PEPCO GROUP

Reuters: PCOP.WA Bloomberg: PCO PW

Santander

CEE Equity Research

Retail, Poland
13/02/2024 08:03 CET

Results rebound might be delayed

Downgrade to Underperform, TP down to PLN19.8

We downgrade our recommendation to Underperform with new TP at PLN19.8 after a decrease of 2024-25E EBITDA (ex. IFRS16) forecast by 23%/19% due to (1) lower than previously assumed operating margin and (2) revised higher IFRS16 impact on EBITDA after the disclosure from a company of its impact per banner in FY23 report. We think that 400+ new openings programme in 2024E is still based on openings in Western markets (c40-50% of new openings mainly Italy and Spain), which are currently margin dilutive. We are also concerned about slower-than-expected LFL growth rebound, which was deep in the negative territory in 1Q24 and is expected to return to a positive reading in 2H24. We earlier assumed faster LFL recovery already in 1H24E. In this light, we think that the operating margin might be still under pressure in 2024E despite assumed 2pp gross margin increase in Pepco. We also see Pepco's valuation with 2024E EV/EBITDA (ex. IFRS16) at 8.8x as high comparing to LPP's 7.7x. This is not justified, in our view. We also still keep 15% discount factor due to the share supply overhang from the major shareholder despite the fact that they announced that they had not intended to sell shares now due to the undervaluation of Pepco. We think that the entire 72% stake will ultimately be put up for sale again.

Equity story. We think that one factor from a group of reasons, which caused weaker operating margins in 2023 - namely high rollout of stores on Western markets - might be again in focus this year. The majority of new openings took place on Western markets in 2023 (262 out of 556 opened under Pepco brand). This improved sales per sqm but also hit costs per sqm. As stores are margin dilutive due to their low profitability or lack of profitability, we think that this year's structure of new openings still focused on Western markets (c40%-50% of net openings planned at >400) should result in a still elevated pressure on costs. Negative LFL growth (-1.8% y/y in Pepco brand) was also mentioned as a factor depressing operating margins in 2H23. We are concerned that the rebound of LFL growth in 2024E might last longer than we thought previously. In 1Q24, the company reported Group's LFL at -2.3% y/y with -3.7% y/y in the largest brand - Pepco. We think that the factors behind LFL turning negative in 2H23 might be in place also in 1H24E: stiffening competition in core CEE markets (Sinsay is again the best performing brand in LPP's family) and prolonged weak consumer demand on the market. In this light, we decreased our forecast of LFL to -3.0% y/y and +3.0% in 1H24E and 2H24E, respectively. We earlier had 0.0% y/y and +7.0% in 1H24E and 2H24E, respectively. In this light, we are decreasing 2024E EBITDA forecast by 1.0pp to 12.3% (PLN804mn vs. prev. PLN838mn). Please see fig. 1. for more details.

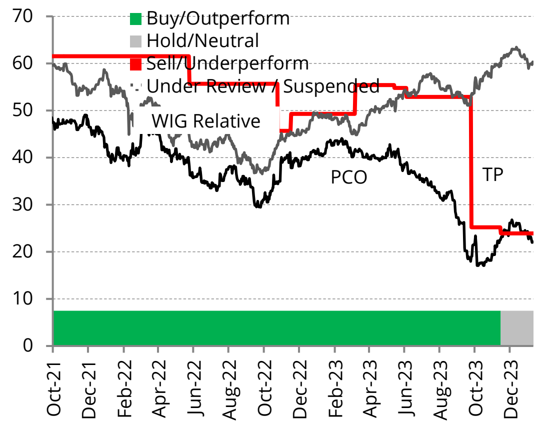
Valuation and risk. Our TP went down by 17% to PLN19.8 from PLN23.9, mainly due to 22% lower multiple valuation (70% weight). DCF valuation (30% weight) also went down by 22% (lower financial forecast). The main risks we see: (1) the fact that problems (margins, rollout etc.) could take longer than we expect, (2) lack of consumption rebound in 2024E, (3) increased competition from other discounters and VFM segment.

Pepco: Financial summary*

EURmn (year to Sep)	2021	2022	2023	2024E	2025E	2026E
Sales	4,122	4,823	5,649	6,519	7,185	7,916
Adj. EBITDA	647	731	753	804	922	1,063
Adj. EBITDA (ex. IFRS16)	424	438	396	392	474	575
Adj. net profit	164	227	152	124	173	250
P/E (x)	37.1	21.8	19.3	23.8	17.0	11.8
EV/EBITDA (x)	14.6	12.0	8.6	8.8	7.2	5.6
FCF Yield	4.9%	-3.2%	-3.3%	-0.6%	2.3%	5.9%
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Company data, Santander Brokerage Poland estimates , 2021-2022 ratios calculated on historical annual share price average*

Recommendation	Underperform
Target price (Dec'24, PLN)	19.8
Price (PLN, Feb 9, 2024)	22.4
Market cap. (PLNmn)	10,488
Free float (%)	21.1
Number of shares (mn)	575
Average daily turnover 3M (mn)	15.1
EURPLN	4.32
Previous report issued on Nov 30, 2023 with:	
Recommendation	*Neutral*
Target price (Dec'24, PLN)	*23.9*



The chart measures performance against the WIG index.

Main shareholders	% of votes
IBEX Retail Investments	72.2

Source: GPW

Company description

Pepco is the CEE variety discounter leader with rising footprint in Western Europe.

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Forecast change

Fig. 1. Pepco: Forecast change

	FY24E			FY25E			FY26E		
EURmn	new	old	chng.	new	old	chng.	new	old	chng.
Sales	6,519	6,277	3.9%	7,185	6,822	5.3%	7,916	7,397	7.0%
Adj. EBITDA	804	838	-4.0%	922	942	-2.1%	1,063	1,024	3.8%
Adj. EBITDA (ex. IFRS16)	392	512	-23.4%	474	584	-18.9%	575	646	-10.9%
Adj. net profit	124	219	-43.3%	173	269	-35.7%	250	312	-19.8%

Source: Company data, Santander Brokerage Poland estimates

At the same time, Pepco's transparency improved as it revealed EBITDA (ex. IFRS 16) per banner in its recent FY23 report (page 53). It turned out that our forecast had been too high (reported EUR330mn vs. SANe EUR421mn) for Pepco banner and too low (reported EUR66mn vs. SANe EUR31mn) for Poundland/Deals segment. Overall, the IFRS16 impact on adj. EBITDA amounted to EUR360mn in 2023 vs. SANe EUR298mn at the Group level. The correction of our forecast by the revised impact of IFRS16 brought in our 2024/26E adj. EBITDA (ex. IFRS16) forecast by 23%,19% and 11% down, respectively. Please note that it also had a material impact on our valuation as (1) we use adj. EBITDA (ex. IFRS16) as a base for valuation purposes as it is a better proxy on cash flows and (2) our previous adj. EBITDA (ex. IFRS16) forecast was too high for Pepco banner, which we see more valuable asset (we use target multiple 8.0x for Pepco vs. 6.0x for P/D) than Poundland/Dealz.

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Fig. 2. Pepco: Key assumptions

EURmn	1H23	2H23	2023	1H24E	2H24E	2024E	1H25E	2H25E	2025E	1H26E	2H26E	2026E
Pepco	**1,719**	**1,697**	**3,416**	**2,047**	**1,955**	**4,002**	**2,304**	**2,218**	**4,522**	**2,611**	**2,501**	**5,112**
chng.	34.1%	18.5%	25.9%	19.1%	15.2%	17.2%	12.6%	13.5%	13.0%	13.3%	12.8%	13.0%
LFL	15.8%	-3.4%	6.3%	-3.0%	3.0%	-0.1%	4.0%	3.0%	3.5%	4.0%	4.0%	4.0%
Stores	**3,101**	**3,523**	**3,523**	**3,743**	**3,903**	**3,903**	**4,023**	**4,263**	**4,263**	**4,383**	**4,623**	**4,623**
new (q/q)	134	422	556	220	160	380	120	240	360	120	240	360
new (y/y)	435	556	556	642	380	380	280	360	360	360	360	360
% chng	16.3%	18.7%	18.7%	20.7%	10.8%	10.8%	7.5%	9.2%	9.2%	8.9%	8.4%	8.4%
floor (k sqm)	1,395	1,585	1,585	1,684	1,756	1,756	1,810	1,918	1,918	1,972	2,080	2,080
avg, store size	*450*	*450*	*450*	*450*	*450*	*450*	*450*	*450*	*450*	*450*	*450*	*450*
P/D	**1,120**	**1,114**	**2,233**	**1,255**	**1,261**	**2,517**	**1,335**	**1,329**	**2,663**	**1,405**	**1,398**	**2,804**
chng.	2.7%	9.3%	5.9%	12.1%	13.2%	12.7%	6.3%	5.4%	5.8%	5.3%	5.2%	5.3%
LFL	4.9%	6.3%	5.6%	-3.0%	3.0%	0.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Stores	**1,026**	**1,106**	**1,106**	**1,186**	**1,216**	**1,216**	**1,236**	**1,256**	**1,256**	**1,276**	**1,296**	**1,296**
new (q/q)	32	80	112	80	30	110	20	20	40	20	20	40
new (y/y)	-4	112	112	160	110	110	50	40	40	40	40	40
% chng	-0.4%	11.3%	11.3%	15.6%	9.9%	9.9%	4.2%	3.3%	3.3%	3.2%	3.2%	3.2%
floor (k sqm)	718	774	774	830	851	851	865	879	879	893	907	907
avg, store size	*700*	*700*	*700*	*700*	*700*	*700*	*700*	*700*	*700*	*700*	*700*	*700*
Sales	**2,839**	**2,810**	**5,649**	**3,303**	**3,216**	**6,519**	**3,639**	**3,546**	**7,185**	**4,016**	**3,899**	**7,916**
chng.	19.7%	14.6%	17.1%	16.3%	14.4%	15.4%	10.2%	10.3%	10.2%	10.4%	10.0%	10.2%
LFL	**11.5%**	**0.4%**	**6.0%**	**-3.0%**	**3.0%**	**0.0%**	**3.3%**	**2.6%**	**3.0%**	**3.3%**	**3.3%**	**3.3%**
Stores	**4,127**	**4,629**	**4,629**	**4,929**	**5,119**	**5,119**	**5,259**	**5,519**	**5,519**	**5,659**	**5,919**	**5,919**
chng.	11.7%	16.9%	16.9%	19.4%	10.6%	10.6%	6.7%	7.8%	7.8%	7.6%	7.2%	7.2%
new	431	668	668	802	490	490	330	400	400	400	400	400
EBITDA	**355**	**346**	**702**	**393**	**410**	**804**	**455**	**467**	**922**	**531**	**533**	**1063**
chng	9%	2%	6%	11%	18%	15%	16%	14%	15%	17%	14%	15%
margin	12.5%	12.3%	12.4%	11.9%	12.8%	12.3%	12.5%	13.2%	12.8%	13.2%	13.7%	13.4%
Pepco	**274**	**255**	**529**	**303**	**305**	**608**	**358**	**356**	**714**	**429**	**416**	**845**
chng	17%	-5%	5%	11%	20%	15%	18%	17%	18%	20%	17%	18%
margin	15.9%	15.0%	15.5%	14.8%	15.6%	15.2%	15.5%	16.0%	15.8%	16.4%	16.6%	16.5%
P/D	**79**	**92**	**171**	**91**	**106**	**196**	**96**	**111**	**208**	**101**	**117**	**219**
chng	-16%	7%	-5%	15%	15%	15%	6%	5%	6%	5%	5%	5%
margin	7.1%	8.3%	7.7%	7.2%	8.4%	7.8%	7.2%	8.4%	7.8%	7.2%	8.4%	7.8%
other	2	0	2	0	0	0	0	0	0	0	0	0
Adj. EBITDA	**377**	**376**	**753**	**393**	**410**	**804**	**455**	**467**	**922**	**531**	**533**	**1063**
chng	9%	-2%	3%	4%	9%	7%	16%	14%	15%	17%	14%	15%
margin	13.3%	13.4%	13.3%	11.9%	12.8%	12.3%	12.5%	13.2%	12.8%	13.2%	13.7%	13.4%
Pepco	**282**	**270**	**552**	**303**	**305**	**608**	**358**	**356**	**714**	**429**	**416**	**845**
chng	17.4%	-3.2%	6.3%	7.5%	12.7%	10.1%	18.3%	16.7%	17.5%	19.8%	16.8%	18.3%
margin	16.4%	15.9%	16.2%	14.8%	15.6%	15.2%	15.5%	16.0%	15.8%	16.4%	16.6%	16.5%
P/D	**98**	**106**	**204**	**91**	**106**	**196**	**96**	**111**	**208**	**101**	**117**	**219**
chng	-7.2%	-1.9%	-4.5%	-7.9%	-0.4%	-4.0%	6.3%	5.4%	5.8%	5.3%	5.2%	5.3%
margin	8.8%	9.5%	9.2%	7.2%	8.4%	7.8%	7.2%	8.4%	7.8%	7.2%	8.4%	7.8%
Other	-3	0	-3	0	0	0	0	0	0	0	0	0
Adj. EBITDA (ex. IFRS16)	**211**	**185**	**396**	**193**	**199**	**392**	**238**	**236**	**474**	**294**	**281**	**575**
chng	3%	-21%	-10%	-9%	7%	-1%	23%	19%	21%	24%	19%	21%
margin	13.3%	13.4%	13.3%	11.9%	12.8%	12.3%	12.5%	13.2%	12.8%	13.2%	13.7%	13.4%
Pepco	180	150	330	180	171	352	223	205	428	277	247	524
P/D	31	35	66	13	28	40	15	31	46	18	34	52

Source: Company data, Santander Brokerage Poland estimates

Valuation

Fig. 3. Pepco: Valuation summary

PLN/shr	New	Previous	Change
DCF valuation	32.5	41.4	-21.5%
Multiple valuation	19.4	25.0	-22.2%
Equity Value (PLN/shr)	**23.4**	**29.9**	**-21.9%**
discount factor*	15%	20%	
Target Price (PLN/shr)	**19.8**	**23.9**	**-17.0%**

*Source: Santander Brokerage Poland estimates, multiple/ DCF weights at 70%/30%, multiple with heavier weight to focus more on mid-term perspectives and market valuation multiples, which we see fair for the company, * discount for share supply risk (entire stake of Steinhoff put up for sale), we lowered it to 15% as major shareholder mentioned it does not intend to sell now, but we think stake will be ultimately sold*

Fig. 4. Pepco: multiple valuation

EURmn	Multiple	EBITDA*	
Pepco			
	8.0x	352	We left our target EV/EBITDA multiple for Pepco at 8.0x.
EV		2,812	
P/D			
	6.0x	40	P/D's EV calculation is based on target EV/EBITDA multiple at 6.0x.
EV		242	
Total		**3,054**	
(-) net debt (cash)		491	
Equity Value (EURmn)		**2,562**	
EURPLN		4.4	
Equity Value (PLNmn)		**11,171**	
no. of shares		575	
Target Price (PLN)		**19.4**	

*Source: Santander Brokerage Poland estimates, * EBITDA (ex. IFRS16, NTM)*

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Fig. 5. Pepco: DCF valuation

EURmn	2024E	2025E	2026E	2027E	2028E	2029E	TV
Revenue	6,519	7,185	7,916	8,557	8,954	9,287	
EBITDA (ex. IFRS16)	392	474	575	628	648	678	
EBIT	259	320	415	465	488	519	
tax	52	64	83	93	98	104	
NOPAT	**207**	**256**	**332**	**372**	**391**	**415**	
D&A	133	154	161	162	160	159	
WC	-8	-9	-11	-12	-2	-2	
CAPEX	-265	-249	-225	-192	-201	-189	
FCF	**67**	**151**	**256**	**330**	**347**	**383**	**397**
WACC	11.4%			10.5%			10.5%
PV FCF 2023-28E	1,234						
Terminal growth	3.5%						
Terminal Value (TV)	5,656						
PV TV	3,104						
Total EV	**4,338**						
Net debt	491						
Equity Value	3,847						
Equity Value (Dec-24)	**4,287**						
EURPLN	4.4						
Equity Value (PLN)	**18,692**						
Number of shares (m)	575						
YE target price (PLN)	**32.5**						
DPS	0						
YE TP (ex-div, PLN)	**32.5**						

Source: Company data, Santander Brokerage Poland estimates

Fig. 6. Pepco: WACC

	23/25E fcst	26/28E + TV
Risk free rate (10-year Polish T-bond yield)	6.0%	5.0%
Unlevered beta	1.0	1.0
Levered beta	1.5	1.5
Equity risk premium	6.0%	6.0%
Cost of equity	**14.9%**	**13.9%**
Risk free rate (10-year Polish T-bond yield)	6.0%	5.0%
Debt risk premium	1.0%	1.0%
Tax rate	19%	19%
After tax cost of Debt	**5.7%**	**4.9%**
%D	38%	38%
%E	62%	62%
WACC	**11.4%**	**10.5%**

Source: Company data, Santander Brokerage Poland estimates

Financial forecasts

Fig. 7. Pepco: P&L forecast

EURmn	2021	2022	2023	2024E	2025E	2026E
Sales	**4,122**	**4,823**	**5,649**	**6,519**	**7,185**	**7,916**
chng.	17%	17%	17%	15%	10%	10%
Pepco	**2,166**	**2,714**	**3,416**	**4,002**	**4,522**	**5,112**
chng.	25%	25%	26%	17%	13%	13%
P/D	**1,956**	**2,109**	**2,233**	**2,517**	**2,663**	**2,804**
chng.	10%	8%	6%	13%	6%	5%
Gross profit	1,769	1,968	2,268	2,724	3,032	3,373
chng.	23%	11%	15%	20%	11%	11%
margin	42.9%	40.8%	40.1%	41.8%	42.2%	42.6%
Opex	1,495	1,690	2,040	2,466	2,712	2,959
chng.	15%	13%	21%	21%	10%	9%
as % of sales	36.3%	35.0%	36.1%	37.8%	37.7%	37.4%
Profit on sales	274	278	228	259	320	415
chng.	108%	1%	-18%	14%	24%	30%
margin	6.7%	5.8%	4.0%	4.0%	4.5%	5.2%
other op. costs	21	0	0	0	0	0
EBIT	253	278	228	259	320	415
chng.	111%	10%	-18%	14%	24%	30%
margin	6.1%	5.8%	4.0%	4.0%	4.5%	5.2%
D&A	324	387	474	545	602	648
EBITDA	**599**	**665**	**701**	**804**	**922**	**1,063**
chng.	42%	11%	5%	15%	15%	15%
margin	14.5%	13.8%	12.4%	12.3%	12.8%	13.4%
Adj. EBITDA	**647**	**731**	**753**	**804**	**922**	**1,063**
chng.	46%	13%	3%	7%	15%	15%
margin	15.7%	15.2%	13.3%	12.3%	12.8%	13.4%
Pepco	457	519	552	608	714	845
chng.	53%	14%	6%	10%	18%	18%
margin	21.1%	19.1%	16.2%	15.2%	15.8%	16.5%
P/D	195	214	204	196	208	219
chng.	37%	10%	-5%	-4%	6%	5%
margin	10.0%	10.2%	9.2%	7.8%	7.8%	7.8%
other	-5	-3	-3	0	0	0
Adj. EBITDA (ex. IFRS16)	**424**	**438**	**396**	**392**	**474**	**575**
chng.	75%	3%	-10%	-1%	21%	21%
margin	10.3%	9.1%	7.0%	6.0%	6.6%	7.3%
Financial income	1	2	6	3	3	5
Financial costs	87	55	85	107	107	107
PBT	167	226	149	155	217	313
chng.	846%	35%	-34%	4%	40%	44%
margin	4.1%	4.7%	2.6%	2.4%	3.0%	4.0%
tax	41	52	39	31	43	63
X/O	0	0	0	0	0	0
Net profit	**125**	**174**	**110**	**124**	**173**	**250**
chng.	n.a.	39%	-37%	13%	40%	44%
margin	3.0%	3.6%	1.9%	1.9%	2.4%	3.2%
Adj. net profit	**164**	**227**	**152**	**124**	**173**	**250**
chng.	983%	38%	-33%	-18%	40%	44%
margin	4.0%	4.7%	2.7%	1.9%	2.4%	3.2%
Adj. EPS	0.3	0.4	0.3	0.2	0.3	0.4
chng.	983%	38%	-33%	-18%	40%	44%

Source: Company data, Santander Brokerage Poland estimates

Fig. 8. Pepco Group: Balance sheet forecasts

EURmn	2021	2022	2023	2024E	2025E	2026E
Current assets	1,232	1,543	1,652	1,839	2,066	2,415
cash and equivalents	508	344	330	314	383	557
other short term investments	0	0	0	0	0	0
accounts receivable	61	75	144	167	184	202
inventories	597	959	1,135	1,316	1,458	1,614
prepaid expenses	66	165	42	42	42	42
Fixed assets	2,305	2,456	2,939	3,071	3,166	3,231
PPE	440	525	746	861	939	986
long-term investments	0	0	0	0	0	0
intangibles	835	814	847	864	882	899
goodwill	0	0	0	0	0	0
long-term receivables	3	2	0	0	0	0
right-of-use asset	957	1,018	1,226	1,226	1,226	1,226
other	70	96	120	120	120	120
Long-term deferred charges	0	0	0	0	0	0
Total assets	**3,537**	**3,999**	**4,591**	**4,910**	**5,232**	**5,646**
Current liabilities	1,114	1,408	1,783	1,978	2,127	2,291
bank debt	71	105	210	210	210	210
accounts payable	744	928	1,266	1,461	1,611	1,774
lease liabilities	260	310	305	305	305	305
Deferred income	39	65	2	2	2	2
Long-term liabilities	1,460	1,446	1,651	1,651	1,651	1,651
bank debt	545	554	612	612	612	612
lease liabilities	839	823	988	988	988	988
Provisions	76	69	50	50	50	50
Equity	963	1,145	1,157	1,281	1,454	1,705
share capital	6	6	6	6	6	6
capital reserves	832	965	1,041	1,151	1,275	1,449
net income	125	174	110	124	173	250
Minority Interest	0	0	0	0	0	0
Total liabilities and equity	**3,537**	**3,999**	**4,591**	**4,910**	**5,232**	**5,646**
Bank debt	616	660	822	822	822	822
lease liabilities	1,099	1,134	1,293	1,293	1,293	1,293
Net debt (ex. IFRS16)	109	316	491	508	439	265
Net debt/EBITDA (ex. IFRS16)	0.3	0.7	1.2	1.3	0.9	0.5
Net debt/EBITDA	2.0	2.2	2.5	2.2	1.9	1.5

Source: Company data, Santander Brokerage Poland estimates

Fig. 9. Pepco Group: Cash flow statement forecasts

EURmn	2021	2022	2023	2024E	2025E	2026E
Cash flow from operations	**673**	**363**	**653**	**660**	**765**	**888**
Net profit	125	174	110	124	173	250
Provisions	29	-22	-17	0	0	0
Depreciation and amortisation	102	91	113	133	154	161
RoU amortization	222	296	360	412	448	488
Changes in WC, o/w	101	-220	85	-8	-9	-11
inventories	-19	-384	-176	-181	-142	-156
receivables	-21	-20	-62	-22	-17	-19
payables	141	184	322	195	149	164
Other, net	93	45	2	0	0	0
Cash flow from investment	**-154**	**-224**	**-385**	**-265**	**-249**	**-225**
Additions to PPE and intangibles	-151	-224	-388	-265	-249	-225
Change in long-term investments	-3	0	3	0	0	0
Other, net	0	0	0	0	0	0
Cash flow from financing	**-411**	**-303**	**-281**	**-412**	**-448**	**-488**
Change in long-term borrowing	-129	2	116	0	0	0
Change in short-term borrowing	0	0	0	0	0	0
Change in equity	0	0	0	0	0	0
Dividends paid	0	0	0	0	0	0
Other, net*	-283	-305	-397	-412	-448	-488
Net change in cash and equivalents	**108**	**-164**	**-14**	**-16**	**69**	**174**
FCF	300	-157	-96	-16	69	174
FCF (ex. growth) *	349	-23	179	116	164	239

*Source: Company data, Santander Brokerage Poland estimates, * capex assumed to be at D&A level*

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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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