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Buy British

Theresa May's strategy for Brexit is anyone's guess, but Mr. Market's plan for the British retail industry is as clear as a bell. He wants cheaper share prices in the cause of better investment value. In the case of Dixons Carphone plc (DC on the London Stock Exchange), the old gentleman has already got his wish. To put the prescriptive cart before the analytical horse, *Grant's* is bullish on Dixons.

When Dixons Retail Group Ltd. and cellphone vendor Carphone Warehouse Group plc merged in 2014, British retailers still had stars in their eyes. The "internet of things" promised fresh marketing channels and dazzling new products to market (your smart refrigerator would tell you when to restock the beer). The Brexit referendum, and attendant political, financial, social and commercial commotion, were two years in the future. Then see what happened. Since year-end 2015, the FTSE 350 General Retailers Index has fallen by 22%, the Dixons Carphone share price by 67%.

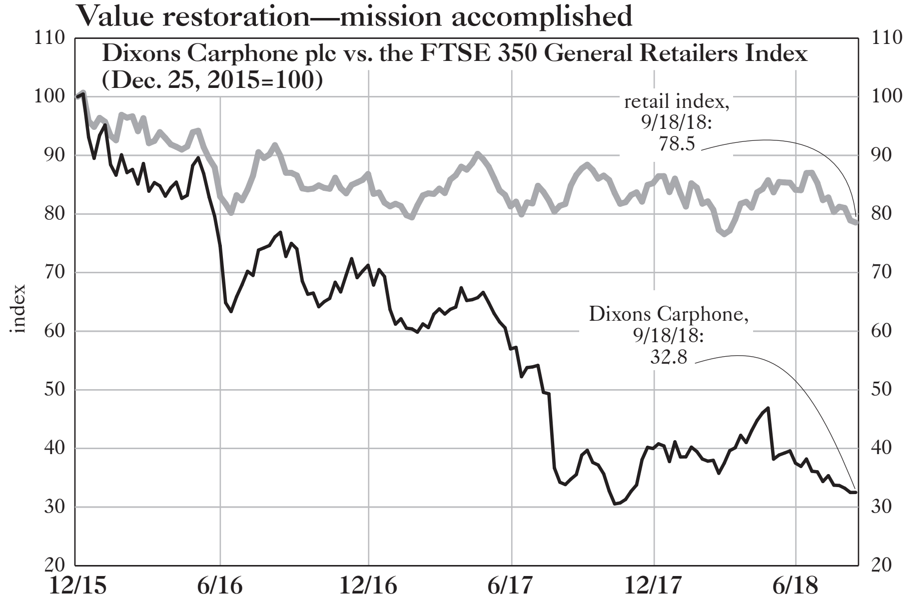
Sir Charlie Mayfield, chairman of John Lewis Partnership, Britain's employee-owned chain of department stores and supermarkets, recently characterized the UK retailing environment as "the most promotional . . . we've seen in almost a decade." He spoke those words, as if for extra emphasis, in the context of disclosing a 98.8% drop in the Partnership's six-months earnings. Last week, Debenhams plc, a struggling department-store chain, had to deny rumors it was about to file a "company voluntary arrangement," a kind of prepackaged bankruptcy. So far this year, 30 retailers and restaurant chains have actually filed.

It's in this fragile setting—the fear of a "hard" Brexit on top of everything else—that the May government is asking pharmaceutical companies to stockpile drugs, that Mondelez International, Inc., owner of Cadbury, is already stockpiling biscuits and that the governor of the Bank of England is warning of a 35% plunge in house prices over the next three years in the event of a contentious Brexit. It would be strange if some portion of tomorrow's bad news were not priced in today.

Though the track of its share price hardly suggests as much, "Europe's leading specialist electrical and mobile-phone retailer and services company, employing over 42,000 people in nine countries," as Dixons describes itself, commanded a price-earnings ratio over 16 times as recently as four years ago and remains a commercial force to be reckoned with. The trouble is that the company has become a progressively less profitable commercial force.

In the fiscal year ended April 28, Dixons sold £10.5 billion ($13.8 billion) worth of smartphones, washing machines, freezers, laptops and other such electronic and electrical merchandise. It sold them in the UK and Ireland (63% of revenue), the Nordic countries (33%) and Greece (4%). In electronics, DC commands a quarter of the UK and Irish markets, a quarter of the Nordic markets and some 33% of the Greek market. In the low-margin electronics-retailing business, James Armstrong,

Value restoration—mission accomplished



source: The Bloomberg

senior analyst at The Analyst Research LLP, advises deputy editor Evan Lorenz, "market share is so critical because you can get the buying scale and central efficiencies." To put DC's dominance in perspective, Best Buy Co., Inc.'s share of the U.S. gizmo market is no greater than 15%.

"Dixons Carphone earned these towering market positions by surviving the existential threat of Jeff Bezos, who entered the British market 20 years ago," Lorenz relates. "By matching the prices on Amazon.com, Inc., DC has picked up share as smaller competitors have disappeared. Currys PC World—one of many DC nameplates—is the only national electronics chain extant in the UK following the bankruptcy of Comet Group Ltd. in 2012. Phones 4u, the No. 2 UK independent retailer of mobile-phone plans, failed in 2014, thereby solidifying Carphone's No. 1 position in the UK and Ireland."

DC is hefty in more ways than one. "A big part of the Dixons business are the things that need two people to pick them up, like fridges, freezers, cookers, dishwashers, washing machines," Armstrong says. "Amazon in the UK doesn't, on their own, do two-man delivery."

Unfortunately, it takes just one hand to lift a phone, and the DC cellphone-vending subsidiary earns nothing on £2 billion a year in revenue. Carphone (a name dating from 1989, when mobile phones were so bulky that you almost couldn't carry them) is a unique business. In America, Verizon will sell you a phone along with a two-year connectivity contract. In Britain, Carphone Warehouse (to give that subsidiary its full name) frequently does the honors. It will sell you a phone and connect you to one of the big three British operators: EE (BT Group plc's mobile-phone network), O2 or Vodafone. The phone is "free." You ultimately pay for it, along with network charges, over the life of a contract. You pay the network—and the network reimburses Carphone Warehouse.

Is this not a case of making a simple thing hard? Mark Reynolds, head of investor relations for DC, contends not. He tells Lorenz that Carphone has 640 standalone stores and "a very loyal customer base. It does provide impartial advice to consumers and gives customers the best deal. We will provide equivalent services that the carriers will at a reduced price, on average £5–£7 per month, so around $10 a month cheaper from the equivalent proposition from the carriers. We have a strong proposition in the market. We don't necessarily shout about that too loudly because we don't want to alienate our carrier partners, but if the customer wants the best deal in the UK mobile market, then Carphone Warehouse is the place to go."

Missing is the profit. When there was a profit, Carphone Warehouse booked it upfront. Whence came that profit? From Carphone's share of the customer's monthly payments for data, minutes and the cost of the phone itself. For Carphone, then, it was—and is—cash out today, cash in tomorrow—"a pretty horrendous working capital model," says a DC bull who asks to go nameless. You can find the contracted future payments on the balance sheet. As of April 28, the line for receivables from the mobile networks totaled £1.1 billion, an immense sum compared to the £1.9 billion DC market cap.

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"For the past 70 years, Britain has been the master of currency devaluations," observed *Financial Times* columnist Chris Giles last week, with 20% lopped off the purchasing power of the pound since 2015 alone. Naturally, such depreciation jacks up the prices of British imports, including Apple phones, which were high enough in dollars to start with. Thus, in 2016, the new iPhone 7 Plus began at $769; the iPhone XS Max, announced last week, starts at $1,099. Inasmuch as the value of the pound has fallen to $1.31 from $1.49 since the 2016 Brexit referendum, phone prices for UK consumers have soared by 53%, 1,000 basis points more than U.S. dollar-priced iPhones. At the same time, must-have features on newer Apple and Samsung phones have been few and far between. Add it all up, and UK consumers feel no irresistible need to upgrade every two years.

In the absence of a trade-in, people are refusing a new two-year contract, rather opting to go month-to-month on a SIM-only plan (SIM as in "subscriber identity module"). Earning no portion of the monthly bill on SIM-only sales, Carphone bends over backwards to lure such customers back to fixed-rate, long-term contracts. The bending shreds margins.

Nor is the European Union's ban on roaming charges a mobile-margin enhancer. Say what you might about the risks of a hard Brexit, it would at least allow British network operators to resume levying fees for customers who venture outside of their coverage networks. If so, Carphone would likely find itself among the gainers.

Management does nothing to lighten the burden of the Dixons Carphone analyst. It provides segment information on a geographic basis only, so Carphone's results in, say, Manchester, are lumped in with those of Currys PC World in, say, Dublin. Thus, while operating margins in the UK and Ireland division fell to 4.2% in fiscal 2018 from 6.5% in fiscal 2017, investors have no way of knowing how much of that decline was driven by Carphone or the goings-on in the electronics division.

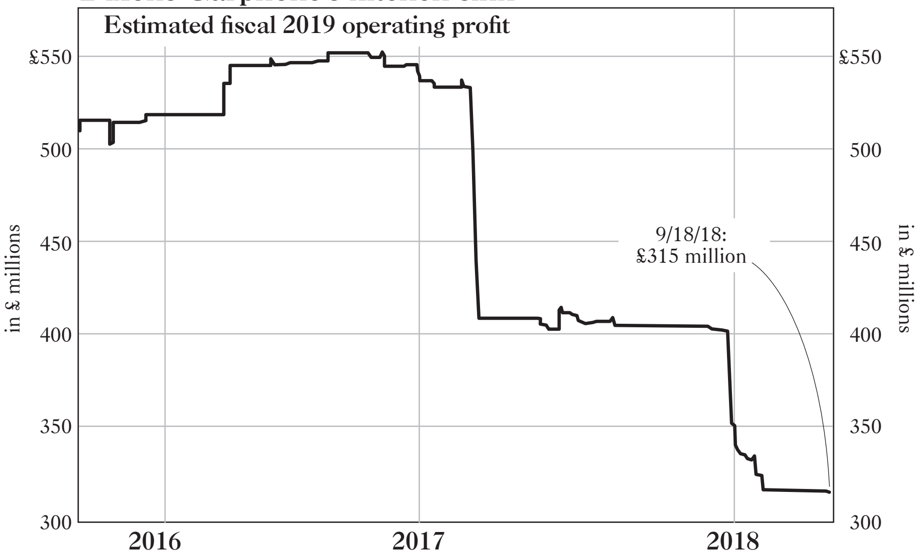
Management has not only bungled the fixing of these problems, but also the telling of the story. One year ago, dialers-in to a call concerning the July quarter heard then-CEO Sebastian James say that, despite 6% like-for-like sales growth, pre-tax profits for fiscal 2018 would decline to the neighborhood of £400 million instead of the £495 million that analysts had been banking on. Shocking it was, though the new figures did serve to clarify the motives of the insiders who had been unloading the stock (net sales of 1,778,993 shares for proceeds of £5.2 million in the five months through July). On the day of the call—it was Thursday, Aug. 24, 2017—DC plunged by 23%.

Even without the pressure of an activist investor, the CEO, the CFO and the chief of the UK and Ireland division have all left the company to spend more time with their families. The new CEO, Alex Baldock, age 47, took over on April 3, his reputation preceding him as the chief who led Shop Direct, Britain's second-largest pure-play online retailer in a makeover from catalogues to online vending. Five consecutive years of record financial results and an almost tenfold leap in earnings are the yield on that transformation.

Simon Wolfson, the highly regarded UK retailer who runs the clothing retailer Next plc, has been heard to sing Baldock's praises. Under Baldock's innovative digital strategy, Wolfson has reportedly observed, Shop Direct, a company with no brand and limited assets, has become a £2 billion property.

Between Jan. 22, the date Baldock's appointment was announced, and May

Dixons Carphone's kitchen sink



source: The Bloomberg

25, shares rallied by 24%, only to tumble by 21% on a May 29 profit warning. It fell to the miracle-working Baldock to admit that a continued decline in earnings was in the cards, to £300 million in fiscal 2019 from a previously expected £387 million. As usual, management vouchsafed no segment details.

"We know that this performance is unacceptable, and that's especially true given Dixons Carphone's strength, and it's up to management to make much better use of those strengths, and we're underway with action to do precisely that," the new broom told the stunned analysts. "There is certainly a big opportunity here. It will take some time and plenty of hard work, but there is nothing wrong here that cannot be fixed. And when we do, we'll have built something of sustainably much higher value to the long-term benefit of us all."

June 13 brought news of a data breach of 5.9 million Dixons Carphone consumers. Company sleuths discovered the hack, which dated from 2017, as part of a Baldock-ordered inspection of IT systems. Following the discovery, DC has tripled its outlay on cyber security.

At the top of Baldock's lengthy to-do list is the job of renegotiating Carphone's contracts with the big three mobile networks. After all, Carphone is providing £1.1 billion of working capital to the telcos on which it is earning exactly nothing. Baldock promises to bare his plans on this and a variety of other critical matters on Dec. 12 in conjunction with the release of second-quarter results.

Meanwhile, low-hanging fruit abounds. To start with, Dixons and Carphone have still not fully integrated four years after the merger. "To give you an example," says Reynolds, "there are six different payrolls across the business. We have contact centers for Carphone Warehouse and for Currys PC World. They are very discrete, and there is no cross-pooling of resources. We have a significant support and overhead structure in our head office that is very siloed with Carphone and Currys PC World. They should come more together.

"We also have two separate IT systems and two separate points of sale," Reynolds goes on. "If you go into one of our electrical stores that has a Carphone concession inside it, you cannot pick something up in the Carphone side of the business and buy it in the Currys PC World side and vice versa."

If Baldock can't fix Carphone, he could wind it up—or simplify it. An average of 2.2 years remains on the leases of the remaining 640 or so Carphone retail locations (98 are on the chopping block this year). Aggregate annual rent runs to £60 million or so. "There is also a significant commercial, finance and overhead team that manages that relationship that we have with the carriers, the receivables and propositions," Reynolds says. Perhaps, he adds, a conventional phone-retailing operation without the network partnerships will be the answer. If so, the existing "extensive support and infrastructure" could be jettisoned. Whatever happens, the three networks must pay DC the £1.1 billion in receivables they owe.

The networks could certainly survive in the absence of Carphone. Could they thrive? "By shouldering the cost of new handsets," Lorenz observes, "Carphone lowers the working-capital intensity of the networks. Carphone's market share is also working to the networks' advantage. In 2006, Vodafone allowed its contract with Carphone to lapse, only to return, hat in hand, to ink another two years later. And Carphone's market share of new handsets is greater today than it was in 2008, thanks to the bankruptcy of Phones 4u."

In conversation with Lorenz, Reynolds volunteered one possible negotiating tack: "We had previously said we hope to get this wrapped up this year. That is still the case, but we could come to an arrangement with two of the networks, and one of them we decide we prefer to not reach a new agreement and let that run off." By signing on with two of the three big networks, Carphone could increase the market share of the chosen duo at the expense of the excluded third. Might that be worth more favorable terms?

"Today," Lorenz observes, "DC is priced at 8 times estimated fiscal 2019 earnings to yield 6.9% on a dividend that free cash flow barely covers. Those projected earnings assume that Carphone breaks even, which may be a fair assumption. However, if Carphone is a secularly declining business, DC can unwind it and realize the £1.1 billion in receivables, an amount equal to 55% of the current market cap. If the business is fixable, DC is trading at a low multiple of depressed earnings. And as for the prospective dividend—say, in the event of the winding up of Carphone, something that Reynolds told me is worth considering—he said: 'Our view of dividends is that we won't sit on cash. Clearly there could be, depending on what happens with the networks, a material unwind with the receivables which could lead to a lot of cash coming into the business. There will be some costs associated with that, but if that is the case, we won't sit on cash.'"

The balance sheet is serviceable. As of April 28, debt, net of cash, amounted to £249 million, or less than the projected £300 million in estimated fiscal 2019 operating profits and less than the £491.7 million in estimated fiscal 2019 earnings before interest, taxes, depreciation and amortization. In the latest 12 months, earnings before interest and taxes covered interest expense by 7:1. While the company shows a pension deficit of £470 million, DC is paying £46 million per year through 2029 to close that shortfall.

Another way to look at the potential value in Dixons Carphone is on a sum-of-the-parts basis. Here is Armstrong with the math: Of the £300 million in operating profits that Baldock has guided to for fiscal 2019, an estimated £120 million will be generated in the Nordic and Greek operations. These businesses have been growing strongly (up 9% and 11% on like-for-like terms in fiscal 2018). Applying a 9-times multiple to these earnings (below the 11-times multiple that Best Buy trades at), you get £1.1 billion in value.

"If you give Carphone Warehouse a £800 million value (i.e., a discount to the £1.1 billion in receivables) and you take the sum of the European businesses and Carphone, you get £1.9 billion," Armstrong says. "If you look at Dixons Carphone's share price today, we are about £2.3 billion of enterprise value, that is market cap plus net debt. That basically puts the electronics business in the UK around £400 million. That is far too low for a business that is making £4 billion in revenue and, we think, about £180 million in operating profit. That's about 2.2 times of operating profit."

Since June 21, Baldock and new CFO Jonny Mason have spent £572,811 acquiring 325,533 shares in the open market. Value investors Baupost Group LLC and Ruffer LLP have accumulated stakes equal to 4.8% and 5.4% of shares outstanding in 2018. Just the people to have in one's investment foxhole.

To own Dixons Carphone, an American investor must gain exposure to the depreciation-prone pound sterling. On that score, according to *The Economist*'s Big Mac index, Britain's national scrip is 23% undervalued. Buy British.

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