5iResearch

5i Opinion

LEON'S FURNITURE LTD.

B+

COMPANY REPORT

HIGHLIGHTS

- eCommerce growth has been sticky
- Strong growing top-line sales
- Buyback program improves valuation
- Inventory levels rising

October 18, 2022

Traded as: TSX: LNF
Price:
Dividend:
Debt:
Market Cap:
Beta:

REPORT CARD

INDUSTRIE	RETAIL	
METRIC	**VALUE**	**GRADE**
Expected 1 Year Revenue Growth	3.32%	B-
5 Yr. Revenue Growth	3.23%	B-
5 Yr. EPS Growth	20.15%	A
5 Yr. ROE	15.80%	A-
Gross Margin	43.80%	A+
Net Margin	7.70%	B
Current Ratio	1.2x	B
Debt/Equity	0.7x	B
Insider Ownership	71.30%	A+
5 Yr. Dividend Growth	9.86%	C/C-
Qualitative	Slow but steady growth, has shown resilence	B
Rating		B+

COMPANY PROFILE

Leon's Furniture Ltd. (TSX: LNF) is a Canadian retailer of home furnishings, mattresses, appliances, and electronics in Canada. The company also operates as a commercial retailer of appliances to builders, developers, renovators, hotels, and property management companies. Additionally, LNF offers household furniture, electronics and appliance repair services, supports warranty service work, and offers credit insurance products. The retail banners under LNF include Leon's, The Brick, Brick Outlet, and The Brick Mattress Store, and the Brick's Midnorthern Appliance and Appliance Canada banners, as well as websites including leons.ca, thebrick.com, furniture.ca, transglobalservice.com and appliancecanada.com. The company has 306 retail stores in Canada, across all provinces. The controlling interest in the company is owned by the Leon family.

REVENUE MIX

LNF engages in retail operations under brands including Leon's Furniture and The Brick, commercial sales, eCommerce division, Trans Global Services, the company's repair service division, credit insurance services, and extended warranty programs on appliances, electronics, and furniture. While top-line sales took a small dip earlier during the pandemic, LNF has done fairly well growing revenues on the back of digital improvement. Margins have improved significantly over the pre-pandemic years. An important point to note is that its inventory levels have been rising sharply, at a rate faster than its peers, and in conjunction with a longer turnover period, thus indicating slowing unit sales. While this might be a cause for concern, we think there might be some margin pressures in the near term.

GROWTH PLANS

LNF has completed the transformation to an omnichannel retailer creating a singular, cohesive shopping experience across all platforms (both online and brick and mortar), which has been central to the company's strategy for several years. As a growing number of customers chose to complete their purchases online over the past few years, management has invested in the IT infrastructure required to manage significantly higher volumes. The eCommerce stores are now fully integrated with nationwide fulfillment and distribution platform, and financing, insurance, warranty, and after-sales services are available to all shoppers. Additionally, to expand into mid-sized markets, LNF's retail network now includes a number of smaller-scale stores, wherein a store may occupy 15,000 square feet rather than the more traditional 35,000-to-50,000 square feet locations. At the start of 2021, LNF opened a new distribution center in Dartmouth, Nova Scotia, which will support the expected growth in Atlantic Canada. Furthermore, management has noted a continued focus on eCommerce. The digital platform is a key component to allowing the company to attract new customers as they begin their shopping experience online and then continue in store to be assisted by sales associates. Despite the retail stores being open, the increase in eCommerce-initiated sales has been sticky. Although it is difficult to gauge future consumer confidence and the impact on retail, looking forward, management is cautiously optimistic on sales and profitability growth, and rightfully so. A report by IBIS world forecasts an increase of only 0.6% in the market size of the Home Furnishings Store industry in 2022, and a decline of 1.2% per year on average between 2017 and 2022. The biggest opportunity for the industry comes from housing sales. As per CREA (Canadian Real Estate Association), every home sale is believed to generate $6,500 worth of furniture, mattress, and appliance sales over the three years immediately after closing. The CREA has forecasted a decline in sales by more than 57,000 units in 2022, followed by another 14,500 units next years, dampening overall sentiment for the industry.

VALUATION

For the second quarter of 2022, LNF reported record sales, same store sales growth of 10% and a strong beat across the board. Earnings per share came in nearly 80% better than estimates. The company has been getting many things right such as the digital shift, omnichannel focus, and warehouse positioning. Additionally, share buyback and a solid and growing dividend has strengthened its thesis. With shares down nearly 30% over the past year, valuations have shrunk from trading at 0.7x forward sales for much of 2020 and 2021 to 0.4x currently. At 7x forward earnings, the stock can be considered very cheap, and we think much of the discount is driven by weaker economic outlook and inflation. Management has stayed on top of changing trends, and an improvement in its infrastructure has driven sales. The growth in the eCommerce business has been the forefront of LNF's growth and has been sticky. With a strong labor market in Canada, Leon's brand equity and a decent balance sheet, this is not a stock we worry about much.

RECENT FINANCIAL RESULTS

For the second quarter of 2022, LNF's revenue came in at $647 million compared to $588.5 million in the second quarter of 2021, beating market expectations of $502.0 million. The increase was driven by a strong performance in all key product categories, with mattress sales being up significantly in the quarter. Comparing to the pre-pandemic quarter (second quarter of 2019), sales increased 15.4%. LNF achieved a 10% increase in same store sales during the quarter. Gross profit margin decreased by 0.3% to 43.8% as SG&A expenses as a percentage of revenue increased by 0.5% to 33.3%. The latter was driven by broad based inflation and increased sales and marketing costs. Adjusted net income rose 1.9% over the prior year's quarter while adjusted earnings per share increased by 20.7%.

KEY RISKS

The household furniture, mattress, appliance, and home electronics retailing industry in Canada has historically been subject to cyclical variations in the general economy and to uncertainty in future economic prospects. Weakness in sales or consumer confidence could result in an increasingly challenging operating environment. Profitability for LNF depends on cost cutting initiatives, market competition, effectiveness of marketing programs, ability to identify and respond to changes in trends, customer service, and general economic conditions. Any material changes in either factors could have a significant adverse effect on LNF's business, financial condition, liquidity, and results of operations. Increased tariffs implemented by the Canada Border Services Agency in relation to upholstered product being sourced from China and Vietnam could impact margins. Lastly, the actions and strategies of LNF's current and potential competitors and the highly competitive nature of the industry means the company is constantly subject to the risk of losing market share to its competitors.

SUMMARY

At the current valuation, LNF represents a good opportunity on the back of a tested business model, solid dividend, and a decent balance sheet. While the management is cautiously optimistic on the underlying economic trends, we think there are pockets of strengths to hold on to. Management's strong track record, LNF's ability to respond to changing consumer needs, improved margins over the pandemic years, and sustainable business fundamentals define the bottom line. While we would watch the inventory levels, we do think the lag in sales-inventory ratio will align sooner rather than later. Rating maintained at 'B+'.

KEY TAKEAWAYS

MANAGEMENT TRACK RECORD SOLID

IMPROVED PLATFORM

ATTRACTIVE DIVIDEND

B+

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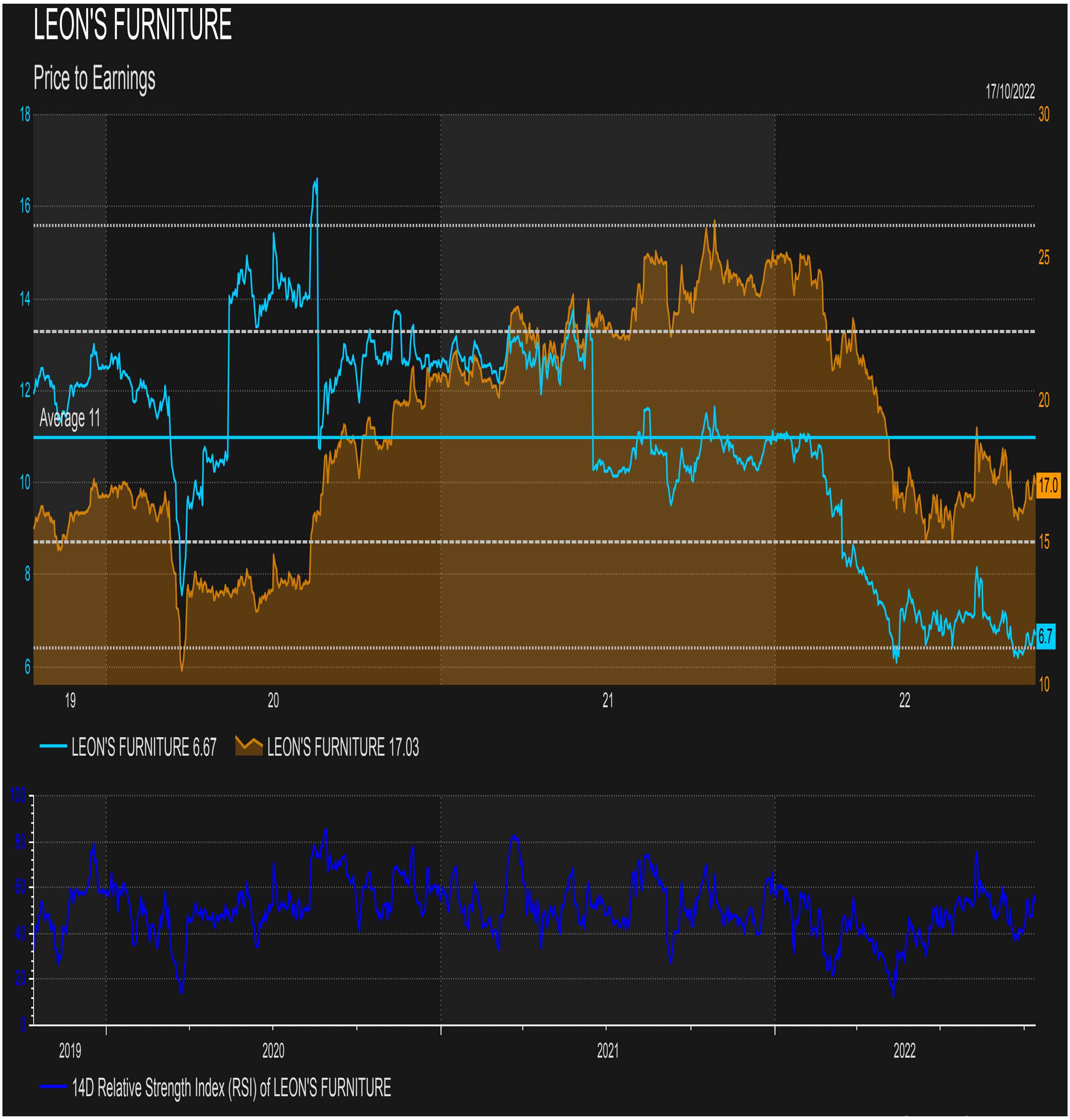
Leon's Furniture Ltd (LNF.TO)								
Scenario	DCF Model		DDM		Relative Valuation		Historical Valuation	
Model Price	$	23	$	6	$	19	$	25
Current Price	$17.0		Risk Level	Medium				
Final Model Value	$22.5		Implied Return	32%		Impl. Total Return		36%

Key Stats

General		Growth		Profitability (Margins)		Financial Health		Valuation	
Market Cap	$1.2B	5-Yr Rev.	7%	Gross Profit	44.1%	Current Ratio	0.9	P/S	0.4X
Insider Ownership	2.06%	5-Yr EBITDA	18%	Net Profit	8.2%	Debt-To-Equity	0.58	P/E	6.8X
Dividend Yield	3.8%	5-Yr Net Profi	-11%	EBITDA	14.8%	Debt Service	#VALUE!	P/B	-



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BUY	A+	We expect very few A+ ratings. This would represent a near perfect stock. This is a great company in good or bad markets.
	A	A great company over long timeframes, with strong fundamentals and management. Near perfect, but missing one or two factors.
	A-	Similar to an 'A', with one or two small areas that could be improved. A great company, sensitive to external factors.
	B+	Fundamentally strong. Usually a great company in a bad sector. Good for the long-term, but some risks exist.
	B	Some fundamental issues, but still strong. Likely to face risks outside company control. A good company with less financial flexibility.
	B-	A company with higher risk or declining results. Likely to be volatile. Often a company in transition, for better or worse.
HOLD	C+	A company we do not expect much growth from. It may pay a dividend that we would view as sustainable, in which case we would own for income, but this company needs to be watched closely.
Sell	C/C-	Typically, this is a bad company with deteriorating results. It may have some turnaround potential but generally this is a name to avoid.
	D+/F	There are very few positives to this company. Use this company as a case study on what to avoid.

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