

Alpha shares analysis

23 September 2021

Beware of emotional investment

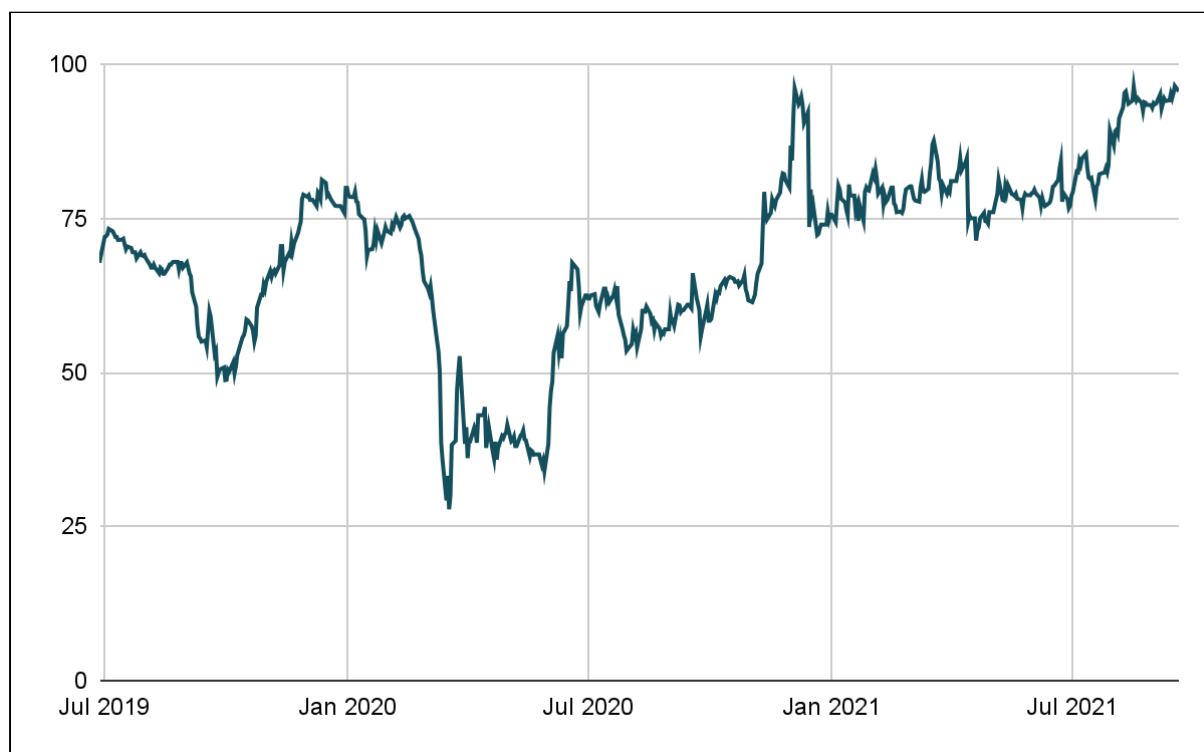
A strong or 'on song' growth story can all too easily allow investors to overlook risk or attach too much value to a powerful investment story that only drives a more moderate part of the total picture for future earnings. As ever, growth is good, but only at the right price. Conversely, a poisoned past can make one overlook the potential of a strong turnaround.

Three 'growth' stories

- **Airtel Africa** – mobile data and in particular mobile money fintechs are experiencing explosive growth in Africa, an area that massively lags the rest of the world in terms of mobile communications and associated apps. So there are strong drivers at the core of this business, but micro and macro issues threaten to overshadow this making investment here higher-risk. The shares are on a low rating, but this reflects a balance of macro positives and risks.
- **Genuit** – formerly Polypipe, this plastic products manufacturer is riding the wave from its environmental product adoption. While sales of such products have only been moderate historically, substantial change is afoot via acquisition and there is strong evidence that the quality of earnings here (historically tied to the lower quality UK construction cycle) is rapidly improving. While the investment story here is changing and improving the shares do appear to have run ahead too far, too fast. The recent slip back in the price may have further to go and that should present a better opportunity to buy into what looks to be a positive long-term story.
- **Marks & Spencer** –. Everyone (in the UK at least) must be aware of the problems suffered by M&S and investors have seen three-quarters of the equity value lost and an ignominious ejection from the FTSE100 index. Various attempts have been made in recent years to right the ship without success but, finally, real progress seems to be occurring – the board has brutally exposed the extent of the rot and has a credible plan. There looks to be untapped value here, but historic mistrust and the wholesale nature of the changes may result in a volatile share price in the short term.

Analyst: **Robin Hardy**

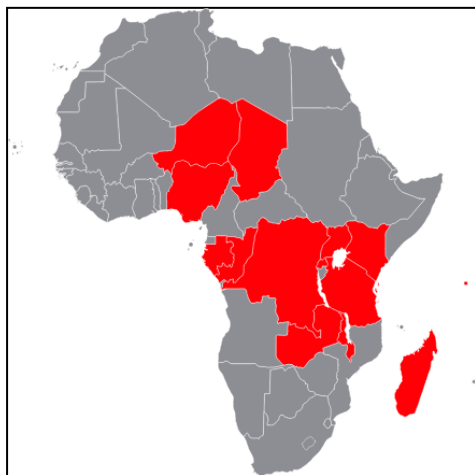
Airtel Africa – a tale of two cities



Source: FactSet

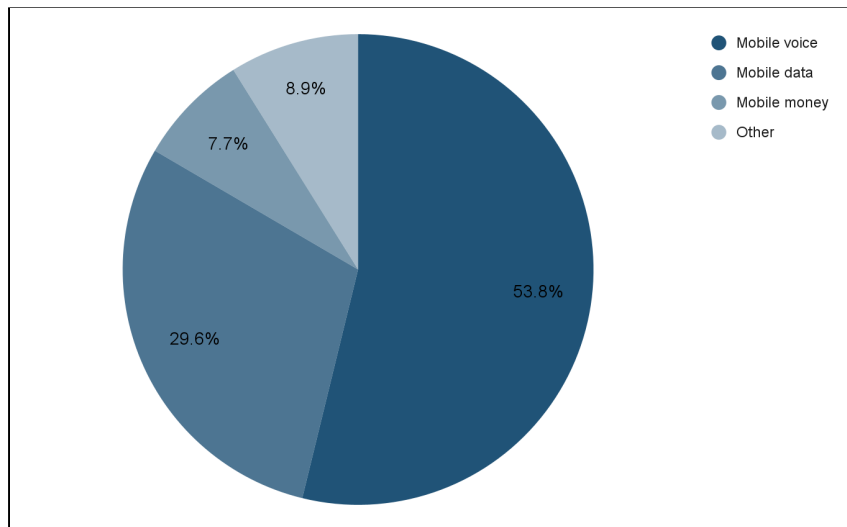
Airtel Africa (AAF) is a leading mobile telephony and mobile money services provider operating in 15 states in predominantly Western and Central Africa. This is a FTSE 250 stock with a market capitalisation of over £3.5bn. The IPO was made in June 2019, raising c.£500m.

Figure 1: Airtel Africa operating locations



Source: Company website

Figure 2: Revenue split

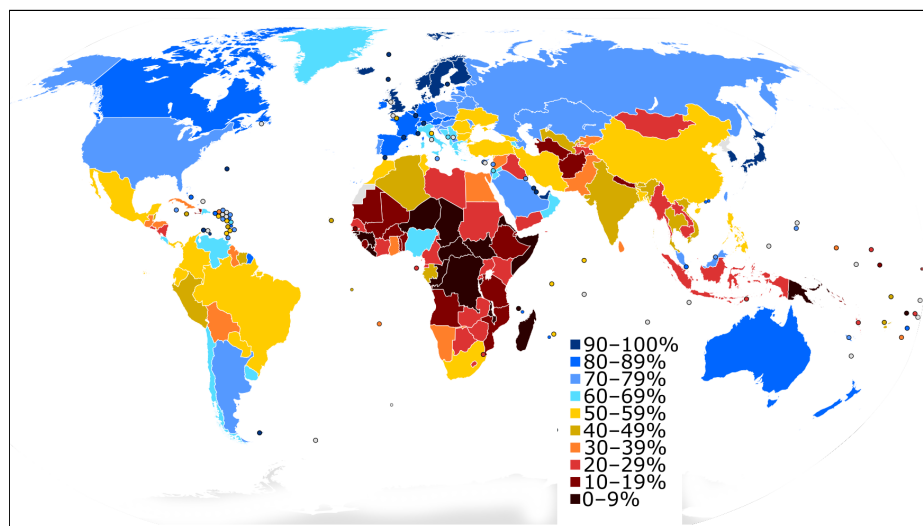


Source: Factset

Explosive growth

Africa has the lowest number of Internet connections in the world, with only 22 per cent of the continent having access (fixed line or mobile) with significant variances country by country – see Figure 3 below. It also has the largest potential for progress. The African Union, with support from the World Bank Group, has set the goal of connecting every individual, business, and government on the continent by 2030: most of this will be mobile-based. Like the pattern in India, connectivity largely by-passed the roll-out of fixed line networks and has leapt straight to mobile. If anything the situation in terms of roll-out in Africa is worse than in India given the more diffuse and rural population.

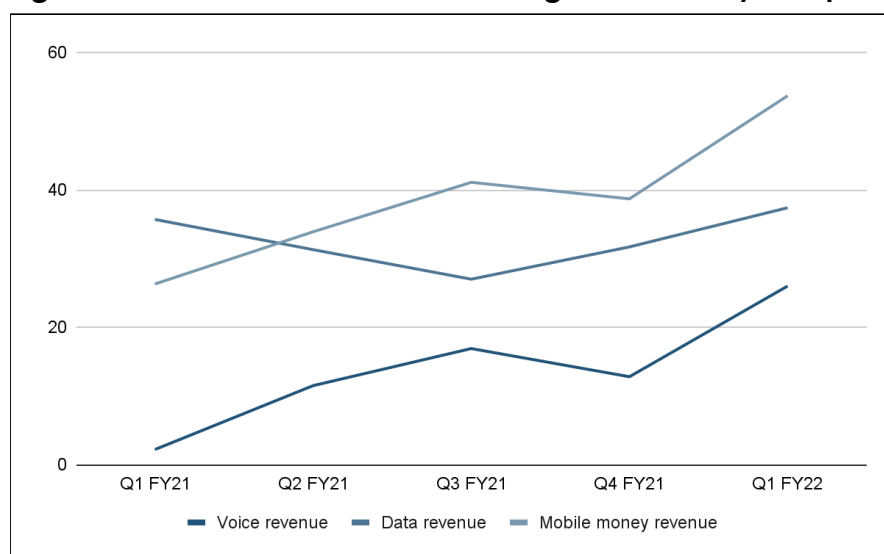
Figure 3: Global internet use by country



Source: ITU/Jeff Ogden

Growth in numbers connected to the internet has been slow to date with 2 per cent connectivity in 2005, 10 per cent by 2010 and now 22 per cent. This puts the scale of the task (of pushing to universal connection in barely eight years) into perspective and overall it feels unlikely to be achieved. That said, explosive growth can still be expected and this is shown in AAF's revenue growth rates.

Figure 4: Airtel Africa annual revenue growth rate by discipline – last five quarters



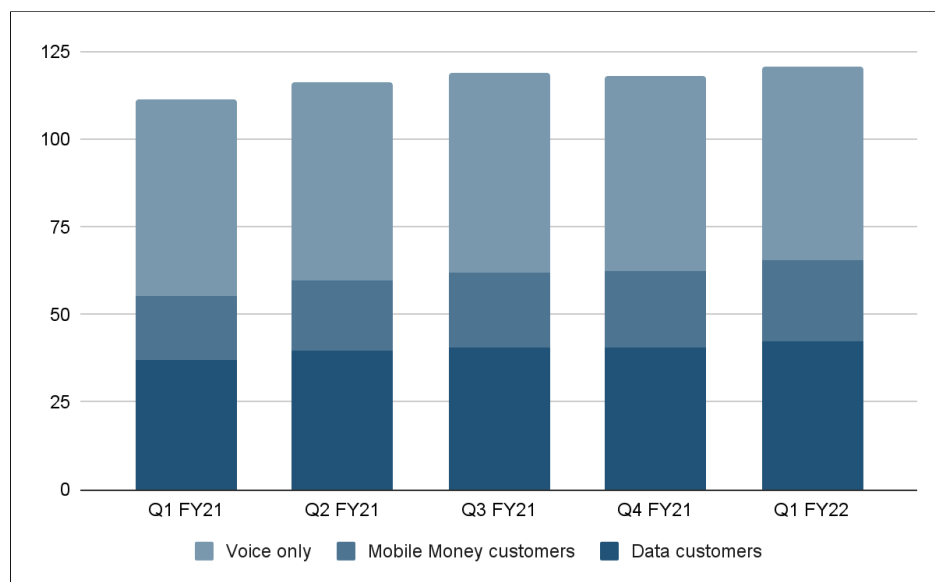
Source: Airtel Africa | figures reflect constant currency

Even voice (call) revenues, which on a global basis are weak (given the increased use of text within apps and voice capabilities within communications platforms such as WhatsApp and Discord) have been strong in Africa. This suggests that Africa could develop along a slightly different path and keep voice as a profit centre. In the UK, phone packages are almost entirely focused on the amount of data bundled with voice and GSM-carried text messages given away in unlimited quantities.

So the growth is now impressive and is likely to remain so. Total customers are growing strongly (see table below) and the average revenue per customer, while low by international standards at \$3 per month, has increased by 19 per cent in the past year. That figure is dragged up by the fastest growth segment, which is mobile money.

Margins are being maintained (high at the Ebitda level with Q1 2022 at 48.6 per cent); expenses are growing at only c.20 per cent per annum and amortisation & depreciation is rising by only 10 per cent - 15 per cent. The growth being delivered is strongly profitable.

Table 3: Growth in customers by class – last five quarters



Source: Airtel Africa

So the fundamentals here appear very strong. Expansion is guided by long experience already secured in India by the parent company, so it should attract lower risk and investors should probably expect to see local currency expansion well in excess of 10 per cent compound annual growth rate (CAGR) for at least the next three years. Consensus is a little more cautious than this with 8 per cent CAGR, which could indicate upgrade potential but may also reflect concerns about currency translation, especially from Nigeria (see later).

However, there are higher-than-average risks attached to this stock. These are likely to be key factors in the apparent disconnect between explosive growth and strong fundamentals and a low equity rating: the shares are trading on a year one PE ratio of just 10x. We look through some key issues below:

Ownership

AAF is a minority listing, i.e the bulk of the shares and its control is held by Indian telco Bharti Airtel, leaving a free float in London of just 15.2 per cent. This is often a depressing factor for the rating and some investors will avoid a stock on this basis alone. Building positions and, more so, exiting an investment can be problematic.

The ownership of the business has been further complicated by the investment from the Qatari Investment Authority (QIA) in a subsidiary of the business, Airtel Money. In total around \$350m is expected to be invested by the QIA, with \$150m already put in. This is in addition to \$175m already invested in the subsidiary by Mastercard and TGP (Kansas City-based private equity fund) – this investment round was made on the basis of the

subsidiary being valued at \$2.65bn. AAF also announced that it would like to IPO this part of the group within the next four years. Airtel Money operates primarily in East Africa so is more stable economically and in FX terms than western or central Africa plus, as we show in the charts above, it is the main growth driver of the group. Also, as this is a fintech business, it would attract a higher rate than voice or basic data services.

This is the most dynamic and attractive part of the group, but remains small, contributing \$230m or c.8 per cent of group revenues – it has grown 35 per cent CAGR since 2018. In its most recent figures (Q1 to June 2021), mobile money grew revenues by 53 per cent. Ebit (earnings before interest and taxes) margins are around 60-65 per cent.

This latest investment round values the Money business at \$2,650m or c.22x Ebit and implies a residual valuation for the core mobile voice and data businesses at just 2.3x Ebit. (2021 FY Ebit = \$1,119m: estimated Money Ebit \$143m ∴ mobile & data Ebit \$976m. Group market capitalisation £5,150m ∴ implied value voice & data: \$2,500m).

AAF is selling investment in the most attractive part of the group away from shareholders and this will certainly serve as a drag on the rating as the minority charge in the accounts will grow rapidly and slow EPS growth. An IPO could (albeit it's unlikely that 100 per cent would be sold) leave the investment heavily biased towards lowly rated earnings.

Mistrust

There is a long history of mistrust of Africa-based or biased businesses listed in London, justified or not. There is a high level of corruption more broadly across the continent and while there is nothing to suggest any issue at AAF, the business is still likely to be tainted by local associations.

Debt

AAF has high debt with gearing close to 100 per cent and sitting at more than 1.5x Ebitda (earnings before interest, tax, depreciation and amortisation). High capital expenditure requirements are likely as the roll-out of the network is still immature, but this will slow in future years. Debt expansion has been reduced by the minority, but this is something of a double-edged sword for investors. More equity could be issued, but with a higher-risk profile and a low rating there is a risk of further dilution.

FX risk

AAF trades in more than a dozen local currencies, reports its results in US dollars and trades with a sterling share price on a UK exchange. This allows for significant distortion of local or underlying trading.

In addition, there has been substantial devaluation in the Nigerian Naira against GBP and USD in the past three years of around 50 per cent with a further structured devaluation of 7.6 per cent undertaken by the Central Bank in May. A devalued currency makes imports more expensive and it is likely that almost all of the telecom hardware used by AAF will be imported. Currency devaluation is also, typically, a driver of domestic inflation which would push up operating costs.

There are profit and balance sheet implications, too. Profits are flattered by a weaker trading currency translated into a strong currency such as the US dollar and the balance sheet is also boosted. There can be complications if debt is denominated in a range of currencies. Nigeria accounts for around 40 per cent of AAF's revenue and is also a beacon being the only nation in Africa where internet access is higher than 60 per cent, so expansion is likely to be at the lower end for the group. This, and the growth in mobile money coming largely from outside Nigeria means that the weight of this country in the overall profit mix will reduce.

Poor ESG

Ratings services such as Morningstar, Reuters and Sustainalytics give AAF a 'poor' rating on an ESG (environmental, sustainability and governance) basis. This is likely to be an increasing barrier to investment and another factor dragging on the rating. Growth in mobile money and the likely regulatory baggage that will inevitably follow could also have implications for the ESG rating.

High tax regimes

Compared with other FTSE 250 companies, AAF operates in higher corporate tax regimes. Most African countries charge tax at 30 per cent– the UK has been running at 19 per cent, but in 2023 will rise to 25 per cent. However, AAF has been charging materially higher rates of tax to its P&L with a 45 per cent rate in FY2021. This means that taken together with high capital expenditure and the growing minority (profits owned by external shareholders) there could be pressures on dividend growth.

Conclusions

Mobile money in Africa is a huge growth area, is socially & commercially transformative and is clearly a key factor driving the valuation of this business. There have been a huge number of start-ups in recent years and significant amounts of venture capital funding have been injected into the fintech market. Fintech is seen by many observers as being a pivotal element in the economic recovery of many countries and the fintech industry is expected to be boosted by the African Continental Free Trade Agreement (AfCFTA) which began implementation in January 2021.

AAF has the great advantage of having its parent Bharti Airtel doing a lot of the pathfinder or pioneering work it will need for roll-out in Africa already achieved in India. This should mean that many of the newer innovations or technologies that are rolled out in Africa are already well-proven – this is usually referred to as intra-company technology transfer and is useful in helping lower risk implementation, especially in very fast markets such as we have here.

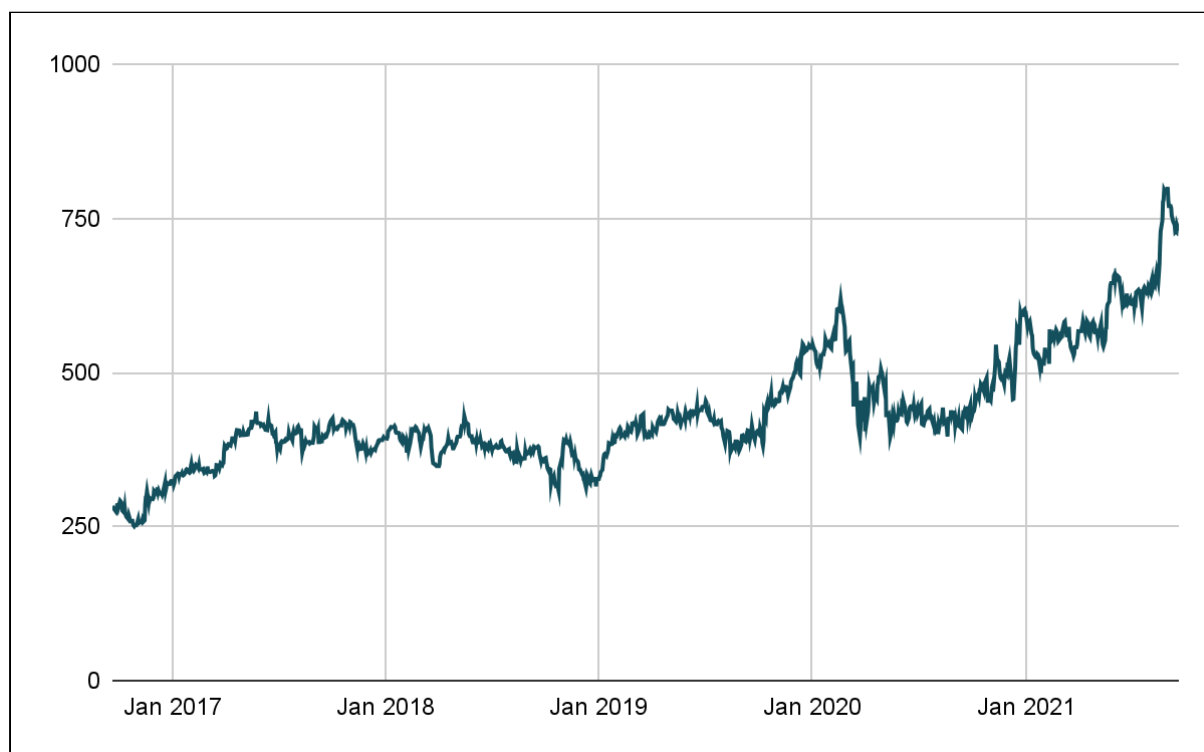
That said, AAF is a classic example of a business where the model on paper appears very strong, but there are potential objects that could harm returns for the investor. The risk here is high, much higher than for a domestic stock and while that is reflected in a low rating, often that discount can prove insufficient. Also, we have already seen that AAF is selling investment in the most attractive part of its operations to minority investors and may even more substantially take it away from group investors via an IPO.

It might be worth considering looking to invest in the Airtel Mobile IPO rather than the whole AAF business as that avoids having to invest in the legacy voice operations.

Overall, the rating is probably too low for the balance of explosive growth and the specific and local market risk. The price has rebuilt strongly more than trebling since the lockdown lows in Q2 of 2020 when the fundamentals and the rating looked significantly out of alignment. It is now much harder to see the share price momentum being maintained although a positive trend is still a very real possibility. If one's investment risk appetite is towards the higher end of the scale then investment here could prove to be rewarding.

Continued below...

Genuit – green flash with a solid backbone



Source: FactSet

Change of name and credentials

Until April this year, this business was known as Polypipe, the long-established manufacturer of plastic components for the plumbing, heating, ventilation and air-con (HVAC) and water management industries. Springing back from a torrid time during Covid lockdowns, management has hitched itself strongly to the 'Build back better' agenda, pushing its green/environmental credentials to the fore. As a result, it has enjoyed a solid re-rating, continuing a robust outperformance that started at the beginning of 2019 when the job of re-invention from standard widget manufacturing first got under way.

A strong backbone

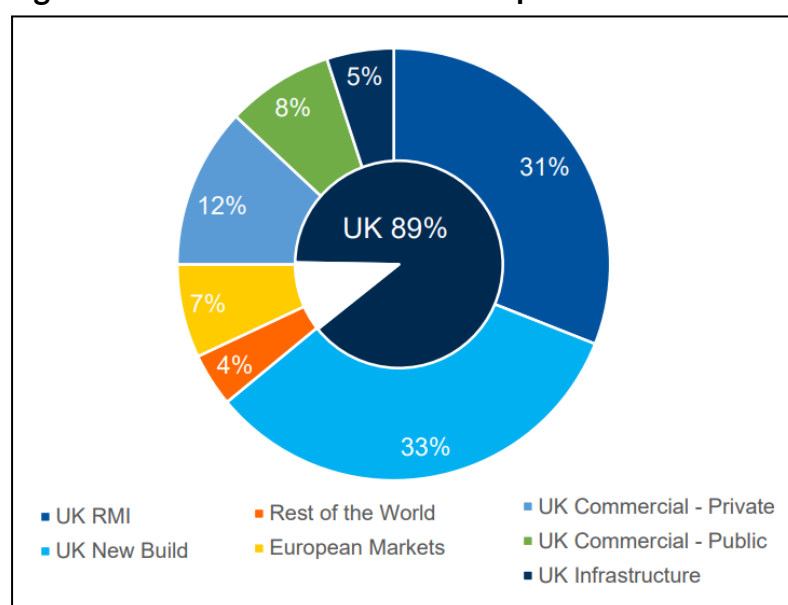
While the greater interest in the investment story here comes from the green/environmental dimension, it is important not to overlook what is a very strong and stable backbone to trading: housing. The largest part of the group's earnings still come from both new build and renovation – as shown in figure 1 more than 60 per cent comes from these two market segments. Housing repair, maintenance and improvement (RMI) is a very stable market due to the need to keep the UK's 27 million homes from falling into disrepair – this is a constant process.

New build is a little less constant but is also, much of the time, a solid market. That's even though it does not grow significantly (new homes completions have averaged around 140,000-150,000 per annum for much of the past 20 years) and has been subject to major declines, such as in 2007-11. However, the beauty of housing is that when people are not moving house (be that to a new or existing home) they are more likely to improve or patch up their existing home.

UK housing stock is on a long, slow growth trend of around 0.5 per cent-1 per cent per annum and much of the housing stock is (comfortably) more than 50 years old. This means it is inefficient and has a large carbon footprint that legislation is likely increasingly to put under pressure.

That means that the traditional sources of demand from within housing are expanding, which gives an additional growth driver and as new-build housing (finally more than 15 years later than originally planned) drives towards a zero carbon agenda, this pushes more of the total spend in Genuit's direction. So, the core from housing is very robust, but also likely to be expanding at a higher rate.

Figure 1: Genuit's demand drivers – past 12 months



Source: Genuit

The expanding part – environmental protection

The remaining 40 per cent of Genuit's business has a generally more dynamic feel. The pressure to change the carbon footprint and water management of buildings and public realms has stronger growth characteristics. Much of this falls within the infrastructure slice of the pie but to a lesser extent also extends across commercial and residential.

What Genuit does in these newer areas of construction is, essentially, the same as it has always done – making injection moulded and extruded components from a range of plastic polymers. Many of these products did not exist 10-15 years ago and represent a material expansion of the group's available end markets.

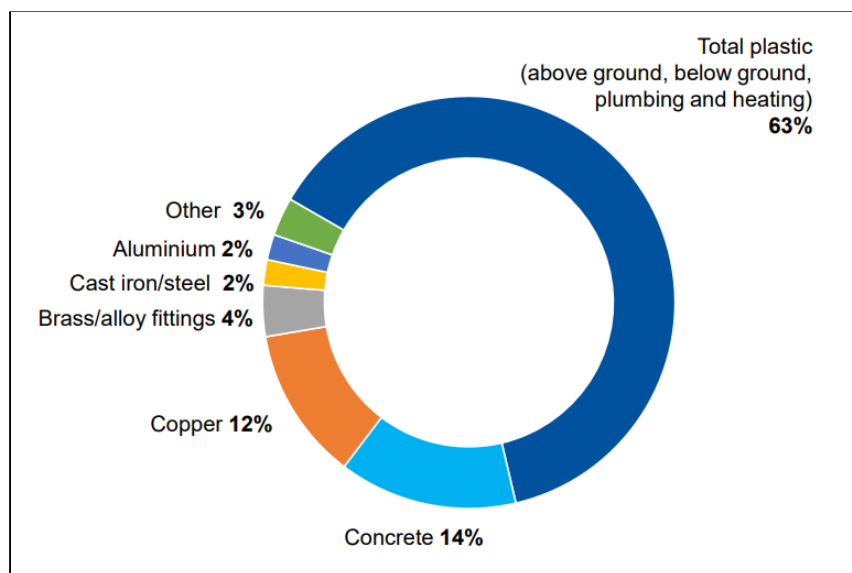
Resilient water – this is working in areas of flood alleviation, which is a constant game of catch-up spending. Government plans and standards still largely relate to the typical flood conditions from 10-15 years ago in terms of frequency and intensity of local flooding events. As we have seen in Europe (Germany and Belgium) this year, the economic damage is immense and massively outweighs the cost of alleviation and water management investment. Genuit's products are primarily passive installed components such as high capacity storm drains and temporary storage/buffering solutions built beneath new and existing buildings as well as under large open areas such as car parks or playgrounds.

Where ground once absorbed rainfall, increased urbanisation or 'concretisation' no sees water run off directly into drainage systems that can fail to cope in the increasing instances of extreme rainfall.

Green urbanisation – this is about new ways of reconnecting urban development with nature and environmental conditions by the use of energy, water and materials at each stage of the city or district's life-cycle. In essence, this is management of water in the urban environment in non-emergency and non-flood conditions in dense urban development, lower density housing and on transport infrastructure.

Legacy materials substitution – plastic plumbing and other products have long been about replacing long-established materials used in construction – uPVC instead of vitrified clay in draining, polybutylene instead of copper in plumbing or plastic instead of cast iron for guttering for example. There are myriad pros and cons in using plastic, but the pros have been winning for many years and plastic alternatives have become the standard choice in a vast array of applications. The pie chart below shows the extent of plastic penetration in the pipework market: note that this position has been built from close to nothing in less than 25 years.

Figure 1: Plastics' share of traditional pipework market



Source: Genuit

Low carbon heating – the government has banned the use of gas boilers in new-build homes from 2025 and is likely to ban the sale of domestic replacement gas boilers before 2040 (recently pushed back 10 years due to excessive cost and poor availability). Electric boilers, hydrogen boilers, district heating systems and heat pumps are main product areas that will need to grow rapidly and Genuit has positioned itself (by acquisition) to secure a market position it does not have in the traditional boiler market. The group's largest acquisition to date (Adey for £210m) and another sizable purchase (Nu-Heat for £27m) both made in February represent a large addition to and shift towards more sustainable product areas.

Better interior air quality – poor internal air quality has been a creeping issue for many years, but Covid-19 has brought this to the fore. Air handling, cooling, filtration and virus elimination (a totally new segment arising since Covid) is a major problem in many commercial and public buildings. The problem is exacerbated by the increasingly sealed nature of buildings to maximise heating efficiency. Genuit has built a substantial business here, again by acquisition, starting with the purchase of Nuarie in 2015, its second largest deal after the recent investment in Adey.

Using more recycled materials – today around half of the raw material input into Genuit's products are recycled but this is to be increased. The board has a target of 62 per cent recycled input by 2025 – this is effectively 100 per cent as a minimum amount of virgin material is (today) needed to enable products to meet British Standards and ISO performance standards.

25 per cent of sales from products that don't yet exist – this statement alone would make me want to buy this stock – what a vision and how different from the staid or creeping evolutionary mindset of many businesses today.

The transformation from being largely a pipe manufacturing business is moving at a high pace with value-accretive acquisitions moving the centre of the group's axis more towards environmental and sustainable products. This has been done without harming the strong existing core, has boosted earnings from day one via smart acquisitions, gives scope to expand more rapidly outside the UK and should raise the underlying growth rate of the business. For too long Genuit has been largely bound by the relatively slow, often volatile and cyclical nature of UK housing and construction but the re-orientation locks it into areas of visibly long-term growth potential.

Wrapping up

The tailwinds behind Genuit are reasonably strong and enduring, with positive trends set to last well beyond any normal investment horizon (which might be only two years) whereas massive environmental change timeframes are more like 30 years.

However, even strong growth has to have a ceiling on its value and Genuit has seen a substantial re-valuation in the last 18 months, recently reaching a share price double that of the lockdown low in Q2 of 2020 (800p from 395p). According to FactSet, estimates for December 2021 are today around 6 per cent higher than they were in Q4 2019, but the rating is now at an enterprise value (EV) to Ebit of 20x against an EV/Ebit of only 12x in 2019. FY2022 has had stronger advances in forecasts with an 11 per cent gain in the mean EPS estimate, much of this coming from the 2021 acquisitions. However, in that time the share price has increased by 61 per cent (at a recent peak up 77 per cent), meaning that the share price really has been driven by a re-rating rather than by earnings upgrades.

This can make it much harder to sustain a share price rally as earnings are objective and ratings subjective. There has been a visible shift in the quality of earnings by lowering the reliance on the UK construction cycle and this is a positive because that market is seen as delivering low quality earnings. The new blood coming into the group is significant, especially Adey which delivers Ebitda equal to around one quarter of the group's existing earnings. A note of caution here, however, is that much of the Adey business is still tied to the core UK construction cycle and is likely to have less impact on the quality of earnings than some of the other actions Genuit is undertaking.

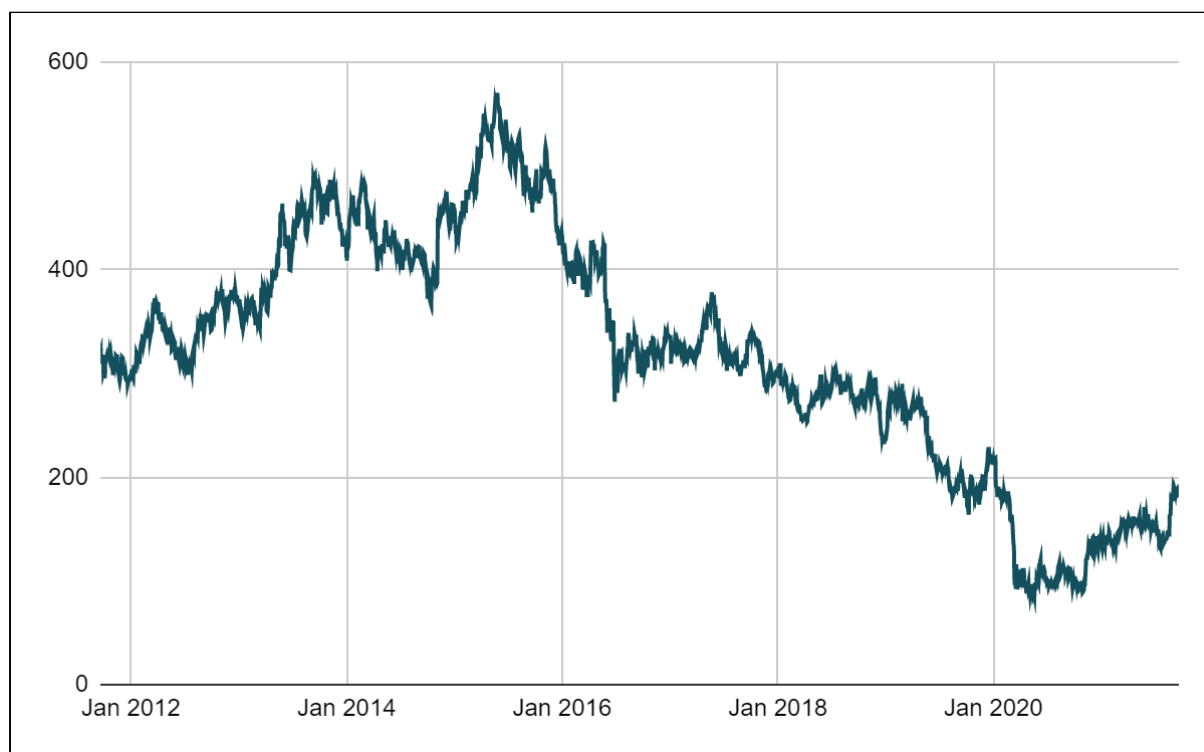
The shares have dropped by close to 10 per cent since the start of September after hitting 800p with no obvious driver, suggesting that the re-pricing of the stock since the

half-year results in mid August (when the shares were 648p) did overstep: the share price strongly broke ahead of what had been pretty stable 50 and 200 moving average trends. Guidance was improved at the half-year stage and the consensus for December 2022 did rise, but by only 1.5 per cent, while the shares rose by almost one-quarter. There was no material change in the investment story at that stage – perhaps just a little over-exuberance due to COP26 (the United Nations climate change conference happening in Glasgow in November).

The share price can be volatile and the chart at the start of this article does show a series of sizeable peaks and troughs. The shares might now be expected to retrace further in order to get everything back into balance. Fair value for this stock feels closer to the level at which they stood before the interim results and if the fundamentals here do appeal, a better point to invest might be if or when the shares re-visit those levels.

Continued below...

Marks and Spencer – still a little shop of horrors?



Source: FactSet

Everyone in the UK knows M&S, the stalwart of the high street. Everyone also knows that this is a business that has lost its sense of direction and of purpose by not understanding who its customers are and ending up not really selling to any demographic. Writing about the parlous condition into which M&S fell could fill an entire bookshelf, but here we reflect on what management has proposed and has already done to right the ship and whether the early success can continue and whether investors can be drawn back.

Chairman Archie Norman acknowledges that investors have been promised change and improvement (many times) before, but that hitherto very little had been achieved. However, the board does seem this time to have faced up to far more and far deeper problems that it needed to address with a comprehensive nine-point plan across food and clothing/household. This seems to recognise problems (many of which might appear very basic and unforgivable for such a large business) and present solutions that should have a profound impact on revenues and profits, but without trying to emerge as something totally new and different.

Table 1: The nine-point plan

Leadership and culture transformation	Accountable businesses	Digital first
Restoring style, fit and value in clothing	Magic again in food	Rebuilding profitable growth in International
Store estate fit for the future	Modernised supply chain	Cost savings of at least £350m

Source: Marks & Spencer

Essentially these points all boil down to a number of common and overlapping areas of concern that encapsulate where things had gone wrong across M&S:

- Outdated operating model
- Customers' perception of M&S
- M&S' misunderstanding of its customers
- Poor use of business and customer data
- Unfit property estate

Leadership and culture transformation

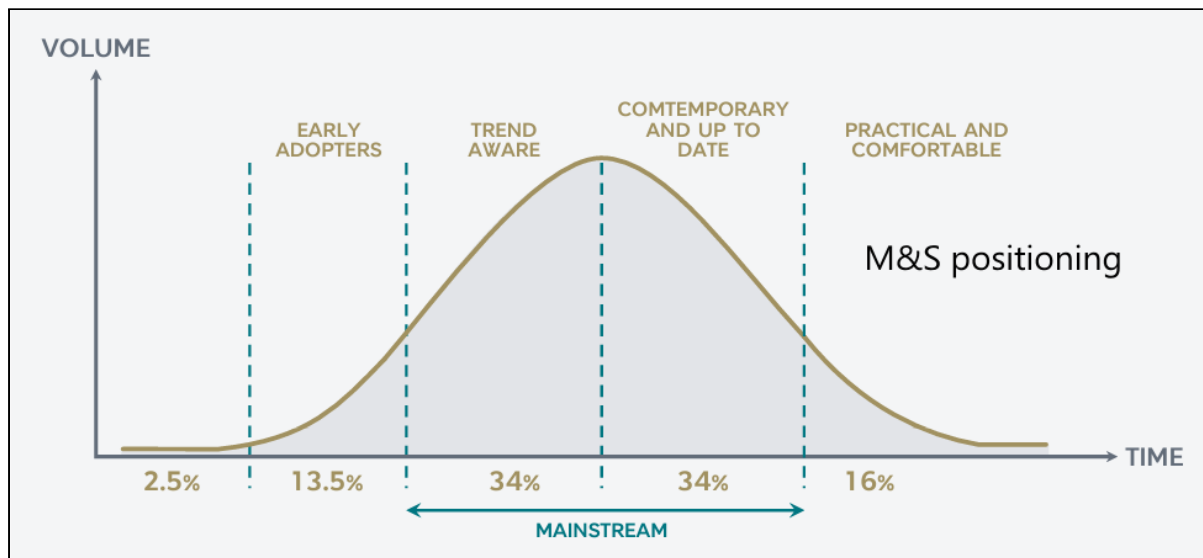
Essentially, M&S ran an out-of-date model and was too head office-centric, too bureaucratic and had bloated corporate functions. Too little management was devolved to store level, operations ran with excessive decision making times and too many decisions were made without adequate reference to active data from the business.

Essentially, too many wrong decisions were made too slowly and in the wrong place. So much was wrong that even applying business school 101 level techniques have had a far-reaching impact.

Restoring style, fit and value in clothing

M&S remains the UK's number one clothing retailer by value market share with 8.6 per cent, followed by Next with 7.5 per cent and Primark with 5.6 per cent so there is still a robust foundation on which to rebuild. This is where M&S appeared to be the most directionless and the company has provided some great examples of exactly how and where it was (and often still is) wrongly positioned in clothing. These charts are related to menswear and serve as good examples of how M&S was overexposed to the wrong market segments. The same is largely true for womenswear too, but to a lesser extent.

Figure 1: Sitting in the tail of the distribution



Source: Marks & Spencer

Figure 2: Too exposed in the wrong places

	MARKET GROWTH	MARKET SHARE
 SUITS	-7%	14%
 KNITWEAR	+1%	12%
 CASUAL TOPS	+6%	5%
 ACTIVEWEAR	+6%	2%

Source: Marks & Spencer / Kantar

Figure 3: An imagined journey via word cloud – customer perceptions



Source: Marks and Spencer

Store estate fit for the future

The M&S property estate contains too many sites that are either too small, too large, are misconfigured (clothing and food balance is wrong) or are simply missing from key locations. There is a heavy bias to town centres which hampers food sales and M&S rarely features in more active and popular retail parks. The regeneration policy has been to close 30 of its 255 clothing stores and turn 45 others into food-only shops.

M&S has long been dogged by poor leasing arrangements with too many long (25-year) leases without good breaks that hurt flexibility. Many of these leases are naturally expiring now, allowing a more substantial reorganisation to take place in coming years (although the full unwind will take another 10 years). The weakness in the retail sector does provide opportunities for M&S to rent better (location, price and terms) – six former Debenhams stores have been taken on, for example, from distressed landlords.

Even where the locations were excellent (M&S was frequently the anchor tenant), other issues that we look at here made many stores expensive white elephants as customers had little desire to shop in them. This was made worse by under-investment especially in poorer performing stores leaving many locations looking unappealing and outdated. Too many stores were in old and unmodernised buildings (flagship store Marble Arch was

built in 1930 and has essentially the same floorplan today) which are cramped and poorly laid out.

Accountable businesses

Historically, store managers did not know their own profit and loss (P&L) and had no benchmarks or internal rankings on any measure. No business, even a small one, can run in the blind like this. Systems are now in place to make local management aware of how well they are performing with mobile tools to help understand key performance indicators (KPIs). Until as little as two years ago, many managers had no mobile access to performance data with many having to print out sheaves of paper with static, non-searchable data.

Magic again in food

M&S Food is a solid enough business, but has under-delivered on a number of fronts historically and offers a patchy, incomplete service to customers. Food is arguably the area that can drive the strongest and most rapid improvements for M&S. Many of the issues here in food also manifested themselves in clothing.

Weak online – discussed above, this has been addressed in food via the formation of the Ocado Retail joint venture (JV) but prior to 2019 M&S Food was heavily biased to store-based sales. Online was largely limited to party/event foods. The JV has also addressed the problem of too much of the M&S range not being available in a large number of stores, especially Simply Food outlets. The full range of food was only available at less than 10 stores.

Lost the customer on price – Price perception is wrong on the actual level of premium for M&S products, or in other words how much extra consumers are being asked to pay for M&S quality. Better communication and better use of social media and direct marketing using the vast pool of data are addressing this.

Poor estate – too many small stores means high relative costs and poor range at too many outlets. This is being addressed by the wider estate rationalisation and through the online JV.

Poor balance – M&S has a 6 per cent market share in fresh/chilled food but only 2 per cent in ambient (longer shelf life) foods. This means that customers are unlikely to make a fuller shop, as highlighted in the next point.

Basket problems – M&S shoppers have had a heavy skew towards small shop value or 'basket size'. While its overall market share of food is c.3.5 per cent, it has

been poorer in medium and large baskets with 4 per cent share of medium and only 1 per cent of large; its share of small baskets is c.18 per cent. Within this there was a heavy bias to ready meals, desserts and ready-made foods, but there were issues arising here too. M&S did not own the relationship with suppliers (it sat with the food manufacturer), meaning that a normally lucrative part of food retail in its own label products was misfiring.

Too reliant on promotions – large numbers of customers have only bought food from M&S when there have been substantial promotions, which had become numerous. Unlike a typical loss leader intended to lure committed shoppers, this practice simply gave away profits. Promotions have been scaled back markedly.

Too few mid-market products – M&S is still seen as selling only premium items, narrowing its market appeal and barring mainstream food shoppers. Waitrose has been very successful by offering its 'Everyday Essentials' alongside core products and M&S is now following suit.

Family market is missing – M&S has failed to cater to a full enough spectrum of the food market only serving, in effect, wealthier or single or older consumers: very few family shops occur. This is not helped by the locations and the estate which have made car-based shops more difficult. There has been an interesting change in advertising with airtime switched to more mainstream TV shows such as 'Britain's got talent', where they try and push more family-focused items.

Modernised supply chain

Possibly one of the weakest areas in the group which showed itself primarily as poor product availability (clothing and food), is excessive levels of inventory and unnecessary waste. This made for bad customer experience, eroded profit and increased debt. A lot of the issues here again relate to poor use of data, but a major overhaul is in train.

Digital first

M&S has been a laggard in online retailing in both clothing and food. It has access to masses of data but has extracted too little value from it. The data pool arises from 7m Sparks loyalty card holders, 11m account-holding M&S.com users, 3m bank customers plus more recently 1m at Ocado Retail. Customer and activity data was kept local to its origin and was not pooled, leading to poor engagement and under-use of social media or targeted advertising.

M&S was slow to adopt online clothes shopping. First, it outsourced to Amazon, missing the opportunity to develop in-house skills and gather data. When setting up in-house, its

initial site was dull, clunky and slow and was tied to an expensive, high-tech warehouse that didn't work properly.

It also failed to utilise its estate with a sub-standard click-and-collect offering: John Lewis / Waitrose has shown how strong a well-managed service can work and utilise the existing store replenishment infrastructure. Things are now much better and M&S expects to make 40 per cent of clothing sales through its website going forward. Part of its online success has been boosted by selling third-party labels on its website for the first time and M&S will also bring more than 1,500 clothing and home lines to Ocado Retail.

Cost savings of at least £350m

This is equivalent to only c.3 per cent of revenues and given the evident extent of 'flabby' costs within the group, this should be easily achieved at the office, store and warehouse levels. Some £23m of costs relating to the transformation plan were incurred in the last financial year. For scale, £350m is equivalent to 60 per cent of the average group Ebit from 2015 to 2019.

Rebuilding profitable growth in International

Still decently profitable in 2021, but profits are halved versus 2019 and sales remain at 9-10 per cent of the group total. Last week the withdrawal from France was announced due to supply chain issues and this would erupt elsewhere too. Getting back to historic profit levels could be hard.

Overall, M&S has a considerable amount of low hanging fruit that can help restore profits and it has had a very deep dive on owning up to its many structural problems. That things got so bad is unforgivable in a large, modern business but there are plenty of reasons for believing that substantial change can be delivered. Early signs are good but the process could easily take close to a decade to run its course.

Another potential private equity takeover target?

As the battle for Morrisons rages on, the appetite for UK food retailing from private equity (PE) investors seems as high as ever. Tesco and Sainsbury's are potentially seen as targets. As the next largest available food retailer (ignoring Lidl and Co-Op for practical ownership reasons) M&S, being decently profitable and with its materially underachieving market share of around 4.5 per cent, must have some appeal.

The rest of the business could be something of a millstone around the neck of an investor targeting food, but there is probably enough embedded value here to make that worthwhile. Clive Black at Shore Capital suggests that a three-way PE-led assembly of Sainsbury's, Boots and M&S is an interesting possibility.

Compared to Morrisons (MRW), M&S could be valued on a lower multiple (reflecting MRW has a high freehold position and also sells fuel) . Morrisons is going out on 13xEbit, so allowing for the potential to plug many holes in the business model, one could see M&S Food worth say 11x Ebit, meaning easily a valuation of £2.5bn.

Clothing and homewares look capable of making £200m-£250m of Ebit and valued using a material discount to Next (NXT), that might have a value of £1.6bn.

International is hard to value as it is in a state of flux but should make more than £50m of Ebit chipping in another £500m of value at least.

M&S Bank is *de-minimus*. So, the core M&S business could be worth £4.5bn before debt.

The debt we would deduct for valuation purposes would exclude the £2.4bn of IFRS16 Lease Obligations – financial debt is £1.1bn.

Then there is the JV with Ocado Retail. M&S invested £750m into the 50:50 venture in 2019 and it does look as if value has been created by the marriage of the two brands. Some observers believe that the venture could be worth £2.3bn (£155m of post-tax profit historic at approximately 15x PE supports this), which means £1.15bn of value to M&S.

The sum of the parts valuation then totals £5.7bn gross or £4.6bn net of debt if all of the separate parts can at least stabilise around 2019 levels, but if improvements and cost savings can be fully realised the value can be more than this. That suggests that a baseline, starting point valuation could be 230p per share before any additional value creation if trust can be restored. The shares are trading today at 185p.

The road through to delivering a better M&S is unlikely to be smooth, is likely to take many years and the shares could be volatile on the way – on positive news in the November Q2 update and the trading update in August 2021, the shares jumped respectively 57 per cent and 25 per cent. Conversely after the 2021 finals in May, the shares slid 23 per cent when the full extent of the Covid-19 impact and reorganisation costs were first unveiled.

Iron out the lumps and bumps and take a long view, there could be 25 per cent to be gained here (potentially more if the improvement plan delivers) plus the restoration of a dividend in due course. Although retailing is not looking overly strong, there has been so much damage already done here, and the scale of the past excesses and under-delivery is

so large, that even in a flattish market for clothing and with continued GDP-matching growth in food, a re-focused and re-vitalised M&S could show strong gains.

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