Monday, April 06, 2020 | update

VRG: hold (downgraded)

VRG PW; VRGP.WA | Retail, Poland

Adapting To a New Reality

VRG stock plunged on coronavirus fears and markets opt to overlook the Company's record-high earnings for FY2019 and low ending net debt of 0.6x of EBITDA. With the global retail landscape dramatically changed by the COVID-19 epidemic, we are prompted to revise our base-case earnings scenario for VRG: Assuming the Company can reopen locked down stores in mid-May (VRG itself is holding our for early May), we see a gradual rebuilding of foot traffic from low initial numbers, with fewer overall visits from Q2 through the rest of the year than in the same period in 2019. The resulting declines in sales will probably be more pronounced at fashion stores than at jewelry stores (the jewelry stores demonstrated great resilience back in 2009). With shoppers moving online, VRG is set to experience downward pressure on gross margins in 2020, underpinned by a likely increase in marketing activity from Q2 2020. On the upside, our base case scenario assumes reductions in store rental rates (-40% in Q2 and -20% each in Q3 and Q4) and payroll (-20% each in Q2 and Q3, -10% in Q4), on top of PLN 10m cutbacks in marketing expenses. It is worth noting that, amid extreme uncertainty, our updated base case assumptions are somewhat more conservative than the assumptions outlined by VRG: namely, for our 31% y/y sales fall estimate, VRG's guidance is for a decline of 20%. We expect to see online sales revenue of PLN 181m this year, while VRG sees PLN 20m. Our 6% rate of expected floorspace reduction is higher than VRG's 2%. We anticipate an EBITDA loss of PLN 15m in FY2020 against VRG's belief in a positive operating profit. Finally, we differ in the assumed rates of inventory reduction in 2020 at -8% us vs. -11% VRG. Below we also analyze a best- and worst-case scenario for how the coronavirus epidemic might impact VRG's business. After updating models, we lower our target price for VRG to PLN 2.00 and we downgrade the stock to hold.

Standing on solid footing

VRG ended FY2019 with a relatively low net debt/EBITDA ratio and barely-tapped credit lines. The payables-inventory ratio was low at December 2019. This year, we assume the Company's financing providers will temporarily suspend covenant measurement, allowing for a momentary deterioration in EBITDA. We expect FY2020 end-of-year net debt to be PLN 85m after increasing by PLN 18m during the year (against VRG's own guidance for zero debt growth this year).

Potential to optimize working capital

As soon as stores went on lockdown as a COVID-19 quarantine measure, VRG changed its order quantities for the spring-summer and autumn-winter fashion season, leading us to expect an 8% reduction in ending inventory in 2020. At the same time, VRG is anticipating an extended payables cycle thanks to concessions made by suppliers and the use of reverse factoring. As a result, we assume VRG will be able to reduce working capital by PLN 35m to PLN 329m in 2020.

(PLN m)	2018	2019	2020E	2021E	2022E
Revenue	805.7	1,068.3	740.0	973.7	1,087.6
EBITDA (adj.)*	89.2	111.1	-15.2	46.8	88.0
EBITDA margin (adj.)*	11.1%	10.4%	-2.1%	4.8%	8.1%
EBIT (adj.)*	71.9	87.5	-37.5	26.0	66.9
Net profit (adj.)*	53.5	65.9	-56.3	8.3	46.0
P/E (adj.)*	8.5	6.9	-	55.1	9.9
P/CE (adj.)*	6.4	5.1	-	15.9	6.8
P/B	0.6	0.5	0.6	0.6	0.5
EV/EBITDA (adj.)*	5.8	4.7	-	10.6	5.8
DPS	0.0	0.0	0.0	0.0	0.0
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%

*ex. IFRS16 effects

Current Price	PLN 1.94
Target Price	PLN 2.00
Market Cap	PLN 454m
Free Float	PLN 215m
ADTV (3M)	PLN 1.6m

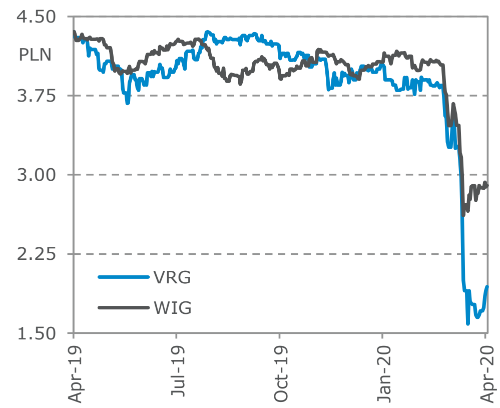
Ownership

Ipopema 2 FIZAN	14.83%
OFE PZU	14.60%
OFE NN	8.45%
Jerzy Mazgaj	8.31%
TFI Forum	6.65%
Others	40.47%

Business Profile

VRG designs and sells high-quality men's and women's apparel and jewelry. The Company runs the fashion labels Bytom, Vistula, Wólczanka, and Deni Cler, and the chain jewelry brand W. Kruk. Vistula owes its fast-paced expansion to a strategy of organic growth complemented by mergers and acquisitions. Vistula is aiming to become a "house of brands" with a presence across the CEE region able to deliver consistent growth in profits.

VRG vs. WIG



Company	Target Price		Rating	
	new	old	new	old
VRG	2.00	4.50	hold	buy

Company	Current Price	9MTP	Upside
VRG	1.94	2.00	+3.1%

Forecast Update	2020E	2021E	2022E
EBITDA	-	-64.1%	-37.1%
Net profit	-	-89.4%	-46.7%
Sales/sqm	-31.5%	-10.7%	-5.5%
SG&A/sqm	-16.9%	-4.7%	-5.4%
Total sales area	-11.2%	-13.0%	-12.3%

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Key Risks

Economic Slowdown

VRG faces a slowdown in sales any time there is a decline in consumer confidence. With economic activity in Poland grinding to a halt under a nationwide lockdown, this is expected to drive job losses and consequently a likely pullback in consumer spending.

Exchange Rate Risk

VRG reports an increasing share of foreign currency payments to international suppliers. At the end of 2019, orders in USD, EUR, and CHF accounted for 35%, 22%, and 8%, respectively, of total purchases. This means that any depreciation in the zloty vis-a-vis the other currencies could raise merchandise costs for the Company, causing a squeeze on sales margins. The same is true for SG&A expenses, with euro-denominated SG&A accounting for approx. 25% of total annual SG&A in 2019.

Price War

VRG operates in a challenging and fiercely competitive casual fashion market where local retailers sometimes are force engage in price wars against global players. After having to close brick-and-mortar stores under lockdown restrictions, fashion chains can be expected to deploy aggressive pricing to support liquidity.

Unattractive Fashion Lines

VRG has to stay on top of the changing tastes of consumers, and by and large it has been successful in keeping up with demands, resulting in increasing like-for-like sales. The Company also works on drawing more traffic to its stores with celebrity marketing campaigns. However if a collection should fail to appeal to shoppers this can potentially hurt sales.

Pricing Policy

A pricing policy that seeks to maximize margins at the expense of revenues is not the best strategy in case of a fashion retailer operating in an intensely competitive market characterized by extremely price-conscious customers. VRG is aware of the risks, and its pricing policies to date have successfully helped to improve efficiency.

Risk Of Failed Acquisitions

VRG aims to become a house of brands by acquiring companies based in Poland and across the CEE region. The Company's M&A track record has been good so far, however there is a chance that a future acquisition might fail to deliver the desired synergies, or take longer than hoped to produce synergies.

Valuation

We used two valuation methods to determine the value of VRG: the Discounted Cash Flow method, indicating a per-share valuation of PLN 2.36, and the Relative Valuation method, yielding a value of PLN 1.10 per share.

(PLN)	weight	Price
Relative Valuation	40%	1.10
DCF Analysis	60%	2.36
	price	1.84
	9M target price	**2.00**

Relative Valuation

We compared the forward P/E and EV/EBITDA multiples of VRG with the multiples of two peer groups as projected for fiscal 2020 through 2022. Both sets of ratios are given equal weights; note that the earnings multiples expected in FY2020 are affected by the anticipated negative impacts of the COVID-19 epidemic. The two peer groups analyzed consist of comparable fashion retailers and jewelry retailers, respectively. The large premium at which VRG is currently trading relative to the sector's 2020-2022 earnings multiples stems from the fact that the earnings expectations for many of its peers have not been updated yet by the analysts to reflect coronavirus risks.

Relative Valuation

		PEG			P/E			EV/EBITDA		
	price	**2020E**	**2021E**	**2022E**	**2020E**	**2021E**	**2022E**	**2020E**	**2021E**	**2022E**
Clothing Retailers										
HENNES & MAURI-B	114.65	6.6	4.9	4.5	19.1	14.2	13.0	10.1	8.6	8.1
INDITEX	21.72	4.0	4.7	3.9	17.7	20.7	17.2	8.5	9.6	8.5
MARKS & SPENCER	95.08	0.1	0.1	0.1	5.4	6.3	5.4	4.7	5.1	4.8
NEXT PLC	3428	6.4	8.0	6.5	7.5	9.4	7.6	7.7	8.7	7.4
HUGO BOSS -ORD	22.01	1.8	1.4	1.2	9.7	7.3	6.3	5.1	4.1	3.8
CCC SA	28.9	-	-	-	23.4	5.3	3.9	4.7	3.7	3.3
LPP	4786	-	-	-	16.7	11.1	9.3	8.1	6.0	4.8
Jewelry Retailers										
TIFFANY & CO	129.0	-	-	-	28.0	66.7	27.3	15.6	21.9	15.8
PANDORA A/S	206.1	0.5	0.4	0.3	6.3	5.0	4.6	5.1	4.3	4.2
LAO FENG XIANG-A	38.8	-	-	-	12.9	11.2	10.5	6.6	5.7	-
CHOW SANG SANG	7.2	0.4	0.3	0.3	6.3	4.8	5.0	4.9	4.0	3.9
LUK FOOK HLDGS I	15.1	-	-	-	9.7	7.9	6.6	5.8	5.2	4.4
CHOW TAI FOOK JE	5.2	1.8	1.5	1.2	13.7	11.2	9.1	10.2	8.8	7.4
LAO FEN XIANG-B	2.8	-	-	-	6.6	5.7	5.3	6.6	5.7	-
Minimum		0.1	0.1	0.1	5.4	4.8	3.9	4.7	3.7	3.3
Maximum		6.6	8.0	6.5	28.0	66.7	27.3	15.6	21.9	15.8
Median (fashion)		4.0	4.7	3.9	16.7	9.4	7.6	7.7	6.0	4.8
Median (jewelers)		0.5	0.4	0.3	9.7	7.9	6.6	6.6	5.7	4.4
Median		1.8	1.4	1.2	11.3	8.6	7.1	6.6	5.7	4.8
VRG	1.94	-	-	-	-	84.9	10.6	-	10.6	5.8
premium / discount		-	-	-	-	883%	49%	-	86%	20%
Implied Valuation										
Median		1.8	1.4	1.2	11.3	8.6	7.1	6.6	5.7	4.8
Multiple weight						50%			50%	
Year weight					0%	50%	50%	0%	50%	50%
Equity value per share (PLN)	**1.10**									

Additional Assumptions

Sales Efficiency Metrics*

	2015	2016	2017	2018	2019	2020P	2021P	2022P
Sales area (1,000 sqm)								
VRG	28.0	30.5	33.3	51.6	54.4	51.1	51.9	54.2
YoY change	7%	9%	9%	55%	5%	-6%	1%	4%
Fashion Stores	20.6	22.2	24.6	42.1	43.7	40.2	40.9	43.0
YoY change	8.2%	8.2%	10.7%	70.9%	3.9%	-7.9%	1.6%	5.2%
Jewelry Stores	7	8	9	10	11	11	11	11
YoY change	3.4%	11.2%	5.0%	10.0%	11.4%	2.4%	1.1%	1.7%
Sales per Square Meter (PLN)								
VRG	1,581	1,705	1,798	1,581	1,679	1,169	1,575	1,708
YoY change	9.6%	7.8%	5.5%	-12.1%	6.2%	-30.4%	34.8%	8.5%
Fashion Stores	1,308	1,164	1,780	1,318	1,049	603	869	978
YoY change	7.9%	-11.0%	52.9%	-26.0%	-20.4%	-42.5%	44.1%	12.5%
Jewelry Stores	2,283	2,185	2,358	2,540	2,689	1,929	2,505	2,564
YoY change	13.1%	-4.3%	7.9%	7.7%	5.9%	-28.2%	29.8%	2.4%
SG&A per sqm (PLN)								
VRG	698	744	766	668	738	630	747	757
YoY change	6.4%	6.6%	2.9%	-12.9%	10.5%	-14.6%	18.7%	1.3%
Fashion Stores	571	618	618	420	598	526	607	611
YoY change	2.1%	8.3%	0.0%	-32.1%	42.5%	-12.0%	15.4%	0.6%
Jewelry Stores	964	970	1,062	1,118	1,216	1,106	1,240	1,239
YoY change	12.6%	0.5%	9.5%	5.3%	8.8%	-9.1%	12.2%	-0.1%
Cash conversion cycle (days)	201	220	240	259	252	300	202	220
Days inventory outstanding	364	362	350	427	382	475	387	365
Days receivables outstanding	11	13	11	11	7	18	18	18
Days payables outstanding	174	154	121	179	137	193	203	163

*Comparability of 2018 numbers is affected by the acquisition of Bytom in December

Sales & Profit Forecast by Operating Segment

	2015	2016	2017	2018	2019	2020P	2021P	2022P
Fashion								
Revenue (PLN m)	310	363	420	483	692	457	607	704
Gross profit (PLN m)	166	189	214	245	358	219	304	353
SG&A expenses (PLN m)	141	165	183	212	314	254	298	315
Other operating gains/losses (PLN m)	-1	0	0	2	-1	-1	-1	-1
EBIT (PLN m)	24	24	29	33	43	-37	5	37
Gross margin	53.4%	52.0%	50.9%	50.7%	51.7%	47.9%	50.1%	50.1%
YoY change (pp)	0.2	-1.4	-1.1	-0.2	1.0	-3.9	2.3	0.0
EBIT margin	7.6%	6.6%	6.9%	6.7%	6.2%	-8.0%	0.9%	5.2%
YoY change (pp)	1.5	-1.0	0.2	-0.1	-0.5	-14.2	8.9	4.3
SG&A/Sales	45.4%	45.5%	43.5%	43.9%	45.3%	55.6%	49.1%	44.8%
YoY change (pp)	-2.0	0.1	-2.0	0.4	1.4	10.3	-6.5	-4.3
Jewelry								
Revenue (PLN m)	204	236	271	323	376	283	367	384
Gross profit (PLN m)	107	123	145	167	198	144	190	201
SG&A expenses (PLN m)	86	96	111	128	155	145	164	167
Other operating gains/losses (PLN m)	-1	0	-1	1	2	0	0	0
EBIT (PLN m)	20	27	34	39	44	0	26	35
Gross margin	52.6%	52.3%	53.6%	51.9%	52.7%	50.9%	51.8%	52.5%
YoY change (pp)	-1.8	-0.3	1.3	-1.7	0.8	-1.8	0.9	0.7
EBIT margin	9.7%	11.4%	12.5%	12.2%	11.8%	-0.2%	7.1%	9.1%
YoY change (pp)	-2.0	1.7	1.1	-0.3	-0.4	-12.0	7.2	2.0
SG&A/Sales	42.2%	40.8%	40.8%	39.7%	41.3%	51.1%	44.7%	43.4%
YoY change (pp)	-0.2	-1.4	0.0	-1.1	1.6	9.7	-6.3	-1.3

DCF Valuation

Assumptions:

- Cash flow is discounted as of 31 March 2020. Equity value calculations factor in net debt as of 31 December 2019.
- We assume gross margin expansion by 3pp to 49% in 2020 and further growth to 50% in 2021.
- Average CAPEX in 2020-29E is PLN 21m.
- The DCF model does not account for the impact of exchange-rate differences on profits.
- Figures are presented ex-IFRS 16.
- We assume an annual tax rate of 19% in 2020-29E.
- Risk-free rate is 3.5%.
- We assume that FCF after FY2028 will grow at an annual rate of 2.0%.
- Unleveraged beta=1.0, avg. leveraged beta=1.15.

DCF Model

(PLN m)	2020P	2021P	2022P	2023P	2024P	2025P	2026P	2027P	2028P	2029P	2029+
Revenue	740	974	1,088	1,125	1,159	1,182	1,206	1,230	1,256	1,282	
change	-30.7%	31.6%	11.7%	3.4%	3.0%	2.0%	2.0%	2.0%	2.1%	2.1%	
EBITDA	-15	47	88	89	90	91	91	91	91	92	
EBITDA margin	-2.1%	4.8%	8.1%	7.9%	7.8%	7.7%	7.5%	7.4%	7.3%	7.2%	
D&A expenses	21.8	20.4	20.6	20.9	21.2	21.3	21.3	21.2	21.0	20.4	
EBIT	-37	26	67	68	69	69	69	70	70	72	
EBIT margin	-5.0%	2.7%	6.2%	6.0%	5.9%	5.9%	5.7%	5.7%	5.6%	5.6%	
Tax on EBIT	0.7	5.0	12.8	12.9	13.1	13.2	13.2	13.3	13.4	13.6	
NOPLAT	-38	21	55	55	56	56	56	57	57	58	
CAPEX	-13.5	-19.6	-21.6	-21.6	-21.5	-21.2	-20.9	-20.5	-20.1	-20.4	
Working capital	34.8	36.3	-59.0	-19.2	-3.1	-3.0	-2.9	-2.9	-4.4	-4.5	
FCF	5	59	-5	35	52	53	54	54	54	53	54
WACC	9.5%	9.2%	8.8%	8.8%	9.1%	9.0%	8.5%	8.5%	8.5%	8.5%	
discount factor	93.4%	85.5%	78.6%	72.3%	66.3%	60.9%	56.1%	51.7%	47.6%	43.9%	
PV FCF	5.0	50.1	-4.2	25.3	34.7	32.4	30.1	28.1	25.5	23.5	
WACC	9.5%	9.2%	8.8%	8.8%	9.1%	9.0%	8.5%	8.5%	8.5%	8.5%	
Cost of debt	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	
Risk-free rate	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	
Risk premium	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	
Effective tax rate	-2.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	
Net debt / EV	18.6%	9.3%	13.0%	7.3%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Cost of equity	10.6%	9.8%	9.5%	9.2%	9.1%	9.0%	8.5%	8.5%	8.5%	8.5%	
Risk premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	
Beta	1.4	1.3	1.2	1.1	1.1	1.1	1.0	1.0	1.0	1.0	

FCF growth after the forecast period	2.00%
Terminal value	838
Present value of terminal value	368
Present value of FCF in the forecast period	250
Enterprise value	619
Net debt	66
Minority interests	0.0
Equity value	552
Shares outstanding (millions)	234.46
Equity value per share (PLN)	2.36
9M cost of equity	6.0%
9M target price (PLN)	**2.50**
EV/EBITDA ('21) at target price	11.8
P/E('21) at target price	103.1
TV / EV	59.5%

Sensitivity Analysis

	FCF growth in perpetuity				
	0.0%	1.0%	2.0%	3.0%	5.0%
WACC +1.0 p,p,	2.57	2.69	2.84	3.01	3.21
WACC +0.5 p,p,	2.37	2.48	2.61	2.77	2.95
WACC	2.27	2.38	**2.50**	2.65	2.83
WACC -0.5 p,p,	2.18	2.28	2.40	2.55	2.71
WACC -1.0 p,p,	2.01	2.10	2.21	2.34	2.50

2019 Q4 Results

VRG reported 2019 Q4 results in line with market expectations. On higher clothing sales virtually across all fashion lines (except for small y/y declines at Vistula/Bytom), combined with an expanded gross margin, EBIT in the fashion segment came in at PLN 27m after increasing 32% from the comparable year-ago period. **On the other hand, the jewelry segment registered contraction in operating profit in Q4 due to negative base effects which made for a slower year-over-year growth rate in the crucial month of December**.

Operating cash flow (ex. IFRS16 effect) amounted to PLN 94m in Q4 2019 vs. PLN 75m in Q4 2018, representing improvement driven by higher profits combined with cash unlocked from inventory and receivables.

The net debt/EBITDA ratio stood at 0.6x as of 31 December 2019 (note that VRG does not include reverse factoring in it debt calculations).

2019 Q4 Results Summary

(PLN m)	4Q'18	4Q'19	change
Revenue	272	332	22.2%
Fashion	162	207	27.7%
Jewelry	110	126	14.0%
Gross margin	52.9%	53.7%	0.8p.p.
Fashion	52.0%	53.6%	1.6p.p.
Jewelry	54.1%	53.8%	-0.3p.p.
EBIT	40.8	47.6	16.7%
Fashion	20.1	26.6	32.1%
Jewelry	21	21	1.6%
margin	15.0%	14.3%	-0.7p.p.
Fashion	12.4%	12.8%	0.4p.p.
Jewelry	18.7%	16.7%	-2p.p.
Pre-tax profit	38.9	53.9	38.6%
Net profit	32.4	44.3	36.7%

Source: VRG, mBank

Revising Forecasts For a Recession

Quarantine measures introduced by countries across the world have drastically transformed the retail landscape, disrupting the business activities of hundreds of companies. After having to close brick-and-mortar stores due to trading restrictions, clothing retailers are seeing their sales plunge at an unprecedented pace, sustaining heavy losses which weigh on medium-term earnings prospects and, in some cases, on the ability of companies to stay above water.

The Polish government has announced an economic aid package to help businesses get through the coronavirus crisis, including rent subsidies up to 90% for the duration of store closure, and wage subsidies up to 40%, capped at the current amount of average pay. These measures are insufficient according to the Polish retail industry, which has called for a removal of the wage cap. According to the CEO of LPP, Marek Piechocki, lawmakers should also consider a six-month suspension of rent on retail stores. The aid package came into force on 1 April 2020.

In our updated **base-case scenario** for VRG, we assume the Company's stores will stay closed until mid-May, and we predict low initial subsequent foot traffic before visits start to increase gradually over the following quarters. We assume brick and online retailers alike will want to draw customers back in with intense marketing and price incentives in the coming months as a way of boosting liquidity.

Our base case also accounts for the wider economic fallout of the coronavirus epidemic, which might drive many firms out of business, causing massive job losses and shrinking consumer spending in Poland.

Further, if the zloty remains as weak as it is now against the euro and the dollar, it will drive up the costs of 2020 autumn-winter fashion collections, as well as raising rental costs for brick stores.

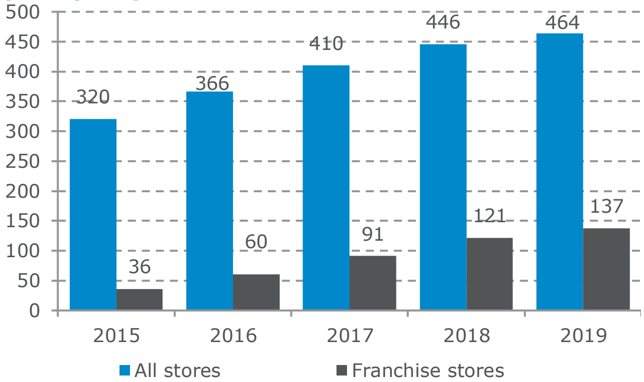
Our base case analyzes a scenario where VRG would permanently close some of its franchise store locations.

We see the risk of insolvency as low in the base-case scenario given VRG's solid financial standing, reflected in a 2019 year-end net debt/EBITDA ratio of 0.6x and a 25% utilization rate for available credit facilities. All told, in our base case scenario VRG would experience substantial earnings contraction in FY2020, and it would exceed loan covenants at the end of the year, resulting in a temporary increase in financing costs by lenders.

A Growing Franchise Network

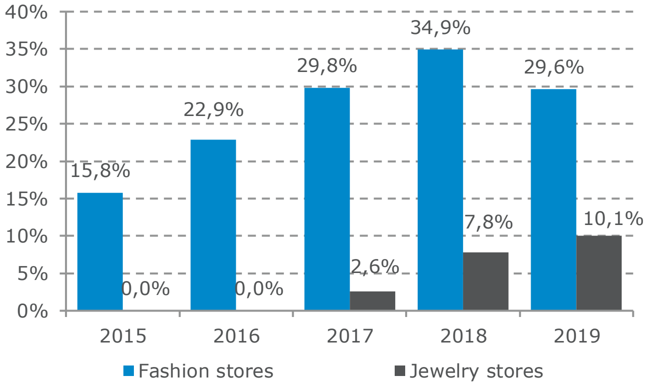
VRG expanded its network of franchise stores to 133 locations as of 31 September 2019 (not including Bytom) from 36 at the end of 2015, representing 29% of all stores at the time (ex. Bytom). Most of the franchise locations are fashion stores,

VRG company-owned and franchise stores (ex. Bytom)



Source: VRG, mBank

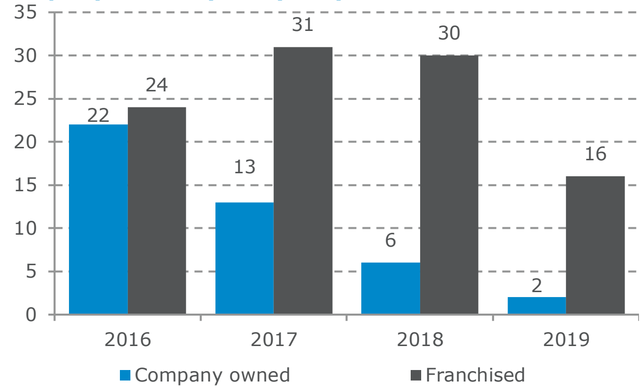
Franchise as a pct. of VRG stores (ex. Bytom)



Source: VRG, mBank

Franchise stores accounted for the majority of new stores opened by VRG in the years 2016-2019. This was part of a strategy aimed at achieving continuing expansion while limiting business risks.

Annual store openings at VRG, franchise vs. company-owned (ex. Bytom)



Source: VRG, mBank

We expect VRG to want to scale back its franchise network in the coming months amid an economic contraction spurred by the coronavirus epidemic. The franchise system delegates business risk to the franchisees. VRG has its own cash registers installed in the franchise locations, and it manages their stocking levels.

The Base Case

- **Sales**: Our base-case scenario for VRG assumes store closures until mid-May and low foot traffic in the months immediately after due to the risk-averse behavior of Polish shoppers. After factoring this into our model, we reduced the FY2020 revenue estimate by 36% to PLN 740m, implying a year-over-year decrease of -31%.
- We also lower the expected annual rate of trading space expansion from +4% to -6% to reflect likely franchise closures and a lack of interest from prospective new franchisees.
- Amid an economic recession and reduced disposable income, we do not see high demand for the type of more formal menswear offered by VRG. As for the more casual lines, here the market is poised for cutthroat competition in the months ahead.
- For the first quarter of 2020, we have a base-case sales decline of 11% (the lockdown in Poland began in mid-March), consistent with VRG's own estimate.

Updated base-case sales forecast for VRG

(PLN m)	2020P	2021P	2022P
Total sales (new)	740.0	973.7	1,087.6
Total sales (old)	1,154.6	1,241.0	1,318.2
difference	-35.9%	-21.5%	-17.5%
Fashion (new)	456.9	606.9	703.7
Fashion (old)	727.7	772.1	815.1
difference	-37.2%	-21.4%	-13.7%
Jewelry (new)	283.1	366.8	383.9
Jewelry (old)	426.9	469.0	503.1
difference	-33.7%	-21.8%	-23.7%

Source: VRG, P - mBank projection

- **Fashion**: With foot traffic assumed to be zero to low in the period during and immediately after the lockdown, we assume that VRG's brick stores will register year-over-tear falls in quarterly sales of 70% in Q2, 30% in Q3, and 20 in Q4.
- We anticipate low initial visits during the second half of Q2 after the stores reopen for business, before foot traffic starts to recover thanks to a decreasing risk aversion of consumers (the French luxury goods group Kering reports that it is observing narrowing declines in traffic at its Chinese stores, echoed by Nike with expectations of flat China sales in March-May, and Adidas with reports of an improving outlook for China).
- At the same time, we anticipate online sales growth at annual rates of 5% in Q2, when consumers are still reeling from the pandemic, rebounding to 30% each in Q3 and Q4. The 2021 outlook is similar in terms of revenues per square meter.
- **Jewelry:** VRG faces likely drop-off in sales of jewelry and watches in the wake of the coronavirus epidemic. To reflect this, for the brick stores, in the base case we assume year-over-year sales contraction of 40% in Q2, followed by narrower declines of 35% in Q3 and 15% in Q4.
- At the same time, we see a pickup in online jewelry sales at annual rates of 5% in Q2 and 10% each in Q3 and Q4.

Updated base-case segmental sales forecast for VRG

(PLN m)	2020P	2021P	2022P
Fashion	456.9	606.9	703.7
Brick Stores	303.7	423.1	492.2
e-Commerce	153.2	183.9	211.4
Sales per square meter (PLN)	603.0	869.1	977.9
YoY change	-42.5%	44.1%	12.5%
e-Commerce growth	31%	20%	15%
Jewelry	283.1	366.8	383.9
Brick Stores	252.3	331.3	344.9
e-Commerce	27.8	30.8	35.4
Sales per square meter	1,929	2,505	2,564
YoY change	-28.2%	29.8%	2.4%
e-Commerce growth	10.9%	15.0%	10.0%

Source: VRG, mBank

- **Sales margins**: Under the current circumstances, the priority of all fashion retailers is to manage liquidity once brick stores are allowed to reopen. With shoppers moving online, VRG is set to experience downward pressure on gross margin in 2020, particularly in the fashion segment, underpinned by price incentives offered to consumers.
- Another drawback is the zloty's depreciation against the dollar and the euro. In 2019 33% of VRG's merchandise purchases were priced in dollars, and 22% were paid for in euros. If the zloty stays as low as it currently is, this will put additional downward pressure on the expected sales margins on VRG's autumn-winter collections.

Updated base-vase gross margin forecast for VRG

(PLN m)	2020P	2021P	2022P
Gross margin (new)	49.0%	50.3%	50.6%
Gross margin (old)	53.0%	53.1%	53.1%
difference	-3.9p.p.	-2.8p.p.	-2.5p.p.

Source: VRG, mBank

- **SG&A expenses**: We reduced our original expectations as to 2020 SG&A expenses to reflect assumed scaled-backed store area expansion, rent deferrals, and lower personnel costs.
- We assume VRG will not pay rent on its stores during the lockdown period under the government's emergency rent assistance, and afterwards rental prices will most likely be reduced through negotiations with property managers. As a result, we see 2020 quarterly rental costs as falling 40% in Q2, 20% in Q3, and 10% in Q4, relative to the comparable periods a year earlier.
- As for personnel costs, we assume they will decrease by 20% each in Q2 and Q3, and fall by a further 10% in Q4. Again, we assume VRG will enroll in the government's aid program during the lockdown period.

- Finally, after an expected cutback in marketing expenses by 50%, we see VRG as lowering its FY2020 SG&A expenses by 15% in the base-case scenario compared to FY2019.
-

Updated base-case SG&A forecast for VRG

(PLN m)	2020P	2021P	2022P
SG&A (new)	398.8	462.0	481.9
SG&A (old)	513.0	551.5	583.2
difference	-22.26%	-16.22%	-17.37%
SG&A/Sales (new)	53.9%	47.4%	44.3%
SG&A/Sales (old)	44.4%	44.4%	44.2%
difference	9.5p.p.	3p.p.	0.1p.p.
SG&A per sqm (new)	629.7	747.2	756.8
SG&A per sqm (old)	757.9	783.7	799.9
difference	-16.9%	-4.7%	-5.4%

Source: VRG, mBank

- **EBITDA & EBIT**: Using the revised assumptions described above, we lower our FY2020 EBITDA forecast for VRG to expect an operating loss of PLN 15m vs. a PLN 121m operating profit anticipated at the beginning. The reduction is driven primarily by the fashion business, which is more sensitive to changes in consumer spending, as evidenced by its performance during the 2009 crisis. By the same token, the fashion business will probably recover from the current crisis at a slower pace than the jewelry business.

Updated base-case EBIT and EBITDA forecast (ex. IFRS 16) for VRG

(PLN m)	2020P	2021P	2022P
Total EBIT (new)	-37.0	26.5	67.4
Total EBIT (old)	98	106	116
difference		-75.2%	-41.8%
EBIT, Fashion (new)	-36.5	5.3	36.5
EBIT, Fashion (old)	43	47	51
difference		-88.6%	-28.7%
EBIT, Jewelry (new)	-0.5	25.9	34.8
EBIT, Jewelry (old)	55	60	64
difference	-100.9%	-56.7%	-46.0%
EBITDA (new)	-15.2	46.8	88.0
EBITDA (old)	121.1	130.3	140.0
difference	-112.6%	-64.1%	-37.1%

Source: VRG, mBank

- **Working capital, debt, CAPEX:** In the base case, VRG would end FY2020 with a net debt of PLN 85m after an increase from PLN 66m reported at the end of 2019.
- As part of working-capital optimization, the Company would reduce 2020 inventory by 8% y/y (VRG itself is guiding for a stronger decrease) and increase accounts payable by 4% (extended payment terms, reverse factoring).
- The 2019 year-end net debt/EBITDA ratio was 0.6x, and credit utilization at the time stood at 25% of PLN 300m total available facilities. VRG has enough cash and credit available in our view to meet its current obligations.
- This leads us to assume limited liquidity risk and low odds of a capital raise; if VRG does exceed loan covenants, at worst it might face a temporary hike in financing costs by some 3pp.
- By the end of 2021, VRG should be able to bring its leverage ratio below 3.5x.

Updated base-case working capital and debt forecast for VRG

(PLN m)	2020P	2021P	2022P
Working capital	328.9	292.6	351.5
Total debt	186.4	144.4	116.6
Net debt	84.6	42.1	59.1
Net debt/EBITDA	-	0.9	0.7
CAPEX	-13.5	-19.6	-21.6

Source: VRG, mBank

Best-Case Scenario

- In our best-case scenario, VRG's brick fashion stores would record year-over-year quarterly sales declines of 50% in Q2, 25% in Q3, and 10% in Q4 2020, alongside respective falls of 30%/20%/5% at brick jewelry stores. On the other hand, online sales for the year would increase 41% for fashion and 19% for jewelry.
- The best-case gross margin contraction in FY2020 would amount to 2.5pp. We assume a reduction in rental costs proportional to the expected decrease in sales effectiveness.
- Finally, for the best case we assume that EBITDA margin would recover to 9.4% in 2022 on increasing sales per square meter.

Best Case scenario assumptions

(PLN m)	2020P	2021P	2022P
Total Revenue	835.3	1,046.7	1,157.1
Fashion	523.3	668.7	754.3
Jewelry	312.0	378.0	402.9
of which e-Commerce	193.8	232.3	267.1
YoY change			
Revenue	-21.8%	25.3%	10.6%
Fashion	-24.4%	27.8%	12.8%
Jewelry	-17.0%	21.2%	6.6%
of which e-Commerce	39.2%	19.8%	15.0%
Gross margin	49.5%	50.7%	51.1%
YoY change	-2.5p.p.	1.2p.p.	0.3p.p.
SG&A/Sales	49.35%	45.78%	43.46%
EBIT	0.5	50.8	87.0
EBIT, Fashion	-13.3	23.8	52.7
EBIT, Jewelry	13.8	30.7	40.4
EBITDA	22.5	71.9	108.6
EBITDA margin	2.70%	6.87%	9.39%
DCF Valuation (9M)	**3.54**		

Source: VRG, mBank

Worst-Case Scenario

- In our worst-case scenario, VRG's brick fashion stores would record year-over-year quarterly sales declines of 80% in Q2, 50% in Q3, and 30% in Q4 2020, alongside respective falls of 60%/35%/20% at brick jewelry stores. On the other hand, online sales for the year would increase 25% for fashion and 6% for jewelry.
- The worst-case gross margin contraction in FY2020 would be 2.5pp. We assume a reduction in rental costs proportional to the expected decrease in sales effectiveness.
- Finally, for the worst case we assume that EBITDA margin would recover to 6.2% in 2022 on increasing sales per square meter.

Worst Case scenario assumptions

(PLN m)	2020P	2021P	2022P
Revenue	657.7	922.7	1,036.6
Fashion sales	402.3	582.9	664.9
Jewelry sales	255.4	339.8	371.7
of which e-Commerce	174.7	205.7	235.0
YoY change			
Revenue	-38.4%	40.3%	12.3%
Fashion sales	-41.9%	44.9%	14.1%
Jewelry sales	-32.1%	33.1%	9.4%
of which e-Commerce	25.5%	17.7%	14.3%
Gross margin	48.7%	49.7%	50.1%
YoY change	-3.4p.p.	1.1p.p.	0.3p.p.
SG&A/Sales	60.48%	49.30%	45.74%
EBIT	-78.5	3.1	43.9
EBIT, Fashion	-69.1	-9.7	22.1
EBIT, Jewelry	-9.4	17.3	30.4
EBITDA	-56.9	23.0	63.9
EBITDA margin	-8.66%	2.50%	6.16%
DCF Valuation (9M)	**1.43**		

Source: VRG, mBank

Earnings History and Future Projections

(PLN m)	2014	2015	2016	2017	2018	2019	2020P	2021P	2022P
Revenue	443.4	514.2	598.5	688.5	805.7	1,068.3	740.0	973.7	1,087.6
change	11.5%	16.0%	16.4%	15.0%	17.0%	32.6%	-30.7%	31.6%	11.7%
COGS	205.7	241.4	286.7	329.1	393.4	512.2	377.3	484.2	537.3
Gross profit	237.7	272.7	311.8	359.4	412.3	556.1	362.8	489.5	550.3
Gross margin	53.6%	53.0%	52.1%	52.2%	51.2%	52.1%	49.0%	50.3%	50.6%
Selling expenses	158.5	174.1	205.1	230.5	272.8	383.1	398.8	462.0	481.9
General and administrative expenses	43.0	52.8	56.1	62.8	67.3	86.1	0.0	0.0	0.0
Other operating activity (net)	0.6	-2.5	0.4	-3.2	-0.2	0.6	-1.0	-1.0	-1.0
EBIT	36.8	43.3	50.9	62.8	71.9	87.5	-37.0	26.5	67.4
change	9.4%	17.8%	17.6%	23.3%	14.4%	21.7%	-	-	154.8%
EBIT margin	8.3%	8.4%	8.5%	9.1%	8.9%	8.2%	-5.0%	2.7%	6.2%
Net financing gains/losses	-11.3	-11.2	-6.6	-7.8	-6.2	-8.1	-23.4	-19.8	-14.4
Pre-tax profit	25.5	32.1	44.3	55.0	65.7	79.4	-60.4	6.6	53.0
Tax	-5.2	-6.8	-9.3	-11.8	-12.2	-15.4	-1.2	-1.3	-10.1
Net profit	20.3	25.4	35.0	43.2	53.5	64.0	-61.6	5.4	42.9
change	-55.0%	25.0%	38.2%	23.3%	23.9%	19.5%	-	-	701.7%
Margin	4.6%	4.9%	5.9%	6.3%	6.6%	6.0%	-8.3%	0.6%	3.9%
D&A expenses	11.3	12.5	14.2	15.5	17.3	23.6	21.8	20.4	20.6
EBITDA	48.1	55.9	65.2	78.4	89.2	198.5	69.3	132.6	177.6
EBITDA (ex. IFRS 16)	48.1	55.9	65.2	78.4	89.2	111.1	-15.2	46.8	88.0
change	7.1%	16.0%	16.7%	20.2%	13.8%	24.5%	-	-	87.9%
EBITDA margin	10.9%	10.9%	10.9%	11.4%	11.1%	10.4%	-2.1%	4.8%	8.1%
EBIT (ex. IFRS 16)	36.8	43.3	50.9	62.8	71.9	87.5	-37.5	26.0	66.9
Net profit (ex. IFRS 16)	20.3	25.4	35.0	43.2	53.5	65.9	-56.3	8.3	46.0
Shares outstanding at eop (millions)	173.9	173.9	173.9	173.9	234.5	234.5	234.5	234.5	234.5
EPS	0.1	0.1	0.2	0.2	0.2	0.3	-0.3	0.0	0.2
ROA	3.2%	3.8%	4.8%	5.6%	5.7%	5.0%	-4.2%	0.4%	2.8%
ROE	4.8%	5.7%	7.4%	8.3%	7.9%	7.7%	-7.4%	0.7%	5.2%

Balance Sheet

(PLN m)	2014	2015	2016	2017	2018	2019	2020P	2021P	2022P
ASSETS	645.3	697.3	751.5	778.8	1,113.4	1,431.3	1,492.0	1,528.4	1,523.4
Fixed assets	420.2	424.6	428.5	425.5	593.2	847.0	858.1	860.3	870.5
Property, plant and equipment	52.0	57.0	61.3	59.4	78.0	71.6	63.4	62.5	63.5
Intangible assets	359.2	357.7	357.6	358.8	507.3	499.7	499.7	499.7	499.7
Deferred tax assets	7.4	7.9	8.2	5.8	6.4	7.7	7.7	7.7	7.7
Other	1.6	2.0	1.3	1.5	1.5	268.0	287.3	290.4	299.6
Current assets	225.1	272.7	323.0	353.4	520.1	584.3	634.0	668.1	652.9
Inventory	196.1	240.6	284.0	315.3	460.8	535.5	491.3	513.1	536.9
Accounts receivable	14.5	15.2	21.0	20.2	23.9	19.9	37.4	49.1	54.9
Cash and cash equivalents	13.2	15.6	16.8	16.4	33.5	25.3	101.8	102.3	57.5
Other	1.4	1.4	1.3	1.4	1.9	3.6	3.6	3.6	3.6

(PLN m)	2014	2015	2016	2017	2018	2019	2020P	2021P	2022P
EQUITY & LIABILITIES	645.3	697.3	751.5	778.8	1,113.4	1,431.3	1,492.0	1,528.4	1,523.4
Equity	430.6	458.5	494.4	542.5	805.1	863.3	801.7	807.1	850.0
Non-current liabilities	109.6	101.1	95.1	85.3	76.8	243.4	262.6	245.7	219.2
Loans and borrowings	0.0	98.1	91.9	82.1	70.8	55.9	55.9	35.9	0.0
Other	109.6	3.0	3.2	3.2	6.0	187.5	206.8	209.9	219.2
Current liabilities	105.1	137.7	162.0	151.0	231.5	324.7	427.7	475.6	454.3
Loans and borrowings	6.0	15.7	31.4	32.9	25.9	35.6	130.6	108.6	116.6
Trade creditors	83.7	114.9	121.2	108.8	192.8	191.7	199.7	269.6	240.3
Finance leases	0.0	0.0	0.0	0.0	0.0	86.3	86.3	86.3	86.3
Other	15.4	7.1	9.4	9.3	12.8	11.1	11.1	11.1	11.1

Debt	6.0	113.7	123.3	115.1	96.6	91.4	186.4	144.4	116.6
Net debt	-7.2	98.2	106.5	98.6	63.1	66.1	84.6	42.1	59.1
Net debt / Equity	-1.7%	21.4%	21.5%	18.2%	7.8%	7.7%	10.6%	5.2%	7.0%
Net debt/ EBITDA	-0.1	1.8	1.6	1.3	0.7	0.6	-	0.9	0.7
BVPS	2.5	2.6	2.8	3.1	3.4	3.7	3.4	3.4	3.6

Cash Flow

(PLN m)	2014	2015	2016	2017	2018	2019	2020P	2021P	2022P
Cash flow from operating activities	18.8	25.7	6.0	20.5	53.5	108.6	79.6	147.9	94.2
Pre-tax profit	20.3	28.2	35.2	43.2	65.7	79.4	-61.6	5.4	42.9
D&A expenses	11.3	12.5	14.2	15.5	17.3	23.6	21.8	20.4	20.6
Amortization of assets held u. finance leases	0.0	0.0	0.0	0.0	0.0	87.4	84.5	85.8	89.6
Change in provisions	0.6	1.8	2.3	0.5	-2.9	0.3	0.0	0.0	0.0
Working capital	-12.5	-12.3	-33.0	-27.0	-21.1	-75.3	34.8	36.3	-59.0
Other	-0.9	-4.6	-12.7	-11.8	-5.6	-6.7	0.0	0.0	0.0
Cash flow from investing activities	-12.3	-12.6	-18.0	-15.3	-18.6	-16.8	-13.5	-19.6	-21.6
CAPEX	-12.5	-14.4	-19.2	-18.7	-18.2	-25.0	-13.5	-19.6	-21.6
Other	0.2	1.8	1.2	3.4	-0.4	8.2	0.0	0.0	0.0
Cash flow from financing activities	-11.6	-10.7	13.2	-5.0	-17.8	-100.1	10.5	-127.8	-117.4
Loans and borrowings	-0.8	108.1	9.4	-8.4	8.0	-4.7	95.0	-42.0	-27.9
Debt securities	-10.5	-119.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Dividends	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	-0.3	0.2	3.9	3.4	-25.8	-95.4	-84.5	-85.8	-89.6
Change in cash	-5.0	2.4	1.3	0.3	17.1	-8.2	76.5	0.5	-44.8
FX effects	0.0	0.0	0.0	0.7	0.0	0.0	0.0	0.0	0.0
Cash at eop	13.2	15.6	16.8	16.4	33.5	25.3	101.8	102.3	57.5
DPS (PLN)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FCF	15.7	20.0	2.3	19.2	36.6	-6.1	5.4	58.5	-5.3
CAPEX/Sales	2.8%	2.8%	3.2%	2.7%	2.3%	2.3%	1.8%	2.0%	2.0%

Trading Multiples*

	2014	2015	2016	2017	2018	2019	2020P	2021P	2022P
P/E*	16.6	13.3	9.6	7.8	8.5	6.9	-	55.1	9.9
P/CE*	10.7	8.9	6.8	5.7	6.4	5.1	-	15.9	6.8
P/B	0.8	0.7	0.7	0.6	0.6	0.5	0.6	0.6	0.5
P/S	0.8	0.7	0.6	0.5	0.6	0.4	0.6	0.5	0.4
FCF/EV*	3.6%	4.6%	0.5%	4.4%	7.1%	-1.2%	1.0%	11.8%	-1.0%
EV/EBITDA	9.1	7.8	6.8	5.6	5.8	4.7	-	10.6	5.8
EV/EBIT*	11.9	10.0	8.7	6.9	7.2	6.0	-	19.1	7.7
EV/S*	1.0	0.8	0.7	0.6	0.6	0.5	0.7	0.5	0.5
OCF/EBITDA	39%	46%	9%	26%	60%	19%	32%	132%	5%
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Price (PLN)	1.94	1.94	1.94	1.94	1.94	1.94	1.94	1.94	1.94
Shares outstanding at eop (millions)	173.9	173.9	173.9	173.9	234.5	234.5	234.5	234.5	234.5
MC (PLN m)	337	337	337	337	455	455	455	455	455
Minority interest (PLN m)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EV (PLN m)*	438	435	444	436	518	521	539	497	514

*ex. IFRS 16

List of abbreviations and ratios contained in the report:
EV – net debt + market value
EBIT – Earnings Before Interest and Taxes
EBITDA – EBIT + Depreciation and Amortisation
P/CE – price to earnings with amortisation
MC/S – market capitalisation to sales
EBIT/EV – operating profit to economic value
P/E – (Price/Earnings) – price divided by annual net profit per share
ROE – (Return on Equity) – annual net profit divided by average equity
P/BV – (Price/Book Value) – price divided by book value per share
Net debt – credits + debt papers + interest bearing loans – cash and cash equivalents
EBITDA margin – EBITDA/Sales

OVERWEIGHT (OW) – a rating which indicates that we expect a stock to outperform the broad market
NEUTRAL (N) – a rating which indicates that we expect the stock to perform in line with the broad market
UNDERWEIGHT (UW) – a rating which indicates that we expect the stock to underperform the broad market

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ACCUMULATE – we expect that the rate of return from an investment will range from 5% to 15%
HOLD – we expect that the rate of return from an investment will range from -5% to +5%
REDUCE – we expect that the rate of return from an investment will range from -5% to -15%
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NAV - valuation based

mBank issued the following recommendations for VRG in the 12 months prior to this publication:

VRG

recommendation	buy	accumulate	buy	overweight
date issued	2020-02-05	2019-12-02	2019-07-26	2019-05-29
target price (PLN)	4.50	4.50	5.20	-
price on rating day	3.93	3.94	4.20	3.90

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