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GLOBAL IDEAS

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Magnit — The ultimate growth stock

Investment thesis

Magnit is one of the most attractive businesses we have observed in recent years. The share is - and will remain - expensive, but should still deliver excellent returns for some time to come. Magnit is one of Russia's leading retailers and is achieving phenomenal space growth by way of aggressive expansion into the under-serviced Southern and Eastern parts of Russia. The company expects to open 1,400 stores this year off a base of 6,884 stores.

We expect sales space to double over the next five years, with 15-20% growth p.a. for the next few years. This should see turnover and profits grow by around 25-30%. The company forecasts 27-29% turnover growth in 2013.

Magnit's metrics are as follows:

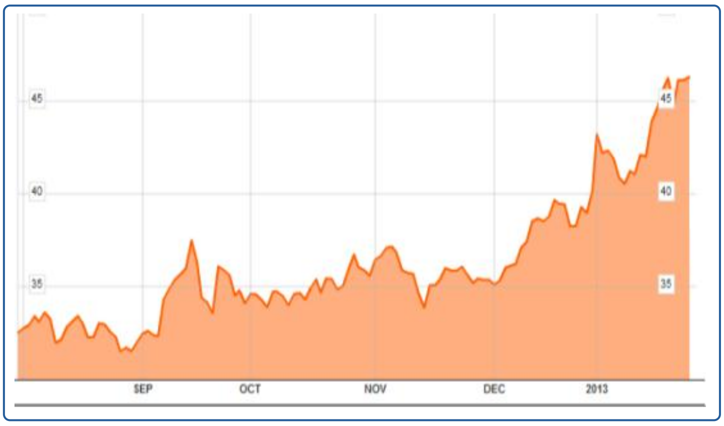
Spot ($)	46.25
Mkt Cap ($bn)	21.1
12M fwd P/E	21
10-year average P/E	15.9
10-year average DY	0.6
FYE	31-Dec
12M trailing DY	0.62
12M fwd DY	0.76

Source: Bloomberg, Anchor Capital

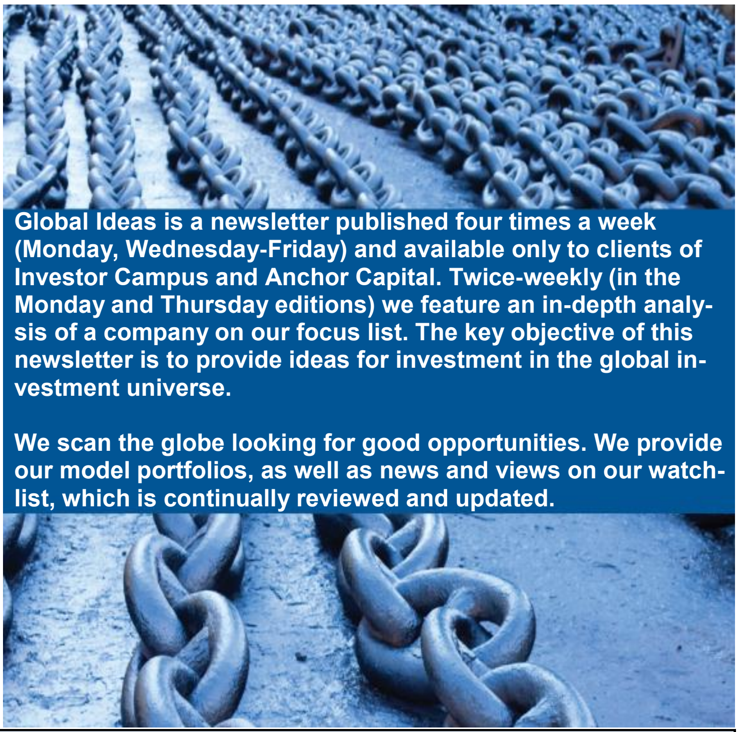
Like South Africa, Russian retailers have business fundamentals which are the envy of other industries. Cash flows are larger than earnings, working capital is net negative and the company achieves a cash payback in 3 years of the capex spent on leased stores and 6 years for owned stores. As a result the returns on equity are in excess of 20% and growing.

Magnit trades at a forward 21x P/E, lower than the 23x of Shoprite and the average of emerging market (EM) retailers. The long-standing management team has got the formula right and momentum looks strong and sustainable. Our price target for the share is $60 (+23%).

Magnit share price



Source: Company data



Global Ideas is a newsletter published four times a week (Monday, Wednesday-Friday) and available only to clients of Investor Campus and Anchor Capital. Twice-weekly (in the Monday and Thursday editions) we feature an in-depth analysis of a company on our focus list. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

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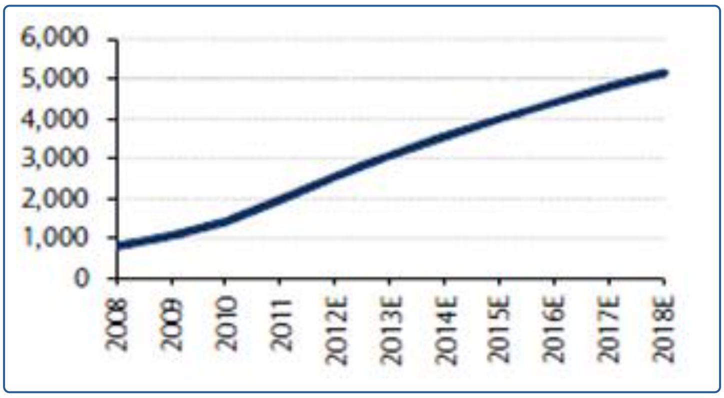
Magnit total sales area (sq m)



Source: Company data, Barclays Research

Forecasts

Magnit forecasts ($)				
December y/e	2011	2012E	2013E	2014E
HEPS	0.89	2	2.24	2.74
% growth		91%	32%	22%
DPS	0.11	0.21	0.28	0.34
P/E		27.2x	20.6x	16.9x
DY	0.2%	0.5%	0.6%	0.7%
Share price	46.25			
12-month FWD P/E		20.2x		

Source: Company data, Bloomberg, Anchor Capital

** The Anchor Capital forecast shown above is materially ahead of the Bloomberg consensus US$1.85 forecast for 2013.*

The key profit drivers of the business are:

⇒ ***Organic sales growth*** (currently >5%), incorporating sales price inflation, which reached 7% in September 2012.

⇒ ***Net new store openings,*** which should add 20% in 2013, 15% in 2014 and 10% for a few years thereafter.

⇒ ***Gross margin.*** Some observers are concerned about the high 26.5% and the extent to which it is sustainable.

⇒ ***Increase in cost base*** – this is largely people and space; both of which go up by around 7-9% p.a.

Margin dilemma

The biggest issue for Magnit investors at present is the high margins being achieved. In 2012 these were:

Gross margin: 26.5%
EBITDA margins: 10.6%
Operating margin: 8.0%

The EBITDA margin is about 200bpts more than its competitors. In discussions with management, they indicated the forecast range of 9.2-9.8% for 2013 is a floor rather than a ceiling and that "there is no particular reason why margins should decline". As the company expands into areas with little competition, so they can maintain larger-than-usual margins, but we do expect these to start reducing in coming years. We believe this will happen later than the consensus forecast. As a result our forecast of $2.24 for 2013 is materially higher than the *Bloomberg* consensus of $1.85. This consensus is being upgraded by the day, however, as analysts digest the phenomenal 2012 results.

USD (US$bn)	2012	2013E	% ch	2014E	% ch
December					
TURNOVER	14.4	18.8	30.0%	23.4	25.0%
GP	3.8	5.0	29.9%	6.1	22.6%
GP%	26.5%	26.5%		26.0%	
Op exp	(2.68)	(3.46)	29.0%	(4.26)	23.0%
Opex %	18.6%	18.5%		18.2%	
EBITDA	1.523	1.99	30.6%	2.46	23.8%
EBITDA %	10.6%	10.6%		10.5%	
Op profit	1.143	2	31.3%	2	21.9%
Op margin	7.9%	8.0%		7.8%	
Headline earnings	0.804	1.06	32.0%	1.29	22.0%
HEPS	1.70	2.24		2.74	

Source: Company data,

Comparison with Shoprite

The following table shows a comparison with Shoprite, the star of African retail:

Magnit vs Shoprite

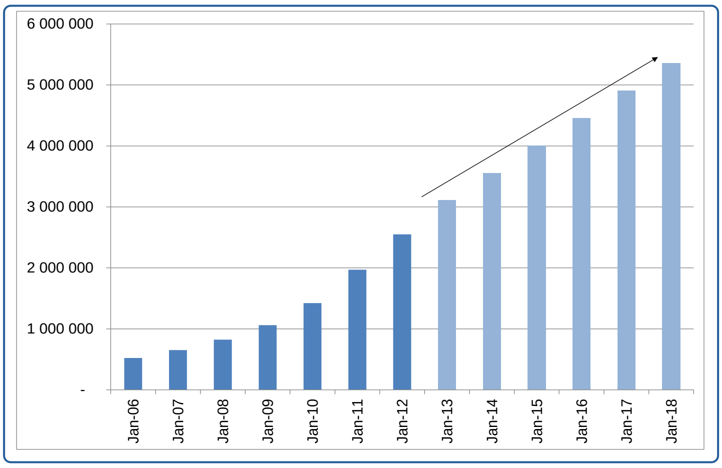
US$	Magnit	Shoprite
Market cap ('bn)	21	12
Earnings ('m)	803	353
Stores	6884	1740
GP margin	27%	21%
Op margin	7.9%	5.6%
Capex ('m)	1800	370
TO growth (2012)	34%	14%
Fwd PE	20.x	23.x

Source: Company data, Anchor Capital

Our observations are as follows: Shoprite has a slower growth rate, is more expensive and is investing considerably less. The margin in Shoprite is lower, but is probably more sustainable.

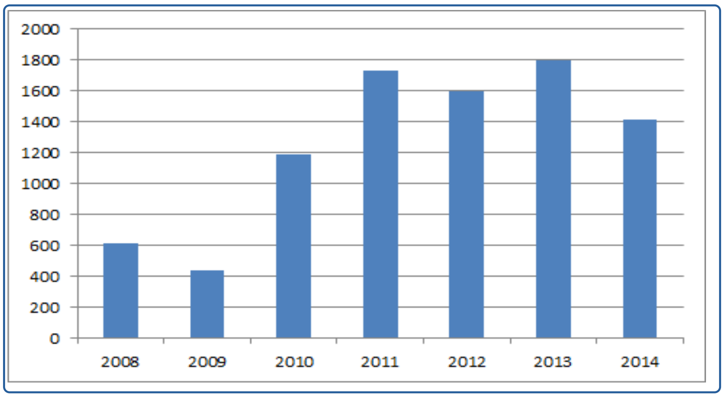
This is one of the reasons we believe it is an attractive phase during which to be invested in Magnit. There is significant potential for growth and investment at high returns. The projected floor space and capex is as follows:

Projected floor space (sq m)



Source: Company data, Anchor Capital

Capex spend ($mn)

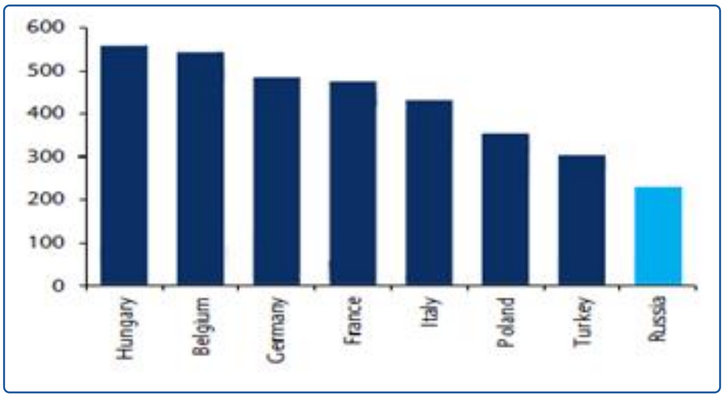


Source: Company data, Anchor Capital

So why is this growth achievable?

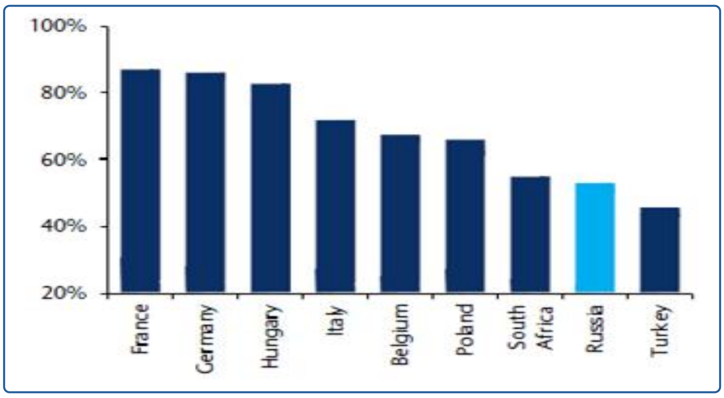
Russia is one of the most underdeveloped retail markets in the world, outside of the major cities. This is shown by the following graphs:

Square metres per ’000 people



Source: Euromonitor, Barclays Research

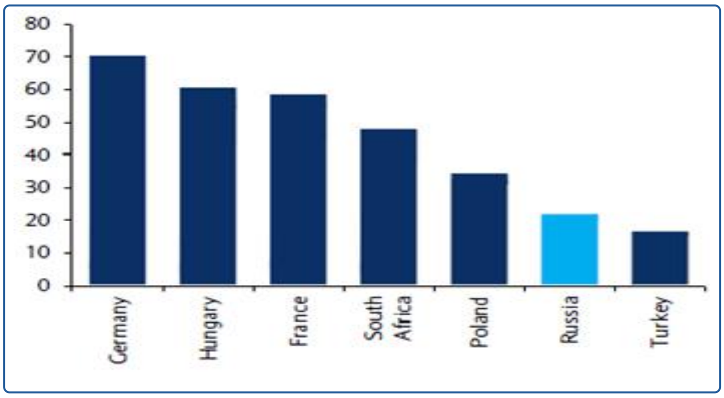
% of modern retail penetration



Source: Euromonitor, Barclays Research

The vast expanses of Russia and years of under-investment saw modern retail expansion being limited to the big cities. This is where Magnit saw its current opportunity in the South and East. Modern retail has roughly 50% market share in Russia and Magnit has around 7% market share. The projections in this report, while seemingly aggressive, only take Magnit’s market share to around 10%.

Top-5 retailers market share



Source: Euromonitor, Barclays Research

The model income statement for Magnit is as follows:

Income statement (rebased to 100)

Turnover	100	
Cost of sales	74.0	
Gross profit	26.0	
Operating expenses	15.5	% of costs
People	9.8	54.3%
Space	3.5	19.5%
Other	2.2	12.5%
EBITDA	10.5	
Depreciation	2.5	13.7%
Operating margin	8.0	

Source: Company data, Anchor Capital

The store formats are as follows:

	Convenience	Family	Hypermarket	Cosmetics
Number of stores	6 046	20	126	692
% of revenue	80%	1%	17%	1%
Growth in 2013	1 100	10	60	250
Avg store size total	446	1 500	7 331	302
Avg own selling space	327	1 500	3 076	231
Market	*within 500 m*		*Accessible by public transport*	*within 500m*
SKU's	3 000	6 000	13 500	6 600
Pvt label %	15%	10%	7%	3%
% owned	32%	20%	85%	28%

Source: Company data, Anchor Capital

Peter Armitage

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