Smiths City Group

Initiation of coverage

Expansion awaits

Care & household goods

Smiths City Group is a New Zealand focused retailer of furnishings and appliances. The company was significantly affected by the Christchurch earthquakes in 2010 and 2011, but is now ready for expansion and growth. It does not have national coverage and is not yet present in the important Auckland market. Our valuation of 83c/share is 69% above the current share price, with the company offering an attractive yield of 7.8%.

Year end	Revenue (NZ$m)	PBT* (NZ$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
04/13	222.5	2.4	10.2	3.5	4.8	7.1
04/14	220.6	4.2	6.8	3.5	7.2	7.1
04/15e	224.8	5.9	9.6	3.8	5.1	7.8
04/16e	229.2	6.0	9.8	4.0	5.0	8.2

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

New Zealand focused retailer

Smiths City Group represents around 4.7% of the New Zealand furnishings and appliance market, although it does not have national coverage and is not present in the important Auckland market. The company has held back on expansion plans while it dealt with the impact of the global financial crisis and the Christchurch earthquakes in 2010 and 2011. With these events now behind it, it is ready for expansion, with a focus on growing its North Island presence, in particular regions such as Auckland and Waikato where it currently does not have a presence.

Furnishings better than appliances

The furnishings market is likely to be more rewarding for Smiths City as it looks to expand its store network. Furnishings have more stable margins and the company thinks that the 'bedroom' offers the best prospects for furnishings sales.

In contrast, appliance retailers have to sell twice as much product as in 2008 to achieve the same revenue due to the dramatic falls in product prices in recent years.

We expect sales growth to be modest in the South Island with new store opportunities. The company is exploring the North Island as a source of growth, and in particular regions where it currently does not have a presence.

Valuation: At a noticeable discount to peers

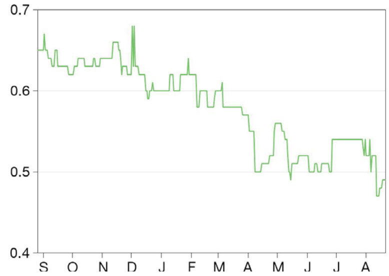
Our DCF valuation is 83c/share, based on a WACC of 9.6% and a terminal growth rate of 2.0%. This is some 69% above the current share price. The company is trading on a 12-month forward P/E of 5.1x, compared to its peers at 15.7x. On an EBITDA multiple basis the company is trading at 4.7x compared to 7.7x for its peers. Smiths City also offers an attractive prospective dividend yield of 7.9%.

At our valuation the company would be trading on a P/E of 8.6x and a 6.7x EBITDA multiple, at a discount of 45.6% and 12.9% respectively to its peer group.

26 August 2014

Price	**NZ$0.49**
Market cap	**NZ$26m**
	US$0.8338/£0.5027/NZ$
Net debt (NZ$m)	20.7
Shares in issue	52.7m
Free float	72%
Code	SCY
Primary exchange	NZX
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(9.3)	(3.9)	(24.6)
Rel (local)	(9.7)	(4.4)	(30.7)

52-week high/low	NZ$0.68	NZ$0.47

Business description

Smiths City Group is a South Island based retailer of home furnishings and appliances. It has successfully weathered the global financial crisis and Christchurch earthquakes and is now poised to grow to become a national retailer.

Next events

AGM	26 August 2014

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Edison profile page

Smiths City Group is a research client of Edison Investment Research Limited

Investment summary

Company description: Furniture and appliance retailer

Smiths City Group is a New Zealand based retailer of furniture and household appliances. The company is based in Christchurch, with most of its operations in the South Island. It was founded in Christchurch in 1918 and has been listed on NZX since November 2003. Since 2008 the company has weathered two major events, the global financial crisis, which saw a major drop in discretionary household spending, and the Christchurch earthquakes in 2010 and 2011, which caused major business disruption. The company has now recovered from the earthquakes and is poised to expand its operations into parts of the country where it currently does not have a presence, and grow its finance operation.

The primary area for expansion is the Auckland market, the largest and fastest-growing region of the country. Auckland alone is equivalent to 70% of Smiths City Group's current population base and 60% of its household base.

Valuation: Large discount to peers

Compared to its New Zealand listed retail peers, Smiths City Group is trading at a sizeable discount. On an EBITDA multiple basis the company is trading at a 30% discount to its peers.

Our DCF valuation, using a WACC of 9.6% and a terminal growth rate of 2.0%, is 83c/share, compared to the current share price of 49c/share, a premium of 69%. The company also offers an attractive 7.8% prospective dividend yield, although for local investors the dividend is not imputed.

We model a scenario where the company enters the Auckland market via an acquisition. We think this is a better option than organic growth due to the ability to gain scale quickly and generate positive earnings growth. An acquisition with revenues of around NZ$20m we think would cost around NZ$3m, assuming an EBITDA margin of 3% for the acquisition. Including scale benefits we think this could add up to 24c/share to our valuation.

Financials: Steady as she goes projections

Our financial projections assume the company continues to operate in its current format as it has done over the past few years, without any incremental increase in revenue or earnings from expansion into Auckland. We expect a modest increase in EBITDA through to FY16, based on small increases in revenue and good cost management. Compared to its larger furnishings and appliance peers, Smiths City Group has comparable margins (see Exhibit 7).

Sensitivities

The company has survived a number of difficult years caused firstly by the global financial crisis reducing discretionary consumer spending, followed by the Christchurch earthquakes in 2010 and 2011. It is now almost through the difficulties caused by the earthquakes in particular and is poised for growth into new regional markets.

The company does have exposure to exchanges rates as an importer of furnishings and appliances, although this is an exposure faced by all furnishings and appliance retailers. Consumer demand is sensitive to economic conditions; however, the New Zealand economy is performing well, with good growth prospects, high consumer confidence and falling unemployment.

The company does operate in a highly competitive market with few large national competitors and many small and locally based competitors. The management team is highly experienced in the furnishings and appliances market and as the last few years attest, is well used to dealing with adversity.

Company description

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The company has now recovered from the earthquakes and is poised to expand its operations into parts of the country where it currently does not have a presence, and grow its finance operation. The New Zealand economy is also in good shape with high consumer confidence, rising dwelling construction and falling unemployment.

The company does not disclose its geographic product line sales or margins.

A South Island based retailer

Smiths City Group operates four retail brands focused on furnishings and home appliances. It currently operates 14 stores in the North Island, with 10 branded as Smiths City and four branded as LV Martin in the Wellington region. The company has 26 stores in the South Island, with 17 branded as Smith City, five as Alectra and four as Powerstore.

The LV Martin, Alectra and Powerstore brands focus on home appliances and electronics, while the Smiths City branded stores are based around home furnishings, although they also carry a range of appliances and electronics.

The 27-store Smiths City brand is the company's flagship brand and makes up around 75% of the company's retail turnover according to its 2014 annual report. The company refers to the brand as its 'lifestyle' brand.

The LV Martin and Powerstore brands make up the company's specialist appliance chain with eight stores in total. The company acquired the LV Martin business in 2004 from the Martin family, with this brand name focused solely on the Wellington region. The company has not opened any Powerstores in the North Island and does not appear to be growing this brand, preferring instead to expand the Smiths City brand into new markets.

The Alectra operation is the company's service and installation business, which provides a key component of the sales proposition via after sales service and support. Alectra has five locations in the South Island, although none thus far in the North Island.

Finance operations

All appliance and furniture retailers offer finance as part of their sales offering, however, Smith City is somewhat unusual in that it runs its own in-house finance book. Most appliance and furnishing retailers have outsourced their finance activities to third parties such as Fisher & Paykel Finance (a unit of Haier Electronics Group (1169.HK)) and GE Money, a unit of General Electric (GE.US). However, Smiths City has retained its in-house finance operation. The Warehouse Group (WHS.NZ) is also launching its own in-house finance operation after raising NZ$100m from shareholders earlier this year.

The company argues that retaining its own finance operation allows it to maintain a stronger relationship with its customers and enhances its promotional opportunities via repeat business. At the end of the 2014 financial year the company had a ledger of NZ$72m and 64,000 active accounts (an average of NZ$1,125 per account). Approximately 29% of the ledger is on revolving credit terms, with the balance on fixed instalment facilities.

In FY13 the company moved away from its bulk funding arrangement with Fisher & Paykel Finance to a new arrangement with ANZ Bank. This new arrangement featured far lower interest costs and more flexible terms than it achieved with Fisher & Paykel Finance. In FY13 its net interest revenue was NZ$3.6m. However, in FY14 this jumped to NZ$7.0m. The impaired loans expense was NZ$0.6m (0.6% loan assets) for FY13 and NZ$0.5m (0.7% loan assets) for FY14.

During FY15 the company will finally emerge from the disruption and costs associated with the Christchurch earthquakes of 2010 and 2011. The company's flagship property and largest store (Colombo Street) was significantly damaged by the 2011 earthquake, which required the rapid relocation of staff and operations. The company should receive its final insurance payout and will complete the repairs to its Colombo Street property during FY15.

Now for expansion

Smiths City's footprint covers 47.4% of New Zealand's population and 49.8% of New Zealand's households according to the 2013 census. The company has a strong presence in the South Island, and in the Wellington and Bay Of Plenty regions in the North Island; however, it is not present at all in the country's largest market, Auckland. Exhibit 1 sets out the regional metrics for furniture and appliance stores in New Zealand.

Exhibit 1: Appliance and furnishings stores by location, population and dwelling metrics

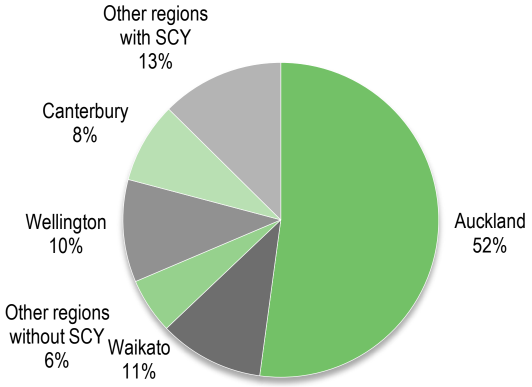
	Census population	Occupied dwellings	Total furniture stores	Total appliance stores	Population/ dwelling	Dwellings/ furniture store	Dwellings/ appliance store
Auckland	1,415,550	473,448	775	722	3.0	611	656
Waikato	403,638	152,493	166	144	2.6	919	1,059
Other regions	412,479	161,973	183	141	2.5	885	1,149
Non Smiths City regions	**2,231,667**	**787,914**	**1,124**	**1,007**	**2.8**	**701**	**782**
Canterbury	539,436	208,146	232	215	2.6	897	968
Wellington	471,315	177,813	213	174	2.7	835	1,022
Other regions	999,030	396,549	434	376	2.5	914	1,055
Smiths City regions	**2,009,781**	**782,508**	**879**	**765**	**2.6**	**890**	**1,023**
New Zealand	**4,241,448**	**1,570,422**	**2,003**	**1,772**	**2.7**	**784**	**886**

Source: Statistics New Zealand

Exhibit 1 shows the regions where Smiths City is not present, at the top, and the regions where it is present, at the bottom. Auckland contains 33.4% of the country's population and 30.1% of the households, making this region alone equal to 70.4% of Smiths City's current footprint in population terms and 60.5% in household terms.

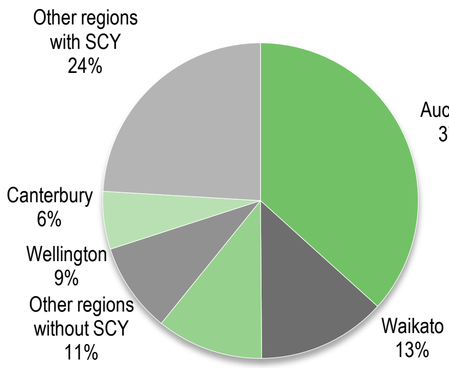
Further, Auckland has the highest number of people per dwelling at 3.0 compared to the national average of 2.7 and the highest concentration of furniture and appliance stores compared to the number of dwellings.

Exhibit 2: Share of population growth 2006 vs 2013



Source: Statistics New Zealand census data

Exhibit 3: Share of dwelling growth 2006 vs 2013



Source: Statistics New Zealand census data

Another aspect of the Auckland market is the relative growth rate of the Auckland region compared to the rest of the country, and in particular compared to the regions currently served by Smith City store brands. Exhibit 2 and Exhibit 3 above show the contribution to population and household growth by the regions between the last two censuses, in 2006 and 2013. Auckland alone accounts for more than half the population growth and almost 40% of the growth in the number of households.

Together the regions where Smiths City is present account for only 31% of the population growth and 39% of the dwelling growth, compared to 69% and 61% respectively for the regions where Smiths City is not currently present.

Exhibit 4 below sets out recent economic data from New Zealand's regions focused on those measures that reflect household spending and influences on purchases of furnishings and appliances, such as dwelling consents and job growth.

Exhibit 4: Regional economic trends – selected data

Region	Retail sales annual growth	EFTPOS transactions annual growth	Job ads annual growth	Dwelling approval annual growth	Consumer confidence March 2014
Auckland	6.7%	6.3%	12.9%	12.7%	126.5
Waikato	-4.3%	5.9%	9.0%	19.7%	124.3
Other regions	2.7%	5.8%	2.6%	19.5%	118.6
Non Smiths City regions	**4.0%**	**6.1%**	**10.3%**	**15.2%**	**124.6**
Canterbury	3.0%	6.9%	8.2%	47.8%	125.2
Wellington	0.9%	2.8%	11.4%	8.4%	116.8
Other regions	3.9%	7.0%	8.1%	9.3%	115.6
Smiths City regions	**2.9%**	**6.0%**	**8.9%**	**19.4%**	**118.5**
New Zealand	**3.8%**	**6.1%**	**9.6%**	**19.5%**	**121.7**

Source: ANZ Bank, ANZ Regional Trends May 2014

Exhibit 4 shows that the non-Smiths City regions have better economic conditions and higher consumer confidence than those regions with Smiths City stores. Note that the strong dwelling approval growth rate in Canterbury is due to the ongoing rebuilding of the city following the earthquakes in 2010 and 2011.

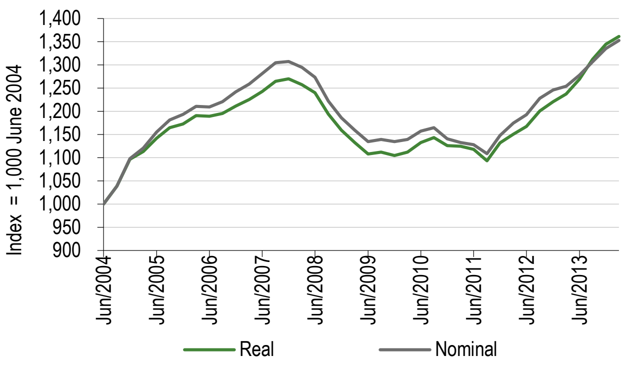
The furnishings and appliances market

The furnishings and appliance market is around NZ$4.7bn in size based on retail trade data from Statistics New Zealand to March 2014. Appliance retailing makes up 57% of the market (NZ$2.7bn), with furnishings taking the remaining 43% (NZ$2.0bn). Over the past six years the appliance market has grown at 2.2% CAGR in nominal terms, while the furnishings market has grown at 1.0% CAGR in nominal terms. In real terms the growth characteristics have been quite different. The appliance market has grown at 11.7% CAGR in real terms while the furnishings market has grown at 1.3% CAGR in real terms.

While fast growth in real terms may seem attractive, the fact that the real growth has been faster than the nominal growth reveals a considerable fall in prices of appliances and electronic goods. Appliance retailers now have to sell almost twice as much product to earn the same revenue as they did in 2008. Exhibits 5 and 6 show the price trends for furnishing and appliance stores in nominal and real terms between June 2004 and June 2014.

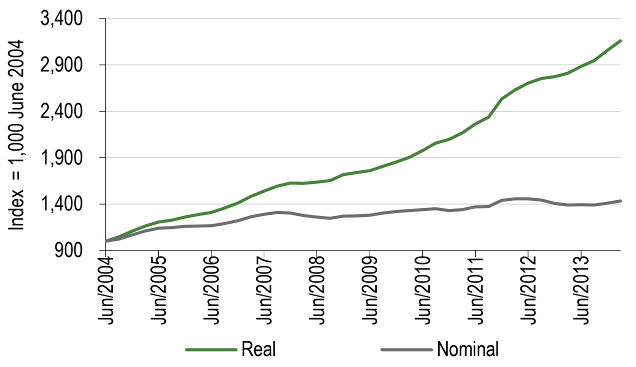
This price/volume differential between appliances and furnishings partly explains Smiths City's focus on furnishings. While it is not abandoning the appliance sector, it is not a focus of future growth at present and we do not expect the company to open any more appliance-focused stores (Powerstore/LV Martin) for the foreseeable future.

Exhibit 5: Price trend for furnishing stores



Source: Statistics New Zealand

Exhibit 6: Price trend for appliance stores



Source: Statistics New Zealand

How does Smiths City compare?

Smiths City operates in market with many competitors; however, there are only a few large national operations. The vast majority are privately held and financial data is not available. However, some of the larger operators are Australian owned, which means their financial data is publicly available from the Companies Office. Exhibit 7 shows Smiths City sales and EBITDA margin for FY13 against the competitors with disclosed financial information. In total these six companies represent just shy of 50% of the appliance and furnishings market.

Exhibit 7: Competitor data FY13

Store	Noel Leeming	Freedom Furniture NZ	Harvey Norman NZ	JB Hi-Fi NZ	Dick Smith NZ	Smiths City	Total
Sales (NZ$m)	719.5	41.9	741.4	209.4	285.6	222.5	2,220.3
EBITDA (NZ$m)	23.9	(0.9)	22.5	4.9	(13.2)	6.6	43.7
EBITDA margin	3.3%	-2.2%	3.0%	2.3%	-4.6%	3.0%	2.0%

Source: Companies Office filings

We have also compared Smiths City in more detail to its nearest and largest competitor, Harvey Norman New Zealand, a subsidiary of Harvey Norman Holdings Ltd (HVN.ASX). As Exhibit 8 shows, Harvey Norman New Zealand has sales 3.5x larger than Smiths City and EBITDA 3.4x larger. It operates through 35 stores, with eight stores in Auckland. In addition to Auckland, Harvey Norman has five other stores in locations where Smiths City is currently not present. Exhibit 8 provides some comparisons between the two companies.

Exhibit 8: Smiths City vs Harvey Norman (NZ)

FY13 data	Smiths City	Harvey Norman (NZ)
Sales growth	0.0%	5.5%
Gross margin	34.9%	31.6%
Employee expense/sales	15.1%	9.1%
EBITDA margin	3.0%	3.0%
Working capital/sales	NZ$0.12	NZ$0.10
Inventory turns (times)	3.8	5.0
Return on equity	14.0%	11.1%

Source: Companies Office filings

While Harvey Norman does generally have better performance metrics than Smiths City, a lot of this can be attributed to its larger scale (lower per unit employment costs, better inventory turns) and efficiency benefits that flow from that. Note, however, that both companies are more or less equal on EBITDA margin and Smiths City does enjoy a higher gross margin.

How to expand?

The Auckland market is somewhat over-serviced by furniture and appliance stores. However, its underlying growth rate compared to Smiths City's existing footprint still makes it an attractive market.

Smiths City has identified the northern half of the North Island for expansion. The key market is Auckland followed by the Waikato. Expanding organically into Auckland would take some years and would require the company to discount products to take market share from competitors. Efficiencies would also take time to develop, as the company would likely have to invest in a logistics/distribution centre in Auckland ahead of generating revenue to make the expansion economic. In contrast, an acquisition, if one could be made on attractive terms, could provide a faster route to the Auckland market.

We consider than an ideal acquisition would be an operator with between three to five stores and a distribution/logistics centre. This is large enough to make a difference in terms of revenue and EBITDA contribution just from the acquisition, but not so large as to require an expansion of its existing administration operations.

Potential acquisition benefits

Expansion into the Auckland market would also provide some strategic benefits to Smiths City in terms of lower costs and spreading existing costs across a larger revenue base. These include:

- **Improved logistics.** Currently Smiths City imports all its products into its Christchurch logistics centre for distribution to all its stores. While this makes sense at the moment, if the company had an Auckland presence and a logistics centre in Auckland it could reconfigure its shipments and have all of its North Island products sent to its Auckland base and all South Island products sent to its Christchurch base. This should lower unit transport costs, reduce double handling and allow it to take advantage of more competitive transport costs through greater volume.
- **More effective advertising spend.** Currently the company spends approximately NZ$10m on promotions and advertising each year, covering its current markets. If it were to move to national advertising, following establishing an Auckland presence, the increase in advertising spend would be less than the increase in population covered, thus there would be savings arising and an effective drop in the cost of promotions as a percentage of revenue.
- **More effective administration spend.** As with the discussion on advertising spend, the company would be able to spread its administration costs over a larger revenue base and thus capture scale benefits.
- **Growth in the finance book.** We would expect that Smiths City would replace any incumbent finance provider with its own finance offering. This would expand the revenue base on which financing could be provided, and also provide a benefit in terms of spreading the administration costs of the finance operation over a larger revenue base. We estimate the administration costs of the finance operation are currently running at NZ$3.3m. While the initial savings would not be great, over time this could provide a material benefit.
- **More effective internet presence.** Smiths City has developed an Internet presence. However, its effectiveness is hampered by its inability to promote its products nationally; it cannot offer a national retail presence to match its national internet presence. This hampers sales opportunities and reduces the effectiveness of its spend on internet services. It is difficult to quantify the benefits that arise from a more effective internet presence as these would largely accrue through 'at home' comparison shopping.

Scenario analysis

We have undertaken a scenario analysis to assess what an acquisition in the Auckland market would add to earnings and the valuation of Smiths City. This is a 'what if' analysis as it is not part of our forecasts or valuation.

We assume an acquisition effective from the start of FY16 with an initial turnover of NZ$20m a year and an EBITDA margin of 3%. We assume an acquisition cost of 5x EBITDA or NZ$3m funded from bank debt. Our DCF analysis assumes NZ$0.5m of scale benefits for FY16 and NZ$1.0m thereafter. We assume a higher growth rate for Auckland revenue than for the balance of the company. Our resultant DCF is 103c/share, 20c higher than our DCF valuation of the company.

Growth in the finance book

Smiths City also has an opportunity to grow its finance book independently of its own retail operations. At the end of FY14 it had 64,000 active accounts with an average balance of just NZ$1,125. The impairment charge for FY14 was NZ$0.5m or 0.7% of the total loan book.

Smiths City is bulk funded by ANZ Bank via a NZ$75m three-year facility at 3% over the 30-day bank bill rate (BBR). At 30 April 2014 the company had drawn just over NZ$60m of the facility, giving it some NZ$15m in headroom. This funding is significantly cheaper than its previous arrangements with Fisher & Paykel Finance.

Most furniture and appliance retailers offer third-party finance options to their customers, and this may provide an opportunity for Smiths City to expand its finance book into other retailers. A number of appliance/furniture retailers offer the Q-card, a finance package offered by F&P Finance, a unit of Haier Electronics Group. In its most recent annual report, F&P Finance disclosed finance receivables of NZ$382.7m, the majority of which were Q-card accounts. GE Finance & Insurance (trading as GE Money) is also active in the consumer finance space and although the company reported total receivables of NZ$1.909bn in its most recent financial statements it did not disclose a breakdown between consumer receivables and commercial receivables.

Smiths City could seek to sign up retailers currently offering the Q-card of GE Money services to its finance package or it could look to acquire a small, privately owned provider of consumer finance. There are a number of these companies in New Zealand and they are generally family owned. These companies do not take deposits directly from the public but are bulk funded by banks or other financiers.

Smiths City sees its finance operation as a key competitive advantage compared to other retailers, allowing it to capture additional margin and generate higher returns. We think expansion of the finance book will be based around offering services to other retailers, although the timing and size of any expansion is currently unknown.

Management and board

Smiths City has a board of five, including the managing director and three independent directors.

Craig Boyce, Chair. Craig was CEO of Smith City from 1990 to 1999 and has been chair since 1999. He is also a director of a number of private companies and chair of Orion Group, an energy distributor based in Christchurch.

Rick Hellings, Managing Director. Rick joined the board of Smiths City in November 1998 and was appointed CEO in May 1999. He has been involved with Smith City in various senior management roles since the mid-1980s.

Brian Lee, CFO. Brian joined Smiths City in February 2005 from a chartered accounting and consulting background. He oversees all the company's reporting, treasury and legal compliance functions.

Martin Simcock, General Manager Merchandise. Martin oversees the group's purchasing, logistics and warehousing operations as well as the commercial division. He joined the company a number of years ago as a sales person.

Stephen Salmon, General Manager Operations. Stephen recently joined Smiths City from Guthrie Bowron where he was CEO. Stephen overseas the group's store operations, its online platform and the service and installation business.

Noel MacDonald, General Manager Smithcorp Finance. Noel joined the company in 1995 and has been running the finance operations since 2008.

The company has 650 staff and a relatively flat management structure.

Sensitivities

Smiths City is exposed to a number of general risks, although it has few company-specific issues:

- **Exchange rates:** The company is exposed to exchange rates as an importer of furnishings and appliances. With a rising New Zealand dollar import costs fall, and with a falling New Zealand dollar import costs rise. However, exchange rate movements also affect its competitors, implying that the company-specific impact is limited.
- **Discretionary spending:** Furniture and appliances are discretionary purchases and can easily be deferred in many cases. The company is also exposed to areas of the country that, as a whole, are growing more slowly than those that it currently does not have a presence in, which may affect the level of discretionary spending in these areas.
- **Competitor activity:** Smiths City operates in a market with few national competitors and a large number of small competitors. Consumers are increasingly price sensitive and comparison shopping from home, thus competitor pricing and sales activity can have an impact. However, Smiths City pricing and sales strategies can also affect competitors.
- **Low barriers to entry**: There are some 3,775 furniture and appliance stores in NZ. As set out in Exhibit 7, six companies control 50% of the market, implying that there are low barriers to entry for new competitors that can be effective at the local level (say through aggressive pricing or a differentiated service offering).

Valuation

We have assessed Smiths City using a discounted cash flow valuation, with a 10-year earnings model. Exhibit 9 sets out the details of our valuation. Our valuation assumes some modest growth in revenue and margins over the forecast period, in line with the earnings profile over the past five years; however, we do not include any estimates for entry into the Auckland market.

Exhibit 9: DCF valuation

NZ$m		Valuation parameters	
Forecast period to FY24	34.8	Asset Beta	0.87
Terminal value	29.8	Equity Beta	1.55
NPV to capital	64.6	Gearing	44.5%
Net debt	20.7	WACC	9.7%
NPV to equity	43.9	Cost of equity	13.7%
		Terminal growth rate	2.0%
Value per share (NZ$)	**0.83**	**DCF return over CMP**	**69.4%**

Source: Edison Investment Research

Based on modest organic growth our valuation is still some 69% higher than the current share price, implying the company is trading at a noticeable discount to its peers.

Exhibit 10 sets out our peer valuation. We have included New Zealand retail stocks in the peer group as being generally representative of the broad retail trading conditions in New Zealand.

Exhibit 10: Peer valuation – NZ retail stocks

Company		Currency	Price (NZ$)	Market cap (NZ$m)	Market cap (US$m)	Prospective 12 month forward P/E (x)	EV/EBITDA (x)	Gross div yield	EBITDA margin	Operating margin
Smiths City Group at market	**NZ**	**NZ$**	**0.49**	**26**	**22**	**5.1**	**4.7**	**7.9%**	**4.0%**	**3.3%**
Smiths City Group at valuation	**NZ**	**NZ$**	**0.83**	**44**	**36**	**8.6**	**6.7**	**4.7%**	**4.0%**	**3.3%**
Briscoe Group	NZ	NZ$	2.85	616	513	16.6	9.4	6.3%	11.3%	9.8%
Hallenstein Glasson Holdings	NZ	NZ$	2.90	173	144	11.0	5.4	12.0%	13.3%	9.8%
Michael Hill International	NZ	NZ$	1.25	479	399	12.5	7.6	7.5%	11.5%	8.8%
Pumpkin Patch	NZ	NZ$	0.42	71	59	18.7	6.0	0.4%	7.4%	3.7%
Restaurant Brands	NZ	NZ$	3.38	331	276	16.5	7.7	7.0%	12.9%	8.3%
The Warehouse Group	NZ	NZ$	3.10	1,075	896	14.9	7.7	8.3%	6.0%	4.1%
Median, excluding Smiths City Group						**15.7**	**7.7**	**7.3%**	**11.4%**	**8.5%**
Weighted average						**14.9**	**7.8**	**7.6%**	**9.2%**	**6.8%**

Source: Bloomberg, Edison Investment Research. Note: Prices as at 25 August.

The peer valuation shows that Smiths City is trading at a significant discount to its peers on a P/E and EBITDA multiple basis. Some discount could be justified based on the company's smaller margins and scale. However, at our valuation of NZ$0.83, Smiths City would still be trading at a discount of 45.6% to the median P/E and 12.9% to the median EBITDA multiple.

Financials

Our forecasts assume that Smiths City continues its modest organic growth of the past several years without any significant expansion in store numbers or expansion into new areas. Accordingly, the scenario analysis outlined in respect of expanding into Auckland is not included in our forecasts.

We also note that Smiths City treats its finance operation as a separate business line, thus the interest and other lending income is included in the revenue and the finance costs are included in the operating costs. Only the non-finance operation interest costs are included in the interest line below EBIT, and the net debt figure does not include the finance company borrowings. This is consistent with the presentations of the company's financial accounts. We set out below our forecasts for the income statement and the balance sheet.

Exhibit 11: Earnings estimates

NZ$m	FY13	FY14	FY15e	FY16e
Retail	211.2	210.2	214.3	217.3
Finance	11.3	10.4	10.5	11.9
Revenue	**222.5**	**220.6**	**224.8**	**229.2**
Cost of Goods Sold	(148.8)	(149.5)	(150.0)	(152.1)
Gross Margin	73.7	71.1	74.8	77.1
Operating Costs	(67.3)	(64.1)	(65.9)	(67.9)
EBITDA	**6.6**	**7.0**	**8.9**	**9.1**
Depreciation	(2.8)	(1.5)	(1.5)	(1.5)
EBIT	3.8	5.5	7.4	7.6
Interest	(1.4)	(1.3)	(1.5)	(1.6)
Other Income	3.9	0.5	-	-
PBT	6.3	4.7	5.9	6.0
PBT normalised	**2.4**	**4.2**	**5.9**	**6.0**
Tax	(0.9)	(0.6)	(0.8)	(0.8)
NPAT	5.4	4.1	5.1	5.2
Gross margin	33.1%	32.2%	33.3%	33.6%
EBITDA Margin (incl finance margin)	3.0%	3.2%	4.0%	4.0%

Source: Smiths City Group, Edison Investment Research

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Exhibit 12: Financial summary

NZ$m	2011	2012	2013	2014	2015e	2016e
Year end April	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue	220.7	222.5	222.5	220.6	224.8	229.2
Cost of Sales	(153.5)	(152.4)	(148.8)	(149.5)	(150.0)	(152.1)
Gross Profit	67.2	70.1	73.7	71.1	74.8	77.1
EBITDA	6.2	7.7	6.6	7.0	8.9	9.1
Operating Profit (before amort. and except.)	3.6	5.4	3.8	5.5	7.4	7.6
Intangible Amortisation	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	(0.1)	3.9	0.0	0.0	0.0
Operating Profit	3.6	5.3	7.7	5.5	7.4	7.6
Net Interest	(1.8)	(1.4)	(1.4)	(1.3)	(1.5)	(1.6)
Profit Before Tax (norm)	1.9	4.0	2.4	4.2	5.9	6.0
Profit Before Tax (FRS 3)	1.9	3.9	6.3	4.2	5.9	6.0
Tax	0.0	0.5	(0.9)	(0.6)	(0.8)	(0.8)
Profit After Tax (norm)	1.9	4.4	5.4	3.6	5.1	5.2
Profit After Tax (FRS 3)	1.9	4.4	5.4	3.6	5.1	5.2
Average Number of Shares Outstanding (m)	52.7	52.7	52.7	52.7	52.7	52.7
EPS - normalised (c)	3.6	8.4	10.2	6.8	9.6	9.8
EPS - normalised and fully diluted (c)	3.6	8.4	10.2	6.8	9.6	9.8
EPS - (IFRS) (c)	3.6	8.4	10.2	6.8	9.6	9.8
Dividend per share (c)	0.0	3.5	3.5	3.5	3.8	4.0
Gross Margin (%)	30.4	31.5	33.1	32.2	33.3	33.6
EBITDA Margin (%)	2.8	3.5	3.0	3.2	4.0	34.0
Operating Margin (before GW and except.) (%)	1.6	2.4	1.7	2.5	3.3	3.3
BALANCE SHEET						
Fixed Assets	59.8	52.7	51.6	51.6	51.4	53.7
Intangible Assets	3.0	2.5	1.9	1.7	1.7	1.7
Tangible Assets	55.2	49.6	49.2	46.9	47.6	50.7
Investments	1.6	0.6	0.5	3.0	2.2	1.3
Current Assets	102.9	103.5	96.6	100.1	103.1	109.7
Stocks	36.2	39.9	39.0	42.4	40.3	40.9
Debtors	63.8	60.3	56.2	54.8	56.1	60.2
Cash	2.9	3.3	1.4	2.9	6.7	8.6
Other	0.0	0.0	0.0	0.0	0.0	0.0
Current Liabilities	(34.1)	(35.1)	(34.9)	(38.3)	(36.5)	(36.9)
Creditors	(26.1)	(25.5)	(22.6)	(25.8)	(24.0)	(24.4)
Short term borrowings	(8.0)	(9.6)	(12.3)	(12.5)	(12.5)	(12.5)
Long Term Liabilities	(88.3)	(84.2)	(72.9)	(70.4)	(72.0)	(77.4)
Long term borrowings	(13.1)	(9.7)	(10.1)	(10.1)	(10.1)	(10.1)
Other long term liabilities	(75.2)	(74.5)	(62.8)	(60.3)	(61.9)	(67.3)
Net Assets	40.3	36.9	40.4	43.0	46.1	49.1
CASH FLOW						
Operating Cash Flow	13.3	5.3	2.1	4.4	10.3	8.7
Net Interest	(1.8)	(1.4)	(1.4)	(1.3)	(1.5)	(1.6)
Tax	0.0	0.0	0.0	0.0	0.0	0.0
Capex	0.5	0.1	7.9	(2.5)	(2.0)	(2.0)
Acquisitions/disposals	0.0	0.0	0.0	0.0	0.0	0.0
Financing	(10.7)	(3.6)	(10.5)	2.7	(0.9)	(1.1)
Dividends	0.0	0.0	(1.8)	(2.0)	(2.0)	(2.1)
Net Cash Flow	1.3	0.4	(3.7)	1.3	3.9	1.9
Opening net debt/(cash)	25.0	18.1	16.0	21.0	19.7	15.8
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0	0.0
Other	5.6	1.7	(1.3)	(0.0)	0.0	0.0
Closing net debt/(cash)	18.1	16.0	21.0	19.7	15.8	14.0

Source: Smiths City Group, Edison investment Research

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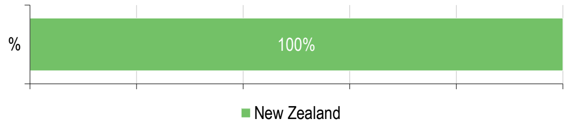
Revenue by geography



CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 12-16e	4.1%	ROCE 15e	10.3%	Gearing 15e	34.4%	Litigation/regulatory	○
EPS 14-16e	19.8%	Avg ROCE 12-16e	8.7%	Interest cover 15e	4.9x	Pensions	○
EBITDA 12-16e	4.4%	ROE 15e	11.0%	CA/CL 15e	2.9x	Currency	◖
EBITDA 14-16e	14.3%	Gross margin 15e	33.3%	Stock days 15e	65.5	Stock overhang	○
Sales 12-16e	0.7%	Operating margin 15e	3.3%	Debtor days 15e	94.7	Interest rates	◖
Sales 14-16e	1.9%	Gr mgn / Op mgn 15e	10.1x	Creditor days 15e	39.0	Oil/commodity prices	○

Management team

Managing Director: Rick Hellings

Rick has over 25 years' experience in the retail sector and was appointed to the board in 1998, and as CEO in May 1999. He has been employed by Smiths City since 1991.

CFO: Brian Lee

Brian joined the company in 2005 from a career in charted accountancy and consulting. He oversees the financial reporting, treasury and legal compliance aspects of the company.

General Manager Merchandise: Martin Simcock

Martin oversees the company's suppliers, purchasing, logistics and warehousing operations, along with the group's commercial division.

General Manager Operations: Stephen Salmon

Stephen recently joined the company from Guthrie Bowron, where he was CEO. He oversees all the store operations, the online platform and the company's service and installation business.

Principal shareholders	(%)
Donald M Campbell	18.3
Utilico Investments Ltd	13.6
Douglas Carrick Belton	8.9
Rick Hellings (Managing Director)	5.5
Paradise Finance Ltd	5.0
Craig Boyce (Chairman)	3.1
Garrett Smythe Ltd	2.1

Companies named in this report

The Warehouse Group Ltd (WHS.NZ), Harvey Norman Holdings Ltd (HVN.AU), Hellaby Holdings Ltd (HBY.NZ), Haier Electronics Group (1193.HK), General Electric (GE.US)

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