sarria

Iceland

Analyst: Tomas Mannion: +44 20 3744 7009 | UK Grocer | Last Update 14.3.2024

Capital Structure £ mm	29-Dec-23 Amount	29-Dec-23 Funded	Book Val. Multiples	Coupon	Maturity	Market Value	Market Value	Market Val. Multiples	YTM	Comment
Cash		(146)					(146)			
New Super Senior RCF	50	-		L + 3.75%	15-Jan-25	100.0%	-			1yr Extension Possible
Restaurant Borrowing	18	18				100.0%	18			
		(128)					(128)			
Off B/S HSBC trade credi	120	60				100.0%	60			
SSNs 2025	50	50		4.625%	15-Mar-25	100.0%	50		4.6%	XS16818063
SSNs 2027	265	265		10.875%	15-Dec-27	106.50%	282		8.6%	
FRNs 2027 (+5.5%)	250	250		9.502%	15-Dec-27	101.0%	253		9.1%	
SSNs 2028	250	250		4.375%	15-May-28	85.5%	214		8.9%	XS2304198331
Total Net Debt	238	747	4.4 x				730	4.3 x		
Other borrowings		18								
		765	4.5 x							
Total Liquidity		196								
FY24 EBITDA		171								

Notes Valuation:	
FY24 EBITDA	171
Val. Multiple	5.5 x
Exs. Cash	146
EV	1,086
Super Senior Debt	78
SSN Cover	1,008
SSN Cover	(930)
	124%

Notes:

- Following the transaction in June 2020, Sir M Walker and T Dhaliwal purchased all of Brait's outstanding B shares via a Company called WD FF Limited. A loan was established from Iceland TopCo Limited to WD FF limited, to fund the initial installment. Subsequently, in September, WD FF accelerated the terms of payment capturing a further discount from Brait.
- This transaction, valuing the 63% of the equity at £115m, valued the equity at £182m, or 6.5x FY20 EBITDA. This is inline with the share buyback in Q1 2019, of N Canning, who left the Company the prior year. He was paid £10m for 4.7% stake, Valuing equity at c. £200m - or 6.4x FY19 EBITDA.

Relevant Credit Statistics:

	Mar-19 FY19	Mar-20 FY20	Mar-21 FY21	Mar-22 FY22	Mar-23 FY23	Jun-23 Actual	Sep-23 Actual	Dec-23 Actual	Mar-24 Forecast	Mar-24 FY24	Mar-25 FY25
Total Revenu	3,085	3,249	3,777	3,667	3,959	936	902	1,302	987	4,127	4,241
Gross Profit	175	172	221	160	155	46	51	51	71	218	220
% Margin	*5.7%*	*5.3%*	*5.9%*	*4.4%*	*3.9%*	*4.9%*	*5.6%*	*3.9%*	*7.2%*	*5.3%*	*5.2%*
Ad EBITDA	**140**	**134**	**176**	**141**	**120**	**34**	**26**	**43**	**68**	**171**	**180**
% Margin	*4.5%*	*4.1%*	*4.7%*	*3.8%*	*3.0%*	*3.6%*	*2.9%*	*3.3%*	*6.9%*	*4.1%*	*4.3%*
WC	14	(6)	(115)	176	(9)	(1)	(32)	33	(33)	(32)	5
Operating CF	**146**	**136**	**191**	**151**	**101**	**45**	**0**	**78**	**34**	**157**	**174**
CAPEX	(101)	(61)	(23)	(38)	(43)	(3)	(6)	(16)	(30)	(54)	(48)
Interest	(43)	(40)	(45)	(43)	(37)	(19)	(16)	(22)	-	(57)	-
Change in De	(5)	19	20	6	(10)	(13)	(43)	(15)	-	(71)	(50)
Net Cashflov	(3)	53	143	45	8	10	(65)	25	4	(25)	76
Super Senior	-	-	-	15	13	-	-	-	-	-	-
Bonds	765	760	800	800	800	800	815	815	815	815	765
Cash	111	140	126	171	161	171	123	146	151	151	226
Net Debt	**654**	**620**	**675**	**644**	**652**	**629**	**692**	**669**	**664**	**664**	**539**
Leverage	4.7x	4.6x	3.8x	4.6x	5.4x	4.6x	4.5x	4.0x	3.9x	3.9x	3.0x

Investment Rationale:

- - In July, we rotated our long position from the Iceland 2025's into the 2028's at 16pts differential (exiting 25's at 97%, buying the 28's at 81%) on the expectation a refinancing would happen. It did happen, but not exactly as we had expected, our base case was the new bond would extend beyond the 2028 maturities. However, despite being the longest dated maturities, we retain our 5% long position in the bonds (up 5pts plus carry).
- We had previously modelled that the Company would not meet its £176m+ EBITDA (FRS 102) prior to the Company acknowledging on the Q3 call this was going to be difficult to achieve. Therefore, we are not changing our model and expectations of £171m with leverage ending the year at 4.0x, in line with Company guidance.
- With energy prices and no upcoming maturity wall we don't see any issues for Iceland in the coming quarters. The name is trading on relative value basis and although we maintain our position, we can foresee exiting for other opportunities.

Key Value Drivers:

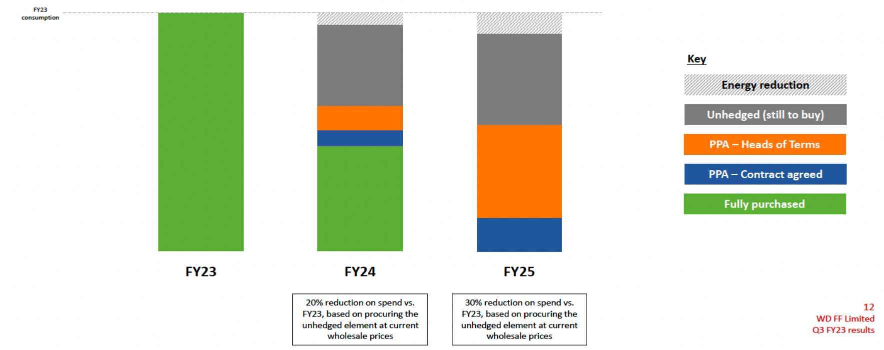
- Management having gained 100% ownership of the Company has clarified the future direction of the Company and Iceland is highly likely to remain in family ownership. This has enabled the Company to take a longer term view in relation to market share and investing in price. Additionally, the Company has increased its own manufacturing capabilities further securing its supply chain.
- Other driving force is the speed of expansion of number of stores and the speed to "full" sales level. The Company has guided to a reduced CAPEX spend, due to current market uncertainty and lack of suitable retail space. With the increased high street closures, rent increases are unlikely.
- Given its market position, Iceland has a natural hedge to a deteriorating consumer confidence in the UK, picking up customers as consumers trade down from traditional supermarkets. In recessionary times, the portion of frozen food sales also increases which will disproportionately favour Iceland.
- Energy prices: Iceland will benefit comparatively from lower energy prices in FY24 versus FY23. Additionally, from our numbers, Iceland entered into some hedges for Q3 and Q4 which in hindsight were expensive. Part of the energy savings in FY24 will be invested into price to defend market share, but the easier comparisons will result in higher EBITDA.
- Bond buybacks: We see the Compmany will do bond buybacks in the coming quarter given their strong cashflow and the fact they have just secured an increase in RCF. Additionally, the covenant of minimum EBITDA has been removed in order to have full availability.

Key Risks:

- UK employers are likely to come under pressure from staff for wage increases. Wages is a large portion of Iceland's cost base, but Iceland is no different than their competitors. We have modelled a 5% wage increase this year, albeit tempered by a reduction in the number of employees per store, back to pre Covid levels.
- Excessive expansion CAPEX is the biggest risk to leverage. This coupled with the move into larger store formats have made investors uneasy. The Company have currently executed and performed on these larger stores directly competing with "deep discounters".
- Competition pressures are not just on the top line or GP level, but it is also causing pressure in the search for property space. Although the High street is struggling, Iceland is finding they are competing for space with discounters.
- The company has an off-BS reverse factoring facility with HSBC. We do not know the size of it, but assume it is super senior.

Energy update

Breakdown of energy procurement progress, based on FY23 annual consumption



Energy:

- We aren't as optimistic as Iceland's management are in the ability to reduce energy costs in FY24 over FY23.
- The Company expect to see a 20% reduction in energy bills in FY24 versus our model of c.13%.
- Although there are always further ways to reduce waste and be more energy efficient, energy has always been a large cost for Iceland, and we suspect the easy cost savings measures have already taken place.
- Our model assumption, based on energy prices assumes static energy use per store and the 13% reduction is driven by the forward curve with no hedge mitigation.

Description:

- UK national food retailer specialising in frozen food with 966 stores in UK (including 106 stores branded 'The Food Warehouse' fascia as well as 35 stores in Ireland and in Czech Republic.
- Second largest retailer in the UK frozen food category (Tesco largest), and the largest player in the frozen ready meals, frozen meats.
- Private label accounts for 44% of total sales and 72% of frozen food sales, with private label enjoying a higher margin than branded products.
- Sale of frozen food tends to be higher during the winter months, with December sales being approximately double those of other months due to Christmas and New Year's celebrations. Cashflow increases in mid-November and peaks in December to early January.
- EBITDA per store has increased from £128.7k in FY16, to £168.6m in FY18, although model shows this declining going forward.
- Other point to note on Working Capital is the fact that Iceland benefits from an off-balance sheet trade credit facility with HSBC which suppliers can opt to be a funded supplier, where HSBC pays the supplier shortly after invoice date and then Iceland pay HSBC at a date later than the suppliers payment terms. Size of the facility is unconfirmed.
- In relation to leases, the Company has annual payments for off balance sheet leases for property and equipment totalling £116m FY19 - majority goes through COGS line.
- Iceland's distribution system is fully outsouced to XPO Logitics, a long-term partner of Iceland. By using a third party distributor, Iceland has limited their CAPEX for distribution. Iceland operate from six distributoon centres. Over the course of FY22, Iceland expanded its distribution centre in Swindon and invested to increase capacity at Livingston.

Restaurant Group:

- Note this sits outside the restricted Group and does not benefit bondholders directly.
- The acquisition of the Restaurant Group came as a surprise to all bondholders. The Company purchased Individual Restaurant Limited for £31m from internal cash resources. The business historically made £7.7m and £7m EBITDA in FY March 2018 and FY March 2019 respectively. There has been no further information disclosed.
- The purchase is to be seen as opportunistic and likely to be divested in the medium term. As at 31st January 2021, the Restaurant Group has external and shareholder loan of £35m (£31m from Iceland Group).
- The business is currently not consolidated into the Restricted Group but the intention is during FY22 that the Company will move the operations within the Restricted Group. This should see the EBITDA increase by c. £5-10m when the Restaurant Group re-commences full operations.

Key Model Assumptions:

- Our model is based on redefining Iceland's Gross Profit, and deducting Wages, Leases and Energy costs, to arrive at an adjusted "Sarria" Selling margin. This enables us to adjust the differing inflationary pressures seen in wages, lease payments and energy, and how this impacts on profitability of Iceland.
- We have reduced our selling margin to reflect the increased likelihood of price competiton in the coming quarters. This partly explains why our model undershoots the Company guidance on EBITDA (FRS 102).
- On wages, we need to highlight the increase in FTE Iceland reported for year ending March 2021. We feel this FTE number is inflated significantly due to COVID, but using the reported numbers shows an increase in FTE per store from c.15 to 18.7! We have modestly reduced this for FY24 but inline with comments from the Company, we are reluctant to reduce all they way to pre Covid norms. Note Iceland only report staffing levels once a year in their Q4 report. Also distorting the numbers is the inclusion of restaurant staff, which is now included.

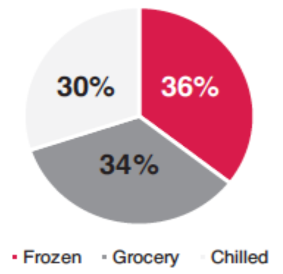
Sales Growth - volume or price?

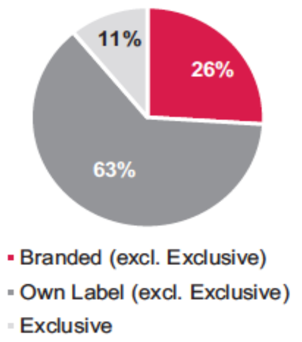
- Given the level of inflation in the UK food sector, all else being equal, it is not unreasonable to assume an increase in "sales per store" basis, and in turn top line sales. However, as working patterns continue to change, food retailers are expecting a reduction in top line sales as customers increase their "eating out" portion.
- The impact on Iceland will be more muted than its rivals, given the social demographics of its customers. In addition, Iceland are likely to increase its market share due to the increased cost pressures UK consumers face.
- Our model has a 5-6% increase for FY23 on a sales per store basis. This is based on a combinatation of volume increase and price increases.

How much does Iceland invest in GP?

- Volume increases should feed through to Sarria's adjusted Gross Profit increasing on static GP margins. We expect that Iceland are likely to have to lower percentage margins, and the wider question is can they maintain a similar absolute level of adjusted Gross Profit? There is no doubt that there are increases in other costs eg. wages, energy, so overall GP will fall.
- Iceland generated higher Gross profit margins in FY18-20 period, but with higher volumes in FY21, lowered their margins. We expect Iceland will be in a position to increase margins in the rising price environment to absorb the "known" inflationary pressures of wages and energy.
- On the basis of our "Selling margin", ex. Energy, wages and leases, we have modelled a modest reduction due to Iceland not fully passing through all their suppliers' price increases. This is due to a combination of maintaining market share and investing in certain brand/marketing ploys i.e. the £1 range etc.

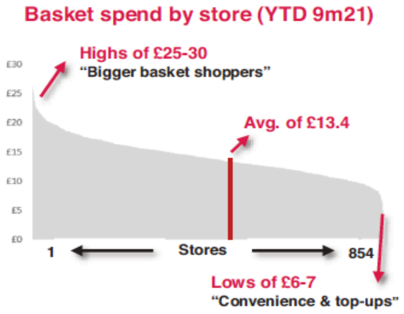
Product Type Mix

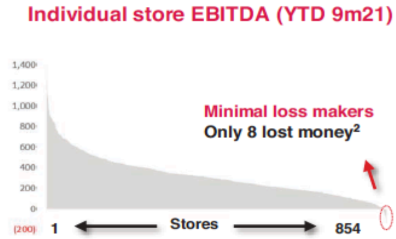




Store Formats:

- Predominately viewed as a seller of frozen items, Iceland still sells basic grocery products in all of its stores.
- Core Iceland Stores(842 stores) are generally 4-8,000 sq ft in size and have 3,000 SKUs. This is the original store format.
- Iceland has expanded into Food Warehouse stores, with 154 stores currently. These stores are typically larger in size (10-15,000 sq ft and c. 3,700 SKUs.
- Small International business with 27 stores, in the "iceland" format. These are all in Ireland. Additionally there is a wholesale/franchise within the International segment, that distributes to over 40 countries.
- Iceland have an Online channel, which uses a store-pcik model (from 661 Iceland stores) and covers 86% of all UK postcodes. It has a free next-day delivery service and upto 1m weekly online delivery slots, secound only to Tesco.
- Alliance with the The Range, having a store-within-store inside the Range's home, garden and leisure stores, reaching different locations and customers.

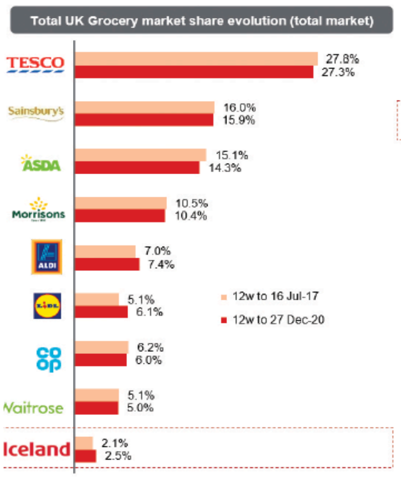


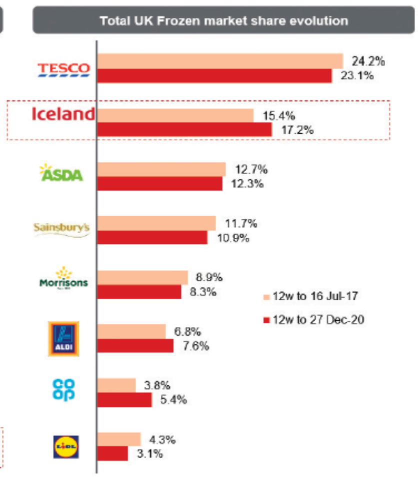


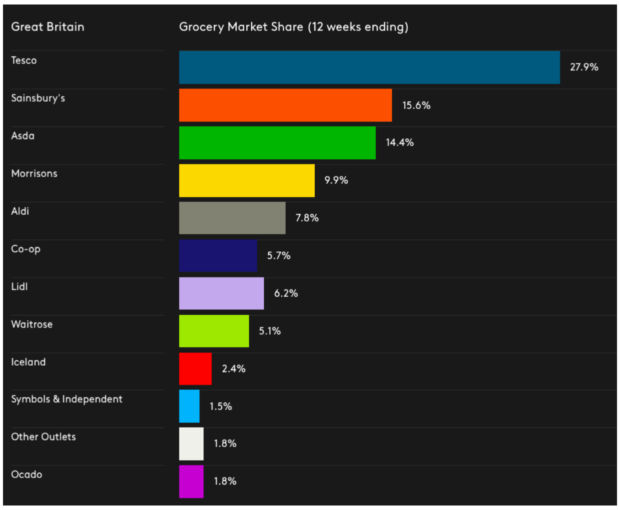
- Iceland's basket size is smaller than their competitors (£25-35 range), reflecting two main differences, namely the lower social demographic nature of their customers, and, secondly, their position on the high street in high footfall areas, leads to higher incidental spending (shoppers tend not to use Iceland for full weekly shopping).
- Iceland's management have actively managed the store base, as seen in the number of openings ans closures, leaving minimal number of stores in negative EBITDA territary.

Industry:

- At the wider aspect of the market, the UK retail space is under severe pressure from price inflation, continued competition from deep discounters, and wage inflation from minimum wage movements.
- At the tighter defined "frozen food" market, Iceland is Number 2, behind Tesco. Iceland enjoys strong buying power in their narrowly defined market, but the reality is severe competition from deep discounters. Iceland has a market share of 15.4% of the frozen food category as of July 2017.
- From Kantor, Iceland showed improved for 12 weeks to December, improving from 2.2 to 2.3% over for 2018 compared to prior year. Kantor is quoted saying "Iceland now accounts for 2.3% of the market – up 0.1 percentage points compared with this time last year. Four-fifths of its growth came from its non-frozen lines as perceptions of the retailer continue to shift. Management alluded to this on the previous call and expect to see it in the Q3 numbers.



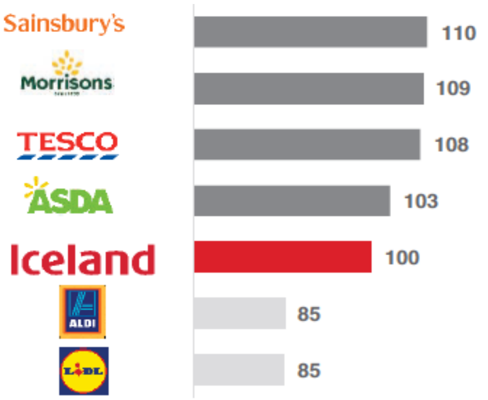


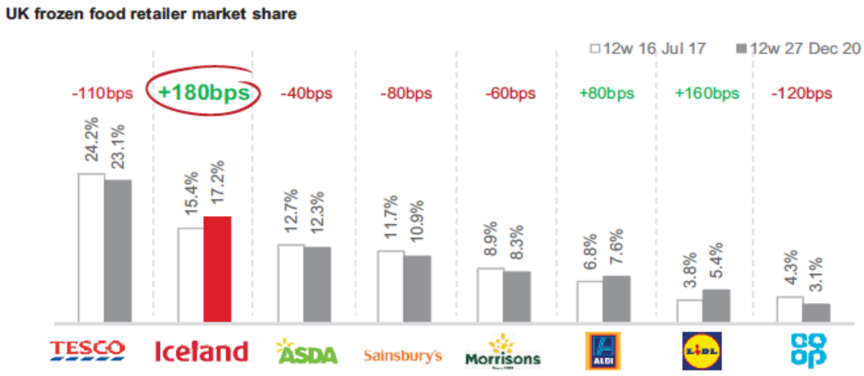


ource: Kantar Worldpanel, 12 weeks ending December 27, 2020; 12 weeks ending July 16, 2017

- Above graphs are from Iceland's Offering Memoradum, with the graph on the right from January 2022.
- Graphs below highlights the market position of Iceland, and on the right, showing Iceland's #2 position in the frozen food retailer market.
- According to Kantor, the frozen food market is counter-cyclical: demand for frozen food generally increases as consumer confidence decreases.

Market Position





Price index of basket of goods v Icleand (LTM av 52 week end Jan'21)

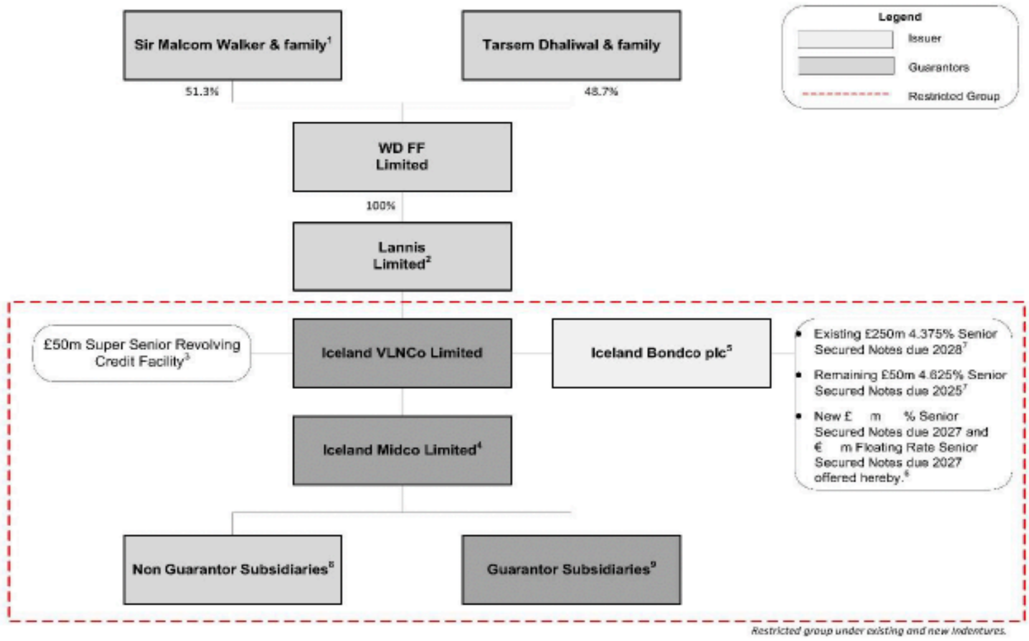
Competitors:

- **TESCO** - market leader with increasing market share over the last couple of quarters. Focus for Tesco's has been the removal of SKUs and renewed focus on its club card members. Note, Iceland also has a Clubcard scheme, which has proven to create loyalty in its customer base.
- **Sainsbury's -** losing market share and perrennially rumoured to be Private Equity target, especially for Fortress, who missed out on Morrisons. Preceived to be in price match "war" with Aldi, management focus has been on internal restructuring, especially trying to integrate the Argos (home catelogue business) into its overall platform which they acquired in 2016.
- **Asda -** Sainsbury had tried to acquire the Asda business from Walmarts, but was rejected by the Competition Authority. Subsequently, the business was acquired by the Issa brothers and TDR capital and after years of the parent, Walmart, underinvestment in the estate, focus is on refreshing the brand.
- **Morrisons** - Another business who have recently been taken private. Business has a predominately northern regional split. CD&R have yet to refinance the bridge financing used to fund the acquisiton. At the time of the acquistion, Morrisons had a larger unincumbered estate than its peers.
- **Aldi/Lidl -** Competing directly for retail space with Iceland's expansion plans. Both of the German discounters have grown from a small base to a 6/7% market share each with huge investment in price and own labels. Have driven down the cost base across the industry.

Competition Pressures:

- **Poundland** have outined planned in 2021 to roll-out their chilled and frozen offering across 250 stores. Poundland compete at a similar price point and would be a direct competitor to Iceland. Additionally, Poundland have been increasing their store numbers, having planned to open & new stores prior to Christmas,
- **B&M** have also expanded the store numbers, another competitor at the similar price point.

Legal:



Game Theory

- The bond documentation allows for additional borrowings under various baskets but given their current leverage it is unlikely that the Company will leverage up. The management are heavily involved in the equity and Malcolm Walker ideal scenario is to keep the business private and gain control for management directly. It is unlikely that management could achieve voting control for 38% share with another sponsor so expect no change in shareholder structure in the medium term.
- Should it come to a restructuring, the UK would be the jurisdiction of choice. Both bond issues are ranking pari passu in every way.
- The bond documentation already regulates the mechanics for a Distressed Disposal under English law.

Collateral:

- Shares, bank accounts, fixed and floating charge over the assets, property, proceeds loan and the IP of the Issuer and the Guarantors.

Guarantees:

- Senior secured over each Guarantor's Collateral.

Covenants:

- Super Senior RCF is is subject to a draw-stop mechanism if 30% utilised and EBITDA is < £120m **(This is currently waived in the high energy environment).**
- In line with other retailers, Iceland has significant operating leases which are not accounted for in their numbers.
- All three bonds are pari-passu and rank junior to the Super Senior facility. There are no maintenance covenants at the bond level.

Restricted Payments

- £3m p.a. in Dividends
- Generally, uncapped if leverage is <3.0x, but have a £60m general basket
- Unlikely payments under the Consolidated Net Income test, as 50% of Net Income, unclear if any has been built up

Permitted Investments

- General Basket of bigger of £75m of 4.5% of Total Assets, currently £75m
- Company also has ability to do JVs up to £30m investments.

Asset Sales

- Up to 75% has to be used for either CAPEX or used to pay down debt or do a further related acquisiton.

Ability to Raise additional Debt

- Company can raise debt at a super senior facilitiy - currently have £30m Super Senior Facility. Terms of the bonds allow for an additional £20m (or 3% of Total Assets SS RCF). There is no capacity for additional senior secured debt given leverage is already above the 4.25x limit.
- The Company can raise some off balance sheet financing, via uncapped Trade Receivables allowance and Purchase money Obligation up to greater of £100m and 6% of Toteal Assets of the Company.

Jurisdictions:

- Both Notes are NY Law
- Issuer is English Law
- Intercreditor is English Law

Disclaimer: