<u>DFS Analyst Call</u>

Thursday, 10/06/2021 08.30 BST

Moderator: Ladies and gentlemen hello and welcome to the DFS analysts call. All participants will be in listen only mode and afterwards there will be a question-and-answer session for analysts. Just to remind you this call is being recorded. Shortly I will be handing over to the CEO Tim Stacey and CFO Mike Schmidt who will give a short introduction. Please go ahead.

Tim Stacey: Good morning everyone. I hope you had a chance to see the announcement. I'll just pull out a few key points for myself and then hand over to Mike and we will leave time for questions. Three key points for me. Point number one you can see really strong trading particularly since reopening of the showrooms in April - we had a staggered reopening, 5th of April Scotland 12 April England Wales etc. Over the last 10 weeks of our quarter four since that reopening order intake has been 92.2% up on FY19 which is the most recent clean comparison we have. Driven by footfall but to a large extent conversion and average order values - we saw customers trading up. A lot of cash business as well. So very strong on reopening and ahead of our expectations. During quarter three when lockdown 3 primarily occurred pretty much all of our stores were closed. The Web performed really well, even compared to lockdown 1. We saw a big step up - over 200 percent up during that period which gave us some heavy level of resilience.

Tim Stacey: So overall for H2 so far we are up 14 percent in terms of order intake despite the stores being closed for nearly 13 weeks of that period. So very strong and I guess that that leads to the second point. So, the implications from a financial point of view is that it clearly underpins our expectations for FY 21 in terms of underlying profit of at least £105 million. We have seen an accelerated deleveraging and Mike come on to that later. It's given us confidence that we're in the desired zone and we intend to propose a final seven point five pence per share dividend which will be confirmed at the AGM.

Tim Stacey: So that's good from an FY twenty-one point of view but it also gives us a boost into FY 22. So, we go into FY22 with a relatively high order bank still. So, to give you a sense of that our average lead times are probably in the region of 12 to 14 weeks depending on the country that the products are coming from – in the UK you're looking at 9, 10 weeks and China 13, 14. So the blended average would be double the normal. So, this gives us a boost into FY22 and we try to give you a sense of what that could look like through the scenarios that Mike will talk through. So that's the implications financially. I think the third point from a strategy point of view, it gives us confidence to keep accelerating. We are investing in the Sofology showroom rollout. We've got about eight confirmed for the next financial year FY22. We've opened two more recently as well. So really putting a foot down on showroom openings and we're investing more in our digital offers, we're investing more in the DFS store formats by the end of July 22 and we'll have around 40 of the DFS showrooms in the new format which is evidenced in places like Milton Keynes, Maidstone and Glasgow. We're investing there and we continue to invest in our self-help programs such as the sofa delivery company, where we have completed the consultation with all of our colleagues and we've moved to seven-day delivery as of the early May. So, from a strategic point of view, that gives us an acceleration into the next couple of years.

Tim Stacey: Finally, I guess the key challenge now that we're facing into is all about capacity and it's all about manufacturing capacity and supply chain capacity. So, factories across the world, our own factories and our partner factories are all pretty full. So, gaining additional capacity to eat into the order bank is the key challenge and at this moment in time it is actively in play. I'm talking to lots of our existing partners and also new partners to try and increase our capacity so that we can eat into the order bank but at this moment in time we're pretty maxed out. You add to that the container challenges in China where it's very difficult to get containers out of China unless you've got a decent contract which we do have: But we need more. So that's the challenge that we're working on but overall, very pleased where we're at. And I'll hand over to Mike who can take you through some of the financial implications a bit further.

Mike Schmidt: Thanks Tim, Good morning. I'm going to make a few brief comments around this year's out-turn, scenarios for next year, leverage position and also what all of the above means for the dividend. So, just starting in terms of this year's performance that Tim has touched on - we've seen very strong order intake indeed. We of course report revenues and profits upon deliveries to customers and we call out that our revenue growth over the first 49 weeks relative to the 2019 financial year is around 10.4% which reflects if you do the maths around a 6% growth rate in the second half to date. So that's a good performance we feel overall given that we knew some of our manufacturers would run out of orders to make in late March due to the lockdown. And since then, we've also faced in to COVID disruption in factory production and container shipping challenges not least the Suez and of course raw materials shortages that have been widely reported across many industries.

Mike Schmidt: But we do expect this level of revenue will be enough to support getting to at least £105 million pounds underlying PBT outcome for the financial year which means that we're going to be slightly above the medium case that we presented in our guidance scenarios at our interims, obviously this guidance does remain subject to deliveries over the final three weeks. It does also mean as Tim has touched on that we will have a lot of resilience going into the 2022 financial year and we sought to illustrate this resilience through three scenarios that we included in the release. These three scenarios differ depending upon order intake and manufacturing rates but they all come up with an outcome well above the consensus we have coming into today and the historical profit levels of course as well. So, looking at the medium case it assumes effectively a flat market environment relative to 2019 with like for like growth of 7 percent effectively underpinned by market share gains that we talk about, the 2 percentage points, and that generates revenue growth given the starting order bank compared to FY19, of 17 percent and the 17 percent revenue growth implies a PBT level of 85 million pounds.

Mike Schmidt: Our low case implies the market goes backwards by around 5 percent from 2019 financial levels. And in that case, we still believe we can deliver profit before tax of 66 million pounds. The high case scenario assumes, as Tim has touched on again, that we are able to scale up our manufacturing output further and start to convert more of the higher level of order intake and supports revenue growth of 19 percent relative to 2019 and generates profit before tax of 96 million pounds. We do feel very positive about the current trading environment in calendar year 2021 and our performance. But we also do recognize in giving these scenarios that there are 55 weeks to go and a hard to predict environment that we're going to be trading through over those 55 weeks. We also call out in the statement the revenue to profit drop through factors but in simple terms we do see the risk of inflation affecting our product margins. Given the pressure on manufacturing capacity and raw materials prices and also our operating cost base which factors in property business rates resuming, showroom pre-opening costs for new Sofology showrooms and also some ongoing investment in our announced strategic areas.

Mike Schmidt: And Finally, just moving onto the balance sheet and dividends a couple of key points. Firstly, the strength of profits has generated robust operating cash flows and so we expect our underlying leverage will be in the half to 1.0 times range of cash EBITDA that we previously talked about. Secondly though we continue to benefit from a significantly elevated level of customer deposits which will be over 50 million pounds higher year on year and which we expect will normalize as the order bank returns to normal levels. So together this means on an as reported basis there will be a small level of net debt reported by the end of this financial year excluding the leases in the business. Finally, just looking at dividends, we previously talked about how we recognize their importance to investors and that we wanted certainty on outlook and leverage before we started to resume payments. We state here in the announcement that we think we have that certainty and so we expect to recommend a final dividend of seven and a half pence per share in September with our normal policy as disclosed previously. Continuing on from that - all in all a very positive outturn compared to our interim updates in March with a strong result in 2021 expected and some great momentum going into next year. That's all I was going to say at this stage. I believe the plan is now to have some analyst Q&A.

Moderator: Thank you. If there are any questions from the analyst please press *2 on your telephone keypad, that is *2 on your telephone keypad. If you wish to retract your question, please press *3. There will be a short pause while questions are registered. The first question is from Andy Wade from Jefferies, your line is now open, please go ahead.

Andy Wade (Jefferies): Morning guys. Well done. Just two questions from me. The first one on the supply side. Just really a bit of colour on how likely it is that you're going to be able to ramp up that capacity in line with that higher scenario particularly given the sort of issues such as with the containers. And if you are able to, where's that likely to come from. And then this is sort of one B if you like rather than question 2. Is there a possibility that orders fall away a little bit if lead time is extended too far?

Tim Stacey: Morning Andy. I will give you some colour on the supply side. I think largely we've got the UK, about 45/50 percent of our orders and that is completely full. So, there's very little spare capacity and it's very hard to increase in the short term. We are investing in our own factories but that's not really going to come on stream in terms of additional capacity until probably even the end of the next financial year. And some of our other partners are also investing in additional space but the actual challenge there is recruiting the skilled upholsterers to actually manufacture the product. So, I think the UK is a challenge to get material amounts more out of. Europe was primarily Poland and Italy. Italy's full as well. Poland has a bit more flexibility but not huge amounts. So, what that leaves you with is the Far East. We're working with the biggest suppliers in the world. They have the production capacity but what we don't have are the containers without paying punitive spot rates. I think the latest spot rates this week are in the region of 10,000 dollars a container which would pretty much wipe out any profit we make. So, we have a forward contract with all of the big shipping lines which guarantees several hundreds of containers a week all of which are full. So, our barrier and bottleneck is about securing containers. And at this moment in time everything I'm hearing and we're talking to all the shipping lines all time it's going to be hard to secure additional containers until at least the autumn and maybe into next calendar year. So, I think production capacity availability is more in China and the challenge is securing the containers. So that's why we the medium scenario tops out at 22/23 million pounds delivered revenue a week, which is a step up from what we've delivered in FY21.

Tim Stacey: And that's going some, going flat-out and assuming no significant disruption from COVID again in different countries. So that's the reason why we're being slightly cautious. It's just that practically that's a huge challenge at this moment in time worldwide. I think the lead times as you know it's all relative isn't it because everybody's got the same problem. Most of our competitors are in the same boat. But what we're finding is by looking at the conversion rates that you know if the customers want that product they are prepared to wait. The key for us with our customers is to under promise and over deliver on lead times. So, we're quite prudent with our lead times given some of the disruptions that you see in the backlog from Suez etc. But I don't think we're missing much business on the back of it. There's a small amount of stocked retailers out there but it's very immaterial in the grand scheme of the market. So, I don't think we're missing out and we're working hard to try and figure out if we can shift production of some of our models between factories to fast track some through. So, we are trying to cater for those who want it a little bit quicker but I don't think there'll be a material miss from having the lead times that we have.

Andy Wade (Jefferies): And then my second question is around the integrated retail model vs. pure play. I mean if you look at that 92 percent growth in order intake that really implies that there's pent up demand that customers aren't just wanting to buy online that the store is important in this category. That seems to be an obvious learn but just interested in what else you've learned over the last year about your integrated retail model versus the pure play advantages and disadvantages.

Tim Stacey: Yes, we talk about this a lot. We genuinely believe in this particular category, so upholstery specifically, the tactile products that the sit test is super important. And we've seen that every time that we've come out of a lock down, a flood of customers coming in to have that sit test, they're much more well researched and they know what they want. So, having a strong website with great content enabling people to feel confident about what they're interested in, we clearly need to do. We've been doing that for a long time. But in the end nearly 90 percent of transactions in this category are influenced by a visit to a showroom and a check on the products and having a conversation with a sales colleague to help you really understand what's right for you. And I think it's interesting our overall online penetration pre COVID was probably running at low 20s, 21/22 percent. It will take some time to settle back down. But this last quarter it's been running at 19 percent. So, there is this desire from customers to come in and spend time with human beings and they're spending a good long time in stores having those conversations and sitting on the product. And we fundamentally believe that that is the right business model for this category. When you talk about broader furniture category, we are seeing some good early success on beds online which is something that we're interested in but that's more of a medium long-term plan. I think broader furniture categories can absolutely be served by the online channel as well. But we think Sofas has just got some unique characteristics that makes the integrated model the one for this market.

Andy Wade (Jefferies): Very helpful. Thanks very much guys.

Moderator: Thank you. The next question is from Jonathan Pritchard from Peel Hunt. Your line is now open, please go ahead.

Jonathan Pritchard (Peel Hunt): Thanks, and good morning from me. Firstly, could you develop your comments on conversion, what ranges are doing particularly well and cash vs. IFC - I think you said that's probably turned around a little bit. And then secondly on inflation what's your view that you could pass some of that onto consumers if they're trading up, perhaps they would tolerate a little bit of price increase potentially.

Tim Stacey: Yes. Good question. I think from a trading point of view as I just mentioned earlier when the customers are coming in once we've reopened they are coming in very well researched so they were coming in with a high level of intent to buy and knew which models they wanted to sit on. So, I think with conversion because people have been sitting at home for 13/14 weeks through locked down 3 it was super high for April/May. It’s coming back down but it's still up significantly up on FY19. So of course, I'd love to say that all our sales colleagues are amazing at converting customers all the time but I think there's some real consumer intent there to buy. And they were trading up. So particularly in DFS where we introduced some new ranges actually during lock down and the grand designs models started incredibly well. The Halo Luxe range at the top end as well and the leather range is doing well. All of our exclusive brands, Joules in particular are really flying - triple digit growth with Joules. So, customers are really spending a bit more on their home which is that trend that we've talked about. I think what we've also seen which we didn't expect - maybe we should have in hindsight is a lot more cash business - people transacting in cash and not using IFC. So certainly, when we reopened it was probably two thirds to one third or 60/40 cash to IFC, which is the opposite way round from normal trading and it has probably settled down to more like 50/50 which is still high. And that leads to the inflated cash customer deposits and cash that we’re holding while we're waiting to make those orders at the year-end as Mike alluded to. But it also reduces our interest free credit costs which goes into margin which is a positive. So, I suspect it might settle back down. But given the amount of savings that consumers seem to have accumulated or certain consumer types have accumulated it may not do for the rest of this calendar year Jonathan.

Tim Stacey: In terms of inflation, we are actually seeing cost of goods inflation across the board whether that's to do with wood, with foam or all the constituent parts of the sofa. And it's a good 2/3/4 percent. I think we can pass some of that onto consumers and we are doing it already but maybe not all of it. And there are further cost pressures on things like containers for example. We've got contracted rates but that contracted rate is still higher than it was back in October Pre COVID, let's put it that way. So, I think we can mitigate probably half of it. We're looking to see what else we can do as we introduce new ranges, we're putting price points slightly higher to cover what we anticipate might happen in the next 12/18 months. But there's definitely a trend upwards on the cost of goods inflation. The rest of inflation Mike I don't think we see much more than a couple of percent on goods not for resale.

Mike Schmidt: I think that's right. I think there's a few more standout categories, things like insurance spiking upwards. But likewise offsetting that things like media rates inflation are relatively low compared to historical levels.

Jonathan Pritchard (Peel Hunt): Great. Thanks a lot.

Moderator: Thank you. The next question is from George Pilakoutas from Numis. Please go ahead.

George Pilakoupas (Numis): Thanks very much. Three for me.
that first one is just kind of understanding the high scenario for FY22 and what should I think of the profit drop through - should it continue to be very strong? And I guess particularly to the second half is there the potential for the manufacturing capacity ceiling to increase -or unless you get additional capacity you are not able to deliver additional sofas this year. That's kind of assuming this current peak demand period and then we see a normalization if the high demand continues throughout, let's say towards the end of this year you would be able to kind of see a higher revenue and profit number come through. The second one is the progress on some of the non upholstery. If there was anything you wanted particularly, any thoughts around the dreams acquisition - is that kind of changing your thoughts or making s you more or less excited about entering that category and then the third one is the net cash position it kind of looks to be now well within your range if you could just remind us on your capital allocation policy, given of the excess cash that is coming through which you could potentially return to investors, I guess you've spoken about manufacturing capacity and potentially accelerating some of the store rollout, but there's only so much you can spend in that direction. So, what is next down the line, a special dividend or buyback?

Tim Stacey: Mike would you want to answer question one around the scenarios in the high scenarios. What the limiting factors might be?

Mike Schmidt: Yes, thanks George I mean I think the medium scenario that we talk about is broadly based on the full utilization of our existing manufacturing capacity. And I think again just to emphasize that's about 17 percent higher manufacturing output than we saw in 2019. So, it's a step up. And so clearly high case or anything beyond the high case would require additional capacity to be secured. And I think Tim touched on some of the constraints and the challenges around that. Clearly, we'll update on that in due course but at this stage I don't think there's anything further that we would say in terms of where that could get to. I think the consequence of that is to become the primary constraint in terms of top line performance for next year with the order intake being the secondary factor alongside it.

Tim Stacey: I might add George that if we can't increase a step change to our manufacturing capacity and order intake continues at high levels then all that will happen is, we will struggle to get our order bank down at the end of FY22. So, it will flow into FY23. So, if however, order intake switches backwards. Due to a resumption of spending on travel etc then we can eat into the order bank and deliver the medium case because we'll have the orders there and therefore the order bank might start to normalize towards the end of FY22. But everything we're seeing at the moment certainly calendar year 21 should be a strong order intake year, calendar year 22 is more difficult to predict but I think that's hopefully that gives you an answer to that one. On to progress on home and I think you mentioned the Dreams acquisition. We are making good progress at home but it will take some time. It's more of a medium-term thing but we're increasing our primary focus on upholstered beds and mattresses. We're developing our range there we're just we're just launching a French Connection zinc bed for example we've launched a French Connection Camden bed and some Joules beds and they're doing very well online growing triple digits. And that's our primary focus a lot of work going into the website over the next few months to improve the navigation and make it more applicable to the bed market.

Tim Stacey: So, we're investing more in digital marketing and imagery and content. So that's our primary focus. And in the background, we're also investing in our stock Fulfilment System working with the Dwell team so that we can deliver on home accessories such as coffee tables, lamps, tables etc. That's more to really land next calendar year. So, beds is the primary focus. I think that when we look at things like Dreams or the categories there, I think we've always got an eye on those things but it's not our current intent. We think we can do things organically quite well. With the partnerships we have with Silent Night For example, who are a really good partner for us and develop our own unique ranges using some of the designs that we have. So, I think acquisitions in the bed market is something that's not on the agenda at the moment but we're always observing what's happening.

George Pilakoupas (Numis): Can I just follow up there? On Tempur Seally and Dreams. I must admit I don't know how much proportion of Dreams product was Tempur Seally previously, but I might expect that to pick up, do you see that potentially opening up opportunities with some of the other brand partners therefore or do you think that they will kind of continue working with a range of manufacturers and so it doesn't really change the industry landscape.

Tim Stacey: Difficult for me to comment on that. I think what we found is a good few partners who are really keen to work with us because they can see that we can grow and we can grow and work in a strong partnership way with them. So, Silent Night being one example but there are another few branded mattress players who we're talking to - commercially sensitive moment, who are really keen to join in with the growth plans that we have. So, I don't think it might change a little bit more in our favour but yet to see that come to fruition - Mike do you want to talk about the net cash position and capital allocation policy.

Mike Schmidt: Yes absolutely. So, I think as we've talked about previously, we are focused as a business on having a resilient but efficient capital structure. We define that to be operating with a bank debt of 0.5 times to 1 cash EBITDA range and what we're saying today is that we think at the end of this financial year we'll be on an underlying basis excluding the one-off working capital benefits within that range. Looking forward clearly subject to generating the level of profits that we're looking at we do believe we'll be strongly cash generative and I think the first priority as always will be investment in the business. And secondly, we will look if there is if there are other opportunities to invest that generate the required rates of capital return. We will look at those two areas that we've pointed to as being an addition to our strategic plan being around the manufacturing investment that we're making and also around the beds area. Manufacturing does require some capital investment but it's relatively limited over a number of years. Likewise, with beds at the moment it's an online proposition and on a stockless basis. So, I think there's some constrained capital requirements there and I think that will mean that there will be a choice at some point in the future dependent on delivery of performance as to what we do. But certainly, I think it'll be a good choice to have and it won't be a choice that is coming at us too imminently. You're looking at least 12 months out.

George Pilakoupas (Numis): Great thanks very much.

Moderator: Thank you, there are no further questions so I will hand back to Tim for closing comments.

Tim Stacey: yes, obviously we are pleased with where we are. We're in a good position going forward. So, we'll keep you posted. Next time will be in September for the full year results. Have a good summer everyone and thanks for dialling in.

Mike Schmidt: Thanks very much.

Tim Stacey: Thanks very much all.