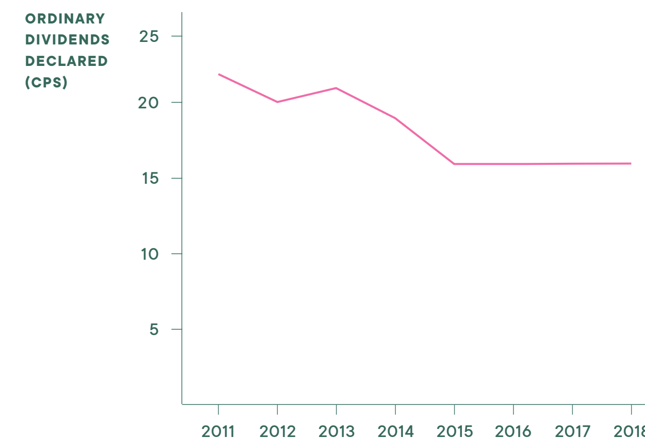
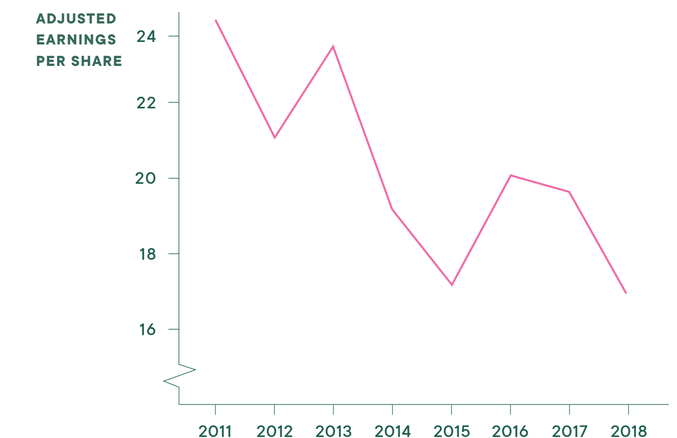
Financial capital

Maintaining financial discipline to enable growth





Capital structure

The Warehouse Group's balance sheet is in good shape to provide sufficient capital headroom to weather potential downturns, and to fund investment in the Company's strategies. Our capital structure remains stable, with a current objective being to continue to reduce debt over the next few years. The share price has been under pressure due to a lack of confidence in our execution by the market, and from uncertainty around the future of the retail sector in general, in the face of increasing competition.

Our transformation programme has been designed specifically to improve the Group's ability to execute our strategies successfully, and focuses extensively on changing the way we work as a business, how we make and execute decisions, and follow through to realise benefits. Those new capabilities, combined with a very granular transformation plan to build our EBIT back to 7.0% will start delivering improved financial results over the next 18 months.

Asset base

The Warehouse Group's asset base has historically been centred around property and inventory based working capital. Over the past ten years, the property component has reduced as the Group has converted property assets into earnings generating business investments. Properties have typically been subject to sale and long term leaseback to secure favourable retail locations, with development of those properties moving from self-funded to a development partnership approach. The latest in this trend is the Lunn Avenue site, which is bare land, and has been sold during FY18 to G P Investments Limited. This is to to be developed into a retail complex, in which The Group has committed to two new leases for The Warehouse, Warehouse Stationery, and Noel Leeming. Typically, capital gains on those deals have been reinvested into favourable rental rates.

The property portfolio is valued at a historical cost of $79.2m, which is approximately $60.0m less than what we consider internally to be the fair value of these properties.

Working capital primarily reflects the funds tied up in inventory, and is cyclical based on the seasonal stock profile of the business. A major focus of business activity and the transformation programmes is to continually improve the way we manage our working capital, ranging from inventory management practices through to supplier trade payment terms. Levels of working capital have increased over time with the increased scale of the Group; however, we expect this to reduce in the future as the impact of transformation initiatives is realised.

Working capital increased from $226.5m in the previous year to $236.6m in FY18 largely due to an increase in inventory, and the cut-off issues intrinsic in a balance date that changes as a consequence of our 4/5/4-week cycle. Our 12-month moving average working capital was $234.3m compared to $232.5m in FY17.

The Diners Club (NZ) finance book is classified as held for sale in our financial statements as that is part of a discontinued operation and we are in the process of working with Diners Club International regarding the future of this business.

Debt position

Our debt structure is straightforward, with core debt represented by our five-year senior bond, supported by flexible commercial lending facilities that accommodate our seasonal stock buying profiles.

Net debt decreased in FY18 from $218.3m to $162.3m. The reduction in net debt is primarily due to the sale of the discontinued Financial Services businesses which resulted in the repayment of the Group's securitised debt facility.

Our current objective is to reduce debt levels, noting that we maintain a comparatively high dividend payout ratio and are undergoing a material transformation of the business. This reflects our forecasts that the transformation can be accomplished within the existing capital investment envelope of the business because most changes are focused on improving business processes, supported by targeted technology investments. We have identified significant opportunities to improve working capital and free up cash flow from operations.

We run a reasonably conservative risk management policy, and want to be as well prepared as possible to withstand external shock events or a tightening of the credit cycle. Our approach to ensuring availability of credit is through maintaining a syndicated debt portfolio, and to continually retain sufficient headroom within the Group's current debt facilities to provide immediately available cover for unexpected activities.

The Group's target gearing is between 20% and 40%. As at 29 July 2018 the Group's gearing ratio is 25.3%. The Group's debt ratios are comfortably below the covenant levels required by our debt providers.

The Group issued a 5-year senior bond on the New Zealand Stock Exchange (NZSE) in June 2015 with a coupon rate of 5.3%. As at last quoted closing price of $1.03 and a market yield of 3.79%, the fair value of the bond as at balance date is $129.2m.

Other assets

All of our business investments are fully consolidated into the balance sheet. Other assets are primarily intangible assets, which include computer software and goodwill arising from acquisitions.

In FY18 the Group wrote off the remaining goodwill in the Torpedo7 Group, reflecting that the cash flows forecast from the business strategy, which is now focused on achieving scale through retail store expansion rather than mainly an online model, no longer support the carrying value of the goodwill.

All goodwill amounts are subject to annual impairment testing, and there is a satisfactory level of headroom in the carrying values of other goodwill items.

Capital investment

Our Group's capex increased from $64.0m in FY17 to $72.0m in FY18. This was driven by the investment required to deliver group-wide transformation. The capital requirements for the

transformation will in part be funded through an uplift in operational performance. We have prioritised investment streams that deliver structural change to our financial performance and favour projects with payback horizons of between 12 and 18 months. Our largest calls on capex over the next few years are directed towards investments in technology and store improvements. We currently estimate capex for FY19 to be between $80m to $100m. We remain focused on delivering a pathway to achieve an EBIT of 7.0% over the course of our transformation.

Impact of NZ IFRS 16

The new accounting standard relating to leases, NZ IFRS 16, comes into effect from FY20, and will require a lessee to recognise a lease liability reflecting future lease payments and a 'right-of-use asset' for all material lease contracts. On adoption, the new standard will significantly gross-up the value of assets and liabilities presented on the Group's balance sheet and increase balance sheet gearing. Based on our initial detailed workings, we expect the impact when the Group adopts the new reporting standard (at the end of July 2019) to be an $871m increase in lease liabilities. This is a non-cash adjustment on the balance sheet and will not affect our lending covenants.

Another impact of the lease standard will be the effect on our EBIT. Rental expenses are effectively reclassified into an amortisation component, and an interest component to reflect the implied financing rate in the lease. This will result in an increase to EBIT, offset by a corresponding increase in interest expense. Our modelling at this time shows a minor expected net impact on the pre-tax expenses of around $2.6m.

Equity performance

In March 2017, we came out of the NZX50 Index when the equity indices were rebalanced based on the free float market capitalisation. Institutional holdings reduced slightly from 4.9% in October 2016 to 3.3% in May 2017 and the number of institutional investors has reduced from 63 to 33. We hope to rejoin the NZX50 Index as we deliver the benefits from our transformation and look to see the value created translate into capital growth.

Institutional holdings

The majority of our share register is owned by four investors who collectively hold 79.0% of the shares issued. This figure includes 27.0% held by the Group's founder, 21.3% by a charitable foundation and 21.6% Corporate. We have institutional holdings at 3.3% and 18.0% of shares held by retail investors. Our free float of approximately 21.0% means our stock experiences low liquidity and this characteristic currently inhibits the level of research coverage we attract.

Focus on investor relations

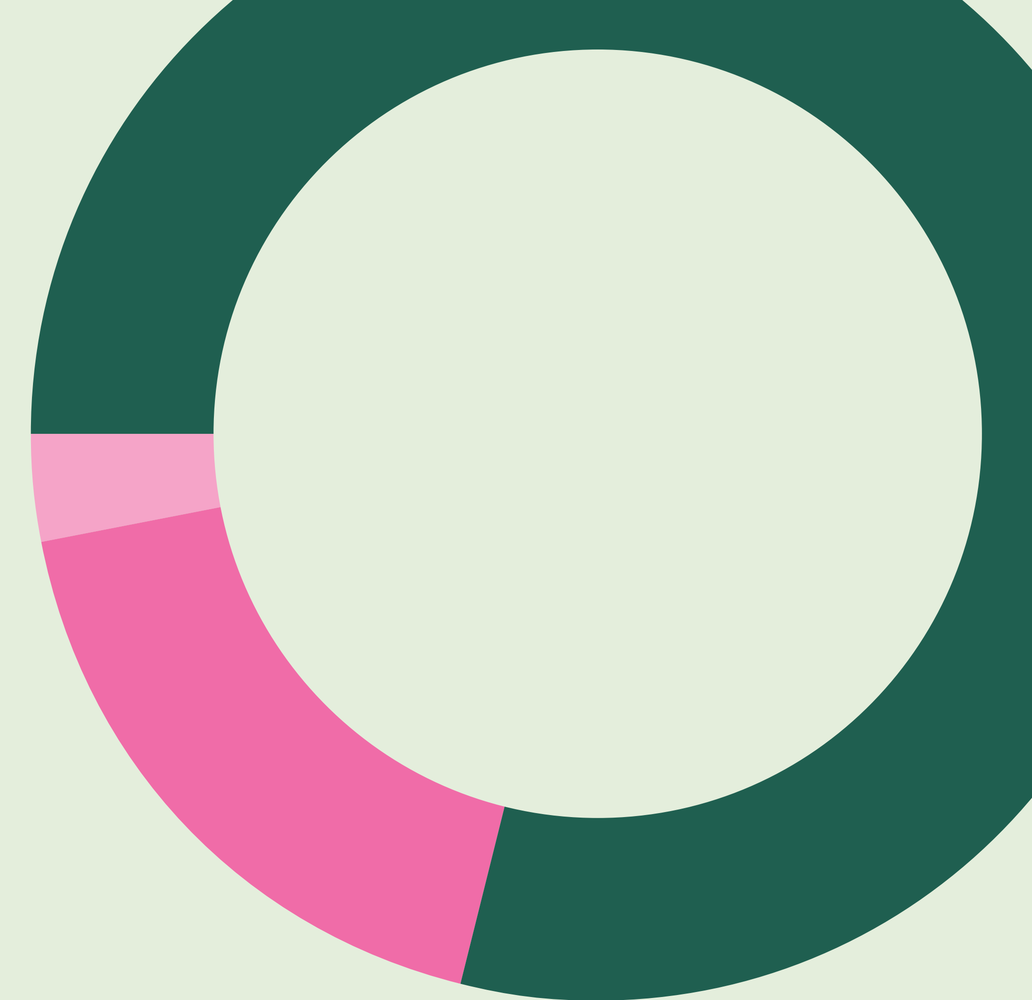
We look forward to being more proactive in our dialogue with the investment community. Our focus is to stimulate commentary and increase research coverage of our stock so our stock liquidity improves. In November 2017 we hosted an investor strategy day where we shared our transformation plans for the first time. We will look to have further engagement with the investor community with a series of roadshows in FY19 and present an update on our transformation progress and strategy.

SHARE REGISTER (AT TIME OF PUBLICATION)

79% Strategic

18% Retail

3% Institutional



Appliance Shed asset and lease purchase

In August 2018 Noel Leeming purchased the key assets of the Appliance Shed. This sale has seen three former Appliance Shed sites in Auckland transitioned to Noel Leeming Clearance Centres (Glenfield, Henderson and St Lukes) and a fourth site becoming a Torpedo7 store (Manukau).

Dividend policy

Our dividend policy remains unchanged with a payout ratio between 75% and 85% of adjusted NPAT. In light of our transformation programme, we will revisit capital structure as appropriate and review our dividend policy on an annual basis to ensure it is aligned with the long-term capital needs of the business.

Hedging FX

We continue to hedge according to our treasury policy and review our positions as appropriate. The Group's biggest exposure is to currency fluctuations which arise from inventory supplied from overseas and priced in US dollars. To ensure gross margins can be achieved when the product selling prices are set, the Group purchases forward currency contracts which provide certainty of exchange rates. At balance date the Group held foreign currency contracts which locked in the exchange rate of approximately 65% of the Group's expected overseas purchases for the next 12 months. The average US dollar exchange rate on these contracts was $0.7153, which compared to a spot rate of $0.6795.

Sale of Financial Services business

In September 2017 we completed the sale of our Financial Services business– except for Diners Club (NZ) – to Finance Now, a subsidiary of SBS Bank. The sale contributed to a decrease in debt with securitised borrowings related to the sold subsidiaries of $45.1m.