Deacons (East Africa) Plc (DCEA)

Initiation of Coverage

Key statistics

Listing price (KES)	15.00
Issued shares (m)	123.56
Market cap (KES bn)	1.85
Market cap (USD m)	18.25
Year end	Dec

Deacons (East Africa) Plc will be listing by introduction on the Alternative Investment Market Segment of the Nairobi Securities Exchange on 2nd August 2016. We initiate coverage on DCEA with an **ACCUMULATE** recommendation. The listing price of KES 15.00 per share compares favourably with the target price of KES 16.43, presenting a 9.5% upside potential. We forecast a 2.4% y/y growth in EPS in 2016 impacted by base effect following the sale of shareholding in Woolworths in 2015. In 2017, we project EPS to grow by 32.9% supported by opening of new stores, with revenue growth reflecting in the bottom line as the company benefits from operating leverage. We further see opportunity for the company to grow in line with growth in the middle-income segment of East Africa's population, a factor that will drive demand in the apparel retail sector in the region.

Analyst

Lucy Awuor

lucya@kestrelcapital.com

+254 20 7608 520

www.kestrelcapital.com

We forecast growth in top line numbers as the company embarks on store network expansion plans with a target of having 60 stores by 2020 (currently has 33 stores). The associated costs may however impact margins in the short term, but are likely to improve in the medium term on account of operating leverage.

We see availability of retail space in the region as a key driver of expansion. With existing mall space of 391,000 sq m (104 sq m/1000 people), Nairobi has been ranked as the largest market by existing shopping centre floor space in Sub-Saharan Africa ex-SA. This is according to a survey done by Knight Frank. The city is also seen to be having high development pipeline on account of new upcoming malls.

Growth in consumer spending to further boost the retail sector. Consumer spending in Kenya has been consistently rising, a factor that directly impacts the retail sector. Further, a report by Euromonitor International ranks Kenyan cities as having the highest forecasted consumer expenditure growth in the period between 2015-2030, with Nairobi having a CAGR of 7.8%.

Signing of new franchise agreements and new brands will be a positive for the company. We expect these to have a direct impact on store network expansion and to further boost margins.

Second-hand apparel (mitumba) is expected to continue to be a competitor to Deacons. It is estimated that 100,000 tonnes of mitumba are imported annually and are most commonly purchased by the lower-middle income market as an alternative to the relatively more expensive products sold by apparel boutiques and supermarkets.

	2013A	2014A	2015A	2016F	2017F
Sales(KES m)	1,792	1,928	2,383	3,202	3,893
% y/y chg		7.6%	23.6%	34.3%	21.6%
COS(KES m)	(1,091)	(1,049)	(1,275)	(1,673)	(2,024)
% y/y chg		-3.8%	21.5%	31.3%	21.0%
Gross profit(KES m)	701	879	1,109	1,529	1,869
% y/y chg		25.3%	26.2%	37.9%	22.2%
PBT(KES m)	164	88	142	169	224
% y/y chg		-46.3%	60.6%	19.3%	32.9%
PAT(KES m)	179	61	123	127	168
% y/y chg		-65.6%	83.6%	2.4%	32.9%

Summary of listing

Listing price per share	KES 15.00
Par value per share	KES 2.50
Total number of issued and fully paid up shares	123,558,228
Issued and fully paid up share capital	KES 308,895,570
Shareholders’ equity as at 31st December 2015	KES 1,512,294,000
NAV per share as at 31st December 2015	KES 12.52
EPS for the year ended Dec 2015	KES 1.20
P/E based on listing price	12.5x
P/B based on listing price	1.2x

Source: Information Memorandum

Key dates for the listing

Annual General Meeting and Shareholder Approval	5th May 2016
CMA Approval for the Listing	1st July 2016
NSE Approval for the Listing	13th July 2016
Suspension of OTC Trading and Record Date	25th July 2016
Dispatch of IM to Shareholders	22nd July 2016
Listing of Shares at the NSE and Commencement of Trading of Shares	2nd August 2016

Source: Information Memorandum

Company Overview

Deacons (East Africa) Plc is an apparel and home furnishings retail company with a portfolio of 10 brands in Kenya, Uganda and Rwanda. These brands include: Truworths (launched in 1999), 4u2 (2003), Mr Price Apparel (2007), Mr Price Home (2007), Angelo (2008), Adidas/Reebok (2010), LifeFitness (2010) Babyshop (2011), and Bossini (2013). The company currently has 33 branches, 29 of which are located in Kenya. The company was incorporated in Kenya in 1973 as a private liability company and converted to a public liability company in 2010. DCEA operates on a buy-and-sell mechanism in which it imports majority of its merchandise and distributes it across the branch network. The company purchases 70% of its stock from South Africa, while the remaining proportion is sourced locally or from China, Dubai and the United States.

DCEA deals in a variety of lifestyle products under its brands portfolio.

- Ladies', men's and children's clothing, footwear, accessories and cosmetics (Mr Price Apparel, 4u2, Angelo, Bossini, Truworths);
- Home furnishings (Mr Price Home);
- Sportswear (Adidas);
- Children's toys, clothing, nursery furniture (Babyshop) and
- Sporting equipment (LifeFitness)

These brands are wholly-owned franchises/sub-franchises of DCEA. 4u2 and Angelo are local self-owned brands while the remaining brands are managed under distributor and franchise agreements.

The Company currently has a total of 33 stores:

Shop	Kenya	Uganda	Rwanda	Total
Mr Price Apparel	5	1	1	7
Mr Price Home	4	0	0	4
Mr Price Combo	1	1	0	2
Babyshop	3	0	0	3
Truworths	3	0	0	3
LifeFitness	1	0	0	1
4U2	3	0	0	3
Bossini	4	1	0	5
Adidas	2	0	0	2
Angelo	3	0	0	3
Total	**29**	**3**	**1**	**33**

Source: Company

Below is a breakdown of each of the brands:

Brand	Business Model	Source	% revenue contribution 2015
Mr Price Apparel	Franchise	South Africa	38
Mr Price Home	Franchise	South Africa	13
Mr Price Combo*	Franchise	South Africa	-
Babyshop	Franchise	Dubai	12
Truworths	Franchise	South Africa	11
Lifefitness	Distribution agreement**	USA	11
4U2	Own brand	Local	5
Bossini	Distribution agreement	China	5
Adidas	Distribution agreement	Dubai	3
Angelo	Own brand	Local	2
Total			**100**

**A combination of Mr Price Apparel and Mr Price Home **Excusive distribution agreement*

Source: Company

Company overview (contd')

Branch expansion is viewed as the key earnings driver, hence a strategic tool in growing revenues. The company intends to increase the total number of stores to 60 by 2020 and has set out a 2016 store rollout plan across major malls in Nairobi and Kigali.

Country	Brand	Period (2016)	Mall
Kenya	Bossini	February	The Hub
Kenya	Adidas/Reebok	March	The Hub
Kenya	Mr Price Apparel	Q3	Two Rivers
Kenya	Mr Price Home	Q3	Two Rivers
Kenya	Adidas/Reebok	Q3	Two Rivers
Kenya	Bossini	Q3	Two Rivers
Rwanda	Bossini	Q3	Kigali Heights
Rwanda	Mr Price Apparel		Relocation to Kigali Heights

Sale of 49% stake in Woolworths

In 2015, DCEA completed the sale of its 49% shareholding in Woolworths Kenya Proprietary Ltd, making a one-off gain of KES 64.9m that boosted the company's earnings in the period. Woolworths now operates in Kenya independently. Prior to the divestiture, Woolworths had the highest gross margin for the company at levels of ~55%. The divestiture was spread out over three years and the impact should not be significant going forward with DCEA targeting to sign up additional international brands. The proceeds of the sale will be invested in new stores, brands and franchises.

Company shareholding:

Shareholder	% shareholding
Swedfund International AB	14.03
Pinpoint Investments Ltd.	8.73
Diana Bird	7.96
Charles Mwangi Gathuri	7.56
Kirimara Ltd	6.50
Tri-Kay Development Co. Ltd.	5.56
Aureos East Africa Fund LLC	5.53
Kestrel Capital Nominees Ltd A/C Peregrine Equity LLC	4.14
Muchiri Wahome*	3.49
Old Mutual Life Assurance Co. Ltd.	3.02
Others (374 shareholders)	33.95
Total (384 Shareholders)	**100.00**

*Source: Annual Report *Company CEO*

Key opportunities

New franchise agreements and brands: The company is in negotiations to sign new franchise agreements and new brands. Additional franchises imply branch expansion and offer a wider product range targeting new customer segments. Profit growth will however be dependent on margins of new brands and the specific franchise terms. We view this as a key tool in growth of company revenues.

Store network expansion: The company has a target of increasing store footprint to 60 stores by the year 2020. In 2015, revenue stood at KES 2.4bn, marking a 24% y/y increase mainly on account of opening of new stores in the period. Earnings also gained partially from sale of shareholding in Woolworths, the proceeds of which are to be invested in new brands, stores and franchises.

E-Commerce: The company plans to embark on online selling to drive sales. This presents an opportunity for the company to generate sales at a lower cost, hence positively impacting margins. There are currently a number of e-commerce platforms in Kenya, and the company would have to compete with the already existing online companies like Jumia Kenya for market share.

Increase in shopping center space: A survey carried out by Knight Frank* showed that Nairobi is a major focus for shopping centre development and ranked it as the largest market by existing shopping centre floor space in Sub-Saharan Africa ex-SA (Nairobi has 391,000 sq m floor space, Kampala has 182,000 sq m floor space while Kigali has 55,000 sq m floor space (Nairobi-104 sq m/1000 people, Kampala-98 sq m/1000 people, Kigali-46 sq m/1000 people). The city was also noted to have about 470,000 sq m of shopping center space in the pipeline. Increasing supply in shopping centre space provides outlets for the company to set up more stores, thus facilitating easier market reach and implying the likelihood of a decline in rental charges for occupants. These factors in turn lead to cost reduction and market penetration, a positive for DCEA and other retail stores.

Disposable income trending upwards, growing consumer spending: East Africa's middle class has seen consistent growth in the past years. A study by the African Development Bank showed that economic growth in the past two decades has helped reduce poverty in Africa and increased the size of the middle class (stood at approx. 34% of Africa's population in 2010). About 60% of Africa's middle class however barely remain out of the poor category. The study showed that Africa's middle class has increased in size and purchasing power. Disposable income has seen consistent growth to reach levels of KES 6.56tn in 2015 as shown in the graph below.

Source: Kenya Economic Survey 2016

** Knight Frank is a commercial and residential consultancy firm*

Key opportunities (contd')

A white paper released by Euromonitor International in July 2016 showed that Kenya's cities have the highest forecasted consumer expenditure growth. In the period 2015-2030, Kisumu is expected to grow by 277% to USD 2.2bn, Mombasa expected to grow by 221% to USD 5.1bn and Nairobi is expected to grow by 208% to USD 17.2bn, averaging to 85% growth in the 30-year period. Further, according to the Oxford Business Group, the average value of consumer spending has risen by approximately 67% in the last five years, making Kenya one of the fastest growing retail markets in Sub-Saharan Africa.

Ban of second-hand apparel (mitumba): Members of the East African Legislative Assembly (EALA) supported the proposed ban of second-hand clothes in the region to help revive the textile industry in East Africa. EALA further said the ban will be spread out over 10 years commencing 2018 to provide sufficient time for growth of the cotton and textile industry. Implementation has however faced major challenges, key among them resistance by market participants given that the second-hand market is a major source of employment and offers cheaper prices. We therefore do not see this taking effect in the short term but rather in the medium-long term.

Key risks

Competition: The apparel retail sector has seen increasing competition with more players entering the market retailing new and second-hand clothes and shoes.

Competition may include:

- Supermarkets like Nakumatt, Tuskys (opened an exclusive apparel store in 2015), Uchumi Supermarkets, Carrefour, Shoprite (Uganda);
- The informal market - second hand clothing (mitumba) which has dominated the informal market segment;
- Other apparel stores like Woolworths, Jade Collections (recently opened another shop in Nairobi), Kings Collection;
- Shoe retailers like Bata, KShoe and
- Online shopping platforms like Jumia Kenya.

Insecurity fears: Most of DCEA's stores are located in shopping malls across East African cities. Malls have been seen to be targeted by terrorists, especially following the 2013 Westgate Mall attack. DCEA had 4 stores at Westgate and was impacted by the attack that led to closure of the mall for a period of time. Following the attack, DCEA closed its stores located in the mall which has since the attack seen reduced footfall.

Second-hand apparel (mitumba): It is estimated that 100,000 tonnes of second-hand clothes (mitumba) are imported annually, and that the informal mitumba market is twice the size of the formal market. Second-hand clothes continue to pose major competition to retailers of new apparel, and the proposed ban of mitumba may likely face increasing opposition given widespread popularity among low and middle income groups, and also due to the fact that the sector is a major source of employment opportunities.

Currency fluctuations: DCEA works on a system of importing merchandise that is then distributed across the store network. The company imports goods mainly from South Africa, China, USA and the UAE. This therefore implies that the company's performance is susceptible to currency fluctuations based on the performance of the shilling.

VAT exemption of EPZ apparel: The National Treasury proposed VAT exemption for made up garments and footwear procured from the country's Export Processing Zone (EPZ). This will imply cheaper local apparel, hence posing a threat to local importers.

Franchise risk: Any changes in existing franchise agreements pose a risk to the company. Signing of new franchise agreements may also impact earnings, depending on new agreements.

Increase of import duty: The Government intends to double import duty on all imported clothes from KES 20.40 per kg to KES 40.80 per kg of garments as a move aimed at promoting the local textile industry. This would imply higher prices for imported garments (both new and second-hand) which in turn may impact volumes in the short term as customers adjust to new prices.

Historical Financials

Income Statement	2011	2012	2013	2014	2015
Sales(KES m)	2,422	2,488	1,792	1,928	2,383
% y/y chg		2.7	(28.0)	7.6	23.6
COS(KES m)	(1,371)	(1,482)	(1,091)	(1,049)	(1,272)
% y/y chg		8.1	-26.4	-3.8	21.3
Gross profit(KES m)	1,050	1,005	701	879	1,111
% y/y chg		-4.3	-30.3	25.3	26.5
Other income(KES m)	2,430	1	470	98	169
Admin expenses(KES m)	700	904	825	732	931
Selling expenses(KES m)	130	144	164	125	144
EBITDA(KES m)	2,718	54	249	181	284
% y/y chg		-98.0	364.2	-27.5	57.4
Finance cost	22,580	70,639	84,782	60,273	79,405
% y/y chg		212.8	20.0	-28.9	31.7
PBT(KES m)	2,634	(38)	164	88	152
% y/y chg		(101.5)	529.8	(46.3)	71.8
PAT(KES m)	2,534	(38)	179	61	148
% y/y chg		(101.5)	569.2	(65.6)	141.6

Balance Sheet

KES '000	2011	2012	2013	2014	2015
Non-current Assets	679,999	723,514	684,620	768,393	798,829
Current Assets	1,117,714	1,230,600	1,298,429	1,193,489	1,717,311
	1,797,713	**1,954,114**	**1,983,049**	**1,961,882**	**2,516,140**
Capital and reserves					
Share Capital	154,448	308,896	308,896	308,896	308,896
Share Premium	703,251	548,803	548,803	548,803	548,803
Retained Earnings	397,881	321,219	499,756	561,159	709,507
Translation Reserve	458	(4,451)	(3,782)	(7,132)	(20,305)
Shareholders' Funds	**1,256,038**	**1,174,467**	**1,353,673**	**1,411,726**	**1,546,901**
Non-current Liabilities	28,005	211,566	246,203	138,381	390,632
Current Liabilities	513,670	568,081	383,173	411,775	578,607
	541,675	779,647	629,376	550,156	969,239
	1,797,713	**1,954,114**	**1,983,049**	**1,961,882**	**2,516,140**

Financial Ratios

Ratios	2011	2012	2013	2014	2015
GP margin(%)	43.4	40.4	39.1	45.6	46.6
EBITDA margin(%)	112.3	2.2	13.9	9.4	11.9
Pre-tax margin(%)	108.8	-1.5	9.2	4.6	6.4
Total Debt/EBITDA	0.0	6.5	1.3	1.3	2.3
Total debt/equity(%)	10.3	29.6	23.3	16.6	42.3
Receivables turnover(x)	24.0	20.2	14.8	21.2	7.6
Payables turnover(x)	3.7	3.8	3.0	3.3	4.0
Inventory turnover(x)	1.5	1.6	1.3	1.4	1.5
Capex intensity(%)	74	75	110	102	94

Forecasts

Income Statement	2014A	2015A	2016F	2017F	2018F
Sales (KES m)	1,928	2,383	3,202	3,893	4,669
% y/y chg		23.6%	34.3%	21.6%	19.9%
COS (KES m)	(1,049)	(1,275)	(1,673)	(2,024)	(2,428)
% y/y chg		21.3%	31.5%	21.0%	19.9%
Gross profit (KES m)	879	1,109	1,529	1,869	2,241
% y/y chg		26.5%	37.6%	22.2%	19.9%
PBT (KES m)	88	142	169	224	286
% y/y chg		71.8%	11.5%	32.9%	27.3%
PAT (KES m)	61	113	127	168	214
% y/y chg		101.4%	2.4%	32.9%	27.3%
EPS (KES)	0.5	1.00	1.03	1.36	1.73
% y/y chg		100.2%	2.4%	32.9%	27.3%

Comparable

Company	Country	Mkt Cap	P/E	P/B	ROE
Mr Price Group Ltd.	South Africa	401	19.86	9.87	49.62
Truworths International	South Africa	253	12.38	4.04	34.65
Woolworths Holdings Ltd.	South Africa	606	18.20	3.93	23.36
Shoprite Holdings Ltd.	South Africa	670	20.23	4.20	22.36
The Foschini Group Ltd.	South Africa	224	13.40	2.90	23.91
Clicks Group Ltd.	South Africa	205	28.89	15.54	57.08
Shufersal Ltd.	Israel	72	14.40	2.49	18.04
Deacons East Africa Plc		**2**	**12.50**	**1.20**	**10.03**
Average			**18.43**	**5.29**	**29.88**
Median			**18.20**	**3.93**	**23.64**

**KES billion*

Valuation

P/E Method

	2016
EPS	1.03
P/E	16.0
Price	**16.40**

P/B Method

	2016
Book value per share	9.33
P/B	1.8
Price	**16.52**

EV/EBITDA

	2016
EBITDA	320,959,385
EV/EBITDA	8.3
EV	2,663,962,894
Less Debt	772,291,343
Add Cash	130,393,820
Equity	2,022,065,371
Price	**16.37**

Average

	2016
P/E	16.40
P/B	16.52
EV/EBITDA	16.37
Average	**16.43**

Recommendation guide

STRONG BUY:	Highly undervalued/ strong fundamentals
BUY:	Good value/ strong fundamentals
ACCUMULATE:	Buy on price dips
HOLD:	Correctly valued with little pricing upside or downside
LIGHTEN:	Overvalued by the market/ Reduce exposure/Declining fundamentals/ industry concerns
SELL:	Weak fundamentals and challenging operating environment/Highly overpriced

Disclaimer