MATALAN

Analyst: Wolfgang Felix: +44 203 744 7003 | UK Value Fashion Retailer, 230 own stores, subject to 2023 D/E Swap | Last Update 16-Feb-24

Capital Structure £ mm			25-Nov-23 Amount	25-Nov-23 Funded	Book Val. Multiples	Coupon	Maturity	Market Value	Market Value	Market Val. Multiples	YTM	Comment
Cash	Q2'24 forecast			(139)	-				(139)			Usually £~10m in tills
Super Sr. Notes	(Incl. Tr. 2)		86	86		10.00%	Jan-27	83.3%	72		18.5%	(a), (b), (c)
Debt through 1.5 Lien			**86**	**(53)**	-0.65x				**(67)**	-0.83x		
Priority Notes	Cash		75	75		10.69%	Jul-27	84.0%	63		18.0%	(a), (b), (c)
Secured Debt			**161**	**22**	0.28x				**10**	0.13x		
SSNs	PIYC		200	200		10.00%	Jan-28	83.3%	166		16.8%	(c), (d)
Secured Debt			**361**	**222**	2.74x				**189**	2.33x		
Equity	Shares (m)	10	183	183				18.3	183			
EV			544	405	4.99x				405	4.99x		

SONIA	5.19%
Notes Valuation:	
EBITDA 24/25	81
Mult. (Distr.)	5.0x
EV	405
Excs. Cash	139
Super Sr. Note	(86)
Priority Notes	(75)
	383
SSNs	(200)
Equity	183
2LNs Cover	**192%**

Major Shareholders:	Invesco, Man GLG, Napier Park and Tresidor and other former SSN holders.
(a) Cash Sweep:	Priority Notes before S.Sr. Notes. Cash sweep above £50m at 102% from March 2024 onward, subj. to forward Looking liquidity Test.
(b) Additional Amounts:	Super Sr. Tranche 2 has been issued. Debt has carve outs for an additional £20m of each: S.Sr. and Priority Notes.
(c) Orig. SSN covenants:	Restrictions from 2x FCCR and 3.5x Net Leverage.
(d) PIK Toggle:	For two years (until Feb '25) PIK optional if p.f. liquidity drops below £50m in the next 6 months. Company started '23 paying cash.

Shareholdings:	
New SSNs	53%
New Priority Notes	20%
Priority Notes Backstop	15%
Super Sr. Notes Backstop	7%
	95%

Relevant Credit Stats:

DCF Valuation:	**405**	**Fair Value underlying Restructuring:**	**586**
DCF Value of Shares	183	Fair Value of Shares	250
DCF Value per Share	18	Fair Value per Share	25
Quote seen for shares	6		6
Money Multiple	3.0x		4.2x

Investment Rationale:

Since the additional Super Sr. request, we are holding a 4.4% of NAV position of Matalan across Sr. Sec. Notes Tranche II, Priority Notes, 2nd Lien Notes and equity. 2024/25 will be a year of transition for Matalan. The cost headwinds from labour and property are certain, the success of its return to a lower price strategy is likely, but altogether less certain. Still, we have been through management's budget back to front and think it perhaps not sustainable (higher than 50% margins have never lasted), but doable for a year while the business needs to adjust. We brace ourselves for 2024/25 EBITDA of £70m on the downside on higher than planned mark-downs with £95 on the upside from better sales performance.

- In light of the uncertainties surrounding the next year, we have taken down our valuation. Even though we remain convinced of Matalan's value in the medium term, it is difficult to model the immediate re-build of its margins without feeling aggressive about any single assumption. But it will happen and so the bonds remain attractive and will be well value covered in the medium term. Meanwhile however, failure to deliver the budget will quickly require fresh cash, as without RCF liquidity is at a minimum and budget cashflow (after cost investments and some expansionary CapEx) only just earns its interest payments.

Fundamental View:

- Fundamental: Matalan continue to occupy an undiminished position in the UK apparel retail landscape where it has neither grown, nor shrunk in the last 20 years. During the pandemic and following the exit of a number of retailers from the market the company has been taking market share. The low-price sector is still relatively insulated from online pressures, so that from an average £90m EBITDA since the cotton spike, the only real headwinds are inflation, FX and for the tail-end (hopefully) of the pandemic: logistics and footfall. Its problems are therefore not secular, but cyclical and margins will largely come back as two new collections roll through, i.e. from SS24.
- Tactical: Irrespective of the company's forecasts, we see the current performance of Matalan as the nadir. We consider the published forecasts reasonable and approve of the new management.
- Aside from recovery however, an additional doubling of valuation will depend on a story. Currently there is none and a mere recovery will be priced at 7x only.

Description of the company:

- Large surface, retail park based UK clothing retailer with 230 full-sized, large-surface, out-of-town stores in the UK and a small franchise business overseas. Matalan operates some 600k m2 of retail space with approx. 13,000 staff, targeting the 35+ year-old "average UK housewife", who is buying for herself and her family as well as the household in general. With significant sections within Matalan stores dedicated to menswear, childrenswear and 17% to homeware, Matalan is not as fully exposed to womenswear demand as other fashion retailers in the UK. Also, its clientele tends to benefit from a more stable disposition and income profile.
- Control has been wrested from its founder John Hargreaves after the company - loaded with debt - failed to grow its topline over the past 15 years.
- in 2009, founder John Hargreaves, who had taken the chain private only in 2006, turned down a bid of £1.5bn for Matalan from CVC. This was on the back of the last refurbishment program. Despite the financial crisis in full swing, EBITDA had risen to £145m at that time, so the valuation stood at 10x.
- Matalan have an undeniable track record of being anticyclical. When there is pressure on the purse of the British mother/housewife, she goes back to Matalan. We expect this to happen again and Matalan to take market share as the initial Cost-Of-Living shock subsides and the economy reverts to equilibrium. Effects have also been overshadowed by a deteriorating exchange rate (£/$), which has been normalising. If it weren't for the perfect storm in British retail, Matalan would be back at similar EBITDA levels, with impressive growth and thus a valuation of 10x.

Value Drivers:

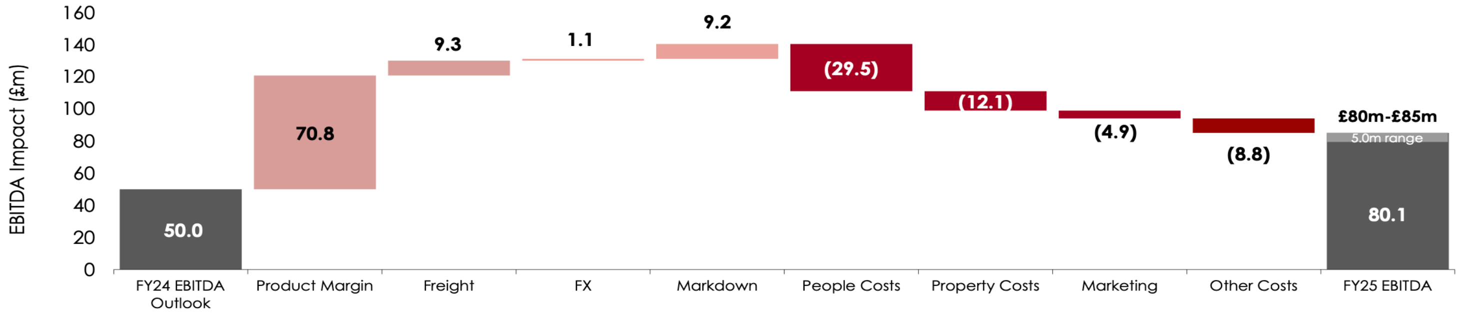
- Underlying the budget is the key assumption that Matalan can drop price by 4% to gain volume of 8%, i.e. 2x elasticity. This ratio has been on display throughout most of 2023m (in reverse) and so we are not exactly alarmed, but the success of this strategy is less certain than the cost increases the company has to overcome.
- Hold on to the 7 percentage points lower purchase prices. Matalan will be trying to sell merchandise that it bought 7percentage points cheaper at only a 4% reduction in price.
- Renegotiated freight contracts provide for a £10m tail wind.
- So far it looks like FX headwinds will not be a major feature next year. The company is 85% hedged for FY24/25 at $1.23.
- The lower price point should noticeably drive the online business, which has been suffering from overpriced merchandise this financial year.
- Management's refocus of CapEx into the store chain is well aimed. In this market the company needs to chase consumers / market share / revenue. Costs savings are great, but they take second place when "depressed" consumers are reorientating themselves and their disposable income.

Risks:

- Matalan is facing a £55m increase in its cost base next year, or about all its LTM EBITDA - and some. Any failure of its strategy - to drop prices and reclaim volumes, despite not passing on all purchasing economics to its customers - will hurt very quickly.
- The volume increase will have effects below Gross Margin and drive a £13m increase in the company's largest cost item - labour and labour costs will further rise with a 10% increase in NLW. Offset only by savings from further automation in its Knowsley warehouse, Labour accounts for over half of next year's cost headwinds.
- Higher energy supply contracts and an increase in business rates are adding £10 of cost headwinds, along with another £3.3m in business rates.
- Management further (reasonably) bet on cleanliness of the estate and on sponsoring stronger rebate and loyalty programs - basic retail strategies.
- Worsening of the UK consumer's disposable income. Matalan are counting on £9m lower markdowns next year, when this year - except for Q1 - the mark-down situation was benign.
- If Matalan fail to deliver the budget materially, shareholders / bondholders will have to inject fresh cash.

Outlook:

Budget EBITDA Bridge



2024/25 Revenue and Gross Margin:

- Sales: £1,300m - growth by a net 4% on 4% price increases resulting (hopefully) in 8% volume growth.

- The FY24/25 plan is looking to increase Gross Margin by roughly £90m (Pink blocks above) and primarily rests on a 2x Elasticity assumption and lower purchase prices. The profit increase can be broken down as follows:
  - £40m for 4% lower selling prices planned for the year, where a large effect comes from a shift in range mix down into more basic items.
  + £40m for 8% higher volumes on a 2x elasticity assumption x ~50% Gross Margin (dealing with savings from Freight and FX separately below), (in line with price/volume effects seen in FY23/24, but past performance is no guarantor for ...). We agree that the lower price point should primarily fuel the online business and less so the store business, which the company puts at 1.5x elasticity.
  + £70m for 7% lower intake prices for the year (This represents a 20%+ reduction in cost across the range of probably ~£300m COGS down to ~£230m). Again the shift in product / price mix should be important in explaining this large reduction, but it's an extremely aggressive cut. Management say that prices are largely locked in. We tried calling management for clarification, but perhaps it was the wrong week (mid-terms in the UK). Good luck selling those rags!
  + £10m are to come from renegotiated freight contracts.
  + £10m supposedly come from lower mark-downs. Mark-downs were bad in Q1 this year, but have since played only a minor role. We are surprised that management budget this much. We understand that purchasing volumes have been prudent, but there will be no flex in that.

- The 2x Elasticity assumption, apart from being on display in H223/24, is underpinned by:
  - "Full chain roll-out of enhanced ladieswear visual merchandising and coordination approach" - whatever that means, but it'll have to do with better presenting the ranges.
  - Restart of the store refit program - effects from this should take time to roll through the P&L, but by year 2 or 3 tend to have a strong (+7% of Sales) impact.
  - Outputs of the "Value Creation Program" that's been running through 2023/24 "more than offsets" the price investment and generates significant Gross Margin improvements. Again, we have no idea what it actually means and management have provided no numerical framework.

2024/25 Expenses:

- People cost:
  - NLW is up another 10% and moving colleagues up from minimum wage. While this increases costs even further, it should lift morale and improve operations.
  - Sales volumes should also add costs of 13m as more personnell is required in the handling of merchandise.
  - Supply Chain automation at Knowsley should offset the increase somewhat. However, further investments into the back-bone are being pared back in favour of focusing available CF on store CapEx.
- Property:
  - Energy costs increase once more by £4.5m as forward contracts are rolling through. The effect is already net of benefit from a LED roll-out across the estate.
  - Business Rates grow by £3.3m, partially offset by renegotiated rents.
  - £5.5m enhancement to cleaning standards and improving store presentation.
  - FY25 still seeing slight store reduction (open 3, but exit 4 or 5).
- Marketing: - Intensified and budget aimed at volume recovery, rebate scheme and loyalty incentives.
- Other Costs: - More investment in supply chain and allowance for IT outsourcing cost.

- EBITDA: £80-85m

2024/25 Cashflow:

- WC:
  - If EBITDA is £80m, CapEx -£40m and Interest -£35m, but the company wants to generate £15-20m of FCF, then there is no space in the budget for any WC build-up.
  - WC peaks in March and October, leaving minimum liquidity of merely 30m.
  - We appreciate that Management consider their purchasing volumes prudent, but underlying the budget is the assumption that volumes grow by 8% (half of the current loss rate). While that is probably a reasonable assumption (same 2x elasticity hopefully working the other way too), there is a risk that the volume growth is not coming and that volumes aren't all that prudent after all. Stock levels are currently very low, prompting management to hold back on sales. We wonder how much lower they can go. The risk of stock overhang will be as palpable as it's always been.
- CapEx: - $40m investments focussed again more on the stores than on the logistics and IT backbone.

- Cash: - Planning to generate Cash of 15-20m.

Q423/24:

- The familiar scissor effect of average price rises being offset by even larger volume declines continues in Q43/24.
- EBITDA of £50m is very difficult to model when taking into account the December sales drop of over 11% and expenses being in line with last year's. We arrive at over 50% Gross Margin, for which there is no historical backing.
- We recognise that management tends to be very accurate in forecasting Q4 economics on its Q3 calls - not least because January and February are small months and December is already in the books by the time the call is held. So for Q423/24 only, we discount our model in the short term and confide in management for the next 45 days. EBITDA will be close to £50m.
- 2023 has a warm winter again. Your's truly meant to buy a jacket, but that won't happen for another year. Customers need discounts to be encouraged to spend. Matalan however held full price through christmas. That should make for a strong gross margin, but once again at the loss of market share. For Matalan, Spring/Summer cannot come soon enough.

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Current Trading:

Update Q323:

- Matalan achieved Full-Price Sales of 68.8% as it held out with winter discounts until after Christmas. The figure is slightly down QonQ, but up sharply YoY. However, once again this had to be achieved at the cost of volumes - and increasingly so.
- Sales missed our Q323/24 expectations by some £-15m, half offset by margins.
- At the current price point, Matalan are losing twice as much volume as they gain in price. We note that this relationship (in place for at least 6 months now) underlies the Budget for 2024/25, only in reverse order. It is worth remembering that the quarter included end-of-summer sales that were pushed back from Q2 into September, affecting this elasticity statistic. A fairer basis for elasticity assumptions should rest on Q2 and Q3 together. The budget then appears to have a little sandbag - we are glad to note.
- Warm winter - Customers are holding back on spending.
- Online: Traffic, Conversion and Baskets up (from low) Full price sales up 7.6% percentage points up from last year or growth of 2.7% to 69%.
- Online revenue is no longer 35% down YoY, but "only" 22% down. Way to go. The channel is held back disproportionately by the high price point of the 2023 collections.
- International activity was challenged as partner had to be refinanced. Operations should resume now.

FX Hedging:

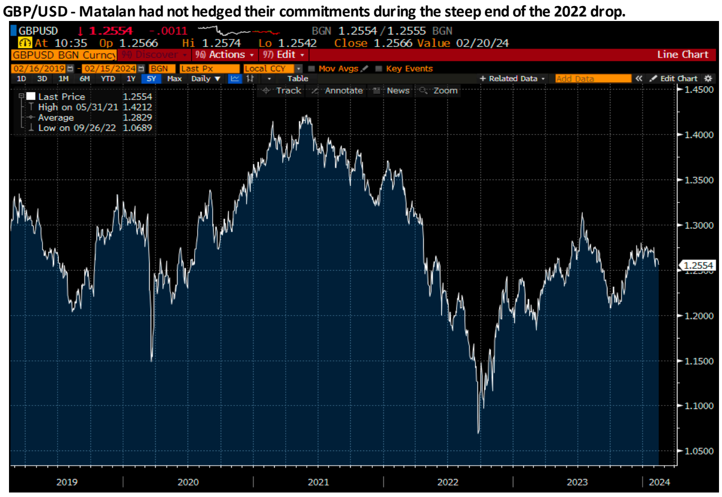
Update Q323:

- Currency headwinds for the quarter were approx. £8m, roughly in line with model.
- The company is back to hedging some 85% of its requirements a year forward - generally as it orders goods / reserves volumes.
- Over the last 12 months Cable has been choppy, but all in all stable. This generally bodes well for planning margins in discount apparel retail.

Headwinds passing through:

- Currency headwinds of above £20m put the nails into Matalan's coffin in 2022 (FY23). The retailer was already suffering from the cost-of-living crisis, even though it had traded through the pandemic reasonably well (needed to raise emergency funds though).
- The Pound now trades at $ 1.24 again, significantly down from the $1.37 level when the AW23 and SS23 goods were ordered, but up from its lows during the Truss premiership. For FY23/24 we were not foreseeing as much YoY impact in total, but Q2 alone has seen currency headwinds of £15m.
- During FY22/23 Matalan have been running down their hedge balance - either to game the exchange rate (if so, well done - stop bothering with the clothes please), or because it couldn't do so beyond the maturity of its capital structure. In the quarter to November '22 the company purchased a great deal of forward contracts, significantly restoring its hedge ratio and has been bolstering again the position from there.
- FX is now fully hedged through the end of FY24 and well beyond.

GBP/USD - Matalan had not hedged their commitments during the steep end of the 2022 drop.



Inflation:

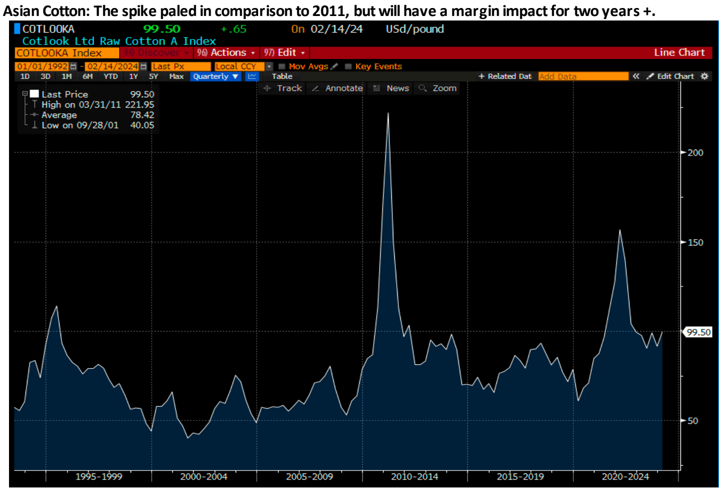
Update Q323:

- Cotton and other raw material prices remain elevated following the 2022 spike, but have been stable since.
- New Collections will be far cheaper made - to cater to the lower price point on demand in the UK as well as the higher raw material costs in the far east (double whammy).
- The stability of the cost levels involved gives us confidence that the 2024/25 collections have been well calibrated.

Raw Materials:

- Every once in a while, cotton can spike out of control - most recently in early 2022. Manufacturers tend not to pass on the full increase to retailers at once. Rather there is an element of cushioning that is then reflected in higher prices in the following seasons. So it was following the GFC and Corona.
- Cotton is only one of the raw materials used and in aggregate we think it might make up only approx. 7% of Matalan's COGS. But depending on the cause of the crisis, yarns and other materials can be affected in the same way aso cotton, amplifying the effect.
- The AW 22/23 and SS23 collections have been expensive to order. Margins were low and low again in Spring '23. In summer '23 Matalan was able to pass on the price, offsetting the lower volumes in return.

Asian Cotton: The spike paled in comparison to 2011, but will have a margin impact for two years +.



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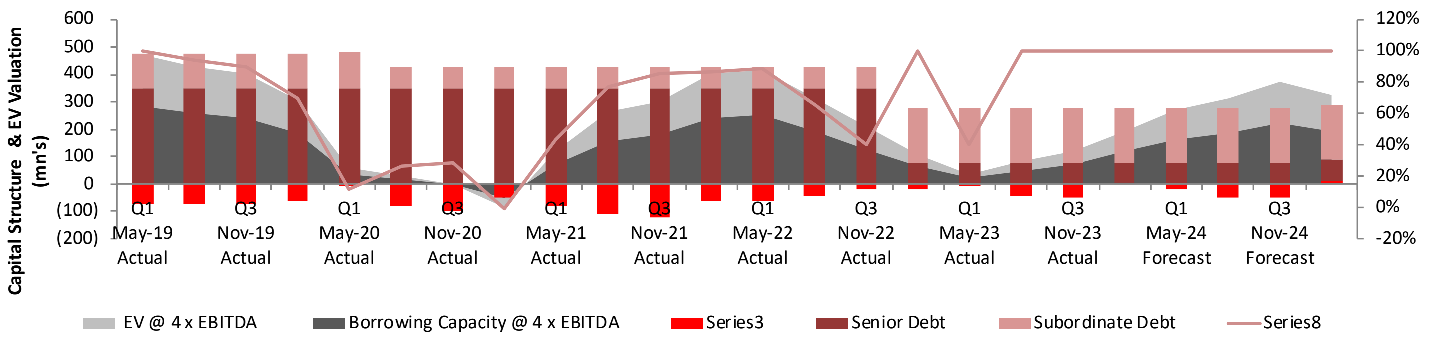
Summary Forecast:

	20/21	21/22	22/23	23/24	24/25	May-23	Aug-23	Nov-23	Feb-24	May-24	Aug-24	Nov-24	Feb-25
	Actual	Actual	Estimate	Forecast	Forecast	Actual	Actual	Actual	Forecast	Forecast	Forecast	Forecast	Forecast
UK+Ire	744	1,027	1,114	1,048	1,090	264	289	289	208	267	299	305	219
International	-	-	-	-	-	-	-	-	-	-	-	-	-
Revenue	**744**	**1,027**	**1,114**	**1,048**	**1,090**	**264**	**289**	**289**	**208**	**267**	**299**	**305**	**219**
Cost of sales	(431)	(543)	(660)	(567)	(519)	(156)	(156)	(156)	(100)	(127)	(142)	(145)	(104)
Gross profit	313	484	454	481	570	108	133	133	107	140	156	160	114
	42%	47%	41%	46%	52%	41%	46%	46%	52%	52%	52%	52%	52%
Staff	(84)	(125)	(137)	(144)	(174)	(35)	(36)	(37)	(36)	(39)	(42)	(45)	(48)
Rent	(102)	(98)	(96)	(94)	(107)	(24)	(23)	(24)	(24)	(27)	(27)	(27)	(27)
Other	(149)	(162)	(194)	(194)	(208)	(47)	(50)	(53)	(44)	(53)	(53)	(53)	(48)
EBITDA	**(21)**	**100**	**27**	**49**	**81**	**1**	**25**	**19**	**4**	**21**	**34**	**34**	**(8)**
Trade WC	45	(44)	(18)	(13)	3	2	19	11	(44)	34	14	(10)	(35)
Other	(25)	11	(53)	15	(13)	12	4	(0)	(2)	(5)	(5)	0	(3)
OCF	**(2)**	**67**	**(44)**	**50**	**72**	**15**	**48**	**29**	**(43)**	**50**	**43**	**24**	**(46)**
CapEx	22	(23)	(39)	(40)	(44)	(13)	(11)	(5)	(11)	(11)	(11)	(11)	(11)
FCF	**20**	**45**	**(83)**	**10**	**28**	**3**	**37**	**25**	**(54)**	**39**	**32**	**13**	**(57)**
Interest	(27)	(29)	(16)	(35)	(36)	(15)	(2)	(16)	(2)	(16)	(2)	(16)	(2)
Other Financing	55	(0)	69	25	-	-	25	(0)	-	-	-	-	-
Net Change In Cash	**48**	**15**	**(31)**	**0**	**(9)**	**(12)**	**60**	**8**	**(56)**	**23**	**30**	**(3)**	**(59)**
Liquidity	**110**	**125**	**83**	**83**	**75**	**71**	**130**	**139**	**83**	**106**	**136**	**134**	**75**
Net Leverage (LTM)	(17.7x)	3.6x	9.2x	5.7x	3.5x	30.6x	11.4x	7.4x	5.7x	3.7x	2.9x	2.4x	3.5x

Model Update Q323:

- The model reflects management budget. We have found the budget overall acrobatic, requiring a significant down-shift in product quality and mix that requires a big bet on volumes. But we consider it sound (Matalan are not acting in isolation here) and we are thus inclined to go with it.
- Looking back, we are not seeing any evidence that the company has been able or willing to keep GM above 50% for long and we don't suppose that will be true in the future. So we think it's a matter of time until margins will have to come back down to between 45% and 50% where they have been in the past. Perhaps this just helps Matalan get over the worst adjustment year now and there will be rook to normalise after all.
- See discussion of FY24/25 above and assumptions on Driver and Model.

Implied Recovery:



DCF

Present Value Attributable to Shareholders

EV		Risk Premium				
		9.00%	9.50%	10.00%	10.50%	11.00%
Terminal Growth Rate	1.00%	418	400	384	369	356
	1.50%	429	411	394	379	364
	2.00%	442	423	405	388	373
	2.50%	456	435	416	399	383
	3.00%	471	449	428	410	393

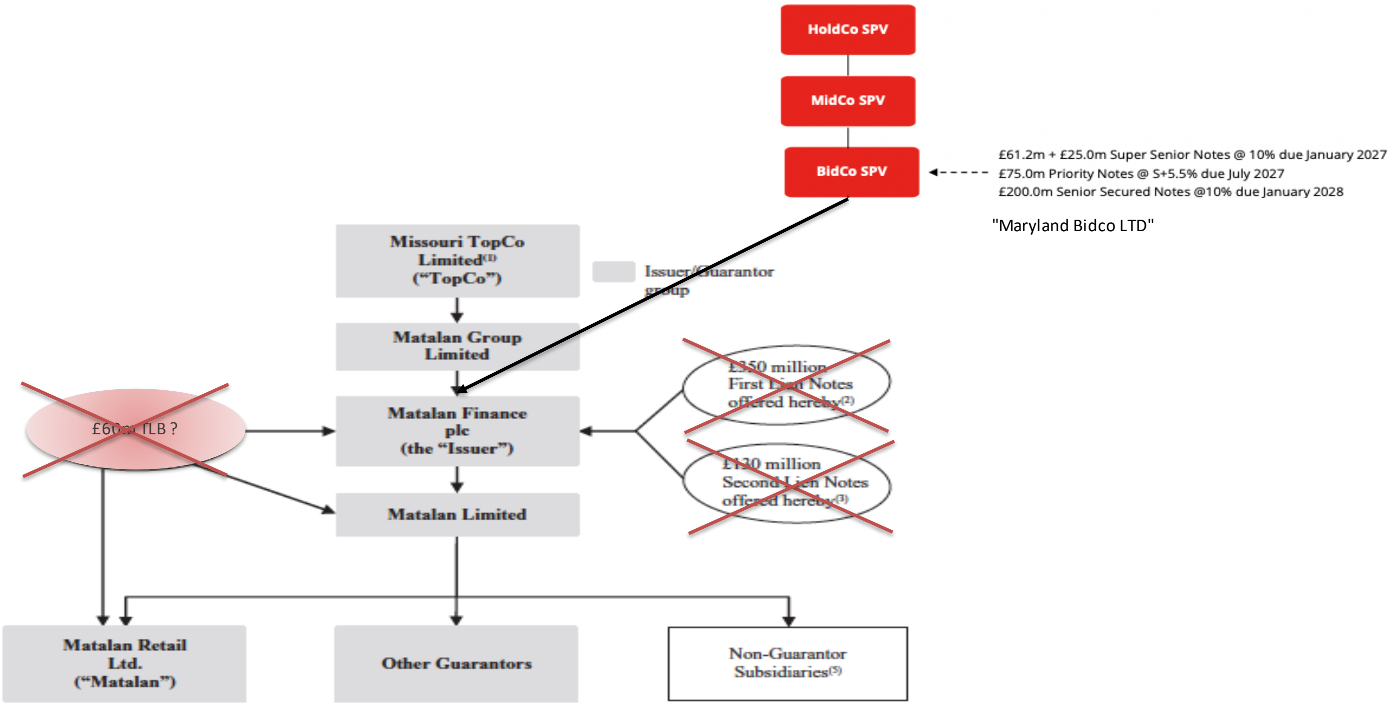
EV		Risk Free Rate				
		4.69%	4.94%	5.19%	5.44%	5.69%
Beta	0.80	589	575	561	548	536
	1.00	491	481	471	462	453
	1.20	420	412	405	398	391
	1.40	366	360	354	349	344
	1.60	324	319	315	310	306

Cost of Capital				**Feb-24**
Risk free rate	5.19%	Equity		33.00%
Risk Premium	10.00%	Debt		67.00%
		Cost of Debt	YTM	16.79%
Beta	1.20	After Tax Cost of Debt	25%	12.59%
Terminal Growth Rate	2.00%	Cost of Equity		26.53%
WACC				**17.19%**

Years			0.0	1.0	2.0	3.0
	Feb-23		Feb-24	Feb-25	Feb-26	Feb-27
EBITDA	100	Normalised	49	81	92	110
Taxes			3	3	0	0
Working Capital			(13)	3	(2)	0
Other Working Capital			13	0	0	0
Rent Arears			0	0	0	0
Other XO Cash Items			(1)	(16)	2	0
Capex			(40)	(44)	(40)	(40)
Other Investment Cash Flow			0	0	0	0
FCFF			**10**	**28**	**52**	**70**
						470
Discount Factor	17.19%		0.99	0.85	0.72	0.62
Present Value of FCF			**10**	**23**	**37**	**334**
LTV Limit			60%			
Borrow Cap.			**243**			

Present Value			
Sum of PV	71		18% of EV
Terminal Value	334		82% of EV
Enterprise Value	**405**	**4.0x**	
Add: Excess Cash	25		
Less: S.Sr. Notes	(86)		
Less Priority Notes	(75)		
PV to Bondholders	**269**		134% SSN value cover

Group Structure:



Game Theory:

- Between backstop, fresh cash and D/E conversion 100% of the equity was allocated to creditors in early 2023. X-holdings across the structure are therefore high and mostly pro rata. Should another restructuring be required before a major refinancing or sale we would expect a consensual deal - pre-agreed by the main actors. To be clear, we do not expect such a second restructuring to be necessary.

Governing Laws:

- Company: English Law
- SSNs and 2LNs: New York Law
- Intercreditor Agreement: English Law

Waterfall:

- The waterfall is primarily the result of the intercreditor agreement and is largely as indicated in the capital structure.
- An intercreditor agreement between all parties regulates the application of all proceeds. Agreement and Issuer are UK law.

1) The Super Sr. Notes: First in right of payment and first beneficiaries of cash sweep.
2) The Priority Notes: After the Sr. Sec. Notes, but before the 2LN. But beneficiaries of cash sweep after the Super Sr. Notes are paid down.
3) The 2LNs: Also known as "New Senior Secured Notes" are the heir to the previous SSNs and represent the main fulcrum security.

Original SSNs:

- Secured by 1st ranking charges over substantially all property and other assets of the issuer (shares of Matalan Limited) and the guarantors.
- Benefits from first lien secured guarantees
- Restricted Payments unrestricted up to 2.5x Net Leverage Ratio. Up to 50% of NI with various carve-outs below 3.5x Senior Secured Net Leverage Ratio.
- Incurrence and Pref Stock Issuance subject >= FCCR of 2:1.
- Permitted Collateral Lien of <= 3.5x Senior Secured Net Leverage Ratio
- Restrictions on Asset Sale, Merger, Consolidation
- Restrictions on Designations and Affiliate Transactions

All Notes:

- benefit from covenants, security etc. similar to that of of the original SSNs.

Original Intercreditor:

- The intercreditor agreement did not contain an automatic release of guarantees. Instead it foresaw and defined a Distressed Sale, which required an independent opinion and consideration to be substantially in cash. Within these confines, however the guarantees could be lifted.

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