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The new bond issue from The Warehouse is not as 'safe' as it may first appear.

The Warehouse is marketing a NZD\$100 million senior bond issue to retail investors at an interest rate of 7.30%. This is the first time the company has issued bonds to the public and the proceeds of the issue are being used to partially refinance existing bank debt and to go towards general corporate purposes.

At first glance it appears The Warehouse maintains a very strong credit profile. The company currently has bank debt of just \$100 million and they are looking to raise an additional \$100 million via the bond issue.

When compared to the company's annual revenue of \$1.7 billion and earnings before interest, tax, depreciation, amortisation and financing (ebitdaf) of approximately \$166 million, the debt levels are low. Debt to earnings (debt/ebitdaf) stands at 1.2 times while the company's interest coverage (ebitdaf/interest) is an impressive 18.9 times.

However, a number of commentators have taken these numbers at face value without digging deeper and there are other issues that need to be considered to get the whole picture on The Warehouse.

A number of years ago The Warehouse made the decision to free up shareholder capital by selling many of their properties and leasing them back off the purchasers. As a result of these transactions the company now pays approximately \$60 million per annum to lease the majority of their iconic 'red sheds'. They are obligated to pay this amount for the next six to eight years (an approximate average lease term).

Effectively, the lease commitments are an alternative form of debt and as such the company's debt level needs to be adjusted accordingly. To adjust the debt the leases need to be capitalised at a multiple of 6 to 8 times. At the more conservative 8 times, which is the multiple used by the Warehouse, this implies that the leases are equivalent to an additional \$465 million of debt. This takes total debt from \$200 million to a sizable \$685 million.

This has a large impact on the company's credit metrics with the debt to earnings measure (or debt/ebitdaf) more than doubling from 1.2 times to 3 times. Equally the

company's interest coverage (or ebitdaf/interest) declines from the impressive 18.9 times to a merely robust 4.8 times.

A measure of 3 times debt to ebitdaf is moderately high for a retailer who by the very nature of their business faces an uncertain earnings profile. Consequently the company is a riskier investment than it initially appears and the yield on the bonds needs to appropriately compensate investors for the level of risk being taken.

This does not make The Warehouse a bad credit. It is a strong business with a great franchise but what The Warehouse bond issue does highlight is the need for, and value of, a rigorous credit analysis process. This is a very good example of why thorough due diligence is required for all bond investments, even those issued by recognisable household names.

THE WAREHOUSE PRICE



THE WAREHOUSE RELATIVE TO NZ SHARES



For further information please contact:



Mark Brooks Ph: 09 377 2277
Principal and Head of Income
New Zealand Funds Management

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