

Dunelm
Interim Results | Video Webcast
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Transcript



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Nick Wilkinson:

Good morning and welcome to the Dunelm Interim Presentation covering the first half of our financial year. My name is Nick Wilkinson, and Karen Witts and I are delighted to welcome you to the offices of Peel Hunt in London. Whether you are here in person, or joining virtually, I hope you are well and feel connected to us, and to the continuing story of Dunelm.

Into that story please welcome... Alison Brittain. Our Chair since January, a customer for much longer, Alison has spent the last six months getting to know the business and its colleagues. I'm thrilled to have Alison in the Dunelm team.

Those of you who attended the IPO roadshows 17 years ago may recall that they featured a number of Dunelm product samples. And today in the room we have some more – this time of our most circular product range yet. These summer weight throws are made using second-life textiles, including those that our customers have placed into our very own instore take back scheme. Please do take one home with you today, and post a product review online.

At heart we are a product company. So before we get into the financial highlights I thought for once we'd do something different this morning and start with a short video of some of our latest product introductions. This was filmed in Somerset House, at an event for press and influencers, in November, and you'll be shown around by our Design Director, Debbie Drake.

I know some of you managed to attend that event, and we'll do some more if you missed it. I hope you enjoyed the video.

Of course there's more to our plans than product, but it all begins with product.

So here's our running order for this morning. I'll get us started. Karen will then take you through the first half financials and how we are navigating the current economic climate. And then I'll be back to talk about our plans for growth, and for seizing the opportunities which we see ahead of us.

Onwards

So, a strong first half. In a period of low consumer confidence, and up against tough comparables from the prior year, we're really pleased with performance. A particularly strong Q2 for sales, good gross margin and excellent operating cost ratios throughout the half, resulting in profit before tax of £117m and high FCF conversion. Another standout is the strong market share performance, which is a calendar year number. We've announced an interim dividend and a special today of 55p in total.

We'll share more detail with you to help you understand the moving parts, but in essence what happened, we think, is pretty simple.

Firstly we grew. How. Well, what we are seeing is consumers working hard to find ways to balance their budgets. They want to be smart and savvy, they don't want to waste money, they want to feel in control. How they do that is very personal to them – their preferences and circumstances. Into this market we were able to offer a wide choice of relevant products, outstanding value at all quality tiers, and we strove to communicate as an ally - helping customers find what's right for them, and not putting them under pressure.

In the pictures, some examples. Warmer weight bedding and door curtains to save on home heating. Batch cooking and food storage to save on waste. Gifts and treats that are practical, from onesies to hot water bottles. Products to make homes feel cosier, like rugs and lighting. We're still selling 'winter warm' products now as we come into Spring to help people save on heating, but that's in addition to our normal spring and summer collections and campaigns.

As a result of all this we've continued to see growth in terms of our customer runway. More active customers and increased shopping frequency. On the right you can see almost 6% growth YoY in the last 12 months for active customers, with shopping frequency also growing, by about 5%.

So if that's how we grew, we were also resilient.

We often talk about operational grip being a driver of our performance. That's never been more true.

Obviously the big challenge we've faced into has been how best to manage inflation in our cost of goods while offering outstanding value to our customers at a time when they need it most. It's detailed work, but we keep it simple with clear frameworks like our good/better/best tiers. Being simple allows us to put our energy into innovation and adapting quickly. Innovation and adapting is fun, and turns a challenge into an opportunity.

Of course, it's easier to have fun when you feel that your operating model is a strong one. Our brand has broad appeal and our audience of home-lovers is engaged in our content, even when they need to budget carefully. Added to this, our product offer is largely own brand and exclusive, and we cherish our long standing supplier relationships. And in a half when both our store and digital channels performed well, we benefit from not just a low cost store portfolio but now a cost-effective total retail system.

But of all the factors behind our resilience, the greatest is the quality of my colleagues and the values we all share. And whilst, as a company, we do many good things to support our colleague's financial well-being, our colleagues do even more to help the communities in which they work. Our Delivery Joy campaign supported 550 local causes this Christmas. This work builds our brand, and it makes us stronger and therefore more resilient as an organisation. For this, and for all the other work they do, thank you to my Dunelm colleagues. Our

good performance is a testament to their hard work, commitment and resilience.

And now to give you more insight into our performance, I'm delighted to hand over to Karen.

Karen Witts:

Thanks Nick and good morning everybody. It's great to see you here again - and also good morning to our virtual audience.

Let's start with a summary of our financial results.

As Nick said, we are really pleased to be reporting a strong set of half year results.

I'll go through the various elements of performance in more detail, but at headline level, we delivered £835m sales in the first half of FY 23. That was 5% more than in the prior year, against a strong set of comparatives. Nick has described what supported the sales growth - choice, relevance, and outstanding value – at every price point.

Our Gross Margin was a healthy 51.1%, and was consistent with our expectation of delivering a full year gross margin of around 50% - because the second half of the year, with its two periods of Sale, typically has a lower gross margin rate than the first half.

The gross margin rate was 170bps lower than last year. We expected that as we reverted to a more typical sales calendar, with bigger sale events and higher customer participation in Sale offers, than we saw during the pandemic.

We talk about tight operational grip, and that's what kept operating costs under control, even in an inflationary environment. Our operating cost to sales ratio last year was very low as strong sales from newly reopened stores delivered particularly strong operating leverage. Nevertheless, our H1 cost to sales ratio of less than 37% helps to show our focus on Making Every Pound Count.

All of that resulted in Profit Before Tax of £117m, £23m lower than the same period last year.

Reflecting the PBT outcome, diluted EPS of 45.8p was 17.3% lower year on year.

Our free cash-flow conversion was strong at 84%, versus 74% in the prior year; we delivered £102m of Free Cash Flow, ending the Half with net cash of £18m.

This year, the Board has declared an interim dividend of 15p per share – an increase of 7.1% year on year, reflecting our strong financial performance and our confidence in future growth.

And with our strong cash generation, healthy balance sheet, and an ongoing commitment to our published capital policy, the Board has also decided to pay a special dividend of 40p per share. So let's now get into more detail on these numbers.

Starting with sales and market share gains.

Total sales for the 26-week period to 31 December 2022 increased by 5% to £835m. Compared to FY20, which was the last fully comparable period, total sales have grown by 43%.

Just to note, in the half, the YoY growth rate did include a benefit of about 2ppts from the timing of our Winter Sale, 6 days of which fell into quarter two – so this impact will reverse in H2.

We saw growth both in stores and online, with digital sales now making up 34% of total sales, up 14ppts since the first half of FY20.

Digital sales growth was particularly strong in the late Autumn and run-up to Christmas, reflecting a very relevant product range and continued focus on outstanding value for money, at a time when customers were facing high inflationary pressures.

We saw broad-based growth across categories. As well as the products Nick has commented on, we saw good sell through of our Christmas lines, and a wide range of impulse buys like candles. Our make and mend and haberdashery categories have also performed well as customers think about repairing and upcycling.

As Nick said, the homewares market share benchmarks from GlobalData reference the calendar year, and in calendar year 2022, while the homewares market declined by around 2%, we reported good growth, with our market share increasing by 160bps to 10.8%. We also gained share in the furniture market, albeit from a smaller base.

And now onto Gross margin.

We delivered a Gross margin of 51.1% which was in line with our expectation that it would reduce from a temporarily higher level during the pandemic period, and it was therefore 170bps lower than H1 FY22.

This included a modest gross margin headwind of about 30bps from the timing of our Winter Sale. We plan our purchasing around two seasons a year, giving ourselves good forward visibility of input costs including for freight and foreign exchange, which alongside product innovation and category level pricing decisions gives us confidence in achieving our planned gross margin rates.

Looking ahead, we expect H2 gross margin to be lower than H1 due to the impact of the two Sale events in the second half and therefore our full year gross margin expectation is still in line with our previous guidance of around 50%.

When it comes to Operating costs

We have a culture of Operational Grip and of Making every pound count. Total operating costs in H1 were £305m, representing an operating cost ratio of 36.6%. The operating cost ratio benefitted from the timing of the Winter Sale in quarter two, which increased sales in the half with relatively little additional operating cost. The prior year operating cost: to sales ratio was also low, reflecting exceptionally strong sales, particularly in stores.

Inflationary pressures, mainly on wages, increased operating costs by around £8m net. We worked hard to mitigate the impact of these increases through operational efficiencies in stores and in our supply chain.

In H1, we saw £6m of investment associated with 3 new store openings and the annualisation of the new supply chain sites which became operational in the second half of FY22.

Meanwhile, supporting the ongoing digitalisation of the business, we invested a further £11m building capability. We are realising the benefits of these investments through our sales growth and through better data management, leading to better insights – Nick will provide more colour on this.

As a reminder, our investment in technology is predominantly expensed through the P&L and has been managed within our tightly controlled cost to sales ratio.

The last year of impact of the withdrawal of business rates relief, introduced in response to the pandemic, increased operating costs by £3m in H1.

We expect to see some further inflationary cost pressures in the second half, mainly driven by wages. And we will continue to invest in our digitalisation plans.

These increases will be partly offset by continuing to remove the costs that we described last year as temporary, which related to our new supply chain operations and higher stockholding. Some of those reductions started to come through in H1.

The next slide covers interest, tax and eps.

Net finance costs of £4m included interest on IFRS 16 lease liabilities of £3m. That was very similar to last year. The year on year increase primarily related to

foreign exchange gains on the revaluation of USD balances last year, which did not recur this year.

Profit before tax in the period was £117m, compared with £141m in the same period last year and profit after tax of £93m reflected an effective tax rate of 20.8%. The increase in the effective tax rate is broadly in line with the increase in the UK headline rate of corporation tax, effective from April 2023, but spread across the financial year.

As a reminder, our effective tax rate is typically slightly higher than the UK headline rate due to the usual disallowable expenses.

Basic earnings per share for the period were 46.1 pence, compared with 55.9 pence in H1 FY22. Diluted earnings per share were 45.8 pence, compared with 55.4 pence in the same period last year.

Moving onto cash generation.

The Group generated £102m of free cash flow in the half year, with a strong cash conversion of operating profit to free cash flow of 84%, higher than the 74% in the prior period.

The improvement primarily related to the working capital position. There was a very small working capital outflow of just under £2m in the period, whereas the prior year outflow of £21m reflected the decision to increase our inventories to mitigate against the risk of supply chain disruption.

Inventories at the end of the period were £233m (compared with £223m at the end of FY22). We still expect inventory levels to reduce during H2. In the meantime, we are comfortable with the quality of our stock. Just to remind you, our stock is largely continuity product with good sell through; we carry over very little seasonal stock; and we have a relatively small amount of range change in any year.

Total capital investment in these first 6 months of the year was £12.5m. This included around £10m spent on the three new stores opened in the period, as well as refits of seven existing stores, and store decarbonization initiatives.

Cash tax paid of £18m was £3m higher than the same period last year as that period included R&D credits received in relation to FY21 claims.

And in the period, the Group spent £7m purchasing shares to be held in treasury to satisfy future obligations under its employee share schemes.

After total dividend payments in the period of £52m, relating to the final dividend declared for FY22, the Group ended the first half with net cash of £18m.

We believe that our straightforward capital allocation framework helps to deliver attractive shareholder returns.

Over the last 10 years, we have returned around £1bn to shareholders in the form of ordinary and special dividends, with an ordinary dividend compound annual growth rate of 11%.

This half year, reflecting the strong performance to date and confidence in our prospects, the Board has declared an interim ordinary dividend of 15 pence per share, 7.1% higher than last year's interim dividend.

Our strong cash generation in the period has also enabled the Board to declare a special dividend of 40 pence per share, which will return the Group to within its target leverage range of 0.2 to 0.6 times net debt to EBITDA.

Finally, I'd like to reiterate our FY23 guidance.

We are all still adapting to a new economic reality, and it's not clear how consumers will respond to continued inflationary pressures in the coming months.

However, from the input cost visibility that we have we continue to expect a gross margin of c50% for the full year.

We are anticipating some further inflation within operating costs, particularly given the increase in the National Living Wage in April. We will also continue with our digitalisation plans, which Nick will describe in more detail. We expect these increases to be partly offset by lower stock holding costs as we reduce our inventory levels.

We still expect a modest working capital benefit as inventory levels normalise.

We now expect capex for the year of £20-25m, depending on the timing of new store openings.

And our effective tax rate will be slightly above the headline rate for FY23, incorporating the new rate of corporation tax.

Overall our Profit Before Tax expectations for the full year are unchanged

Thanks so much for your attention. And with that, I will hand back to Nick to continue our update.

Nick Wilkinson:

Thank you, Karen. So how are our plans evolving post pandemic, how much opportunity do we see, and how are we going to seize it.

Let's start by saying that we see a very significant market share runway ahead. Dunelm operates in the large and fragmented markets of homewares and furniture. These markets break down further into a significant number of product categories, often with different and fragmented competitors in each. The combined market size is about £23bn, with our share of this total market being about 7%.

In this graphic we've indicated our current Global Data market share in the approximately 15 categories they report on, covering about 80% of our total sales. It excludes some of our seasonal ranges, and it excludes rugs which is classified in the floorcoverings market rather than homewares or furniture markets.

On the right, in dark green, with higher market shares tend to be our longer-established categories, such as ready-made curtains, and blinds and bedding. These categories account for a third of the market.

In the remaining categories our shares are below 5%, and for simplicity we've put all the furniture categories which we participate in together. Typically in these categories we find ourselves at a relatively early stage of maturity in terms of our product capability, so as we develop more of what we call product mastery, alongside our suppliers, we start to grow.

There is significant growth opportunity across the runway. We have never been more confident about our ability to grow our total share beyond 7% in aggregate, as well as our share in each of these categories. Indeed, our highest rates of category growth are evenly spread across all four tiers shown here.

Our approach to growth along this runway is entrepreneurial. As we learn we invest and build, which in turn opens up new opportunities to learn and invest again.

We call this our plan to become our customers' 1st choice for home. Our purpose, ambitions and shared values are constants, and I hope are familiar to you.

Our priorities are evolving as we start to understand some of the key dynamics we are seeing. We are strengthening our customer offer, particularly in the areas of choice and value.

We are still digitalising our business, but entering a new phase of this. And we are developing our marketing ecosystem.

This is an update on our thinking and of progress on our plans, and I'll pull out the 'so what's' as we go.

In terms of product the 'so what' is that never before have so many consumers been re-evaluating their spending and shopping habits. Its volatile, but also filled with opportunity. Our insight is that our customers are working hard to be savvy, and many feel like they are doing it pretty well. In our categories they are not trading down quality tiers so much as being more demanding on what they get for their money at all quality tiers.

That means there's never been a better opportunity to win on value. The sideboard in the picture is a lower priced alternative, launching this Spring, to a best selling line, but at a significant saving because it requires self assembly.

Doing this, making products that are self assembly, and are beautiful and high quality at the lowest price good tier requires product mastery – deep knowledge of customers, sources, materials and production. We're building more of that into our furniture capabilities, though still with a way to go, and products like this are the result of it.

Mastering the science of sustainability also gives us scope to win new customers. Our conscious choice collection now runs to 7,000 items. With strict criteria for inclusion, typically over 50% by weight sourced from more sustainable materials, it is priced to be affordable. The throws I talked about earlier are part of a range of over 20 brightly coloured cushions and throws priced from £5 to £35 made from post-consumer products, including those generated from our take back schemes in store.

And finally, we are also offering more choice. Adding more curated choice from trusted suppliers, typically in product categories where we have less in-house product mastery. This allows us to more quickly test new product and increase the choice available to customers, introducing almost 10,000 more lines in the half.

As you know we have been focused on investing in technology for a number of years now. We've talked about this through examples in the past, but we'd like to share a clearer overview, and pull it all together and also share with you that we think we're entering a new phase. 'Digitalising the total business' to us means not just digital experiences on Dunelm.com, but the wider introduction of technology across the whole business and the use of the data that this generates to improve our proposition and operational efficiency. Initially the business was seeking to catch up. In 2018 Dunelm's digital sales were less than 15% of our total sales, and we still talked about the website as our biggest shop.

We then worked hard to launch our own digital front end in the Autumn of 2019, gaining confidence in investing in technology as we went.

In 2020, at the same time as the pandemic, we scaled up significantly, and created 5 focus areas which we've run with consistently since then, setting up product management skills, roadmaps and engineering crews across each of

them. I'll now run through the key things we've been working on in each of those areas.

Data & Insight is an over-arching focus on building the data platform, now live, tools, definitions, reports and data skills to manage data across the business. We are focused on a single customer view, an enriched view of network stock, and a conformed view of product attributes across the business.

Commercial operations is a focus area creating key new capabilities in product data management, and forecasting and replenishment. In essence these are capabilities that are supplanting processes which we do in our SAP systems or manually by our commercial team. SAP will still continue to operate as our central system of record, but we are putting more functionality into more advanced tools alongside it where we see benefit.

Customer marketing is a focus area that has developed our single customer-view and the marketing tech stack to manage audiences and content distribution.

Shopping experience covers the site and our stores, developing new payment services and all the devices in store used by colleagues. We are also building out a more complete shopping experience online, particularly in higher service categories like Made to Measure curtains and blinds.

Post sale experience is focused on the quality and efficiency of our delivery and support services, as well as warehouse operations.

The stage we've now reached, and we're excited about this, is that we are starting to now leverage what we have built to improve our customer proposition and productivity. We'll continue to build out new capabilities too so this stage we're calling building and optimising.

What I've described isn't a map of our technology, or its architecture. I haven't covered the ongoing work we do to develop our serverless cloud platforms and operations, or the development of our core SAP systems. But it does give you a sense of how we think about technology. We learn and we invest as we understand more, but we are also disciplined. It's as important to us that our total retail system is cost effective, as it is that it is fully formed and fit for the future.

As I said we are starting to unlock the improvements to our customer proposition and productivity from these sorts of investments.

I've listed 12 here, half done and half in progress, half driving growth and half driving efficiency.

A couple of examples to bring this to life.

We are focused on improving our perfect order rates in home delivery, measured in terms of lead times, service levels, and the quality of customer communication, and having fewer split deliveries. Over the next 12 months we'll get to our goal for where we want to be for customers, but already we are seeing the benefit of improved order tracking reducing post sale contacts, and reducing costs from fewer split deliveries.

We are making better data-informed decisions to flex store space and range to the market opportunity of each catchment. This in turn is opening up a wider playbook of store sizes that we will consider in target catchments. The store pictured earlier, which is in Feltham at 15k sq ft, sales space is half the size of a typical out of town store, and opened in December. We'll be opening a greater variety of store sizes going forward.

And, bottom right, we are about to leverage the customer platform we've been building to offer more personalised marketing activations, experiences and content.

We've come a long way on marketing over the years, but see a lot more scope to develop further. On the right you can see a picture of our customer data platform. We've now matched 5 years of customer profiles across our channels, and combined this with digital journey data, and delivery and product review data. In the coming months we'll add customer demographics and marketing engagement. By the summer we'll further improve the quality of matching of customer profiles by moving our payment service provider in stores to the same one we use online. When we do this we'll get another a key identifier to allow us to better match cross-channel customer transactions in the form of tokenised card details, and we'll be able to back date this matching for two years. We've recently built a predictive churn model from the customer data platform, which is running an automated lifecycle email campaign to reduce lapsing. More personalised content will be coming into play in the next 12 months, giving us both a better customer experiences and more cost-effective digital marketing. Indeed, having a cost-effective marketing ecosystem is a goal we've been nurturing for a while. Without an enormous product catalogue it used to feel hard to achieve, but we are excited by what we're doing, and what we've seen in our paid marketing returns in the first half.

The combination of a national brand, effective digital marketing and the growing followership of our store-based community work we see now as a key advantage - especially when combined, for our audience, with unique product content across multiple home categories So having begun this section with a picture of a market share runway, we are now talking about our customer runway – meaning more active customers and a higher shopping frequency as we become the 1st choice for home for more of them. Our own data platform and personalisation is a significant enabler of attracting and developing more of those most valuable multi-category customers that we've talked to you about in the past. You may recall that they shop 5 times as frequently, and spend 7 times as much as an average customer, in a year.

So, I've run through some examples of the work we are doing on our offer, our technology plans and our marketing. I hope you see why we are so confident about the future. But let's end by returning to what we've already achieved this year.

Namely further growth in customer numbers, frequency and market share and therefore sales with very resilient margins. And for those of you who like to be even more up to date, we've also had a strong Winter Sale.

Looking forward, our expectations for full year profit remain unchanged. We've seen our customers be resilient to date, but the consumer outlook remains unpredictable, and we will be taking nothing for granted. We see so much opportunity to build sustainable and profitable growth and we are very excited about the runway we are on.