Halfords Group Plc FY19 Preliminary Results

Tuesday, 21st May 2019

Transcript produced by Global Lingo
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CEO Update

Graham Stapleton

CEO, Halfords Group Plc

Welcome

Good morning everyone. Welcome to the Halfords Group Preliminary Results Presentation for FY19. Today I am joined by Loraine Woodhouse, our Chief Financial Officer, and let us begin by having a quick look at the agenda. I am going to start by taking you through an overview of the FY19 performance and share some of the operational highlights from the year. I will then give a brief update on our FY20 outlook. I will then pass over to Loraine who will take you through the financial results for FY19 and provide more detail on the outlook for FY20. I will then summarise and open the floor up to questions.

FY19 Group Financial Summary

Let us start then by looking at the financial performance for FY19. Despite a challenging consumer environment, Group revenue was up 1.1% on a like-for-like basis with Retail +0.8% and Autocentres +2.6%; a pretty good performance in the current retail climate. After a disappointing Q3, the Group returned to positive like-for-like sales growth in Q4. This was principally driven by a strong performance in both Cycling and Autocentres. Motoring continued to suffer as a result of an extremely mild winter and tough comparators.

Gross margin has been under significant pressure for several years so it was a positive step forward to see Group gross margin at 70 basis points ahead of last year. Operating costs were also well-controlled in the second half and came in below guidance. Over the full year, costs grew 4.3%.

Underlying profit before tax, whilst disappointing, was in line with the guidance given in January. The decline was driven by a lower Motoring sales mix, year on year, predominantly due to mild weather, weakened consumer confidence in the run-up to Christmas, Retail cost inflation and investment in strategic projects. Loraine will take you through this in a bit more detail later on.

Cash generation continued to be strong. Free cash flow was up, year on year, and despite unseasonable weather and Brexit-related challenges, the Group reduced stockholding by £12 million in the year through effective inventory management.

Net debt reduced by £6 million, year on year to 0.8x underlying EBITDA, which is in line with last year. Given the cash-generative nature of the business the Board has proposed a final dividend increase of 3% and if approved, will take the full year dividend to £0.1857.

FY19 Operational Highlights

Moving on to operational highlights, the Group continues to make positive progress against the strategy set out at the Capital Markets Day in September. We have continued to strengthen our market leadership position in Bikes, with the sales of electric bikes up 47% on the year. We have also introduced more premium bike brands, like Brompton, and further improved our exclusive own brand proposition.

Autocentres significantly improved profitability by 34% in the year and improved customer experience, coupled with good revenue growth, better buying and tight cost control, led Autocentres to a second consecutive year of profit growth.

Service-related sales continued to grow as a proportion of overall revenue, with Group service-related sales now accounting for 24% of total sales. On-demand service trials in Autocentres garages provided promising results. And we continue to increase the number of Halfords Mobile Expert vans, extending the trial to three cities.

The strengthening of our Financial Services proposition saw sales through this offer to customers grow by 30%, year on year. A combination of increased focus on business sales, the launch of a new website and continued growth in Cycle to Work saw our B2B sales performance in strong double-digit growth, year on year, too. Group online sales were up 9.5% in the period and Click & Collect continues to remain strong with 83% of Halfords.com orders being collected in store, highlighting the service-led nature of our business, but also the importance of our physical estate.

Our colleagues remain our most valuable asset and we continue to invest in training to support them and, in turn, our customers as we move towards a service-led strategy. We remain in the coveted *Sunday Times* Top 20 list of Best Big Companies to Work For.

FY20 Outlook

Before handing over to Loraine, I would like to provide an overview of our FY20 outlook. We continue to anticipate FY20 profit before tax to be broadly in line with FY19. Our view assumes average weather conditions across the year, and a consumer and economic outlook in line with that that was experienced during the second half of FY19.

Customer confidence remains fragile and consequently, we will continue to place greater emphasis on cost control and efficiency. The recent move towards a more holistic group operation has helped us identify even more opportunity here, and the delivery of the associated initiatives will be key to underpinning profit growth in FY21 and beyond.

We, though, firmly believe that the customer strategy presented at the CMD last year is the right direction for Halfords, but the execution of this will take longer than we expected as we adapt the plan to the current economic environment. Capital investment this year will therefore be likely to be around c£35 million, which is slightly below the £40-60 million guidance for FY20. Any revenue investment in the strategy will be self-funded by rigorous cost efficiency plans.

Free cash flow will be in line with our medium-term financial targets and underpinned by working capital efficiencies.

I will now hand over to Loraine to take you through the FY19 financial performance and FY20 outlook in a bit more detail.

FY19 Financial Performance & FY20 Outlook

Loraine Woodhouse

CFO, Halfords Group Plc

Retail Financial Overview

Good morning everybody. There are a number of familiar faces in the room but for those of you I have not managed to meet over the last six months, I am Loraine Woodhouse, the Halfords CFO. Graham has already talked about our overall financial position, so I will not repeat that. Instead, I will look at the results in a little bit more detail.

If we start with Retail, we saw like-for-like growth of just over 1% which, in the current retail environment, was an achievement. Profit, however, as we know, was more challenging with our underlying EBITDA down 19% at £58.8 million. Our Retail performance this year was impacted by a number of factors. Our Motoring mix was lower on the back of a very mild winter and Motoring, as you know, is high margin. We experienced the impact of weaker consumer confidence, especially in the run-up to Christmas, and you can see both of these factors at play in the like-for-like chart on the right-hand side during Q3 and Q4. Ongoing Retail cost inflation impacted the cost base and at the same time, we continued to invest in the delivery of our strategy, particularly in building capability and in the promotion of our Services offering.

Retail Gross Margin

Moving to gross margin, given the challenging background, we were pleased to see Retail margin grow by 60 basis points. On the back of weakness in sterling, gross margin has been declining for a number of years, as you can see from this chart. It was really encouraging to see the step forward this year. The improvement reflected a number of factors, including a positive FX tailwind, as flagged at the interims with our average USD rate this year at $1.32, versus $1.29 last year. We also saw ongoing improvements in our levels of stock loss and we continued to focus on buying efficiencies. Offsetting these improvements, of course, was the impact of softer Motoring sales, particularly within the second half of the year where the mix impact resulted in a 30 basis points decline in margin.

Retail Operating Costs

Our overall cost growth this year as a Group was 4.3% but Retail cost growth across the full year was 5%. At the interims we talked through the drivers of our first half cost growth and in the corner of this chart, you can see the slide from our interims. I will not repeat the factors in detail but we did incur some costs in the first half that were one-off in nature. Also, some additional costs that were associated with a weaker first half Cycling market. We also faced, like all retailers, ongoing cost inflation in a number of areas and we did continue to invest in strategic initiatives, particularly in building capability for the longer term. In the second half, as we guided at the interims, you can see that our cost growth was significantly lower as we focused on managing cost in light of lower sales.

Autocentres Financial Overview

Moving to Autocentres, Autocentres is a positive story and took a further step forward in profitability this year, growing EBIT by 34%. The ongoing profit recovery was across all aspects of the business and all aspects of the P&L. Revenues were up by 2.6% on a like-for-like basis, with a broad-base sales growth across Servicing, Tyres and MOT. Improved buying margins, particularly on tyres, led to a 50 basis points improvement in gross margin and an effective programme of cost efficiency capped cost growth at just 1.7%, despite the sales growth. Within the Autocentre business, we expect to see ongoing improvements from the investments that we've made over the last 12 months.

Group Financial Overview

To summarise, the Group delivered like-for-like sales growth of 1.1% and it was good to see gross margin improving by 70 basis points. Underlying PBT at £58.8 million, as Graham said, was disappointing, down £12.8 million, year on year, albeit it was in line with the guidance that we gave back in January.

Before I come on to talk about cash and debt I will just briefly touch upon exceptional items. Exceptional items this year totalled £7.8 million versus £4.3 million last year. The most significant element of that is a £5.3 million asset write-off, primarily relating to the strategic decision to re-platform the Retail and Autocentres websites into one Halfords website, strategically important for us. A further £1.5 million related to redundancy costs as we restructured a number of areas across the business.

Group Cash Flow

Moving to cash, cash was a positive story with free cash flow at £42.7 million, ahead of last year. It is worth spending a little bit of time just explaining the key drivers of that cash movement. EBITDA, post our exceptional items, dropped by £14 million but compensating for that our stockholding levels, year on year, reduced by £12 million with a particular focus on Cycling stock levels. The lower stock came despite a small stock build for Brexit of around £4 million. Unsurprisingly, in a year where we were developing our strategy, we spent less on capital in-year, particularly on stores, wanting to make sure we formulated our plans before we started to invest. Within 'Other' on this chart, we saw an adverse creditor movement reflecting lower stock levels towards the end of the year. We do expect some of that creditor movement to reverse as the stock intake should be more balanced throughout FY20.

Net Debt

The positive cash reduced our Group net debt by £6 million with our net debt/EBITDA ratio remaining at 0.8x, as Graham said. On this chart you can see the positive trend in net debt reduction over time.

FY20 Guidance

Finally, coming back to the guidance for full year 2020, as we stated back in January, we expect our FY20 underlying profit to be broadly in line with FY19. We do expect underlying sales growth to be fairly muted, given the current economic backdrop, but we do also expect to see some growth from some of the early initiatives within our strategy. We expect cost growth in FY20 to be lower than the year just closed, albeit we will experience Retail inflation. We will also see some increase in incentive costs, year on year, and we have an increase in employment costs relating to a recent change in case law.

We will continue to make strategic investments but this will be self-funded by cost efficiency plans in goods not for resale and goods for resale. Again, those plans are already in place. It is worth saying at this point that any guidance we do give around profit does reflect a consumer and economic outlook broadly similar to that that we saw in the second half of last year. It also assumes that we experience average weather.

Capital investment will be around £35 million which is lower than the £40-60 million guidance, as we balance the need to invest with the need to recognise the fact that we are operating in a different economic and financial environment.

We remain confident in our ability to generate consistent levels of free cash flow and that will be underpinned by working capital efficiencies that, again, we already have underway. On that point, we will inevitably see greater emphasis on reducing our cost base and maximising our Group efficiencies, both of which will be necessary to underpin profit growth in FY21. Thank you.

Summary

Graham Stapleton

CEO, Halfords Group Plc

In summary, FY19 trading was challenging for Halfords Group, however, despite a tough Retail backdrop, the Group delivered revenue and gross margin growth in the year. Whilst some of our cycling competitors struggled, Halfords delivered a full year like-for-like growth of +2.6%. We are now well-placed to take further market share in Cycling. Motoring performance was hampered in the year by unseasonable weather, with our winter-related sales in significant decline as a consequence. In Autocentres, we continue to make significant progress, delivering a second consecutive year of very good profit growth. We remain a cash-generative business with a strong balance sheet. Free cash flow was up in the year, supporting the growing dividend. Net debt at 0.8x EBITDA remains below the 1.0x target. Underlying profit before tax, whilst disappointing, was in line with the guidance given in January. Finally, our focus is now firmly on the delivery of FY20.

The strategy set out at the CMD continues to be the right direction for Halfords. However, as I mentioned earlier, the execution will take longer than we expected as we adapt the plan to the current economic environment. We will continue to execute and prioritise our Group cost and efficiency plans, together with the delivery of some key elements of our customer strategy.

Before I finish, a quick update on current trading performance. The seven weeks ending 17th May 2019, which includes Easter, remain in line with our expectations. Thank you for listening and I look forward to speaking to you all again at our 20-week trading update on 4th September. Loraine and I will now be happy to take your questions.

Q&A

Jonathan Pritchard (Peel Hunt): Two and a half, if I may. On current trading, it was a late Easter and a very warm Easter; obviously Cycling does have a very strong link to the weather. It sounds like you did not see much of a pull-forward of trade. Is that a shade disappointing that we are only in line, given the beneficial weather conditions?

Graham Stapleton: It is only seven weeks in, so it is difficult to see the whole season. We have got another May bank holiday at the back end of this period. We are happy at this stage that we are in line with expectations in a tough and challenging retail market.

Jonathan Pritchard: On the CAPEX reduction of that, can you tell us about a potential for a Store-Of-The-Future model and a rollout of that? Because I am rather thinking that you are talking an awful lot about reducing costs and efficiencies, but not really about driving the top line. Less CAPEX would rather suggest that you are perhaps looking at other ways to drive the recovery as opposed to sales. Can you square that circle for me in terms of less CAPEX but clearly you have got over 400 stores that need more than a lick of paint?

Graham Stapleton: Yes, sure Jonathan. I think the first thing to say is that we have had to adapt our plan to the current economic environment. It is important to do so and look at that prudently. We are going to be spending more capital in this financial year than we did in last financial year, so we are still investing – and not just capital. We will also make revenue investment in the strategy as well, albeit funded through the cost and efficiency programme that we have.

We will be investing very heavily this year in digital and we think that is the right place to be, is a Digital First plan, with the re-platforming of the website. We talked about the exceptional costs earlier on that go with that. We will also be investing in developing our Services business to make the most of the 'do it for me' trend that we see customers moving towards. There will be investment and some of that will impact our store portfolio. However, what you will see less of is a major refurbishment programme until we are confident we have got the right model there to move forward.

Jonathan Pritchard: That is an ongoing piece of work to crack that, is it?

Graham Stapleton: Yes. The important thing to say there is we do not believe this is a format change. It is customer experience change that we are trying to create. In the past, it has been very format-driven. It is an omni-channel customer experience we need to create in a physical store. That is going to take longer and you have to have a digital platform first to do that.

Adam Tomlinson (Liberum): A quick question touching on the Autocentres side of the business. A second consecutive year of growth there. Do you think that the initiatives that you have put in place there have actually started to impact this year, or is it more a case of the momentum that perhaps was in the business before you joined? In terms of the balance of growth going forward, how much we can expect those initiatives you have put in to start impacting.

Then also on the inventory side, some good discipline there; inventory levels down. Can you talk a little bit about the categories that you have been through, what is left to do and the further opportunities on that side in terms of the working capital management?

Graham Stapleton: In terms of Autocentres, we have done a lot of work. The team have done some fantastic work in getting the operating model, particularly in the back office part of the business, into a more effective and efficient position. We are now starting to see the benefits of that work coming through now and that work is not finished. There is more opportunity there. I think you will see continued improvement, as Loraine indicated in her part of the presentation, in the Autocentres business. We have also improved the customer experience. Our NPS scores are growing in Autocentres and customers are telling us that they like the experience in Autocentres more than they have ever done.

I think a combination of a much more efficient business coupled with better customer experience gives us real hope that we have got not just the momentum of the past but something to take going forward.

Loraine Woodhouse: We made good progress on stock, principally in Cycling. It would not be fair to call it tactical changes throughout FY19, but we have basically put in a lot more rigour around the commercial open-to-buy processes. Through a combination of that and some range rationalisation we made a good step forward. However, there is more to go after, again, particularly in Cycling.

Two initiatives this year will really help that. One is a store relay for Cycling in probably about 200 of our stores. Relevant to Jonathan's question I think as well, in the sense that we are changing the way in which our Cycling shops look within at least 50% of our stores to help that be a better shopping experience for the consumer and make the e-bike range much more prominent. As part of that, we are definitely making sure we have got the right ranges for the right stores. That will more strategically take out some stock.

Then alongside that, we are quite a long way through a forecasting and replenishment system implementation. We are quite spreadsheet-led at the moment in that space and an F&R system will really help us target where our stock should be in the supply chain. A combination of those two things should give us more to go after in FY20.

Wayne Brown (Liberum): I missed the entire presentation so if you did cover my questions, apologies. Just two from me. On rent rolls and clearly a theme that we are hearing from a number of companies across the sector is reductions in rent when rent clauses and rent renewals come up. If you can give us a reminder as to what the profile of your estate looks like from upcoming rent reviews and what those rent reviews are leading to from a cost reduction perspective?

Then secondly, on your last point that you just made on the new system for stock that is well-advanced, this may be a question you may not want to necessarily give a number towards but by the sounds of it, it sounds like there are probably sales which have been left on the table, through merchandising on paper as opposed to necessarily moving the stock where it needs to be. Can you give us a flavour of what that feels like, of how much sales from Cycling has not been optimised?

Loraine Woodhouse: If I do the sales first, I think we are more likely to have been overstocked, personally. We monitor our availability of key lines very closely. We very rarely dip below 98% availability of all of our key lines across the estate. So the challenge for us has probably been more around overloaded stock rooms than it has about stock not getting to the right place. What F&R will allow us to do is make sure we have got enough stock but not too much stock, which will be positive.

On the rent, you are right. We have got a big estate, obviously. Over the next four years, we have got 175 either break clauses or points of review in the rent, so we have got a lot of opportunity to go back to landlords and renegotiate rents, which we have seen some success in over the last year. I would say on average, we have probably seen, if you add up the rent free plus the rent review, probably around double-digit savings. However, not everywhere. It is very inconsistent. We have seen up to a 50% reduction and we have seen up to a 20% increase, so the swings are enormous. On average we are seeing savings, as you would expect, and we are confident we will be negotiating hard for those 175 leases.

Kate Calvert (Investec): On your Bike like-for-like growth of 2.6% last year, can you give us an idea of how much was volume and how much was price driven?

Graham Stapleton: The volume was fairly flat in our business and therefore, most of that growth was price. That was predominantly through the growth we saw in areas like electric, which have a higher average ticket price. That was our business.

Kate Calvert: Relative to the rest of the market, do you still believe the market is down in volume terms versus pre-Brexit?

Graham Stapleton: It is a good question. All we can go on is what we have in terms of market intelligence. We obviously have seen the challenges that Evans have had, the recent CVA with Cycle Surgery. We look at the import data, which is less reliable these days as bikes come in componentry. If you look at all of those threads, you would think that we have outperformed the market by some way.

Matthew McEachran (N+1 Singer): A couple of questions but all pointing probably towards the same direction. The guidance you have given for the year talks about average weather, which I think would signal that you hope that Motoring does better than it has done in the year just ended. And that is the highest margin part of the business with the highest attachment rates obviously in We Fit. You seem to have started the year relatively well in Cycling, as per the original question, and Autocentres has got a bit of momentum in it as a result of the initiatives there. There is clearly something which we have not really discussed in a lot of detail yet today, which is the drag. We have got a bit of cost inflation, but are you very nervous about the Cycling market as you go into mainstream summer season? Is that the piece that we have not yet talked about? What is the bit that we have not yet talked about?

Graham Stapleton: Weather has an impact on sales. We are planning and forecasting for average weather because that is all we can do at this stage. We have had a good start to the year in as much as we are in line with where we forecast to be. With the extremes that we saw last year in the weather, the hottest summer for 100 years, the mildest winter for 30, two days of frost, the Beast from the East and one of the hottest Easters we have just had for 40 or 50 years, all you can do is plan for an average position. If we have average weather, we will deliver the guidance that we are suggesting. We are very confident about that.

If we do see a more challenged Cycling market, it is likely to be as a consequence of the weather being cooler and wetter and that favours the Motoring business. It is one of the big positives about the Halfords model is that we are able to hedge the weather to some extent with the mix of products that we have got. Obviously, when there are very extreme differences in weather it is more difficult to hedge, but usually we can do that pretty well.

Loraine Woodhouse: The thing, Matthew, I would add is last year was very much a game of two halves. We had quite a strong first half last year and if you look at the consumer confidence and tracking throughout the year, there was a big dip in September. We really felt that in the run-up to Christmas. In giving this guidance we are assuming that that challenging consumer, which for us was experienced very much in the second half of the year, continues throughout FY20. Now, of course that is contingent on many factors, none of which sadly are within our gift to control. However, that is really driving the heart of our guidance. The weather, if it genuinely is average, should help us a bit. But the consumer that really dipped in the second half, if we see that and experience that throughout FY20, that will be the offsetting factor.

Matthew McEachran: Thank you very much for that. Second question was a little bit around the write-off on the platform, one of the exceptional charges. Is that the primary reason for depreciation in Autocentres being well-down in the second half, or is there anything else? Should we expect the level of depreciation to have been rebased as a consequence of that write-off?

Loraine Woodhouse: I do not think you should expect to see a significant shift in depreciation. The bulk of that write-off would have been Retail assets rather than Autocentre assets. We are simply taking the write-off on both websites because we are obviously pulling the whole thing together. However, the underlying depreciation is just slightly down on Autocentres.

Matthew McEachran: In the second half it was well-down, year on year.

Loraine Woodhouse: Yes, which will reflect the website but it will normalise a little bit.

John Stevenson (Peel Hunt): A couple of questions, please. Starting on the consumer side of Autocentres, I am interested in spending trends. Are people calling down the extra work when they come in, in terms of the yellow and red light type stuff? Are they reacting to CRM as the same[?] they would? Are they delaying services? What are you seeing in terms of trends, in terms of how people are spending? Are they being more cautious or actually, are you seeing people act the same as they have done in the past?

Graham Stapleton: I think it is a good question. In the market overall, there is definitely some themes around customers being more cautious and waiting longer to replace tyres and other parts in the car because of all of the other circumstances we have talked about today. There is no doubt that is the case. They are being more value conscious, although actually what that means is we are in a good place because in the autocentre and garage world we are very competitively priced against the main dealers and main dealership servicing. We are seen as one of the high quality but value players. As you can see by the like-for-like growth, we are not necessarily seeing some of that impact that perhaps the more premium players are in the market at the moment. We have got more customers coming to us and are happier.

John Stevenson: The second question is on cash in terms of the strategy. Earnings are down, it is a tight market, you have re-phased your CAPEX but you have increased the dividend. I am interested in the messaging why you cut back on CAPEX but increased the dividend.

Loraine Woodhouse: We were confident in the cash flow, so we generated a little bit more cash this year than we did last year through working capital efficiencies. We think we have got line of sight to continue to drive working capital opportunities. That gave us the confidence to increase the dividend, in line with our policy.

John Stevenson: On that basis, though, would that not be better spent on pushing forward with some of the initiatives?

Loraine Woodhouse: I think it is always a balance, is it not? We have opportunities this year to invest in the business which we believe we can fund. We have stated we are looking to spend around £35 million, which is an increase on the previous year. We are confident that that will allow us to do the things that are important for FY20, with some revenue investment alongside that. Clearly, if we felt there was a point at which we were starving the business of capital we would make a different choice, but we are not at that point and we were comfortable with the dividend that we have proposed.

Tony Shiret (Whitman Howard): You were asked about market share in Cycling. I wondered if you could make some comments about the extent to which you know your market share in the Motoring side of the business, the various categories. I expect that will be quite difficult but if you could try anyway.

The second thing, when you talked about sales growth coming from some of your early stage strategic initiatives, I wondered if you could make that a bit more precise. What particularly do you think is going to grow?

Graham Stapleton: Let us start with Motoring. A bit like Cycling, we have not got a total Motoring share picture. We do have some market share data on select product areas within Motoring, areas like technology, pressure washers, the big branded buys that other retailers also sell a lot of. In those categories we have seen good share growth in this year. We are pleased with the growth that we have got. We have made some investment in price in some of those big branded categories as well to ensure we remain competitive in the market. That is what we have on Motoring.

Loraine Woodhouse: Our Motoring market share, Tony, are very different depending on the different categories. As you would expect, in the technology areas we have got really, really very high share. Therefore, our performance tends to reflect what is happening to the market. Then, in other areas like Autocentres we have got a tiny share of the market and plenty of opportunity. It is very, very different depending on the different categories.

Graham Stapleton: In terms of strategy, moving on to the second question, when we were here this time last year we talked about a few areas that we would invest in early. They were B2B, Financial Services and customer data. We have done all of that. The B2B business last year performed very well. We delivered 20% growth in B2B sales, so it is now 12% of our total business from 10%. Our Financial Services business, as I think we have mentioned in the presentation, all the sales that we deliver through that customer offer grew by 30%, year on year. We are seeing very good traction there and we will be investing more in that space in the coming year.

In terms of customer, we launched a free MOT campaign that we mentioned at the interims. We are very pleased with the take-up of that campaign. 50% of the 152,000 MOTs have been delivered now. 70% of them are brand new to the Autocentre business. In terms of the value that creates financially going forward, obviously we will need to wait a year or two to see that come through because this was about acquisition of customers, not making profit immediately. There are some very good signs in terms of the strategic investments that we have been making over the last 12 months.

Thank you very much indeed.

Loraine Woodhouse: Thank you very much.

Graham Stapleton: Thank you.

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