Thursday, November 08, 2018 | special comment

Vistula Retail Group – Post-Merger Future Looks Bright

Vistula (VST PW) | rating: overweight | current price: PLN 4.06
Bytom (BTM PW) | rating: overweight | current price: PLN 2.68

Analyst: Piotr Bogusz +48 22 438 24 08

A year and a half since its announcement, the merger of Vistula and Bytom is nearing completion, with the next and final step after a green light obtained from both sets of shareholders in October, the registration of the merger deed in the Companies Register, expected in November. This would mean the merged company will produce the first consolidated financial statements as soon as in December. According to our calculations, by acquiring Bytom, Vistula can create revenue and margin synergies to the tune of PLN 10m in 2019. Moreover, with its market capitalization increased to roughly PLN 886m at PLN 3.9/share, Vistula, which is about to change its post-merger name to "Vistula Retail Group" (VRG), will gain more appeal in the eyes of investors, potentially making its way to the mWIG40 index in the medium term.

Based on weaker-than-expected sales volumes and profits generated in September and October, we have lowered our 2018 FY EBITDA forecast for Vistula by 12.5%, and we cut the estimate for Bytom by 14.3%. From the reduced pro-forma comparable base, including synergy effects, in 2019 we anticipate 35% growth to PLN 139m in VRG's EBITDA, accompanied by a 42% net profit rebound to PLN 88m. On these estimates, VRG is currently trading at 10.5x 2019E P/E (a ratio 25% lower than the average 12M BF forward ratio of Vistula for the last five years) and 6.8x EV/EBITDA. At the current BTM/VST share swap ratio of 0.66, 8.3% less than the actual merger ratio of 0.72x, we would pick BTM over VST.

Deal expected to close end-November

Shareholders of Vistula and Bytom gave their approval for the merger during their respective extraordinary meetings toward the end of October, agreeing to a share exchange ratio of 1:0.72, i.e. 0.72 shares of Bytom for each share of Vistula. With the registration of the tie-up expected in November, Vistula Retail Group can start reporting its financials on a consolidated basis from December. **After focusing on the integration of the two businesses during an initial transitional period, VRG should see the first revenue and margin synergies materialize during the 2019 spring/summer fashion sales season.**

2018-2020 earnings forecast for VRG

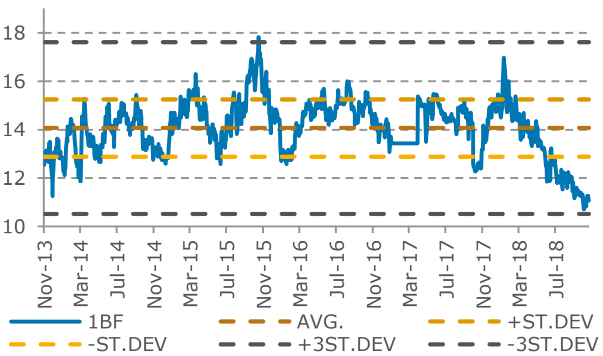
(PLN m)	2018E*	2019P	YoY change	2020P	YoY change
Revenue	984.9	1.125.8	+14.3%	1.215.8	+8.0%
Gross profit	506.8	584.0	+15.2%	634.2	+8.6%
margin (%)	51.5%	51.9%		52.2%	
EBIT	85.4	115.6	+35.3%	133.7	+15.6%
EBITDA	108.2	139.4	+28.9%	158.9	+14.0%
margin (%)	11.0%	12.4%		13.1%	
Net income	62.2	88.2	+41.8%	103.3	+17.1%
EV/EBITDA (x)	8.8	6.5		5.3	
P/E (x)	14.2	10.0		8.6	

*pro-forma figures assuming the merger occurred on January 1st
Source: Bytom, Vistula, E - estimates by Dom Maklerski mBanku

Valuation at 10.5x 2019E earnings

By merging with Bytom, underpinned by synergy, we predict VRG is poised to see a 34% increase in annual EBITDA in 2019, alongside a 41% boost to net profit. We estimate next year's synergy benefits at PLN 10m, reflected primarily in **higher revenues and sales margins**, achieved with a more effective pricing policy. Accordingly, after making an allowance for the likely negative effects of a stronger US dollar (the currency in which both companies incur over 30% of their annual COGS), we expect the 2019 gross margin to be 0.4pp higher at 51.9% than this year's pro-forma combined figure.

12M blended forward P/E ratio of VST



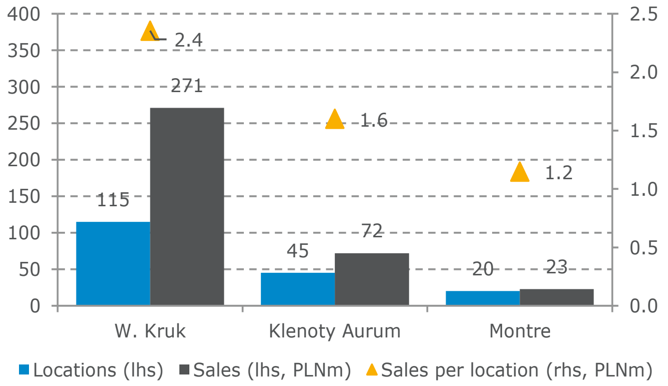
Source: Bloomberg, Dom Maklerski mBanku

With potential synergies excluded, the expected annual growth rates of 2019 EBITDA and net profit still look impressive at 20% and 26%, respectively. On our estimates, at the current price level, **VRG is trading at 6.8x EV/EBITDA and 10.5x 2019E P/E, i.e. 25% below Vistula's 12M blended forward P/E ratio for 2013-2018E, which averaged 14.1x.**

Geographic diversification

By transforming into Vistula Retail Group, VRG is aiming to become a "house of brands" with a presence across international markets. In August 2018 Vistula, via its jewelry unit W.Kruk, announced it had agreed to acquire two retailers south of the Polish border: Klenoty Aurum, the #1 jewelry retailer in the Czech Republic, and Montre, the online watch retailer based in Slovakia. According to Vistula, the Czech target operates on a larger scale and generates higher profits than the Slovakian store.

W.Kruk store count & sales vs. M&A targets



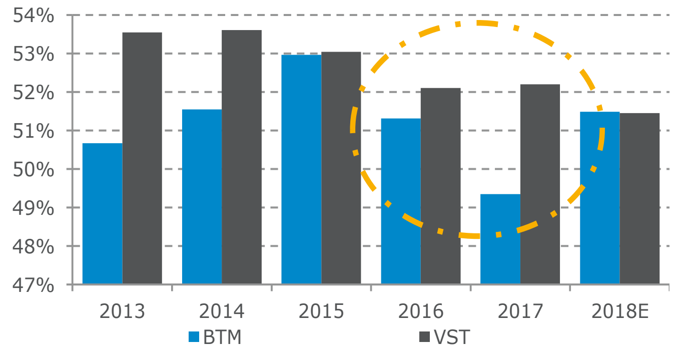
Source: Vistula, Dom Maklerski mBanku

After a due diligence process, followed by talks with financing providers, Vistula expects it could close the acquisitions by the end of Q1 2019. We do not yet factor these deals into our earnings outlook for VRG at this stage. **VRG wants to be an active player in M&A, targeting mainly companies from the women's apparel industry.**

Historical earnings performance, VST vs. BTM

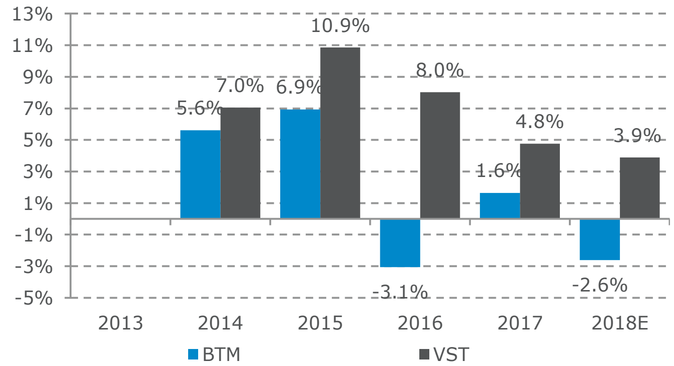
A common factor which shaped the earnings results of both Vistula and Bytom in the 2016-2017 period were **aggressive pricing policies**. In addition, the sales margins of fashion retailers in the period were negatively impacted by the dollar's appreciation vis-à-vis the zloty. Vistula's sales profits are more resilient thanks to a more diversified business, which includes the W.Kruk jewelry brand.

2013-2018E gross margins, Bytom vs. Vistula



Source: Vistula, Bytom, E - estimates by Dom Maklerski mBanku

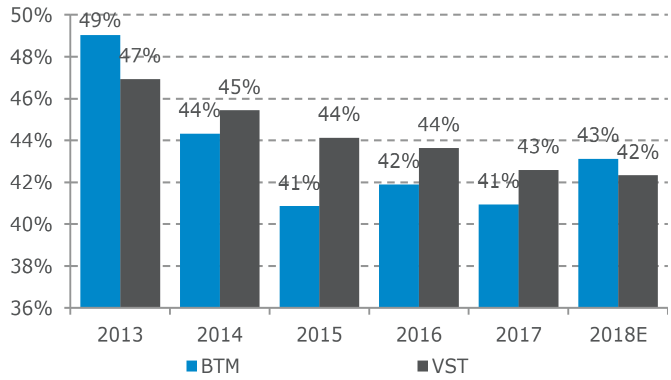
2013-2018E revenues per square meter, BTM vs. VST



Source: Vistula, Bytom, E - estimates by Dom Maklerski mBanku

The reduced sales margins did not correlate directly with like-for-like sales growth at Bytom. Vistula registered consistent growth in revenues per square meter of store area in 2014-2018 owing to a successful marketing strategy and the jewelry business.

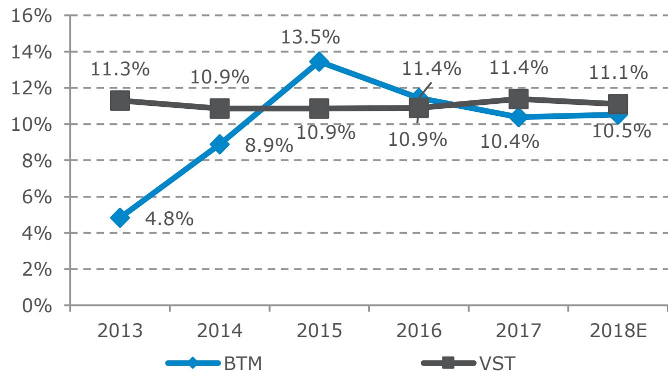
2013-2018E SG&A/Sales ratios, BTM vs. VST



Source: Vistula, Bytom, E - estimates by Dom Maklerski mBanku

Both companies generated high lfl sales in 2015, resulting in reduced SG&A/Sales ratios. Since 2016, despite registering slower lfl growth, Bytom has been able to keep the ratio stable by enforcing tight cost controls, however the cost-containment policy might prove unsustainable in the years ahead given the strong pay pressures observed in Poland.

2013-2018E EBITDA margins, BTM vs. VST



Source: Vistula, Bytom, E - estimates by Dom Maklerski mBanku

By keeping SG&A-to-Sales ratios low, Bytom was able to curb the negative effect of tightening sales margins on EBITDA margins in 2016-2017. At the same time, Vistula was able to grow EBITDA margins in the period in line with improving sales effectiveness. **We believe the merged VRG has potential to attain meaningful gross margin synergy by aligning and maintaining a consistent pricing policy. The synergy potential when it comes to the already-low SG&A/Sales ratio is not as high, especially in the current market environment which may force Bytom to loosen its tight grip on costs in the future.**

Weak sales cloud 2018 Q3 earnings prospects

As fashion brands specializing in business wear for men and jewelry, historically, neither Bytom nor Vistula have shown much sensitivity to weather. This year, however, their usual immunity seems to have been compromised by unseasonably warm temperatures in September and October, resulting in slower-than-expected sales of new fashion lines, which lead us to cut our 2018 EBITDA forecasts for both companies by 13% in case of Vistula and 14% in case of Bytom. In addition, in order to account for the dollar's appreciation versus the zloty, coupled with increasing costs of labor, we revise lower our earnings forecasts for 2019 and 2020, and we make corresponding adjustments to the expected synergy effects.

Revised 2018-2020 forecasts for Vistula

(PLN m)	2018	2019	2020
Revenue	780.2	894.0	968.3
Gross profit	401.4	464.3	505.8
margin (%)	51.5%	51.9%	52.2%
EBIT	69.6	97.4	111.6
EBITDA	86.6	115.4	130.8
margin (%)	11.1%	12.9%	13.5%
Net income	51.1	74.3	86.3

Pct. increase/decrease from original forecast

(%)	2018	2019	2020
Revenue	-2.3%	-0.5%	-2.1%
Gross profit	+11.7%	+11.9%	+8.5%
EBIT	-15.9%	-1.7%	+1.8%
EBITDA	-12.5%	-1.0%	+1.7%
Net income	-16.0%	-0.4%	+3.1%

Source: Forecasts by Dom Maklerski mBanku

The 12.5% reduction in the expected 2018 EBITDA of Vistula, aside from low September and October sales, is led by tighter-than-expected sales margins generated this year. The adjustments made to the forecasts for 2019-2020, in addition to rising payroll expenses and negative FX effects, also factor in additional costs of post-merger integration.

Our updated calculations for Bytom take into account the positive effects of synergies on gross margins in 2018-2020, but assume that the associated growth in EBITDA margins will be curbed by an unavoidable rise in costs.

Revised 2018-2020 forecasts for Bytom

(PLN m)	2018	2019	2020
Revenue	204.7	231.8	247.5
Gross profit	105.4	119.8	128.4
margin (%)	51.5%	51.7%	51.9%
EBIT	15.9	18.2	22.0
EBITDA	21.6	24.0	28.1
margin (%)	10.5%	10.4%	11.4%
Net income	11.2	13.9	16.9

Pct. increase/decrease from original forecast

(%)	2018	2019	2020
Revenue	-4.2%	-4.8%	-5.3%
Gross profit	-2.9%	-0.1%	+1.2%
EBIT	-19.9%	-16.0%	-6.1%
EBITDA	-14.3%	-12.3%	-5.1%
Net income	-30.3%	-20.3%	-10.4%

Source: Forecasts by Dom Maklerski mBanku

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

Recommendations of Dom Maklerski mBanku:
A recommendation is valid for a period of 6-9 months, unless a subsequent recommendation is issued within this period. Expected returns from individual recommendations are as follows:
BUY – we expect that the rate of return from an investment will be at least 15%
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%
Recommendations are updated at least once every nine months.

mBank S.A. with its registered office in Warsaw at Senatorska 18 renders brokerage services in the form of derived organisational unit – Brokerage Office which uses name Dom Maklerski mBanku.

This document has been created and published by Dom Maklerski mBanku. The present report expresses the knowledge as well as opinions of the authors on day the report was prepared. The opinions and estimates contained herein constitute our best judgment at this date and time, and are subject to change without notice. The present report was prepared with due care and attention, observing principles of methodological correctness and objectivity, on the basis of sources available to the public, which Dom Maklerski mBanku S.A. considers reliable, including information published by issuers, shares of which are subject to recommendations. However, Dom Maklerski mBanku S.A., in no case, guarantees the accuracy and completeness of the report, in particular should sources on the basis of which the report was prepared prove to be inaccurate, incomplete or not fully consistent with the facts. mBank S.A. bears no responsibility for investment decisions taken on the basis of the present report or for any damages incurred as a result of investment decisions taken on the basis of the present report.

This document does not constitute an offer or invitation to subscribe for or purchase any financial instruments and neither this document nor anything contained herein shall form the basis of any contract or commitment whatsoever. It is being furnished to you solely for your information and may not be reproduced or redistributed to any other person. This document nor any copy hereof is not to be distributed directly or indirectly in the United States, Australia, Canada or Japan.

Recommendations are based on essential data from the entire history of a company being the subject of a recommendation, with particular emphasis on the period since the previous recommendation. Investing in shares is connected with a number of risks including, but not limited to, the macroeconomic situation of the country, changes in legal regulations as well as changes on commodity markets. Full elimination of these risks is virtually impossible.

It is possible that mBank S.A. in its brokerage activity renders, will render or in the past has rendered services for companies and other entities mentioned in the present report.

mBank S.A. does not rule out offering brokerage services to an issuer of securities being the subject of a recommendation. Information concerning a conflict of interest arising in connection with issuing a recommendation (should such a conflict exist) is located below.

This publication was not transferred to the issuer prior to its publication.

The production of this recommendation was completed on November 8, 2018, 8:40 AM.
This recommendation was first disseminated on November 8, 2018, 8:40 AM.

mBank S.A., its shareholders and employees may hold long or short positions in the issuer's shares or other financial instruments related to the issuer's shares.

Recommendations are addressed to all Clients of Dom Maklerski mBanku.

All investment recommendations and strategies issued by mBank S.A. over the last 12 months are available at:
http://www.mdm.pl/ui-pub/site/market_and_analysis/analysis_and_recommendations/fundamental_analysis/recommendations?recent_filter_active=true&lang=en

The activity of mBank S.A. is subject to the supervision of the Polish Financial Supervision Commission.

Individuals who did not participate in the preparation of recommendations, but had or could have had access to recommendations prior to their publication, are employees of Dom Maklerski mBanku authorised to access the premises in which recommendations are prepared and/or individuals having to access to recommendations based on their corporate roles, other than the analysts mentioned as the authors of the present recommendations.

This publication constitutes investment research within the meaning of Art. 36.1 of Commission Delegated Regulation (EU) 2017/565.

The compensation of the research analysts responsible for preparing investment research is determined independently of and without regard to the compensation of or revenue generated by any other employee of the Bank, including but not limited to any employee whose business interests may reasonably be considered to conflict with the interests of the persons to whom the investment research prepared by the Research Department of Dom Maklerski mBanku is disseminated. With that being said, since one of the factors taken into consideration when determining the compensation of research analysts is the degree of fulfillment of annual financial targets by customer service functions, there is a risk that the adequacy of compensation offered to persons preparing investment research will be questioned by a competent oversight body.

For U.S. persons only: This research report is a product of mBank SA which is the employer of the research analyst(s) who has prepared the research report. The research analyst(s) preparing the research report is/are resident outside the United States (U.S.) and are not associated persons of any U.S. regulated broker-dealer and therefore the analyst(s) is/are not subject to supervision by a U.S. broker-dealer, and is/are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with U.S. rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.
This report is intended for distribution by mBank SA only to "Major Institutional Investors" as defined by Rule 15a-6(b)(4) of the U.S. Securities and Exchange Act, 1934 (the Exchange Act) and interpretations thereof by U.S. Securities and Exchange Commission (SEC) in reliance on Rule 15a 6(a)(2). If the recipient of this report is not a Major Institutional Investor as specified above, then it should not act upon this report and return the same to the sender. Further, this report may not be copied, duplicated and/or transmitted onward to any U.S. person, which is not the Major Institutional Investor.
In reliance on the exemption from registration provided by Rule 15a-6 of the Exchange Act and interpretations thereof by the SEC in order to conduct certain business with Major Institutional Investors, mBank SA has entered into an agreement with a U.S. registered broker-dealer, Cabrera Capital Markets. ("Cabrera"). Transactions in securities discussed in this research report should be effected through Cabrera or another U.S. registered broker dealer.

Strong and weak points of valuation methods used in recommendations:
DCF – acknowledged as the most methodologically correct method of valuation; it consists in discounting financial flows generated by a company; its weak point is the significant susceptibility to a change of forecast assumptions in the model.
Relative – based on a comparison of valuation multipliers of companies from a given sector; simple in construction, reflects the current state of the market better than DCF; weak points include substantial variability (fluctuations together with market indices) as well as difficulty in the selection of the group of comparable companies.
Economic profits – discounting of future economic profits; the weak point is high sensitivity to changes in the assumptions made in the valuation model.
Discounted Dividends (DDM) – discounting of future dividends; the weak point is high sensitivity to changes in the assumptions as to future dividends made in the valuation model.
NAV - valuation based on equity value, one of the most frequently used method in case of developing companies; the weak point of the method is that it does not factor in future changes in revenue/profits of a company.

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

recommendation	overweight	overweight	overweight
date issued	2018-11-08	2018-05-23	2017-11-28
target price (PLN)	-	-	-
price on issue date	2.68	2.92	2.50

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

recommendation	overweight	overweight	neutral	overweight	neutral	overweight
date issued	2018-11-08	2018-05-23	2018-02-02	2018-01-19	2017-12-13	2017-11-28
target price (PLN)	-	-	-	-	-	-
price on issue date	4.06	4.79	5.16	4.34	4.36	3.88

mBank.pl

Dom Maklerski mBanku
Senatorska 18
00-082 Warszawa
http://www.mbank.pl/

Research Department

Kamil Kliszcz
director
+48 22 438 24 02
kamil.kliszcz@mbank.pl
energy, power generation

Michał Marczak
+48 22 438 24 01
michal.marczak@mbank.pl
strategy

Michał Konarski
+48 22 438 24 05
michal.konarski@mbank.pl
banks, financials

Jakub Szkopek
+48 22 438 24 03
jakub.szkopek@mbank.pl
industrials, chemicals, metals

Paweł Szpigiel
+48 22 438 24 06
pawel.szpigiel@mbank.pl
media, IT, telco

Piotr Zybała
+48 22 438 24 04
piotr.zybala@mbank.pl
construction, real-estate development

Piotr Bogusz
+48 22 438 24 08
piotr.bogusz@mbank.pl
retail

Sales and Trading

Traders

Piotr Gawron
director
+48 22 697 48 95
piotr.gawron@mbank.pl

Krzysztof Bodek
+48 22 697 48 89
krzysztof.bodek@mbank.pl

Tomasz Jakubiec
+48 22 697 47 31
tomasz.jakubiec@mbank.pl

Jędrzej Łukomski
+48 22 697 49 85
jedrzej.lukomski@mbank.pl

Adam Prokop
+48 22 697 47 90
adam.prokop@mbank.pl

Szymon Kubka, CFA, PRM
+48 22 697 48 54
szymon.kubka@mbank.pl

Andrzej Sychowski
+48 22 697 48 46
andrzej.sychowski@mbank.pl

Tomasz Galanciak
+48 22 697 49 68
tomasz.galanciak@mbank.pl

Magdalena Bernacik
+48 22 697 47 35
magdalena.bernacik@mbank.pl

Sales, Foreign Markets

Marzena Łempicka-Wilim
deputy director
+48 22 697 48 82
marzena.lempicka@mbank.pl

Bartosz Orzechowski
+48 22 697 48 47
bartosz.orzechowski@mbank.pl

Private Client Sales

Kamil Szymański
director
+48 22 697 47 06
kamil.szymanski@mbank.pl

Jarosław Banasiak
deputy director
+48 22 697 48 70
jaroslaw.banasiak@mbank.pl