Gear4music (Holdings) Plc

Well positioned for profitable growth

23 June 2020

Gear4music's FY2020 results reflect the positive momentum of the company's announcements so far this calendar year. The data re-confirm brisk sales growth but in our view improved profits and profitability is the salient story. Moreover, with an online distribution focus, a well sourced product range and clear evidence that its logistics are being run more efficiently, the company's ability to deliver positive newsflow looks increasingly sustainable. FY2021 started on an exceptionally strong note.

EBITDA increased significantly to £7.8m in FY2020 from £2.3m in FY2019, which was a 13 months year. In addition, the FY2020 EBITDA figure comfortably exceeded the company's latest guidance of "not less than £7.0m" issued on 23rd April 2020. The profit increase was driven by a combination of continued underlying sales growth, which was pre-announced as 9%, and crucial ly gross margin expansion from 22.8% to 25.9%. Margin strength reflects better pricing both for the company's higher margin own brands and other brands.

Gear4music remains financially robust. The company reports that on-hand cash has improved: it was £7.8m at the end-2020 - again ahead of expectations - compared with £5.3m a year earlier. Net debt shrank in FY2020 to £5.5m from £7.5m at the end of the previous financial year with a trailing net debt/EBITDA ratio of only 0.7x. The business should remain cash positive going into FY2021.

The recent run of news was favourable and continues to be. Gear4music is reporting exceptionally strong trading in FY2021 Q1, having navigated the early operational challenges from Covid-19 and ensuring that it had all appropriate safeguards in place. Furthermore, management are clearly confident in the position and prospects of the business over and above any beneficial lockdown effects. Underlying sales growth is expected to accelerate in H1 and average out to a mid-teens pace in FY2021. We forecast +19% sales growth to £143.5m in FY2021 with £10.3m of EBITDA.

Gear4music's attractions as a company which can generate mature market sales volume growth remain in place. Notably, its distribution model is arguably far more appropriate for an industry in which frequently "hobbyist" customers wish to **maximise available choice,** than that of traditional retailing. Since year-end the company's sales performance was notably strong. Further ahead, business may benefit from a more pronounced shift to online retailing within the musical instrument sector.

Valuation

Sales resilience and positive announcements for profitability were helpful for Gear4music's share price in recent weeks. Yet, despite that recent positive share price momentum, the company's £67m market cap still only represents around 50% of expected FY2021 sales revenue.

Investors may wish to note this momentum and undemanding rating when considering companies that are well placed to thrive as the UK emerges from the COVID-19 lockdown period.

Company Data

EPIC	G4M
Price (last close)	320p
52 week Hi/Lo	320p/135p
Market cap	£67m

Share Price, p

Source: ADVFN

Description

Gear4music sells own-brand musical instruments and music equipment alongside premium third-party brands including Fender, Yamaha and Roland, to customers ranging from beginners to musical enthusiasts and professionals, in the UK, Europe and, more recently, into the Rest of the World.

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Investment case

Gear4music's investment case continues to centre on a distribution model and product category that are both capable of generating mature market sales revenue growth. Irrespective of lockdown easing in its main markets, **online is clearly the most appropriate channel for a musical instruments company** in our view. In particular, musical instruments is a category which lends itself to hobbyist behaviour where customers seek to make precise purchasing decisions from a wide range of brands and modifications.

Furthermore, as we highlighted in our 23rd April report "Gear4music – *Update confirms over-delivered on plans for FY2020,"* the company's senior management team is not only long-serving, but also consistent in its ability to deal with business challenges. They responded to problems associated with rapid sales volume growth and its impact on warehousing and logistics requirements in FY2019 by prioritising profitability in FY2020. That move appears to have paid off as rising gross margins coincided with strong sales revenue expansion.

Preliminary results

Financial highlights

Gear4music already released its sales and gross margin figures for the year ending 31st March 2020 on 23rd April. These showed a 9% underlying increase to £120.3m and an improvement from 22.8% to 25.9% respectively. Furthermore, the company indicated that it expected EBITDA to be at least £7.0m. We note that the 9% increase refers to the 12 months to end-March 2020 compared with the 12 months to end-February 2019 rather than the full FY2019 13 month fiscal year.

EBITDA was £7.8m which compared favourably with the most recent guidance of not less than £7.0m. Pre-tax profits were £3.1m compared with a £0.6m loss in FY2019 while EPS was positive to the tune of 12.2p, a marked improvement from -0.8p. We summarise financial KPIs in Figure 1.

Figure 1 - FY2020 Financial KPIs

£m	FY2019 (13 months) (year to end-Mar)	FY2020 (12 months) (year to end-Mar)	Change
Revenue	118.2	120.3	+2%
UK revenue	63.7	61.8	-3%
International revenue	54.5	58.5	+7%
Gross margin (%)	22.8%	25.9%	+310bps
Gross profit	26.9	31.2	+16%
Total admin expenses	26.9	27.1	+1%
European admin expenses	2.8	2.5	-10%
EBITDA	2.3	7.8	+239%
Cash at year end	5.3	7.8	+47%
Net debt	7.5	5.5	-27%

Source: Company data

Aside from positive momentum on sales and profits, we also note Gear4music's strong cash position. End-year net debt was £5.5m, which represented 0.7x EBITDA. Moreover, the company already stated that it had £7.8m cash at hand compared with £5.3m at end-FY2019.

Commercial highlights

Gear4music's underlying business strength tends to be confirmed by its commercial highlights, which recorded growth in website visitors, active customers and products listed. The company's conversion rate slipped a little from FY2019. However, a lower conversion rate is to be expected with increased mobile usage as well as the company's commitment to margin expansion and any associated price increases. Average order value was unchanged. We summarise the commercial KPI's data in Figure 2.

Figure 2 – FY2020 Commercial KPIs

	FY 2019 (13 months)	FY 2020 (12 months)	Change
Website visitors, m	27.1	28.4	+5%
Conversion rate	3.40%	3.29%	-11bps
Average order value	£117	£117	-
Active customers	727,000	807,000	11%
Products listed	51,500	54,200	5%

Source: Company data

Sustaining positive news despite Covid19

Positive newsflow

Gear4music enjoyed strong share price momentum year to date as the price increased by 27%, whereas the AIM All Share Index fell by 8%. This 38% outperformance significantly reflects the company's consistent publication of positive news.

The company released three important RNSs in the months ahead of today's results announcement, which are summarised in Figure 3. These included the important initial comment that it was relatively unimpaired by coronavirus crisis, a profit upgrade and confirmation of near double digit sales growth with over £7.0m EBITDA in a trading statement.

Figure 3 – Positive RNS timeline

Date of RNS	Key message
18th March 2020	No adverse impact of coronavirus being experienced
2nd April 2020	Upgrade to company's profit expectations
23rd April 2020	9% sales growth in FY2020 with at least £7.0m EBITDA
23rd June 2020	£7.8m EBITDA announced with stronger £7.8m cash at hand

Source: Company data

Importantly, Gear4music's strong performance is attributable to more than the benefits of being an online operator during lockdown in a number of its key markets. Rather, it can be seen that the company's management team has done well to correct within a relatively short timeframe some of the operational, warehousing and logistics problems which hampered progress in FY2018 and FY2019.

In particular, Gear4music entered the Christmas 2018 period with what proved to be inadequate warehousing capacity which in turn impaired group margins. As a result, the company's full year profit margins (EBITDA) dipped from 4.3% to 1.9%. However, in FY2020 the EBITDA margin bounced back significantly to 6.4%, matching the 6.4% recorded in FY2017 when the company had sales around half its current size and had far less continental exposure.

It should be noted that there was a +£1.4m IFRS16 impact for EBITDA from rents. On a like for like basis, EBITDA would have risen from £3.7m in FY2019 to £7.8m. Overall, the margin and profitability story is robust and a key feature of these results.

Covid19

Despite the implementation of specific safety measures within the business, Gear4music was still a beneficiary from Covid-19's impact, both towards the end of FY2020 and entering into the FY2021 financial year. The company enjoyed exceptionally strong sales towards the end of March 2020 and this momentum continued into April and May (both being part of FY2021). It anticipated this exceptional trading period by adding to stock. There was a £3.4m inventory increase from last year in the FY2020 balance sheet.

Gear4music is also a clear beneficiary from the overall secular switch to online. As stressed elsewhere in this report, the ability to avoid stock outs and offer a wide product range when serving an essentially hobbyist customer community, augurs well for Gear4music relative to its traditional competition. The long term ability to gain share from traditional music retailers, notably smaller store formats, remains in place.

Covid19 may have had a short term positive impact on Gear4music's sales revenue due to the more severe phases of lockdown when consumers had no option other than online through which to make purchases. Moreover, there is a clear case that musical instruments can be a comfort purchase as well as providing a useful "at home" pastime for those stuck indoors.

However, the business segment's shift to online would probably be happening anyway. **So investors should look at the "exceptional" period as consistent with an expected trend rather than as a temporary boost to business which arose from Covid19.**

A reinvigorated platform for growth

Gear4music highlighted a number of problems facing its ability to cope with business execution in January 2019, which were reflected both in the company reporting a full year loss in the 13 month period to end-March 2019 but also in poor share price performance. These problems now appear resolved after senior management prioritised their time on them and from a financial commitment to this part of the business. The company is well placed to meet future demand growth.

The central problem which the company highlighted in a 4th January 2019 RNS statement was that sales growth was constrained by the UK logistics operation reaching maximum capacity

during the company's peak trading period between Black Friday and Christmas. This capacity limitation meant that a planned reduction in gross margins could not be compensated for by increased volume – hence the negative impact on profitability.

Even at that stage the company was confident that it could increase its capacity and would be in a position to meet trading requirements by the autumn of calendar 2019. These latest results and the related commentary tend to confirm that capacity is now adequate for growth.

In addition to the company's warehousing facilities in the UK, Germany and an enlarged facility in Sweden, significant investment was made in focusing software development resources on upgrading backend systems and infrastructure during FY2020.

Moreover, the company states that it will refocus its software development efforts back toward customer experience and growth oriented projects in FY2021. Specific development areas included bolstering distribution operations to cope with peak trading periods and improvements in productivity and efficiency. Some highlights of operational strength improvement are as follows:-

- Stronger management teams
- Extended working hours
- Increased storage space
- Investment in new equipment
- Upgraded software control systems

The central message that we reiterate in this section is that whatever the beneficial effects of Covid19 for online music, Gear4music has demonstrated **a significant improvement in its ability to function as an international internet distributor** of a wide variety of branded and own brand musical instruments. It has the look of a robust platform.

Online musical instruments as a growth story

Equity Development initiated coverage of Gear4music with a 28th May 2018 report entitled "*Gear4music - Geared4growth*". In that report we noted the importance of musical instruments offering investors a play on what we dubbed mature market growth – i.e. in contrast to a number of consumer-facing products, people appear happy to accumulate collections of musical instruments. As an online provider, Gear4music can satiate that demand optimally.

Some idea of the brisk tempo of Gear4music can be gleamed from the movement in the KPIs which we show in Figure 2. Website visitors, active accounts and products listed all demonstrate consistent long term momentum. Expansion of these KPIs in the past 2 years was 68%, 70% and 21% respectively. We summarise the longer term positive trends in Figure 4.

Figure 4 - Long-term trends in select KPIs

KPI	2014	2015	2016	2017	2018	2019	2020
Website visitors (millions)	6.4	8.1	10.1	12.6	16.9	27.1	28.4
Active customers (thousands)	119.0	158.8	230.3	340.0	475.0	727.0	807.0
Products listed (thousands)	21.9	27.2	31.5	37.1	44.7	51.5	54.2

Source: Company data

Financials

Relative valuation

On the basis of EV/sales, Gear4music appears attractively valued relative to key comparators using our upgraded sales forecast for FY2021. While the opening months of the financial year might be described as "exceptional," there is no change to the overall growth story. In our view, investors should note underlying business expansion when assessing relative valuation. On the basis of our updated FY2021 EBITDA forecast, prospective EV/EBITDA is 6.8x.

Figure 5 – EV/sales comparators

Company	Share price (pence)	Shares o/s (m)	Market cap (£m)	Debt (£m)	EV (£m)	Sales 2021 (£m)	EV/sales 2021 x
AO World	145	458.3	665	25	690	1215	0.6
ASOS	3429	83.6	2867	39	2906	3431	0.8
Boohoo	410	1145.7	4697	-419	4278	1592	2.7
Gear4music	**320**	**20.9**	**67**	**3**	**70**	**143**	**0.5**
Ocado	2049	671.5	13759	236	13995	2394	5.8
Average							**2.1**

Source: Company data, ED estimates, marketscreener.com, ADVFN

Note: share prices refer to closing price 22nd June 2020

Financial forecasts

Our updated forecasts for income statement, balance sheet and free cash flow are shown in Figures 6 to 8. What is important in our view is that both the historic data and forecasts are consistent with a profitable growth model which, through its online business structure, is capable of being consistently cash generative.

While inventory levels rose in FY2020 that should be seen as a swift reaction to anticipated increased demand. Working capital movements will probably continue to benefit cash flow as a result of sustained investment in the company's warehousing efficiencies.

We assume an increase in gross margin in FY2021 to 26.4% from the 25.9% achieved last year. Our revised FY2021 forecasts look for £143.5m of net sales revenue – i.e. 19% growth of which only 5% should be seen as exceptional and 14% as underlying. Reflecting the company's commitment to margins and profitability, we project £10.3m EBITDA in FY2021

Both these numbers represent upgrades from when we last published numbers in a 23rd January report "Gear4music – *Good rhythm headroom to grow*". At that stage we were looking for £143.0m in sales and £8.0m of EBITDA.

At this stage we are confining forecasts to one year out, which reflects overall uncertainty in relation to the global economy. As stressed earlier in this report, pandemic influences have so far biased towards the positive for Gear4music.

Figure 6 – Income statement projections

March year-end	**2018**	**2019**	**2020**	**2021**
All figures in £'000s	**actual**	**actual**	**actual**	**forecast**
		13 month year		
Revenue	80,100	118,155	120,326	143,488
% increase in revenue	42.7%	47.5%	1.8%	19.2%
Gross profit	20,319	26,916	31,156	37,881
Gross margin (%)	25.4%	22.8%	25.9%	26.4%
EBIT	1,961	-11	4,067	5,881
EBIT margin (%)	2.4%	0.0%	3.4%	4.1%
EBITDA	3,458	2,282	7,754	10,294
EBITDA margin	4.3%	1.9%	6.4%	7.2%
Total net finance expense	-461	-598	-989	-800
Pre-tax profit	1,500	-609	3,078	5,081
Taxation	-114	446	-488	-1,016
Tax rate (%)	-7.6%	-73.2%	-15.9%	-20.0%
Net income	1,386	-163	2,590	4,065
EPS - fully diluted (pence)	**6.7**	**-0.8**	**12.2**	**19.2**

Note – year-end switched from end-February to end-March in FY2019

Source: Company historic data and ED estimates

Figure 7 - Balance Sheet projections

March year-end	2018	2019	2020	2021
All figures in £'000s	**actual**	**actual**	**actual**	**forecast**
Assets				
Property, plant & equipment	10,054	10,766	11,219	11,721
Right of use assets	-	-	8,962	7,762
Intangible assets	6,378	7,827	9,084	11,121
Total non-current assets	16,432	18,593	29,265	30,604
Inventories	17,055	18,661	22,015	24,253
Trade and other receivables	2,704	1,657	2,501	2,982
Cash and cash equivalents	3,540	5,304	7,839	10,217
Total current assets	23,299	25,622	32,355	37,453
Total assets	**39,731**	**44,215**	**61,620**	**68,057**
Liabilities				
Other interest bearing loans/debt	3,914	8,555	9,949	9,949
Trade and other payables	10,916	11,533	14,442	16,942
Lease liabilities	-	-	1,148	1,150
Total current liabilities	14,830	20,088	25,539	28,041
Other interest-bearing loans/debt	4,616	4,272	3,439	3,439
Other payables	751	263	107	107
Lease liabilities	0	0	9,519	8,400
Deferred tax liability	649	885	1,407	2,387
Total non-current liabilities	6,016	5,420	14,472	14,333
Total liabilities	**20,846**	**25,508**	**40,011**	**42,374**
Net assets	18,885	18,707	21,609	25,683
Share capital	2,087	2,095	2,095	2,095
Share premium account	13,055	13,152	13,152	13,152
Foreign currency translation reserve	12	3	3	3
Retained earnings	2,307	2,033	4,623	8,688
Revaluation reserve	1,424	1,424	1,736	1,745
Total equity	**18,885**	**18,707**	**21,609**	**25,683**

Note – year-end switched from end-February to end-March in FY2019

Source: Company historic data and ED estimates

Figure 8 - Free cash flow projections

March year-end	2018	2019	2020	2021
All figures in £'000s	**actual**	**actual**	**actual**	**forecast**
		13month year		
Operating cash flow	-3,123	-62	-925	-19
Tax paid	10	593	501	-1,016
Net cash from operating activities	**155**	**2,576**	**7,474**	**8,808**
PP&E disposal proceeds	19		50	
PP&E	-7,443	-1,785	-740	-1,000
Capitalised development spending	-1,693	-2,703	-2,820	-3,600
Business acquisition	-400	-400	-400	-200
Net cash from investing activities	**-9,517**	**-4,888**	**-3,910**	**-4,800**
Free cash flow before financing	**-9,362**	**-2,312**	**3,564**	**4,008**
Cash from share issue		105		
Net proceeds from new borrowings		5,030	1,565	450
Interest paid	-178	-352	-806	-350
Repayment of borrowings		-593	-546	-450
Payment of lease liabilities	-102	-105	-1,205	-450
Payment of lease capital				-830
Net cash from financing activities	**-280**	**4,085**	**-992**	**-1,630**
Forex	2	-9	-37	0
Change in cash	**-9,640**	**1,764**	**2,535**	**2,378**

Note – year-end switched from end-February to end-March in FY2019

Source: Company historic data and ED estimates

EQUITY DEVELOPMENT

Investor Access

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