

Gear4music Holdings

Pre-close statement

On song

Gear4music (G4M) has ended the year with 58% revenue growth, slightly ahead of expectations, and has also guided to profit performance marginally ahead. Driven by European sales growth, this shows continuing development of its international presence, as does the opening of (now) two distribution centres on the mainland. Sales growth is now building against strong growth last year, and the strategic argument for medium-term investment continues to strengthen.

Year end	Revenue (£m)	EBITDA (£m)	PBT* (£m)	EPS* (p)	P/E (x)	EV/EBITDA (x)
02/15	24.2	0.8	(0.6)	(4.1)	N/A	N/A
02/16	35.5	1.7	0.6	3.1	N/A	79.1
02/17e	56.0	3.2	2.4	9.3	72.6	41.6
02/18e	79.1	4.1	2.9	11.5	58.7	32.7

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

A strong finish in line with our expectations

G4M has reported full-year revenue of £56.1m, growth of 58%, marginally ahead of our expectation of £56.0m. The last two post-Christmas months continued to move ahead strongly and in line with our upgraded forecast. Active customers were strongly up by 49% to 324,000, and have risen 5% since December.

European focus develops

In support of its Europe-focused strategy, G4M has opened its distribution centre in Germany in addition to the centre opened in Sweden in November 2016. That centre is performing strongly and Scandinavian sales are up 186% since it opened.

Profit expectations marginally raised

Despite investment both in the UK and Europe, costs have been controlled within the company's plans. As a result, management is guiding to profit expectations marginally ahead for FY17. We are leaving our forecasts unchanged.

Valuation: Share price discounting over-performance

The share price is now nearly five times its 139p IPO level in June 2015. Profit expectations have themselves increased – our earnings per share estimate for FY17 is 42% higher than when we initiated in May 2016. The calendar 2017 P/E of 56x is at a discount of 15% to ASOS and Boohoo, which we would regard as appropriate. It is on a narrower P/E discount for 2018, and also for both years on EV/EBITDA measures. On a reverse DCF basis, the share price is discounting either (i) a medium-term revenue growth rate some 5% higher than our assumption of 22% in 2020, or (ii) a 13% terminal EBITDA margin, outside a peer range of 7-11%, or a combination of the two.

Retail

3 March 2017

Price 675.00p

Market cap £136m

Net cash (£m) at 31 August 2016 0.9

Shares in issue 20.2m

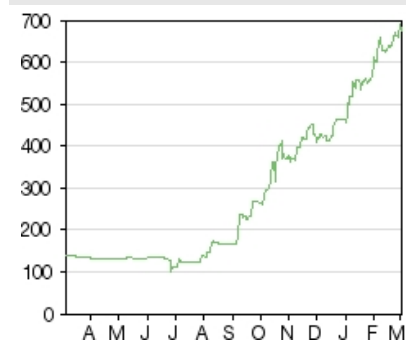
Free float 42%

Code G4M

Primary exchange AIM

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 12.5 61.3 413.3

Rel (local) 8.8 47.3 331.5

52-week high/low 688.5p 99.5p

Business description

Gear4music is the largest dedicated, UK-based online retailer of musical instruments and music equipment. It sells branded instruments and equipment, alongside its own brand products, to customers ranging from beginners to professionals, in the UK and into Europe and the rest of the world.

Next events

Final results 9 May 2017

Analysts

Paul Hickman +44 (0)20 3681 2501

David Stoddart +44 (0)20 3077 5700

consumer@edisongroup.com

[Edison profile page](#)

Gear4music Holdings is a research client of Edison Investment Research Limited

A strong finish to the year

G4M has finished the year marginally ahead of our expectation of £56.0m total revenue, with £56.1m, growth of 58%, after the last two months continued to move ahead strongly and in line with our upgraded forecast.

Exhibit 1: Geographic sales

£'000	H1			Sept-Dec	Sept-Dec	Sept-Dec	Jan-Feb	Jan-Feb	Jan-Feb	Full year	Full year	Full year
	FY16	FY17	Gth %	FY16	FY17	Gth %	FY16	FY17	Gth %	FY16	FY17	Gth %
UK	9,584	13,784	43.8	11,608	15,019	29.4	4,824	6,062	25.7	26,016	34,865	34.0
European	2,909	7,825	169.0	4,082	9,365	129.4	2,482	4,073	64.1	9,473	21,263	124.5
Total	12,493	21,609	73.0	15,690	24,384	55.4	7,306	10,135	38.7	35,489	56,128	58.2
Sales pm	2,082	3,602		3,923	6,096		3,653	5,068		2,957	4,677	
% UK rev.	77	64		74	62		66	60		73	62	
% Euro. rev.	23	36		26	38		34	40		27	38	

Source: Gear4music Holdings

Growth continues to be strongly powered by Europe, which is now a much more significant element of the total, at 38% compared with 23% in H116. As we also show in Exhibit 1, average sales per month have continued to develop, so that for instance sales per month in the final two months of FY17 were 140% higher than in the first half of 2016.

Actives and transaction values up

Active customer numbers are 324,000, up 49% across the year. The numbers have risen 5% since December, and in comparison with revenue growth of 58%, suggest that transaction values are continuing on an upward path.

European bases operational

The company's strategy has a strong focus on developing the European opportunity, in a market that management has estimated is six times larger than the UK. In support of that strategy and to improve the delivery service to European customers, G4M opened a distribution in Sweden in November, and now has one in Mulheim, in a densely populated region of north Germany. Revenue growth in Scandinavia since November has been spectacular at 186%, although that was of course from a low base.

Profit guidance positive

Investment in the business continues in line with strategy, but the company reports that with costs being closely managed, FY17 profits expectations are likely to be marginally ahead of upgraded expectations. We are not changing our forecasts, which we upgraded 20% at EPS level in January.

Valuation

We have updated our valuation work from our last [note](#) on 6 January 2017. G4M's share price has risen by 35% since then and is now nearly five times its 139p IPO price in June 2015.

Peer comparison on earnings multiples

Exhibit 2: Significant discount to pure-play online retailers											
Calendarised	Share price p	Market cap £m	P/E (x)			EV/Sales (x)			EV/EBITDA (x)		
			2016	2017e	2018e	2016	2017e	2018e	2016	2017e	2018e
G4M	688.5	138.8	49.0	56.1	48.9	4.1	2.6	1.8	46.0	34.6	27.5
ASOS	5,539.0	4,624.5	85.5	65.5	51.0	2.9	2.2	1.8	43.2	32.1	25.0
Boohoo	155.3	1,743.9	83.9	66.5	49.3	6.2	4.2	3.3	53.0	40.8	30.5
AO World	150.3	631.6	N/A	N/A	77.9*	0.9	0.7	0.6	N/A	75.6*	31.1
Average			84.7	66.0	50.1	3.3	2.4	1.9	48.1	36.5	28.9
Discount			-42.2%	-15.0%	-2.5%	22.9%	6.8%	-6.3%	-4.3%	-5.2%	-4.6%
N Brown	199.9	566.6	8.7	8.9	8.6	0.0	0.9	0.9	N/A	7.2	6.7
Findel	199.4	174.4	8.9	8.3	7.6	0.9	0.8	0.8	8.8	8.3	6.9
Average of whole group			46.8	37.3	29.1	2.2	1.8	1.5	35.0	22.1	20.0
Premium/(discount)			4.8%	50.3%	67.9%	87.8%	42.9%	21.2%	31.5%	56.5%	37.4%

Source: Bloomberg, Edison Investment Research. Note: *Outlier, excluded. Prices as at 2 March 2017.

For calendar 2017, G4M trades at a 15% P/E discount to the more established e-retailers ASOS and Boohoo. A discount to those peers is appropriate for this much smaller and younger company; however, as its credibility and results delivery increases, that discount will justifiably reduce. It is significant that the company has guided that it will complete its first full year on the market ahead of expectations, which have themselves been materially increased – our earnings per share estimate for FY17 is 42% higher than when we initiated in May 2016. As a result, we now see the appropriate discount as 10-15%. Whereas the 2017e P/E discount of 15% is in line with this, the discount for 2018 is below it, as are the discounts for both years on EV/EBITDA measures.

Clearly when other small-cap online retailers N Brown and Findel are included, G4M trades at a significant premium to the wider group. However, as we explained in January, we do not see those companies as close comparators.

Reverse DCF valuation

We model DCF valuation on a reverse basis to examine the assumptions that the current market price is currently discounting in relation to the scale and shape of the long-term cash flow.

Our DCF model fades revenue growth from FY19e (+24.3%) by 3% in FY20e and then by c 2% each year to terminal growth of +2%. This puts revenue at £230m by FY26.

In the table below we show the effect of a faster or slower step-down in FY20e, given that our model reduces the revenue growth rate over subsequent years to achieve the terminal growth of +2%.

Exhibit 3: Scenarios for terminal EBITDA margin and revenue growth fade						
		Step-down in growth rate, FY19-20				
		0.0%	1.0%	2.0%	3.0%	4.0%
Terminal EBITDA margin	15.0%	898	870	842	816	789
	13.0%	744	720	697	675	654
	11.0%	589	570	553	535	518
	9.0%	434	421	408	395	383
	7.0%	279	271	263	255	247

Source: Edison Investment Research

Using our base assumption of a 2% reduction in the rate of revenue growth in Year 4 of our projection (2020), which would be 21.5%, then fading to our terminal rate of 2% over the next seven years, the current share price would approximate to an assumption of 13% terminal EBITDA margin. This lies outside the range of 7-11% that we defined in January as typical for peers. If instead we assume no reduction in the rate of growth at that time, the share price would approximate to a 12% terminal margin.

We do not show it in Exhibit 3, but if terminal EBITDA margin were 11% and thus within the range we defined as reasonable to expect, that would imply a 2020 revenue growth rate some 5% higher than we assume. That is clearly not outside the bounds of possibility. However, it appears the market is discounting either a higher growth rate or higher terminal margin than we currently model, or a combination of the two.

Exhibit 4: Financial summary

	£'000s	2015	2016	2017e	2018e	2019e
Year end: February		IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue		24,240	35,489	56,040	79,083	98,312
Cost of Sales		(17,483)	(26,303)	(41,059)	(58,294)	(72,428)
Gross Profit		6,757	9,186	14,981	20,788	25,884
EBITDA		842	1,688	3,213	4,062	5,091
Normalised operating profit		376	903	2,310	2,905	3,684
Amortisation of acquired intangibles		0	0	0	0	0
Exceptionals		(165)	(606)	0	0	0
Share-based payments		0	(8)	(92)	(116)	(137)
Reported operating profit		211	289	2,218	2,789	3,546
Net Interest		(1,008)	(283)	78	(1)	(4)
Joint ventures & associates (post tax)		0	0	0	0	0
Exceptionals		0	0	0	0	0
Profit Before Tax (norm)		(632)	620	2,388	2,904	3,680
Profit Before Tax (reported)		(797)	6	2,296	2,788	3,543
Reported tax		111	(49)	(519)	(581)	(736)
Profit After Tax (norm)		(521)	571	1,869	2,323	2,944
Profit After Tax (reported)		(686)	(43)	1,777	2,207	2,807
Minority interests		0	0	0	0	0
Discontinued operations		0	0	0	0	0
Net income (normalised)		(521)	571	1,869	2,323	2,944
Net income (reported)		(686)	(43)	1,777	2,207	2,807
Basic average number of shares outstanding (m)		12.7	18.2	20.2	20.2	20.2
EPS - basic normalised (p)		(4.1)	3.1	9.3	11.5	14.6
EPS - diluted normalised (p)		(4.1)	3.1	9.2	11.5	14.5
EPS - basic reported (p)		(5.4)	(0.2)	8.8	11.0	13.9
Dividend (p)		0.00	0.00	0.00	0.00	0.00
Revenue growth (%)		37.1	46.4	57.9	41.1	24.3
Gross Margin (%)		27.9	25.9	26.7	26.3	26.3
EBITDA Margin (%)		3.5	4.8	5.7	5.1	5.2
Normalised Operating Margin		1.6	2.5	4.1	3.7	3.7
BALANCE SHEET						
Fixed Assets		3,755	4,477	5,450	6,087	6,724
Intangible Assets		2,764	3,238	3,977	4,556	5,095
Tangible Assets		991	1,239	1,473	1,531	1,629
Investments & other		0	0	0	0	0
Current Assets		6,458	11,194	15,817	20,817	25,754
Stocks		5,326	6,906	10,948	15,604	19,360
Debtors		216	740	1,169	1,649	2,050
Cash & cash equivalents		916	3,548	3,700	3,564	4,344
Other		0	0	0	0	0
Current Liabilities		(5,842)	(6,022)	(8,999)	(12,429)	(15,196)
Creditors		(4,522)	(5,188)	(8,065)	(11,495)	(14,262)
Tax and social security		0	0	0	0	0
Short term borrowings		(1,320)	(834)	(934)	(934)	(934)
Other		0	0	0	0	0
Long Term Liabilities		(4,660)	(290)	(90)	(90)	(90)
Long term borrowings		(4,570)	(127)	0	0	0
Other long term liabilities		(90)	(163)	(90)	(90)	(90)
Net Assets		(289)	9,359	12,177	14,384	17,191
Minority interests		0	0	0	0	0
Shareholders' equity		(289)	9,359	12,177	14,384	17,191
CASH FLOW						
Op Cash Flow before WC and tax		842	1,688	3,213	4,062	5,091
Working capital		1,012	(1,416)	(1,300)	(1,706)	(1,390)
Exceptional & other		(304)	(607)	14	(116)	(137)
Tax		0	0	0	(581)	(736)
Net operating cash flow		1,550	(335)	1,927	1,659	2,828
Capex		(953)	(1,509)	(1,900)	(1,794)	(2,044)
Acquisitions/disposals		0	0	0	0	0
Net interest		(185)	(130)	78	(1)	(4)
Equity financing		0	9,535	0	0	0
Dividends		0	0	0	0	0
Other		(377)	0	0	0	0
Net Cash Flow		35	7,561	105	(136)	780
Opening net debt/(cash)		4,694	4,974	(2,587)	(2,692)	(2,556)
FX		0	0	0	0	0
Other non-cash movements		(315)	0	0	0	0
Closing net debt/(cash)		4,974	(2,587)	(2,692)	(2,556)	(3,336)

Source: Company accounts, Edison Investment Research

Edison is an investment research and advisory company, with offices in North America, Europe, the Middle East and AsiaPac. The heart of Edison is our world-renowned equity research platform and deep multi-sector expertise. At Edison Investment Research, our research is widely read by international investors, advisers and stakeholders. Edison Advisors leverages our core research platform to provide differentiated services including investor relations and strategic consulting. Edison is authorised and regulated by the [Financial Conduct Authority](#). Edison Investment Research (NZ) Limited (Edison NZ) is the New Zealand subsidiary of Edison. Edison NZ is registered on the New Zealand Financial Service Providers Register (FSP number 247505) and is registered to provide wholesale and/or generic financial adviser services only. Edison Investment Research Inc (Edison US) is the US subsidiary of Edison and is regulated by the Securities and Exchange Commission. Edison Investment Research Limited (Edison Aus) [46085869] is the Australian subsidiary of Edison and is not regulated by the Australian Securities and Investment Commission. Edison Germany is a branch entity of Edison Investment Research Limited [4794244]. www.edisongroup.com

DISCLAIMER

Copyright 2017 Edison Investment Research Limited. All rights reserved. This report has been commissioned by Gear4music Holdings and prepared and issued by Edison for publication globally. All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of Edison at the time of publication. The securities described in the Investment Research may not be eligible for sale in all jurisdictions or to certain categories of investors. This research is issued in Australia by Edison Aus and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. The Investment Research is distributed in the United States by Edison US to major US institutional investors only. Edison US is registered as an investment adviser with the Securities and Exchange Commission. Edison US relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. As such, Edison does not offer or provide personalised advice. We publish information about companies in which we believe our readers may be interested and this information reflects our sincere opinions. The information that we provide or that is derived from our website is not intended to be, and should not be construed in any manner whatsoever as, personalised advice. Also, our website and the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. This document is provided for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Edison has a restrictive policy relating to personal dealing. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report. Edison or its affiliates may perform services or solicit business from any of the companies mentioned in this report. The value of securities mentioned in this report can fall as well as rise and are subject to large and sudden swings. In addition it may be difficult or not possible to buy, sell or obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (ie without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision. To the maximum extent permitted by law, Edison, its affiliates and contractors, and their respective directors, officers and employees will not be liable for any loss or damage arising as a result of reliance being placed on any of the information contained in this report and do not guarantee the returns on investments in the products discussed in this publication. FTSE International Limited ("FTSE") © FTSE 2017. "FTSE" is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under license. All rights in the FTSE indices and/or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and/or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.