OPINION

Confusion over Warehouse bond issue

By JENNY RUTH

THE WAREHOUSE Group's proposed $100 million bond issue has many in the markets scratching their heads.

The discount retailer's balance sheet is extremely conservative: gearing at August 2 last year was just 23.7% and earnings covered its interest bill 18.3 times. Total bank borrowings were $100 million and the company had $52.8m in cash on the other side of the ledger. Equity was $321.1m.

The reasons The Warehouse has given for the issue are wide enough to drive a truck through and clarified little: it "intends to use the proceeds from the offer for its general corporate purposes, which may include redeeming existing debt, extending the tenor [duration] of its debt, placing funds on deposit, advancing monies to, or making an investment in, a member of the group, acquiring a new member of the group or funding a return of capital.

> 'They need to work out where their competitive advantage is.'

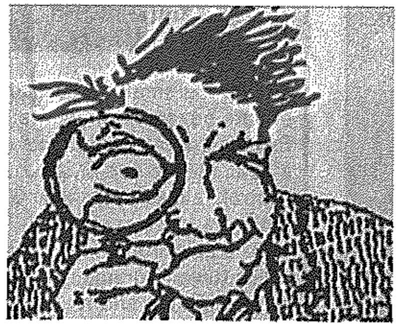
"The bond issue will be for a five year term and it's common knowledge banks aren't willing to lend to corporates for any more than three years at the moment."

However, The Warehouse has very strong cashflow, $194.5m from operations in the year ended August 2, and turns over its stock more than six times a year, so you have to wonder why it needs five-year debt.

The bond issue "didn't stack up", says Rickey Ward, equities manager at Tyndall Investment Management. "The market couldn't quite understand why you would want to do it."

Having such a bond issue isn't a bad thing but the market would like more of an explanation, Ward says.

Since The Warehouse is planning a



THE ANALYST

series of investor presentations around the country next month after it announces its first-half results, it may explain them.

One possibility is the retailer has an acquisition in its sights, although most observers think this is unlikely.

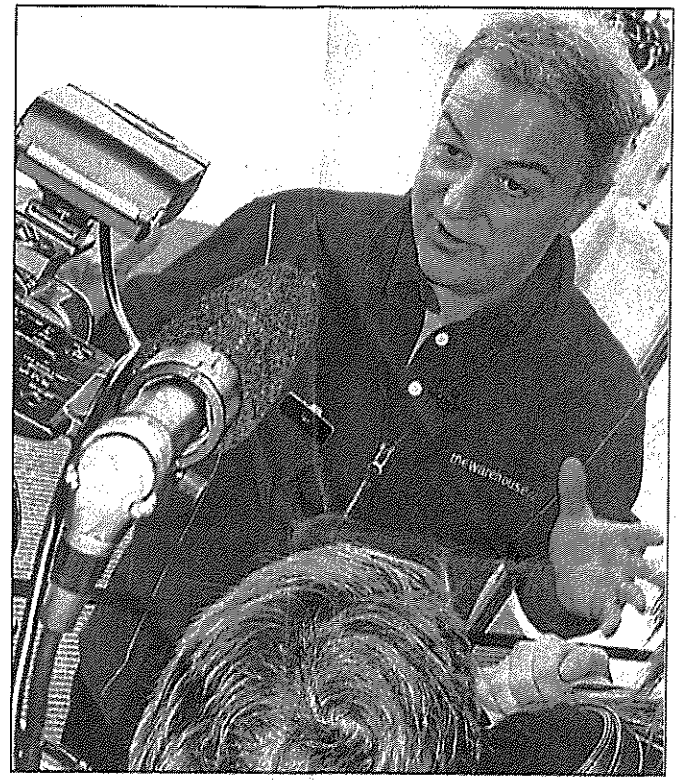
"They've been looking at acquisitions constantly for the last four years and haven't found anything they would want to buy at a price they would be prepared to pay," says one analyst.

Guy Hallwright, an analyst at Forsyth Barr, says he doubts the company has any appetite for an acquisition at the moment. "I don't think there's any appetite from shareholders either."

The Warehouse's last acquisition in Australia was disastrous, its exit costing the company $88.8m before tax in 2006.

Craig Brown at ING Funds Management says he'd never want any company to completely rule out acquisitions. "If they could show us they had found something value-adding and had a good story around it, we would have to listen."

The Warehouse is planning to update investors on its strategy during next month's roadshow and investors will be listening closely for any change from the company's strategy of the last three years or

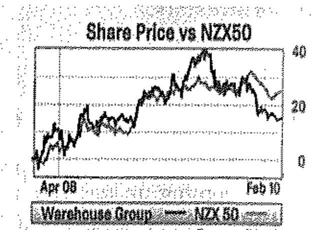


Ian Morrice opening the Mosgiel store.

Photo: Southland Times

THE WAREHOUSE GROUP

Market capitalisation: $1.17 billion
Managing director: Ian Morrice
Revenue: $1.72 billion
Net profit: $76.8 million
Annual dividend: 31c



more of gradually moving its stores more upmarket.

Certainly, at the annual shareholders's meeting last November, chief executive Ian Morrice was still elaborating on that strategy, talking about the company's expanding jewellery offering.

"We're now starting to see customers quite comfortable to spend $500 to $1000 a time on quality jewellery at The Warehouse," he said.

He also talked about moving up from the sub-$30 a pair shoe category to price points between $30 and $60, as well as trying in the manchester area to sell customers a complete package of bedding rather than single items.

However, The Warehouse went on to have a disappointing Christmas, announcing early January sales had been flat in the nine weeks ended January 3. "We believe that our sales are indicative of the broader non-food retail market overall," the company said then.

But the retail sales figures for the December quarter, released earlier this month, didn't back up that view. Department store sales for the quarter were up 2.8% by value and "other retailing", which includes jewellery, flowers, antiques and used goods and garden stores, saw sales rise 6.4%.

The problem for The Warehouse is its traditional place in the market of being the cheapest seller is being eaten into by a wide range of specialist retailers ranging from JB HiFi and Harvey Norman through to Bunnings and Mitre 10 Mega.

And in the upmarket space it is aiming for are well-established players such as Farmers, Michael Hill International and Pascoes – Michael Hill's New Zealand sales were up 5.5% in the six months ended December.

So it's small wonder The Warehouse's shares have tumbled from $4.21 ahead of the post-Christmas update to as low as $3.71 last week.

"They need to work out where their competitive advantage is," says ING's Brown. "That footprint they've got has got to be worth something."

Nick Dravitzky, whose portfolio concentrates on yield, is one of the stock's few fans. With the shares at current levels, the cash yield is nearly 6% and the gross yield about 8.5%, he says. Despite its disappointing Christmas, The Warehouse's fortunes are very much tied to the improving economy and its last results were already showing signs of margins improving, Dravitzky says.

■ Jenny Ruth is a freelance financial journalist and a columnist for *The Independent*.