STOCKS DOWN UNDER

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ASX Small Caps Stocks Down Under

It is by spending oneself that one becomes rich.

- Sarah Bernhardt (1844-1923), Stage actress

BEST & LESS GROUP

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Stocks Down Under rating: ★★

ASX: BST
Market cap: A$253.4M

52-week range: A$1.90 / A$4.45
Share price: A$2.01

The long-anticipated IPO of clothing retailer Best & Less (ASX: BST) proved to be worth the wait – until a couple of months ago. After listing at $2.16 its share rose as high as $4.45 in early January as the company exceeded its prospectus forecasts. However, it has come crashing back to earth in recent months as inflation and interest rates hit discretionary retailers, even though this hasn't shown in Best & Less' results - yet.

Share price chart

Source: Tradingview

A long history and loyalty aspirations

Best & Less began in 1965, with its first store in Parramatta. The company has changed ownership a handful of times since then and was most recently bought by Allegro. Allegro retained a 40% stake post-listing and retail entrepreneur Brett Blundy owned another 16%. The company has 244 stores across Australia and New Zealand, including its own Best & Less Stores in Australia and Postie in New Zealand. It mostly sells its own labels (accounting for 86% of sales) and has 1.8 million loyalty club members.

It has a focus on instore sales (with just 12% of its sales being online) and on baby and kids' items (being 50% of group sales). It may not look any more important than adults' clothing, which is the other 50%, but Best & Less argues it establishes a long-term relationship, allowing its companies to grow with children. Furthermore, it's baby category sales have grown by 13% CAGR over the last five years.

Not the best-timed IPO

At the time Best & Less listed, it was almost the end of an IPO bull run that begun a few weeks after the Corona Crash. It was also the high watermark for a boom in discretionary retailers and ecommerce stocks, which benefited from consumer stimulus and lockdowns. The first test for a newly listed company is meeting its prospectus forecasts and the company passed with flying colours. In FY21, it generated total sales of $663.2m, which was up 6.1%, but it's EBITDA and NPAT were both more than 160% higher than FY20 – at $71.6m and $47m respectively. It had a solid net cash position of $47m and operating cash flow of $59.8m.

However, the Delta lockdowns saw its store shuttered – with 9,000 trading days lost across the group – and the company missed its forecasts for 1HY22. It generated $287.5m in revenue (down 14% from 1HY21), $30.6m EBITDA (down 20%) and a $20m NPAT (down 21%). Nevertheless, it still exceeded its CY21 forecasts and paid its maiden dividend of 11c per share, representing an annualised fully franked dividend yield of 6.5%. It is company policy to pay 60-80% of statutory NPAT.

The company's most recent update came at a Macquarie conference held a few weeks ago. It has begun to feel the brunt of supply chain pressures, severe weather in Australia, the Omicron wave and lower consumer demand as petrol prices rose. So far in 2HY22, total like-for-like sales has dropped 7% across the entire period, but specifically in Q4 rose 2%. It argued that it is positioned to benefit from the inflationary environment as the market migrates to value. It boasted having good stock availability, proactive price and cost management to manage inflationary pressures and a strong forex hedge book.

Turning to ESG matters, Best & Less has not committed to Net Zero just yet, but there are some things to like about it. These include its 100-day guarantee for items, the promise that no fur or leather is used in garments and that all packaging will be re-usable, recyclable or compostable by 2025. The supply chains of clothing retailers have been heavily scrutinised, but Best & Less has a Modern Slavery Statement, a workers grievance hotline and regular supplier audits. We also note that Best & Less has recently been admitted to the All Ordinaries, allowing a greater number of institutional investors to hold the stock.

A lot to like about the company, but not the environment

The company has not given formal guidance for its FY22 results, due in August. However, consensus estimates suggest $625m revenue and $60.8m EBITDA – down 6% and 15% from FY21. Current estimates for FY23 suggest a return to growth with $698.7m revenue and $67.7m EBITDA, both up 11% from FY22. In FY24, analysts estimate $731.5m in revenue and $71.6m in EBITDA, which would be more in line with FY21.

Currently Best & Less is trading at 6.3x EV/EBITDA and 5.8x P/E for FY23, which we think is a reasonable multiple. Its peer Baby Bunting (ASX: BBN) is at 6.8x EV/EBITDA and 13.9x P/E, while Wesfarmers (ASX: WES) - which owns competitors Target and K-Mart - trades at 10.7x EV/EBITDA and 19.7x P/E. We can appreciate the premium for Wesfarmers because of its greater footprint, balance sheet capacity and diversification. Meanwhile, Baby Bunting has a store footprint only a quarter the size of BST as well as lower revenue, EBITDA and NPAT. Admittedly Wesfarmers and Baby Bunting grew in 1HY22, unlike BST, but the latter has not updated the market since these results were released in February.

We think there is plenty to like about Best & Less, but we wouldn't invest in any discretionary retailer right now. Even if you believe demand will not change, we think labour and logistics challenges will continue to weigh on the sector. And we think rising interest rates and costs of living will impact consumer demand and confidence – with the latter at levels not seen since the GFC, particularly among low to middle income earners, which is BST's primary demographic. It is unlikely demand will plunge significantly, but it may take some time to return to growth levels seen in FY21. As a relatively mature retailer without ambitious growth plans, consumer demand is most critical for its earnings.

Given its valuation, maturity as a company and track record of long-term growth we would like to give Best & Less four stars. But we're giving it two at the moment just because of the equity market environment. Still, we think this company could be one to look at when cost of living pressures and inflation ease, and when central banks become more dovish.

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