UP Global Sourcing Holdings PLC

Benefits of underlying strengths

30th April 2020

UPGS's interim results included a number of positive outcomes for underlying sales growth, profits and free cash flow in the half. Despite some Covid-19 related setbacks since then, UPGS appears well placed to emerge positively from the current pandemic crisis. In particular, the business benefited from underlying strengths built up over time. Moreover, we welcome the greater importance of UPGS's online pillar in a post Covid-19 environment.

As indicated in a 10th February 2020 trading statement, UPGS's sales revenue increased by 2.8% to £67.7m in the first half of FY2020. An 11.5% advance in UK sales offset an 11.2% fall in Germany, the group's second largest market. Importantly, online sales grew by 25.5% to be 11.3% of the total. **Profit measures improved more quickly than revenue**, as gross margins expanded from 22.4% to 23.6% and underlying EBITDA and pre-tax profits increased by 3.5% and 4.8% respectively. Adjusted EPS rose by 3.5%. Net bank debt was £11.2m compared with £14.0m a year earlier.

UPGS made it clear from an early stage that it encountered "double disruption" from Covid-19. First, there was an inevitable setback for its China based manufacturing. Second, orders from its UK customer base were dramatically reduced. However, roughly **90%** of Chinese suppliers are now reported to be functioning normally and total sales year to date, combined with orders, amount to **£104.0m**. While well beneath FY2019's £123.3m total, the divergence is certainly not disastrous. We have adjusted our FY2020 sales forecast downwards.

Covid-19 and the efforts to contain its spread have created massive economic and trading uncertainty. However, there is a clear argument that a consumer facing business such as UPGS which offers "feel good" branded products that can be enjoyed in the home may recover sooner than those which sell items more closely associated with going out – e.g. apparel. As a result, consumers who have accumulated cash through staying in may be tempted to accelerate purchases of UPGS's homeware ranges and in-home treats.

UPGS undertook a number of ameliorative steps early in the pandemic crisis and again later, which should enhance the business's resilience. For example, the company halted capex projects, furloughed staff under the Covid Job Retention Scheme and suspended some top level management salaries. Moreover, the company secured credit approval for a £4.0m rise in its RCF with HSBC, in addition to some extension on other facilities. A simple stress test based on conservative assumptions appears to confirm the company's ability to cope with Covid-19 financially.

This year will see a sharp reduction in both sales revenue and profits, clearly. However, a significant portion of that expected decrease appears to have been reflected in the company's share price decline – a 43% drop in the calendar year to date. Company guidance has been suspended for FY2021 and is currently of the order of £93m of sales revenue for FY2020.

On that marked-down basis the FY2020 EV/sales ratio would be only 0.6x.

Company Data

EPIC	UPGS
Price (last close)	53p
52 week Hi/Lo	28p/99p
Market cap	£44m
Proforma net debt	£11m

Share Price, p

Source: ADVFN

Description

UP Global Sourcing Holding (UPGS) develops new, innovative concepts and brings professional, sought-after products to the mass market. Their offices span two continents, with headquarters in the UK, a sourcing office and showroom in Guangzhou, as well as a showroom in Germany.

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Benefits of underlying business strength

A combination of a consistent business model with a track record of delivering growth, ameliorative Covid-19 measures, greater potential emphasis on online and a likely sweet spot for home oriented consumption, places UPGS in a relatively attractive position for when the UK's corona virus lockdown period ends.

Clearly, there is uncertainty. However, UPGS should be given much credit for the positive momentum which the company achieved ahead of the crisis. We next look in more detail at the results, the Covid-19 measures, the "sweet spot opportunity" and the company's underlying financial health.

Interim results

UPGS released its FY2020 sales revenue in a 10th February 2020 trading statement, reporting a 2.8% increase to £67.7m in the first half of FY2020. Headline profits improved more quickly as gross margins expanded from 22.4% to 23.6% and underlying EBITDA and pre-tax profits increased by 3.5% and 4.8% respectively. EPS rose by 3.5%. We summarise key features of the interim results in Figure 1.

Figure 1 - FY2020 Interim Results Highlights

	FY2019 H1	FY2020 H1	Change	
Revenue (£m)	65.8	67.7	2.8%	
Gross margin	22.4%	23.6%	120	bps
Underlying EBITDA (£m)	7.0	7.2	3.5%	
Underlying EBITDA margin	10.6%	10.7%	10	bps
Underlying pre-tax profit (£m)	5.9	6.2	4.8%	
Underlying EPS (p)	5.7	5.9	3.5%	
Dividend (p)	1.16		n/a	
Net debt (£m)	14.0	11.2	-2.8	£m
Net debt/underlying EBITDA ratio (x)	1.5	1.0	-0.5	x

Source: Company data

Geographically, an 11.5% advance in UK sales offset an 11.2% fall in Germany. The German setback reflected the cessation of business with the company's largest customer in the country after the sale of that operation by its parent company. We summarise sales split by location in Figure 2.

Figure 2 - UPGS - H1 Sales Growth and Split by Location

All figures in £m	H1 FY2019	H1 FY2020	Increase	Share of total
United Kingdom	39.6	44.2	11.5%	65.2%
Germany	6.6	5.9	-11.2%	8.7%
Rest of Europe	18.1	16.9	-6.9%	24.9%
USA	0.6	0.4	-35.2%	0.6%
Rest of World	0.9	0.4	-55.5%	0.6%
Total	65.8	67.7	2.8%	100.0%

Source: Company data

Within the brand portfolio, **Beldray** whose sales rose an impressive 22.8%, **Salter** similarly strong at 20.1% higher and **Intempo** up by 4.8%, were the stronger performers in FY2020 H1. Whereas **Russell Hobbs** and **Progress** declined by 39.4% and 14.1% respectively. The pattern of brand performance reflects a combination of traction for the "feel good" brands in the UK and the above-mentioned discounter issue in Germany.

Importantly, Beldray and Salter are the leading UPGS brands by far and represented 74.7% of the group's premier brands sales in the period and around half of the group total. It is the proven ability of the company to provide these kinds of 'feel good' homeware brands at affordable prices which should drive growth going forward.

By category, **small and domestic appliances** and **houseware** were strongest and rose by 18.2% and 1.1% respectively; whilst **audio** suffered the steepest setback with a 24.9% decrease. These three categories were together 72.1% of FY2020 H1 sales.

UPGS's online growth is very important for both the mid Covid-19 and post Covid-19 trading environment. This channel was targeted at reaching 20% of group sales ahead of the pandemic and reached 11.3% in FY2020 H1. Online sales rose 25.5% in the discrete period and are well above double where they stood in the same six months in FY2018.

Figure 3 - UPGS - FY2020 H1 Sales Growth and Split by Strategic Distribution Channel

All figures in £m	H1 FY2019	H1 FY2020	Increase	Share of total
Discount retailers	33.8	28.2	-16.5%	41.6%
Supermarkets	11.0	16.0	45.4%	23.7%
Online channels	6.1	7.7	25.5%	11.3%
sub-total	50.9	51.9	1.9%	76.6%
Multile-store retailers	10.5	10.4	-1.2%	15.4%
Other	4.4	5.4	23.2%	8.0%
Total	65.8	67.7	2.8%	100.0%

Source: Company data

Covid-19: A measured approach

UPGS first alerted investors to potential Covid-19 supply disruption on 10th February 2020. With the group's manufacturing suppliers largely based in China it is unsurprising that UPGS flagged up issues in relation to the pandemic with details of responses sooner than other consumer stocks. In this section we look at the four key areas: China, key customer demand, UPGS's responses and financing.

China

According to the interim statement, the group's manufacturing suppliers in China have normalised. More than 90% of factories are back up to full production. The impact on net FY2020 sales revenue was relatively small at £0.8m. The group is in a position to match future orders with demand, which tends to confirm the benefit of its **strong relationships with suppliers.**

Key customer demand

The impact of lockdown on "non-essential" business activities has clearly been wide in scale. Almost all of the major domestic retailers suspended their operations during the current phase of UK lockdown. As a result, a number of UPGS's customers deferred and cancelled existing orders. They also delayed any new orders post-lockdown. The early stages of this process were covered in a trading update released on 19th March 2020.

UPGS's operational responses

Right now, UPGS's demand problem is larger than that of supply. As a result, the company has implemented a programme of operational and internally driven financial responses which we detail below.

Capital expenditure. UPGS temporarily ceased all capital expenditure projects.

VAT deferral and Time to Pay initiative. The company is making full use of these UK government initiatives.

Purchase orders. Under constant review and subject to slowdown.

Interim dividend. Suspended.

Senior management compensation. Salary waivers and reductions at board level.

Government furlough scheme. Full implementation of Covid Job Retention Scheme.

UPGS's financing responses

UPGS's salient external financial relationship is with the company's lead commercial bank, HSBC, with whom it has secured three key agreements:

RCF facility. A £4.0m increase has been credit approved.

Invoice discounting. Increase in percentage of receivables advanced.

Import funding. An extension of the funding period with HSBC from 120 days to 180 days.

"Feel Good" products matter in Good Times and Bad

Enduring lockdown

UPGS proves itself adept in sourcing, marketing and distributing relatively low price branded items which convey a feel good factor. It offers its end-customers access to brands such as Salter and Russell Hobbs (excluding scales and electrical respectively) as well as Beldray and Constellation. These are all well supported brands, which sustain relevance to consumers.

Importantly, these are brands which are **enjoyed at home** during a time when UK and other Western European consumers are not only spending more time at home but – with due regard for economic uncertainty – are in many cases making significant expenditure savings: notably on meals 'out', travel to work, workplace food, sporting events, personal travel and general hospitality.

What seems likely is that lockdown restrictions will be lifted in phases. For example, in UPGS's second largest end-market (Germany) the first easing of restrictions occurred on 27th April

2020 when office workers we readmitted to their places of employment and retail stores re-opened. However, bars, hotels and restaurants remained closed.

A potential impact of a phased lockdown lift is that consumers will take advantage of being able to visit "non-essential" retail premises long before they are able to spend money on other forms of discretionary spend. As a result, UPGS's product ranges may receive a near term boost in the period of gradually eased lockdown. In particular, so long as hospitality remains off-limits, the benefits of adding to homewares will be clear.

Beyond lockdown

There is much speculation about the long-term impact of Covid-19 related lockdown. However, what seems most likely to us is that within consumer goods the key features which made companies successful pre-pandemic will largely determine future success.

In particular, there is already some evidence to suggest that consumer demand is likely to resume more quickly **for trusted, established brands and products** than for adventurous and unconventional items.

This tendency was highlighted in a 24th April 2020 *Financial Times* article about the UK food industry sub-titled *"Consumers seeking comfort in troubled times return to decades-old brands."* Beldray, Russell-Hobbs and Salter are all well placed to qualify. Any post-lockdown consumer preference for comfort giving, established feel-good brands also benefits UPGS.

A word on Core Financial Strength

Stress testing

UPGS entered the period of the pandemic with arguably robust financials. Indeed, the company's interim results showed net bank debt to be £11.2m, which was an improvement from £14.0m a year earlier as the company enjoyed higher retained earnings and stable working capital. Net working capital itself fell to £22.7m from £23.3m, despite an increase in net sales.

The implied trailing net debt/EBITDA ratio was 1.0x at end-January 2020 which was also an improvement from 1.3x at end-July 2019 and 1.5x a year earlier.

As mentioned in our section on "UPGS's financing responses," the company agreed a package of measures to strengthen finances. These included RCF facility expansion, increased use of invoice discounting and extended import funding.

Moreover, the company already indicated that it has booked year-to-date sales of £85.9m with orders on hand currently worth £18.1m.

Even assuming that all outstanding orders were cancelled that would still imply a positive adjusted EBITDA number for the group in FY2020. We make the following calculation:-

Sales revenue year-to-date	£85.9m
Gross profit @ FY2019 gross margin	£19.0m
Cash expenses based on FY2019	£16.5m
EBITDA (adjusted)	**£2.5m**

This calculation is in our view conservative. It assumes that all outstanding FY2020 orders are cancelled, that there is no reduction in FY2020 expenses due to furloughing of staff and other measures. Moreover, it is based on the FY2019 gross margin. So far, FY2020 is higher.

Even at a £2.5m level of EBITDA, although the trailing net debt:EBITDA ratio would be uncomfortable at 4½x, the company would be in a position to match the previous year's interest and tax payments from cash earnings.

We also note that there was no "emphasis of matter" paragraph in the auditor's review, which also argues positively for the business's resilience.

Financing a return to normality

UPGS's invoice discounting and import loan facilities tend to argue against any major financial constraints inhibiting post-pandemic crisis recovery. The company sources and distributes product on both FOB (i.e. direct to the customer) and stock (i.e. delivered to warehouse) bases. Invoice discounting is more pertinent for the former and import loans for the latter.

Financials & Valuation

Forecasts

This section covers the impact of Covid-19 related disruption on our near-term financial forecasts. We are suspending our forecasts for FY2021 and subsequent years.

The immediate impact on FY2020 is a sharp reduction in net sales revenue associated with reduced orders from key customers in the company's larger European markets. As mentioned above, invoiced sales year to date were £85.9m with a further £18.1m in unfilled orders. Our forecasts assume that a little over half of outstanding orders are cancelled, which generates a £93m sales revenue outcome in FY2020. This would be a better outcome than our stress test.

As a result of the UK government's furlough scheme, operating costs are likely to fall overall in FY2020. We assume that cash costs could drop by as much as £1m in the second half of the year relative to the first due to furloughed workers, senior management wage cuts and suspensions and other cost reductions. In Figure 4 we summarise key lines from our FY2020 income statement forecasts.

Figure 4 - UPGS - Changes to Equity Development FY2020 Forecasts

All figures in £'000s	FY2020
Sales revenue	93,000
EBITDA - adjusted	5,721
Pre-tax profit - adjusted	3,613
EPS - adjusted (pence)	3.5

Source: Equity Development estimates

The full revised income statement forecast is shown in Figure 5, which includes an increase in gross margins for the whole year, as in H1. All our FY2019 numbers are re-stated to comply with IFRS16.

Aside from the above, we make few changes in assumptions. For net interest we factor in a similar split to last year when the full year amount was double the H1 figure. The tax rate based on adjusted pre-tax profits is assumed to be broadly similar to FY2019, which is arguably conservative given the prevalence right now of government measures.

At this stage we are not publishing updated FY2020 balance sheet and free cash flow forecasts.

Figure 5 - Income statement forecasts

All figures in £'000s	2017A	2018A	2019A re-stated	2020E
Revenue	109,953	87,571	123,257	93,000
% increase in revenue	39.1%	-20.4%	40.8%	-24.5%
Gross profit	24,567	19,592	27,244	21,950
Gross margin (%)	22.3%	22.4%	22.1%	23.6%
EBITDA - underlying	8,280	6,280	10,720	5,721
EBITDA margin - underlying	7.5%	7.2%	8.7%	6.2%
Net financial income	-464	-330	-810	-684
Pre-tax profit - reported	7,427	5,423	8,130	3,265
Pre-tax profit - adjusted	10,499	5,231	8,387	3,613
Taxation	-1,852	-1,141	-1,720	-748
Tax rate (%) - adjusted	17.6%	21.8%	20.5%	20.7%
Net income - adjusted	8,246	4,090	6,667	2,865
EPS - basic adjusted (p)	10.7	5.0	8.1	3.5
Dividend per share (pence)	5.1	2.7	4.1	-

Source: ED estimates, Company historic data

Relative valuation

We include a relative valuation for UPGS in Figure 6. Like many in its peer group, the company's share price has fallen sharply year to date. However, the inferred EV/sales ratio based on our revised FY2020 number is comfortably beneath peer group average.

Figure 6 - Relative Valuation

	Share price (pence)	Shares (m)	Mkt cap (£m)	Net debt (£m)	EV (£m)	Sales 2020 (£m)	EV/sales (x)
Gear4Music	297	21	52	9	61	122	0.5
Luceco	95	161	153	21	173	125	1.4
UPGS	53	82	44	11	55	93	0.6
Warpaint	42	77	32	5	37	50	0.8
Average							0.8

Source: ADVFN, MarketScreener and Equity Development estimates

Investor Access

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