This report was prepared by mBank at the request of the WSE as part of the Exchange's Analytical Coverage Support Programme

Wednesday, September 23, 2020 | update

VRG: buy (upgraded)

VRG PW; VRGP.WA | Retail, Poland

Hope for Rapid Post-Lockdown Recovery

Since posting disappointing sales figures for March through May, the post-lockdown sales momentum at VRG stores has consistently improved from month to month, supported by a sharp rise on online orders. By July, monthly sales returned to pre-lockdown levels, and with a similarly strong recovery reported in August it looks like VRG might be able to curb this year's profit contraction more effectively than thought, thanks in part to tight cost management. In addition, the Retailer expects to deliver positive movements in working capital. In the first half of 2020, VRG generated operating cash flow (ex. IFRS16 effects) of PLN 14.7m, representing a major improvement on the negative year-ago OCF of PLN 43.7m achieved despite a PLN 63.7m slump in sales profit. The Company owed the stronger cash flow to better working capital management, specifically cash unlocked from inventories. As a result, VRG was also able to reduce its net debt/EBITDA ratio by 0.2x to 1.3x as of 30 June 2020 vs. June 2019, reflecting a healthier balance sheet and reduced liquidity risk. We have updated our financial forecasts for VRG to reflect faster-than-expected recovery and tight cost discipline, and we raise our FY2020 EBITDA estimate from PLN 6m to PLN 39m, and revise the FY2021 forecast upwards from PLN 51m to PLN 67m. Note that, at the updated levels, our estimates stand below the FY2021-23 targets that VRG has set for its executives. Our new models also point to FCF of 8.2% in FY2020E and 5.6% in FY2021E. We upgrade VRG from accumulate to buy with an updated target price of PLN 3.14.

2020 Q2 Results Beat Expectations

VRG generated better-than-expected adjusted results for Q2 2020 after incurring lower SG&A expenses. In addition, the Company achieved strong operating cash flow in the period, and managed to reduce its leverage ratio compared to the same year-ago period in spite of much lower EBITDA.

Continued Recovery in Q3

VRG's sales report for July showed flat sales compared to the same month a year earlier, and in August sales increased slightly on the year while at the same time the rate of sales margin decline was curbed to 2ppt. Jewelry stores were the main driver behind the August rebound with sales up 21% on the year. We expect continued sales growth going forward, and tight cost discipline this should help to curb VRG's earnings losses in FY2020.

Incentive Scheme and Share Buyback

VRG is holding an EGM on 13 October 2020 to vote on a repurchase of up to 46.9 million shares of treasury stock, carrying 19.09% of total votes, and on the terms of a new Executive Incentive Scheme for 2021-2023. The buyback represents an alternative to cash dividends, but we do not expect many shareholders to want to give up their holdings. As for the Incentive Scheme, the EBIT targets its sets for the Company at PLN 71.7m in 2021, PLN 87.3m in 2022, and PLN 100m in 2023 stand above the corresponding results forecast by us.

(PLN m)	2018	2019	2020E	2021E	2022E
Revenue	805.7	1,068.3	904.3	1,065.9	1,185.3
EBITDA (adj.)*	89.2	111.1	39.4	67.3	93.6
EBITDA margin (adj.)*	11.1%	10.4%	4.4%	6.3%	7.9%
EBIT (adj.)*	71.9	87.5	18.2	47.8	73.6
Net profit (adj.)*	53.5	65.9	8.0	29.1	53.3
P/E (adj.)*	11.0	8.9	73.8	20.2	11.0
P/CE (adj.)*	8.3	6.6	20.5	12.2	8.1
P/B	0.7	0.7	0.7	0.7	0.6
EV/EBITDA (adj.)*	7.3	5.9	16.7	9.2	6.4
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 2.51
Target Price	PLN 3.14
Market Cap	PLN 589m
Free Float	PLN 238m
ADTV (3M)	PLN 1.5m

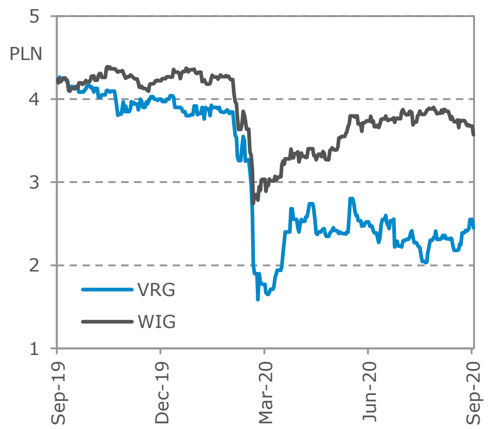
Ownership

Ipopema TFI	18.27%
OFE PZU	15.33%
OFE NN	14.13%
Jerzy Mazgaj	8.87%
TFI Forum	6.69%
Others	36.71%

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	3.14	2.43	buy	accumulate

Company	Current Price	9MTP	Upside
VRG	2.51	3.14	+25.1%

Forecast Update	2020E	2021E	2022E
EBITDA	563.1%	32.4%	4.9%
Net profit	-	167.2%	15.5%
Sales/sqm	8.3%	0.4%	-0.3%
SG&A/sqm	0.9%	1.0%	3.4%
Sales area	2.9%	2.9%	3.1%

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Key Risks

Second Lockdown

The Polish government might decide to put another round of restrictions on businesses this autumn or winter if coronavirus cases rise, however a complete lockdown on retail establishments is unlikely in our view with consumers by now used to shopping under sanitary and social distancing restrictions. As a result, any potential declines in sales are not likely to be as severe as in the spring.

Economic Slowdown

VRG faces a slowdown in sales any time there is a decline in consumer confidence.

Exchange Rate Risk

VRG reports an increasing share of foreign-currency payments to international suppliers. As of 30 June 2020, orders denominated in USD, EUR, and CHF accounted for 39%, 16%, and 10%, respectively, of total purchases. This means that any depreciation in the zloty vis-à-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. 22% of total.

Price War

VRG operates in a challenging and fiercely competitive casual fashion market where local retailers sometimes are forced engage in price wars against global players that can be potentially destructive to sales profits.

Negative Reception of 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. The pandemic has forced VRG to adjust its clothing designs, and if the tweaked fashion lines fail this could reflect negatively on sales and profits.

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 current pricing policy has proved successful, as demonstrated by improving sales profits on both clothing and jewelry.

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 them.

Valuation

We used two valuation methods to determine the value of VRG: the Discounted Cash Flow method, indicating a per-share valuation of PLN 3.32, and the Relative Valuation method, yielding a value of PLN 2.60 per share. Based on this, we set our new 9-month target price at PLN 3.14.

(PLN)	weight	price
Relative Valuation	50%	2.60
DCF Analysis	50%	3.32
	price	2.96
	9M target price	**3.14**

Relative Valuation

We compared the forward P/E, EV/EBITDA, and price/earnings-to-growth (PEG) ratios of VRG with the multiples of two peer groups as projected for fiscal 2020 through 2022. Each multiple is assigned an equal weight. The two peer groups analyzed consist of comparable fashion retailers and jewelry retailers, respectively. The final valuation outcome does not include FY2020E multiples because of the unprecedented circumstances faced this year by fashion retailers.

Relative Valuation Summary

		PEG			P/E			EV/EBITDA		
	Price	**2020E**	**2021E**	**2022E**	**2020E**	**2021E**	**2022E**	**2020E**	**2021E**	**2022E**
Clothing Retailers										
HENNES & MAURI-B	148.75	-	-	-	174.6	22.8	18.5	14.7	9.5	8.8
INDITEX	23.95	-	-	-	19.6	48.6	23.5	9.5	15.4	11.0
MARKS & SPENCER	102	0.1	0.2	0.1	6.1	17.0	7.9	4.7	6.1	5.4
NEXT PLC	5990	-	-	-	13.1	28.1	15.3	11.2	16.9	11.5
HUGO BOSS -ORD	21.66	-	-	-	-	12.6	9.0	9.5	5.6	4.9
CCC SA	46.71	-	-	-	-	41.3	14.2	22.0	7.2	6.0
LPP	6870	-	-	-	93.0	53.4	23.2	12.4	12.0	8.3
Jewelry Retailers										
TIFFANY & CO	116.0	-	-	-	25.2	46.5	28.2	14.3	23.9	15.2
PANDORA A/S	466.0	2.8	1.8	1.7	20.7	13.5	12.4	11.4	8.3	7.9
LAO FENG XIANG-A	48.9	1.4	1.2	1.0	17.0	14.5	12.8	7.1	6.3	5.5
CHOW SANG SANG	8.2	0.8	0.4	0.4	10.6	6.1	5.8	5.4	3.7	3.5
LUK FOOK HLDGS I	19.2	-	-	-	15.0	13.1	9.9	8.2	7.2	5.7
CHOW TAI FOOK JE	10.3	6.9	5.9	4.7	29.0	24.9	19.9	18.7	15.3	12.7
LAO FEN XIANG-B	2.9	-	-	-	7.0	5.9	5.2	7.1	6.3	5.5
Minimum		0.1	0.2	0.1	6.1	5.9	5.2	4.7	3.7	3.5
Maximum		6.9	5.9	4.7	174.6	53.4	28.2	22.0	23.9	15.2
Median (fashion)		0.1	0.2	0.1	19.6	28.1	15.3	11.2	9.5	8.3
Median (jewelers)		2.1	1.5	1.3	17.0	13.5	12.4	8.2	7.2	5.7
Median		1.4	1.2	1.0	18.3	19.9	13.5	10.4	7.7	7.0
VRG	2.51	-	-	-	-94.6	20.9	11.1	16.7	9.2	6.4
premium / discount		-	-	-	-618%	5%	-18%	61%	19%	-9%
Implied Valuation										
Median		1.4	1.2	1.0	18.3	19.9	13.5	10.4	7.7	7.0
Multiple weight						50%			50%	
Year weight					0%	50%	50%	0%	50%	50%
Equity value per share (PLN)	**2.60**									

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	52.6	53.4	55.9
YoY change	7%	9%	9%	55%	5%	-3%	1%	5%
Fashion Stores	20.6	22.2	24.6	42.1	43.7	41.7	42.3	44.6
YoY change	8.2%	8.2%	10.7%	70.9%	3.9%	-4.7%	1.5%	5.4%
Jewelry Stores	7	8	9	10	11	11	11	11
YoY change	3.4%	11.2%	5.0%	10.0%	11.4%	3.1%	1.2%	1.8%
Sales per Square Meter (PLN)								
VRG	1,581	1,705	1,798	1,581	1,679	1,408	1,675	1,808
YoY change	9.6%	7.8%	5.5%	-12.1%	6.2%	-16.1%	19.0%	7.9%
Fashion Stores	1,308	1,164	1,780	1,318	1,048	719	927	1,049
YoY change	7.9%	-11.0%	52.9%	-26.0%	-20.5%	-31.4%	29.0%	13.2%
Jewelry Stores	2,283	2,185	2,358	2,540	2,689	2,314	2,693	2,759
YoY change	13.1%	-4.3%	7.9%	7.7%	5.9%	-13.9%	16.4%	2.5%
SG&A expenses per sqm (PLN)								
VRG	698	744	766	668	738	652	772	808
YoY change	6.4%	6.6%	2.9%	-12.9%	10.5%	-11.5%	18.4%	4.5%
Fashion Stores	571	618	618	420	598	538	626	643
YoY change	2.1%	8.3%	0.0%	-32.1%	42.4%	-10.1%	16.4%	2.8%
Jewelry Stores	964	970	1,062	1,118	1,216	1,140	1,304	1,368
YoY change	12.6%	0.5%	9.5%	5.3%	8.8%	-6.2%	14.4%	4.9%
Cash conversion cycle (days)	201	220	240	259	252	281	234	225
Days inventory outstanding	364	362	350	427	382	392	355	337
Days receivables outstanding	11	13	11	11	7	20	20	20
Days payables outstanding	174	154	121	179	137	132	142	132

*The 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
Clothing								
Revenue	310	363	420	483	692	544	648	746
Gross profit	166	189	214	245	358	265	331	381
SG&A expenses	141	165	183	212	314	269	318	344
Other operating gains/losses	-1	0	0	2	-1	-14	-1	-1
EBIT	24	24	29	33	43	-17	12	36
Gross margin	53.4%	52.0%	50.9%	50.7%	51.7%	48.8%	51.1%	51.1%
YoY change (pp)	0.2	-1.4	-1.1	-0.2	1.0	-3.0	2.3	0.0
EBIT margin	7.6%	6.6%	6.9%	6.7%	6.2%	-3.2%	1.9%	4.9%
YoY change (pp)	1.5	-1.0	0.2	-0.1	-0.5	-9.4	5.1	2.9
SG&A/Sales	45.4%	45.5%	43.5%	43.9%	45.3%	49.4%	49.0%	46.1%
YoY change (pp)	-2.0	0.1	-2.0	0.4	1.4	4.1	-0.4	-2.9
Jewelry								
Revenue	204	236	271	323	376	360	418	439
Gross profit	107	123	145	167	198	183	217	231
SG&A expenses	86	96	111	128	155	150	174	186
Other operating gains/losses	-1	0	-1	1	2	3	0	0
EBIT	20	27	34	39	44	36	43	45
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%	9.9%	10.2%	10.2%
YoY change (pp)	-2.0	1.7	1.1	-0.3	-0.4	-1.9	0.3	0.0
SG&A/Sales	42.2%	40.8%	40.8%	39.7%	41.3%	41.7%	41.6%	42.3%
YoY change (pp)	-0.2	-1.4	0.0	-1.1	1.6	0.4	-0.1	0.7

DCF Valuation

Assumptions:

- Cash flow is discounted as of the end of August 2020. Equity value calculations factor in net debt as of 31 December 2019.
- We assume a decrease in gross margin by 2.4pp to 49.7% in 2020, and by 2023 we anticipate a rebound to 51.7%.
- Average CAPEX in 2020-29E is PLN 19.8m.
- 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.
- The risk-free rate is 3.5%.
- We assume that FCF after FY2029 will grow at an annual rate of 2.0%.
- Unleveraged beta=1.0, avg. leveraged beta=0.99.

DCF Model

(PLN m)	2020P	2021P	2022P	2023P	2024P	2025P	2026P	2027P	2028P	2029P	2029+
Revenue	904	1,066	1,185	1,227	1,266	1,290	1,309	1,329	1,350	1,371	
change	-15.4%	17.9%	11.2%	3.5%	3.2%	1.9%	1.5%	1.5%	1.5%	1.6%	
EBITDA	39	67	94	105	108	110	109	107	106	104	
EBITDA margin	4.4%	6.3%	7.9%	8.6%	8.5%	8.5%	8.3%	8.1%	7.9%	7.6%	
D&A expenses	20.8	19.1	19.7	20.2	20.6	20.9	21.0	21.0	20.8	20.4	
EBIT	19	48	74	85	87	89	88	86	85	83	
EBIT margin	2.1%	4.5%	6.2%	6.9%	6.9%	6.9%	6.7%	6.5%	6.3%	6.1%	
Tax on EBIT	-2.8	9.2	14.1	16.1	16.6	17.0	16.7	16.4	16.2	15.8	
NOPLAT	21	39	60	69	71	72	71	70	69	67	
CAPEX	-15.0	-19.5	-21.5	-21.6	-21.6	-21.2	-20.8	-20.4	-20.0	-20.4	
Working capital	7.5	9.1	-25.1	-22.4	-7.9	-7.7	-8.4	-8.5	-9.4	-6.2	
FCF	34.6	47.8	32.9	45.1	62.0	64.4	62.9	62.0	60.5	61.3	62.5
WACC	8.6%	8.7%	8.8%	8.5%	8.5%	8.4%	8.0%	8.0%	8.0%	8.0%	
discount factor	97.3%	89.5%	82.3%	75.8%	69.9%	64.5%	59.7%	55.3%	51.2%	47.4%	
PV FCF	33.7	42.8	27.1	34.2	43.3	41.5	37.5	34.3	30.9	29.0	

WACC	8.6%	8.7%	8.8%	8.5%	8.5%	8.4%	8.0%	8.0%	8.0%	8.0%	
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	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	
Net debt / EV	11.8%	5.6%	1.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Cost of equity	9.3%	9.0%	8.8%	8.5%	8.5%	8.4%	8.0%	8.0%	8.0%	8.0%	
Risk premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	
Beta	1.2	1.1	1.1	1.0	1.0	1.0	0.9	0.9	0.9	0.9	

FCF growth after the forecast period	2.00%
Terminal value	1,037
Present value of terminal value	491
Present value of FCF in the forecast period	354
Enterprise value	845
Net debt	66
Minority interests	0.0
Equity value	779
Shares outstanding (millions)	234.46
Equity value per share (PLN)	3.32
9M cost of equity	6.1%
9M target price (PLN)	**3.53**
EV/EBITDA ('21) at target price	8.3
P/E('21) at target price	14.7
TV / EV	58.10%

Sensitivity Analysis

	FCF growth in perpetuity				
	1.0%	1.5%	2.0%	2.5%	3.0%
WACC +1.0 p,p,	3.57	3.75	3.95	4.20	4.49
WACC +0.5 p,p,	3.32	3.48	3.67	3.89	4.16
WACC	3.20	3.35	3.53	3.75	4.00
WACC -0.5 p,p,	3.08	3.23	3.41	3.61	3.85
WACC -1.0 p,p,	2.87	3.01	3.17	3.35	3.58

Financial Results for Q2 2020

The 2020 Q2 earnings preview released by VRG after adjustment for a PLN 13.9m one-time inventory charge showed quarterly figures above our expectations and the forecasts of market analysts. The preliminary 2020 Q2 revenue and gross margin results are consistent with those calculated based on monthly sales reports.

The highlight of the second quarter were lower-than-expected SG&A expenses, facilitated in a large part by reduced rental rates.

With stores closed to shoppers in April, the jewelry business did better than the clothing business in Q2, generating a positive EBIT for the period.

Because of large discounts offered to shoppers as a liquidity protection mechanism, the quarterly sales margins in both segments, but in the clothing segment in particular, suffered a squeeze, compounded by a higher share of e-commerce in total sales, which increased from 13.4% in 1H'19 to 29.9% in 1H'20.

VRG reduced total inventories by 4% y/y in Q2 2020, including a 9% decrease in the clothing stock, and it increased use of supplier financing (PLN 13.6m w 2Q'20). As a result, despite significantly lower EBITDA, the net debt/EBITDA ratio as of 30 September was 0.2x lower than in September 2019 at 1.3x.

2020 Q2 Results Summary

	2Q'19	2Q'20	change
Revenue (PLN m)	270	175	-35.3%
Fashion	184	114	-37.9%
Jewelry	87	61	-29.8%
Gross margin (%)	53.5%	46.9%	-6.6p.p.
Fashion	53.8%	45.7%	-8p.p.
Jewelry	52.9%	49.2%	-3.7p.p.
EBIT (PLN m)	28.6	-10.4	-136.3%
Fashion	18.7	-15.6	-183.4%
Jewelry	10	5	-47.5%
EBIT margin (%)	10.6%	-5.9%	-16.5p.p.
Fashion	10.2%	-13.7%	-23.8p.p.
Jewelry	11.4%	8.5%	-2.9p.p.
Pre-tax profit (PLN m)	29.3	-3.3	-111.2%
Net profit (PLN m)	23.9	-2.3	-109.6%

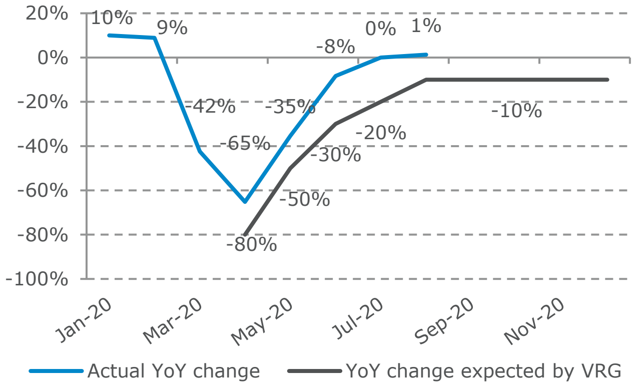
Source: VRG, mBank

VRG did not change its financial guidance for FY2020 after the second quarter, including e-commerce growth to 25% of total sales, revenue contraction of at an annual rate of no more than 20%, tight management of SG&A expenses, and a positive IAS 17 EBITDA result.

Hope for Rapid Post-Lockdown Recovery

Since posting disappointing sales figures for March through May, VRG has consistently improved its monthly result, with sales in July and August reaching pre-pandemic levels, which means they outpaced the Company's own targets. Nevertheless, as mentioned, VRG so far has opted not to change its original (now conservative-looking) guidance for FY2020.

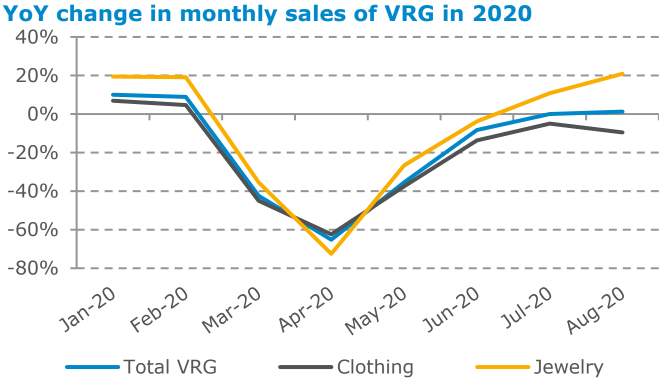
YoY pct. growth in 2020 monthly sales of VRG: actual values vs. target values



Source: VRG, mBank

VRG has improved jewelry sales every month since May, and from July the volumes passed the year-ago levels, increasing at a faster pace than the brick-and-mortar trading area. On the other hand, clothing sales have slumped since the pandemic hit and brought with it a change in shopping habits. That is why we expect a longer trajectory for VRG's fashion business when it comes to post-lockdown recovery.

YoY change in monthly sales of VRG in 2020

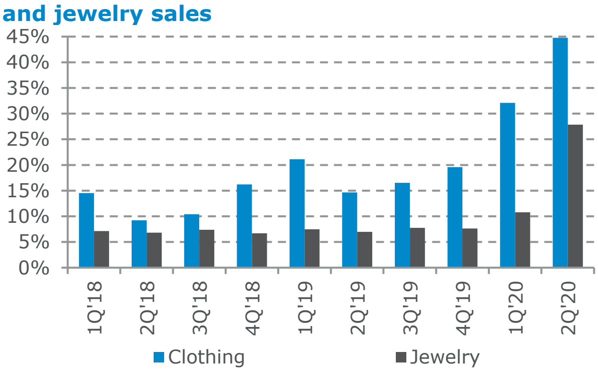


Source: VRG, mBank

e-Commerce Growth Explodes in 2020

The March store closures have accelerated growth in online shopping. For VRG, the e-commerce business typically generates lower sales margins than the brick-and-mortar business, but its EBIT margins tend to be higher. VRG's Web stores were ready for the increased lockdown traffic thanks to earlier investment aimed at optimizing the online platforms.

e-Commerce as a pct. of total VRG's total clothing and jewelry sales

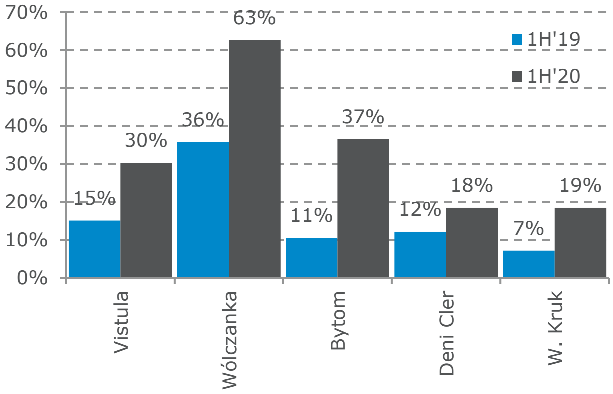


Source: VRG, mBank

The Bytom menswear brand increased its share in total sales at the fastest rate in H1 2020, and the sister label Wólczanka achieved the highest share overall in the period.

Going forward, we expect some of the online customers to come back to brick and mortar stores, resulting in a lower share of e-commerce, which, however, is set to continue its momentum in the future, albeit at a slower pace than in the first half of 2020.

Online sales as a pct of total sales in H1 2020 compared to H1 2019: breakdown by label

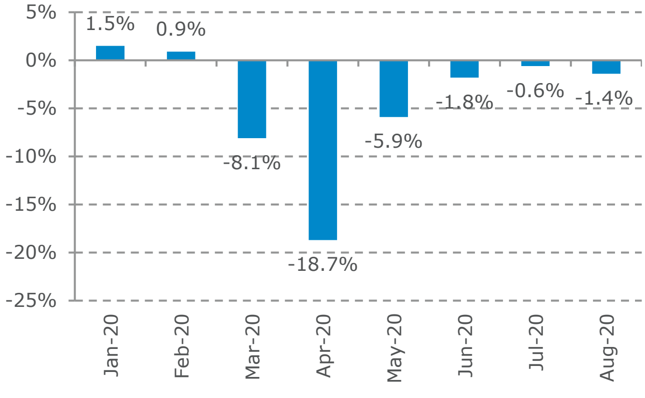


Source: VRG, mBank

Slower Declines in Sales Margins

The shift online, combined with large mark-downs, caused VRG's sales margins during lockdown to plummet. However since stores reopened in May, and footfall returned, the declines in the last few months have been curbed to an annual rate of 2% max.

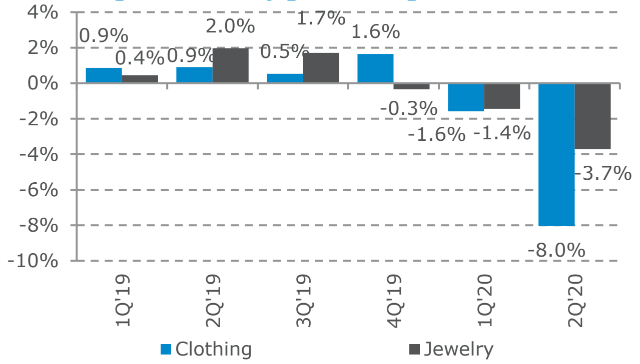
YoY change in monthly gross margins of VRG



Source: VRG, mBank

Margins on jewelry sales have contracted at a much slower rate this year than the clothing margins. Since June, this trend has been supported by rising prices of gold and silver (VRG has a policy of keeping constant markup over costs). When it comes to fashion, we expect gross margins to gradually return to normal in Q3 2020.

YoY change in monthly gross margins of VRG

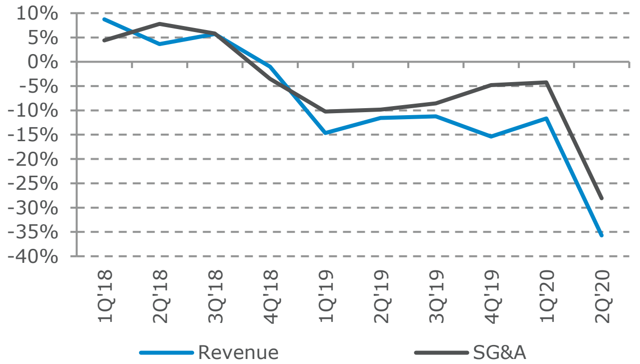


Source: VRG, mBank

Slow Decline in Store Costs

VRG has put measures in place to optimize the costs of running brick-and-mortar stores, but in Q2 2020 the effects of these measures were eclipsed by falling sales. The pandemic notwithstanding, VRG has reported a faster rate of decline in revenues per square meter compared to the rate of reduction in per-sqm SG&A expenses since the first quarter of 2019, when it acquired the Bytom label. We believe the Company will eventually reverse the trend with continued savings measures.

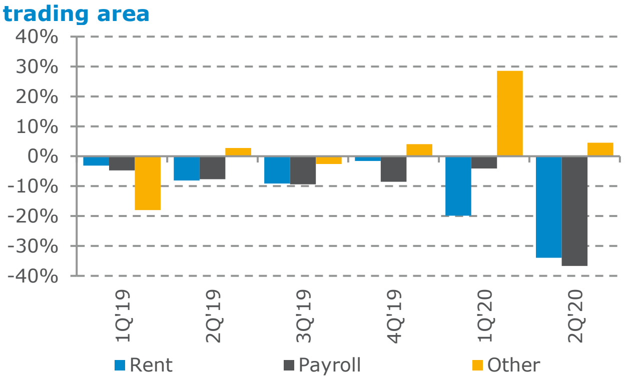
YoY change in per-sqm sales and SG&A expenses at VRG



Source: VRG, mBank

The way VRG expects to further reduce store costs is by negotiating lower rental rates, and by bringing down employment costs per square meter of trading area by increasing the size of the stores.

YoY change in quarterly costs per square meter of trading area



Source: VRG, mBank

Slower Store Expansion

VRG decided to curb the pace of new own-clothing store openings in 2020 in the face of the uncertainty generated by the global pandemic, and after considering Poland's high market penetration rate. Instead, the Company shifted its focus to maximizing synergy from the Bytom merger, and to growing e-commerce channels. Meanwhile the VRG sales network continues to grow through franchise partners.

VRG expects its clothing store area to decrease 4% in 2020, but we believe the actual number might turn out higher. When it comes to jewelry stores, after accelerated expansion in the 2018-19 period, led in part by franchise stores, in 2020 VRG curbed the target increase in trading area to 3%, but we think this is a temporary interruption before another round of rapid expansion.

YoY change in VRG store area

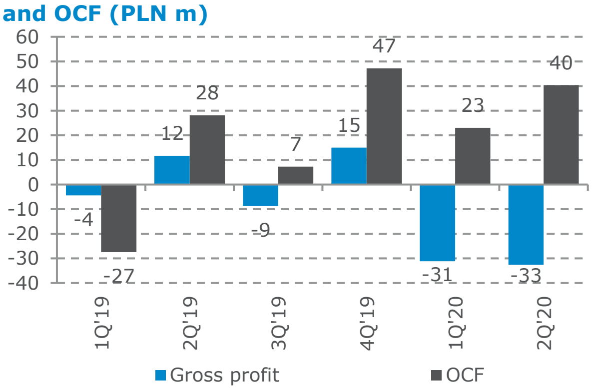
	2015	2016	2017	2018	2019	2020E
Total store area (1,000 sqm)						
VRG	26.2	28.0	30.5	33.3	51.6	54.4
Fashion	19.0	20.6	22.2	24.6	42.1	43.7
Jewelry	7.2	7.4	8.3	8.7	9.6	10.6
YoY change						
VRG	7%	9%	9%	15%	5%	-3%
Clothing	8%	8%	11%	17%	4%	-5%
Jewelry	3%	11%	5%	10%	11%	3%

Source: VRG, mBank

Optimization of Working Capital

The unexpected outbreak of the COVID-19 pandemic, and the subsequent lockdown, gave VRG a push to further improve its working capital. As a result, despite a substantial decrease in sales profits, in H1 2020 the Company was able to report a noticeable rise in operating cash flow, facilitated by scaled-back merchandise orders, more effective bill collection, and greater utilization of supplier financing (which resulted in increased payables). In Q2 2020, VRG registered a PLN 19m decrease in recurring gross profit while at the same time it grew quarterly OCF by PLN 40m compared to Q2 2019.

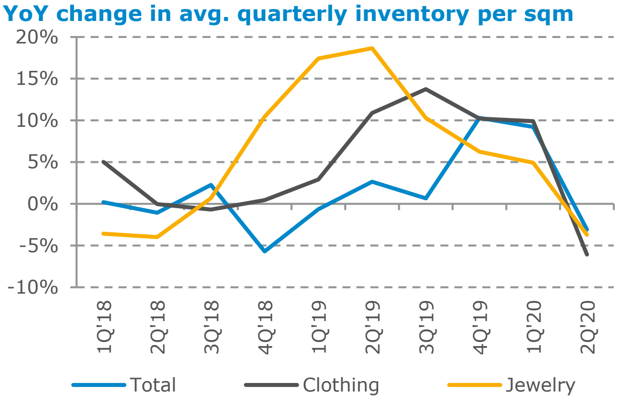
YoY nominal change in VRG's quarterly gross profit and OCF (PLN m)



Source: VRG, mBank

The efforts to reduce inventories by clearing stock left over from lockdown brought measurable results in Q2 2020. Inventory as of 30 June amounted to PLN 485.3m, of which PLN 224.6m was jewelry stock and PLN 260.7m was clothing. By the end of the year, VRG is aiming to reduce the clothing inventory by 15% compared to the end of 2019 (we assume a smaller decrease of 10%) and it hopes to bring the jewelry stock down by 5% (we assume -4%). The cash flow that could be unlocked as a result is approximately PLN 63m, equivalent to 56% of 2019 IAS 17 EBITDA.

YoY change in avg. quarterly inventory per sqm



Source: VRG, mBank

Inventory reductions are where VRG has the most room to improve when it comes to working capital, but it can optimize even more thanks to supplier financing programs.

All told, we expect to see PLN 4m higher debt at the end of 2020 than at year-end 2019 at PLN 70m (VRG itself is aiming to keep stable debt this year). Accordingly, we are anticipating FCF yield to be 5.9% in 2020, and rise to 8.2% in 2021.

Management Reshuffle

VRG has experienced an extensive reshuffling of its top management ranks this year, starting with the replacement of former CEO (since 2009), Grzegorz Pilch, on 29 June, with Michał Wójcik, previously CEO of Bytom, who, however, was subsequently dismissed on 13 July along with Deputy CEO Mateusz Żmijewski. In their place, the Supervisory Board appointed Andrzej Jaworski to be the new CEO, and nominated Radosław Jakociuk and Ernest Podgórski to Deputy CEO functions. After Mr. Podgórski resigned effective September 13th, his duties as acting CFO have been taken over by Michał Zimnicki.

Incentive Scheme and Share Buyback

VRG is holding an Extraordinary General Meeting on 13 October 220 to vote among others on the terms and conditions of an executive incentive plan for 2021-23, and on a PLN 135m max share buyback program, set to run through 2023, for up to 46.9 million shares of treasury stock carrying 19.09% of total votes. The proposed repurchase price range is PLN 0.7 to PLN 2.88.

A buyback would be a welcome development for investors who have not received cash dividends from VRG in previous years. VRG's principal shareholder, Jerzy Mazgaj, had declared he will not be taking part in the buyback.

When it comes to the 2021-23 incentive scheme, VRG is proposing to allocate to it no more than 6,750,000 shares, vesting in three equal tranches (2.9% of votes). The shares will vest subject to VRG achieving the following targets:

- The average annual price per share cannot drop below 3.10 zlotys in 2021, 3.90z in 2022, and 4.60z in 2023 (50% weight);
- Annual EBIT will be at least PLN 71.7m in 2021, PLN 87.3m in 2022, and PLN 100m in 2023 (25% weight); and

- Annual net profit will be at least PLN 51.4m in 2021, PLN 62.9m in 2022, and PLN 74.6m in 2023 (25% weight).

Compared to these targets, the EBIT and net profit values indicated by our models are lower, especially in 2021 when we envision a slower pace of earnings recovery.

VRG incentive plan targets vs. our forecasts

	2021E	2022E	2023E
VRG (PLN m)			
EBIT	71.7	87.3	100.0
Net profit	51.4	62.9	74.6
mBank (PLN m)			
EBIT	47.8	73.6	84.6
Net profit	29.1	53.3	66.0
Difference			
EBIT	-33.3%	-15.7%	-15.4%
Net profit	-43.5%	-15.3%	-11.5%

Source: VRG, mBank

Outlook for FY2020

Operating in pandemic conditions, so far VRG has managed to exceed expectations with the pace at which it is rebuilding sales, as well as managing to mitigate the backlash with measures aimed at reducing costs and improving working capital, which have allowed the Company to keep its head above water during these unprecedented times.

The challenges still ahead are to continue to recoup losses in the clothing business, which needs more time than the jewelry stores to bring sales margins back to pre-pandemic levels, especially after the sharp rise in lower-margin e-commerce sales. Jewelry has demonstrated strong resilience in the face of the global pandemic.

We feel confident in our positive outlook for VRG, and we see the main downside risk to our forecasts in another lockdown in the fall – an unlikely prospect in our view.

Key efficiency metrics, historical values and 2020-2021 estimates

	2017	2018	2019	2020E	2021E
Sales per sqm (PLN)	1,798.4	1,581.1	1,679.3	1,408.1	1,675.3
Gross margin	52.2%	51.2%	52.1%	49.6%	50.7%
SG&A/Sales	42.6%	42.2%	43.9%	46.3%	46.1%
SG&A per sqm	766.1	667.5	737.5	652.5	772.5
EBIT margin	9.1%	8.9%	8.2%	2.1%	4.5%
Store area (1,000 sqm)	33.3	51.6	54.4	52.6	53.4
YoY change					
Sales per sqm	5.5%	-12.1%	6.2%	-16.1%	19.0%
Gross margin	0.1p.p.	-1p.p.	0.9p.p.	-2.4p.p.	1.1p.p.
SG&A/Sales	-1p.p.	-0.4p.p.	1.7p.p.	2.4p.p.	-0.2p.p.
SG&A per sqm	2.9%	-12.9%	10.5%	-11.5%	18.4%
EBIT margin	0.6p.p.	-0.2p.p.	-0.7p.p.	-6.1p.p.	2.5p.p.
Store area (1,000 sqm)	9.2%	55.0%	5.4%	-3.2%	1.5%

Source: VRG, E – mBank estimates

Forecast Revision

We have upgraded our financial outlook for VRG to reflect faster-than-expected post-lockdown recovery, in particular in jewelry sales and gross margins, which signal better earnings performance. Note that, at the updated levels, our estimates stand below the FY2021-23 targets that VRG has set in its executive incentive scheme.

Changes to 2020-2021 earnings forecasts

(PLN m)	2020		change	2021		change
	old	new		old	new	
Revenue	823.7	904.3	9.78%	1,032.1	1,065.9	3.27%
Gross margin	47.9%	49.6%	1.8p.p.	48.8%	50.7%	1.9p.p.
EBITDA	5.9	39.4	563.13%	50.9	67.3	32.37%
margin	0.7%	4.4%	3.6p.p.	4.9%	6.3%	1.4p.p.
EBIT	-16.8	18.2		29.2	47.8	63.59%
Pre-tax profit	-36.2	5.3		13.4	35.9	167.18%
Net profit	-36.0	8.0		10.9	29.1	167.18%

Source: 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	904.3	1,065.9	1,185.3
change	11.5%	16.0%	16.4%	15.0%	17.0%	32.6%	-15.4%	17.9%	11.2%
COGS	205.7	241.4	286.7	329.1	393.4	512.2	455.5	525.2	580.8
Gross profit	237.7	272.7	311.8	359.4	412.3	556.1	448.7	540.7	604.5
Gross margin	53.6%	53.0%	52.1%	52.2%	51.2%	52.1%	49.6%	50.7%	51.0%
Selling expenses	158.5	174.1	205.1	230.5	272.8	383.1	380.0	491.5	529.5
General and administrative expenses	43.0	52.8	56.1	62.8	67.3	86.1	39.1	0.0	0.0
Other operating activity (net)	0.6	-2.5	0.4	-3.2	-0.2	0.6	-11.1	-1.0	-1.0
EBIT	36.8	43.3	50.9	62.8	71.9	87.5	18.6	48.2	73.9
change	9.4%	17.8%	17.6%	23.3%	14.4%	21.7%	-78.8%	159.4%	53.4%
EBIT margin	8.3%	8.4%	8.5%	9.1%	8.9%	8.2%	2.1%	4.5%	6.2%
Net financing gains/losses	-11.3	-11.2	-6.6	-7.8	-6.2	-8.1	-24.0	-13.4	-8.6
Pre-tax profit	25.5	32.1	44.3	55.0	65.7	79.4	-5.4	34.8	65.3
Tax	-5.2	-6.8	-9.3	-11.8	-12.2	-15.4	-0.8	-6.6	-12.4
Net profit	20.3	25.4	35.0	43.2	53.5	64.0	-6.2	28.2	52.9
change	-55.0%	25.0%	38.2%	23.3%	23.9%	19.5%	-	-	87.6%
margin	4.6%	4.9%	5.9%	6.3%	6.6%	6.0%	-0.7%	2.6%	4.5%
D&A expenses	11.3	12.5	14.2	15.5	17.3	23.6	20.8	19.1	19.7
EBITDA	48.1	55.9	65.2	78.4	89.2	198.5	135.2	166.6	197.4
EBITDA (ex. IFRS 16)	48.1	55.9	65.2	78.4	89.2	111.1	39.4	67.3	93.6
change	7.1%	16.0%	16.7%	20.2%	13.8%	24.5%	-64.6%	71.1%	39.0%
EBITDA margin (adj.)	10.9%	10.9%	10.9%	11.4%	11.1%	10.4%	4.4%	6.3%	7.9%
EBIT (ex. IFRS 16)	36.8	43.3	50.9	62.8	71.9	87.5	18.2	47.8	73.6
Net profit (ex. IFRS 16)	20.3	25.4	35.0	43.2	53.5	65.9	8.0	29.1	53.3
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	0.0	0.1	0.2
ROA	3.2%	3.8%	4.8%	5.6%	5.7%	5.0%	-0.4%	1.9%	3.5%
ROE	4.8%	5.7%	7.4%	8.3%	7.9%	7.7%	-0.7%	3.2%	5.8%

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	1,451.6	1,480.4	1,521.0
Fixed assets	420.2	424.6	428.5	425.5	593.2	847.0	862.8	866.3	878.0
Property, plant and equipment	52.0	57.0	61.3	59.4	78.0	71.6	61.9	62.3	64.1
Intangible assets	359.2	357.7	357.6	358.8	507.3	499.7	499.4	499.4	499.4
Deferred tax assets	7.4	7.9	8.2	5.8	6.4	7.7	12.7	12.7	12.7
Other	1.6	2.0	1.3	1.5	1.5	268.0	288.9	292.0	301.9
Current assets	225.1	272.7	323.0	353.4	520.1	584.3	588.8	614.1	643.0
Inventory	196.1	240.6	284.0	315.3	460.8	535.5	489.7	511.3	535.6
Accounts receivable	14.5	15.2	21.0	20.2	23.9	19.9	49.1	57.8	64.3
Cash and cash equivalents	13.2	15.6	16.8	16.4	33.5	25.3	47.5	42.4	40.5
Other	1.4	1.4	1.3	1.4	1.9	3.6	2.6	2.6	2.6

(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	1,451.6	1,480.4	1,521.0
Equity	430.6	458.5	494.4	542.5	805.1	863.3	857.1	885.3	938.2
Non-current liabilities	109.6	101.1	95.1	85.3	76.8	243.4	267.5	250.6	224.7
Loans and borrowings	0.0	98.1	91.9	82.1	70.8	55.9	54.6	34.6	-1.2
Other	109.6	3.0	3.2	3.2	6.0	187.5	212.9	216.0	225.9
Current liabilities	105.1	137.7	162.0	151.0	231.5	324.7	326.9	344.5	358.1
Loans and borrowings	6.0	5.9	17.7	20.4	14.6	21.3	62.5	40.5	48.5
Trade creditors	83.7	114.9	121.2	108.8	192.8	191.7	164.3	203.8	209.4
Finance leases	0.0	0.0	0.0	0.0	0.0	86.3	90.1	90.1	90.1
Other	15.4	16.9	23.2	21.8	24.0	25.3	10.1	10.1	10.1

Debt	6.0	103.9	109.6	102.6	85.4	77.2	117.2	75.2	47.3
Net debt	100.5	98.2	106.5	98.6	63.1	66.1	69.7	32.8	6.8
Net debt / Equity	23.3%	21.4%	21.5%	18.2%	7.8%	7.7%	8.1%	3.7%	0.7%
Net debt/ EBITDA	2.1	1.8	1.6	1.3	0.7	0.6	1.8	0.5	0.1
BVPS	2.5	2.6	2.8	3.1	3.4	3.7	3.7	3.8	4.0

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	109.6	155.7	151.3
Pre-tax profit	20.3	28.2	35.2	43.2	65.7	79.4	-10.3	28.2	52.9
D&A expenses	11.3	12.5	14.2	15.5	17.3	23.6	20.8	19.1	19.7
Amortization of assets held u. finance leases	0.0	0.0	0.0	0.0	0.0	87.4	95.9	99.3	103.8
Change in provisions	0.6	1.8	2.3	0.5	-2.9	0.3	-1.0	0.0	0.0
Working capital	-12.5	-12.3	-33.0	-27.0	-21.1	-75.3	7.5	9.1	-25.1
Other	-0.9	-4.6	-12.7	-11.8	-5.6	-6.7	-3.2	0.0	0.0
Cash flow from investing activities	-12.3	-12.6	-18.0	-15.3	-18.6	-16.8	-14.6	-19.5	-21.5
CAPEX	-12.5	-14.4	-19.2	-18.7	-18.2	-25.0	-15.0	-19.5	-21.5
Other	0.2	1.8	1.2	3.4	-0.4	8.2	0.4	0.0	0.0
Cash flow from financing activities	-11.6	-10.7	13.2	-5.0	-17.8	-100.1	-72.8	-141.3	-131.7
Loans and borrowings	-0.8	108.1	9.4	-8.4	8.0	-4.7	27.5	-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	-100.3	-99.3	-103.8
Change in cash	-5.0	2.4	1.3	0.3	17.1	-8.2	22.2	-5.0	-1.9
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	47.4	42.4	40.5
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	34.6	47.8	32.9
CAPEX/Sales	2.8%	2.8%	3.2%	2.7%	2.3%	2.3%	1.7%	1.8%	1.8%

Trading Multiples*

	2014	2015	2016	2017	2018	2019	2020P	2021P	2022P
P/E*	21.5	17.2	12.5	10.1	11.0	8.9	73.8	20.2	11.0
P/CE*	13.8	11.5	8.9	7.4	8.3	6.6	20.5	12.2	8.1
P/B	1.0	1.0	0.9	0.8	0.7	0.7	0.7	0.7	0.6
P/S	1.0	0.8	0.7	0.6	0.7	0.6	0.7	0.6	0.5
FCF/EV*	2.9%	3.7%	0.4%	3.6%	5.6%	-0.9%	5.3%	7.7%	5.5%
EV/EBITDA	11.2	9.6	8.3	6.8	7.3	5.9	16.7	9.2	6.4
EV/EBIT*	14.6	12.3	10.7	8.5	9.1	7.5	36.2	13.0	8.1
EV/S*	1.2	1.0	0.9	0.8	0.8	0.6	0.7	0.6	0.5
OCF/EBITDA	39%	46%	9%	26%	60%	19%	35%	84%	51%
Dividend Yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Price (PLN)	2.51	2.51	2.51	2.51	2.51	2.51	2.51	2.51	2.51
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)	436	436	436	436	588	588	588	588	588
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)*	537	535	543	535	652	655	658	621	595

*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%
SELL – we expect that an investment will bear a loss greater than 15%
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mBank issued the following recommendations for VRG in the 12 months prior to this publication:
VRG

recommendation	**accumulate**	**hold**	**hold**	**buy**	**accumulate**
date issued	2020-07-02	2020-06-03	2020-04-06	2020-02-05	2019-12-02
target price (PLN)	2.43	2.43	2.00	4.50	4.50
price on rating day	2.33	2.40	1.94	3.93	3.94

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