTM	Spread
XS1081972850	£200m	B2 / B	5.25%	£100k	15th May 2021	78	14.92%	1420bps

Introduction

Debenhams can trace its history to 1778 when William Clark established a drapers store at 44 Wigmore Street in London's West-End selling fabrics, bonnets, gloves and parasols. The firm became a public company for the first time in 1928, effectively concluding the involvement of the Debenhams family.

By 1950, Debenhams was the largest department store group in the UK, owning 84 companies and 110 stores. It continued to grow and in 1966 central buying was introduced for the first time. The first international franchise store opened in Bahrain in 1997.

After a period in private ownership, the group relisted in May 2006. The group trades out of over 241 stores (165 UK, 17 international, and 59 International franchises).

Backdrop

Debenhams has marginally increased revenues over the past five years from £2.28bn to £2.34bn. Underlying profitability has however been continually eroded with profit before taxes falling from £139m in 2013 to just £59m in 2017 (pre-exceptional items, the number rises to £95.2m).

Sergio Bucher, who became CEO in mid-2016, arrived with a promising CV. For Debenhams, which is grappling with ever-growing competition from online retailers, Bucher offered plentiful experience in fashion retail as well as online sales. He was previously a Vice President at Amazon Fashion Europe as well as General Manager of Retail and e-commerce Worldwide at Puma.

In April 2017 a new turnaround strategy was announced aimed at boosting its appeal as a destination shop and improving its online service. The plan also envisaged the closure of 10 of its 176 UK stores over the following five years, and stepping up investment in store cafes, restaurants and beauty services - all designed to reposition the chain for "social shopping".

One year into the plan, the retail environment has remained very challenging, leading to Debenhams to issue a series of profit warnings; most recently in a 19th June Trading update: -

"against a background of increased competitor discounting and weakness in key markets, trading in May and early June has been below plan despite weak comparatives. We have reassessed our expectations for the balance of the year and now expect pre-tax profit for FY2018 to be in the range of £35m-£40m, with EBITDA in the range £160-£165m".

"We are driving out further cost opportunities beyond those already announced, focusing on self-help and prioritising cash generation. We anticipate year end net debt will be in line with our previous guidance, at c.£320m, retaining significant headroom on our £520m facilities. To give us maximum flexibility amidst difficult trading conditions we are taking the opportunity to strengthen our balance sheet further. Whilst still pushing ahead with key strategic initiatives, we are planning for a material reduction in FY2019 capex. As a result, we expect net debt to be lower in FY2019 than in FY2018. We also intend to conduct a strategic review of non-core assets, aiming to focus investment behind our strategy".

Earnings

In the first half of 2018 (to March 2018) Debenhams generated revenues of £1.32bn. Like for Like ("LFL") sales declined 2.2% with constant currency LFL declining 2.8%. Management highlighted particularly disruptive weather conditions, which led to almost 100 stores being closed temporarily (a £12m sales impact, £5m on profits).

However, leaving aside exceptional factors in H1, the overall picture over the past five years has been a sustained decline in gross margin from circa 13% to around 11% at FY 2017 - and the group is guiding towards a further 100bps decline year on year for FY 2018.

Part of that squeeze relates to the competitive landscape which has led to seasonal discounting / mark downs becoming established practice; but the change of business mix towards higher growth segments such as beauty and in-store concessions has also diluted margins. A five-year summary of performance is outlined below: -

Debenhams over 5 years…	2013	2014	2015	2016	2017	2017 (H1)	2018 (H1)
Revenue	2,282	2,313	2,323	2,342	2,335	1,351	1,319
Gross profit	299.6	279.3	299.2	293.4	264.8	192.6	130.6
Gross margin	*13.13%*	*12.08%*	*12.88%*	*12.53%*	*11.34%*	*14.26%*	*9.90%*
Distribution costs	-97.5	-98.5	-111.1	-117.2	-135.1	-68.7	-80.5
Admin expenses	-46.7	-52.2	-54	-57.6	-58.4	-30	-32.3
Group EBITDA	250.2	230.8	238.6	239.7	217	149.1	103.5
Net finance costs	-16.4	-18.3	-20.6	-12.8	-12.3	-6.1	-4.9
Profit before tax (before exceptional items)	139	105.8	113.5	118.2	95.2	87.8	42.2
Profit before tax	139	105.8	113.5	105.8	59	87.8	13.5

Debenhams continues to build out its online presence, with a focus on mobile. A new head of digital was appointed in May to drive growth initiatives. There was 9.7% growth in sales in the first half of the year, with EBITDA growing 10.3%. Digital sales now account for 21% of the UK's sales (c. £250m) although the group has not broken out underlying profitability.

Balance sheet / cash flow

Over the past five years, the group has chipped away at its net debt position from £372m to £276m at FY 2017. Debt reduction has been made possible by healthy free cash flow, which has averaged £73m over the past five years.

	2013	2014	2015	2016	2017	2017 (H1)	2018 (H1)
Net debt	372	362	320	279	276	217	248
S/H equity	744.4	767.4	853.3	883.9	917.6	957.1	890.4
Cash generated from operations	241.1	240.5	236.3	240.2	200.4	156.2	130.9
Capex	133.3	128	133.4	126.5	124.8	47.5	60.3
Operating cash flow (post capex)	107.8	112.5	102.9	113.7	75.6	108.7	70.6
Free Cash Flow	66	78.8	84.7	87.4	48.2	102	58.2
Leverage ratio (Net debt/EBITDA)	1.5x	1.6x	1.3x	1.2x	1.3x	0.9x	1.4x

The full year debt position is generally elevated versus the half year number due to yearly stock build in the lead up to Christmas – the group is guiding towards a figure of £320m. This is comprised of the £200m 5.25% 2021 bonds, and the revolving credit facility maturing in 2021, minus cash/cash equivalents.

The group has historically used its cash flows for capex and dividends. The group has already confirmed in its most recent guidance in June that it is planning for a material reduction of capex in FY 2019; it has also cut the interim dividend from 1p per share to 0.5p. It wouldn't surprise us if the group opts to cut/cancel its final dividend at the results announcement in October. The dividends are of course paid out of after tax earnings, and so a cut provides no support to its interest cover. But equity remaining in the group should be regarded as mild credit positive, notwithstanding earnings pressures in recent years.

About the bond

> Issued by Debenhams plc (listed parent), pari-passu alongside Revolving Credit Facility
> Pays 5.25% per annum, semi-annually on 15th January / 15th July
> Guaranteed on senior basis by companies that generated 88% of EBITDA (as at 1st March 2014)
> Holders have right to opt for an early redemption of the notes at 101%, upon a change of control

Comment

At the half year, the group guided to net debt of £300-£320m over the coming three years. By June, Debenhams had changed its tune. Now, as outlined above, the group is targeting lower net debt in FY 2019 through a "material reduction" in capital expenditure, as well as some possible asset sales.

At the FY results in October we will learn more about the shift in sentiment. But reading between the lines, the ongoing weakness in its key markets has started to undermine Bucher's growth strategy for the group. The new store lay-out in Wolverhampton appears to be yielding results, but each store refit is a huge drain on the group's rapidly diminishing cash flows.

Bucher does speak positively and enthusiastically about the pace of change within the chain, with many of the improvements to efficiency invisible to the investor base. Automation at distribution centres has been improved, with some facilities facing closure. At the group's London support centre, 320 middle management roles have been removed to cut costs and to improve pace of decision making.

Within its Uxbridge store, the group has been trialling a new model in which footage is reduced in exchange for rent reductions. And in other stores the group is trialling (third party) gyms to make more effective use of low density footage.

Despite these initiatives, the retail market is changing rapidly. And the group could ill afford a sustained UK consumer downturn coupled with the relentless competitive pressure from online retail. At least Debenhams is strengthening its own e-commerce offering.

Conclusion

In March the group said there was no change to its plan to close 10 stores, two of which have already been shut. With free cash flow under material pressure it would not surprise us if that plan is revised at the full year.

From a creditor's point of view, leverage isn't out of control. But metrics definitively worsened at the half year, and it's hard to imagine the full year figures will provide any material relief.

Consensus forecasts…	FY 2018 (est)*		2019 (est)*	
	Low	High	Low	High
EBITDA	157	180	163	204
Pre-tax Profit	31	53	31.4	72.5
Net Debt	288	331	267	320
Enterprise Value	452	495	431	484
EBITDA / Interest (Guy Butler estimate)	13.08	15.00	13.58	17.00
Current EV / projected EBITDA	2.88	2.75	2.64	2.37

** SOURCE: Bloomberg, analyst consensus (function: EE)*

The group also stated in June that it intends to "conduct a strategic review of non-core assets, aiming to focus investment behind our strategy"; with 17 international stores, divestments could follow. Magazin du Nord department store chain in Denmark, which contributed £20.1m of EBITDA in H1 ("a consistent track record of good sales and profit improvement") would likely attract buying interest; although with group plans in motion to open stores in Norway and Sweden, the group would likely be reluctant sellers.

Mike Ashley's future involvement with the group remains a mystery. It was long thought he might seek a full takeover of the group, having amassed just shy of 30% of the ordinary shares.

Following Sports Direct's acquisition of House of Fraser estate (and brand) out of administration, Ashley's interest in the group may have subsided; or a bid for the whole business may be on hold until House of Fraser has been fully integrated into his retail empire.

When asked about collaboration opportunities with Sports Direct at the half year call, Bucher spoke of his commercial and investor relationship; on both subjects he sounded vague and non-committal.

A capital markets day is scheduled for 24th September, with the full year results announcement expected end of October.

Please contact the desk if you have any questions.

Rupert Harcus

23rd August 2018