Pepco Group N.V.

CEE Equity Research

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Plenty of growth still ahead

Pepco Group is a pan-European variety discount retailer with the goal of being the leader in its field in Europe. It operated 3,021 stores in FY20 in 15 European countries under three retail brands: Pepco and Poundland/Dealz (P/D), with the majority of sourcing integrated into its subsidiary Pepco Global Sourcing (PGS). We see the Pepco Group's equity story as appealing from the perspective of growth, quality and return potential. Firstly, taking into account opportunities regarding (1) further store chain roll-out, not only in CEE but also in Western Europe, (2) LFL growth enhancement, and (3) operating efficiencies. We forecast Pepco Group's 2020-23E CAGR of sales and underlying pre-lease EBITDA at 14%/34%, respectively. We also believe that it should be a beneficiary of a post Covid-19 world characterised by discounters' continued market share growth in retail. Secondly, we see the high quality of its self-financing business model proved by a high ROIC of 32% on average in 2021-23E and low indebtedness. Last but not least, Pepco Group plans to start dividend payments from 2022E, which we assume at EUR64mn (DPR at 40%).

Financial forecast. We expect Pepco Group's sales to grow at a 2020-23E CAGR of 14.2%. We assume that Pepco should remain the driving force of this growth, with its sales rising at a healthy 2020-23E CAGR of 17.9%. Poundland/Dealz is likely to grow at 2020-23E CAGR of 10.4%. In 2021E we expect the underlying pre-lease EBITDA margin of Pepco Group to return close to its pre-pandemic level (9.8%) due to the positive effect of operating leverage and operating cost savings initiatives. We expect both Pepco and P/D to record an underlying pre-lease EBITDA margin in 2021E of 15.8% (vs. pre-pandemic 16.8% in 2019) and 3.2% (vs. pre-pandemic 3.3% in 2019) respectively.

Online: Due to the still-unattractive basket economics, online expansion has remained nascent in discount/value retail so far. According to the company's surveys, customers have not shown major interest in its offer going online for now. However, Pepco Group is constantly observing the development of the prevailing shift to online and is ready to take action if needed.

Risks. We see a prolonged Covid-19 pandemic as the major risk to our forecasts. Other risks we see are: (1) further growth of online competition, (2) slower rollout of new stores, (3) increased competition from other discounters, (4) wage pressure, (5) introduction of retail taxes locally in CEE and (6) risk of potential share overhang from parent company.

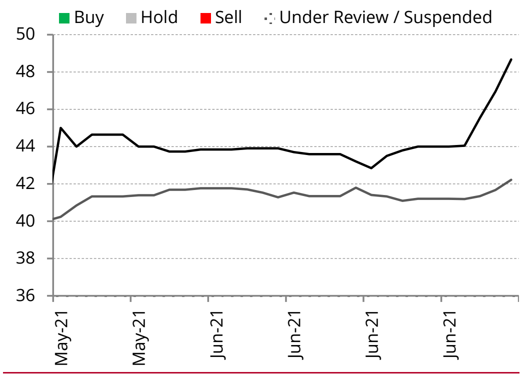
Valuation. We value Pepco Group share at PLN61.1 based on the DCF model (PLN75.4/share, 50% weight) and multiple valuation (PLN46.8/share, 50% weight).

Pepco Group: Financial summary*

EURmn	2018	2019	2020	2021E	2022E	2023E
Sales	3,045	3,415	3,518	4,080	4,617	5,240
Adj. EBITDA (pre lease)	277	333	230	395	472	555
Adj. EBIT	219	255	152	295	355	421
Adj. NP (pre leas lease)	109	149	64	216	271	323
P/E (x)	54.4	40.0	92.8	27.5	22.0	18.4
EV/EBITDA (x)	23.6	19.3	27.3	15.6	12.8	10.6
DY	0.0%	0.0%	0.0%	0.0%	0.2%	0.3%

*Source: Company data, Santander Brokerage Poland estimates, * post IFRS16, adj. by one-off items*

Recommendation	Buy
Portfolio weighting	-
Price (PLN, 23 June 2021)	46.95
Target price (PLN, 12M)	61.1
Market cap. (PLNmn)	26,191
Free float (%)	17.0
Number of shares (mn)	575
Average daily turnover 3M (mn)	1.0
USDPLN	3.79



The chart measures performance against the WIG index.

Main shareholders	% of votes
Pepco Holdco Ltd.	83.0
Free float	17.0

Source: stooq.pl

Company description

Pepco Group is a pan-European variety discount retailer operating under Pepco and Poundland/Dealz brands.

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Investment summary

Pepco Group: pan-European variety discount retailer

Pepco´s goal is to be the leading discounter in Europe. The group serves budget customers with their top-up needs (small, regular shops without charging more for convenience). Pepco Group operated 3,021 stores in 2020 (end of September 2020) in 15 European countries under three retail brands: Pepco and Poundland/Dealz, while the majority of sourcing was integrated in its subsidiary Pepco Global Sourcing (PGS). Its stores served c.50mn customers/month in pre COVID-19 LTM to February 2020. Group sales have been growing at a 2018-20 CAGR of 8.2% (21.9% for Pepco and -0.7% for P/D) to reach EUR3.5bn in 2020. In pre COVID-19 years, sales were growing at a 12% CAGR (from October 2017 to February 2020). The number of stores has been growing at a 2018-20 CAGR of 13.1%. Pepco Group operates across the three major retail categories of fast moving consumer goods (FMCG) (34% of sales), general merchandise (GM) (34%) and apparel (32%).

Pepco (49% of sales in 2020) is the CEE's leading non-food discount retailer with a multi-price customer offer, led by apparel (57% of sales), home decor, toys and seasonal products (43%). It operated 2,100 stores as at September 2020 with 350-550 sqm retail floor area per store across 11 countries in Central and Eastern Europe (CEE), Serbia and recently entered the Italian market.

Poundland Group (51% of sales in FY20) comprises **Poundland** in the UK and its international brand **Dealz**, which are mainly FMCG-led (66% of sales) retailers with a price architecture historically anchored at a single price point. Poundland operated 756 stores in 2020, while Dealz (introduced in 2011) operated 165 stores in the Republic of Ireland, Spain and Poland. Store retail floor areas range between 400 - 1,000 sqm for Poundland and Dealz.

Low priced products based on buying and operating style

The company's everyday business is solely based on a strong commitment to discount retail basics, namely effective buying and operations and understanding customers. Pepco Group enjoys a scale advantage over its closest competitors in many markets where it is present, which also plays an important role in buying. Constant growth has increased Pepco Group's scale advantage. Well-known brands (especially Pepco in CEE) and a high share of own brands (over 95% in Pepco and very high in non-FMCG Poundland / Dealz) also play a role.

Pepco Group targets EUR1bn EBITDA in the next 5-7 years …

… with (1) strong discount retail basics and (2) strategic opportunities like: a large and growing market to tap into, store chain rollout, LFL growth improvement and operating cost efficiencies.

Large and growing market to tap into

Pepco Group's total available market (TAM) was valued at EUR130bn in 2019 (EUR96bn for Apparel & GM and EUR34bn for Grocery). Discount Apparel & GM markets for Pepco Group were worth EUR26bn in 2019 and are projected to grow at a 2019-25E CAGR of 4.4% to EUR34bn, according to independent consultancy OC&C. Other European markets that Pepco Group plans to exploit were worth EUR70bn last year and are set to grow at a 2019-25E CAGR of 2.8% to EUR83bn, according to OC&C. Existing grocery markets (mainly for Poundland/Dealz) were worth EUR8bn in 2019 and are projected to grow at a 2019-25E CAGR of 3.2% to EUR10bn, according to OC&C. Other European markets that Pepco Group plans to exploit in the mid-/long term were valued at EUR26bn in 2019 and are projected to grow at a 2019-25E CAGR of 2.9% to EUR30bn. Both existing and new potential markets make up a TAM of EUR40bn by 2025E, according to OC&C.

As well as the growth of Pepco Group's TAMs, we see (1) further catch-up potential of penetration of Pepco Group's TAM in total retail in CEE compared to Western European markets (difference was 6pp in 2019 vs. 11pp in 2017); and (2) a continued increase in discounters' market share at the cost of hyper/supermarket retailers as the most supportive growth themes for the company in the medium term. Indeed, slower projected European GDP growth rate in the coming years vs. 2015-19 might result in consumers being more willing to look for value for money in discounters' offerings.

Store chain rollout

Pepco Group had 3,021 stores as at the end of September 2020 and believes that it has the potential to roll out both the Pepco & Poundland/Dealz brands over the next two decades to reach c.11,100 stores in existing and prioritized new markets. Following an independent (validated by OC&C and excluding Pepco Spain & Italy) market/catchment analysis, the company identified the potential for 8,188 Pepco stores in the long term (vs. 2,100 now) and 2,927 Poundland/Dealz stores (vs. 921 now). Moreover, prolonging the target for payback of capex for store opening to 36 months from 30 might give the ability for an additional 158 potential stores in Poland, while applying Poland store density expectations to other CEE would give an additional 1.4k potential stores.

Pepco Group has identified 2,856 potential new stores for Pepco and 5,134 for Dealz across other CEE and WE markets: Ukraine, Belgium, Finland, Luxembourg, Netherlands, Denmark, Norway, Sweden, Switzerland, Turkey (for Pepco); and Ukraine, Germany, Belgium, Italy, the Netherlands, Sweden, Turkey, Austria and Others (for Dealz).

Same-store sales growth improvement

Pepco has historically delivered solid growth on a LFL basis amounting to 9.1% on average in 2011-20. The company continues to work on enhancing the customer proposition to add to its store sales growth. Over recent years, its general merchandise offer has been improved to raise stores' attractiveness and after successful trials, the company plans to rebalance trading space in 400-500 stores per annum to dedicate 40% space to GM, up from the current c.36%. Store format enhancement might deliver an additional c.3% to LFL with EUR6k investment per store with a c.8 month payback, according to the company.

With regards to Poundland, its LFL growth averaged 1.8% in 2017-19. Poundland enjoys the highest visit frequency vs. competitors in UK and scores strongly on key purchasing criteria, however it has a lower than average transaction value, according to the company. To tap into this potential it has introduced a category expansion programme to improve LFL growth such as: (1) the development of a Pep&Co clothing range in large Poundland stores through 330 “shop-in-shops”, (2) introducing a greater range of chilled and frozen food following a trial in ten stores, which has been rolled out to c.120 stores to date; further rollout potential in c.250-350 UK stores in the next two financial years, and (3) continued expansion of the Pep&Co brand in homewares.

Also, continuation of multi-price expansion (30% penetration currently) in Poundland/Dealz is planned. Historically, the majority of products within Poundland and Dealz remained at a core anchor price (£1 in the UK). Recently, Poundland and Dealz have expanded the number of price points in a response to rising demand for such a move from customers. P/D internal estimates suggest that expansion might give access to additional consumer expenditure of EUR4bn to already existing core categories as it increases addressable market to 70% in total FMCG&GM. Current penetration of multi-price is at 30% of sales in 1Q21 (+14pp y/y). Improved store format, category expansion and multi-price usually result in c.5% higher LFL growth after store refit, according to the company.

Operating costs improvement

Pepco Group is also introducing an operating costs optimization programme for both Pepco and Poundland. In Poundland, it involves: (1) optimisation of retail property rental costs (a cost reduction opportunity of c. GBP20mn), (2) reduction of shrinkage costs (a possible cost reduction of c. EUR28mn in three years) and (3) streamlining the supply chain (GBP2.5mn/year possible cost reduction by the end of the programme, according to the company). Pepco has also completed a detailed assessment of end-to-end supply chain improvements through better stock in distribution centres (DC) and product flow to store. Moreover, the company sees operating efficiency improvements in the store plan, buying, product movements and store selling.

New channel opportunities - online

So far online expansion remains nascent in discount/value retail and is limited to a product catalogue search engine mainly due to the still-unattractive basket economics that are unable to cover logistics costs in home delivery or click & collect costs. Currently, Pepco Group’s customers show no interest in its offer going online, according to the company’s surveys. On the other hand, Pepco Group is constantly observing the shift to online and is undertaking low scale trials in order to better understand the challenges of an online offer. It uses online platforms and social media to engage with customers including shopping list trials in Dealz Spain, brands promotion and digital advertising. Moreover, the company has undertaken trials of home delivery, own platform and C+C lockers with InPost in Poundland/Dealz, and home delivery and outsourced platform trials in a limited range for Pepco.

Potential beneficiary of post COVID-19 world

COVID-19 initially emerged as a potential supply issue in February 2020, which then quickly turned out to be a serious demand side issue for all retail group brands. As a non-essential goods retailer, the Pepco brand took the largest hit as its sales dropped to just c.15% of expected sales levels following the introduction of lockdown in March. Poundland, as an essential goods retailer, had an initial boost from stockpiling demand, however 130 stores out of 830 in that period were closed, while c.700 stores faced reduced traffic. Poundland recorded c.60% of expected sales levels in that period. The group's LFL sales declined by 3.5% and 21% in 2Q20 and 3Q20 (Jan-August 2020) and rebounded to 1.7% in 4Q20. LFL rebounded after closure periods, with trading stores recording a +5.5% LFL in 1Q21.

Pepco Group broke down its response to the current environment into three stages: (1) "Lockdown" with a focus on cash & safety, (2) "recovery" with a focus on optimizing trading stores and proper inventory management, and (3) the "new normal," namely a redefinition of its business model to make it flexible in relation to potential further volatility.

In our view, Pepco Group might be a beneficiary in a new post COVID-19 world as we believe (1) discounters should continue winning market share from other formats, and Pepco Group's (2) brands' resilience, (3) scale and (4) operating cost enhancement and working capital improvement should be permanent. Despite the COVID-19 setbacks, Pepco Group has not stopped its rollout of net 327 stores openings in 2020 (vs. 339 in 2019) and continued infrastructure projects such as the Enterprise resource planning software and the Distribution Centre in Hungary.

Financial forecasts

We expect that Pepco Group's sales should grow at 2020-23E CAGR of 14.2%, taking into account the predicted rebound after the COVID-19 pandemic. We assume that Pepco should remain the driving force increasing sales at a healthy 2020-23E CAGR of 17.9%. We expect P/D to grow at 2020-23E CAGR of 10.4%. We expect that Pepco Group's store park should grow at a 2020-23E CAGR of 13.1%, reflecting both Pepco's and mainly Dealz's growth in the number of stores. With regards to LFL growth, we expect 6.0%/5.0%/5.0% in Pepco and 2.0%/2.5%/2.5% in 2021-23E.

In 2021E we expect underlying the pre-lease EBITDA margin of Pepco Group to return close to its pre-pandemic level of 9.8% thanks to the positive effect of operating leverage and operating cost savings initiatives. We expect both Pepco and P/D to record underlying pre-lease EBITDA margin in 2021E of 15.8% (vs. pre-pandemic 16.8% in 2019 and 11.5% in 2020) and 3.2% (vs. pre-pandemic 3.3% in 2019 and 1.7% in 2020). The group's underlying pre-lease EBITDA margin should also be supported by a better sales structure with a bigger share of higher Pepco's margins. Pepco's share in total revenues is expected by us to increase to 52% in 2021E from 48% in 2019. In the medium term, we expect Pepco's underlying pre-lease EBITDA to rise to 17.2% in 2025E mainly on positive effects of operating leverage resulting from 5% same stores sales growth. With regards to P/D, we think that the reduction of shrinkage and operating cost savings initiatives (mainly logistics) should lead to further improvement of the underlying pre-lease EBITDA margin to 3.7% by 2025E. With regards to underlying net profit (post-IFRS16), we expect it to rebound above the pre-pandemic level (4.6%) in 2021E, which implies underlying net profit (post-IFRS16) at EUR188mn, EUR240mn and EUR289mn in 2021-23E, respectively.

Risks

Apart from this, we see (1) prolonged Covid-19 pandemic, (2) further growth of online share growth, (3) slower rollout of new stores, (4) increased competitiveness from other discounters, (5) wage pressure, (6) introduction of retail taxes locally in CEE and (7) risk of share overhang from parent company as the main risks to our forecasts. For more on risks please page 56.

We see the owner risk, namely Steinhoff International Holdings, as a limited to the story. Pepco Group is operating as a completely separate entity from an operational and legal standpoint, while the Independent Investigation Summary Report concluded that no entity or manager in the Pepco Group was connected to the irregularities.

Valuation

We set TP at PLN61.1 based on our DCF model (PLN75.4/share, 50% weight) and multiple valuation (PLN46.8/share, 50% weight).

Fig. 1. Pepco Group: Valuation summary

PLN/share	New	Previous	Change.
DCF	75.4	n.a.	n.a.
Multiple (based on 2022E)	46.8	n.a.	n.a.
Target Price	**61.1**	**n.a.**	**n.a.**

Source: Santander Brokerage Poland estimates, DCF/multiple valuation weights at 50%/50%

DCF

Below we discuss in brief the foundations of our DCF model:

Sales: We expect that Pepco Group's sales should grow at 2020-23E CAGR of 14.2% taking into account a rebound after the Covid-19 pandemic. Pepco should remain the driving force, growing its sales at a healthy 2020-23E CAGR of 17.9%, while P/D is likely to grow at 2020-23E CAGR of 10.4%. We expect Pepco Group's store park to grow at a 2020-23E CAGR of 13.1% reflecting both Pepco and Dealz's store growth expected by the company in guidance. With regards to LFL growth, we expect it at 6.0%/5.0%/5.0% in Pepco and 2.0%/2.5%/2.5% in P/D in 2021-23E.

Costs & margins: We expect the underlying pre-lease EBITDA margin of Pepco Group in 2021E to return close (9.7%) to the pre-pandemic level 9.8% due to the positive effect of operating leverage and operating cost savings initiatives. We expect both Pepco and P/D to record 2021E underlying pre-lease EBITDA margin at 15.8% (vs. pre-pandemic 16.8% in 2019 and 11.5% in 2020) and 3.2% (vs. pre-pandemic 3.3% in 2019 and 1.7% in 2020) respectively. In the medium term, we expect improving underlying pre-lease EBITDA in Pepco of 17.2% in 2025E mainly from the positive effects of operating leverage resulting from 5% same-store sales growth. With regards to P/D, we think that both the reduction of shrinkage and operating cost savings initiatives (mainly logistics) undertaken by the company should lead to further improvement of underlying pre-lease EBITDA margin to 3.7% by 2025E.

Working Capital: We do not expect any major working capital changes in the foreseeable future. We assume that rising trade payables should generally finance increasing inventories in line with Pepco Group's scale.

Capex: should be mainly driven by store roll-out (EUR109mn/EUR97mn/EUR109mn in 2021-23E). The remaining capex amounts of EUR139mn/EUR83mn/EUR88mn should be spent on maintenance, remodelling, warehouse and IT, according to our estimates.

Tax: We use 24% tax rate in 2021E and 21% beyond.

We use **a terminal growth rate** for FCF of 2.5% taking into account continued store chain rollout opportunities for Pepco Group beyond the DCF period.

In our DCF analysis we use 2020's net debt figure of EUR328mn.

Our **WACC** of 8.0% includes 8.7% cost of equity, 2.8% risk-free rate (LT average of 10Y Polish government yield), 5.3% equity risk premium (7Y average; ERP calculated as the difference between an earnings yield on WIG index and 10Y Polish government debt coupon), 1.0 unlevered beta and a D/E ratio of 14%.

Fig. 2. Pepco Group: WACC calculation

Risk-free rate	2.8%
Unlevered beta	1.0
Levered beta	1.1
Equity risk premium	5.3%
Cost of equity	**8.7%**
Risk-free rate	2.8%
Debt risk premium	1.0%
Tax rate	19%
After tax cost of debt	**3.1%**
%D	12%
%E	88%
WACC	**8.0%**

Source: Santander Brokerage Poland estimates

Fig. 3. Pepco Group: DCF analysis

EURmn	2021E	2022E	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Revenue	**4,080**	**4,617**	**5,240**	**5,895**	**6,584**	**7,310**	**8,077**	**8,714**	**9,388**	**10,102**
Underlying EBITDA*	395	472	555	648	745	842	948	1,023	1,096	1,171
Underlying EBIT*	280	339	402	485	569	655	750	816	876	939
tax	67	71	84	102	119	138	158	171	184	197
NOPAT	**213**	**267**	**318**	**383**	**450**	**518**	**593**	**644**	**692**	**742**
D&A	115	133	153	163	176	187	198	207	219	232
WC	0	-5	-6	-8	-9	-11	-12	-4	-4	-5
Capex	-198	-181	-197	-202	-255	-214	-219	-184	-251	-258
FCF	**130**	**215**	**268**	**337**	**362**	**480**	**559**	**663**	**656**	**711**
WACC	8.0%									
PV FCF 2021-30E	2,655									
Terminal growth	2.5%									
Terminal Value (TV)	13,229									
PV TV	6,122									
Total EV	**8,777**									
Net debt	328									
Equity Value	**8,449**									
Month	6									
Current Equity Value (EUR)	**8,787**									
EURPLN	4.5									
Current Equity Value (PLN)	**39,885**									
number of shares (mn)	575									
Current value per share (PLN)	69.4									
12M Target Price (PLN)	**75.4**									
Sales growth	16.0%	13.2%	13.5%	12.5%	11.7%	11.0%	10.5%	7.9%	7.7%	7.6%
EBITDA growth	72.2%	19.4%	17.6%	16.7%	14.9%	13.0%	12.6%	7.9%	7.1%	6.9%
NOPAT growth	101.4%	25.7%	18.8%	20.6%	17.3%	15.2%	14.5%	8.7%	7.4%	7.2%
FCF growth	-45.3%	65.3%	24.5%	25.6%	7.5%	32.7%	16.3%	18.7%	-1.0%	8.3%
EBITDA margin	9.7%	10.2%	10.6%	11.0%	11.3%	11.5%	11.7%	11.7%	11.7%	11.6%
NOPAT margin	5.2%	5.8%	6.1%	6.5%	6.8%	7.1%	7.3%	7.4%	7.4%	7.3%
Capex/Revenues	-4.8%	-3.9%	-3.8%	-3.4%	-3.9%	-2.9%	-2.7%	-2.1%	-2.7%	-2.6%
Change in WC/Revenues	0.0%	-0.1%	-0.1%	-0.1%	-0.1%	-0.1%	-0.2%	0.0%	0.0%	0.0%

*Source: Company data, Santander Brokerage Poland estimates, * Underlying pre-lease EBITDA and EBIT*

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Fig. 4. Pepco Group: Valuation sensitivity matrix (PLN/share)

	Terminal growth rate						
WACC	**2.2%**	**2.3%**	**2.4%**	**2.5%**	**2.6%**	**2.7%**	**2.8%**
7.7%	77.1	78.2	79.3	80.5	81.7	83.0	84.3
7.8%	75.5	76.5	77.6	78.7	79.9	81.1	82.4
7.9%	73.9	74.9	76.0	77.0	78.1	79.3	80.5
8.0%	72.4	73.4	74.4	**75.4**	76.5	77.6	78.7
8.1%	71.0	71.9	72.9	73.8	74.9	75.9	77.0
8.2%	69.6	70.5	71.4	72.3	73.3	74.3	75.4
8.3%	68.2	69.1	70.0	70.9	71.8	72.8	73.8

Source: Santander Brokerage Poland estimates

Fig. 5. Pepco Group: Valuation sensitivity matrix, percentage change

	Terminal growth rate						
WACC	**2.2%**	**2.3%**	**2.4%**	**2.5%**	**2.6%**	**2.7%**	**2.8%**
7.7%	2%	4%	5%	7%	8%	10%	12%
7.8%	0%	1%	3%	4%	6%	8%	9%
7.9%	-2%	-1%	1%	2%	4%	5%	7%
8.0%	-4%	-3%	-1%	**0%**	1%	3%	4%
8.1%	-6%	-5%	-3%	-2%	-1%	1%	2%
8.2%	-8%	-7%	-5%	-4%	-3%	-1%	0%
8.3%	-9%	-8%	-7%	-6%	-5%	-4%	-2%

Source: Santander Brokerage Poland estimates

Multiple valuation

We value Pepco Group with a SOTP valuation based on target 2022E adj. pre lease EV/EBITDA for both the Pepco and P/D businesses, which yields a target price of PLN46.8 per share.

We value Pepco against successful tier 1 CEE retailers, like LPP and Dino, as Pepco already has a successful CEE business and has started to expand in Western European markets. We set our target 2022E adj. pre lease EV/EBITDA at 14.1x, which is in line with the average 2022E pre lease EV/EBITDA for LPP and Dino. Comparing the growth of Pepco to CEE peers, we would expect Pepco to grow faster than Dino but slower than LPP, as measured by 2020-2023E CAGR; however please note the low base for Pepco and LPP as Dino has not been impacted by the pandemic. On the other hand, looking at Covid-19 adjusted growth measured by 2019-23E CAGR, Pepco fares worse than Dino (15% vs. Dino's 28%) and better than LPP (15% vs. LPP's 10%) in terms of sales growth. In terms of pre lease EBITDA growth, Pepco fares also worse than Dino (15% vs. Dino's 31%) and better than LPP (15% vs. LPP's 12%). In this light, we think Pepco deserves a premium over LPP, but a discount to Dino. We value Pepco's EV (before debt allocation) at EUR5.7bn. As a sanity check, we note that our 14.1x target 2022E pre-lease EV/EBITDA is also roughly in line (4% premium) with international peers (Dollar, Five Below, B&M, Lojas Am., Dollarama and Fix Price), which we think are the most comparable to Pepco.

In our valuation methodology we treat P/D as an underperforming retail business but with an opportunity to rebound. For valuation purposes, we use a 2022E pre lease EV/EBITDA multiple of 5.5x, which is line with 2022E pre lease EV/EBITDA for Tesco using Bloomberg consensus estimates. We note that our valuation does not reflect the rerating opportunity likely resulting from better than expected positive effects of ongoing restructuring. We value P/D's EV (before debt allocation) at EUR383mn.

Fig. 6. Pepco Group: Multiple valuation

	Target multiple	2022E	Description
Pepco (pre lease EBITDA)		402	
EV	14.1x 2022E EBITDA	5,674	In line with avg. 2022E EV/EBITDA (pre lease) for LPP & Dino
P/D (pre lease EBITDA)		70	
EV	5.5x 2022E EBITDA	383	In line with 2022E EV/EBITDA (pre lease) for Tesco
Enterprise value		**6,057**	
(-) net debt (cash)		79	
Equity Value (EURmn)		**5,978**	
EURPLN		4.5	
Equity Value (PLNmn)		**26,902**	
no. of shares		575.0	
Target Price (PLN)		**46.8**	

Source: Santander Brokerage Poland estimates

Fig. 7. Pepco Group: Peer group selection – P/E and EV/EBITDA ratios

		mkt.cap.		P/E			EV/EBITDA*	
Name	Price	(USD)	2021E	2022E	2023E	2021E	2022E	2023E
DOLLAR GE	215	50,746	21.0	19.1	17.3	13.8	12.9	12.0
FIVE BELOW	193	10,804	40.6	34.6	28.5	23.7	19.9	16.3
B&M	555	7,745	16.7	15.5	14.2	13.6	12.2	11.7
DOLLARAMA	58	14,263	26.7	22.2	17.6	15.2	13.5	12.1
FIX PRICE	9	7,761	23.5	18.3	14.4	15.3	12.3	9.7
LOJAS AMERIC	22	8,127	65.8	49.8	53.5	13.5	10.7	10.1
LPP	11,510	5,626	30.3	26.3	22.1	14.5	12.5	10.5
DINO POLSKA	275	7,114	30.3	24.4	19.1	19.7	15.8	12.2
JERONIMO	16	11,758	24.1	20.9	19.0	8.7	7.8	7.1
TESCO	224	24,163	12.2	11.1	10.6	5.8	5.5	5.3
Median			**25.4**	**21.6**	**18.3**	**14.1**	**12.4**	**11.1**
Average			**29.1**	**24.2**	**21.6**	**14.4**	**12.3**	**10.7**
Pepco Group	47	6,911	27.5	22.0	18.4	15.6	12.8	10.6
disc.toavg.**			-9%	-14%	-11%	-9%	-10%	-7%

*Source: Bloomberg, Santander Brokerage Poland estimates, * pre lease, ** avg. multiple for LPP & Dino, pricing date at 22 June 2021*

Fig. 8. Pepco Group: Profitability comparison vs. peers

		Gross margin			EBITDA margin			Net margin			ND/ EBITDA	
	2021E	2022E	2023E	2021E	2022E	2023E	2021E	2022E	2023E	21E	22E	23E
DOLLAR	36.0%	36.1%	36.2%	11.4%	11.3%	11.3%	7.1%	7.0%	7.1%	0.9	0.8	0.4
FIVE BELOW	43.0%	43.1%	44.7%	15.5%	15.6%	16.6%	9.4%	9.4%	9.6%	-0.3	-0.3	-0.5
B&M	35.1%	34.8%	35.4%	14.3%	14.2%	13.7%	6.8%	6.8%	7.0%	1.8	1.8	1.5
DOLLARAMA	27.6%	28.0%	28.4%	28.8%	29.7%	31.0%	14.9%	15.9%	17.4%	1.9	1.6	n.a.
FIX PRICE	n.a.	n.a.	n.a.	19.2%	18.9%	19.3%	10.1%	10.4%	10.8%	0.3	0.2	0.1
LOJAS	21.8%	21.8%	21.8%	13.5%	13.5%	13.7%	2.1%	2.7%	2.8%	-0.1	-0.3	-0.2
LPP	54.8%	54.8%	54.8%	12.9%	13.0%	13.4%	6.1%	6.2%	6.6%	0.1	-0.2	-0.4
DINO	26.2%	26.2%	26.2%	10.7%	10.4%	10.4%	6.8%	6.7%	6.9%	0.4	-0.1	-0.5
JERONIMO	25.9%	26.0%	26.0%	7.5%	7.7%	7.7%	2.0%	2.2%	2.2%	0.4	0.3	0.3
TESCO	4.4%	4.3%	4.2%	7.1%	7.3%	7.4%	2.4%	2.6%	2.7%	2.6	2.3	2.3
median	**27.6%**	**28.0%**	**28.4%**	**13.2%**	**13.2%**	**13.5%**	**6.8%**	**6.8%**	**7.0%**	**0.4**	**0.3**	**0.1**
average	**30.5%**	**30.6%**	**30.9%**	**14.1%**	**14.2%**	**14.4%**	**6.8%**	**7.0%**	**7.3%**	**0.8**	**0.6**	**0.3**
Group	42.0%	42.1%	42.3%	9.7%	10.2%	10.6%	4.6%	5.2%	5.5%	n.a.	n.a.	n.a.
Pepco	46.2%	46.0%	46.1%	15.8%	16.3%	16.7%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
P/D	37.5%	37.6%	37.7%	3.2%	3.2%	3.4%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Bloomberg, Santander Brokerage Poland estimates

Fig. 9. Pepco Group: Growth comparison vs. peers

	Sales CAGR'20/23E	EBITDA CAGR'20/23E	net profit CAGR'20/23E	ROE (%) 2021E	2022E	2023E
DOLLAR	5.3%	-6.8%	4.8%	35.5%	37.3%	36.9%
FIVE BELOW	25.1%	17.2%	45.8%	26.3%	26.0%	26.5%
B&M	4.9%	-3.6%	-3.1%	40.5%	49.6%	66.9%
DOLLARAMA	8.0%	11.9%	21.2%	n.a.	n.a.	n.a.
FIX PRICE	24.4%	24.3%	411.4%	n.a.	n.a.	n.a.
LOJAS	16.7%	14.9%	21.8%	5.8%	7.7%	6.0%
LPP	22.4%	46.9%	97.6%	31.6%	34.6%	34.5%
DINO	26.5%	27.1%	29.9%	32.8%	29.7%	28.4%
JERONIMO	6.0%	8.0%	18.2%	18.1%	19.6%	19.3%
TESCO	1.8%	8.9%	-30.8%	9.8%	10.1%	10.1%
Median	**12.3%**	**13.4%**	**21.5%**	**28.9%**	**27.9%**	**27.5%**
Average	**14.1%**	**14.9%**	**61.7%**	**25.1%**	**26.8%**	**28.6%**
Group	14.2%	34.3%	109.2%	22.7%	24.2%	24.8%
Pepco	17.9%	33.4%	n.a.	n.a.	n.a.	n.a.
P/D	10.4%	39.9%	n.a.	n.a.	n.a.	n.a.

Source: Bloomberg, Santander Brokerage Poland estimates

Key comparable companies

Dollar General

Dollar General Corporation is a U.S.-based discount retailer. The company offers a broad selection of merchandise led mainly by food and including seasonal, home products and apparel. Dollar General offers a standard online product sales system with courier shipping to the customer's address. Stores are located mostly in rural areas of the southern, south-western, mid-western, and eastern United States. As at 14 November 2020, Dollar General Corporation operated 17,000 stores in 46 American states. Below, we present the key financial and factual metrics of Dollar General Corp.

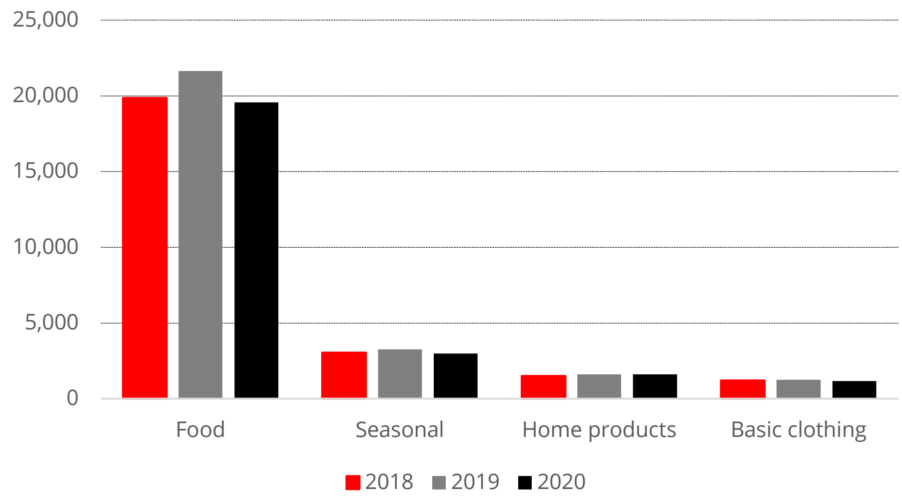
Putting aside the fact that Dollar GE and Pepco Group might be difficult to compare on an apples-to-apples basis due to the former's higher exposure to food retailing (77% vs. 34% in Pepco Group), we note that Pepco Group's sales were growing at a similar rate in 2018 (9.6% vs. 9.2% in Dollar), while faster in 2019 (12.2% vs. 8.3% in Dollar). As an essential goods retailer, Dollar's sales performed better during the pandemic outbreak. Pepco Group's 2018-20 average gross sales (41.6% vs. 30.9% in Dollar) and EBITDA margin (11.9% vs. 10.8% in Dollar) were stronger than the US comparator's. ROIC of Pepco Group was also better, while financial leverage was at a similar level. With regards to forecasts by 2023E, using Bloomberg consensus, Dollar GE's sales and profits are expected to noticeably underperform those of Pepco Group (low single-digit growth of sales coupled with declining profits from record levels in 2020 vs. double-digit growth in Pepco Group).

Fig. 10. Dollar General: Key financial metrics

(USDmn)	2018	2019	1-3Q 2020
Sales	25,625	27,754	25,332
LFL	3.2%	3.9%	17.6%
Gross profit	7,804	8,489	7,982
Opex	5,688	6,156	5,300
Profit on sales	2,116	2,333	2,683
Other op. Profit	0	0	0
EBIT	2,116	2,333	2,683
D&A	454	505	424
EBITDA	2,570	2,838	3,107
Financials, net	-101	-101	-110
PBT	2,015	2,233	2,572
Tax	426	496	560
Net profit	1,589	1,737	2,012
Margins			
Gross margin	30.5%	30.6%	31.5%
EBIT margin	8.3%	8.4%	10.6%
EBITDA margin	10.0%	10.2%	12.3%
Tax rate	21.1%	22.2%	21.8%
Net margin	6.2%	6.3%	7.9%
Growth*			
Sales	9.2%	8.3%	23.0%
EBITDA	6.6%	10.4%	57.0%
net profit	29.0%	9.3%	68.0%
net debt (pre lease)	2,627	2,671	1,932
net debt/EBITDA	1.02	0.94	0.62
Cash conversion	1.29	1.28	1.09
ROIC	16%	17%	18%

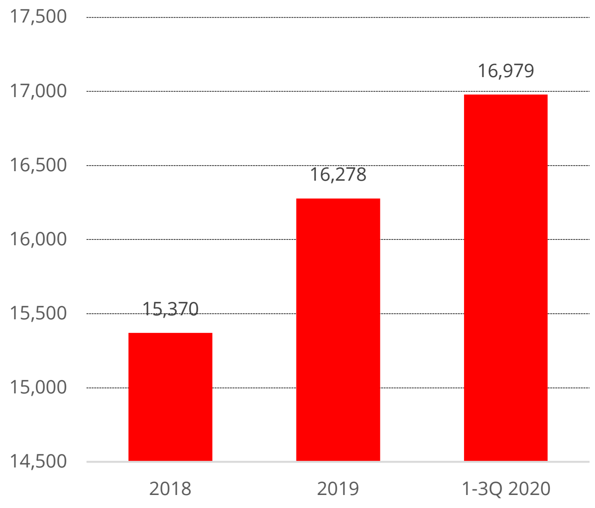
*Source: Santander Brokerage Poland, Company data, * growth in 2020 vs. 1-3Q19*

Fig. 11. Dollar General: Sales breakdown in 2018-20



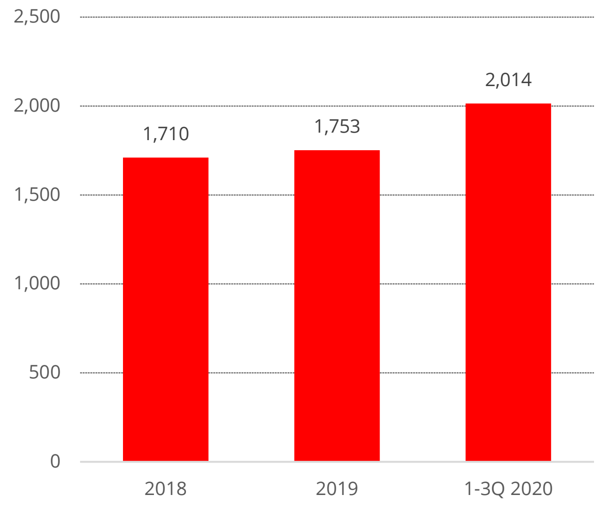
*Source: Santander Brokerage Poland, Company data, * growth in 2020 vs. 1-3Q19*

Fig. 12. Number of stores



Source: Santander Brokerage Poland, Company data

Fig. 13. Average sales per store



Source: Santander Brokerage Poland, Company data, 2020 based on Bloomberg consensus

Five Below

Five Below (FB) is an U.S chain of specialty discount stores that sells small assortment products that cost up to USD10. Five Below operates around 1,020 stores in shopping centres in 35 US states; it also operates an e-commerce site. The network strategy is aimed at young clientele. Core merchandise includes fun but inexpensive items such as jewellery and accessories, novelty T-shirts, novelty socks, sports gear, decor and crafts, and mobile phone accessories. FB works with 800 vendors, which allows the chain to switch products quickly as it tries to capitalize on the popular items of the moment. Its stores measure about 743sqm and are located primarily in shopping centres across a variety of urban, suburban, and semi-rural markets. The company is based in the Northeast but Five Below has expanded into the South and Midwest USA. Texas, Pennsylvania and Florida are the largest markets. The distribution centres are located in NJ and MS.

Compared to Five Below, Pepco Group sales were growing at a slower rate in 2018 (9.6% vs. 22.0% in FB) and in 2019 (12.2% vs. 18.4% in FB). FB sales performed better during the pandemic outbreak. Although 2018-20 average gross margins were higher at 41.6% for Pepco vs. 35.3% in FB, its EBITDA margin (11.9% vs. 13.6% in FB) were lower due to higher operating costs. ROIC of Pepco Group was higher (28% vs. 22%) in pre COVID-19 2018-19 years. Unlike Pepco Group, FB has not had financial leverage. With regards to 2020-23E forecasts, according to Bloomberg consensus, FB's sales are expected to grow faster than Pepco, however Pepco Group´s EBITDA/net profit are likely to grow more quickly thanks to better opex control, lower interest rates and effective tax rate.

Fig. 14. Five Below: Key financial metrics

(USDmn)	2018	2019	2020
Sales	1,560	1,847	1,962
LFL	4%	1%	-5%
Gross profit	565	674	652
Opex	378	457	498
EBIT	187	217	155
D&A	41	55	69
EBITDA	229	272	224
Financials, net	-5	-4	2
PBT	192	222	153
Tax	42	47	30
Net profit	150	175	123
Margins			
Gross margin	36.2%	36.5%	33.2%
EBIT margin	12.0%	11.8%	7.9%
EBITDA margin	14.7%	14.7%	11.4%
Tax rate	22.0%	21.0%	19.4%
Net margin	9.6%	9.5%	6.3%
Growth			
Sales	22.0%	18.4%	23.0%
EBITDA	19.9%	19.1%	57.0%
Net profit	46.1%	17.0%	68.0%
Net debt (pre lease)	-168	-201	-268
Net debt/EBITDA	-0.7	-0.7	-1.2
Cash conversion	50%	22%	11%
ROIC	21%	23%	14%

Source: Santander Brokerage Poland, Company data

Fig. 15. FB: Sales breakdown in 2020

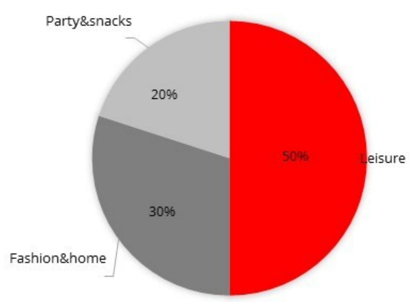


Fig. 16. Number of stores and …

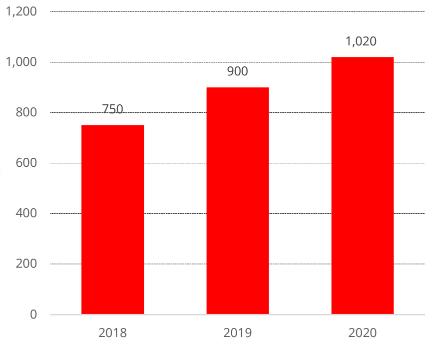
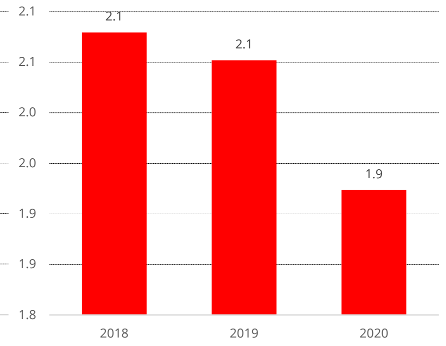


Fig. 17. … sales per store (USDmn)



Source: Santander Brokerage Poland, Company data for all three charts

The B&M Group

Founded in 1978, this variety goods value retailer has stores operating in the UK and France. The group includes: (1) the B&M general merchandise and grocery stores, with a chain of over 600 stores throughout the UK, (2) general merchandise and grocery stores branded both Babou and B&M, with a chain of over 90 stores in locations in France and (3) the Heron Foods convenience stores, with a chain of over 275 stores in locations predominantly in the North of England. B&M, the French stores and Heron Foods stores offer customers leading branded products at prices for budget customers. Average store size is c19k sqft. Food/non-food sales breakdown is 30%/70% on sales. It offers c.5,5k SKU with 34% of SKUs at or below 99p/GBP1 price point. Up to 30% (or 67% of non-groceries) of B&M's stock is sourced and purchased directly from China.

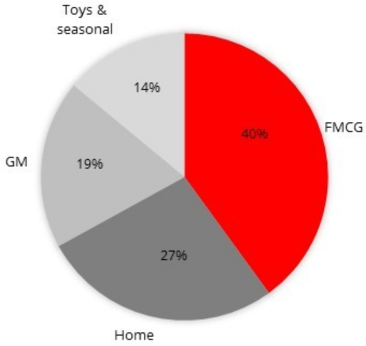
Pepco Group sales were growing at a slower rate in 2018 (9.6% vs. 22.4% in B&M), but faster in 2019 (12.2% vs. 10.0% in B&M). B&M sales performed better during the pandemic outbreak. Both 2018-20 average gross (41.6% vs. 33.9% in B&M) and EBITDA margin (11.9% vs. 9.4% in B&M) were better in Pepco Group. ROIC of Pepco Group was slightly in lower (28% vs. 32% in B&M) in pre COVID-19 2018-19 years, while financial leverage remained at a similar level. With regards to forecasts, according to Bloomberg consensus, B&M's sales and net profit are expected to noticeably underperform those of Pepco Group, while EBITDA is likely to grow in line with Pepco Group's.

Fig. 18. B&M: Key financial metrics

(GBPmn)	2018	2019	2020
Sales	2,976	3,273	3,813
LFL	5.0%	0.7%	3.2%
Gross profit	1,010	1,116	1,282
opex	767	841	998
EBIT	243	275	285
D&A	36	45	58
EBITDA	279	320	342
Financials, net	21	35	41
PBT	221	240	243
Tax	44	52	56
Net profit	178	188	187
Margins			
Gross margin	33.9%	34.1%	33.6%
EBIT margin	8.2%	8.4%	7.5%
EBITDA margin	9.4%	9.8%	9.0%
Tax rate	19.8%	21.6%	23.2%
Net margin	6.0%	5.7%	4.9%
Growth			
Sales	22.4%	10.0%	23.0%
EBITDA	18.8%	14.6%	57.0%
net profit	18.5%	5.9%	68.0%
net debt (pre lease)	521	601	344
net debt/EBITDA	1.9	1.9	1.0
Cash conversion	59%	67%	63%
ROIC	29%	35%	39%

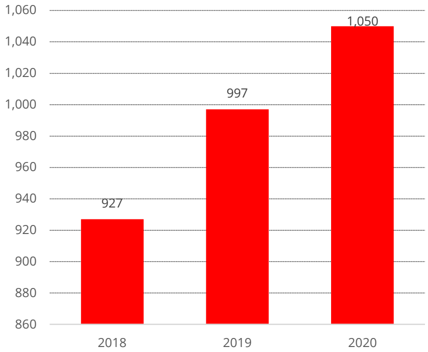
Source: Santander Brokerage Poland, Company data

Fig. 19. B&M: Sales breakdown in 2020



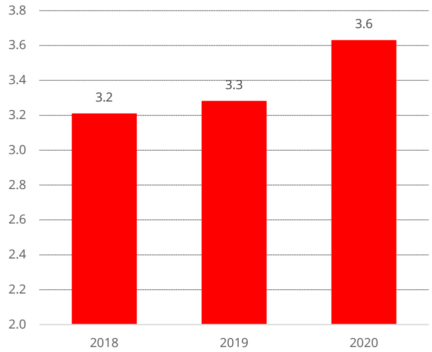
Source: Company data

Fig. 20. Number of stores and ...



Source: Company data

Fig. 21. ... sales per store (GPBmn)



Source: Company data

Action

Action is a fast-growing international non-food discount chain with stores located in the Netherlands, Belgium, France, Germany, Luxembourg, Austria, Czechia and Poland. Action had 17k stores in 2019, of which 106 were in Poland. Below, we present some key facts about Action NL and its Polish subsidiary. Its offering includes products from 14 categories: decoration, DIY, toys and entertainment, hobbies, multimedia, household goods, garden, laundry and cleaning, food and beverages, personal hygiene, pets, sports, clothing and bedding. The company is known for fast product rotation. About a third of more than 6,000 SKU in Action's stores belongs to the standard range, while the remainder rotates quickly, with the company introducing more than 150 new items to the shelves every week.

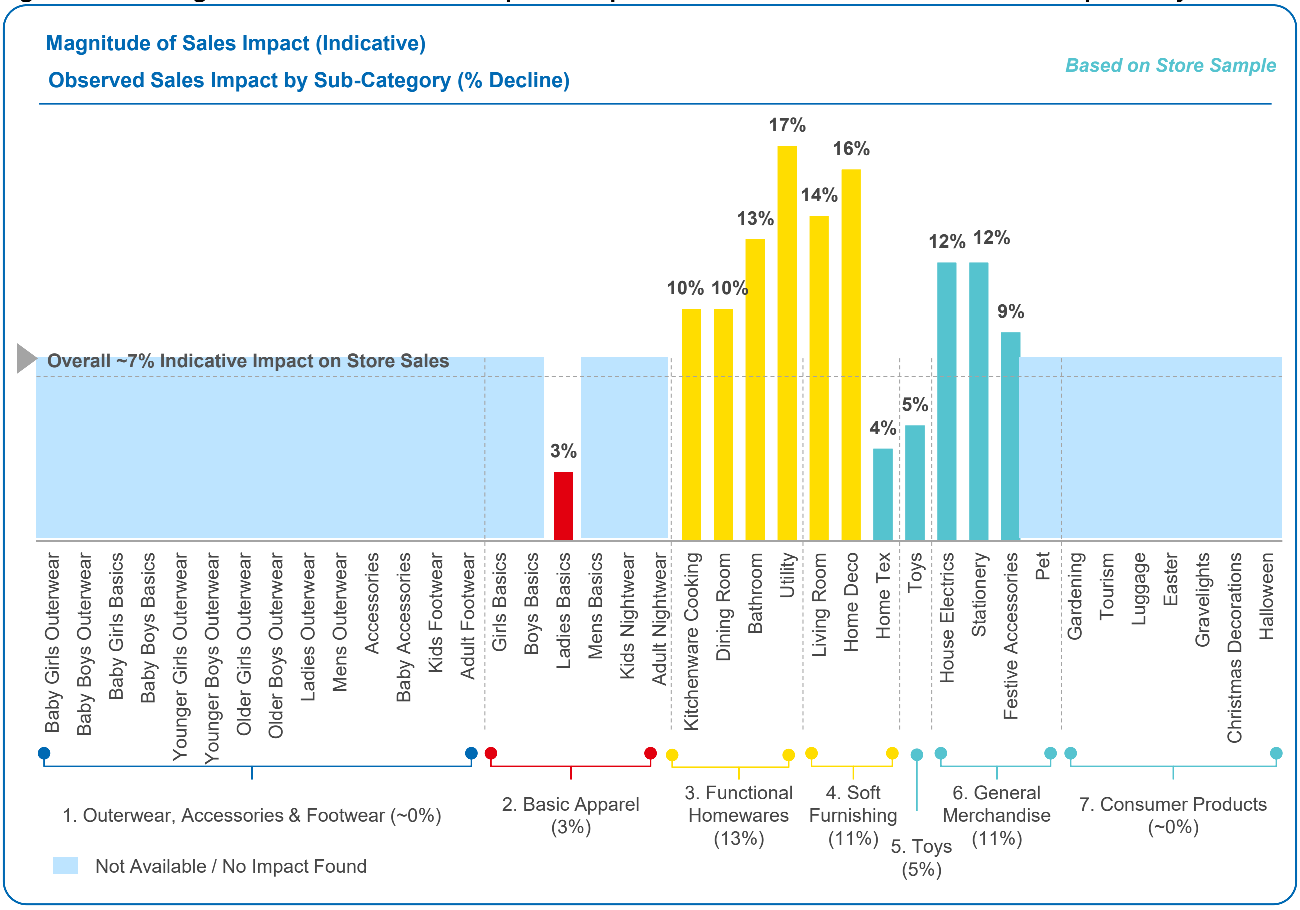
Fig. 22. Action: key data

	Action Poland (PL)	Action Group NV
Numer of stores (2019)	106	17,000
Employees *	n.a.	50,000
Sales (2019)	PLN272mn	EUR5,114
EBITDA (2019)	PLN15mn	EUR541
Net profit (2019)	PLN7mn	n.a.

*Source: EMIS, Santander Brokerage Poland, *directly employed by Action (2019 data)*

Pepco Group estimates a relatively low (7% average sales decline) impact on store sales in locations next to Action, mainly driven by the homeware category. Pepco Group also believes it operates at higher gross margin than 35% for Action, which provides a safe pricing buffer.

Fig. 23. Action: magnitude of indicative sales impact in Pepco stores where Action's stores are in close proximity



Source: Company data

Fix Price

Fix Price successfully priced its IPO on the London Stock Exchange in March at USD9.75 per GDR, the top end of the previously announced price range, giving Fix Price a market capitalisation of USD8.3bn. The company is one of the largest retailers in Russia, with over 4,200 stores mainly in Russia and the neighbouring countries (Belarus, Kazakhstan, Uzbekistan, Kyrgyzstan, Latvia and Georgia). Fix Price is the market leader in terms of number of stores and value of sales in Russia. According to an independent industry consultant report, Fix Price's share was estimated at 93% of the Russian variety value retail market in 2019. The variety value retail market is one of the fastest-growing segments of Russian retail and is expected to triple in size by 2027E with a CAGR of 16.9% for 2019-2027, according to the research body. Fix Price has an efficient and easily scalable business model that is based on the following key pillars: data-driven procurement, streamlined centralized logistics, efficient and standardized store management, and an experienced management team. IT solutions allow Fix Price to achieve a high degree of automation of all operations.

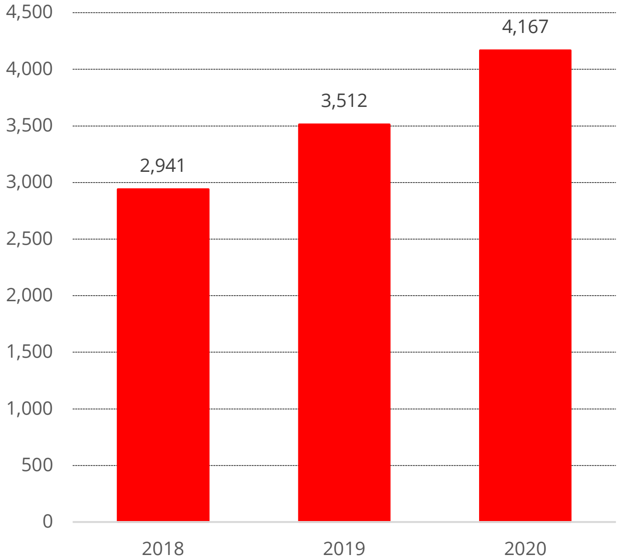
Fix Price and Pepco Group may be easier to compare due to similarities in sales mix (similar exposure to food retailing). Fix Price was growing at a faster rate y/y in both 2019 and the COVID-19 impacted 2020. It operated at lower 2018-20 average gross margins (31.9% vs. 41.6% in Pepco Group), while 2018-20 average EBITDA margin was higher (17.1% vs. 11.9% in Pepco Group). ROIC of Fix Price was better, while financial leverage has been at a similar level to Pepco Group.

Fig. 24. Fix Price: Key financial metrics

(RUBmn)	2018	2019	2020
Sales	108,724	142,880	190,059
Gross profit	33,886	45,961	61,515
Opex	-21,156	-27,506	-34,592
EBIT	12,730	18,455	26,923
D&A	1,464	8,695	9,865
EBITDA	14,194	27,150	36,788
Financials, net	-461	-920	-613
PBT	12,269	17,535	26,310
Tax	3,141	4,362	8,735
Net profit	9,128	13,173	17,575
Margins			
Gross margin	31.2%	32.2%	32.4%
EBIT margin	11.7%	12.9%	14.2%
EBITDA margin	13.1%	19.0%	19.4%
Tax rate	25.6%	24.9%	33.2%
Net margin	8.4%	9.2%	9.2%
Growth			
Sales	n.a.	31%	33%
EBITDA	n.a.	91%	35%
Net profit	n.a.	44%	33%
Net debt (pre lease)	-5,381	5,957	23,015
Net debt/EBITDA	-0.4	0.2	0.6
Cash conversion	70%	85%	83%
ROIC*	76%	115%	96%

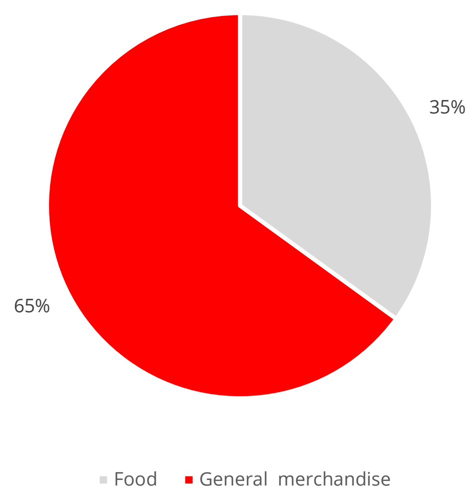
*Source: Santander Brokerage Poland, Company data, * adj. by RUB23mn dividend payable*

Fig. 25. Fix Price: store numbers in 2018-20



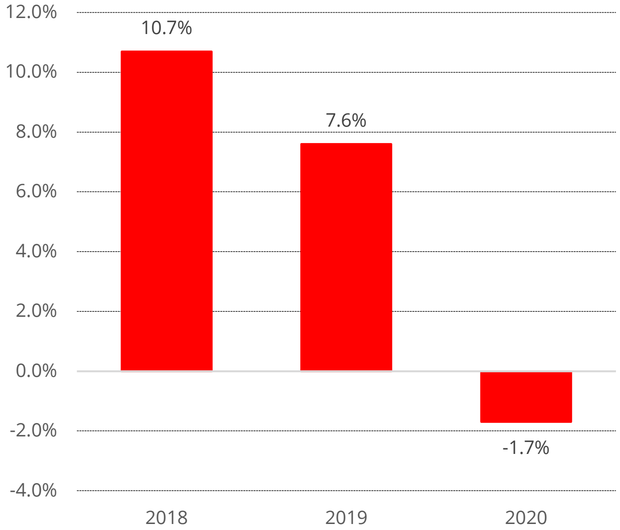
Source: Company data

Fig. 26. Retail sales mix in 2020



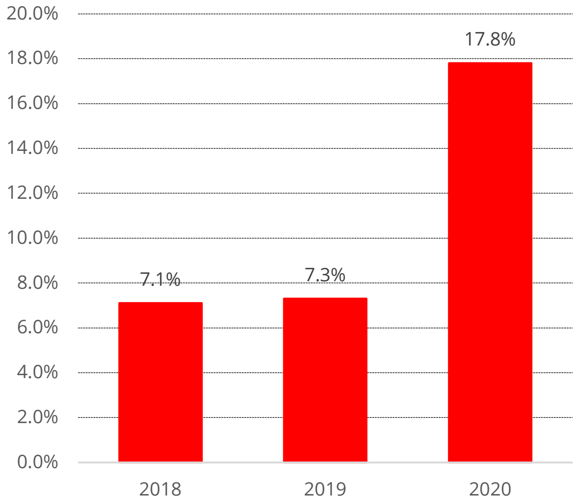
Source: Company data

Fig. 27. Fix Price: Traffic growth in 2018-20



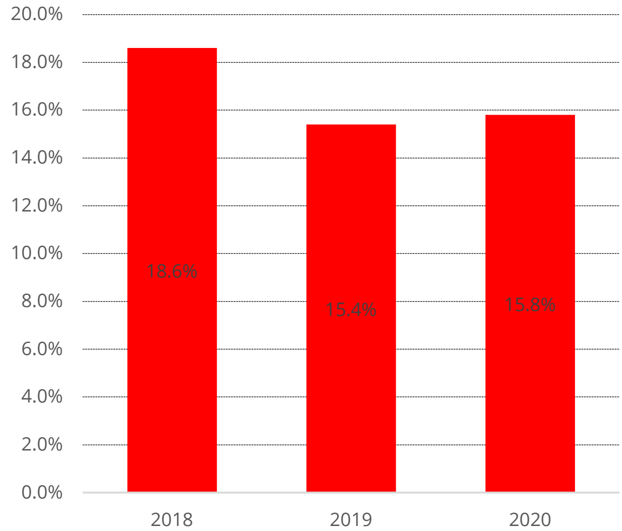
Source: Company data

Fig. 28. Fix Price: Avg. sale receipt growth in 2018-20



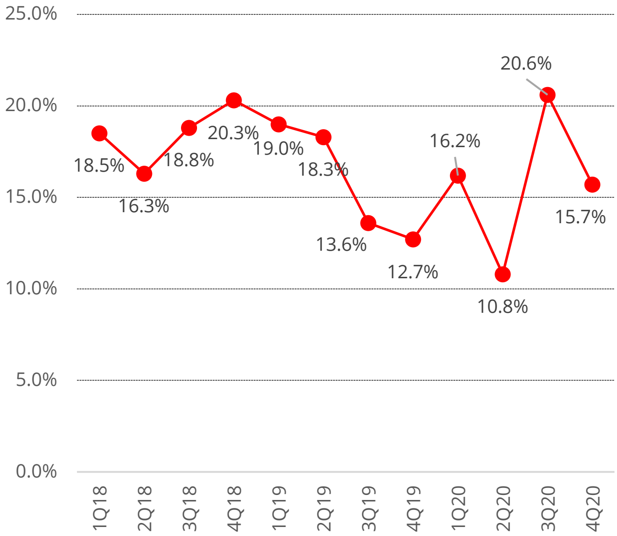
Source: Company data

Fig. 29. Fix Price: LFL growth in 2018-20



Source: Company data

Fig. 30. Fix Price: Quarterly LFL growth

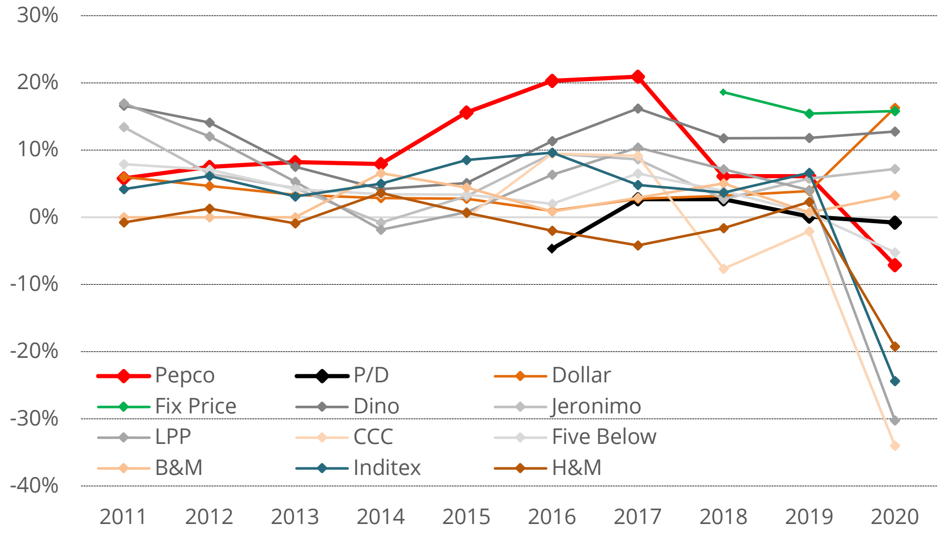


Source: Company data

LFL growth – Pepco Group vs. peers

Pepco was among the best retail performers in terms of LFL growth up to 2017 and ahead of the pack in 2015-17 (500+ programme in Poland impact). In the pandemic year 2020, it recorded 7.1% negative LFL sales, which places it between general apparel & footwear retailers, food retailers and Russian Fix Price (69% of sales in general merchandise). Poundland/Dealz's LFL growth remained low across the entire period [when?] but in 2020, it benefited from being an essential goods retailer.

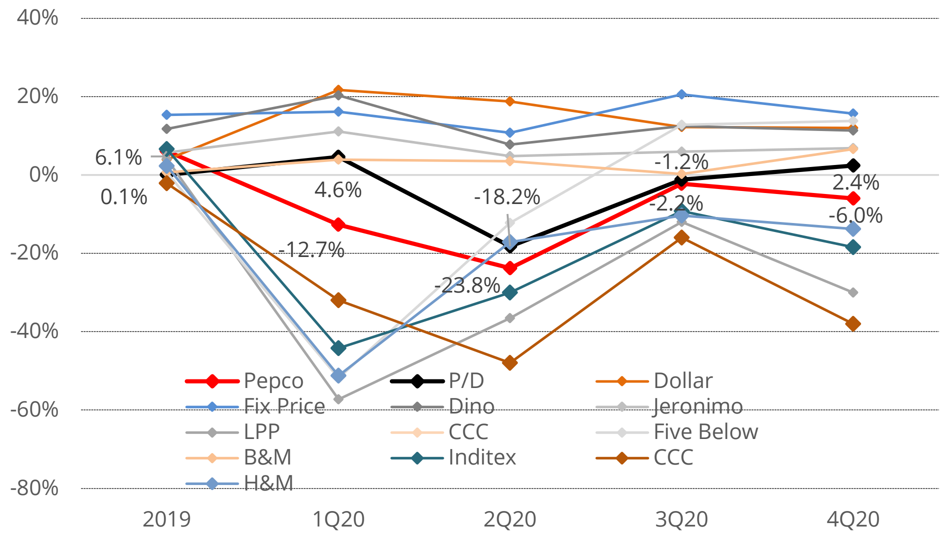
Fig. 31. Peer group: LFL performance comparison



Source: Santander Brokerage Poland, Company data

Looking specifically at 2020's LFL performance by quarter, Pepco took a more severe hit than Poundland and other essential goods retailers, however it was not as bad as for general retailers. Food retailers like Dollar RE, Dino, Jeronimo, variety discounter Fix Price and Poundland/Dealz to some extent were winners of the new reality during the COVID-19 outbreak in terms of LFL growth.

Fig. 32. Peer group: LFL performance per quarter in 2020



Source: Santander Brokerage Poland, Company data, 4Q20 is 1Q21 for Pepco Group, LFL in trading stores amounted to 5.5% in Pepco in 1Q21

Fig. 33. Pepco & P/D vs. peers – sales, opex and EBITDA per sqm analysis

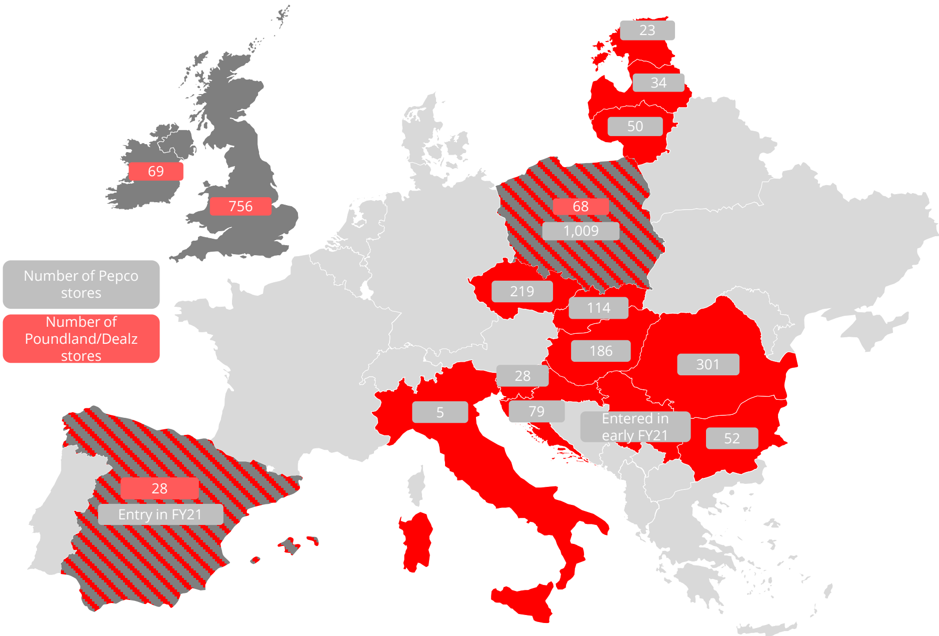
	Sales density		Opex/sqm		EBITDA/sqm	
EUR/sqm	**2019**	**2020**	**2019**	**2020**	**2019**	**2020**
Pepco*	2,004	1,839	641	648	137	163
chng.	5.4%	-8.2%	-7.3%	1.1%	11.6%	18.9%
P/D*	2,870	2,761	1,037	1,009	21	52
chng.	-2.0%	-3.8%	-8%	-3%	9%	153%
Dollar GE	2,081	2,393	462	503	213	296
chng.	2.4%	15.0%	2.3%	9.0%	4.4%	38.9%
B&M **	1,918	2,137	458	508	192	209
chng.	12.4%	11.4%	12.4%	11.1%	14.0%	9.1%
Five Below	2,629	2,385	650	605	388	272
chng.	-2.1%	-9.3%	-0.1%	-7.0%	-1.6%	-29.7%
Fix Price	1,527	1,712	294	312	290	331
chng.	10%	12%	9%	6%	60%	14%

*Source: Company data, Santander Brokerage Poland estimates, * Pepco and P/D sales floor based on average stores size at 450sqm (350-550sqm) and 700sqm (400-1,000sqm), underlying EBITDA (post IFRS16) for Pepco and P/D, * 2020 is the year of IFRS16 adoption, ** only for UK + Heron*

Business model

Pepco Group is a large-scale variety discount retailer operating across Europe. Its typical customer is often a young person responsible for family with top-up needs, including regular shopping replenishment needs. According to the company's in-house research, its "top-up" and replenishment proposition drives high customer frequency, with over 60% of Pepco customers visiting its stores 3.8 times per month, which is high for a mainly non-food retailer. Top-up needs are defined as a small, regular shops which do not cost more for convenience. They are one of the most lucrative areas within the convenience sector focused on products needed in a hurry, according to the company. Pepco Group operated 3,021 stores in 2020 in 15 European countries under three retail brands: Pepco and Poundland/Dealz. Its stores served around 50m customers/month in pre-COVID-19 LTM to February 2020.

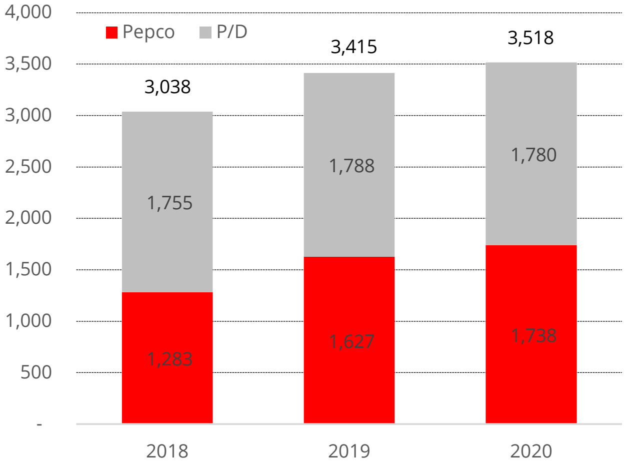
Fig. 34. Pepco Group: Geographical footprint



Source: Company data

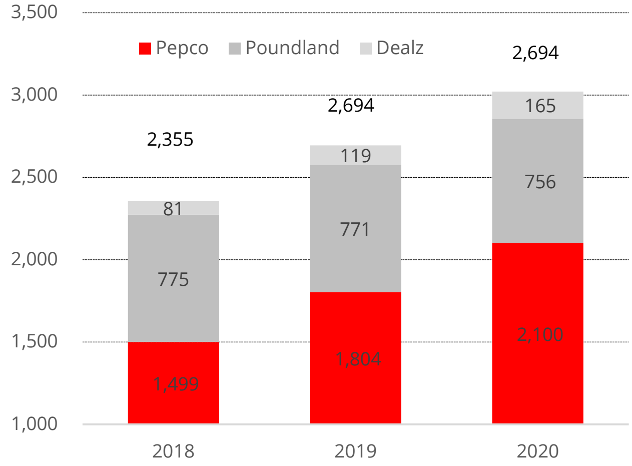
Group sales have been growing at a 2017 – LTM Feb 20 CAGR of 12.1% (30.0% for Pepco and 1.0% for P/D), and at a 2017-20 CAGR of 8.2% (21.9% for Pepco and -0.7% for P/D). Similar to other non-essential goods retailers, the group's sales growth has been adversely affected by COVID-19. The number of stores has been growing at 2018-20 CAGR of 13.1%.

Fig. 35. Sales of Pepco and P/D in 2018-20 (EURmn)



Source: Company data

Fig. 36. Pepco Group: Store count in 2018-20



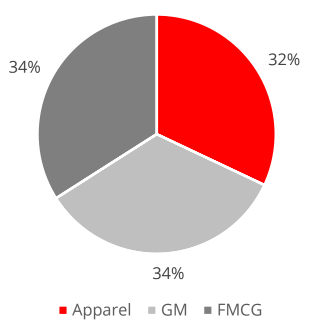
Source: Company data, NOTE Poundland number includes Pep&Co stores

Pepco Group operates across the three major retail categories of fast moving consumer goods (FMCG, 34% of sales), general merchandise (GM, 34%) and apparel (32%) with a clear and common focus on serving parents on a budget by meeting their family and household needs.

Pepco Group's product offering is tailored to products that have the greatest importance to customers and offers children's clothing, homeware, impulse groceries, health and beauty and seasonal goods. The Pepco brand offers a clear focus on a childrenswear-led apparel and soft homeware, while Poundland and Dealz offer FMCG, with recognized brands underpinning customers' value perception, hard homeware and seasonal/celebration categories. Pepco Group's offering of basic apparel and homeware products that do not target high- or fast-fashion products limits markdown risk. In addition, the focus on childrenswear creates a further bias towards more needs-driven products.

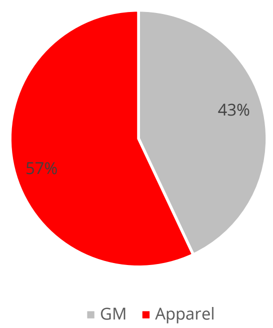
The majority of products sold are sourced via the Group's integrated sourcing business, Pepco Global Sourcing (PGS), which serves to maximise buying scale and operating efficiencies.

Fig. 37. Sales breakdown of Pepco Group...



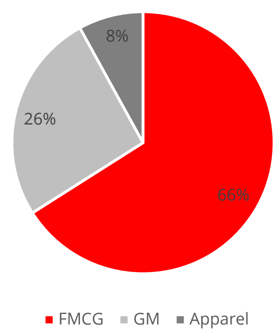
Source: Company data

Fig. 38. Pepco and ....



Source: Company data

Fig. 39. P/D: breakdown in 2020



Source: Company data

Pepco

Pepco (49% of sales of group in 2020) is one of the CEE's leading variety discount retailers with a multi-price customer offer, led by apparel (57% of sales) for the family (with strength in children's wear), home decor, toys and seasonal products (43%). Its core philosophy is to deliver Western European-quality products and customer experience at CEE prices.

Pepco operated 2,100 stores at 30 September 2020 with 350-550 sqm retail floor area across 11 countries in Central and Eastern Europe (CEE) plus Serbia (entered after 30 September 2020), and recently entered the Italian market, opening 5 stores in late September 2020.

Pepco operates variable price points, however its price architecture is simpler than competitors, with an anchor price point and 2-3 trade up options. Pepco is the price leader and ranks no. 1 for value for money, low prices and great deals, according to strategy consultants OC&C's analysis. OC&C's quantitative analysis of Pepco's price position across its core categories of apparel and soft homeware confirms its price leadership at the critical entry price point but also at the highest and average price positions.

Fig. 40. Pepco's rank on different selection criteria *

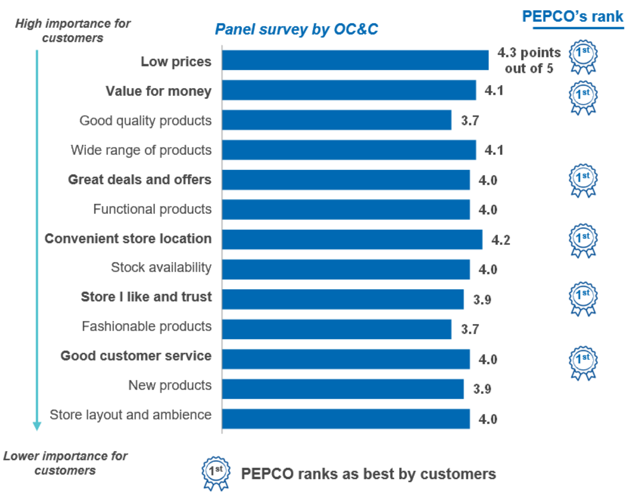
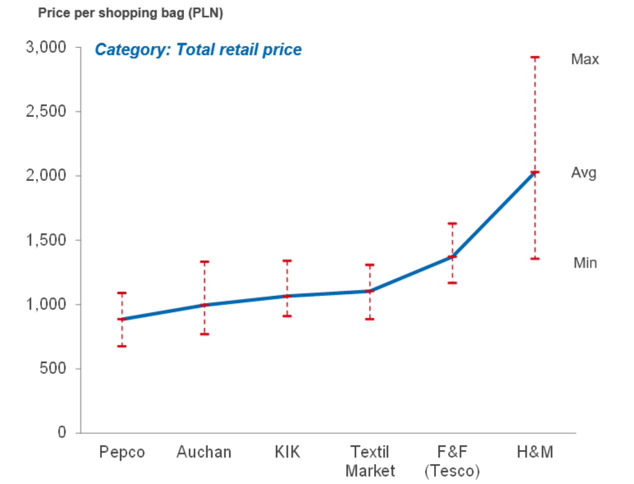


Fig. 41. Pepco is among the cheapest stores on the market **



*Source: OC&C analysis, Company data, * number of respondents between 256-1,566 varying by competitor and key purchase criteria, Competitors include: KiK, Auchan, Takko, H&M and Jysk, ** OC&C analysis, based on a list of comparable product categories common to all retailers.*

With Net Promotor Score of 57, Pepco is in the top 20% of all major retailers in Poland (sample size 49 retailers). It is 5pp higher than its close competitor Action, while the difference is even higher among customers for who both companies directly compete as they live in the same catchment area (Pepco: +61 vs. Action +36 and Tedi +28).

Poundland Group

Poundland Group (51% of sales) comprises Poundland in the UK and its international brand Dealz, which are mainly FMCG-led retailers with a price architecture historically anchored at a single price point. Poundland has operated in the UK since 1990 and operated 756 stores in 2020, while Dealz (introduced in 2011) operated 165 stores in the Republic of Ireland, Spain and Poland. Stores' retail floor area ranges between 400 sqm and 1,000 sqm for Poundland and Dealz. Poundland offers each of the Group's three core categories in larger stores, while smaller Poundland and Dealz stores offer mainly FMCG and general merchandise. Historically, the majority of products within the Poundland Group have remained at a core anchor price (£1 in the UK). However, in recent years Poundland has expanded the number of price points both above and below the anchor price point in response to the rising demand for a greater choice of individual products and brands.

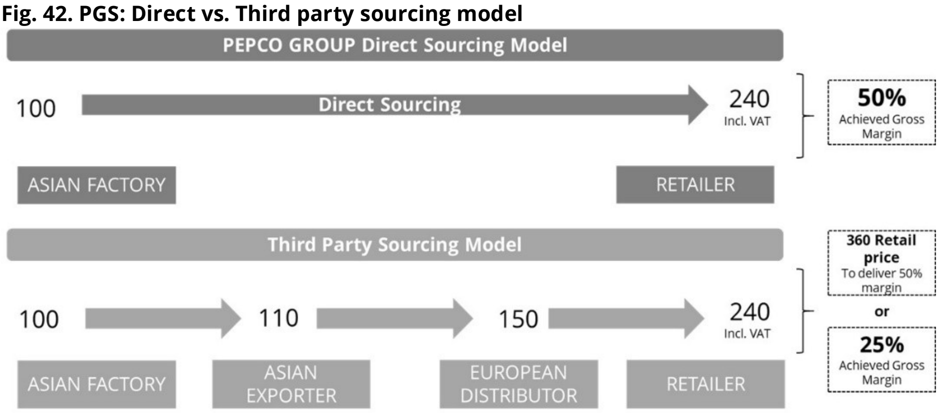
Poundland is a mature business with identified sales growth opportunities through proposition development and margin improvement on costs savings. According to market research by the company, Poundland's typical customer is a budget-conscious woman aged 18-44 from households with an income below GBP30k. She also tends to be image-conscious, cares for quality and is reassured by brands. In Poundland she looks for low prices, value for money and 'great deals'.

Dealz is a young and growing business within the Poundland Group, which is increasing its footprint in Poland, Ireland and Spain. Dealz's typical customer is an employed and educated woman aged 19-45. She cares for quality and is reassured by brands. Her average spend per visit amounts to EUR7.56 in Spain and EUR5.65 in Poland. In Dealz she looks for low prices, product proposition and store locations. The key differentiation between Dealz and competitors in Poland is Dealz's FMCG proposition (52% of sales) vs. 24% and 16% in competitors Action and TEDi, respectively. It also enjoys c.27% average price discount vs. key competitors in Spain. Its Net Promotor Score of 55 is better in Poland vs. Action: 39 and TEDi: 39 and the best on the market at the same time. The same is found in Spain, where Dealz NPS of 22 is better than Mercadona: 21 and Lidl: -4 and the best on the market at the same time, according to the company.

Direct sourcing through PGS

PGS is responsible for direct sourcing for Pepco Group and offers strategic differentiation vs. competitors. Over 60% of apparel and GM are sourced internally. PGS's sourcing structure consisted of apparel (59%), GM (38%) and FMCG (3%) in 2020. Sourcing geographies break down to China (67% of sourcing), Bangladesh (24%), India (9%) and Pakistan (1%). The company plans to add Cambodia, Myanmar and Turkey in the near future. PGS sources c.75% of the Group's apparel, according to the company. The direct sourcing model has a clear advantage over third-party models due to sourcing cost advantages (lack of intermediary margin) and quality of service. We also see other positives behind this model, as it delivers benefits beyond low product costs such as: its own global logistics, working capital management, product quality and supply chain transparency and compliance. Continued expansion of the PGS footprint across Asia and other near-shore markets aims to provide flexibility, cost benefits and risk diversification. The company has offices in Shanghai, Bangladesh and India and is developing near sourcing in Turkey and pan-European FMCG buying. Pepco Group also leverages Poundland's relationships with pan-European suppliers to source branded FMCG products.

Fig. 42. PGS: Direct vs. Third party sourcing model



Source: Company data

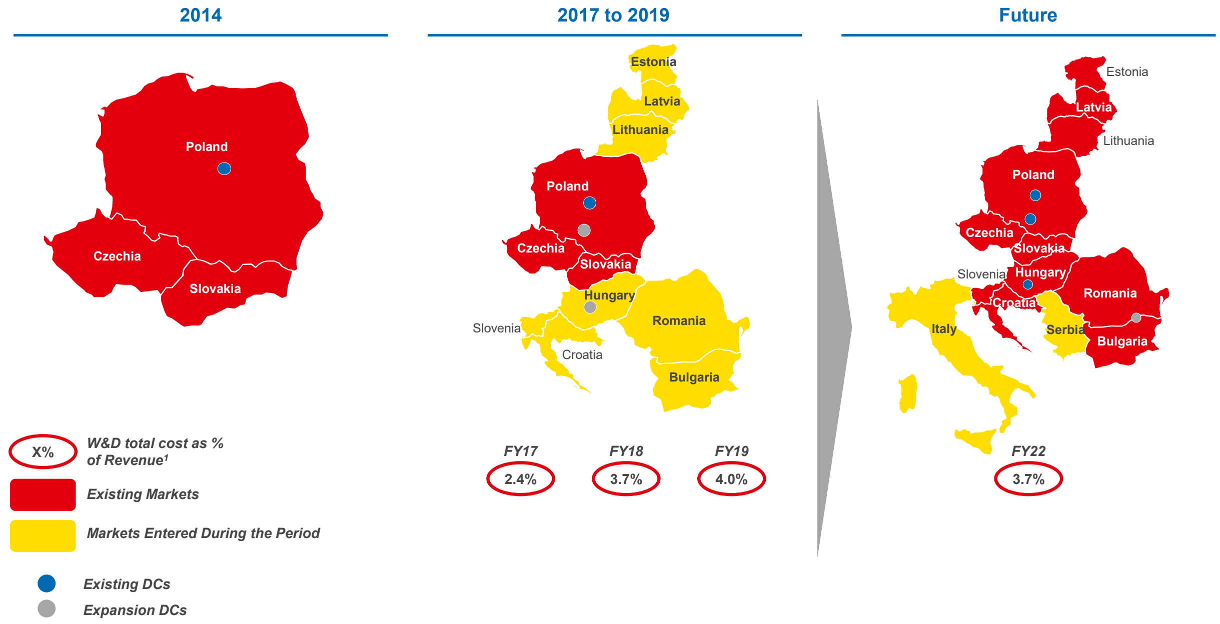
Even though the Pepco Group might be seen as complex, given it runs two different discount models mainly FMCG discounters (Poundland & Dealz) and a mainly apparel & GM discounter (Pepco), it has three main layers of synergies. First, PGS provides a pan-European sourcing service for the entire Group. Second, the common store proposition and layout in all geographies provides scale benefits. Third, know-how is shared between markets and formats.

Warehousing & Distribution

Continued infrastructure development is seen as a key driver required to secure future profitable growth. Pepco plans to expand its strategy network while maintaining the centre of gravity with Poundland by using the existing infrastructure. The development of infrastructure is set to be financed from internal cash generation. Pepco distribution channel is planned to change after a broad expansion in 2017-19, but which also brought in inefficiencies, measured by an increase of warehousing and distribution cost/sales ratio to 4.0% in 2019 from 2.4% in 2017. This was caused by the interruption on the development of a distribution centre (DC) because a construction company ceased works on DC in Hungary after the Steinhoff financial irregularities in late 2017, which resulted in a two-year delay. The current distribution strategy is focused on achieving the following milestones by 2022:

1. Operating in 13 countries (vs. current 11);
2. 2,700 stores (vs. 1,804);
3. 4 DCs (3 ready and 1 under construction with 100k sqm mega DC in Hungary);
4. Planned automation (voice picking, sortation);
5. 1.75mn pallet capacity (vs. current 950k);
6. revenue above EUR3.5-3.8bn requires additional DC in southern Poland (depends on success of E2E strategy implementation).

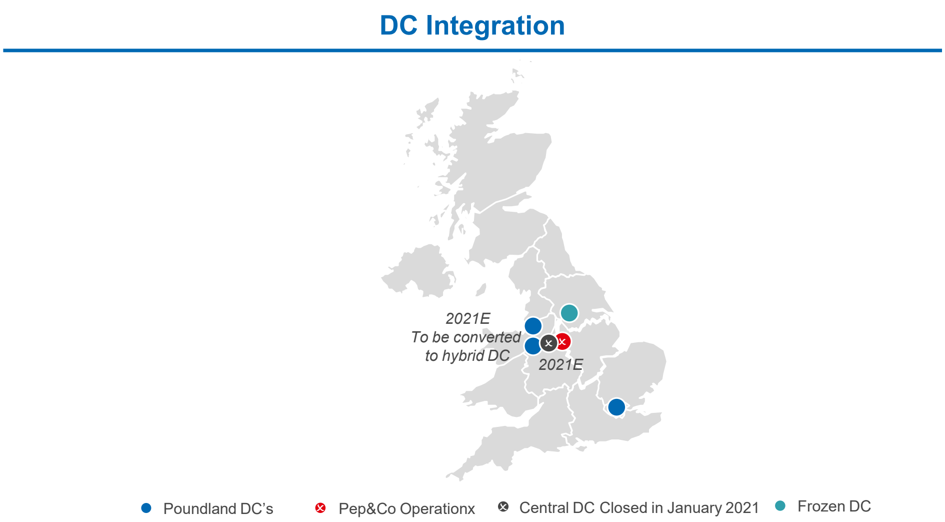
Fig. 43. Pepco: warehousing & distribution system development



Source: Company data

Poundland's warehouse & distribution system was also rationalized this year: one DC and all Pep&Co warehouse operations were closed in January 2021. The number of distribution centres was cut from 4 to 3, with relocation to lower cost offices and a uniform Enterprise resource planning system introduced. These changes are currently being implemented and full effects should be visible in the coming years.

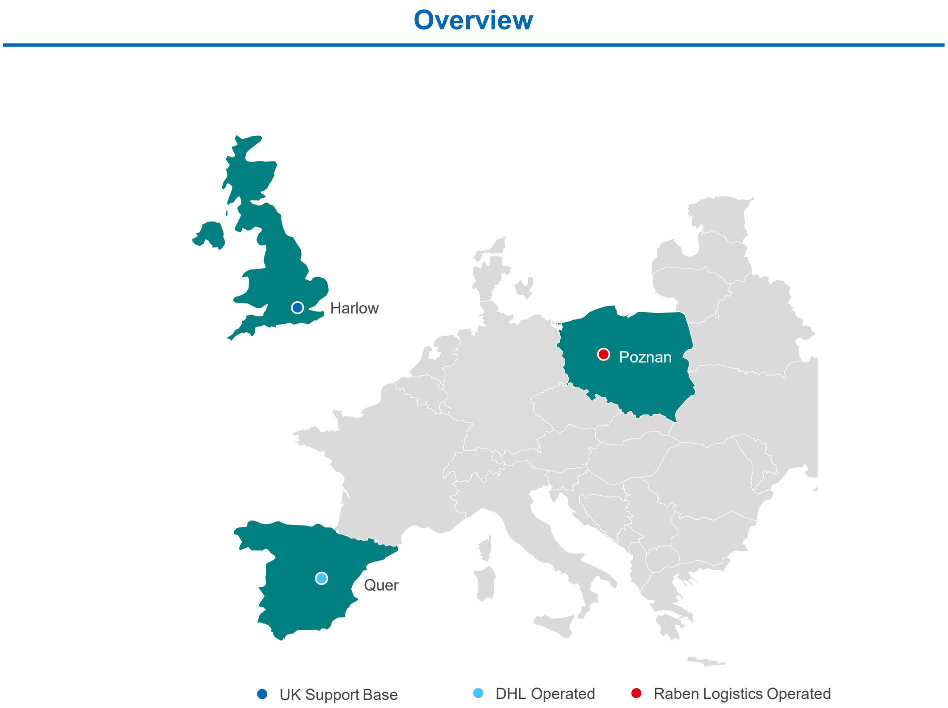
Fig. 44. Poundland: DC integration



Source: Company data

The Dealz warehousing system is based on the UK´s regional DC as a cross dock support base and two outsourced locations in Spain (operated by DHL) and in Poland (operated by Raben).

Fig. 45. Dealz: Warehousing system



Source: Company data

IT Systems

To provide capability and infrastructure scale to support a much larger business, the company needs to upgrade its IT systems to Tier One apps (Oracle ERP). These steps are planned to minimize implementation risk. ERP is to simplify and standardize processes within the companies of the Pepco Group. All four pillars of the organization will have an app designed for their needs.

Fig. 46. Pepco Group: IT applications

Capability	Scope/Benefits	Pepco App	Poundland/Dealz
Human Resource Management	Recuitment Time & attendance Payroll	SAP	Frontier / Kronos / B Plan
Core ERP	Finance & inventory	ORACLE	Jda. / MS Dynamics / ORACLE
Point of Sale	Sales, refunds & cash management	Diebold Nixdorf	Aptos
Warehouse Management	Workforce planning	Jda./Warehouse Management	Jda./Warehouse Management

Source: Company Data

The synergy objectives of the Tier One EPR system involve underpinning multi-territory growth in Pepco & Dealz, efficiencies in Poundland and cross-trading of products within the Group.

The basic synergistic challenge involves an implementation risk, then designing rules to follow best practices from Oracle. Finally, it can minimize risk by reducing volatility and differences between Pepco and Poundland/Dealz. This should result in:

1. Any product available, anywhere in the Group;
2. Flexible Format Strategy;
3. Leveraged Back Office Scale.

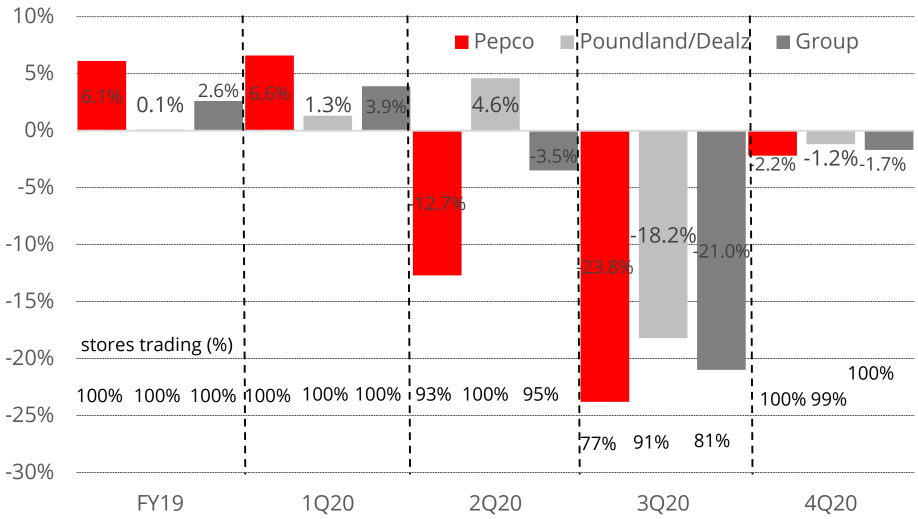
COVID-19 impact

Covid-19 initially emerged as a potential supply issue in February 2020, which then quickly turned out to be a demand side issue for all the Group's retail brands. Governmental restrictions were introduced across the CEE from mid-March, Spain from 15 March, the UK from 23 March and Ireland from 27 March.

As a non-essential goods retailer, the Pepco brand took the largest hit. In the last week of March 2020, just 856 (44% of 1,930 store park) of Pepco's stores were opened. Entire store estates were closed in seven countries including Czechia, Slovakia and Romania. Poland only allowed stores outside shopping malls to trade, while stores in Hungary traded only between 9 am-3 pm each day. As a result, Pepco's sales dropped to just c.15% of expected levels in the first four weeks after the start of the first lockdown, which was the most severe in many markets (especially in Poland).

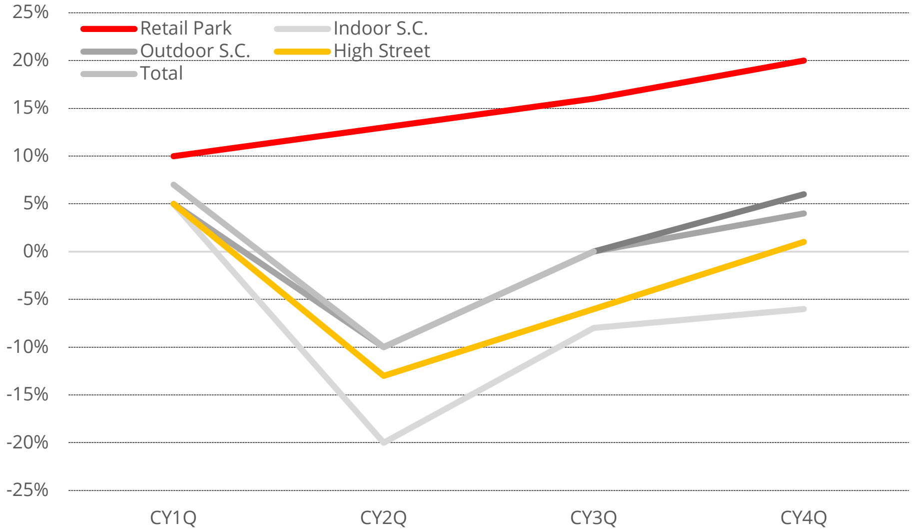
Poundland, as an essential goods retailer, had an initial boost from stockpiling demand. Retail parks and outdoor locations performed best across all quarters in 2020. 130 stores out of 830 in that period were closed, while c.700 stores faced reduced traffic. Poundland recorded c.60% of expected sales levels in the early stage of pandemic, however in a relatively short time period after lockdown introduced on 23 March in UK.

Fig. 47. Pepco Group: LFL growth vs. % of stores trading



Source: Company data

Fig. 48. Poundland: LFL y/y performance by shopping location

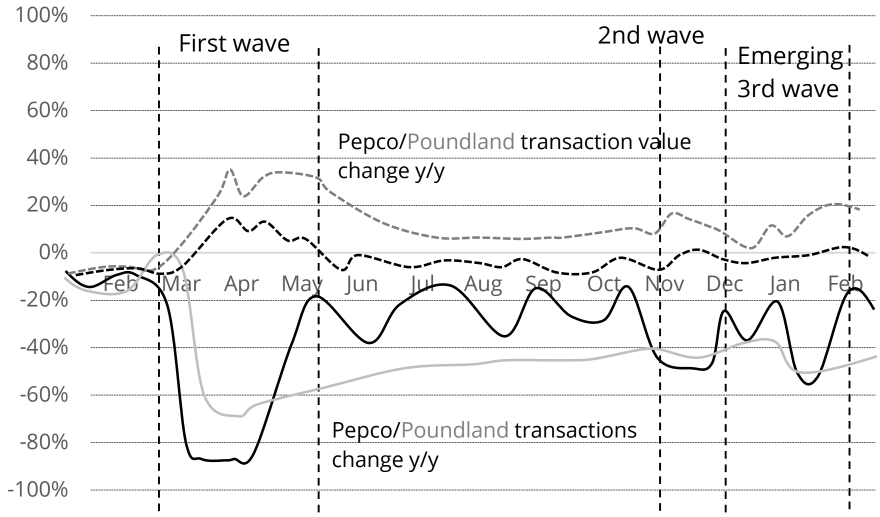


Source: Company data

Pepco Group's response to the new reality can be broken down into three stages:

1. "Lockdown" with a focus on cash & safety. Pepco Group has not stopped new store openings. Pepco Group has drawn committed bank facilities of EUR53mn (repaid in full in July 2020), reduced forward inventory commitments with cancellations and deferrals of EUR300mn. The monthly operating cost was reduced by c.40% thanks to discretionary expenditure reductions and access to available government support including rates reliefs and all available furlough programmes. In May stores reopened across the CEE (2,880 out of 2,913 on 21 June). Pepco Group LFL totalled -21.0% in 3Q20 with collapsing traffic but surging transaction value (typical for many retailers at that time).

Fig. 49. Pepco Group: customer behaviour changed during COVID-19 outbreak



Source: Company data

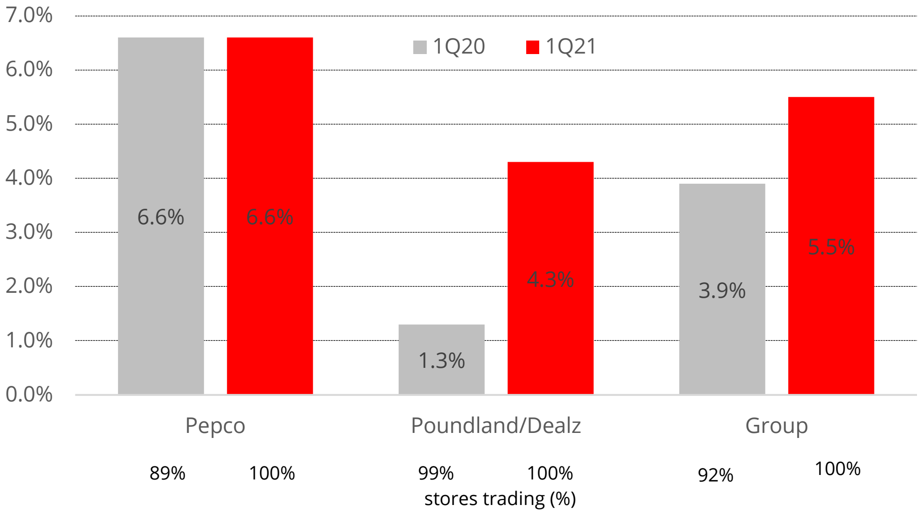
2. "Recovery" with a focus on optimization of trading stores and reopening, with attention to inventory management. Customers remained cautious about visiting busy locations. Group-level LFL remained subdued at -2.2% in 4Q20. Stores' seasonal inventory was reduced through a series of store-level and more targeted promotions.

Despite dilution of gross margins in the short term, excess stock was cleared and its quality was improved.

3. The "new normal" sees a redefinition of the business model to make it flexible to potential further volatility. 1Q21 (Oct-Dec 2020) was further hampered by Covid-19-related lockdown restrictions on consumer behaviour.

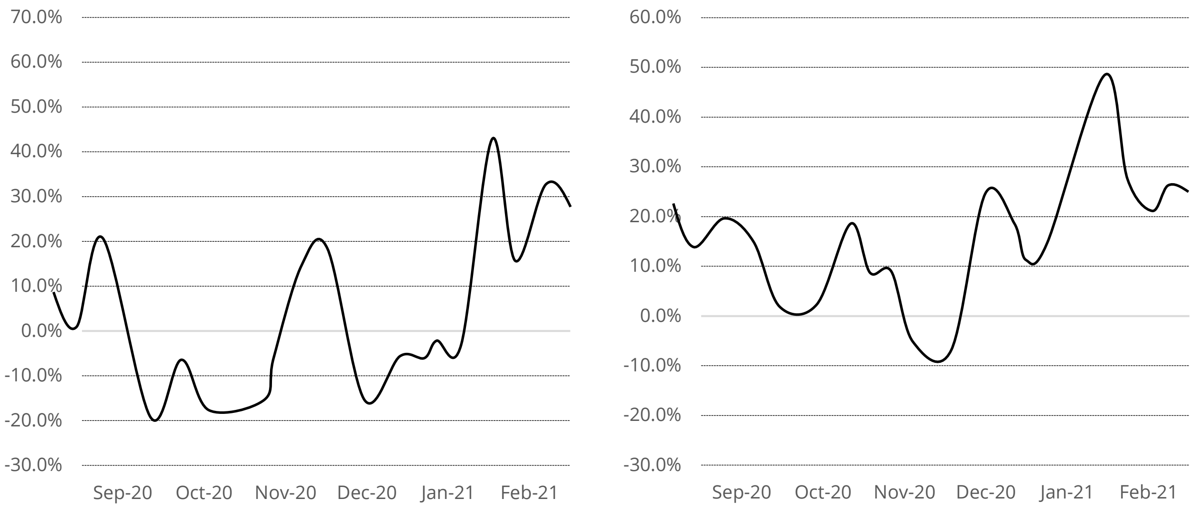
Outside periods of Covid-19 restrictions, which primarily fell into November and late December, Pepco Group's LFL (+5.5%) was above the levels reported prior to the impact of Covid-19 (3.9% in 1Q20) on trading stores. Also, Pepco Poland and Romania have shown strong recoveries post restriction easing in January.

Fig. 50. Pepco Group: LFL in trading stores in 1Q21 vs. 1Q20



Source: Company data

Fig. 51. Pepco Poland (left) and Pepco Romania (right) – LFL growth y/y



Source: Company data

To sum up, we expect Pepco Group to be a beneficiary in a new post Covid-19 world as we think discounters will win market share in a weakened competitive environment from other formats. The strong rebound of LFL sales after closure periods and +5.5% y/y LFL in 1Q21 prove the resilience of Pepco Group's brands in our view. We expect some portion of operating costs savings as well as working capital improvement (60-day extension of payables through direct relationships) to be permanent. Despite the Covid-19 setbacks, Pepco Group did not stop its rollout of 327 new stores in 2020 (vs. 339 in 2019) and continued infrastructure projects like ERP and DC in Hungary.

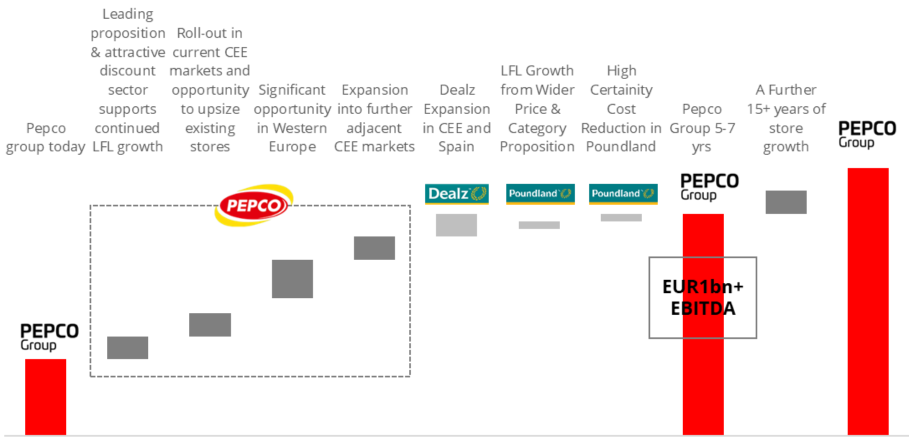
Equity story

Ambitious long-term goal: to be a leading discount retailer in Europe

Pepco Group says it aims to be a leading discount variety retailer in Europe to address budget customers' top-up needs (one of the most lucrative areas within the convenience sector focused on products needed in a hurry) with the best range at the lowest price within apparel, homeware-led general merchandise and FMCG.

Pepco's delivery so far, especially in the CEE region, proves it has so far been effective. The company's strategy is based on a strong commitment to discount retail basics, namely: permanently selling for less through effective buying and operations, and knowing what customers want (category leadership). The business's long-term mission is coupled with a **long-term financial target of achieving +EUR1bn of pre-lease underlying EBITDA in the next 5-7 years.**

Fig. 52. Roadmap to a +EUR1bn of pre-lease underlying EBITDA goal in next 5-7 years



Source: Company data

Large and growing market to tap into

The markets Pepco addresses had a TAM value of EUR130bn in 2019, which should be mentioned as the fundamental background for its further strategic targets. The existing discount apparel and general merchandise (GM) markets were worth EUR26bn in 2019 and are projected to grow at 2019-25E CAGR of 4.4% to EUR34bn, according to independent strategy consultant OC&C. Other than core for Pepco Group's CEE markets like Poland, Romania, Czechia and Slovakia and Western Italia, European markets that Pepco Group plans to move into in the medium to long term are worth EUR70bn and are projected to grow at 2019-25E CAGR of 2.8% to EUR83bn. Both existing and new potential markets are likely to make up a TAM of EUR117bn for Pepco Group by 2025E.

Existing grocery markets, where P/D is present, were worth EUR8bn in 2019 and are projected to grow at 2019-25E CAGR of 3.2% to EUR10bn, according to OC&C. Other potential European markets, which mainly Poundland/Dealz plans to exploit in the medium to long term were worth EUR26bn in 2019 and are projected to grow at 2019-25E CAGR of 2.9% to EUR30bn. Both existing and new potential markets are likely to make up a TAM of EUR40bn for Poundland/Dealz by 2025E, according to the

OC&C analysis. Branded products market share is expected by OC&C to grow to 2.6% of the total grocery market with a stronger than average market growth.

Fig. 53. Apparel&GM TAM forecast by 2025E* (EURbn)

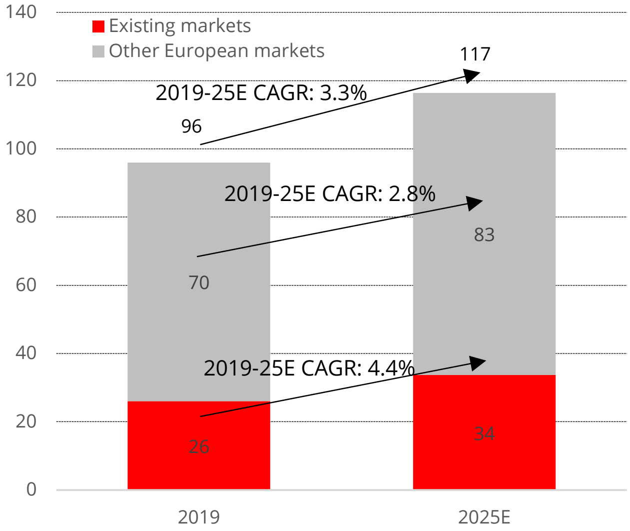
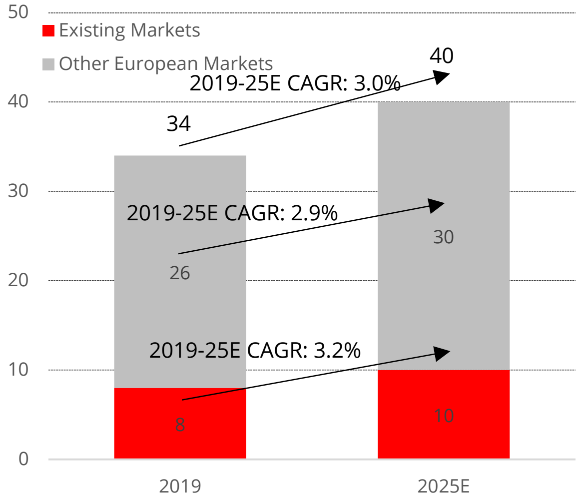


Fig. 54. Top-up convenience TAM growth by 2025E (EURbn)



*Source: OC&C, GlobalData, Company, * based on current prices, local curr/EUR at 2019 level, Apparel&footwear include men's, women's and children's wear, Home-focused GM include homeware, stationery, card, toys and games.*

The core CEE markets for Pepco Group should still be driven by penetration catch-up vs. Western markets. The difference between Pepco's addressable apparel market penetration in total retail in Poland + CEE and WE amounted to 6pp in 2019 vs. 11pp in 2017, which suggests that the convergence trend remains intact and should continue, in our view. There is another supportive trend for Poundland in particular, namely that hard discounters have been continuously gaining market share from mainly mid-market operators and small niche specialists due to the attractive perception of low prices and value for money.

Fig. 55. Pepco's apparel addressable market in total retail in 2017/19

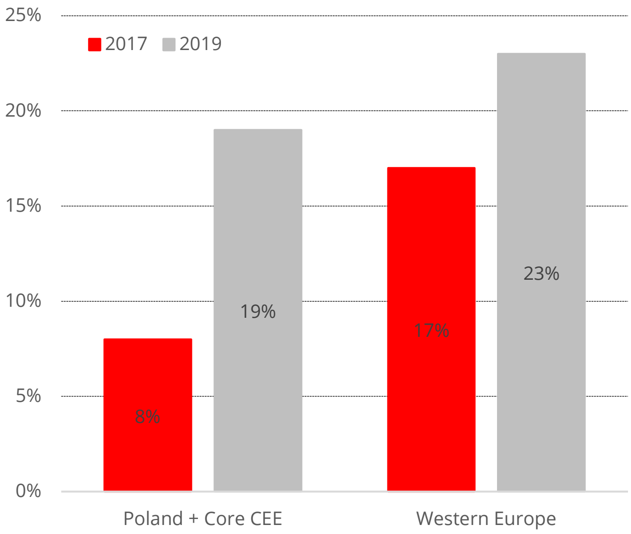
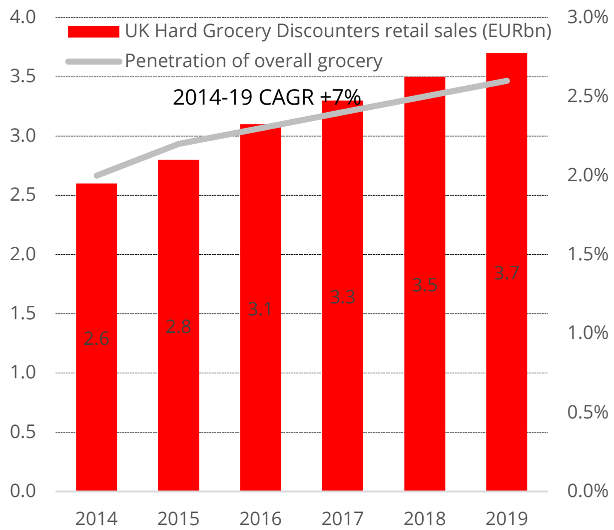


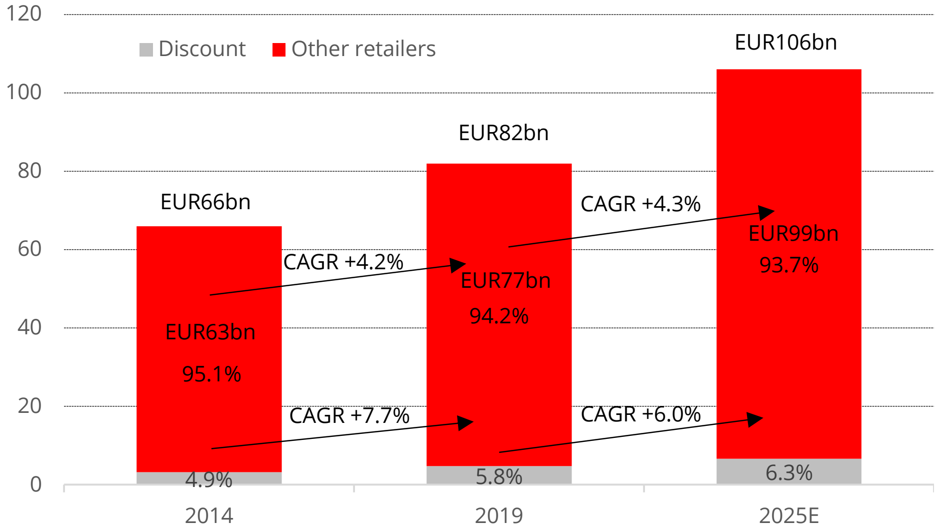
Fig. 56. UK hard discounters' share and sales evolution



Source: OC&C, Company data, Note: 2017 refers to discount apparel channel penetration (does not include apparel sold through groceries), while 2019 refers to Pepco's apparel addressable market penetration (includes value apparel sold through grocery retailers).

Discount addressable market penetration in the total retail market is also rising in Poland, a core market for Pepco. It outperformed the total retail market by 3.5pp in 2014-19 and is set to outperform it by 1.7pp by 2025E, according to OC&C's analysis.

Fig. 57. Pepco: Discount addressable market penetration in total retail market in Poland



Source: OC&C, Company data

In addition, the macro fundamentals remain supportive, albeit affected by the pandemic, in our view. The pan-European market is sizeable, with a large population of over 500mn people based mainly within the European Union. GDP growth should support retail in the medium-term, while a slower projected pace of growth, compared to 2015-19, might further support discounters as a cheaper alternative to high street retailers.

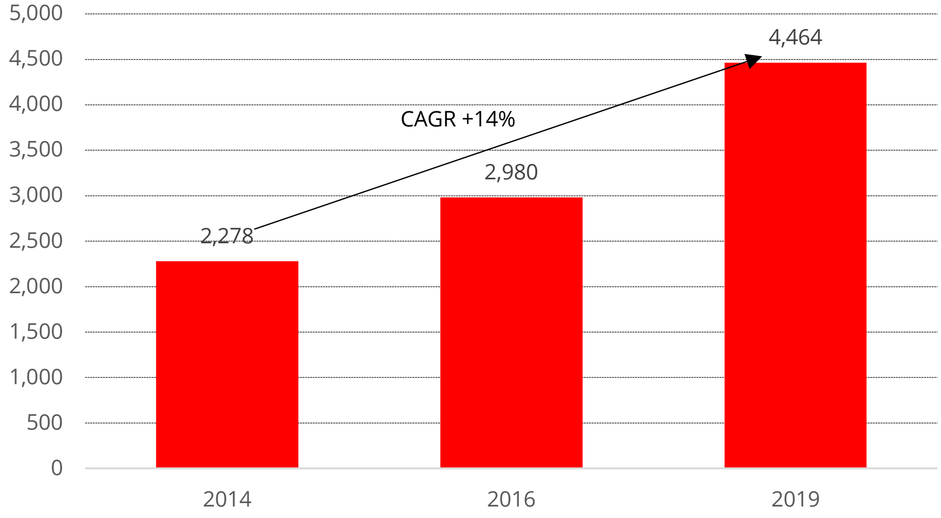
Fig. 58. Pepco Group: Macro fundamentals forecast

	2015-19 CAGR	2019-23E CAGR
Real GDP growth		
Poland	4.5%	2.1%
Other CEE	3.9%	1.7%
Western Europe	1.9%	0.9%
Real Disposable Income growth		
Poland	4.4%	1.1%
Other CEE	5.1%	1.9%
Western Europe	1.6%	0.8%
Offline retail sales growth		
Poland	3.5%	1.5%
Other CEE	5.8%	3.7%
Western Europe	0.3%	-0.7%

Source: UN DESA, Oxford economics, Global Data, OC&C, Company data

Discounters format leads to physical store sector growth and generates above-average industry EBIT margins at 8-10% compared to 5-7% for speciality and multiline retailers in Europe, according to OC&C's analysis.

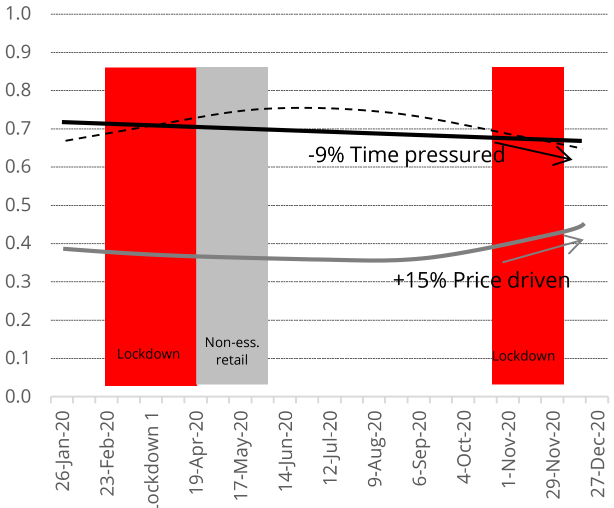
Fig. 59. Number of stores: Six selected discount/value retailers in UK Case Study

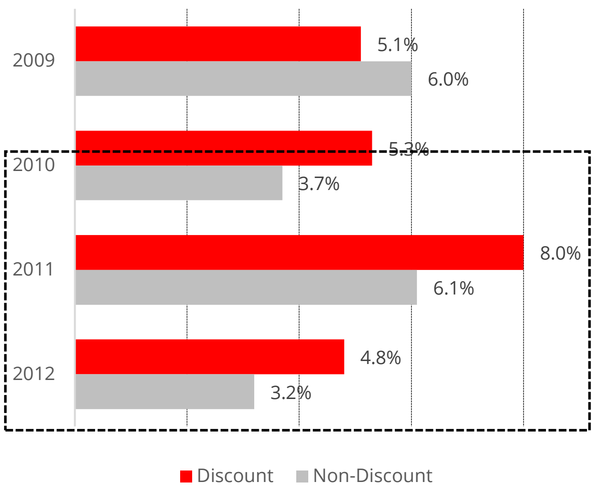


Source: OC&C analysis, BRC Retail Sales monitor

Discounters seem likely to benefit from the adverse impact of Covid-19 on the economy. As shown in a UK case study above, discounters tend to outperform in tougher economic conditions as consumers become more price-driven.

Fig. 60. Time-pressured shoppers became more price driven **Fig. 61. U.K. discount vs. Non-discount sales growth in 2009-12**





Source: Oxford economics, GlobalData, OC&C, Company data, Capital IQ

Significant store expansion opportunities

Pepco Group had 3,021 stores as at the end of September 2020 and believes that it has the potential to roll out both the Pepco & Poundland/Dealz brands over the next two decades to reach 11,100 stores in existing and prioritised new markets. Following an independent market/catchment analysis (validated by OC&C, except for Pepco Spain&Italy), the company identified the potential for 8,188 Pepco stores in the long term (vs. 2,100 now) and 2,927 Poundland/Dealz stores (vs. 921 now; management analysis). With regards to Pepco, 52% of the roll-out potential is seen at existing markets with a majority in WE (72% of existing markets potential). With regards to P/D, 59% of its roll-out potential is seen as taking place in existing markets, which is equally blended between WE and CEE markets.

Fig. 62. Pepco Group: Long-term roll out opportunity

	Now	Existing markets CEE	Existing markets WE	Priority Expansion Markets CEE	Priority Expansion Markets WE	L-T goal
Pepco	**2,100**	908	2,250	217	2,713	**8,188**
P/D	**921**	592	595	735	85	**2,928**
Total	**3,021**					**11,116**

Source: OC&C, Company data, validated by OC&C except for Pepco Spain&Italy, Poundland/Dealz: management estimates, For Pepco priority CEE markets include: Montenegro, Moldova, Albania, Bosnia, North Macedonia, Priority WE markets include Germany, Portugal, Austria and Greece; For P/D existing markets include: Poland, Spain and Ireland, Priority new markets include Portugal, Romania, Hungary, Czech Rep., Slovakia

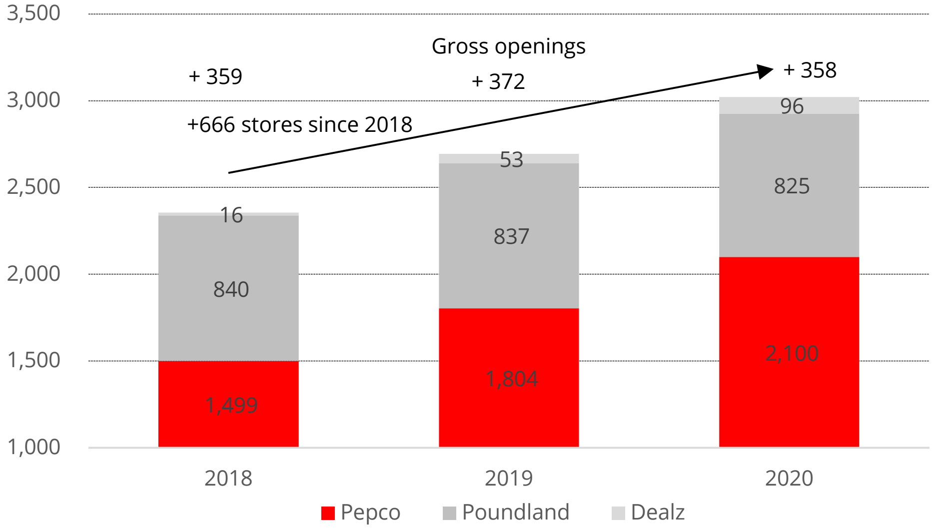
Moreover, easing of the payback target to 36 months from 30 in Poland should allow an additional 158 potential stores according to the company's analysis, while ROIC would still be in line with the global peer average, despite reduced payback, according to the company. Also, applying Poland store density expectations to other CEE countries (excl. Poland) gives an additional 1.4k potential stores.

In addition, Pepco has identified 2,856 potential new stores for Pepco and 5,134 for Dealz across other CEE and WE markets like: Ukraine, Belgium, Finland, Luxembourg, the Netherlands, Denmark, Norway, Sweden, Switzerland, Turkey (for Pepco) and Ukraine, Germany, Belgium, Italy, the Netherlands, Sweden, Turkey, Austria and others (for Dealz).

So far, Pepco has proven its roll-out capabilities with a solid expansion in recent years supported by attractive paybacks in Pepco and payback improvement in Dealz, thanks to rising scale effects (better brand awareness and sales density). During that time, Pepco entered the Baltic States, Bulgaria, Serbia and Italy. Harmonized layout and merchandising have enhanced roll-out efficiencies thanks to lower opening costs and shorter opening periods.

At the start of FY21 Pepco targeted opening 320-350 new stores. 194 of these targeted store openings leases have been signed, 87 stores have been internally approved but leases not yet signed, while 29 stores are to be approved in the course of the year. Pepco Group plans to add approximately net 450-480 new stores in total in 2021E.

Fig. 63. Pepco Group: Store chain expansion in 2018-20



Source: Company data

Fig. 64. Pepco: Payback* post tax in 2019

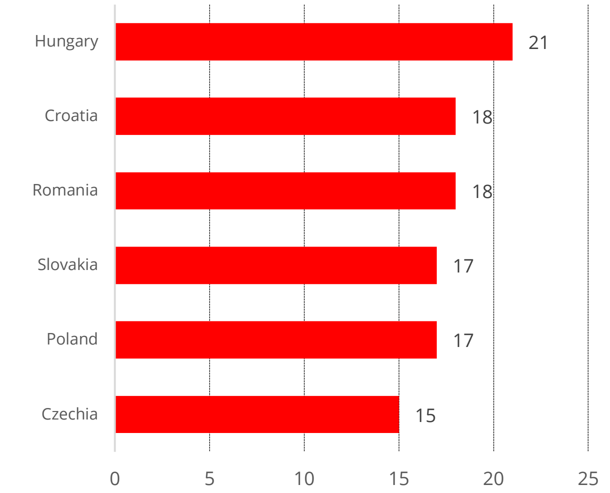
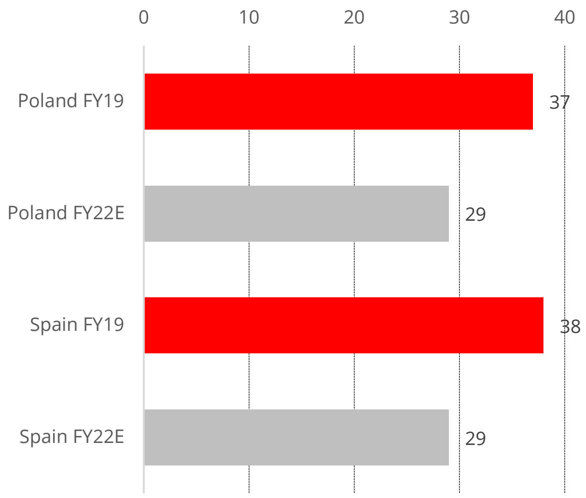


Fig. 65. Dealz: Payback* improvement potential



*Source: Company data, * investment outflows (capex & WC investments) over pre investment inflows (store contribution after tax)*

Interestingly, the fast roll-out with 2017-20 CAGR of 13% has not adversely impacted store economics. The sales density of stores from the 2011-13 cohort has increased by 5.7% compared to the 2009-10 cohort, while the 2014-16 cohort has increased by 11.0%, showing that more recent stores deliver higher LFL growth than previous cohorts. A typical store operating for over a year brings a EUR235k contribution measured as pre-tax-and-central-costs profit. The company says that nearly all (99.9%) Pepco stores were profitable in FY19 (pre COVID-19), with CEE being the most profitable with c.71% of Pepco stores delivering more than 20% of the contribution margin.

Fig. 66. Pepco: Sales densities of mature stores *

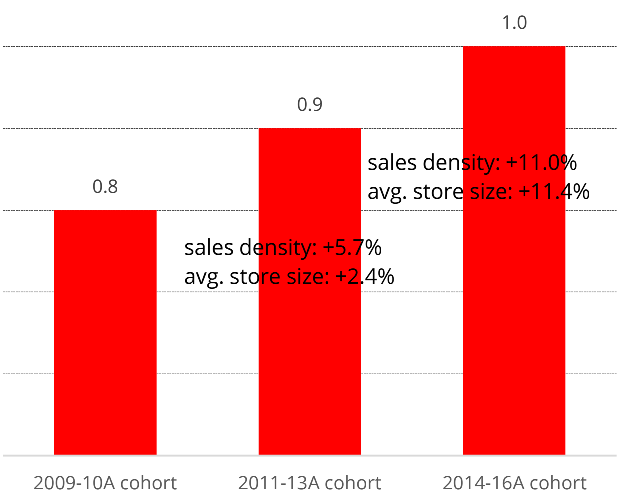
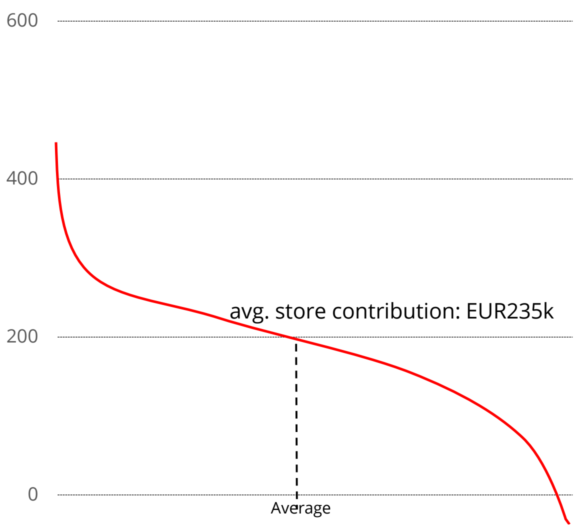


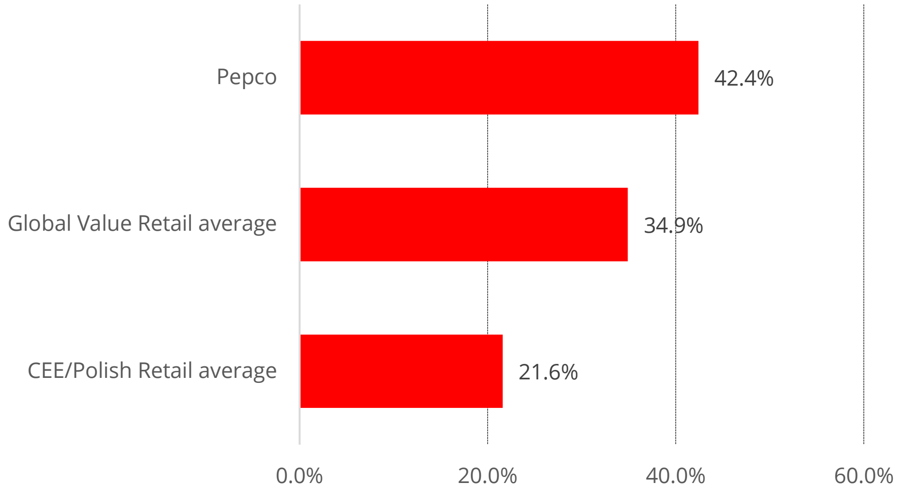
Fig. 67. Pepco: Store profitability in FY19 **



*Source: Company data, OC&C analysis, * based on 2009-10 store cohort, ** stores trading for more than one year*

Pepco also compares well with peers from Global Value Retail and CEE/Polish retail average in terms of ROIC.

Fig. 68. Pepco: ROIC vs. Global Value Retail and CEE/Polish retail average in 2020



Source: Company data, ROIC = NOPAT/IC (PPE + intangibles ex. goodwill + NWC), Global Value Retail = B&M, Burlington, Dollar General, Dollar Tree, Dollarama, Five Below, Ollie's, Ross Stores and TJX, CEE/Polish Retail = LPP, CCC, Dino, Jeronimo

According to the company, improvements to working capital (mainly trade liabilities) from last year are likely to be permanent, which should enhance new store openings, increasing roll-out potential. At the same time, a payback period decline by 5 months appears to be permanent. The company has identified 550 incremental CEE catchments in addition to its base plan based on this.

Fig. 69. Pepco: Improved individual store payback due to lower WC needs– case study]

EURk	FY2019	Base Case Future	Previous Future
EBITDA	235	242	242
Capex	150	180	180
Working Capital	132	64	132
Pre-Opening Costs	25	35	35
Payback (months)	19	18	23

Source: Company data

Pepco has a first-mover advantage, in our view. Its large footprint in many markets and solid store economics should give the company an opportunity to conquer much smaller catchment areas than competitors. Over 35% of its stores are within a catchment area of below 20k inhabitants. This, coupled with the limited strength of organized competition, provides barriers of entry and space for further roll-outs, in our view.

Santander

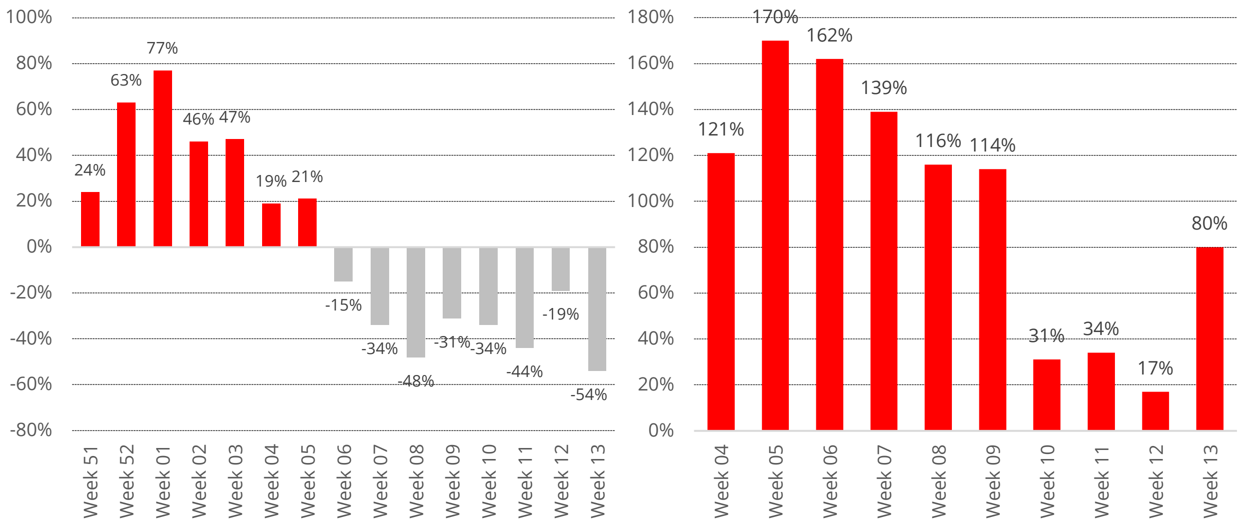
Fig. 70. Pepco: Store footprint vs. competitors

	PL	RO	CZECH	HU	SLOV	CRO	LI	SLO	LTV	EST	BUL	SERBIA	TOTAL
PEPCO	1009	301	219	186	114	79	50	28	34	23	52	Entering	2095
ACTION	80	–	2	–	–	–	–	–	–	–	–	–	82
TEDi	52	–	2	–	14	37	–	26	–	–	–	–	131
KIK	352	41	225	75	93	81		52	–	–	8	–	927
TXM	195	–	–	–	–	–	–	–	–	–	–	–	195
TAKKO	40	69	110	52	50	25	13	18	–	14	–	19	410
PRIMARK	Entering	–	1	–	–	–	–	1	–	–	–	–	2
SINSAY	184	25	13	6	12	7	2	2	4	7	1	4	267
SZACHOWNICA	80	–	–	–	–	–	–	–	–	–	–	–	80
Competitor Total	983	135	353	133	169	150	15	99	4	21	9	23	2,094

Source: Company data, OC&C, Pepco: store data as of Sept 2020 and does not include 5 stores in Italy, Competitors: store data as of Feb 2021

The early results from new markets that Pepco entered last year, namely Italy and Serbia, prove that the store model works and paves the way for accelerating expansion in these markets. They also suggest the company is capable of expanding in adjacent markets and sizeable new ones. Both markets provided solid and above-budget sales in the weeks before the introduction of Covid-19 restrictions (Italy: week 6 and Serbia: week 10).

Fig. 71. Pepco: Actual sales vs budget in 2020, % by weeks in Italy (left) and Serbia (right)



Source: Company data

Fig. 72. Pepco: Average weekly no. of transactions per store in 1Q20

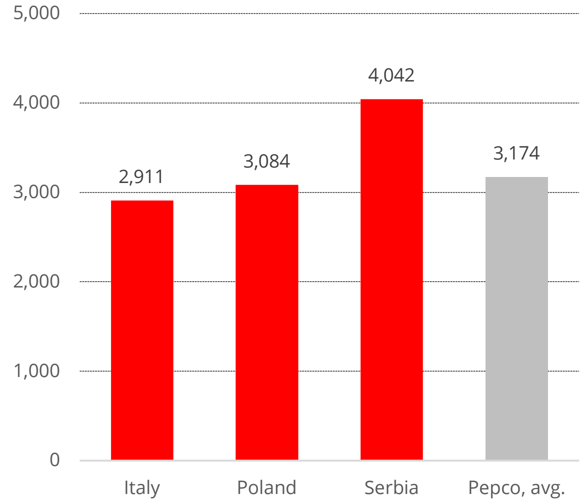
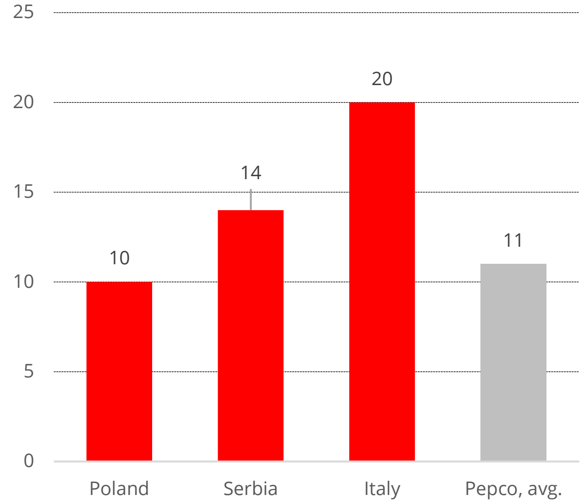


Fig. 73. Pepco: average basket value (EUR)



Source: Company data, data prior to Covid restrictions for Italy and Serbia

Fig. 74. Pepco: Western Europe has similar attractive potential to Poland

	Population (mn)	Children <10 years old (mn)	#small & mid-size towns (5-20k)	Market (EURbn 2018)	Penetration of discount: Apparel	Penetration of discount: Home Focused GM	Indicative store potential
Italy	60	5.5	1503	99	14.4%	29.7%	1,250
Spain	47	4.4	800	45	13.4%	16.0%	1,000
Poland	38	3.9	409	20	16.8%	38.3%	

Source: Company estimates, OC&C estimates, apparel, homewear & toys as of 2018

The risk related to opening stores in new locations appears to be low, in our view. In its store selection strategy, the company first looks for market attractiveness criteria with the availability of an appropriate group of consumers seeking value for affordable prices with an attractive demographic profile (e.g. child population), an underpenetrated discount market and limited organised competition. Then, the company examines the possibilities of achieving attractive margins, looking for a stable legal environment (EU or similar regulations) and the availability of space with a favourable rental market and logistics environment. All of these factors lead Pepco to open its stores mainly in shopping malls and high streets with sufficient customer traffic in sizable EU markets or adjacent markets to where it is currently operating.

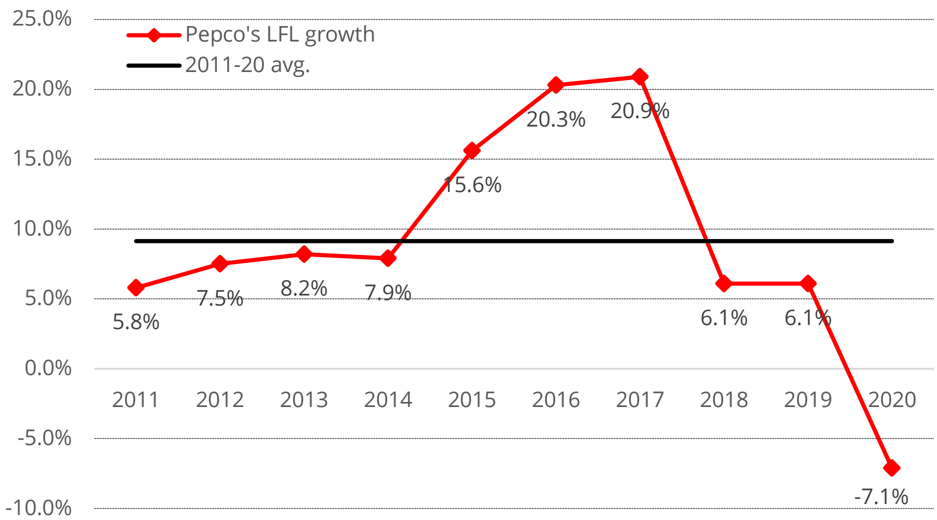
Dealz's roll-out is also one of the growth pillars for Pepco Group. Following its startup in 2017 and positive early feedback, the company aims to roll-out 100 stores per annum in 2021-22E. Increasing brand awareness should bring about a sales density improvement and further efficiencies of scale in the form of faster payback of initial capex per new store (29 months projected in 2022E vs. current 37 in Poland and 29 months in Spain vs. 38).

Continued sales growth on LFL basis driven by customer proposition development and new channel opportunities

Pepco has historically delivered solid growth on a LFL basis of 9.1% on average since 2011. Major LFL sales growth in 2015 - 2017 was a result of the introduction of the PLN500+ Child Support payments in Poland and the enhancement of ranges at that time by the category director. As growth on an LFL basis is a key KPI, which confirms the rationale behind the continued store chain roll-out, Pepco sees continued LFL growth as a key priority and continues to work on enhancing the customer proposition. Over recent years, a focus has been placed on general merchandise offer improvement to increase its attractiveness. The company plans to rebalance trading space in stores to dedicate more space to its general merchandise offer (40% share in total space vs. the current c.36%) through store refreshment, store flow improvement and better adjacency/space engineering, which should enable it to add 10 new modules to existing store space and improve its density. Importantly, it aims to achieve this without a high reduction in overall space allocated to apparel (60% share vs. 64%) through improvements to space allocation capability and in-store equipment increasing merchandising density to enable more effective clothing grouping and enhancement of queuing/cash register areas.

The program aims to deliver an additional c.3% to LFL sales growth with a EUR6k investment and an c.8 month payback. Pepco aims to reformat c.400-500 stores per annum in the next few years. Pepco's core ranges are also planned to be enhanced, i.e. by trial tests of a new range of baby-focused FMCG products.

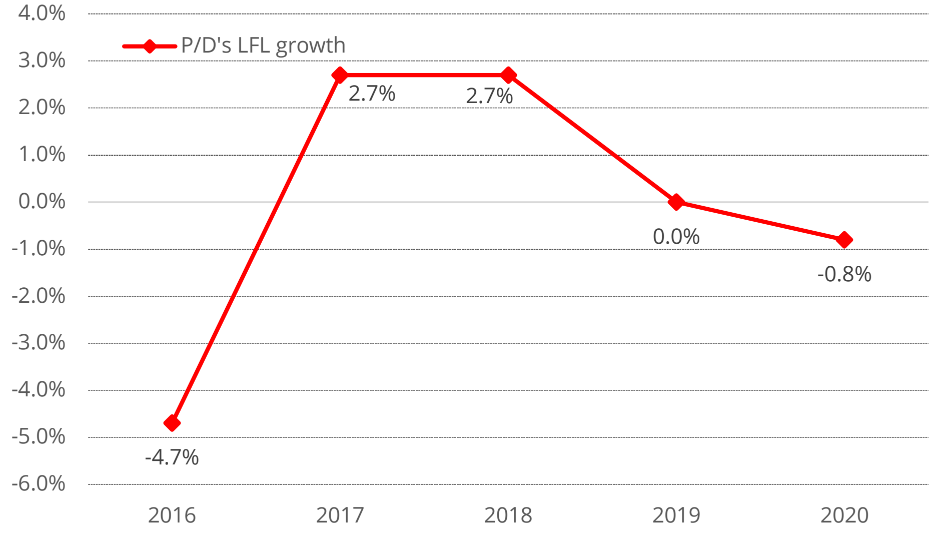
Fig. 75. Pepco's LFL growth in 2011-2020



Source: Company data

With regard to Poundland, its LFL growth averaged at 1.8% in 2017-19 after an initial decline of 4.7% in 2016 after the acquisition of Poundland by Pepco Group.

Fig. 76. Poundland/Dealz's LFL growth in 2011-2020



Source: Company data

Poundland enjoys the highest visit frequency, scores strongly on key purchasing criteria, but has a lower than average for industry standard transaction value, which offers an opportunity for LFL growth. To address this opportunity, Poundland has introduced a few initiatives to improve LFL growth:

1. The development of Pep&Co clothing range in generously spaced Poundland stores through 330 "shop-in-shops". As a result, the Pep&Co brand has grown to become the UK's 18th largest clothing brand by volume, according to Kantar Fashion in 2020;
2. SKU rationalisation aimed at making available additional space for introduction of new categories or extending existing ones. For example, following a successful trial in ten stores, chilled and frozen food was rolled out to 120 stores in 2020 and is planned to be rolled out to over 250-350 UK stores in the next two financial years. Poundland also acquired Fultons Food in October 2020. Before the acquisition, the company provided category management and logistics capability to Poundland during the initial trial period;
3. An extension of homeware assortment to leverage the Pep&Co brand.

   After initial analysis of the catchment area, Poundland will have three distinctive formats: (1) 'destination stores' in retail parks with the full proposition, (2) core 'heartland' stores on high streets/ at shopping centres with a more limited proposition, and (3) smaller 'essential' stores in neighbourhood locations.

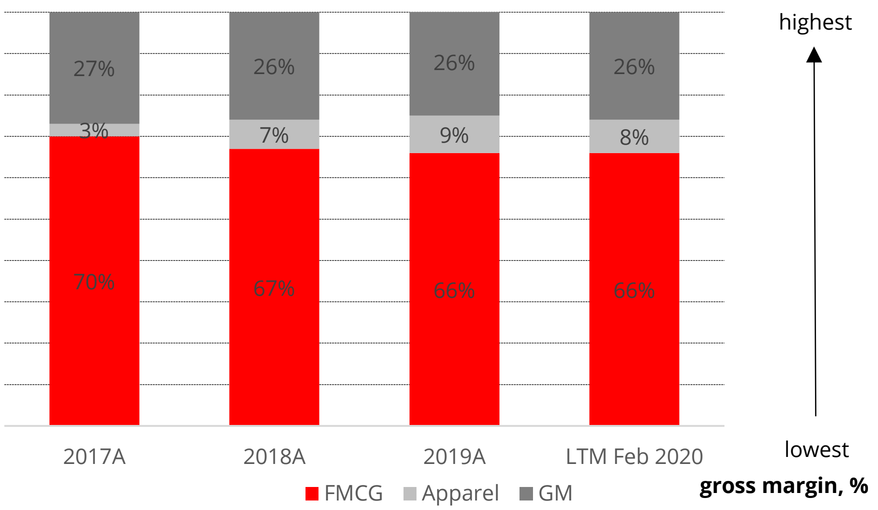
Fig. 77. Poundland/Dealz format development

	Essentials	Heartbeat	Destination
Mission	Edited version of Poundland with emphasis on "To Go" and Core Categories	Top Up and weekly shop meeting specific household needs across FMCG, GM and clothing	Full proposition with extended FMCG, GM and clothing ranges
Location	High footfall transit locations and local neighbourhoods	High Streets and town centre locations	Out of town Retail Park locations
Core FMCG	✓	✓	✓
Core GM	✓	✓	✓
Extended GM (Home)	.	✓	✓
Pep&Co	.	✓	✓
Ice - Frozen	.	✓	✓
Ice - Chilled	✓	✓	✓

Source: Company data

Gradual shift from FMCG towards apparel and GM should also have a positive impact on gross margin in Poundland&Dealz.

Fig. 78. Poundland/Dealz: gross margin on FMCG/apparel/GM



Source: Company data, pre-IFRS16 data

Multi-price expansion in Poundland/Dealz

Historically, the majority of products in Poundland and Dealz remained at a core anchor price (£1 in the UK). Recently, Poundland and Dealz have expanded the number of price points in response to demand following research involving over 3,000 customers, who confirmed their interest in buying more for their regular replenishment needs. Now, the price architecture includes eight prices from 50p to GBP5 with the average unit price at GBP1.2 with a broader access to key brands. P/D internal estimates suggest that multi-price expansion might give access to additional consumer expenditure of EUR4bn on top of existing core categories and increase the addressable market in FMCG/GM categories to c70%. Price expansion was carried out in (1) health and beauty, (2) homeware, and (3) grocery last year and brought about encouraging first effects with an increase in price of the average basket and thus of store economics. The price architecture in all other categories will be expanded in 2021E.

The improved store format, category expansion and multi-price offer usually result in c.5% higher LFL growth after store refit, according to the company.

Operating costs improvement

Pepco Group sees the ongoing implementation of Oracle - a uniform ERP system across group operations - as a key enabler for the optimization of operating costs. A new system is going to replace the existing core systems, improving process efficiency, accuracy and transparency.

Poundland

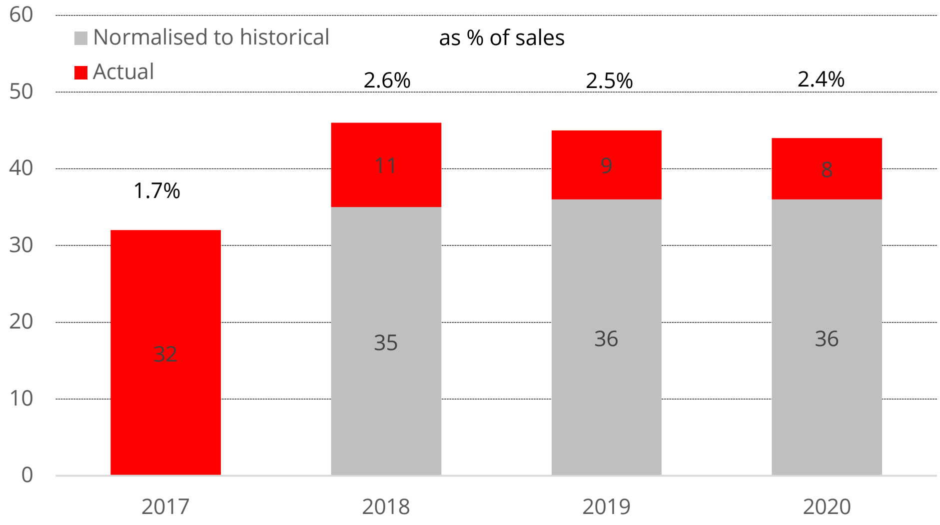
The potential to optimize operating costs in Poundland can be broken down into:

1. optimizing store rental costs;
2. reducing shrinkage costs; and
3. streamlining the supply chain.

(1) Store rent cost in Poundland was GBP101mn in 2020 (the largest part of operating costs). The company plans to reconsider rent agreements at lease expiry in the context of the existing location attractiveness. Then the rent agreement will be extended on the most favourable terms possible, or if the attractiveness of the location has declined or the store is the wrong size, Poundland will re-site the store or seek to change the agreement. The company always seeks to maximise flexibility within the new lease with a short lease commitment and tenant-only break clause within the initial lease period. Poundland has successfully renegotiated 181 leases with an average reduction in cost in excess of 36% in the last two years. 55% of Poundland's leases may be renegotiated in the next four years (by 2024E) representing a cost reduction opportunity of c. GBP20mn, according to the company's analysis.

(2) Shrinkage has recently increased by 90bps due to the initial implementation of multi-price offers (more products attractive to thieves) without adequate additional protection, and the introduction of self-scanning tills. Poundland has decided to remove some self-checkouts and (re)introduce guarding and CCTV where necessary. All these measures are aimed to reduce shrinkage to 2.0% of revenue in the next four years.

Fig. 79. Poundland/Dealz: shrinkage opportunity



Source: Company data

(2) On Streamlining, Poundland integrated the Pep&Co supply chain into the existing Poundland distribution network in 2019. It is implementing a programme of rationalising the current distribution infrastructure of one national distribution centre (NDC), three regional distribution centres (RDCs) and four outbases to one hybrid warehouse (both NDC and RDC), two RDCs and three outbases by the end of 2021. The programme is set to reduce total logistics costs by approximately GBP2.5mn per annum by the end of the programme, in our view.

Pepco

Pepco has completed a detailed assessment of end-to-end supply chain improvements through better stock in DC and product flow to stores with more efficient transportation. The company also sees operating efficiency improvements in the store planning (integrated store, range and assortment planning), buying (packaging size optimization), product movements (optimizing containers, in-store stock building and transport) and store selling (replenishment enhancement). All these factors offer opportunities to address the potential rise in labour inflation in coming years through operating efficiencies.

New channel opportunities - online

The rapid growth in online sales in retail is not a new phenomenon that appeared as a consequence of the **Covid-19** outbreak, but is rather a longer-lasting trend that has shaped retail for many years. So far, digital remains nascent in discount/value retail and is limited to product catalogue search engines, mainly due to still unattractive basket economics that are not able to cover logistics costs of home delivery or click & collect costs.

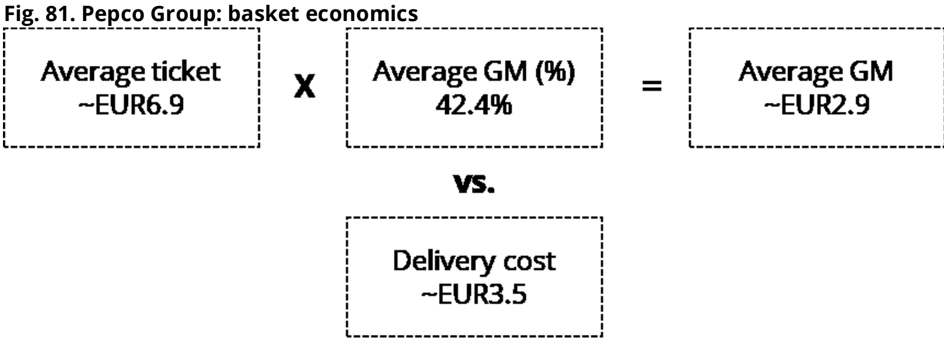
Fig. 80. Online analysis presence for select discount retailers

	Action	B&M	Primark
Product Search	✓	✓	✓
Click & Collect	-	-	-
Home Delivery	-	-	-

Source: OC&C analysis, BRC Retail Sales Monitor

Pepco Group remains aware of the increasing role that online plays in retail, however its analysis of customer demographics, high store density and basket economics has shown high levels of cash purchases in small baskets (53% of all payments in Pepco; just 5pp down during Covid-19). An average gross margin of 42.3% (group's gross margin in 2019) on an average ticket of EUR6.9 amounts to EUR2.9, which is still below the company's estimate of delivery costs at EUR3.5 (for the whole logistics process from warehousing to last-mile delivery). The company still sees the upsurge of online's share in retail during Covid-19 as being short term, and expects a rebalancing between off/online channels to occur after the pandemic.

Fig. 81. Pepco Group: basket economics



Source: OC&C analysis, BRC Retail Sales Monitor

On the other hand, Pepco Group is constantly watching the development of the shift to online both in terms of brand relationship and shopping. The company is confident that its customer proposition with market-leading prices and store chain density delivers a perceived advantage versus online including convenience and value. The company is also confident that these values will work online at some point in time. Also, its broad store portfolio offers more click & collect services compared to competitors. The company is undertaking low-scale trials in order to better understand the challenges of the online offer. Pepco Group uses online platforms and social media to engage with customers. Examples include: shopping list trials in Dealz Spain, brand promotions and digital advertising. The company has undertaken trials of deliveries to home, and used lockers in Poundland/Dealz and has achieved limited trials of deliveries to home or an outsourced platform in Pepco.

For now, Pepco's customers do not show much interest in its offer going online, according to the company's surveys, however, the company believes it is ready to take advantage of online development. In our view, it is both an opportunity for development of a future omnichannel offer but also a risk of higher capex spending on developing such a service.

Domestic / global portfolios corner

Warsaw Stock Exchange (WSE) key market indices

With respect to the broad market benchmark, the WIG Index, Pepco was introduced to the portfolio three business days following its trading introduction. Index share amounts to ca. 1.28% as at June 23rd.

When the remaining main WSE indices are concerned, we estimate there are relatively high odds for Pepco's unconditional inclusion to the blue chips portfolio at the yearly index review in March 2022E (based on the historical trading patterns of entities with similar market characteristics). In the meantime, the company should join the mWIG40 portfolio (est. index weight at ca. 6.6% based on current market prices) at the occasion of December quarterly index review (based on the updated index methodology requiring minimum four-month trading history. Unfortunately, we are unable to reliably estimate potential net passive demand triggered by the either mWIG40 or WIG20 index inclusion. Nevertheless, we point out expanding assets under management (AuM) of the domestic long-term equity pension pillars (PPKs) and their pre-defined AuM allocation limits (minimum 40% allocation to the WIG20 Index) could translate into increased interest in the company by the domestic investment firms.

Foreign indices – MSCI / FTSE / STOXX

Taking into account Pepco Group's market characteristics, the company should be eligible for inclusion to the main global index families as well. We consider MSCI, FTSE and STOXX as the most important ones from a passive demand perspective.

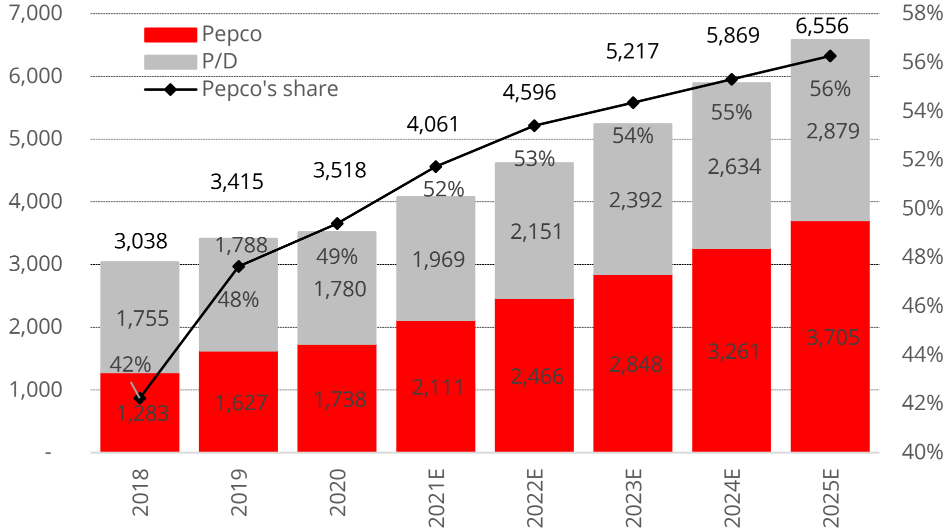
In the optimistic scenario, the promotion to the MSCI EM indices might take place already at ordinary index review scheduled for August 2021E. If not, the semi-annul ordinary index review in November appears most probable. We calculate net passive demand resulting from inclusion to the MSCI Emerging Markets Standard Index at ca. PLN380mn. The inclusion to the FTSE Developed Markets GEIS might happen in September, while the net passive demand could near PLN180mn, we calculate. With respect to the STOXX index family methodology, the issuer should join the regional portfolios at the time of regular index review (potentially September 2021E) and might result in net passive demand of PLN50mn.

Financials & forecasts

Pepco Group's sales CAGR was 8.2% in 2018-20. Sales growth was hit by the pandemic, as in 2017 – the LTM Feb-20 sales CAGR was 12.1%. Group sales were driven predominantly by Pepco (2017-20 sales CAGR at 21.9%; 2017–LTM Feb-20 CAGR at c.30%). Poundland/Dealz's revenue remained pretty much at the same level in that period (2017-20 sales CAGR at -0.7%; 2017–LTM Feb-20 sales CAGR at c.1.5% vs. -1.3% for UK high street footfall). Pepco's share of group sales increased to 49% in 2020 from 42% in 2018.

In 2021-23E, we expect Pepco Group's sales to grow at a faster rate of 14.2%, taking into account the predicted rebound after the COVID-19 pandemic. We assume that Pepco should remain the driving force for the growth, with its sales rising at a healthy 2020-23E CAGR of 17.9%. We expect its share in the group to continue to grow to 56% of sales in the long term. P/D's sales is likely to grow at a 2020-23E CAGR of 10.4%, in our opinion.

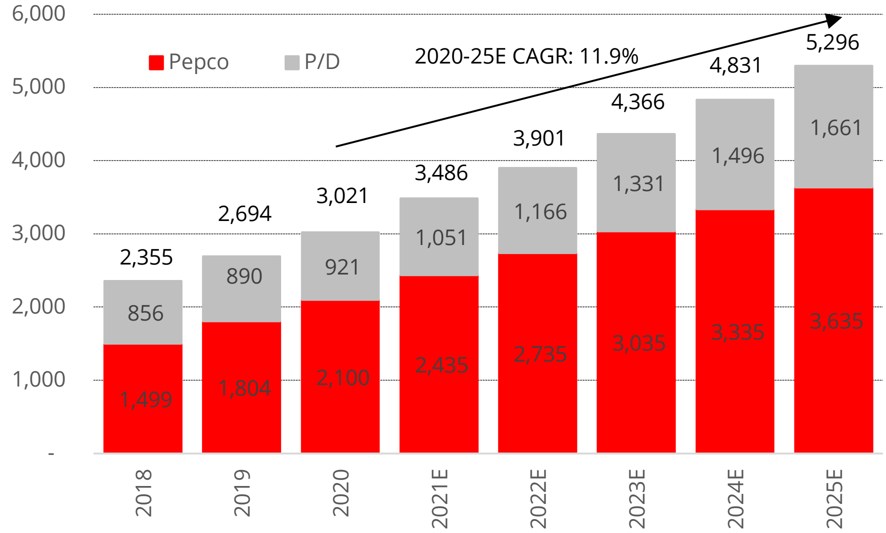
Fig. 82. Pepco Group: Sales forecast (EURmn)



Source: Company data, Santander Brokerage Poland estimates

The number of Pepco Group stores grew by 13.1% on average in 2017-20. The growth was driven predominantly by Pepco (2017-20 CAGR at 20.1%). Poundland/Dealz stores remained pretty much at the same level in that period (2017-20 CAGR at 1.7%). We expect that the number of Pepco Group stores should grow at a 2020-23E CAGR of 13.1%, reflecting the growth in both Pepco and Dealz stores.

Fig. 83. Pepco Group: number of stores



Source: Company data, Santander Brokerage Poland estimates

With regards to Pepco, we expect its sales to grow at a 2020-23E CAGR of 17.9% to EUR2,848mn. The growth should be driven by: (1) LFL growth at 6%/5%/5% in 2021-23E respectively, reflecting, among other factors, the results of reformatting 400-500 stores per annum in the next few years, which should add 10 new modules to existing store space and improve density through dedicating more space to the general merchandise offer (a 40% share in the total space vs. the current share of c.36%); and (2) the opening of new stores: 335 (+16% y/y)/300 (+12%)/300 (+11%) in 2021-23E respectively, reflecting using opportunities in existing, adjacent and new markets. We expect that most new stores will be opened in existing CEE markets, however, we assume a gradual acceleration of the roll-out in Italy from +50 new stores in 2021E to +100 in 2022-23E. All in all, we assume Pepco's market share in TAM should increase to 11.0% in the long term (2025E).

Fig. 84. Pepco: Sales forecast *

EURmn, year to Sept.	2018	2019	2020	2021E	2022E	2023E	2024E	2025E
Sales	1,283	1,627	1,738	2,111	2,466	2,848	3,261	3,705
chng.	34%	27%	7%	21%	17%	16%	14%	14%
LFL	6.1%	6.1%	-7.1%	6.0%	5.0%	5.0%	5.0%	5.0%
Sales 'old' stores	1,019	1,361	1,511	1,842	2,216	2,589	2,991	3,424
chng.	n.a.	34%	11%	22%	20%	17%	16%	14%
Sales/old store	0.8	0.9	0.8	0.9	0.9	0.9	1.0	1.0
chng.	n.a.	8.1%	-7.7%	4.7%	3.7%	4.0%	4.1%	4.2%
Sales 'new' stores	264	266	227	268	249	259	270	281
chng.	n.a.	0%	-15%	19%	-7%	4%	4%	4%
Sales/new store	0.9	0.9	0.8	0.8	0.8	0.9	0.9	0.9
New store productivity	110%	96%	91%	91%	91%	91%	91%	91%
No. of stores	1,499	1,804	2,100	2,435	2,735	3,035	3,335	3,635
chng.	24%	20%	16%	16%	12%	11%	10%	9%
new stores, net	286	305	296	335	300	300	300	300
TAM*	n.a.	26	27	28	30	31	32	34
chng.	n.a.	n.a.	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%
mkt. share	n.a.	6.3%	6.4%	7.4%	8.3%	9.2%	10.1%	11.0%

*Source: Company data, Santander Brokerage Poland estimates, * Apparel&GM addressable existing market value and growth estimated by OC&C research*

With regard to P/D, we expect its sales to grow at a 2020-23E CAGR of 10.4% to EUR2,392mn. The growth should be driven mainly by new store openings of: 130 (+14% y/y)/115 (+11%)/165 (+14%) in 2021-23E respectively, reflecting the continued exploitation of growth opportunities for Dealz (+100/+100/+150 new stores in 2021-

23E). We expect that most new stores will be opened in existing markets. We expect the LFL sales growth to be at 2.0%/2.5%/2.5% in 2021-23E respectively, reflecting the effects of (1) a multi-price architecture expansion, (2) chilled and frozen food roll-out in over 400 UK stores over the next two financial years, and (3) the extension of Pep&Co's brand to Pep&Co Home. All in all, we assume that Pepco's market share in TAM will increase to 20.0% in the long term (2025E).

Fig. 85. Poundland/Dealz: Sales forecast *

EURmn, year to Sept.	2018	2019	2020	2021E	2022E	2023E	2024E	2025E
Sales	1,755	1,788	1,780	1,969	2,151	2,392	2,634	2,879
chng.	-3%	2%	0%	11%	9%	11%	10%	9%
LFL	2.7%	0.1%	-0.8%	2.0%	2.5%	2.5%	2.5%	2.5%
Sales of 'old' stores	1,866	1,757	1,774	1,816	2,019	2,205	2,452	2,700
chng.	n.a.	-6%	1%	2%	11%	9%	11%	10%
Sales/old store (EURmn)	2.1	2.1	2.0	2.0	1.9	1.9	1.8	1.8
chng.	n.a.	-4%	-3%	-1%	-3%	-2%	-3%	-2%
Sales of 'new' stores	-111	31	6	154	133	187	182	179
chng.	n.a.	n.a.	-80%	2339%	-14%	41%	-3%	-2%
Sales/new store	n.a.	0.9	0.2	1.2	1.2	1.1	1.1	1.1
New store productivity	n.a.	45%	10%	60%	60%	60%	60%	60%
No. of stores	856	890	921	1,051	1,166	1,331	1,496	1,661
chng.	-2%	4%	3%	14%	11%	14%	12%	11%
new stores, net	-20	34	31	130	115	165	165	165
Poundland	840	837	756	786	801	816	831	846
Dealz	16	53	165	265	365	515	665	815
TAM*	n.a.	8.0	8.3	8.5	8.8	9.1	9.4	9.7
chng.	n.a.	n.a.	3%	3%	3%	3%	3%	3%
mkt. share	n.a.	n.a.	14%	15%	16%	17%	19%	20%

*Source: Company data, Santander Brokerage Poland estimates, * Grocery addressable existing market value and growth estimated by OC&C research, market share based on only FMCG revenue*

Costs and margins

We expect the underlying pre-lease EBITDA margin of **Pepco Group** to be 9.7% in 2021E, almost returning to its pre-pandemic level of 9.8% due to the positive effect of operating leverage and operating cost saving initiatives. In 2021E, we expect Pepco and P/D to record an underlying pre-lease EBITDA margin of 15.8% (vs. pre-pandemic 16.8% in 2019 and 11.5% in 2020) and 3.2% (vs. pre-pandemic 3.3% in 2019 and 1.7% in 2020) respectively. The group's underlying pre-lease EBITDA margin should also be supported by a better sales structure with a higher share of better margins in Pepco. We expect Pepco's share of total revenues is expected to increase to 52% in 2021E from 48% in 2019. In the medium term, we expect an improvement in the underlying pre-lease EBITDA in Pepco to 17.2% in 2025E, mainly due to the positive effects of operating leverage resulting from the 5% same-store sales growth. With regard to P/D, we think that the reduction of shrinkage and operating cost saving initiatives (mainly logistics) undertaken by the company should lead to a further improvement of its underlying pre-lease EBITDA margin to 3.7% by 2025E.

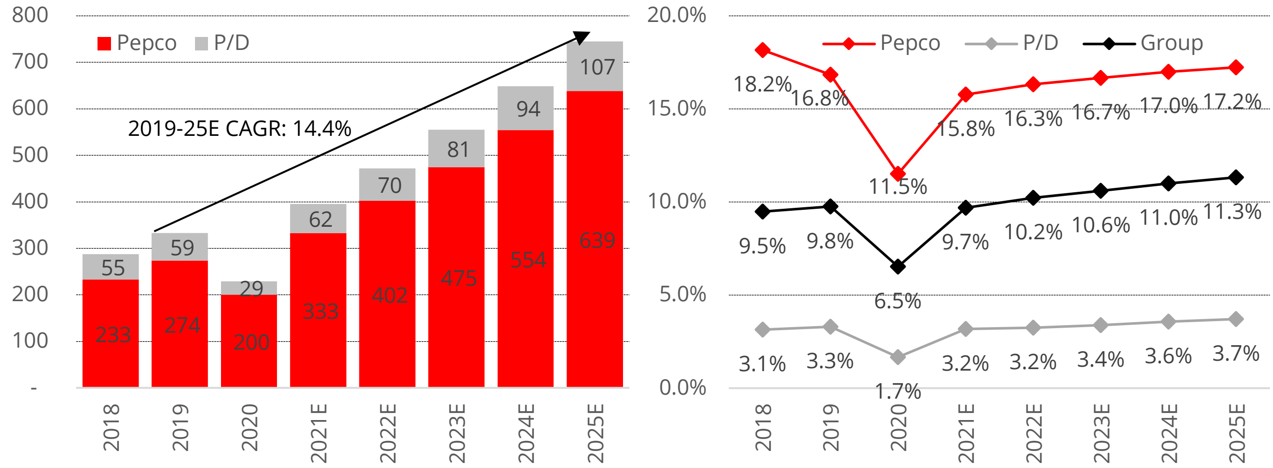
With regards to **Pepco**, underlying pre-lease EBITDA fell to 16.2% (LTM figure for February 2020) and 11.5% in FY20 from 18.2% in 2018. The margin dilution came from (1) reducing prices to secure the leading position on the market (gross margin decrease to 46.1% (LTM Feb 20) from 47.4% in 2018), (2) spending on in-house infrastructure and (3) inefficiencies in the DC network due to small temporary DCs and intra-warehouse inventory transfers (6.9%/7.2%/7.3% in sales in 2018-LTM Feb 20). Overall, labour costs/sales ratio oscillated at 10.1% in 2019 and LTM Feb 20, and was 9.6% in 2018.

We expect Pepco to improve its underlying pre-lease EBITDA margin in 2021E to 15.8% (vs. pre-pandemic 16.8% in 2019 and 11.5% in 2020), gradually rising to 17.2% in 2025E thanks to (1) the return of gross margin to 46.2% in 2021E, close to its pre-pandemic level (46.4% in 2019) and much higher than 44.1% in 2020, and (2) positive effects of operating leverage on direct and central costs resulting from the 5% same-store sales growth.

With regard to **Poundland & Dealz**, underlying pre-lease EBITDA increased to 3.3% in LTM Feb 20 and 3.1% in 2018, mainly due to (1) gross margin expansion to 37.3% (LTM Feb 20) from 36.6% in 2018 thanks to Pep&Co's own brand growth, shrinkage reduction and purchasing benefits from group-wide sharing of core products through joint supplies (PGS), and (2) the reduction of rental costs to 9.8% (LTM Feb 20) from 10.1% in 2018. On a negative note, central costs increased to 4.4% of sales (LTM Feb 20) vs. 3.6% in 2018, reflecting infrastructure investments in Dealz necessary for the accelerated increase in the number of stores starting from 2020.

We expect P/D to improve its underlying pre-lease EBITDA margin in 2021E to 3.2% vs. the pre-pandemic 3.3% in 2019, to reach 3.3% by 2025E due to lower shrinkage and operating cost saving initiatives undertaken by the company. With regard to shrinkage, we expect it to return to 2.3%/2.2%/2.1% of sales in 2021-23E respectively, compared to 2.5% in 2020. Overall, we expect the gross margin to increase to 37.5% vs. 37.2% in 2019 and 36.5% in 2020. With regard to the operating costs reduction, we assume EUR2.5mn savings from the logistics optimisation programme from 2022E.

Fig. 86. Pepco Group: Underlying pre-lease EBITDA progression and margins by 2025E



Source: Company data, Santander Brokerage Poland estimates

Fig. 87. Pepco Group: P&L forecast

Year to Sept, EURmn	2018*	2019	2020	2021E	2022E	2023E	2024E	2025E
Sales	**3,038**	**3,415**	**3,518**	**4,080**	**4,617**	**5,240**	**5,895**	**6,584**
chng.	9%	12%	3%	16%	13%	14%	12%	12%
Pepco	1,283	1,627	1,738	2,111	2,466	2,848	3,261	3,705
chng.	34%	27%	7%	21%	17%	16%	14%	14%
P/D	1,755	1,788	1,780	1,969	2,151	2,392	2,634	2,879
chng.	-3%	2%	0%	11%	9%	11%	10%	9%
Gross profit	**1,271**	**1,443**	**1,433**	**1,714**	**1,943**	**2,215**	**2,502**	**2,800**
margin	41.8%	42.3%	40.7%	42.0%	42.1%	42.3%	42.4%	42.5%
Pepco	608	755	766	975	1,134	1,313	1,506	1,712
margin	47.4%	46.4%	44.1%	46.2%	46.0%	46.1%	46.2%	46.2%
P/D	642	666	649	739	809	902	996	1,088
margin	36.6%	37.2%	36.5%	37.5%	37.6%	37.7%	37.8%	37.8%
Other	21	22	18	-	-	-	-	-
Labour	**331**	**375**	**403**	**458**	**516**	**585**	**657**	**732**
as % of sales	10.9%	11.0%	11.5%	11.2%	11.2%	11.2%	11.1%	11.1%
Pepco	123	164	183	215	251	291	333	378
per store (EURk)	91	99	94	95	97	101	104	108
chng.		9.5%	-5.6%	1.3%	2.5%	3.5%	3.7%	3.8%
as % of sales	9.6%	10.1%	10.5%	10.2%	10.2%	10.2%	10.2%	10.2%
P/D	208	211	220	242	265	294	324	354
per store (EURk)	240	242	243	246	239	236	229	224
chng.		0.6%	0.5%	1.1%	-2.8%	-1.3%	-2.7%	-2.1%
as % of sales	11.9%	11.8%	12.4%	12.3%	12.3%	12.3%	12.3%	12.3%
Occupancy	**259**	**285**	**278**	**319**	**356**	**402**	**447**	**493**
as % of sales	8.5%	8.3%	7.9%	7.8%	7.7%	7.7%	7.6%	7.5%
Pepco	82	106	117	136	152	169	186	203
per store (EURk)	60	64	60	60	59	59	58	58
chng.		6.1%	-6.6%	-0.2%	-1.5%	-0.6%	-0.5%	-0.4%
as % of sales	6.4%	6.5%	6.7%	6.4%	6.2%	5.9%	5.7%	5.5%
P/D	177	179	161	184	204	233	262	290
per store (EURk)	204	205	178	186	184	186	185	184
chng.		0.3%	-13.3%	4.8%	-1.3%	1.4%	-0.7%	-0.6%
as % of sales	10.1%	10.0%	9.0%	9.3%	9.5%	9.7%	9.9%	10.1%
Direct opex	**229**	**256**	**285**	**312**	**345**	**389**	**434**	**482**
as % of sales	7.5%	7.5%	8.1%	7.6%	7.5%	7.4%	7.4%	7.3%
Pepco	89	116	136	154	175	202	232	263
as % of sales	6.9%	7.1%	7.8%	7.3%	7.1%	7.1%	7.1%	7.1%
per store (EURk)	66	70	70	68	68	70	73	75
chng.		7.0%	-0.8%	-2.5%	-0.3%	3.5%	3.7%	3.8%
P/D	140	140	149	158	170	186	203	219
per store (EURk)	161	160	165	160	153	149	144	139
chng.		-0.8%	3.0%	-2.9%	-4.3%	-2.4%	-3.9%	-3.3%
as % of sales	7.9%	7.8%	8.4%	8.0%	7.9%	7.8%	7.7%	7.6%
Central & other	**144**	**173**	**220**	**230**	**254**	**284**	**315**	**348**
as % of sales	4.7%	5.1%	6.2%	5.6%	5.5%	5.4%	5.4%	5.3%
Pepco	81	95	130	137	153	177	202	230
as % of sales	6.3%	5.8%	7.5%	6.5%	6.2%	6.2%	6.2%	6.2%
P/D	63	78	90	93	101	108	113	118
as % of sales	3.6%	4.3%	5.0%	4.7%	4.7%	4.5%	4.3%	4.1%
Underlying pre lease EBITDA	**277**	**333**	**229**	**395**	**472**	**555**	**648**	**745**
chng.	28%	20%	-31%	72%	19%	18%	17%	15%
margin	9.1%	9.8%	6.5%	9.7%	10.2%	10.6%	11.0%	11.3%
Pepco	233	274	200	333	402	475	554	639
chng.	28%	18%	-27%	66%	21%	18%	17%	15%
margin	18.2%	16.8%	11.5%	15.8%	16.3%	16.7%	17.0%	17.2%
P/D	55	59	29	62	70	81	94	107
chng.	20%	7%	-50%	112%	12%	16%	16%	13%
margin	3.1%	3.3%	1.7%	3.2%	3.2%	3.4%	3.6%	3.7%

Source: Company data, Santander Brokerage Poland estimates, 2018's Underlying pre lease EBITDA of PLN277mn contains EUR11mn 'corporate' costs

In 2020, Pepco Group recorded one-off expenses of EUR31.8mn related to (1) EUR6.4mn of costs related to stock moves, short term under-utilisation of production capacity, third-party transitional storage and HR costs relating to redundancy and retention, (2) a EUR13.3mn 'Value Creation Plan' - a one-off reward tool to incentivise top management of Pepco Group, and (3) EUR11.3mn of project costs associated with a potential exit transaction and emergency refinancing-related costs of EUR0.7mn. Pepco Group recognised EUR113mn of goodwill impairment in 2018. We assume EUR13mn non-cash cost of incentive scheme by 2024E.

Cash flow / indebtedness / dividends

According to our forecasts, Pepco Group should be self-financing in coming years, just as it used to be in the past. We estimate that operating cash flows generated by the company should easily finance capex driven mainly by roll-out, keep financial leverage at safe levels and enable dividend pay-outs starting from 2022E (at an assumed pay-out ratio at 40%). Please note that we have included the savings of EUR23mn (EUR5.9mn per annum) generated by rent renegotiation by 2024E. At the same time, Pepco Group should maintain its high ROIC effectiveness measures at approximately 30% in 2021-25E.

Fig. 88. Pepco Group: Cash flow forecast

Year to Sept, EURmn	2018	2019	2020	2021E	2022E	2023E	2024E	2025E
Cash flow from operations	72	142	560	554	620	721	827	941
Capex, of which:	-115	-136	-164	-249	-181	-197	-202	-255
- new stores	-75	-67	-70	-109	-97	-109	-110	-111
- maintenance	-13	-9	-24	-30	-33	-38	-42	-47
- store remodelling	0	0	0	-30	0	0	0	-47
- warehouse	-6	-34	-32	-40	-30	-30	-30	-30
- IT	-17	-22	-34	-40	-20	-20	-20	-20
- other	-4	-4	-4	0	0	0	0	0
Assets disposal	0	0	0	0	0	0	0	0
Organic FCF	**-43**	**6**	**396**	**305**	**439**	**524**	**625**	**686**
Other, M&A included	-65	5	-1	51	0	0	0	0
FCF, before dividends	**-107**	**11**	**394**	**356**	**439**	**524**	**625**	**686**
debt repayment	180	53	0	-110	0	0	0	0
dividend	0	0	0	0	-61	-92	-112	-137
Other *	-1	-2	-241	-230	-256	-289	-322	-354
Net change in cash and equivalents	**71**	**62**	**153**	**17**	**123**	**143**	**191**	**194**
ST debt	41	22	9	9	9	9	9	9
LT debt	722	725	723	613	613	613	613	613
lease liabilities	0	0	919	1,019	1,136	1,246	1,356	1,466
Net debt (pre lease)	579	500	332	206	83	-60	-252	-446
Net debt/EBITDA (pre lease)	2.0	1.5	1.7	0.5	0.2	-0.1	-0.4	-0.6
Net debt (IFRS 16)	579	500	1,251	1,224	1,219	1,186	1,105	1,020
Net debt/EBITDA (IFRS 16)	2.0	1.5	3.0	2.0	1.7	1.4	1.1	0.9
Invested capital	682	885	670	794	934	1,121	1,353	1,636
ROIC	30%	26%	15%	32%	32%	32%	32%	31%

*Source: Company data, Santander Brokerage Poland estimates, * includes right-of-use asset amortization*

1H21 results review

Pepco Group reported solid results in 1H21 (ending March 2021) with 4.4% y/y sales growth (9.0% y/y in constant currency). LFL sales growth amounted to -2.1% y/y in 1H21 due to lockdowns as LFL sales in trading stores amounted to 5.0% y/y. Underlying EBITDA amounted to EUR324mn, growing 16.8% y/y (or EUR209mn in pre lease terms). Results were driven by (1) gross margin accretion of over 100bps achieved through ongoing sourcing benefits and a short-term Covid benefit from increased general merchandise revenue, (2) revenue growth and (3) effective cost management.

Fig. 89. Pepco Group: 1H FY21 results' review

EURmn, year to Sept.	1H20	1H21
Sales	1,911	1,995
chng.	n.a.	4.4%
LFL	n.a.	-2.1%
trading stores LFL	n.a.	5.0%
Underlying EBITDA	277	324
chng	n.a.	16.8%
Underlying PBT	76	112
chng	n.a.	47.2%
store number	2,844	3,246

Source: Company data, Santander Brokerage Poland

Pepco Group also said that it had entered Spain with Pepco as the brand's second Western European market. It also presented the outlook for the reminder of the year. According to the company, all stores are now trading, although some restrictions remain, placing limitations on customer footfall. Looking forward, despite the short-term challenges that renewed cost inflation will likely bring, the company confirmed that underlying trading remains in line with full-year guidance provided in the IPO.

Pepco Group financial guidance

Fig. 90. Pepco Group: Guidance for 2021- medium-term

	2021	2022	Medium-term
Rollout	Pepco: 320-350; Poundland: c. 30; Dealz: c. 100	Pepco: c. 300; Poundland: c. 10-20; Dealz: c. 100	Pepco: c. 300; Poundland: c. 10-20; Dealz: c. 150
LFL	Pepco: high single digit; Poundland: low single digit; Dealz: low single digit	Pepco: mid-single digit; P/D: c3% (in line with market).	Pepco: mid-single digit; P/D: c3% (in line with market).
Gross profit margin	Pepco: return to pre Covid level; P/D: moderate increase vs. pre Covid level.	Pepco: decrease due to FX and input inflation not passed onto customers; P/D: flat	Pepco: marginal increase due to scale & reduced markdown; P/D: flat
Opex	Pepco: decrease of opex/sales ratio to pre Covid level on LFL leverage; P/D: moderate decrease of opex/sales ratio to pre Covid level on strategic improvements in Poundland.	Pepco: moderate decrease of opex/sales ratio due to HQ savings; P/D: marginal decrease of opex/sales ratio.	Pepco: marginal decrease of opex/sales ratio due to HQ savings offsetting inflation; P/D: significant decrease of opex/sales ratio due to cost reductions in Poundland and scale leverage in Dealz.
CAPEX	c. EUR50mn	c. EUR180mn	averages c. EUR200mn
Net debt	Target to maintain net debt/EBITDA (pre IFRS16) at 1.5x.	Target to maintain net debt/EBITDA (pre IFRS16) at 1.5x.	Target to maintain net debt/EBITDA (pre IFRS16) at 1.5x.
Effective tax rate	c. 24%	c. 20-21%	c. 20-21%

Source: Company data

Risks

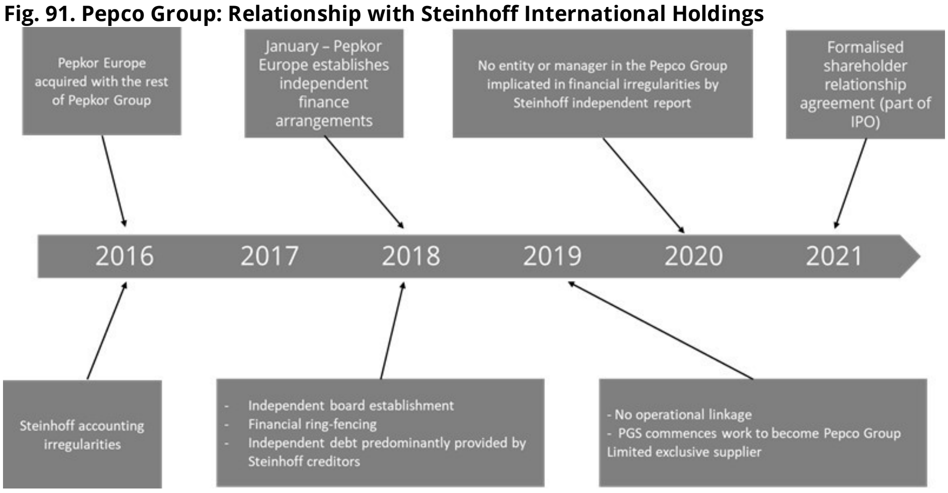
Prolonged Covid-19 pandemic, which might have strong adverse impact on LFL growth due to lockdown of stores located mainly in shopping malls. Current levels of vaccination (c30%) in Europe is not enough to avoid another wave of the pandemic this autumn, according to WHO.

Steinhoff International Holdings irregularities

Pepco Group is 83% owned by Steinhoff International Holdings. Steinhoff was involved in an accounting scandal in 2018, which resulted in serious financial distress. The accounting scandal was related to irregularities in reporting the real level of assets in the company. In 2020, Steinhoff proposed to pay around USD1bn to settle the outstanding legal claims arising from the accounting fraud, which is still a fraction of the USD10.5bn that claimants are seeking.

With regard to Pepco Group, it was shown in 2019 that there were no operational links between those involved in the scandal and Pepco employees, according to the company. Later, it was proven that no entity or manager in Pepco group was connected with the irregularities (according to the Independent Investigation Summary Report by PwC that was released in 2020). Pepco Group has also no operational linkages to Steinhoff and works as a completely separate entity. After the IPO, no Steinhoff representative will sit on the Pepco Group Board. And Pepco Group has no liabilities towards Steinhoff creditors.

Fig. 91. Pepco Group: Relationship with Steinhoff International Holdings



Source: Company data

Risks of online - so far, digital remains nascent in discount/value retail and is limited to product catalogue search engines, mainly due to still unattractive basket economics that are not able to cover logistics costs of home delivery or click & collect costs. For now, Pepco's customers do not show much interest in its offer going online, according to the company's surveys. In our view, further growth of online channel is a risk for higher capex spending in future to develop such a service.

Slower rollout of new stores than in our forecasts. This might have a potentially adverse impact on sales growth forecast. We also note that the lack of success of profitable rollout of Pepco's stores in new Western European markets like Italy, Spain and Austria, which might impact long-term growth of the store chain.

Increased competitiveness from other discounters, which might have an adverse impact on margins due to potential price wars.

Wage pressure might have negative impact on margins. Further growth of GDP post pandemic may increase pressure from labour costs.

Retail taxes imposed locally mainly in CEE, and other regulatory changes, might have an adverse impact on financial results due to the difficulty in passing on such tariffs through higher prices.

Risk of share overhang from parent company potentially selling its stake in future;

We see a limited **risk to gross margins from FX fluctuations** thanks to the hedging policy in Pepco Group. With USD and CNY denominated purchases (52% in USD and 48% in CNY in FY21), Pepco uses forward contracts to hedge against USDPLN and CNYPLN fluctuations (at least 40% at point of purchase commitment and 100% by start of season. In P/D, given GBP (86%), USD (10%) and EUR (4%) denominated purchases, group companies hedge 95-100% of currency requirements up to 1yr forward, 25-50% up to 15 months forward and 0-25% up to 18 months forward.

We also think that discounters mainly address top-up needs (small, regular shops without charging more for convenience), which we see as a factor that limits potential disruption by online channel expansion through merchandising platforms or potential online competitors.

Financial statements

Fig. 92. Pepco Group: Income statement forecasts

Year to Sept, EURmn	2018	2019	2020	2021E	2022E	2023E
Sales	3,045	3,415	3,518	4,080	4,617	5,240
chng,	9.6%	12.2%	3.0%	16.0%	13.2%	13.5%
Gross profit	1,271	1,443	1,433	1,714	1,943	2,215
margin	41.7%	42.3%	40.7%	42.0%	42.1%	42.3%
Opex	1,052	1,192	1,306	1,419	1,588	1,794
other operating profit *	-112	5	-6	-13	-13	-13
EBIT	106	255	120	282	342	408
chng.	-91%	140%	-53%	134%	21%	19%
margin	3.5%	7.5%	3.4%	6.9%	7.4%	7.8%
adjustments	113	0	32	13	13	13
Underlying EBIT	219	255	152	295	355	421
chng.	-80%	16%	-40%	94%	20%	19%
margin	7.2%	7.5%	4.3%	7.2%	7.7%	8.0%
D&A	183	78	91	115	133	153
right-of-use asset amortization	0	0	200	230	256	289
Underlying EBITDA	277	333	443	640	745	863
chng.	-75%	20%	33%	45%	16%	16%
margin	9.1%	9.8%	12.6%	15.7%	16.1%	16.5%
IFRS 16 adjustment	0	0	213	245	273	308
Underlying pre lease EBITDA	277	333	230	395	472	555
chng.	-75%	20%	-31%	72%	19%	18%
margin	9.1%	9.8%	6.5%	9.7%	10.2%	10.6%
net financial cost	42	-4	102	82	52	55
PBT	65	259	18	200	291	353
tax	53	43	17	48	61	74
Loss on disc. operations	15	8	1	0	0	0
net profit	-4	208	0	152	230	279
chng.	n.a.	n.a.	n.a.	n.a.	51%	21%
margin	-0.1%	6.1%	0.0%	3.7%	5.0%	5.3%
Underlying net profit*	109	148	32	188	240	289
chng.	n.a.	36%	-79%	496%	27%	21%
margin	3.6%	4.3%	0.9%	4.6%	5.2%	5.5%

*Source: Company data, Santander Brokerage Poland estimates, * non- cash cost of incentive scheme in 2021-23E, adjusted by one-off items, 2021E net profit includes annualised interest savings of EUR50mn due to debt refinancing, while reported savings of EUR15mn include transaction fees and term loan prepayment penalty*

Fig. 93. Pepco Group: Balance sheet forecasts

Year to Sept, EURmn	2018	2019	2020	2021E	2022E	2023E
Current assets	734	870	1,020	1,134	1,355	1,612
cash and equivalents	184	247	400	417	539	683
other short term investments	0	14	4	4	4	4
accounts receivable	83	70	46	53	60	68
inventories	464	538	567	657	748	855
prepaid expenses	2	2	3	3	3	3
Fixed assets	1,221	1,208	2,050	2,233	2,397	2,551
PPE	298	348	379	474	517	557
intangibles	141	143	155	193	197	201
goodwill	674	675	656	656	656	656
long-term receivables	75	0	3	0	0	0
right-of-use asset	0	0	807	907	1,024	1,134
other	4	9	1	1	1	1
Long-term deferred charges	29	33	50	2	2	2
Total assets	1,955	2,079	3,070	3,366	3,752	4,163
Current liabilities	490	477	883	1,007	1,134	1,248
bank debt	41	22	9	9	9	9
accounts payable	391	410	611	708	801	910
lease liabilities	0	0	247	247	276	276
Deferred income	58	45	15	42	48	54
Long-term liabilities	894	806	1,434	1,454	1,543	1,653
bank debt	722	725	723	613	613	613
lease liabilities	0	0	672	771	860	970
Provisions	171	81	39	70	70	70
Equity	571	796	754	905	1,074	1,261
share capital	0	0	0	0	0	0
capital reserves	575	589	754	754	845	983
net income	-4	208	0	152	230	279
Total liabilities and equity	1,955	2,079	3,070	3,366	3,752	4,163

Source: Company data, Santander Brokerage Poland estimates

Fig. 94. Pepco Group: Cash flow statement forecasts

Year to Sept, EURmn	2018	2019	2020	2021E	2022E	2023E
Cash flow from operations	72	142	560	554	620	721
Net profit	-4	208	0	152	230	279
Provisions	-39	-31	-12	31	0	0
Depreciation and amortisation	183	78	91	115	133	153
, of which: right-of-use asset amount.	0	0	200	230	256	289
Changes in WC, o/w	-110	-61	207	0	-5	-6
inventories	-94	-78	-51	-91	-91	-106
receivables	-9	-1	20	-7	-7	-8
payables	-7	17	238	98	93	108
Other, net	42	-52	74	26	6	6
Cash flow from investment	-179	-131	-165	-198	-181	-197
Additions to PPE and intangibles	-115	-136	-164	-249	-181	-197
Change in long-term investments	0	0	0	0	0	0
Other, net	-65	5	-1	51	0	0
Cash flow from financing	179	52	-241	-340	-317	-381
Change in long-term borrowing	180	53	0	-110	0	0
Change in short-term borrowing	0	0	0	0	0	0
Change in equity	0	0	0	0	0	0
Dividends paid + buyback	0	0	0	0	-61	-92
Other, net*	-1	-2	-241	-230	-256	-289
Net change in cash and equivalents	71	62	153	17	123	143

*Source: Santander Brokerage Poland estimates, * includes right-of-use asset amortization*

Appendix 1. Pepco is aware of core ESG values

Environment - Pepco is focused on improving energy efficiency and reducing the carbon footprint of its operations by: (1) reducing the amount of packaging waste (including plastic bags), (2) reducing the energy consumption in stores by using LED lighting, and (3) reducing fuel consumption and emissions in its transport fleet through more efficient route planning.

Supply Chain Integrity – supply is concentrated in its subsidiary PGS, which is certified for integrated procurement (75% of clothing supplies). Internal and external compliance audits are performed regularly. Pepco's Supplier Code of Conduct fully complies with the Basic Code of the Ethical Trade Initiative (ETI), while Sedex data are used to make decisions about new suppliers.

Community – the company is committed to measure and promote colleague engagement by ensuring career opportunities (>90% of Pepco store management vacancies are filled internally). The company provides employee assistance services (Retail Trust in UK), while being involved in various charitable projects of local communities around the stores

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EBITDA – earnings before interest, taxes, depreciation, and amortization
P/E – price-earnings ratio
EV – enterprise value (market capitalisation plus net debt)
PEG - P/E to growth ratio
EPS - earnings per share
CPI – consumer price index
WACC - weighted average cost of capital
CAGR – cumulative average annual growth
P/CE – price to cash earnings (net profit plus depreciation and amortisation) ratio
NOPAT – net operational profit after taxation
FCF - free cash flows
BV – book value
ROE – return on equity
P/BV – price-book value

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The discounted cash flows (DCF) valuation method is based on expected future discounted cash flows. One advantage of the DCF valuation method is that it takes into account all cash streams reaching Issuer and the cost of money over time. Some disadvantages of the DCF valuation method are that a large number of parameters and assumptions need to be estimated; and the valuation is sensitive to changes in those parameters.
The comparative valuation method is based on the economic rule of "one price". Some advantages of the comparative valuation method are that the analyst need only estimate a small number of parameters; the valuation is based on current market conditions; the relatively large accessibility of indicators for companies being compared; and that there is an extensive knowledge of the comparative method among investors. Some disadvantages of valuation by the comparative method are the considerable sensitivity of the results of the valuation on the choice of companies to the comparative group; the method can lead to a simplification of the picture of the company which in turn can lead to omitting certain important factors (e.g. growth dynamics, extra-operational assets, corporate governance, the repeatability of results, differences in applied accounting standards); and the uncertainty of the effectiveness of a market valuation of companies being compared.
The mid-cycle multiple valuation is based on long-term average valuation multiples of a sector or a peer group. The methodology aims to calculate a fair, through the cycle value of the company. Among its shortfalls is that at peaks and/or troughs of the cycle, the implied fair value may deviate substantially from the market's value of an analysed stock as well as the methods' reliance on the quality of external data (we usually use Bloomberg or Damodaran databases). Simplicity and average through-cycle value allowing to capture over- as well as under-valuation of a given stock are the main advantages of this methodology.
The dividend discount model (DDM) valuation is based on the net present value of the future dividends that are expected to be paid out by the company. Some advantages of the DDM valuation method are that it takes into account real cash flows to equity-owners and that the methodology is used in respect to companies with long dividend payout history. Main disadvantage of the DDM valuation method is that dividend payouts are based on a large number of parameters and assumptions, including dividend payout ratio.
Residual income method is conceptually close to the discounted cash flows method (DCF) for non-financial stocks, the difference being that it is based on expected residual income (returns over COE) rather than expected future cash flows. One advantage of this valuation method is that it captures the excess of profit potentially available to shareholders and the cost of money over time. Main disadvantage of the valuation method is that a large number of parameters and assumptions need to be estimated; and the valuation is sensitive to changes in those parameters.
The warranted equity method (WEV) is based on the formula P/BV = (two year forward ROE less sustainable growth rate)/(Cost of equity less sustainable growth rate) which allows estimating a fair value (FV) of a given stock in two years' time. Subsequently the FV is discounted back to today. The main advantage of the WEV method is that it is a transparent one and based on relatively short term forecasts, hence substantially reducing the margin of forecasting error. The main disadvantage in our view is that the model is based on the principle that stock price should converge towards its fair value implied by company's ROE and COE.
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