

Pan-Euro General Retail – HAC, Online & Valuation

Not Over Yet

- **2014 and 2015 UK HAC and non-food retail LFL raised c.+2%pts** — In combination, the recent +80bp upgrade to Citi's 2014 GDP growth forecast, recent reductions in UK savings ratio expectations, and upgrades to 2015 UK employment growth/wage growth forecasts, have driven a +150bp and +250bp increase in our 2014 and 2015 UK non-food LFL sales forecasts to +2.5% and +3.5%. This underpins our current sector +10-13% EPS growth forecast. The improving UK housing trends support demand upside, while the online channel shift is a margin headwind.
- **Year to date UK General Retailers +31%, driven by +32% PE re-rating** — Notably, this strong performance (vs. UK equity market c.+13%) has been generated across all three of our investment segments – Growth, Self-help, Cyclical; albeit for Cyclical and UK Growth stocks this has been more pronounced (c.+41% re-rating vs +20% for Self-help).
- **Preference for Self-help and Growth retailers. M&S also recently upgraded to Buy** — Despite the higher current PE multiple of the sector (15x 2014E, 125 PE relative), we argue for further sector share price upside. We make three points.
 - The 10.7x sector 2014E EV/EBIT multiple is not demanding (more in line with the 10x long run average).
 - While the sector has dramatically re-rated, the Self-help retailers have not (12-month forward PE +5% to c.13x).
 - Growth retailers have strong earnings visibility, in aggregate the strongest EPS growth, and can sustain higher multiples.
- **Most favoured: adidas, Dixons Retail, Kingfisher, Inditex. Least favoured: Home Retail and Darty.**

Richard Edwards
+44-20-7986-4006
richard.edwards@citi.com

Assad M Malic
+44-20-7986-8139
assad1.malic@citi.com

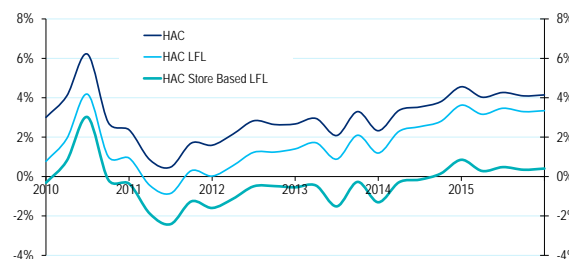
Dan F Homan
+44-20-7986-4112
dan.homan@citi.com

Figure 1. European Retail Segmentation and Recommendations

| | Buy | | | Neutral | Sell |
|----------------|------|------|------|---------|------|
| Revenue Growth | ADS | ACS | DNLM | H&M | |
| | ITX | SPD | | | |
| Self-Help | CPW | KGF | NXT | | |
| | SHFJ | SMWH | | | |
| Cyclicals | DXNS | MKS | | BWNG | DEB |
| | | | | INCH | HFD |
| | | | | | HOME |
| | | | | | DRTY |

Source: Citi Research

Figure 2. Household Available Cash with Implied Store LFL



Source: BRC and Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Sector Changes

Figure 3. General Retail – Summary of Key Changes (fiscal year closest to calendar year-end)

| | <u>Current Price</u> | | <u>Citi Rating</u> | | <u>Target Price</u> | <u>ETR</u> | <u>Earnings revision</u> | | |
|--------------------|----------------------|---------|--------------------|---------|---------------------|------------|--------------------------|--------|--------|
| | | Old | New | Old | New | | 2013E] | 2014E | 2015E |
| Growth | | | | | | | | | |
| adidas | € 82 | Buy | Buy | € 98 | € 95 | 18.0% | (0.4%) | (2.0%) | (1.5%) |
| ASOS | £49 | Buy | Buy | £48 | £58 | 18.0% | - | - | - |
| Dunelm | 951 p | Buy | Buy | 1200 p | 1200 p | 27.9% | 1.7% | 3.1% | 4.3% |
| H&M | SKr 246 | Neutral | Neutral | SKr 220 | SKr 220 | (6.8%) | - | - | - |
| Inditex | € 103 | Buy | Buy | € 117 | € 117 | 17.1% | - | - | - |
| Sports Direct | 693 p | Buy | Buy | 780 p | 780 p | 12.6% | - | - | - |
| CDON | SKr 21 | Neutral | Neutral | | | - | - | - | - |
| Delticom | € 38 | Neutral | Neutral | € 37 | € 37 | 1.7% | - | - | - |
| Zooplus | € 49 | Neutral | Neutral | | | - | - | - | - |
| Self Help | | | | | | | | | |
| Carphone Warehouse | 242 p | Buy | Buy | 290 p | 290 p | 23.0% | - | - | - |
| Kingfisher | 395 p | Buy | Buy | 455 p | 455 p | 17.6% | - | - | - |
| Next | £49.8 | Buy | Buy | £52.0 | £56.5 | 15.5% | (0.2%) | 0.4% | 0.4% |
| Steinhoff | ZAR 29 | Buy | Buy | ZAR 29 | ZAR 29 | 1.5% | - | - | - |
| WH Smith | 852 p | Buy | Buy | 900 p | 900 p | 9.3% | - | - | - |
| Cyclicals | | | | | | | | | |
| Darty | 77 p | Sell | Sell | 47 p | 60 p | (22.1%) | - | - | - |
| Debenhams | 107 p | Neutral | Neutral | 95 p | 95 p | (9.5%) | - | - | - |
| Dixons Retail | 42 p | Buy | Buy | 50 p | 53 p | 27.7% | - | 4.0% | 6.3% |
| Halfords | 366 p | Neutral | Neutral | 325 p | 325 p | (6.5%) | - | - | - |
| Home Retail | 143 p | Sell | Sell | 105 p | 115 p | (18.4%) | - | 4.7% | 5.4% |
| Inchcape | 616 p | Neutral | Neutral | 615 p | 615 p | 2.3% | - | - | - |
| M&S | 483 p | Buy | Buy | 535 p | 535 p | 14.6% | - | - | - |
| N Brown | 559 p | Neutral | Neutral | 435 p | 435 p | (19.7%) | - | - | - |

Source: dataCentral, Citi Research. Priced as of 3 September 2013.

Executive Summary

Pan-European Demand Outlook – modest improvement

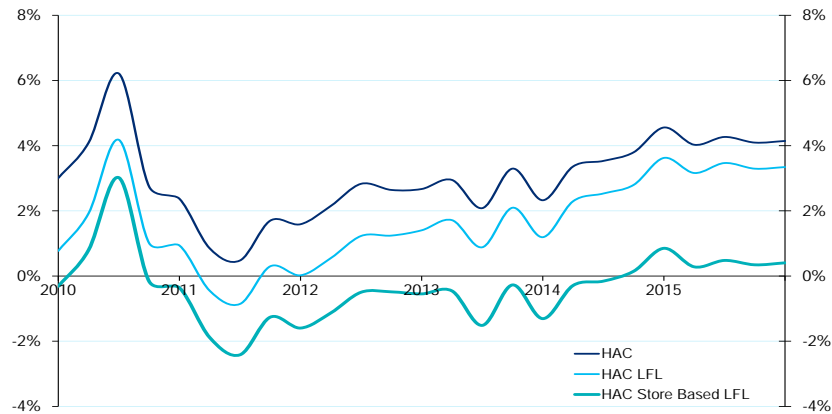
The Citi Global Economic Outlook and Strategy publication summarises the Economic framework that drives our European Household Available Cashflow analysis and our bottom-up General Retail revenue forecast agenda (link: [Global Economic Outlook and Strategy - August 2013](#), Willem Buiter et al, 21 August). Applying these assumptions to our Pan-European Household Available Cashflow framework argues for a -0.4% fade in 2014 LFL retail sales (from -0.9%), driven by a notable LFL sales growth increase in the UK to +2.5% (from +1.0%), a modest 2014 LFL improvement in Germany (+0.1% from -0.1%) and in France (-0.3% from -1.0%), against a small deterioration in Spain (-3.7% from -3.4%).

Figure 4. Pan-European – Household Available Cashflow

| | UK | | | France | | | Germany | | | Spain | | |
|---------------------------|-------|-------|-------|--------|-------|-------|---------|-------|-------|-------|-------|-------|
| | 2012 | 2013E | 2014E | 2012 | 2013E | 2014E | 2012 | 2013E | 2014E | 2012 | 2013E | 2014E |
| Nominal disposable income | 3.3% | 0.5% | 2.2% | -1.1% | -0.4% | 0.5% | 1.9% | 2.6% | 2.8% | -7.6% | -6.0% | -3.7% |
| Household credit | -0.5% | 2.3% | 1.3% | -0.9% | -0.6% | -0.2% | -1.9% | -1.8% | -1.7% | 1.4% | 1.6% | 0.0% |
| Household Available Cash | 2.6% | 2.8% | 3.5% | -2.0% | -1.0% | 0.2% | 0.0% | 0.8% | 1.1% | -6.2% | -4.5% | -3.7% |
| Space | -1.2% | -1.0% | -0.8% | -1.0% | -1.0% | -0.5% | -1.0% | -1.0% | -1.0% | 0.0% | 0.0% | 0.0% |
| VAT | | | | | | | | | | -0.5% | -0.5% | 0.0% |
| Implied LFL | 1.1% | 1.6% | 2.5% | -3.0% | -2.0% | -0.3% | -1.0% | -0.2% | 0.1% | -6.7% | -5.0% | -3.7% |
| Previous forecast | 0.7% | 1.1% | 1.0% | -4.6% | -3.0% | -1.0% | -1.1% | 0.3% | -0.1% | -6.5% | -4.4% | -3.4% |
| Delta | +0.4% | +0.5% | +1.5% | +1.6% | +1.0% | +0.7% | +0.1% | -0.5% | +0.2% | -0.2% | -0.6% | -0.3% |

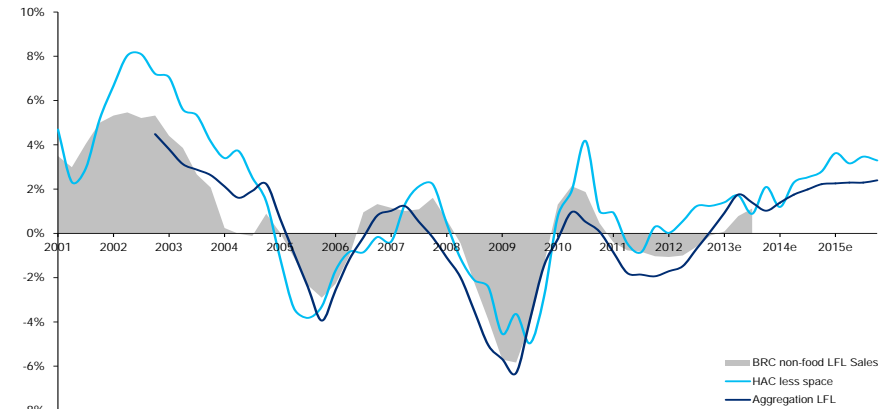
Source: Citi Research

Figure 5. Household Available Cash with Implied Store LFL



Source: BRC and Citi Research Estimates

Figure 6. UK HAC less Space vs BRC Non-Food Retail LFL Sales vs Aggregation LFL Sales



Source: BRC and Citi Research Estimates

Earnings Sensitivity

Figure 7. Earnings Sensitivity

| 1% increase in: | Impact on 2014e HAC | Impact on UK Agg earnings |
|-------------------------------|---------------------|---------------------------|
| Employment or Earnings growth | +1.6% | +8.7% |
| Benefits income | +0.6% | +3.2% |
| Food & Drink spend | -0.2% | -1.3% |
| Fuel & Utilities spend | -0.1% | -0.5% |
| Income tax | -0.3% | -1.8% |
| Base interest rate | -2.5% | -13.5% |
| Savings Ratio | -1.6% | -8.5% |

Source: Citi Research

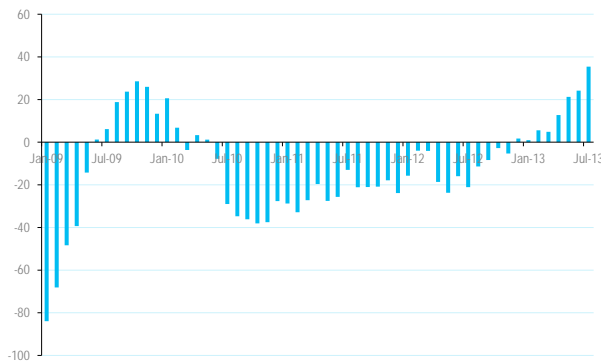
Our estimate for the **operational gearing of the UK retail aggregation is currently c.5.5x**, i.e. each +1% increase in sales results in +5.5% on aggregated earnings. This only holds if incremental sales are through the store channel; the continuing migration to online is likely to be eroding this gearing and explains why our aggregated earnings forecast is +6.6% next year on +2.3% LFL sales growth.

UK Housing market – a further source of demand

A lack of mortgage availability has been a key constraint on UK housing transactions in recent years

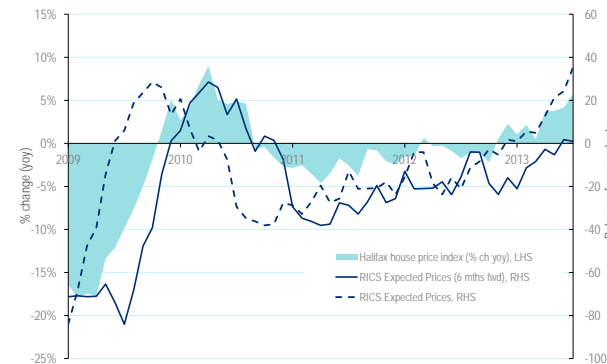
We expect the Help to Buy scheme to improve mortgage availability and stimulate housing transactions into 2014 and 2015. Affordability is a key component in relation to the housing market and assuming interest rates do not rise too significantly and with some wage growth assuming a more rapid recovery in the UK, one might expect house prices to start to move up at least in line with wage growth. We believe that the wealth effect linked to a rising UK housing market (and rising consumer confidence) should underpin our expectation that the UK savings ratio will fade from here, possibly to below our c.6% 2014 and 2015 forecast agenda.

Figure 8. RICS – Price Net Expectations (Jan 09 – present)



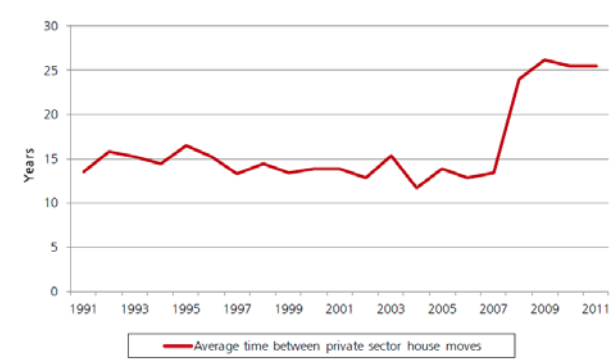
Source: RICS, Citi Research

Figure 9. Halifax House Prices vs. RICS Price Expectations (6m fwd)



Source: Halifax, RICS, Citi Research

Figure 10. Average time between private sector house moves

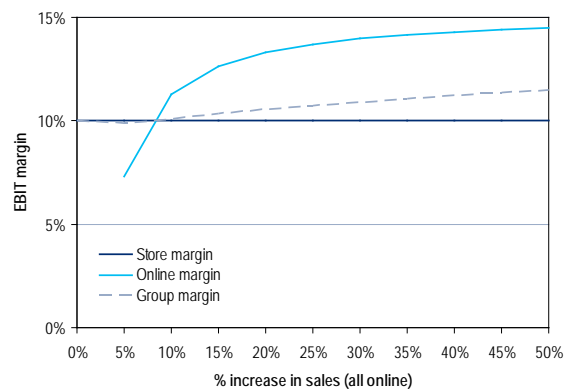


Source: HM Treasury

Online channel migration – remains an EBIT margin headwind

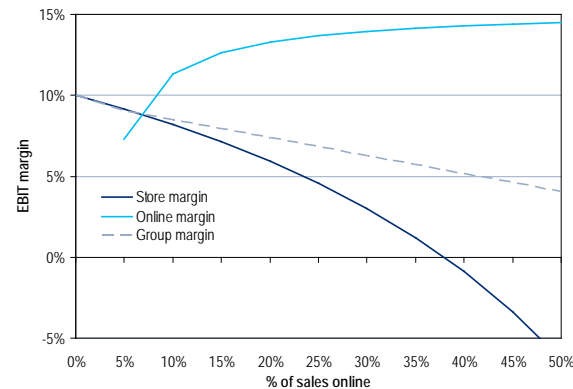
As illustrated above (Figure 15), within the UK we split out both space and online non-food sales growth, and now expect the better overall consumer demand environment to drive a return to c. flat store-based LFL sales from 2013. Despite this, we argue that retailers' store-based EBIT margins will likely remain under pressure from underlying opex inflation trends. This argument stems from the store-based sales cannibalisation and consequent opex deleverage, as set out in the general examples below. This theme is discussed in greater length in our April 2013 report ([Online Implications for Retail Profitability](#), 19 April).

Figure 11. Generic Example – 100% Incremental (Extra Sales Are Generated Online)



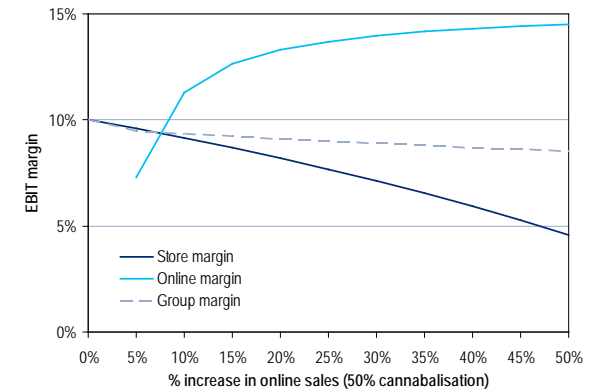
Source: Citi Research

Figure 12. Generic Example – 100% cannibalisation (store sales migrate online)



Source: Citi Research

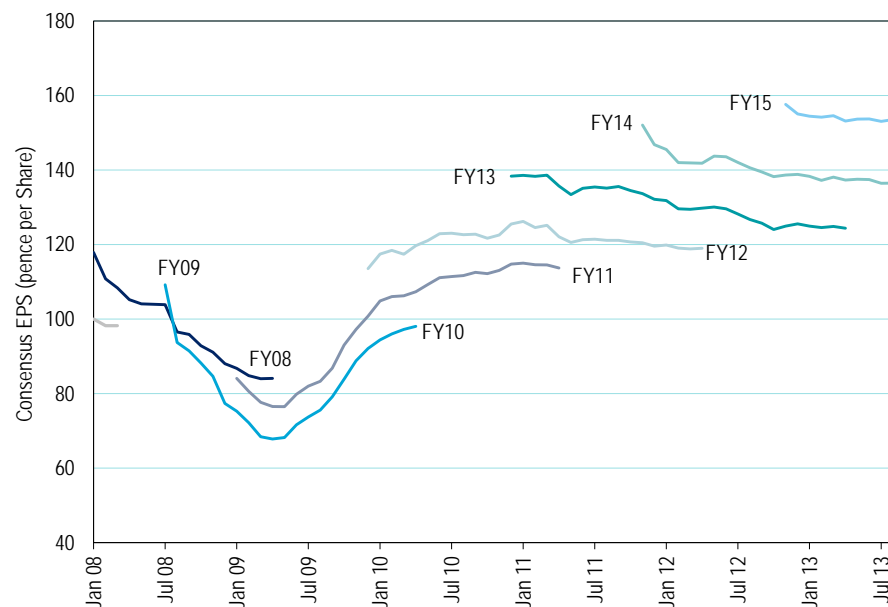
Figure 13. Generic Example – Online Generates Extra Sales, 50% of Which Migrate from in Store



Source: Citi Research

Earnings Growth Forecast

Figure 14. UK Retail – Consensus EPS



Source: Datastream and Citi Research

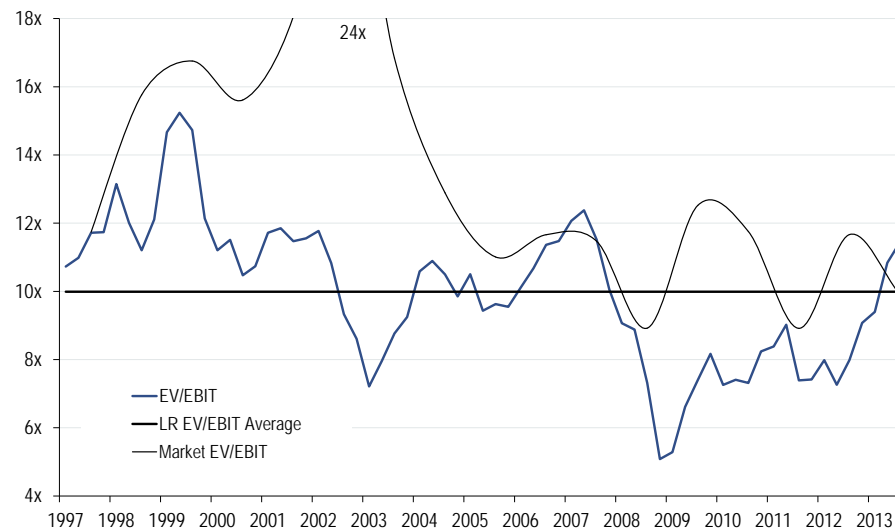
- Looking across entire coverage universe, we now forecast +12% sector EPS growth in both 2014 and 2015.
- As a consequence of the move from negative UK LFL trends (2007-2011) to >+2% LFL sales growth in 2014 and 2015, we forecast double-digit 2014 and 2015 UK EPS growth.
- For context, our coverage universe last saw >+2% LFL sales growth trends in 2003.

Valuation

Recent sharp sector re-rating

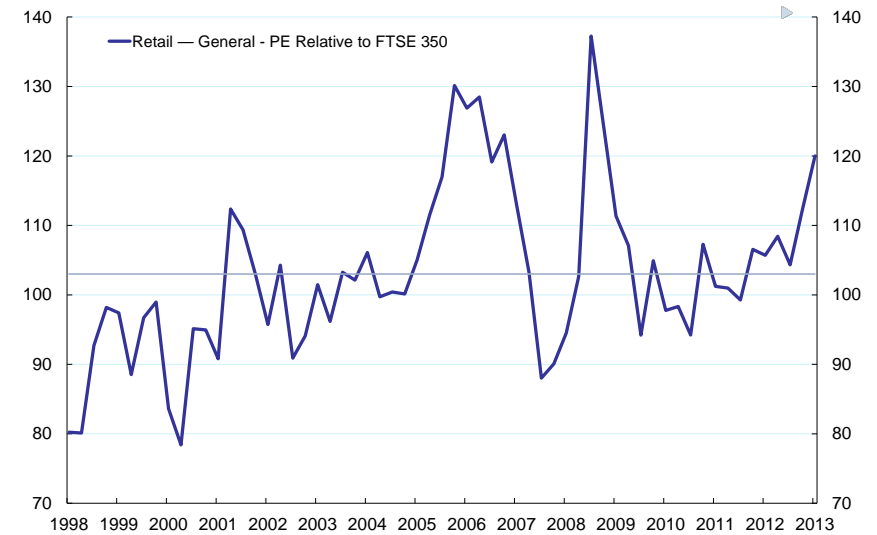
Year to date the UK General Retail sector share price index has increased c.+31% against a UK equity market c.+13%, entirely driven by a valuation re-rating as EPS forecasts have been modestly trimmed (circa -1%). Notably, this sector performance has been consistent across all three sector sub-segments (Growth +31%, Self-help +31%, Cyclical +29%), albeit the Self-help segment has seen a c.+11% EPS upgrade and hence seen a less pronounced re-rating.

Figure 15. UK General Retail – Long Run EV/EBIT



Source: Company Reports and Citi Research

Figure 16. UK General Retail – Long Run P/E



Source: Company Reports, Datastream and Citi Research

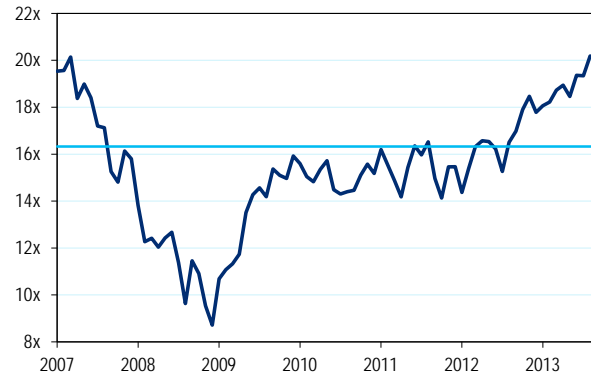
Figure 17. General Retail – YTD 2013 Share Price Performance, Valuation Multiple Delta, and EPS Changes

| | Dec-12 2013 PE | Aug-13 2013 PE | Share Price Delta YTD | Re-rating YTD | EPS Upgrades/ (Downgrades) |
|--------------------------|-------------------|-------------------|--------------------------|------------------|-------------------------------|
| Growth | | | | | |
| adidas | 15.2 | 18.5 | 19.1% | 21.7% | -2.6% |
| ASOS | 52.7 | 99.7 | 90.6% | 89.2% | 1.4% |
| Dunelm | 14.3 | 21.4 | 50.3% | 49.7% | 0.6% |
| H&M | 19.6 | 23.8 | 13.2% | 21.4% | -8.2% |
| Inditex | 23.1 | 24.3 | 0.2% | 5.2% | -5.0% |
| Sports Direct | 12.7 | 21.5 | 70.0% | 69.3% | 0.7% |
| Average (ex ASOS) | 17.0 | 21.9 | 30.6% | 29.0% | 1.6% |
| Self-Help | | | | | |
| Carphone Warehouse | 14.2 | 12.4 | 21.2% | -12.7% | 33.8% |
| Kingfisher | 11.3 | 16.2 | 42.6% | 43.4% | -0.8% |
| Next | 11.8 | 15.5 | 31.8% | 31.4% | 0.5% |
| WH Smith | 9.4 | 12.1 | 28.0% | 28.7% | -0.7% |
| Average | 11.7 | 14.1 | 30.9% | 20.3% | 10.6% |
| Cyclicals | | | | | |
| Darty | 10.4 | 22.2 | 69.5% | 113.5% | -44.0% |
| Debenhams | 10.7 | 11.1 | -6.7% | 3.7% | -10.4% |
| Dixons Retail | 16.0 | 22.8 | 49.7% | 42.5% | 7.2% |
| Halfords | 13.1 | 15.7 | 7.8% | 19.8% | -12.0% |
| Home Retail | 19.8 | 18.2 | 14.0% | -8.1% | 22.1% |
| Inchcape | 10.9 | 14 | 35.1% | 28.4% | 6.6% |
| M&S | 11.4 | 14.7 | 18.6% | 28.9% | -10.4% |
| N Brown | 13.0 | 18.3 | 46.2% | 40.8% | 5.5% |
| Average | 13.2 | 17.1 | 29.3% | 30.1% | -0.8% |
| UK Sector Average | 12.8 | 16.9 | 31.0% | 32.0% | -1.0% |

Source: Company Reports and Citi Research Estimates

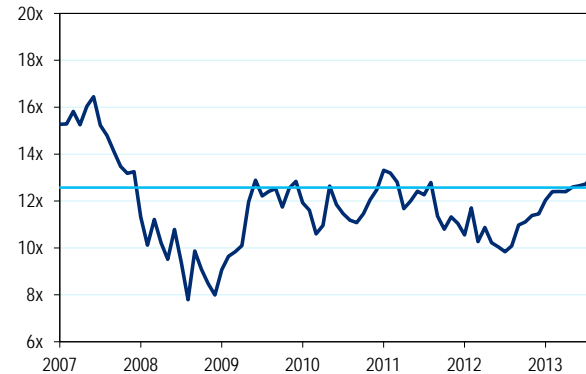
Looked at against average valuation metrics since the financial crisis (2007-2013), the 'Growth' retailers' valuation has re-rated c.+24% (primarily at ASOS, Dunelm and Sports Direct), and the 'Cyclicals' by c.+33% following a material re-rating across all the retailers in this sub-sector. However, the 'Self-help' segment continues to trade broadly in line (c.+5%) with its 2007-2013 average 12-month forward PE.

Figure 18. 'Growth' Retail 12 month forward PE (ex ASOS)



Source: Datastream, Citi Research

Figure 19. 'Self-Help' Retail 12month forward PE



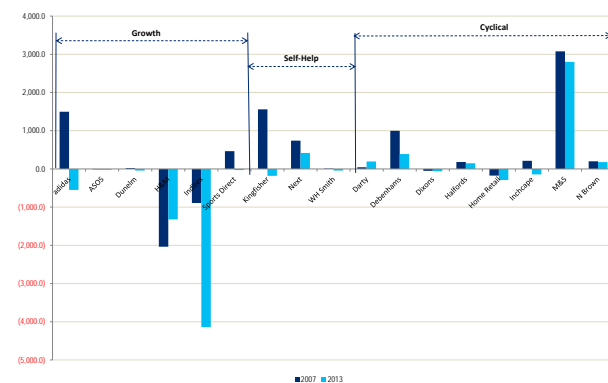
Source: Datastream, Citi Research

Figure 20. 'Cyclical' Retail 12 month forward PE



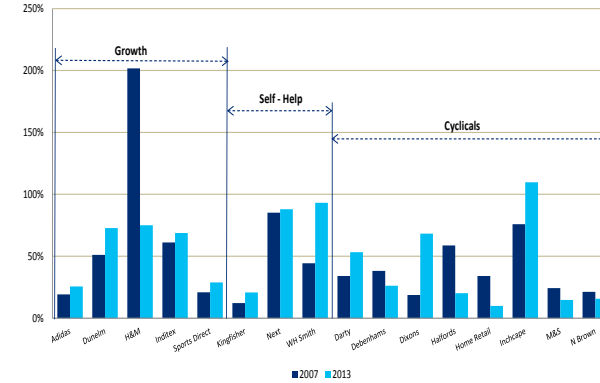
Source: Datastream, Citi Research

Figure 21. Sector Net Debt/(Cash), 2007 v 2013



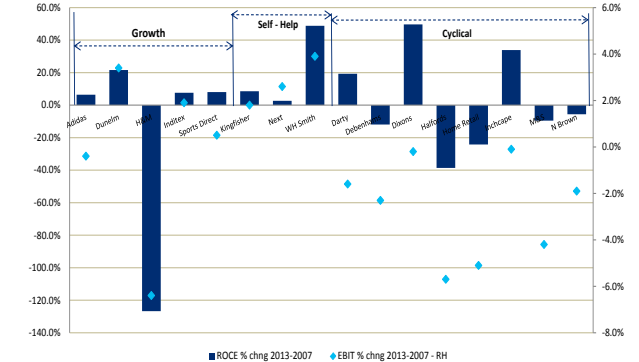
Source: Company reports and Citi Research estimates

Figure 22. Sector ROCE (book), 2007 v 2013



Source: Company reports and Citi Research estimates

Figure 23. Sector ROCE delta and EBIT delta, 2007 v 2013



Source: Company reports and Citi Research estimates

In the context of a UK general retail sector that now trades on a 15x 2014E PE (a c.125 PE relative), sharply above the long-run average (average PE Rel 100-105), there is a growing share price debate over the extent to which a stronger UK consumer demand outlook is already discounted in retail valuations. Here we make three points.

- Firstly, 10.7x sector 2014E EV/EBIT multiple is much more in line with the 10x long run average, reflecting the sector's current strong cash generation and hence improved net debt/(net cash) position.
- Secondly, as flagged above, while the 'Cyclicals' have dramatically re-rated and now trade at a +33% premium to the long-run average (a lofty 17x 2013E PE), the 'Self-help' retailers have not (2013E PE +5% to c.14x), and are currently exposed to both a better demand environment and the earnings upside from their underlying EBIT margin/restructuring activity. We argue that these 'Self-help' retailers (Carphone Warehouse, Kingfisher, Next and WH Smith) continue to offer strong share price upside (see below).
- Finally, while the 'Growth' retailers have re-rated to a c.+24% premium to their average (to 22x 2013E PE), this has been driven primarily by the recent re-rating of three stocks (ASOS, Sports Direct and Dunelm), all in response to growing confidence in their medium-term growth outlook. Conversely, the valuation metrics for H&M and Inditex are little changed over the last six years. We continue to believe that the Growth retailers have strong earnings forecast visibility, in aggregate the strongest absolute EPS growth, and should be able to sustain these valuation metrics over time.

Given this analysis, we remain **Buyers of all four of the 'Self-help' retailers (Carphone Warehouse, Kingfisher, Next and WH Smith)** and today upgrade our Next target price to 5,650p (from 5,200p), while Kingfisher is our Most Preferred. In addition, we continue to argue for **Buy ratings on most of the 'Growth' retailers, including Buys on adidas, ASOS, Dunelm, Inditex and Sports Direct**. Of these we also raise our target price on ASOS today, to 5,800p (from 4,800p). Finally, despite our view that the recent re-rating of the 'Cyclical' retail valuations already discounts a stronger EPS growth forecast agenda, we have **two 'Cyclical' retail Buy ratings, on Dixons Retail and M&S**. We believe both are trading on modest underlying valuation metrics, and both offer high revenue/earnings gearing to a better consumer demand outlook.

Recommendations and Target Prices

Taken together, our most favoured stocks for 2013/14 are adidas, Dixons Retail, Kingfisher, and Inditex. Least favoured are Home Retail and Darty. Notably, we recently raised M&S to a Buy rating (from Neutral), in large part as a consequence of our raised UK consumer demand forecast agenda which we argue has improved the credibility of the group's FY15 and FY16 double-digit earnings growth forecast (cf: [Marks & Spencer: There Is A Light](#), 27 August).

Figure 24. Valuation And Earnings Growth Sector Segmentation (Fiscal Year Nearest to Calendar Year-End)

| | | PE | | | EV/EBIT | | | EPS Growth | | |
|---|---------|-------|------|------|---------|------|------|------------|------|------|
| | | 2013 | 2014 | 2015 | 2013 | 2014 | 2015 | 2013 | 2014 | 2015 |
| Growth basket | | | | | | | | | | |
| adidas | Buy | 19.0 | 16.5 | 14.2 | 12.7 | 11.0 | 9.4 | 14% | 15% | 17% |
| ASOS | Buy | 103.2 | 79.8 | 59.1 | 76.8 | 59.6 | 44.1 | 20% | 29% | 35% |
| Dunelm | Buy | 21.2 | 19.0 | 17.0 | 15.4 | 13.6 | 11.8 | 13% | 11% | 12% |
| H&M | Neutral | 24.1 | 21.7 | 19.7 | 18.1 | 16.3 | 14.8 | 0% | 11% | 10% |
| Inditex | Buy | 24.9 | 22.4 | 19.8 | 17.8 | 15.4 | 13.5 | 9% | 11% | 13% |
| Sports Direct | Buy | 22.1 | 18.4 | 16.8 | 16.3 | 13.1 | 10.9 | 17% | 20% | 10% |
| CDON Group | Neutral | 51.9 | 24.1 | 15.4 | 22.7 | 12.3 | 7.4 | -248% | 115% | 57% |
| Delticom | Neutral | 21.5 | 18.9 | 16.5 | 13.8 | 12.3 | 10.8 | -4% | 13% | 15% |
| Zooplus | Neutral | 165.4 | 46.5 | 25.7 | 143.0 | 37.5 | 20.4 | -185% | 256% | 81% |
| Average (equal weighted) ex Online stocks | | 22.2 | 19.6 | 17.5 | 16.1 | 13.9 | 12.1 | 11% | 14% | 12% |
| Average (equal weighted) | | 50.3 | 29.7 | 22.7 | 37.4 | 21.2 | 15.9 | -40% | 53% | 28% |
| Self Help | | | | | | | | | | |
| Carphone Warehouse | Buy | 12.7 | 11.3 | 10.7 | 8.8 | 8.2 | 7.8 | 57% | 12% | 6% |
| Kingfisher | Buy | 16.6 | 14.8 | 13.5 | 11.9 | 10.5 | 9.5 | 8% | 12% | 9% |
| Next | Buy | 15.8 | 14.2 | 12.8 | 12.0 | 11.7 | 11.2 | 12% | 11% | 12% |
| Steinhoff | Buy | 8.3 | 7.7 | 0.0 | 7.8 | 6.9 | 0.0 | 9% | 8% | 9% |
| WH Smith | Buy | 12.2 | 11.3 | 10.6 | 9.4 | 9.0 | 8.7 | 11% | 8% | 6% |
| Average (equal weighted) | | 13.1 | 11.9 | 9.5 | 10.0 | 9.3 | 7.4 | 20% | 10% | 9% |
| Cyclicals | | | | | | | | | | |
| Darty | Sell | 21.4 | 17.7 | 15.8 | 13.0 | 11.2 | 9.9 | 81% | 21% | 12% |
| Debenhams | Neutral | 11.0 | 10.9 | 9.9 | 10.3 | 10.2 | 9.6 | -1% | 1% | 10% |
| Dixons Retail | Buy | 23.1 | 17.5 | 16.1 | 7.8 | 6.5 | 6.7 | 48% | 32% | 9% |
| Halfords | Neutral | 15.9 | 13.6 | 11.6 | 13.7 | 11.9 | 10.0 | -16% | 17% | 18% |
| Home Retail Group | Sell | 18.3 | 17.6 | 15.9 | 9.7 | 10.0 | 9.6 | 3% | 4% | 11% |
| Inchcape | Neutral | 14.6 | 13.1 | 12.0 | 9.1 | 8.3 | 7.9 | 9% | 11% | 9% |
| M&S | Buy | 15.1 | 13.4 | 12.0 | 13.0 | 11.8 | 10.7 | 2% | 13% | 11% |
| N Brown | Neutral | 18.9 | 18.3 | 17.8 | 16.1 | 15.3 | 14.8 | 4% | 3% | 3% |
| Average (equal weighted) | | 17.3 | 15.3 | 13.9 | 11.6 | 10.6 | 9.9 | 16% | 13% | 10% |

Source: Company Reports and dataCentral (priced on 3 September)



Sector Segmentation

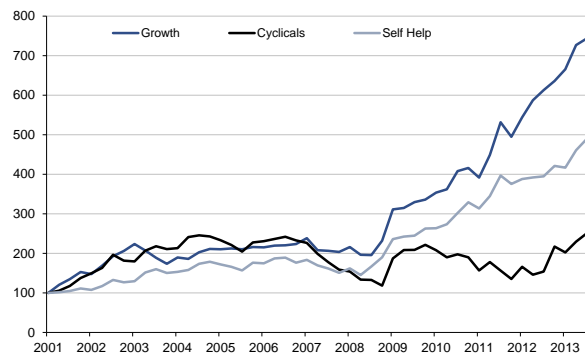
Sector Investment Segmentation

We segment the European General Retail sector into categories that we argue offer differentiated performance in this low-growth environment, namely Revenue Growth, Self-help and Cyclical stocks.

- **Revenue Growth** – companies that are capable of growing their sales in the current low-growth environment, predominantly through international expansion, incremental online sales, or new space opening. We expect these retailers to continue taking market share.
- **Self-help** – companies that have the ability to drive their own earnings independent of the broader macro environment. We include companies with ongoing programmes to drive margin upside and those retiring their own equity.
- **Cyclicals** – companies that are dependent on broader macro conditions to drive earnings.

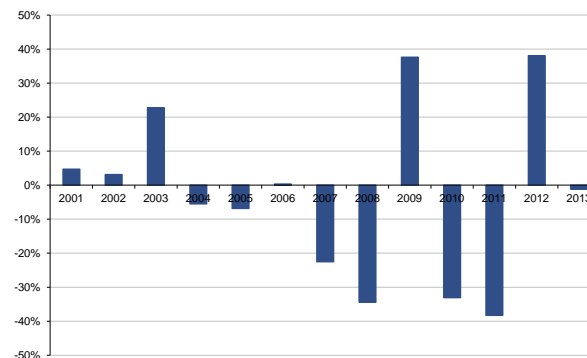
Over time the 'Growth' and 'Self-Help' retailers have sharply outperformed the 'Cyclicals', albeit since the financial crisis the 'Cyclicals' have outperformed twice, in 2009 and 2012, in response to vast macro stimulus.

Figure 25. Growth vs Self-help vs Cyclicals, Relative to Eurostoxx



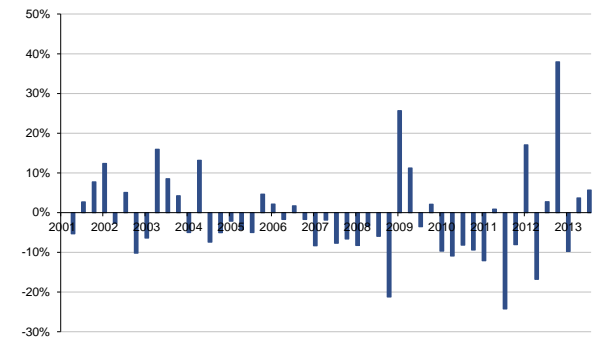
Source: Datastream, Citi Research

Figure 26. Cyclicals vs. Growth/Self-help Performance



Source: Datastream, Citi Research

Figure 27. Cyclicals vs. Growth/Self-help Performance



Source: Datastream, Citi Research

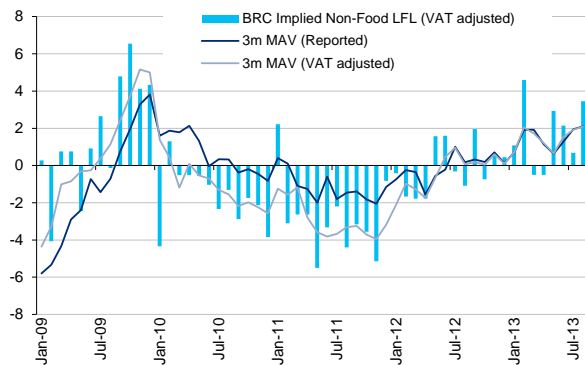
Household Available Cashflow Analysis

UK General Retail – Demand Outlook

Since our last update in December, [Reasons To Be Cheerful](#), Citi forecasts for UK GDP have been raised to +1.1% for 2013 and +2.1% for 2014, from +0.4% and +0.7%, respectively, with 2015e now forecast at +2.7%. This reflects the recent upturn in housing, consumer spending and exports.

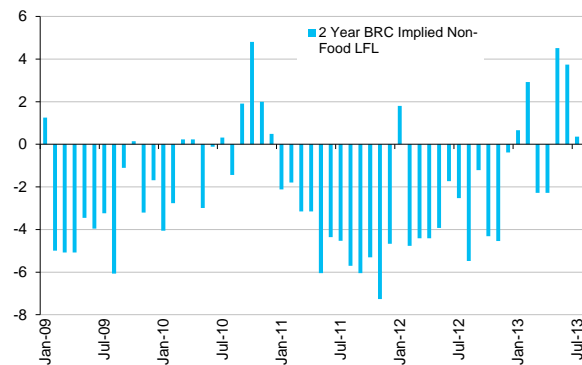
As illustrated below, the BRC non-food LFL sales growth pattern in 2013 to date has been running at c.+1.5%, against a c.-0.4% LFL comparative from last year. Notably, this c.+1.5% UK non-food LFL run rate is in line with our Household Available Cash (HAC) analysis (see below).

Figure 28. Citi Implied Non-Food LFL



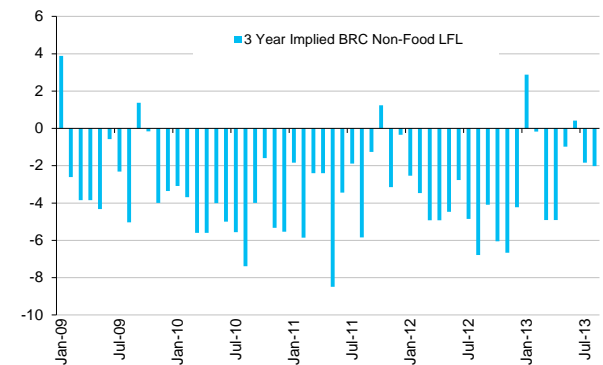
Source: BRC, Citi Research

Figure 29. Citi Implied Non-Food LFL – 2 year



Source: BRC, Citi Research

Figure 30. Citi Implied Non-Food LFL – 3 year



Source: BRC, Citi Research

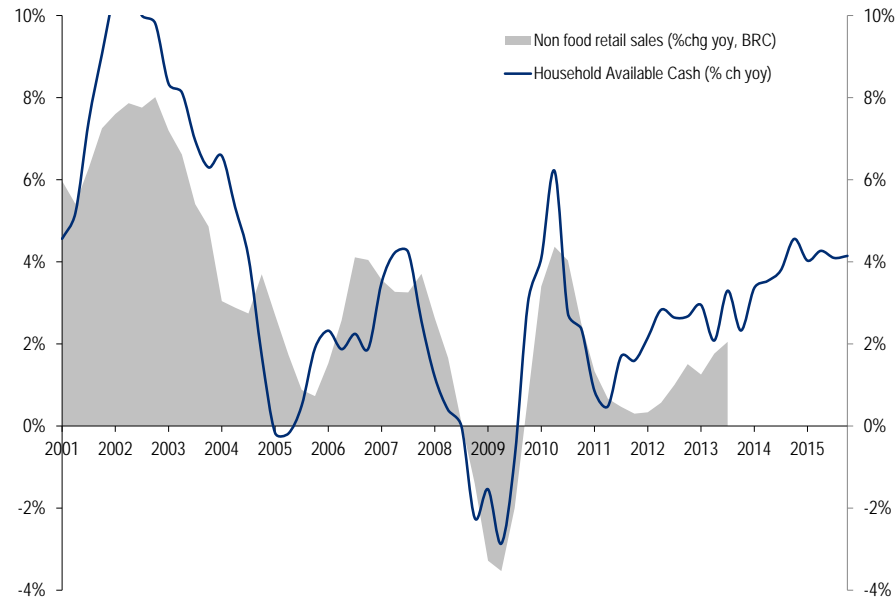
HAC implied 2014e LFL raised to +2.5% (from +1.0%). Above +1.6% 2013e LFL (raised from +1.1%)

We use a proprietary model, HAC, to forecast demand trends in the sector. HAC gathers multiple economic inputs across income, consumption and leverage and calculates the yoy% change in cash available for discretionary spending. We use this approach across the major European economies. Back-tested over nearly two decades, this is our best lead indicator for non-food retail LFL.

In this report we broadly maintain the 2013 consensus UK employment forecast agenda (+1.0% from +1.2%), following the recent weakening of month-on-month employment trends and lower the savings ratio expectation to 5.9% from 7.2%. This is the primary reason for an improvement in our HAC-driven 2013E LFL to +1.6% (from +1.1%), and also our 2014E LFL at +2.5% (from +1.0%). Looking out to 2015, we argue for a +3.5% UK non-food LFL sales trend driven by c.+3.5% total earnings forecast and a savings ratio maintained at 5.7%.

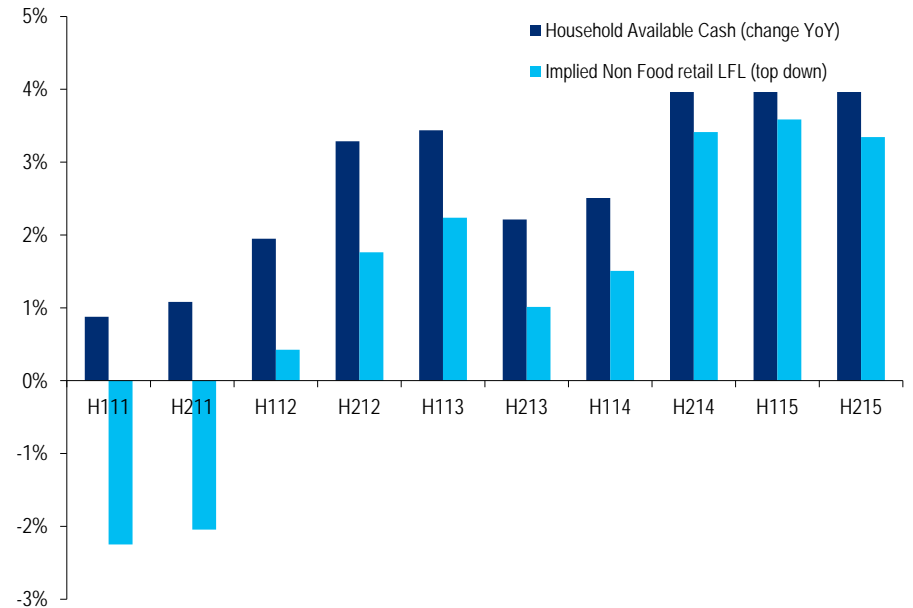
Importantly, when applying this analysis to the general retailers under our research coverage, given the absence of other material earnings growth levers, the Cyclical retailers' relative share price performance is the most highly correlated to the UK HAC trends. Given their alternative sources of earnings growth (international markets, share buybacks), the Revenue Growth and Self-help companies have outperformed the Cyclical and the HAC since 2001, with 17% and 14% annual total returns versus 8% for the Cyclical and growth in HAC of c.2% per annum.

Figure 31. Household Available Cash vs. Non-Food Retail Sales



Source: ONS, DataStream, BoE and BRC and Citi Research Estimates

Figure 32. Household Available Cash – Half-Yearly LFL



Source: ONS, DataStream, BoE and BRC and Citi Research Estimates

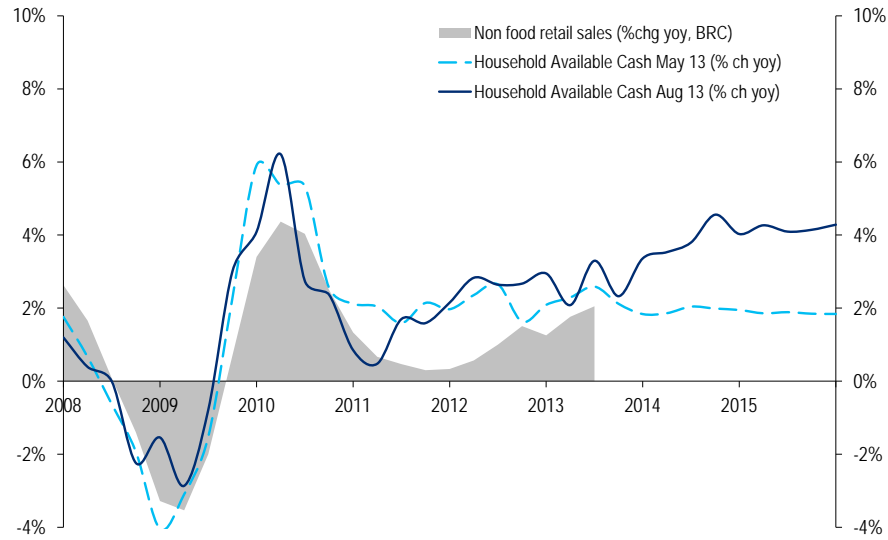
LFL sales forecast increased to +1.6% and +2.5% in 2013 and 2014 (from +1.1% and +1.0%)

Figure 33. Household Available Cash – Half-Yearly Breakdown

| | H110 | H210 | H111 | H211 | H112 | H212 | H113 | H213 | H114 | H214 | H115 | H215 |
|--|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Household Available Cash (change YoY) | 5.3% | 4.1% | 0.9% | 1.1% | 1.9% | 3.3% | 3.4% | 2.2% | 2.5% | 4.4% | 4.4% | 4.1% |
| Space Contribution | (1.9%) | (1.9%) | (1.3%) | (1.3%) | (1.5%) | (1.5%) | (1.2%) | (1.2%) | (1.0%) | (1.0%) | (0.8%) | (0.8%) |
| VAT | (1.8%) | (1.8%) | (1.8%) | (1.8%) | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Implied Non Food retail LFL (top down) | 1.6% | 0.4% | (2.2%) | (2.0%) | 0.4% | 1.8% | 2.2% | 1.0% | 1.5% | 3.4% | 3.6% | 3.3% |
| Reported/Forecast LFL (bottom up) | 0.1% | (1.8%) | (1.9%) | (1.5%) | 0.1% | 1.8% | 1.0% | 1.7% | 2.2% | 2.6% | 2.4% | 2.7% |

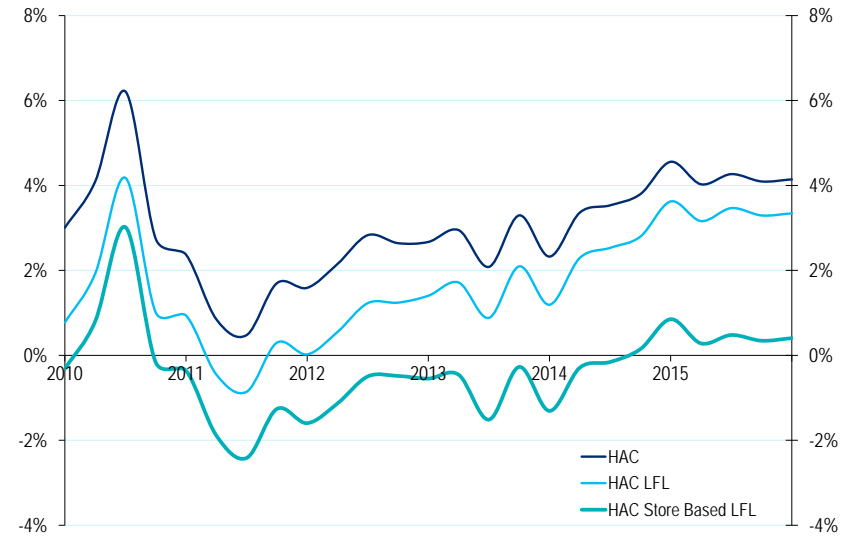
Source: ONS, DataStream, BoE and BRC and Citi Research Estimates

Figure 34. Household Available Cash (short run, 2008-15)



Source: ONS, DataStream, BoE and BRC and Citi Research Estimates

Figure 35. Household Available Cash with Implied Store LFL



Source: ONS, DataStream, BoE and BRC and Citi Research Estimates

Summary of HAC gross earnings assumption changes in this report

Figure 36. Citi Research Household Available Cash – 2013 and 2014 Forecast Changes

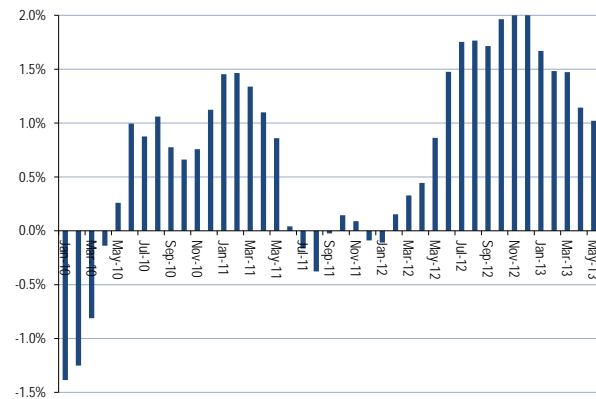
| | % ch yoy 2013 | | | % ch yoy 2014 | | | Comment |
|-----------------------|---------------|--------|--------|---------------|--------|--------|--|
| | Dec-12 | May-13 | Aug-13 | Dec-12 | May-13 | Aug-13 | |
| Employment | +0.9% | +1.2% | +1.0% | +0.7% | +0.8% | +0.8% | Recent employment data has softened slightly |
| Average earnings | +1.8% | +1.3% | +1.2% | +1.6% | +1.7% | +1.7% | Rel stable inflation outlook |
| Base Rates (year-end) | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% | Unchanged |
| Food & Drink | +2.5% | +3.3% | +3.3% | +2.5% | +2.6% | +2.7% | Unchanged inflation outlook |
| Savings Ratio | 7.0% | 7.2% | 5.9% | 7.2% | 7.1% | 5.7% | Evidence of household deleverage slowing |

Source: Citi Research Estimates

■ Employment – expected to rise +1.0% in 2013 and +0.8% in 2014

In 2013, we derive a consensus UK employment forecast of +1.0% (from +1.2% previously). In summary we think UK labour supply is likely to be lifted by high inflows of foreign workers (due to high labour mobility in EU, the UK's relatively high pay levels and plentiful non-UK English speakers), rising participation rates among the over 50s and tightening benefits standards.

Figure 37. UK Employment (3m average % ch yoy)



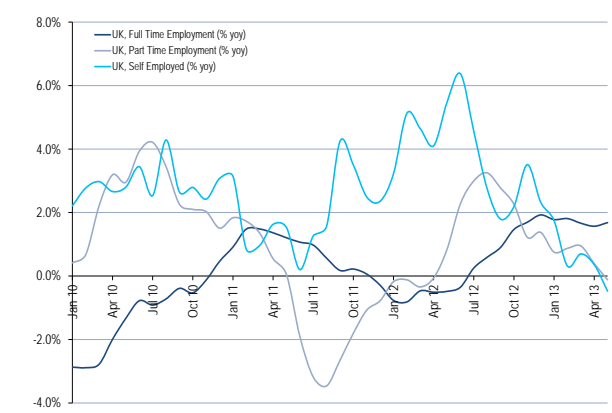
Source: LFS and Citi Research

Figure 38. UK Employment – Private vs Public Sector (% ch yoy)



Source: LFS and Citi Research

Figure 39. UK Employment by Category (yoy %chg)

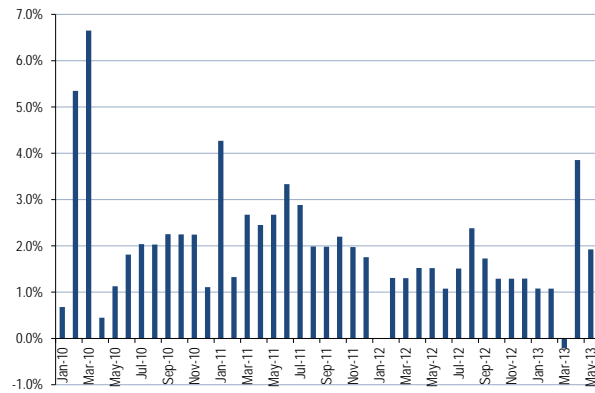


Source: LFS and Citi Research

■ Average earnings – forecast to rise +1.2% in 2013 and +1.7% in 2014

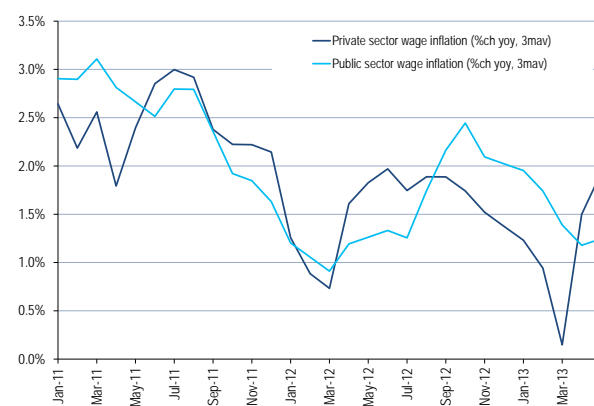
Average earnings have remained relatively stable at c.1.5% over the last 12 months. However, the mix effect of lower full time employment is not captured in these figures, which are essentially LFL. Market economists' expect this picture of +1-1.5% wage growth to persist in 2013 and to increase to around +1.7% in 2014 due to cyclical productivity rebound.

Figure 40. UK Weekly Earnings (%ch yoy)



Source: LFS and Citi Research

Figure 41. Public vs Private sector Wage Inflation (3m average)

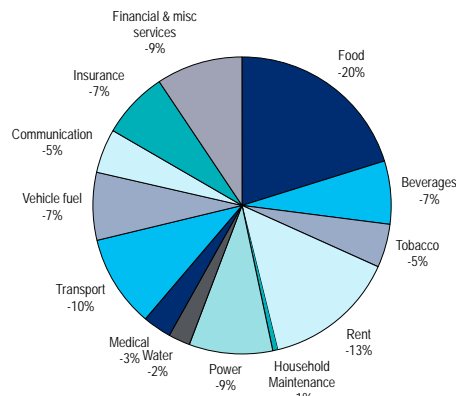


Source: LFS and Citi Research

■ Non-discretionary costs – +3.3% in 2013, slightly lower than 2012

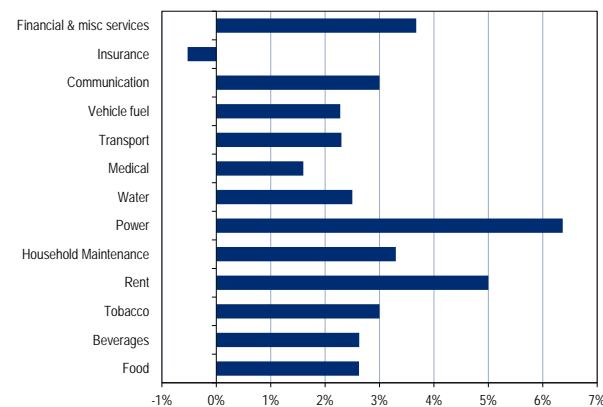
We assume inflation in non-discretionary costs continues at a moderate level of c.3% in 2013 and outer years. We forecast Food & Drink spending will grow at c.3.3% in 2013 and +2.7% in 2014. For utilities, particularly electricity and gas, we maintain our high inflation assumptions due to continuing price increases to energy bills. The only category where we expect price reductions is insurance.

Figure 42. Split of 2014E Non-discretionary Costs



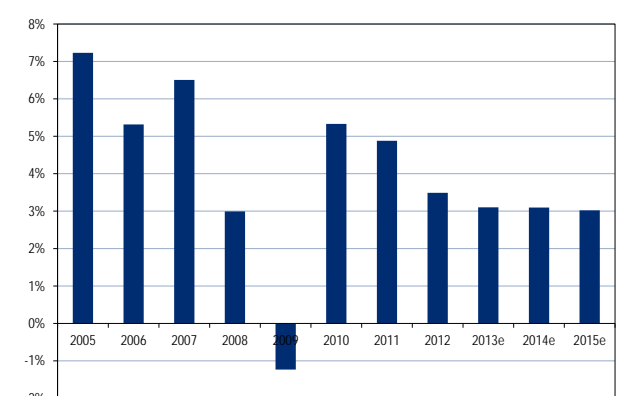
Source: Citi Research

Figure 43. Non-discretionary cost % change, 2014E



Source: Citi Research

Figure 44. Non-discretionary costs yoy % change

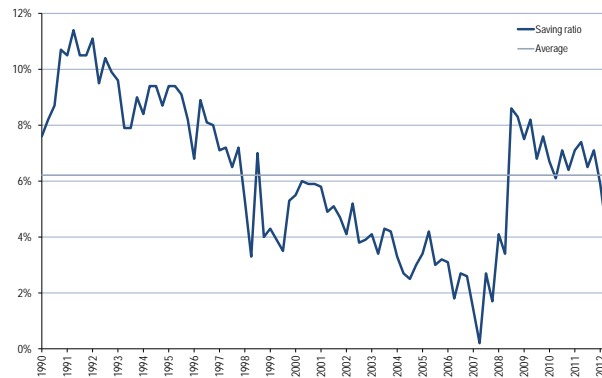


Source: Citi Research

■ UK base rates; expected to remain unchanged until 2017

The MPC's recent guidance is clear that no tightening will take place until jobless rate falls to 7%. Citi economists believe this will take until 2017, reflecting scope for a cyclical productivity rebound, greater use of under-employed labour and strong labour supply growth. Therefore we forecast base rates to stay at 0.5% through our forecast years.

Figure 45. UK Household Savings ratio



Source: ONS, DataStream

■ Household saving ratio expected to fall and moderate over coming years

Since early 2009 the Household savings ratio has averaged 7%, fading slightly to 6.7% in 2012. We expect this fade to accelerate driven by increasing consumer confidence around the out turn for the UK economy.

HAC Sensitivity

Figure 46. HAC – Sensitivity Analysis

| 1% increase in: | Impact on 2014e HAC |
|-------------------------------|---------------------|
| Employment or Earnings growth | 1.6% |
| Benefits income | 0.6% |
| Food & Drink spend | -0.2% |
| Fuel & Utilities spend | -0.1% |
| Income tax | -0.3% |
| Base interest rate | -2.5% |
| Savings Ratio | -1.6% |

Source: Citi Research

Our HAC is most sensitive to increases in total earnings growth which can be driven by employment growth in increases in average wages, a change to the savings ratio or to the base interest rate. The sensitivity to the base interest rate is particularly pronounced and we forecast base rates staying low for longer, in line with Carney's recent guidance and Citi economists, but not necessarily in line with current market assumptions.

Interestingly, if a more positive outlook than our forecast was taken then it could be assumed that average earnings could be improved +1%pt and at the same time increased consumer confidence could lead to a -1%pt decrease in the savings ratio. This would add c.+3% to our HAC forecast, a pretty significant upgrade. The same logic could be applied in the opposite direction if a worse outcome was expected.

We summarise our UK HAC forecast and assumptions in the table below

Figure 47. UK Household Available Cash – 2005-2015e

| £m | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013e | 2014e | 2015e |
|--|----------------|----------------|----------------|----------------|----------------|------------------|------------------|------------------|------------------|------------------|------------------|
| Gross earnings | 726,928 | 766,517 | 811,806 | 827,429 | 808,438 | 839,358 | 864,940 | 890,057 | 906,182 | 928,516 | 960,378 |
| - % ch yoy | 4.2% | 5.4% | 5.9% | 1.9% | (2.3%) | 3.8% | 3.0% | 2.9% | 1.8% | 2.5% | 3.4% |
| State benefits | 211,542 | 225,986 | 226,921 | 251,187 | 276,584 | 287,531 | 295,554 | 312,568 | 328,221 | 343,388 | 358,840 |
| - % ch yoy | 6.8% | 6.8% | 0.4% | 10.7% | 10.1% | 4.0% | 2.8% | 5.8% | 5.0% | 4.6% | 4.5% |
| Income tax & NIC | (117,764) | (169,046) | (182,534) | (187,533) | (179,448) | (181,450) | (189,038) | (187,043) | (187,891) | (191,581) | (197,197) |
| - % ch yoy | (19.6%) | 43.5% | 8.0% | 2.7% | (4.3%) | 1.1% | 4.2% | (1.1%) | 0.5% | 2.0% | 2.9% |
| - as % gross earnings | (0.0%) | 0.0% | 0.0% | 0.0% | (0.0%) | 0.0% | 0.0% | (0.0%) | 0.0% | 0.0% | 0.0% |
| Other | 10,300 | 48,315 | 53,420 | 39,001 | 53,862 | 66,250 | 62,708 | 49,882 | 33,689 | 26,752 | 23,824 |
| - as % gross earnings | 1.4% | 6.3% | 6.6% | 4.7% | 6.7% | 7.9% | 7.3% | 5.6% | 3.7% | 2.9% | 2.5% |
| After Tax Earnings | 831,006 | 871,772 | 909,613 | 930,084 | 959,436 | 1,011,689 | 1,034,164 | 1,065,464 | 1,080,201 | 1,107,074 | 1,145,844 |
| - % ch yoy | 4.3% | 4.9% | 4.3% | 2.3% | 3.2% | 5.4% | 2.2% | 3.0% | 1.4% | 2.5% | 3.5% |
| Non-discretionary costs | (302,635) | (318,723) | (339,456) | (349,613) | (345,305) | (363,715) | (381,462) | (394,777) | (407,017) | (419,616) | (432,292) |
| - % ch yoy | 7.2% | 5.3% | 6.5% | 3.0% | (1.2%) | 5.3% | 4.9% | 3.5% | 3.1% | 3.1% | 3.0% |
| Mortgage Interest | (48,617) | (56,600) | (61,137) | (62,388) | (61,783) | (46,678) | (44,953) | (43,485) | (42,824) | (42,790) | (43,008) |
| Consumer credit cost | (16,983) | (16,713) | (16,350) | (17,690) | (15,084) | (12,487) | (12,354) | (12,163) | (12,282) | (12,840) | (13,456) |
| Interest payments | (65,599) | (73,314) | (77,487) | (80,079) | (76,867) | (59,165) | (57,307) | (55,648) | (55,106) | (55,630) | (56,464) |
| - % ch yoy | 13.7% | 11.8% | 5.7% | 3.3% | (4.0%) | (23.0%) | (3.1%) | (2.9%) | (1.0%) | 1.0% | 1.5% |
| Net Increase/(Decrease) in Household Debt | 23,079 | 17,123 | 19,933 | 14,491 | (31,914) | (59,806) | (61,216) | (66,885) | (54,454) | (48,710) | (49,102) |
| Savings ratio | 3.0% | 3.4% | 2.2% | 2.2% | 7.1% | 7.5% | 6.9% | 7.0% | 5.9% | 5.7% | 5.7% |
| Non discretionary costs and change in debt | (345,155) | (374,914) | (397,010) | (415,201) | (454,086) | (482,686) | (499,985) | (517,310) | (516,577) | (523,956) | (537,859) |
| Total Discretionary Income | 485,851 | 496,859 | 512,603 | 514,883 | 505,350 | 529,003 | 534,179 | 548,154 | 563,625 | 583,118 | 607,986 |
| - % ch yoy | 0.7% | 2.3% | 3.2% | 0.4% | (1.9%) | 4.7% | 1.0% | 2.6% | 2.8% | 3.5% | 4.3% |
| Less Space contribution | (3.7%) | (2.6%) | (2.1%) | (2.4%) | (2.1%) | (1.9%) | (1.3%) | (1.5%) | (1.2%) | (1.0%) | (0.8%) |
| VAT | | | | | 1.8% | (1.8%) | (1.8%) | | | | |
| Implied Non Food Retail LFL (top down) | (3.0%) | (0.3%) | 1.1% | (2.0%) | (2.2%) | 1.0% | (2.1%) | 1.1% | 1.6% | 2.5% | 3.5% |
| Reported/Forecast LFL (bottom up) | (2.5%) | 0.8% | (1.3%) | (5.7%) | (0.2%) | (0.9%) | (1.7%) | 1.0% | 1.4% | 2.3% | 2.5% |
| Online Contribution | 0.7% | 0.7% | 0.8% | 0.9% | 1.1% | 1.2% | 1.6% | 1.7% | 2.4% | 2.7% | 3.0% |
| Store based LFL | (3.6%) | (1.0%) | 0.3% | (2.9%) | (3.2%) | (0.2%) | (3.7%) | (0.6%) | (0.8%) | (0.2%) | 0.5% |

Source: ONS, DataStream, BoE and BRC and Citi Research Estimates

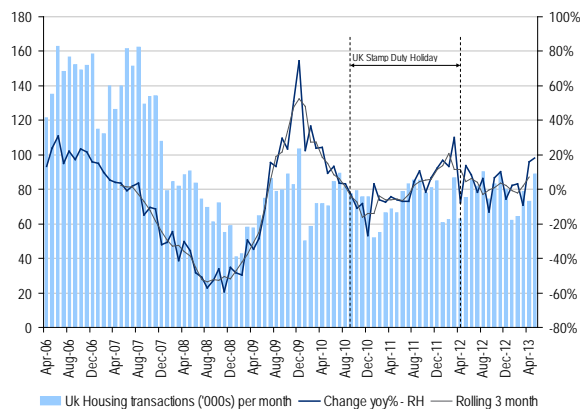
UK Housing Market – A further source of demand

A lack of mortgage availability has been a key constraint on UK housing transactions in recent years

We expect the Help to Buy scheme to improve mortgage availability and stimulate housing transactions into 2014 and 2015. Affordability is a key component in the relation to the housing market and assuming interest rates do not rise too significantly and with some wage growth due to a recovery in the UK, one might expect house prices to start to move up at least in line with wage growth.

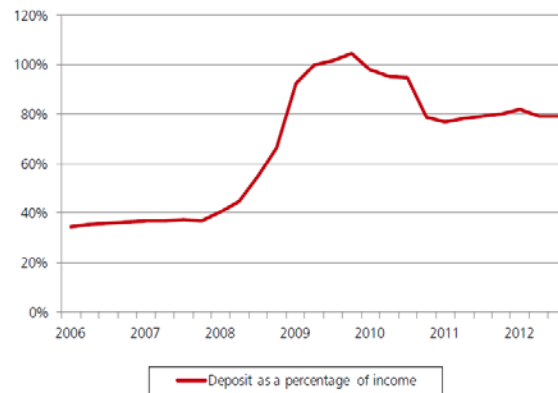
As part of the 2013 Budget, the government announced two main Help to Buy initiatives designed to help consumers move up through the property ladder in the UK and to encourage more volume of lending at higher loan to values given the current tight state of the mortgage market. The first was the 'Equity Loan' scheme which applies to new-builds only and the second and the focus of our analysis is the 'Mortgage Guarantee' scheme. This scheme comes into effect from January 2014 and will provide lenders with the option to purchase a government guarantee that compensates them for a position of their losses in the event of a foreclosure.

Figure 48. UK Housing Transactions – Monthly



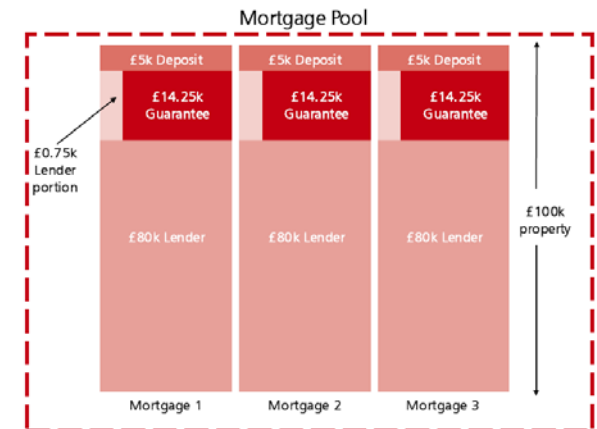
Source: Datasteam

Figure 49. First-time buyer deposit as % of income



Source: HM Treasury

Figure 50. Illustration of Mortgage guarantee scheme



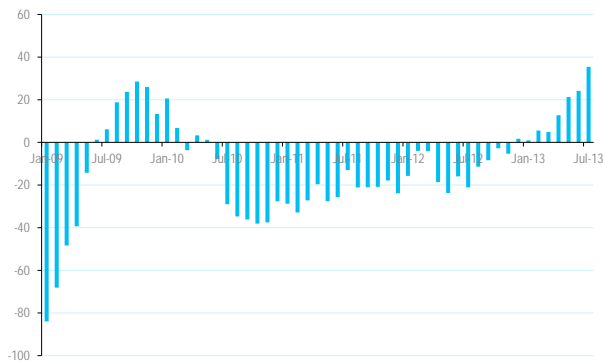
Source: HM Treasury

We believe the mortgage guarantee scheme should lead to incremental housing transactions through 2014 and 2015 and be beneficial to UK DIY

UK Housing transactions are about 50% off peak post the material step down in 2008. This has resulted in current turnover rates equivalent to houses selling once every 25 years, compared to once every 15 years before the crisis. In particular we believe the mortgage guarantee scheme should lead to incremental housing growth in housing transactions in 2014 and 2015 stimulating further activity in the first time buyer market.

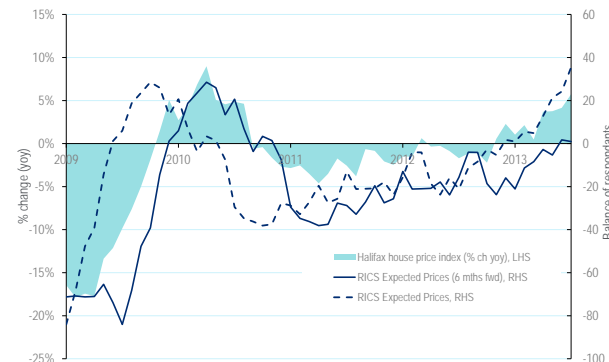
According to the HM Treasury in 2012 there were 40% fewer first-time buyers than in 2007 and as Figure 48 shows first time buyers' deposit as % of income has increased from c40% in 2006-2009 to nearer 80% post the financial crisis. Outside of weather effects, part of the underlying softness in DIY in the UK has been down to lack of first time buyers (weak housing transactions) as: 1) these are less likely to use DIFM (Do It For Me); and 2) According to Kingfisher, new home-owners spend up to 3x the average annual spend on home improvement.

Figure 51. RICS – Price Net Expectations (Jan 09 – present)



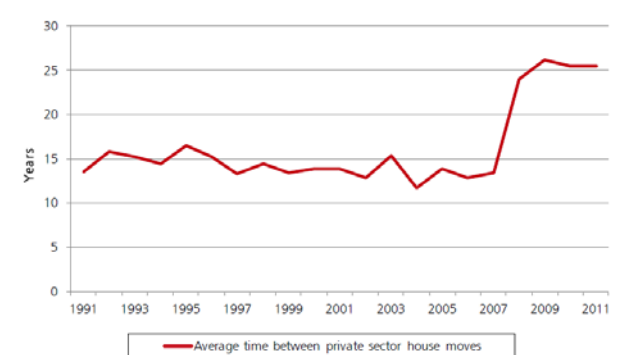
Source: RICS, Citi Research

Figure 52. Halifax House Prices vs. RICS Price Expectations (6m fwd)



Source: Halifax, RICS, Citi Research

Figure 53. Average time between private sector house moves



Source: HM Treasury

Our analysis of the mortgage guarantee scheme suggests there is scope for a c337,000 increase in housing transactions over the three year period and we assume split 25% in Year 1 (2014), 40% in Year 2 and 35% in Year 3, driving increases yoy of +9%, +13% and +11%.

For Kingfisher we estimate this could add at least +2% LFL to Kingfisher's UK & Ireland business in FY 2015 and +5% in FY 2016, driving potential EPS upgrades of 3% and 6% at the group level respectively.

Figure 54. Housing Transaction Analysis from Help to Buy Mortgage Guarantee

| Deposit | 5.0% | 7.5% | 10.0% | 12.5% | 15.0% | 17.5% |
|---|----------|----------|----------------|----------|----------|-----------|
| Average House price | 200,000 | 200,000 | 200,000 | 200,000 | 200,000 | 200,000 |
| Deposit | 10,000 | 15,000 | 20,000 | 25,000 | 30,000 | 35,000 |
| Mortgage required | 190,000 | 185,000 | 180,000 | 175,000 | 170,000 | 165,000 |
| Losses on which Guarantee Apply | 30,000 | 25,000 | 20,000 | 15,000 | 10,000 | 5,000 |
| 5% covered by lender | 1,500 | 1,250 | 1,000 | 750 | 500 | 250 |
| Government Guarantees | 28,500 | 23,750 | 19,000 | 14,250 | 9,500 | 4,750 |
| Guarantee Cap | 8 | 8 | 8 | 8 | 8 | 8 |
| No of loans | 280,702 | 336,842 | 421,053 | 561,404 | 842,105 | 1,684,211 |
| Total Mortgage Lending | 53.3 | 62.3 | 75.8 | 98.2 | 143.2 | 277.9 |
| Gross Increase in loans over 3 years | | | 421,053 | | | |
| % of which are remortgages | | | 20% | | | |
| Housing Transaction Increase | | | 336,842 | | | |
| Yr 1 | | 25% | 84,211 | | | |
| Yr 2 | | 40% | 134,737 | | | |
| Yr 3 | | 35% | 117,895 | | | |
| 2013E Housing Transactions | | | 963.4 | | | |
| Implied growth Yr 1 | | | 8.7% | | | |
| Implied growth Yr 2 | | | 12.9% | | | |
| Implied growth Yr 3 | | | 10.7% | | | |

Source: HM Treasury, Land Registry, Citi Research estimates

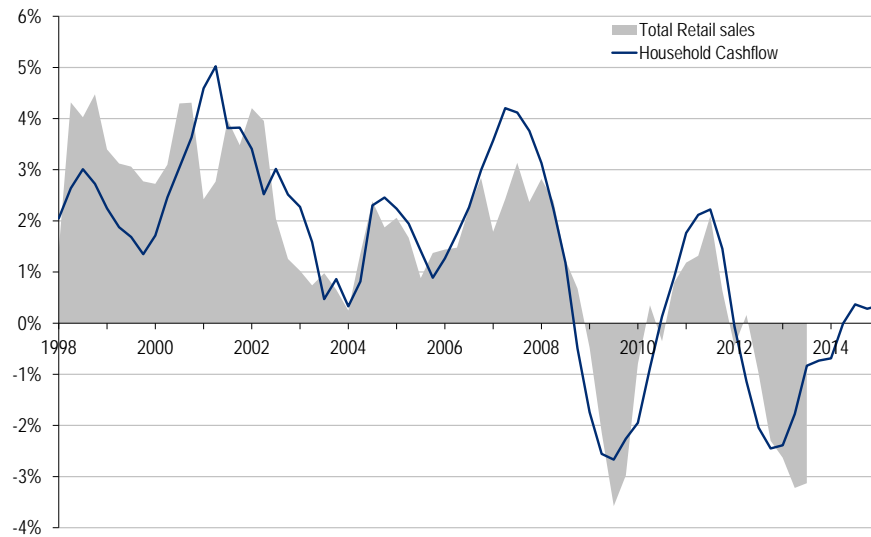
Figure 55. Housing Transactions – Benefit to Kingfisher

| B&Q | 2014E | 2015E | 2016E |
|------------------------------|--------------|--------------|--------------|
| Turnover (£m) | 3,611 | 3,690 | 3,764 |
| Total growth | -2% | 2% | 2% |
| LFL | -2% | 2% | 2% |
| Gross Margin | | | |
| % margin | 40.9% | 41.0% | 41.2% |
| % change | 0.2% | 0.1% | 0.2% |
| EBIT (£m) | 177.4 | 199.0 | 210.5 |
| EBIT % | 4.9% | 5.4% | 5.6% |
| Incremental sales % | | 2% | 5% |
| Total LFL % | -1.6% | 4% | 7% |
| Incremental sales | | 71 | 179 |
| Incremental EBIT (£m) | | 23 | 59 |
| Current Group PBT (£m) | 765 | 860 | 932 |
| Current Group EPS (p) | 23.8 | 26.8 | 29.2 |
| New Group PBT (£m) | 765 | 883 | 991 |
| New Group EPS (p) | 23.8 | 27.5 | 31.0 |
| % increase on EPS | 0.0% | 3% | 6% |
| New EPS Growth % | 8.0% | 15.5% | 12.7% |

Source: Citi Research Estimates

French General Retail – Demand Outlook

Figure 56. France – Non-food Retail Sales vs. Household Available Cash, 1998-2014e



Source: Banque de France and Citi Research

- Citi GDP forecasts have been raised by +40bps and +60bps in 2013e and 2014e respectively;
- Employment growth expectations have weakened -10bps in both years;
- Wage growth expectations have increased by +50bps and +80bps in 2013e and 2014e;
- CPI has nudged up +10bps and +20bps.

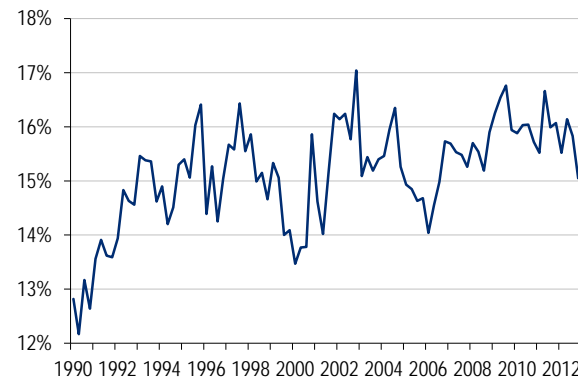
Due to improving trends in nominal disposable income from better employment trends and less severe credit tightening in 2014e we forecast that HAC will turn mildly positive in France resulting in broadly flat LFL non-food retail sales.

Figure 57. HAC and Key Economic Assumptions, 2012 – 2014e

| | 2012 | 2013E | 2014E |
|---------------------------------|--------------|--------------|--------------|
| Nominal disposable income | -1.1% | -0.4% | 0.5% |
| Household credit | -0.9% | -0.6% | -0.2% |
| Household available cash | -2.0% | -1.0% | 0.2% |
| Space | -1.0% | -1.0% | -0.5% |
| Implied LFL | -3.0% | -2.0% | -0.3% |
| Key economic assumptions | 2012 | 2013E | 2014E |
| GDP | 0.0% | 0.2% | 0.8% |
| Employment | -0.2% | -0.5% | 0.6% |
| Average earnings | 2.1% | 1.9% | 2.0% |
| CPI | 2.2% | 1.1% | 1.7% |

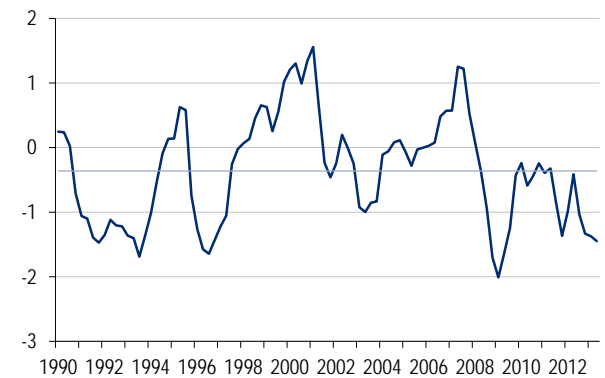
Source: DataStream and Citi Research Estimates

Figure 58. French Savings Ratio



Source: DataStream

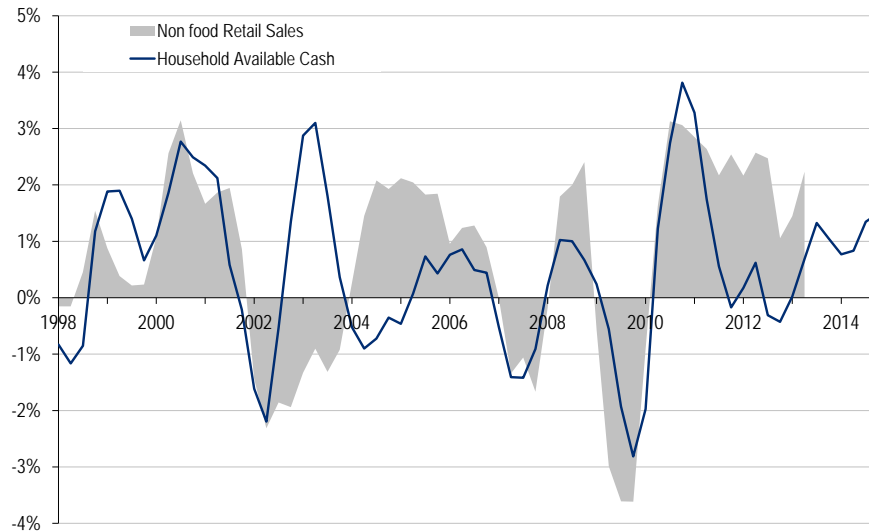
Figure 59. French Consumer Confidence



Source: DataStream

German General Retail – Demand Outlook

Figure 60. Germany – Non-food Retail Sales vs. Household Available Cash, 1998-2014e



Source: DataStream and Citi Research

- GDP forecasts have been cut by -20bps and raised by +90bps in 2013e and 2014e respectively;
- Employment growth expectation has strengthened +30bps in 2014e;
- Wage growth expectations have weakened by -40bps and -50bps in 2013e and 2014e;
- CPI has nudged up +30bps and +20bps.

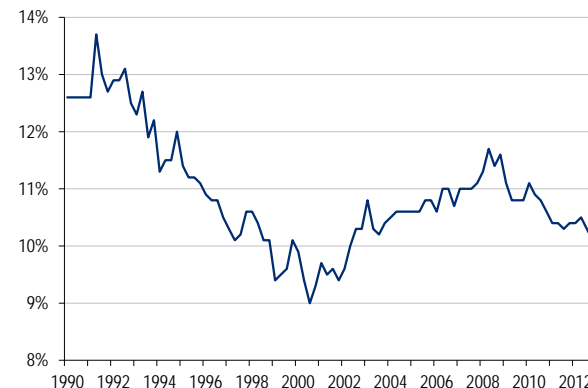
Driven by employment growth we expect a mild improvement in nominal disposable income, coupled with continued tight credit conditions. This results in a HAC forecast will remain c.+1% positive in 2014e, resulting in broadly flat non-food retail LFL sales.

Figure 61. HAC and Key Economic Assumptions, 2012 – 2014e

| | 2012 | 2013E | 2014E |
|---------------------------------|--------------|--------------|--------------|
| Nominal disposable income | 1.9% | 2.6% | 2.8% |
| Household credit | -1.9% | -1.8% | -1.7% |
| Household available cash | 0.0% | 0.8% | 1.1% |
| Less space | -1.0% | -1.0% | -1.0% |
| Implied LFL | -1.0% | -0.2% | 0.1% |
| Key economic assumptions | 2012 | 2013E | 2014E |
| GDP | 0.9% | 0.6% | 1.7% |
| Employment | 1.1% | 0.3% | 0.6% |
| Average Earnings | 2.8% | 2.8% | 2.6% |
| CPI | 2.0% | 1.7% | 1.9% |

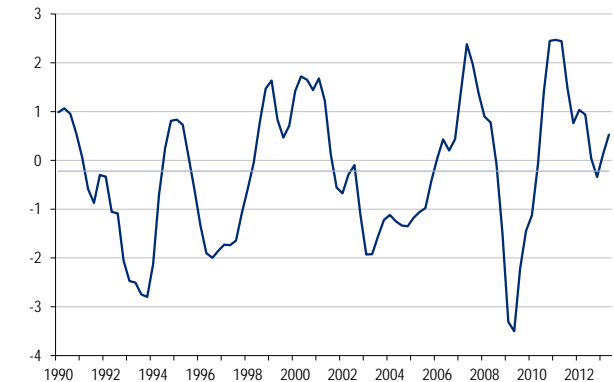
Source: DataStream and Citi Research Estimates

Figure 62. German Savings Ratio



Source: DataStream

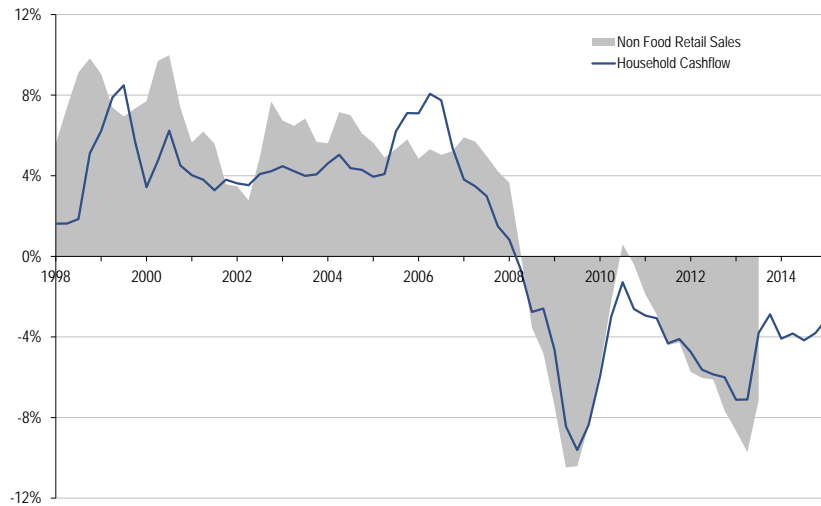
Figure 63. German Consumer Confidence



Source: DataStream

Spanish General Retail – Demand Outlook

Figure 64. Spain – Non-food Retail Sales vs. Household Available Cash, 1998-2014e



Source: Datastream, INE and Citi Research

- GDP forecasts have been raised by +80bps and +190bps in 2013e and 2014e respectively but are still predicted to be negative in both years;
- Employment growth expectations have weakened by -80bps in 2013e and -40bps in 2014e;
- Wage growth expectations have weakened by -30bps and -40bps in 2013e and 2014e;
- CPI has nudged up +20bps in both years.

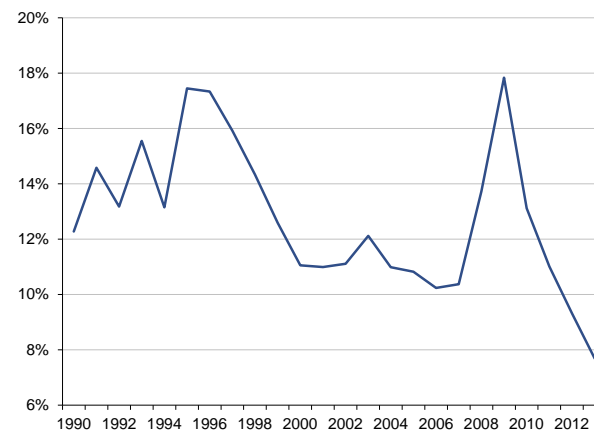
Due to continued employment shrinkage and negative earnings growth we forecast that HAC will remain -3.7% negative in 2014e, albeit less bad than in 2013e. This results in a similar non-food retail LFL sales decline as we expect little contribution from new space.

Figure 65. HAC and Key Economic Assumptions, 2012 – 2014e

| | 2012 | 2013E | 2014E |
|---------------------------------|--------------|--------------|--------------|
| Nominal disposable income | -7.6% | -6.0% | -3.7% |
| Household credit | 1.4% | 1.6% | 0.0% |
| Household available cash | -6.2% | -4.5% | -3.7% |
| Less space | 0.0% | 0.0% | 0.0% |
| less VAT increase | -0.5% | -0.5% | 0.0% |
| Implied LFL | -6.7% | -5.0% | -3.7% |
| Key economic assumptions | | | |
| GDP | -1.4% | -1.4% | -0.2% |
| Employment | -4.5% | -3.6% | -2.4% |
| Wage growth | 0.3% | -0.4% | -0.4% |
| CPI | 2.4% | 1.8% | 0.9% |

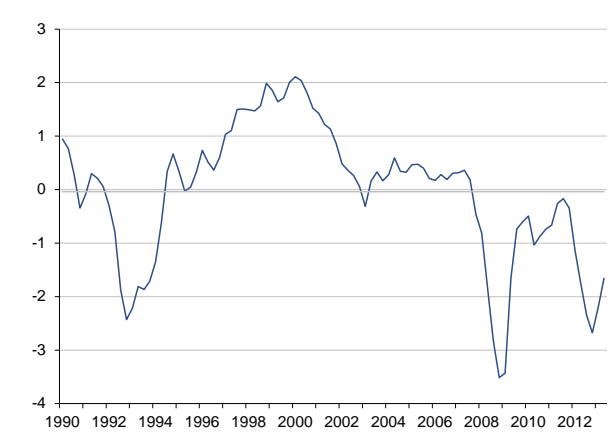
Source: DataStream and Citi Research Estimates

Figure 66. Spanish Savings Ratio



Source: DataStream

Figure 67. Spanish Consumer Confidence

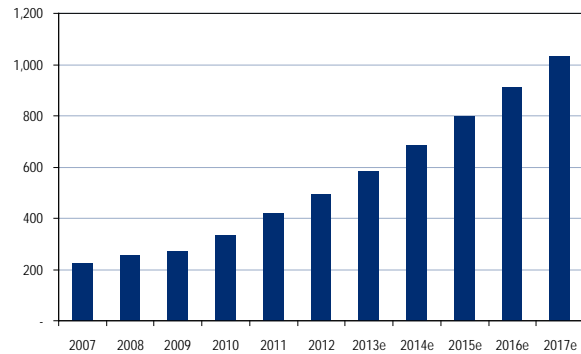


Source: DataStream

Online Retail

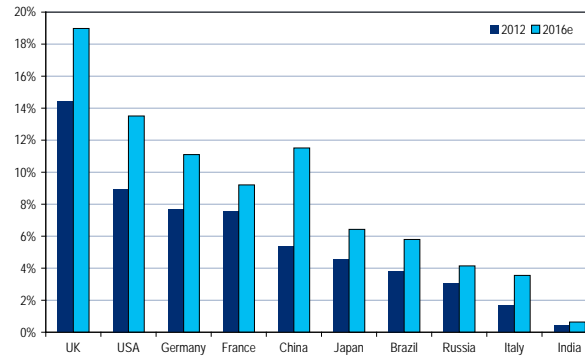
Globally online retail will change more in the next five years than it has in the last 25 years

Figure 68. Online Non-food Retail, Market Size, 2007–2017e (\$bn)



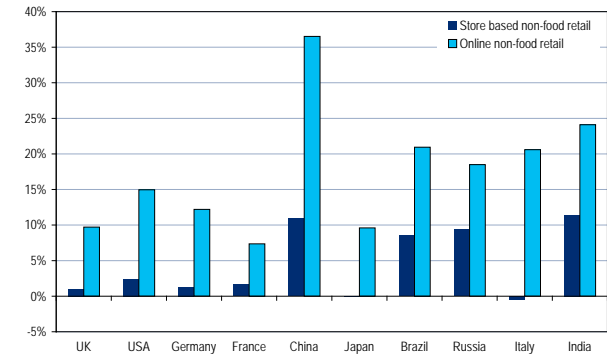
Source: Euromonitor International

Figure 69. Non-food Retail, Online Penetration



Source: Euromonitor International

Figure 70. Non-food Retail, Store and Online, 2012-2016e CAGR

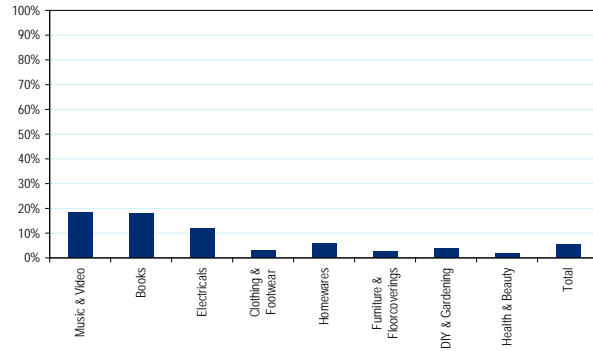


Source: Euromonitor International

The UK has the highest penetration of online retail in the world

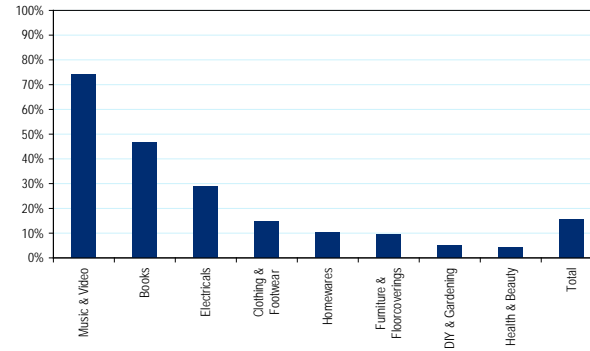
The UK serves as a test bed and case study for likely outcomes in other regions. If growth in UK is sustainable then we see no reason why it is not sustainable in other countries as they have lower penetration. We acknowledge that the relatively small size and advanced transport networks of the UK are an advantage, but with continued development across global transport networks we do not see country size as a limiting factor to internet penetration, although it may affect growth rates.

Figure 71. UK – Online Sales Penetration by Category, 2006



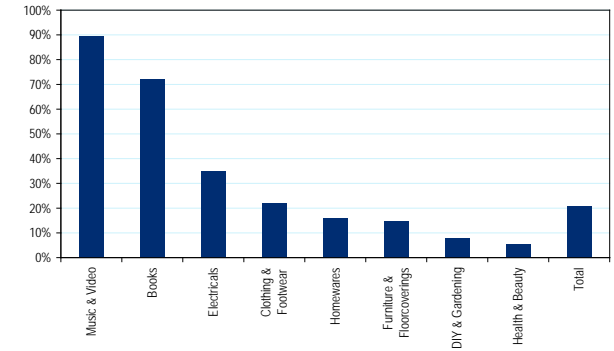
Source: Verdict

Figure 72. UK – Online Sales Penetration by Category, 2012



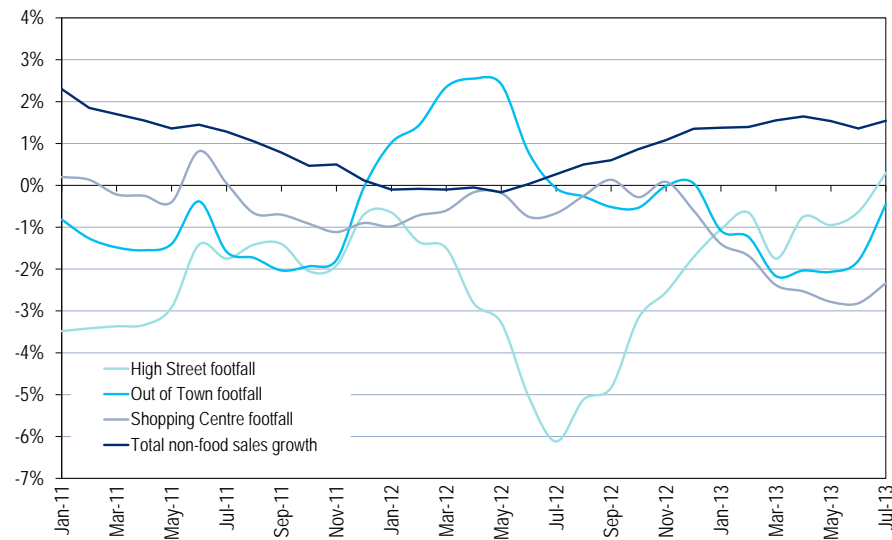
Source: Verdict

Figure 73. UK – Online Sales Penetration by Category, 2016e



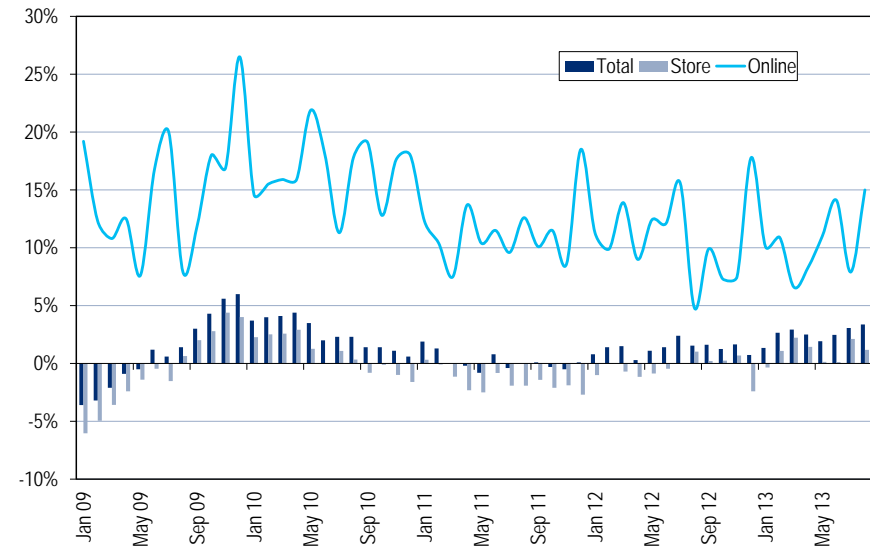
Source: Verdict and Citi Research Estimates

Figure 74. UK Shopper Footfall vs Total Sales Growth



Source: BRC and Citi Research

Figure 75. UK Non-food Retail Sales Growth vs Implied Store Sales Growth vs Online Sales Growth

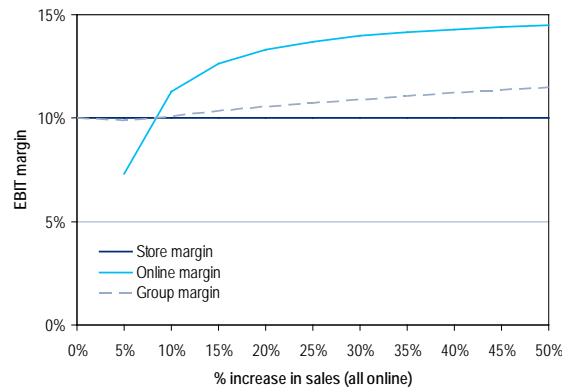


Source: BRC, Euromonitor International and Citi Research Estimates

Online sales are cannibalising store-based sales and affecting profitability

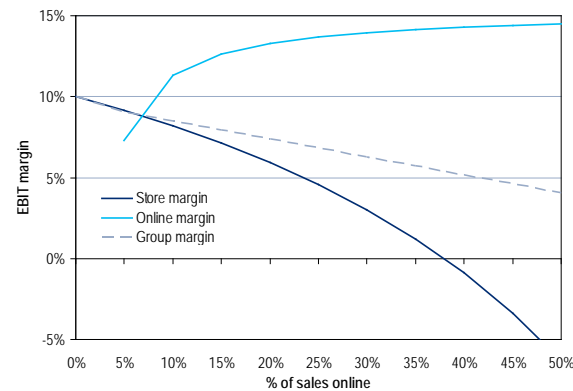
The migration of sales to online channels is creating a dynamic where retailers have to cover costs of online logistics while store-based costs remain. Whether retailers are getting a sales uplift from online or simply experiencing a shift in channel is relevant but profitability is affected in both cases.

Figure 76. Generic Example – Extra Sales Are Generated Online



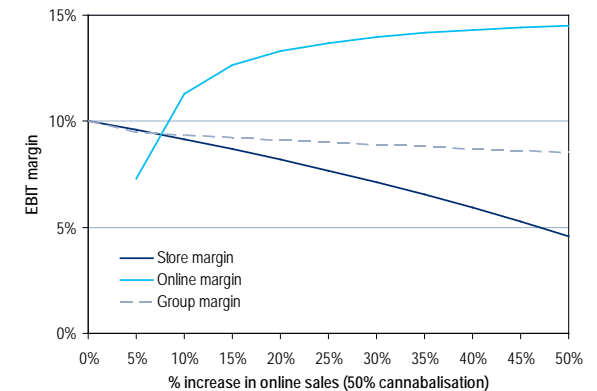
Source: Citi Research

Figure 77. Generic Example – Sales Migrate to Online



Source: Citi Research

Figure 78. Generic Example – Online Generates Extra Sales, 50% of Which Migrate from in Store



Source: Citi Research

Online sales are incremental – In this bullish scenario, an established store-based retailer opens an online channel that generates extra sales for the group without any cannibalisation of the existing sales base. After online sales have reached a critical mass, this outcome generates margin enhancements across the group.

Online represents sales migration from stores – In this case, an established store-based retailer experiences a channel shift so that sales that were previously in store are purchased online without any uplift to total volumes. All store fixed costs remain in place, while some of the variable costs can be lowered due to the lower sales volumes. Here the de-leverage of the fixed costs sees store margin under intense pressure, trending to zero and below as sales migrate online. Even though the online margin is higher than the store average, this deleverage causes the total group EBIT margins to decline.

Online generates an extra sales channel, some sales migrate – In this scenario the retailer experiences a mixed effect from online. While the online channel does generate new sales, it also cannibalises some (50% in this case) of the existing sales base. This is likely to be the most relevant example and, although the level of online sales and cannibalisation will differ by retailer, we conclude that, even with a highly profitable online channel, the deleverage of the fixed cost of the stores makes it very challenging for a retailer to hold group EBIT margins.

UK – At a profit tipping point?

Following the rapid growth of online sales in early adoption non-food retail markets (media products, electricals), clothing and footwear is the next most significant online retail market. Currently c.15% of sales are online and the market is growing rapidly at c.+15% p.a. From here, we expect the store-based sales cannibalisation dynamics described above to begin to have significantly implications for clothing retail profitability (see below).

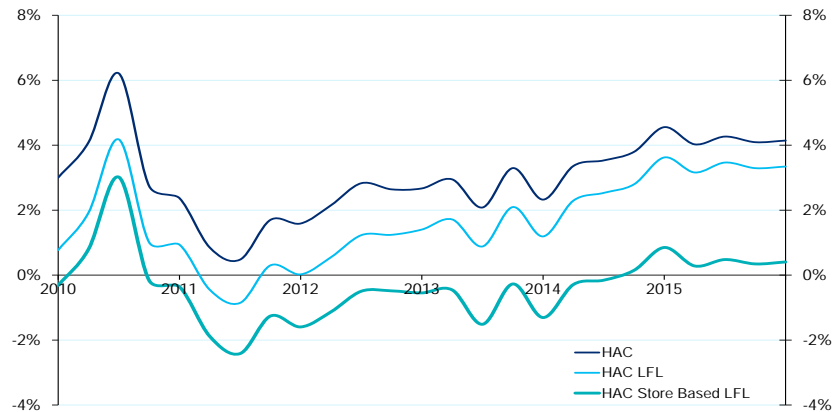
Figure 79. Summary - UK clothing profitability, by channel (2009-2012)

| Nearest calendar year end | ASOS | N Brown | Debenhams | M&S UK | M&S - Gen Mer | Next | Sports Direct |
|---------------------------------------|-------|---------|-----------|--------|---------------|-------|---------------|
| Online sales penetration, 2012 | 100% | 100% | 10% | 7% | 16% | 35% | 15% |
| Online sales growth, 2009-2012 CAGR | 42.5% | 3.8% | 65.7% | 16.6% | 16.6% | 11.7% | 80.6% |
| Online EBIT/sales, 2012 | 8.2% | 13.4% | 5.0% | 7.0% | 7.0% | 25.3% | 12.0% |
| Store-based sales penetration, 2012 | Na | Na | 90% | 93% | 84% | 65% | 85% |
| Store-based LFL sales growth, 2009-12 | Na | Na | -4.8% | -0.2% | -3.2% | -4.6% | 2.8% |
| Store-based LFL opex growth, 2009-12 | Na | Na | -1.5% | -0.3% | na | -3.7% | -0.5% |
| Store-based EBIT/sales, 2012 | Na | Na | 7.1% | 7.5% | 13.9% | 15.1% | 11.0% |
| Online EBIT growth, 2009-12 | 56.0% | 1.2% | 183.3% | 16.6% | Na | 18.1% | 127.5% |
| Store-based EBIT growth, 2009-12 | Na | Na | -4.9% | 0.5% | Na | 0.7% | 22.0% |
| Total EBIT growth, 2009-12 | 56.0% | 1.2% | -2.5% | 1.3% | Na | 7.6% | 28.1% |
| Total EBIT/sales delta, 2009-12 | 2.0% | -1.0% | -0.9% | -0.2% | Na | 2.3% | 2.9% |

In the context of declining store-based LFL sales trends, Next has delivered the most impressive LFL operating expense improvements (LFL opex -3.7% p.a. 2009-12). Taken together with the strong growth of the high-margin Next Directory operation, this has driven group EBIT margins +230bp to 18.7% by calendar 2012, resulting in a +7.6% total EBIT 2009-12 EBIT CAGR, well ahead of the broadly flat UK EBIT trends at N Brown, Debenhams and M&S. However, the stand-out EBIT growth performances came from ASOS, Sports Direct and Inditex, which delivered impressive +56%, +28% and +22% 2009-12 EBIT CAGR trends, following both rapid sales growth and EBIT margin progress.

Source: Company reports and Citi Research Estimates

Figure 80. Household Available Cash with Implied Store LFL



Source: BRC and Citi Research Estimates

Looking ahead, we forecast online sales penetration of 20-25% of UK retail sales at Debenhams, M&S (Gen Merch) and Sports Direct by 2015, and 40% of UK sales at Next. The latter assumes Next Directory sales trends slow to +7% p.a. from here. While we forecast stable store-based LFL sales at Sports Direct (c.11% p.a.), the growing cannibalistic impact of online sales growth is forecast to drive Debenhams, M&S (Gen Merch) and Next store-based LFL sales of -1.1%, -1.6% and -2.5%, respectively.

As referenced above, applying our improved HAC forecast for non-food retail sales, we can derive a total non-food retail LFL and **non-food store-based LFL sales** forecast. The latter is expected to **stabilise at c.0% beyond 2013, from the -1-2% recent trend**.

Figure 81. Summary - UK Clothing Profitability, by Channel (2012-2015E)

| Nearest calendar year end | ASOS | N Brown | Debenhams | M&S UK | M&S - Gen Mer | Next | Sports Direct |
|--|-------|---------|-----------|--------|---------------|-------|---------------|
| Online sales penetration, 2015E | 100% | 100% | 20% | 10% | 23% | 40% | 23% |
| Online sales growth, 2012-2015E CAGR | 29.7% | 4.7% | 30.7% | 15.8% | 15.8% | 7.2% | 31.3% |
| Online EBIT/sales, 2015E | 7.3% | 13.4% | 9.0% | 9.0% | 9.0% | 25.9% | 9.5% |
| Store-based sales penetration, 2015E | Na | Na | 80% | 90% | 78% | 60% | 77% |
| Store-based LFL sales growth, 2012-15E | Na | Na | -1.1% | 0.7% | -1.6% | -2.5% | -1.0% |
| Store-based LFL opex growth, 2012-15E | Na | Na | 0.4% | 0.9% | -2.6% | -1.9% | 2.5% |
| Store-based EBIT/sales, 2015E | Na | Na | 5.4% | 8.0% | 15.9% | 14.6% | 9.5% |
| Online EBIT growth, 2012-15E | 24.7% | 4.8% | 58.8% | 25.0% | 25.0% | 8.0% | 41.4% |
| Store-based EBIT growth, 2012-15E | Na | Na | -9.0% | 4.8% | 5.3% | -0.8% | 6.6% |
| Total EBIT growth, 2012-15E | 24.7% | 4.8% | -0.2% | 6.5% | 7.3% | 3.6% | 13.9% |
| Total EBIT/sales delta, 2012-15E | -0.9% | 0.0% | -0.7% | 0.7% | 1.8% | 0.4% | -0.2% |

Source: Company reports and Citi Research Estimates

To cope with the adverse-gearing effect of this on store-based EBIT margins, we argue that both M&S (Gen Merch) and Next should be capable of a further c.-2% LFL opex reduction p.a. 2012-15E, driving +5% and -1% store-based EBIT trends respectively. The former also reflects the gross margin progress forecast at M&S. Elsewhere, given the heavy opex-reduction programmes undertaken while owned by private equity, we fear that Debenhams will have less scope for further opex reductions, and assume store-based LFL opex rises at c.+0.5% p.a. 2012-12E. Taken in combination with our -1.1% store-based LFL sales forecast, we derive a -9% p.a. Debenhams store-based EBIT forecast. Notably, we believe that this should be offset by the group's rapid online sales growth trajectory, driving a flat 2012-15E UK EBIT pattern.

Sector Earnings Profile

Sector Profit Aggregation

At our previous aggregation update, in May we forecast 2013 LFL sales of +1.6% with flat gross margin progress and +5.0% EBIT growth. Based on reported results and updated forecasts, our LFL sales aggregation has faded to +1.4% and our EBIT growth has been cut to +3.9%, largely due to the 15% cut to Halfords forecasts and the 3.5% reduction in M&S EBIT.

On the back of the above UK consumer analysis, we derive +6.6% (from +4.4%) and +6.1% 2014E and 2015E UK EBIT growth forecasts respectively. For 2014, we raise our UK aggregate LFL sales forecast to +2.3% (from +1.6%) and maintain our gross margin delta forecast at +10bps, due primarily to forecast gross margin improvements at M&S, Kingfisher, Dunelm and WH Smith being offset by declines at Dixons and Home Retail. We forecast positive LFL sales growth for all UK companies in 2014e with the exception of WHSmith. Alongside this, we forecast a +170bp increase in the UK sector's LFL cost base driven in part by the de-leverage of the fixed store costs from the growing penetration of the online channel.

Figure 82. UK Divisional Aggregation

| Calendar Year | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013E | 2014E | 2015E |
|-------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Sales | 36,720 | 38,665 | 40,091 | 40,543 | 41,574 | 32,439 | 31,593 | 32,305 | 32,325 | 31,944 | 32,643 | 33,388 | 34,411 | 35,455 |
| % Change | 8.6% | 5.3% | 3.7% | 1.1% | 2.5% | 2.4% | -2.6% | 2.3% | 0.1% | -1.2% | 2.2% | 2.3% | 3.1% | 3.0% |
| Space contribution | 4.8% | 3.2% | 3.1% | 3.6% | 1.8% | 3.7% | 3.1% | 2.5% | 1.0% | 0.5% | 1.2% | 0.9% | 0.8% | 0.5% |
| LFL | 3.8% | 2.1% | 0.6% | -2.5% | 0.8% | -1.3% | -5.7% | -0.2% | -0.9% | -1.7% | 1.0% | 1.4% | 2.3% | 2.5% |
| Gross profit | 14,290 | 15,223 | 15,835 | 16,270 | 16,846 | 13,291 | 12,910 | 13,288 | 13,431 | 13,294 | 13,538 | 13,856 | 14,309 | 14,795 |
| Gross margin | 38.9% | 39.4% | 39.5% | 40.1% | 40.5% | 41.0% | 40.9% | 41.1% | 41.6% | 41.6% | 41.5% | 41.5% | 41.6% | 41.7% |
| Gross Margin change (%) | | 0.5% | 0.1% | 0.6% | 0.4% | 0.2% | -0.1% | 0.3% | 0.4% | 0.1% | -0.1% | 0.0% | 0.1% | 0.1% |
| Costs | 11,170 | 11,932 | 12,614 | 13,318 | 13,814 | 10,557 | 10,784 | 10,940 | 10,991 | 10,964 | 11,142 | 11,366 | 11,654 | 11,977 |
| % Change | | 6.8% | 5.7% | 5.6% | 3.7% | 4.2% | 2.2% | 1.4% | 0.5% | -0.2% | 1.6% | 2.0% | 2.5% | 2.8% |
| Underlying cost growth | | 3.6% | 2.6% | 2.0% | 1.9% | 0.5% | -0.9% | -1.0% | -0.5% | -1.9% | 0.4% | 1.1% | 1.7% | 2.3% |
| % of sales | 30.4% | 30.9% | 31.5% | 32.8% | 33.2% | 32.5% | 34.1% | 33.9% | 34.0% | 34.3% | 34.1% | 34.0% | 33.9% | 33.8% |
| EBIT | 3,120 | 3,291 | 3,221 | 2,951 | 3,032 | 2,734 | 2,125 | 2,348 | 2,440 | 2,330 | 2,396 | 2,490 | 2,655 | 2,818 |
| % EBIT growth | | 5.5% | -2.1% | -8.4% | 2.7% | -2.2% | -22.3% | 10.5% | 3.9% | -4.5% | 2.9% | 3.9% | 6.6% | 6.1% |
| % EBIT margin | 8.5% | 8.5% | 8.0% | 7.3% | 7.3% | 8.4% | 6.7% | 7.3% | 7.5% | 7.3% | 7.3% | 7.5% | 7.7% | 7.9% |
| LFL Gross profit % | | 3.3% | 0.9% | -0.9% | 1.7% | -0.9% | -6.0% | 0.4% | 0.1% | -1.6% | 0.6% | 1.1% | 2.5% | 3.1% |
| EBIT Indexed | 100 | 111 | 115 | 110 | 117 | 115 | 89 | 98 | 102 | 98 | 100 | 104 | 111 | 118 |

Source: Company Reports and Citi Research Estimates

Looking out 2015, we forecast UK divisional LFL sales at +2.5% to reflect our improved UK HAC assumption. The Kingfisher and M&S sourcing and stock initiatives drive +10bps UK gross margins progress, which taken together with +2.3% LFL cost inflation due to online cannibalisation and wage inflation pressures, drives our 2015 UK divisional EBIT growth forecast of +6.1%.

Notably, given that online sales represent c.15% of UK non-food retail sales and are growing at c.+15% p.a., our 2013E and 2014E aggregate LFL growth is all derived from the online channel, leaving the UK non-food store base under our coverage with a broadly flat LFL outlook (see Figure 79).

Figure 83. FY14E UK Divisional Aggregation Assumptions

| Company | Period-end | Sales | % ch | LFL % | Gross margin % | GM delta | Gross Profit | Costs | % ch | EBIT | % ch | EBIT/ Sales | Delta | Implied Cost Inflation |
|----------------------------------|------------|---------------|-------------|-------------|----------------|-------------|---------------|----------------|-------------|--------------|-------------|-------------|-------------|------------------------|
| Debenhams | Feb-15 | 2,681 | 4.4% | 3.1% | 43.9% | 0.0% | 1,176 | -1,010 | 4.6% | 166 | 2.8% | 6.2% | -0.1% | 3.3% |
| Dunelm | Dec-14 | 765 | 8.3% | 2.7% | 49.4% | 0.4% | 378 | -252 | 8.3% | 125 | 11.0% | 16.4% | 0.4% | 2.8% |
| DSGI (UK) | Apr-15 | 4,256 | 2.0% | 2.5% | 27.3% | -0.2% | 1,162 | -1,025 | 0.3% | 137 | 8.7% | 3.2% | 0.2% | 0.8% |
| Halfords | Mar-15 | 799 | 3.5% | 3.5% | 51.6% | -0.2% | 412 | -349 | 2.2% | 63 | 8.6% | 7.9% | 0.4% | 2.2% |
| Home Retail Group (Argos) | Mar-15 | 4,018 | 1.0% | 2.0% | 30.6% | -0.3% | 1,229 | -1,132 | 0.0% | 97 | 0.2% | 2.4% | 0.0% | 1.0% |
| Home Retail Group (Homebase) | Feb-15 | 1,445 | 1.0% | 2.0% | 51.0% | 0.0% | 737 | -721 | 0.5% | 16 | 30.0% | 1.1% | 0.2% | 1.5% |
| Kingfisher (UK) | Jan-15 | 4,389 | 3.2% | 2.0% | 41.1% | 0.1% | 1,802 | -1,544 | 2.4% | 257 | 11.4% | 5.9% | 0.4% | 1.2% |
| M&S (UK Retail & Food) | Mar-15 | 9,510 | 3.6% | 1.9% | 41.4% | 0.3% | 3,935 | -3,191 | 3.4% | 744 | 8.5% | 7.8% | 0.3% | 1.7% |
| Next (Retail & Directory) | Jan-15 | 3,581 | 3.0% | 1.3% | 57.5% | -0.1% | 2,059 | -1,375 | 3.0% | 684 | 2.4% | 19.1% | -0.1% | 1.4% |
| Sports Direct (Group) | Apr-15 | 1,783 | 7.0% | 7.0% | 42.3% | 0.0% | 755 | -495 | 5.0% | 260 | 11.1% | 14.6% | 0.5% | 5.0% |
| WH Smith (UK Retail & UK Travel) | Feb-15 | 1,185 | -2.5% | -1.7% | 56.2% | 1.8% | 666 | -560 | 0.5% | 105 | 1.3% | 8.9% | 0.1% | 1.3% |
| Sector | | 34,411 | 3.1% | 2.3% | 41.6% | 0.1% | 14,309 | -11,654 | 2.5% | 2,655 | 6.6% | 7.7% | 0.3% | 1.7% |

Source: Citi Research Estimates

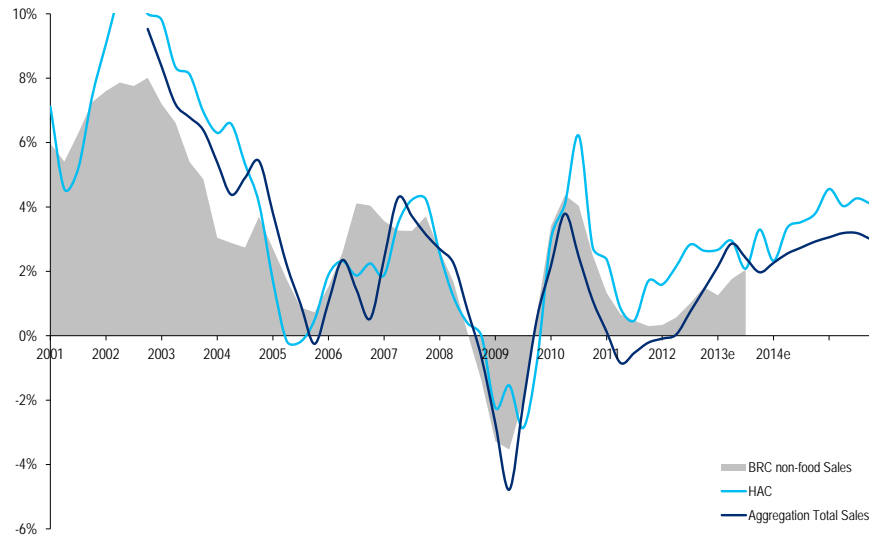
Figure 84. UK Divisional Aggregation Assumptions – Half-yearly split (£millions)

| | Sales | % Chg | LFL % | Gross Margin % | GM delta | Gross Profit | Costs | % Chg | EBIT | % Chg | EBIT/Sales | Delta | Implied Cost Inflation |
|--------------|---------------|-------------|-------------|----------------|---------------|---------------|-----------------|-------------|--------------|-------------|-------------|-------------|------------------------|
| 1H12 | 15,266 | 1.4% | 0.1% | 42.3% | 0.1% | 6,454 | (5,428) | 1.8% | 1,026 | 1.6% | 6.7% | 0.0% | 0.5% |
| 2H12 | 17,378 | 2.9% | 1.8% | 40.8% | (0.4%) | 7,084 | (5,714) | 1.4% | 1,370 | 3.8% | 7.9% | 0.1% | 0.3% |
| FY12 | 32,643 | 2.2% | 1.0% | 41.5% | (0.1%) | 13,538 | (11,142) | 1.6% | 2,396 | 2.9% | 7.3% | 0.0% | 0.4% |
| 1H13e | 15,567 | 2.0% | 1.0% | 42.3% | 0.0% | 6,581 | (5,559) | 2.4% | 1,023 | (0.4%) | 6.6% | (0.2%) | 1.5% |
| 2H13e | 17,821 | 2.6% | 1.7% | 40.8% | 0.1% | 7,274 | (5,807) | 1.6% | 1,468 | 7.1% | 8.2% | 0.4% | 0.8% |
| FY13e | 33,388 | 2.3% | 1.4% | 41.5% | 0.0% | 13,856 | (11,366) | 2.0% | 2,490 | 3.9% | 7.5% | 0.1% | 1.1% |
| 1H14e | 16,022 | 2.9% | 2.2% | 42.4% | 0.1% | 6,789 | (5,704) | 2.6% | 1,085 | 6.1% | 6.8% | 0.2% | 1.9% |
| 2H14e | 18,389 | 3.2% | 2.3% | 40.9% | 0.1% | 7,520 | (5,951) | 2.5% | 1,569 | 6.9% | 8.5% | 0.3% | 1.6% |
| FY14e | 34,411 | 3.1% | 2.3% | 41.6% | 0.1% | 14,309 | (11,654) | 2.5% | 2,655 | 6.6% | 7.7% | 0.3% | 1.7% |
| 1H15e | 16,502 | 3.0% | 2.4% | 42.5% | 0.1% | 7,015 | (5,857) | 2.7% | 1,157 | 6.7% | 7.0% | 0.2% | 2.1% |
| 2H15e | 18,953 | 3.1% | 2.7% | 41.0% | 0.2% | 7,780 | (6,120) | 2.8% | 1,660 | 5.8% | 8.8% | 0.2% | 2.4% |
| FY15e | 35,455 | 3.0% | 2.5% | 41.7% | 0.1% | 14,795 | (11,977) | 2.8% | 2,818 | 6.1% | 7.9% | 0.2% | 2.3% |

Source: Company Reports and Citi Research Estimates

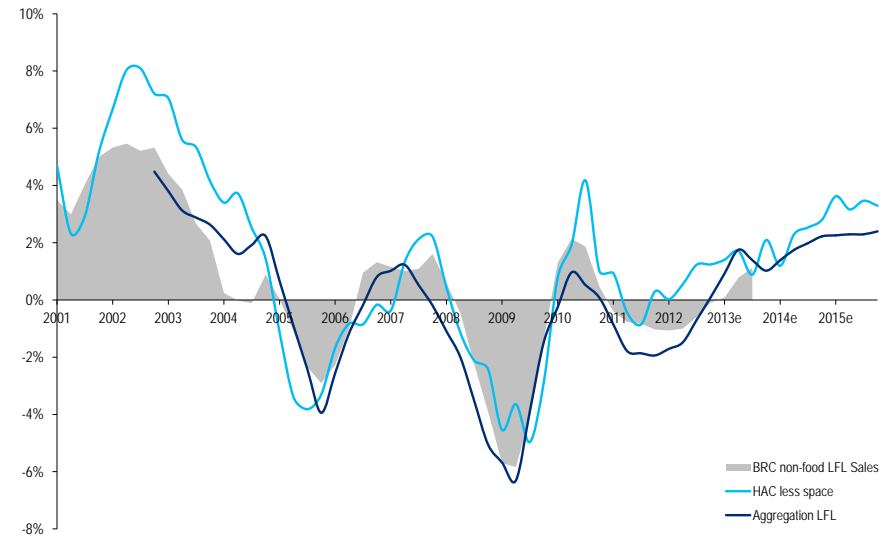
The correlation of our UK aggregate total and LFL sales history and forecasts are plotted against the reported BRC total non-food sales trends, our HAC history and forecast agenda in the graphs below. In general, our UK aggregate sales forecasts assume that the companies under our coverage will continue to broadly track the HAC total and LFL sales forecast in the next 18 months.

Figure 85. UK HAC vs BRC Non-Food Retail Total Sales vs Aggregation Total Sales



Source: BRC and Citi Research Estimates

Figure 86. UK HAC Less Space vs BRC Non-Food Retail LFL Sales vs Aggregation LFL Sales



Source: BRC and Citi Research Estimates

Earnings Sensitivity

Figure 87. Earnings Sensitivity

| 1% increase in: | Impact on 2014e HAC | Impact on UK Agg earnings |
|-------------------------------|---------------------|---------------------------|
| Employment or Earnings growth | +1.6% | +8.7% |
| Benefits income | +0.6% | +3.2% |
| Food & Drink spend | -0.2% | -1.3% |
| Fuel & Utilities spend | -0.1% | -0.5% |
| Income tax | -0.3% | -1.8% |
| Base interest rate | -2.5% | -13.5% |
| Savings Ratio | -1.6% | -8.5% |

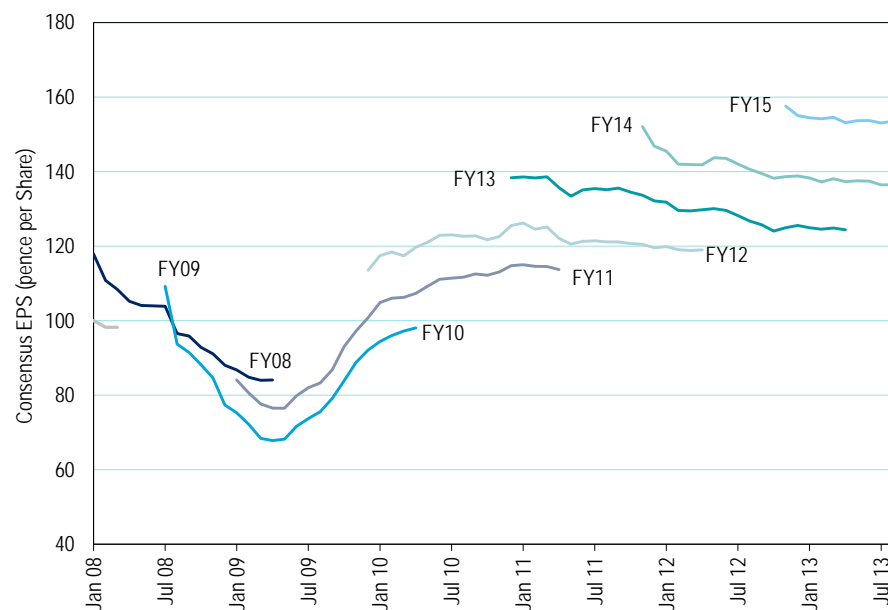
Source: Citi Research

- The operational gearing of the UK retail aggregation is c.5.5x, i.e. each +1% increase in sales results in +5.5% on aggregated earnings. This only holds if incremental sales are through the store channel, the continuing migration to online is likely to be eroding this gearing and explains why our aggregated earnings forecast is +6.6% next year on +2.3% LFL sales growth.

Earnings Growth Forecast

Looking across entire coverage universe, we now forecast +12% sector EPS growth in both 2014 and 2015.

Figure 88. UK Retail – Consensus EPS



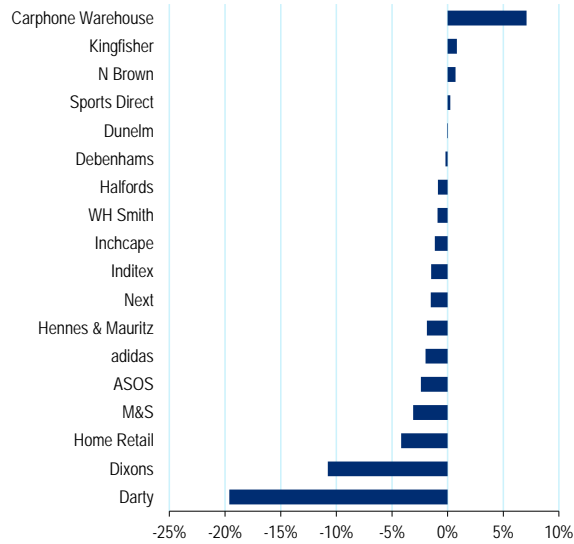
Source: Datastream and Citi Research

- As a consequence of the move from negative UK LFL trends (2007-2011) to >+2% LFL sales growth in 2014 and 2015, we forecast double-digit 2014 and 2015 UK EPS growth.
- For context, our coverage universe last saw >+2% LFL sales growth trends in 2003 (see Figure 81. UK Divisional Aggregation) (cf: the UK Aggregation P&L above).

Citi vs Consensus

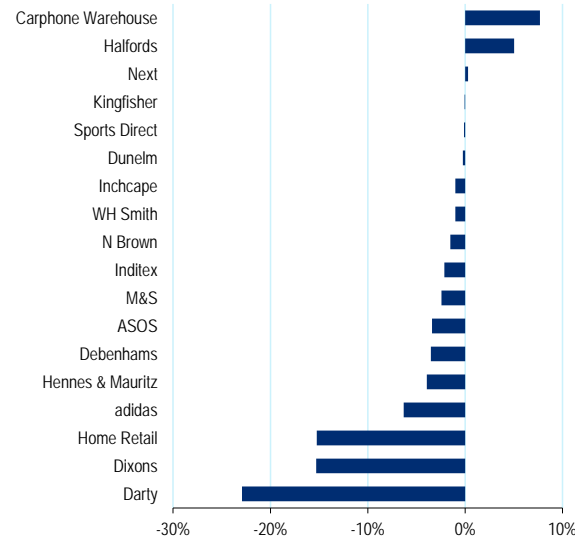
Our UK sector EPS forecasts are 2-5% below consensus

Figure 89. Citi vs Consensus Cal-2013e



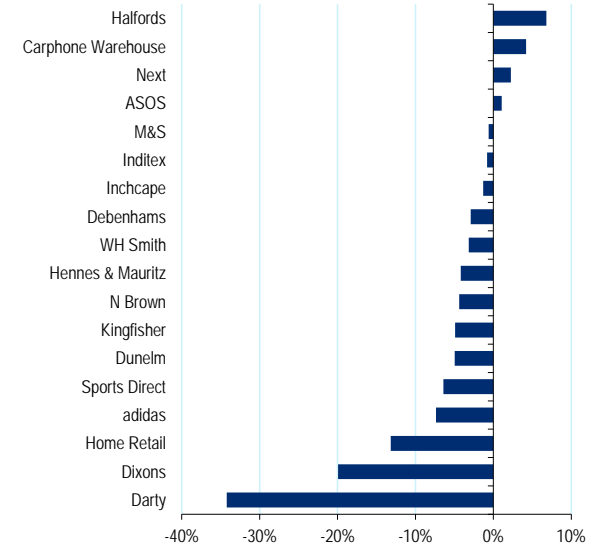
Source: dataCentral, Citi Research

Figure 90. Citi vs Consensus Cal-2014e



Source: dataCentral, Citi Research

Figure 91. Citi vs Consensus Cal-2015e



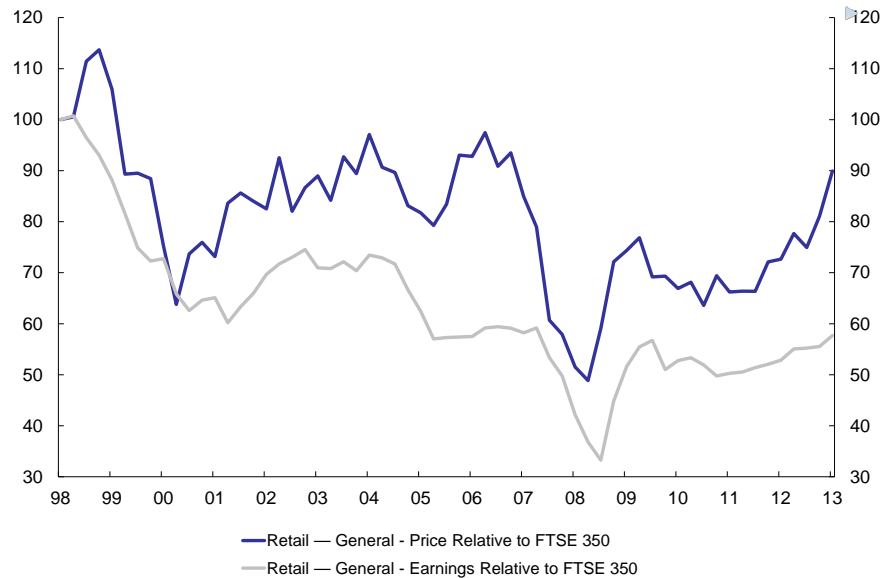
Source: dataCentral, Citi Research

Valuation

UK Retail valuation sharply re-rated

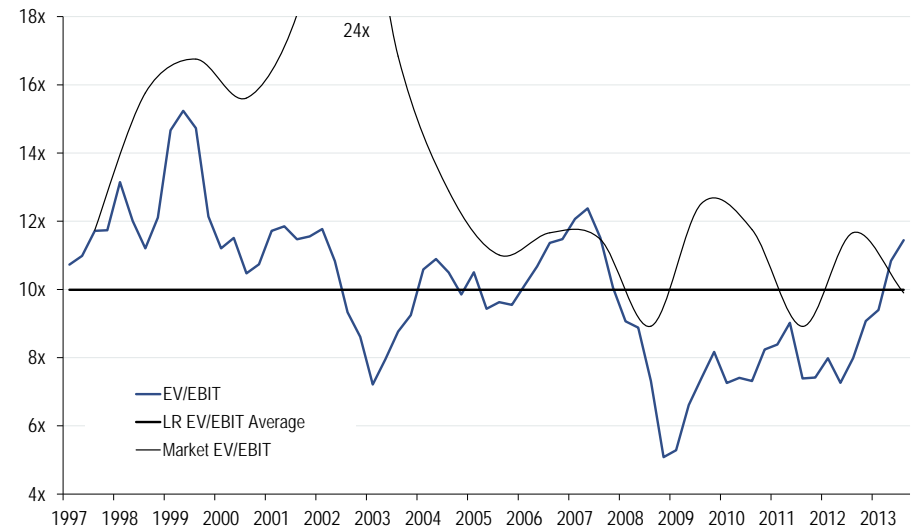
In the context of a UK general retail sector that now trades on a 15x 2014E PE (a c.125 PE relative), sharply above the long-run average (average PE Rel 100-105), there is a growing share price debate over the extent to which a stronger UK consumer demand outlook is already discounted in retail valuations.

Figure 92. General Retailers – Price and Earnings Relative to FTSE 350, 1998-13



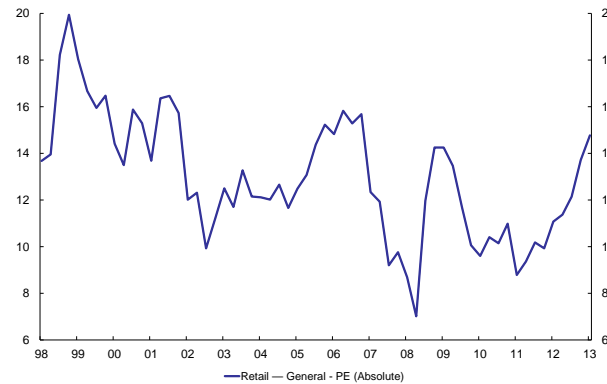
Source: Company Reports and Citi Research

Figure 93. UK General Retail – Long Run EV/EBIT



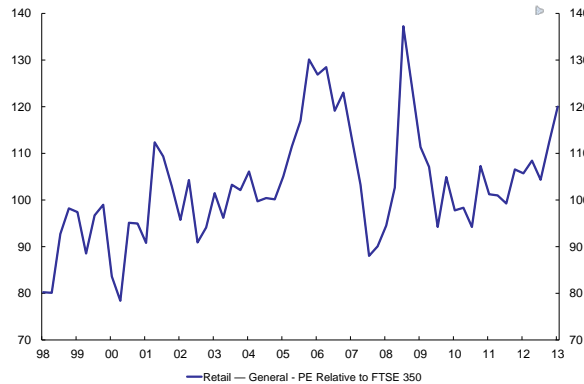
Source: Company Reports, Datastream and Citi Research

Figure 94. UK General Retail – 1-Yr Fwd Consensus PE Absolute



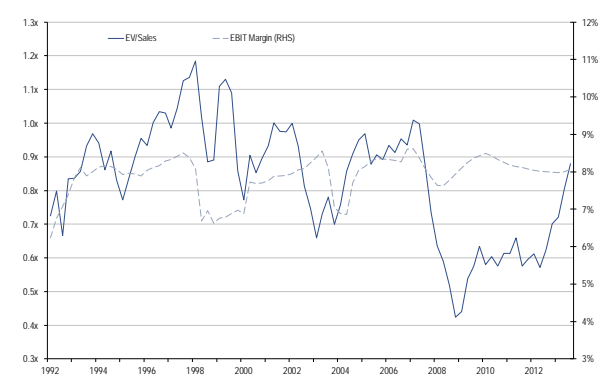
Source: Datastream, IBES and Citi Research

Figure 95. UK General Retail – 1-Yr Fwd Consensus PE Relative



Source: Datastream, IBES and Citi Research

Figure 96. UK General Retail – Long Run EV/Sales, EBIT Margin



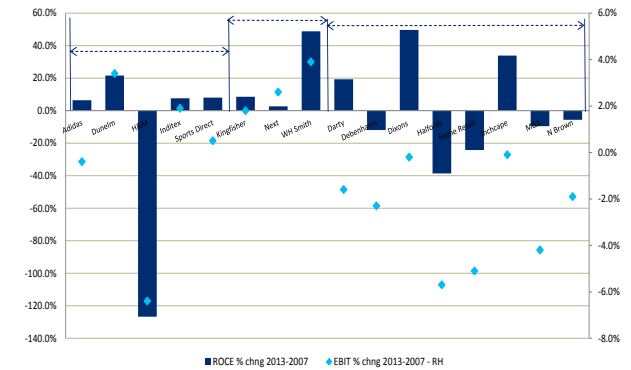
Source: Datastream and Citi Research

Citi View

Here we make four points.

- Firstly, 10.7x sector 2014E EV/EBIT multiple is much more in line with the 10x long run average, reflecting the sector's current strong cash generation and hence improved net debt/(net cash) position.
- Secondly, while the 'Cyclicals' have dramatically re-rated and now trade at a +33% premium to the long-run average (a lofty 17x 2013E PE), the 'Self-help' retailers have not (2013E PE +5% to c.14x), and are currently exposed to both a better demand environment and the earnings upside from their underlying EBIT margin/restructuring activity. We argue that these 'Self-help' retailers (Carphone Warehouse, Kingfisher, Next and WH Smith) continue to offer strong share price upside (see below).
- While the 'Growth' retailers have re-rated to a c.+24% premium to their average (to 22x 2013E PE), this has been driven primarily by the recent re-rating of three stocks (ASOS, Sports Direct and Dunelm), all in response to growing confidence in their medium-term growth outlook. Conversely, the valuation metrics for H&M and Inditex are little changed over the last six years. We continue to believe that the Growth retailers have strong earnings forecast visibility, in aggregate the strongest absolute EPS growth, and should be able to sustain these valuation metrics over time.
- The Cyclical retailers' 12-month forward PE has re-rated the most, and arguably some cyclical retailers already discount a better EPS outlook. Within the Cyclicals we have two Buy ratings, Dixons and M&S. We believe both have stock-specific management initiatives that should be more potent in an improving macro environment, and both have strong sales/earnings gearing to a better UK consumer demand environment.

Figure 99. Sector ROCE delta and EBIT delta, 2007 v 2013



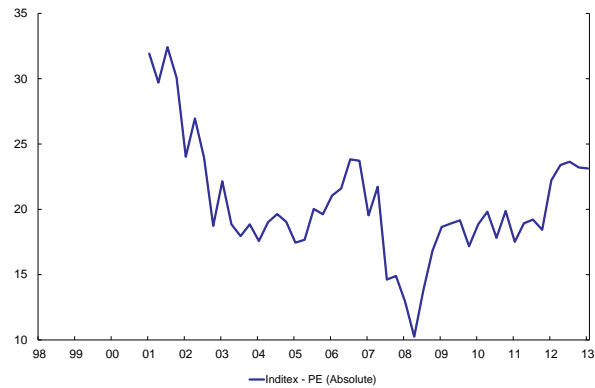
Source: Company reports and Citi Research estimates

Figure 102. 'Cyclical' Retail 12 month forward PE



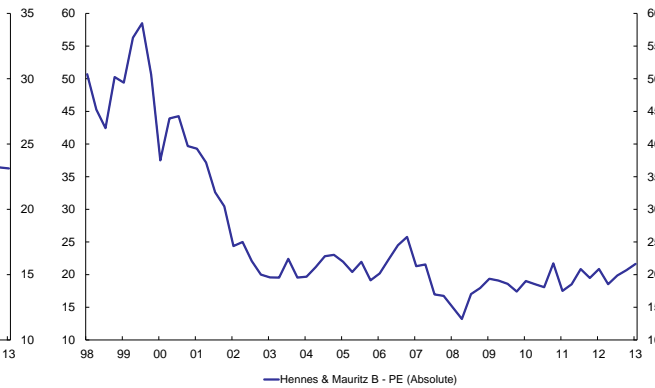
Source: Datastream, Citi Research

Figure 103. ITX PE, 2001-2013



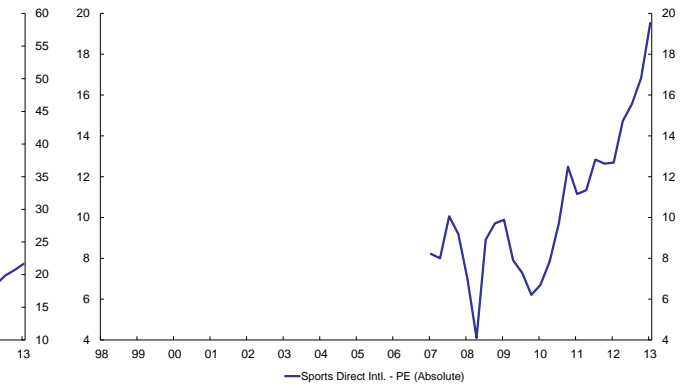
Source: Datastream and Citi Research

Figure 104. H&M PE, 1998-2013



Source: Datastream and Citi Research

Figure 105. Sports Direct PE, 2007-2013



Source: Datastream and Citi Research

Conclusion

Given this analysis, we remain **Buyers of all four of the 'Self-help' retailers (Carphone Warehouse, Kingfisher, Next and WH Smith)** and today upgrade our Next target price to 5,650p (from 5,200p), while Kingfisher is our Most Preferred. In addition, we continue to argue for **Buy ratings on most of the 'Growth' retailers, including Buys on adidas, ASOS, Dunelm, Inditex and Sports Direct**. Of these we also raise our target price on ASOS, to 5,800p (from 4,800p). Finally, despite our view that the recent re-rating of the 'Cyclical' retail valuations already discounts a stronger EPS growth forecast agenda, we have **two 'Cyclical' retail Buy ratings, on Dixons Retail and M&S**. Both are trading on modest underlying valuation metrics, and both offer high revenue/earnings gearing to a better consumer demand outlook, in our view.

Recommendations and Target Prices

Taken together, our most favoured stocks for 2013/14 are adidas, Dixons Retail, Kingfisher, and Inditex. Least favoured are Home Retail and Darty. Notably, we recently raised M&S to a Buy rating (from Neutral), in large part as a consequence of our raised UK consumer demand forecast agenda which we argue has improved the credibility of the group's FY15 and FY16 double-digit earnings growth forecast (cf: [Marks & Spencer: There Is A Light](#)).

Figure 106. Valuation And Earnings Growth Sector Segmentation (Fiscal Year Nearest to Calendar Year-End)

| | | PE | | | EV/EBIT | | | EPS Growth | | |
|---|---------|-------|------|------|---------|------|------|------------|------|------|
| | | 2013 | 2014 | 2015 | 2013 | 2014 | 2015 | 2013 | 2014 | 2015 |
| Growth basket | | | | | | | | | | |
| adidas | Buy | 19.0 | 16.5 | 14.2 | 12.7 | 11.0 | 9.4 | 14% | 15% | 17% |
| ASOS | Buy | 103.2 | 79.8 | 59.1 | 76.8 | 59.6 | 44.1 | 20% | 29% | 35% |
| Dunelm | Buy | 21.2 | 19.0 | 17.0 | 15.4 | 13.6 | 11.8 | 13% | 11% | 12% |
| H&M | Neutral | 24.1 | 21.7 | 19.7 | 18.1 | 16.3 | 14.8 | 0% | 11% | 10% |
| Inditex | Buy | 24.9 | 22.4 | 19.8 | 17.8 | 15.4 | 13.5 | 9% | 11% | 13% |
| Sports Direct | Buy | 22.1 | 18.4 | 16.8 | 16.3 | 13.1 | 10.9 | 17% | 20% | 10% |
| CDON Group | Neutral | 51.9 | 24.1 | 15.4 | 22.7 | 12.3 | 7.4 | -248% | 115% | 57% |
| Delticom | Neutral | 21.5 | 18.9 | 16.5 | 13.8 | 12.3 | 10.8 | -4% | 13% | 15% |
| Zooplus | Neutral | 165.4 | 46.5 | 25.7 | 143.0 | 37.5 | 20.4 | -185% | 256% | 81% |
| Average (equal weighted) ex Online stocks | | 22.2 | 19.6 | 17.5 | 16.1 | 13.9 | 12.1 | 11% | 14% | 12% |
| Average (equal weighted) | | 50.3 | 29.7 | 22.7 | 37.4 | 21.2 | 15.9 | -40% | 53% | 28% |
| Self Help | | | | | | | | | | |
| Carphone Warehouse | Buy | 12.7 | 11.3 | 10.7 | 8.8 | 8.2 | 7.8 | 57% | 12% | 6% |
| Kingfisher | Buy | 16.6 | 14.8 | 13.5 | 11.9 | 10.5 | 9.5 | 8% | 12% | 9% |
| Next | Buy | 15.8 | 14.2 | 12.8 | 12.0 | 11.7 | 11.2 | 12% | 11% | 12% |
| Steinhoff | Buy | 8.3 | 7.7 | 0.0 | 7.8 | 6.9 | 0.0 | 9% | 8% | 9% |
| WH Smith | Buy | 12.2 | 11.3 | 10.6 | 9.4 | 9.0 | 8.7 | 11% | 8% | 6% |
| Average (equal weighted) | | 13.1 | 11.9 | 9.5 | 10.0 | 9.3 | 7.4 | 20% | 10% | 9% |
| Cyclicals | | | | | | | | | | |
| Darty | Sell | 21.4 | 17.7 | 15.8 | 13.0 | 11.2 | 9.9 | 81% | 21% | 12% |
| Debenhams | Neutral | 11.0 | 10.9 | 9.9 | 10.3 | 10.2 | 9.6 | -1% | 1% | 10% |
| Dixons Retail | Buy | 23.1 | 17.5 | 16.1 | 7.8 | 6.5 | 6.7 | 48% | 32% | 9% |
| Halfords | Neutral | 15.9 | 13.6 | 11.6 | 13.7 | 11.9 | 10.0 | -16% | 17% | 18% |
| Home Retail Group | Sell | 18.3 | 17.6 | 15.9 | 9.7 | 10.0 | 9.6 | 3% | 4% | 11% |
| Inchcape | Neutral | 14.6 | 13.1 | 12.0 | 9.1 | 8.3 | 7.9 | 9% | 11% | 9% |
| M&S | Buy | 15.1 | 13.4 | 12.0 | 13.0 | 11.8 | 10.7 | 2% | 13% | 11% |
| N Brown | Neutral | 18.9 | 18.3 | 17.8 | 16.1 | 15.3 | 14.8 | 4% | 3% | 3% |
| Average (equal weighted) | | 17.3 | 15.3 | 13.9 | 11.6 | 10.6 | 9.9 | 16% | 13% | 10% |

Source: Company Reports and datacentral (priced on 3 September)

Appendices

European Clothing Retail

Figure 107. UK, H&M and Inditex – Gross Margin Drivers, 2011-13E

| | 2011 | | | | 2012E | | | | 2013E | | | |
|---------------------------------|-------|-------|---------|--------|-------|-------|---------|--------|-------|-------|---------|--------|
| | UK | H&M | Inditex | adidas | UK | H&M | Inditex | adidas | UK | H&M | Inditex | adidas |
| Product cost inflation | 8.1% | 9.2% | 5.6% | 4.6% | -2.2% | -1.9% | -0.4% | -0.3% | 0.0% | -0.9% | 0.4% | -0.9% |
| Currency | -0.6% | 4.1% | 1.5% | -1.6% | -0.1% | -0.6% | 0.3% | -2.5% | -0.1% | 2.0% | 1.1% | 2.0% |
| Net inflation (local ccy) | 7.5% | 13.3% | 7.1% | 3.0% | -2.2% | -2.4% | -0.2% | -2.8% | -0.1% | 1.1% | 1.6% | 1.1% |
| Implied GM delta (bps) | -335 | -530 | -295 | -150 | 100 | 100 | -5 | 140 | 5 | -45 | -55 | -55 |
| Forecast GM delta (bps) | 15 | -280 | -5 | -20 | 15 | -60 | 60 | 20 | 0 | -30 | -30 | 130 |
| Implied out/(under)-performance | 350 | 250 | 290 | 125 | -85 | -160 | 65 | -125 | -5 | 15 | 25 | 185 |

Source: Company Reports and Citi Research

Figure 108. Clothing, Sourcing: UK vs Europe

| | UK | H&M | Inditex | adidas |
|-----------------------|-----|-----|---------|--------|
| Asian sourcing | 67% | 75% | 33% | 100% |
| Cotton as a % of COGS | 17% | 20% | 10% | 15% |
| Gross margin | 55% | 60% | 58% | 50% |

Source: Company Reports and Citi Research Estimates

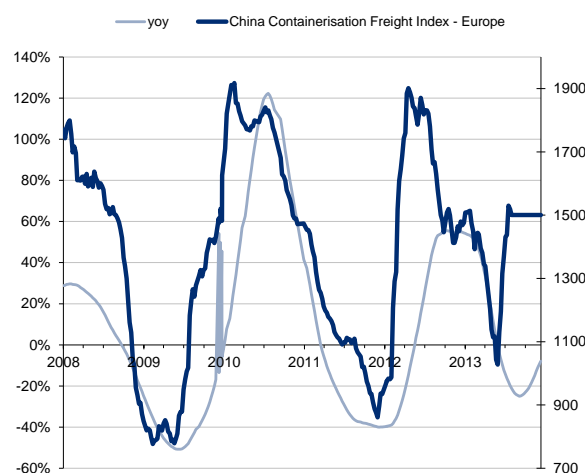
For the European clothing retailers, we have updated our analysis of input costs (cotton price, freight costs, wage inflation and currencies) to understand the theoretical movements in gross margin for the UK clothing retailers, as well as H&M, Inditex and adidas. Our conclusions are summarised above, but in general we conclude that 2013 gross margin dynamics are broadly neutral for UK apparel retailers, with a modest headwind for the primarily € sales based retailers (H&M, Inditex and adidas). Notably, the material impact of product, geographical and channel mix effects are still expected to drive c.+80bp achieved gross margin progress at adidas.

Figure 109. Chinese Cotton Price, 2008-2013



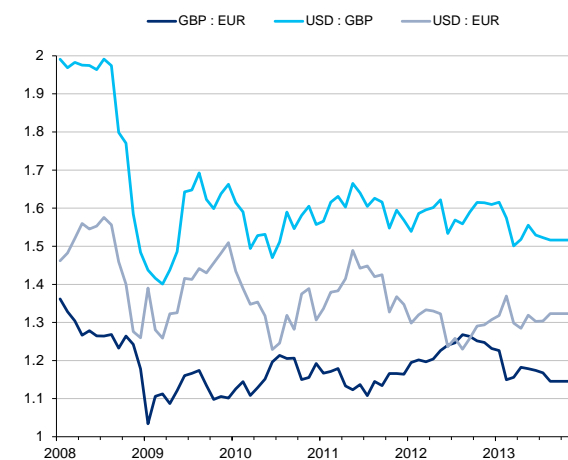
Source: Datastream, Citi Research

Figure 110. China Container Freight Index, 2008-2013



Source: Datastream, Citi Research

Figure 111. Exchange Rates



Source: Datastream, Citi Research

UK Clothing Retail Gross Margin Drivers

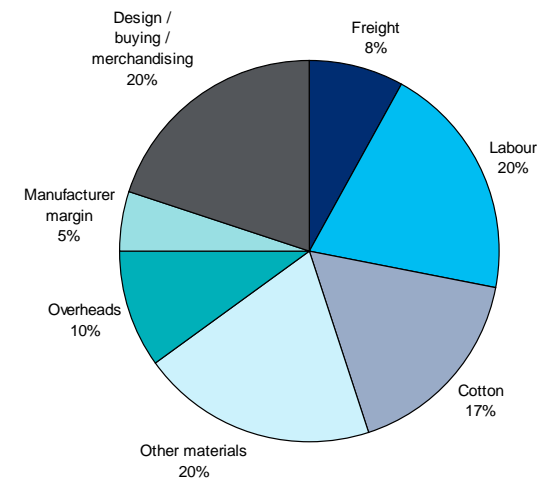
Following the fade in cotton prices and freight cost inflation, we forecast broadly stable gross margins for the UK clothing retailers in 2013.

Figure 112. Gross Margin Drivers for a Typical UK Clothing Retailer, 2010-2013e

| | | 1H 10 | 2H 10 | FY 10 | 1H 11 | 2H 11 | FY 11 | 1H 12 | 2H 12e | FY 12e | 1H 13e | 2H 13e | FY 13e |
|------------------------------------|-----|--------|-------|-------|-------|-------|-------|--------|--------|--------|--------|--------|--------|
| Freight | 8 | -12.0% | 62.9% | 25.5% | 33.4% | -0.2% | 16.6% | -11.5% | 4.6% | -3.5% | 27.1% | -4.8% | 11.2% |
| Labour | 20 | 0.0% | 3.0% | 1.5% | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% |
| Cotton | 12 | 3.2% | 28.4% | 15.8% | 46.8% | 56.0% | 51.4% | 7.6% | -49.3% | -20.9% | -28.9% | 4.1% | -12.4% |
| Other materials | 25 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Overheads | 10 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Manufacturer margin | 5 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Design / buying / merchandising | 20 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Inflation at constant currency | 100 | -0.6% | 9.0% | 4.2% | 8.9% | 7.3% | 8.1% | 0.6% | -4.9% | -2.2% | -0.7% | 0.7% | 0.0% |
| Currency | | | | | | | | | | | | | |
| - dollar / gbp | | 3.4% | -2.9% | 0.3% | 3.2% | -3.1% | 0.0% | -1.0% | 1.2% | 0.1% | 0.0% | 1.1% | 0.6% |
| - euro / gbp | | 2.3% | -0.7% | 0.8% | -1.1% | -0.2% | -0.6% | 0.8% | -1.2% | -0.2% | -1.9% | 0.6% | -0.7% |
| Inflation | | 5.2% | 5.4% | 5.3% | 11.0% | 4.0% | 7.5% | 0.4% | -4.9% | -2.2% | -2.6% | 2.5% | -0.1% |
| Implied GM delta (bps) | | -230 | -240 | -235 | -490 | -180 | -335 | -20 | 220 | 100 | 120 | -110 | 5 |
| Achieved / Forecast GM delta (bps) | | 50 | 20 | 35 | 0 | 30 | 15 | 0 | 30 | 15 | 60 | -60 | 0 |
| Implied out/(under)-performance | | 280 | 260 | 270 | 490 | 210 | 350 | 20 | -190 | -85 | -60 | 50 | -5 |

Source: Company reports and Citi Research

Figure 113. Typical COGS Split for a Clothing Retailer



Source: Citi Research

H&M Gross Margin Drivers

For H&M, while we forecast a modest ex-currency COGS decline in 2013, the recent euro/US\$ weakness argues for c.+1.1% COGS inflation in 2013, equivalent to a -45bp bought-in gross margin decline. While H&M is typically capable of offsetting much of this (through negotiation, product mix, supplier allocation) we still fear 2013 could see approaching -30bp H&M bought-in gross margin headwind. Notably, this analysis assumes the US\$/€ remains c. 1.32.

Figure 114. H&M - Gross Margin Drivers, 2010-2013e

| | | 1H 10 | 2H 10 | FY 10 | 1H 11 | 2H 11 | FY 11 | 1H 12 | 2H 12e | FY 12e | 1H 13e | 2H 13e | FY 13e |
|--|-----|--------|-------|-------|-------|-------|-------|-------|--------|--------|--------|--------|--------|
| Freight | 8 | -13.9% | 30.8% | 8.5% | 16.6% | 1.0% | 8.8% | -3.6% | 16.0% | 6.2% | 13.3% | -9.1% | 2.1% |
| Labour | 20 | 0.0% | 3.8% | 1.9% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% |
| Cotton | 15 | 3.2% | 28.4% | 15.8% | 46.8% | 56.0% | 51.4% | 7.6% | -49.3% | -20.9% | -28.9% | 4.1% | -12.4% |
| Other materials | 27 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Overheads | 10 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Manufacturer margin | 5 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Design / buying / merchandising | 15 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| | 100 | -0.6% | 7.5% | 3.4% | 9.1% | 9.2% | 9.2% | 1.6% | -5.4% | -1.9% | -2.5% | 0.6% | -0.9% |
| Currency | | | | | | | | | | | | | |
| - dollar / euro | | 1.0% | -4.5% | -1.7% | 7.8% | 0.4% | 4.1% | -4.8% | 2.6% | -1.1% | 3.8% | 0.2% | 2.0% |
| - euro / gbp | | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Inflation | | 0.4% | 3.0% | 1.7% | 16.9% | 9.6% | 13.3% | -3.2% | -2.7% | -3.0% | 1.2% | 0.9% | 1.1% |
| Implied gross margin delta (bps) | | -20 | -120 | -70 | -680 | -380 | -530 | 130 | 110 | 120 | -50 | -40 | -45 |
| Achieved / Forecast gross margin delta (bps) | | 500 | -225 | 130 | -410 | -160 | -280 | -90 | -20 | -60 | -50 | 0 | -30 |
| Implied out/(under)-performance | | 520 | -105 | 200 | 270 | 220 | 250 | -220 | -130 | -180 | 0 | 40 | 15 |

Source: Company Reports and Citi Research Estimates

Inditex Gross Margin Drivers

At Inditex, we argue that the lower US\$ sourcing exposure (c.33% vs. H&M at 70-80%) and greater pricing power should be sufficient to offset the weak €-driven 2013 bought-in gross margin headwind. Hence product mix effects are the primary driver of our -30bp calendar 2013E gross margin delta.

Figure 115. Inditex - Gross Margin Drivers, 2010-2013e

| | | 1H 10 | 2H 10 | Cal 10 | 1H 11 | 2H 11 | Cal 11 | 1H 12 | 2H 12e | Cal 12e | 1H 13e | 2H 13e | Cal 13e |
|--|-----|--------|-------|--------|-------|-------|--------|-------|--------|---------|--------|--------|---------|
| Freight | 8 | -13.9% | 30.8% | 8.5% | 16.6% | 1.0% | 8.8% | -3.6% | 16.0% | 6.2% | 15.0% | 1.5% | 8.3% |
| Labour | 20 | 0.0% | 3.8% | 1.9% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% |
| Cotton | 10 | 3.2% | 28.4% | 15.8% | 46.8% | 56.0% | 51.4% | 7.6% | -49.3% | -20.9% | -28.9% | 4.% | -12.4% |
| Other materials | 32 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Overheads | 10 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Manufacturer margin | 5 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Design / buying / merchandising | 15 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| | 100 | -0.9% | 5.5% | 2.3% | 5.8% | 5.3% | 5.6% | 1.1% | -1.9% | -0.4% | -0.4% | 1.2% | 0.4% |
| Currency | | | | | | | | | | | | | |
| - dollar / euro | | -1.3% | -0.4% | -0.9% | 5.2% | -2.2% | 1.5% | -1.4% | 2.0% | 0.3% | 2.5% | -0.% | 1.% |
| - euro / gbp | | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Inflation | | -2.2% | 5.0% | 1.4% | 11.0% | 3.1% | 7.1% | -0.4% | 0.1% | -0.2% | 2.2% | 1.0% | 1.6% |
| Implied gross margin delta (bps) | | 90 | -210 | -60 | -460 | -130 | -295 | 50 | -60 | -5 | -70 | -40 | -55 |
| Achieved / Forecast gross margin delta (bps) | | 400 | 70 | 215 | -100 | 90 | 0 | 120 | 10 | 60 | -85 | 25 | -30 |
| Implied out/(under)-performance | | 310 | 280 | 275 | 360 | 220 | 295 | 56 | 70 | 65 | -15 | 65 | 25 |

Source: Company Reports and Citi Research Estimates

adidas Gross Margin Drivers

While adidas sources almost entirely in US\$, Europe is 30% of its sales mix and hence the recent € weakness vs. the US\$ has less impact than at other major European US\$-sourced apparel retailers (e.g. H&M), a conclusion also helped by the group's pricing power. In addition, the recent declines in rubber, polyester and cotton prices should more than offset higher freight costs, helping to reduce the recent adverse currency movements. Taken together with geographical mix effects, ASP inflation and some Reebok gross margin recovery, we forecast modest (+130bp) adidas gross margin progress in 2013.

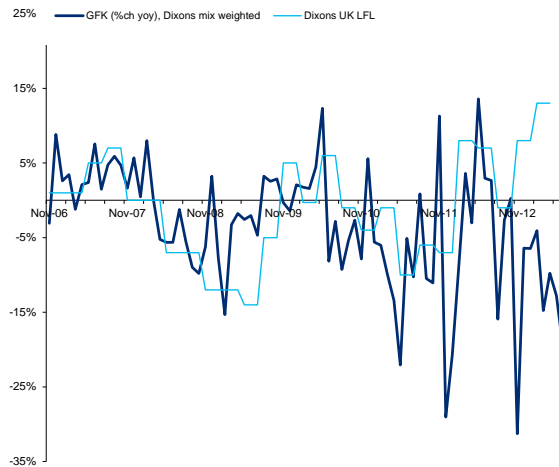
Figure 116. adidas - Gross Margin Drivers, 2010-2013e

| | | 1H 10 | 2H 10 | FY 10 | 1H 11 | 2H 11 | FY 11 | 1H 12 | 2H 12e | FY 12e | 1H 13e | 2H 13e | FY 13e |
|---|-----|-------|-------|-------|-------|-------|-------|-------|--------|--------|--------|--------|--------|
| Freight | 5 | -9% | 13% | 2% | 16% | -2% | 7% | -9% | 0% | -4% | 5% | 12% | 9% |
| Labour | 15 | 0% | 5% | 3% | 5% | 5% | 5% | 5% | 5% | 5% | 5% | 5% | 5% |
| Cotton | 15 | 3% | 28% | 16% | 47% | 56% | 51% | 8% | -28% | -10% | -6% | -1% | -4% |
| Polyester | 10 | -6% | 36% | 15% | 18% | 41% | 29% | 26% | -14% | 6% | -15% | 1% | -7% |
| Rubber | 13 | -15% | 92% | 39% | 50% | 50% | 50% | 17% | -28% | -6% | -32% | -20% | -26% |
| Other materials | 27 | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| Overheads | 10 | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| Manufacturer margin | 5 | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| Theoretical inflation | 100 | -2.5% | 21.5% | 9.5% | 17.0% | 19.7% | 18.4% | 6.4% | -8.6% | -1.1% | -5.7% | -1.4% | -3.5% |
| Bought in inflation | | -0.6% | 5.4% | 2.4% | 4.2% | 4.9% | 4.6% | 1.6% | -2.2% | -0.3% | -1.4% | -0.3% | -0.9% |
| Currency | | 5.4% | 4.4% | 4.9% | -2.5% | -0.8% | -1.6% | -1.3% | -3.7% | -2.5% | 0.3% | 3.7% | 2.0% |
| Inflation | | 4.8% | 9.8% | 7.3% | 1.7% | 4.2% | 3.0% | 0.3% | -5.8% | -2.8% | -1.1% | 3.4% | 1.1% |
| Implied gross margin delta (bps) | | -240 | -490 | -365 | -90 | -210 | -150 | -10 | 290 | 140 | 60 | -170 | -55 |
| Achieved / Forecast Group gm% delta (bps) | | 370 | 120 | 240 | 0 | -50 | -20 | -80 | 110 | 20 | 214 | 53 | 130 |
| Implied out/(under)-performance | | 610 | 610 | 610 | 90 | 160 | 125 | -70 | -180 | -125 | 154 | 223 | 185 |

Source: Company Reports and Citi Research Estimates

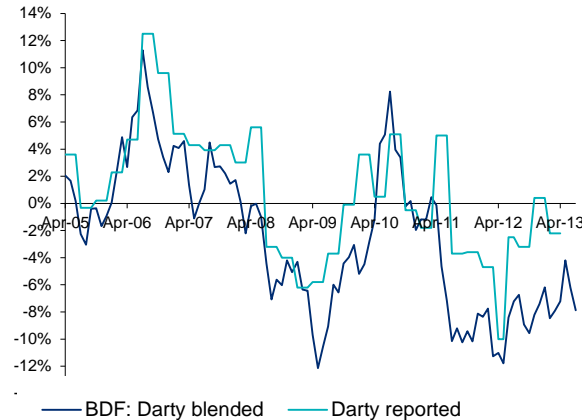
European Electricals

Figure 117. UK Electrical Market Growth vs Dixons UK LFL



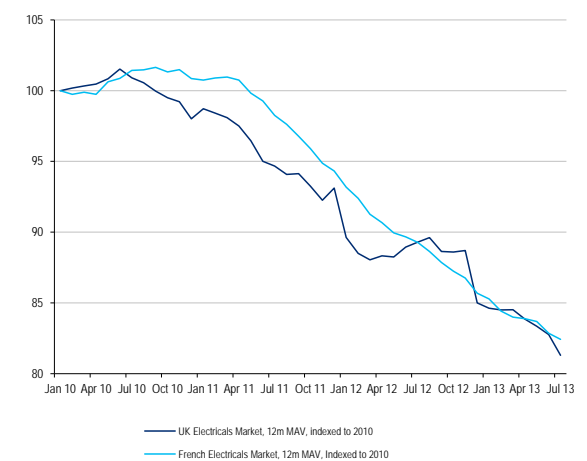
Source: Company Reports, GFK and Citi Research Estimates

Figure 118. France Electrical Market Growth vs Darty LFL



Source: Company Reports, BDF and Citi Research Estimates

Figure 119. Rolling 12-Month MAV Industry Sales, Indexed to 2010



Source: Company Reports and Citi Research Estimates

Over-capacity – but signs of improvement for incumbents

This in general remains a category under pressure. Some signs of over-capacity are still present, compounded by historical incursion by food retailers into non-food and high online penetration within the consumer electronics space. The UK continues to lead penetration in Europe, where online electrical sales are now approaching 30% (Verdict). We have in the last 6-12 months seen some exit of capacity, most recently by the administration of Comet, Best Buy UK exiting the market and the administration of Game Group. Dixons is still progressing with its plan to reduce its UK store estate from c.498 (ex-Ireland and Dixons Travel) stores to between 380 and 400 stores over time.

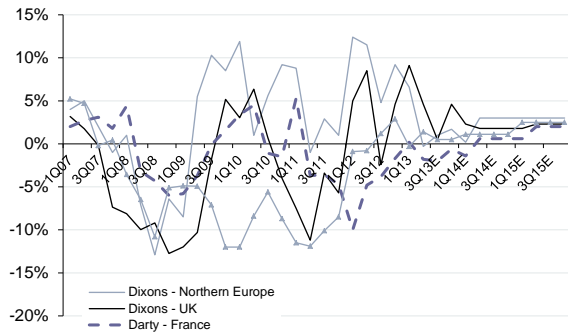
UK market performance mixed, France still weak

The UK performance since the beginning of the year has been mixed, with ongoing weakness in brown goods offset by a robust performance in white goods. Within brown goods, category performance has been driven largely by the strength of the current technology cycle in tablets. Market share gains from the demise of Comet are notably showing up strongest in Dixons, which reported Q4 UK LFL of +13%. French consumer electronic sales remain weak, down 10% in the last three months (to July), with white goods down 3% according to Banque De France, although Darty has been performing ahead of this (given its white goods exposure). Given ongoing macro headwinds in France, we expect little improvement in this trend near term.

Dixons putting pure-play and stores under renewed pricing pressure in the UK?

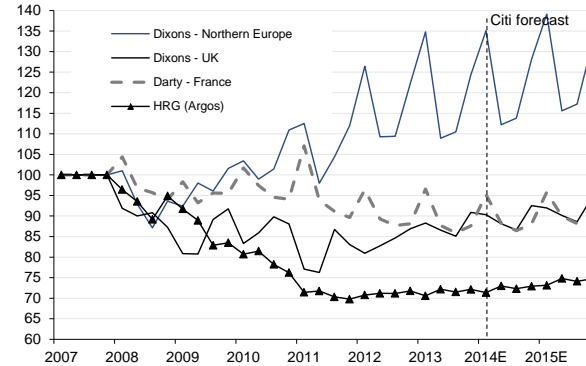
Dixons' recent results continue to highlight the extent to which the UK business has been narrowing its product pricing differential against the pure online players across both white and brown goods. As Figure 123 shows, while this has allowed Dixons UK to be more competitive on price, we believe it also acting as a disruptive force to existing store-based retailers, who, as the chart shows, have been reducing their own electricals product pricing in response, potentially at the risk of impacting gross margins.

Figure 120. Electricals LFL Gross Profit Trends (Calendarised)



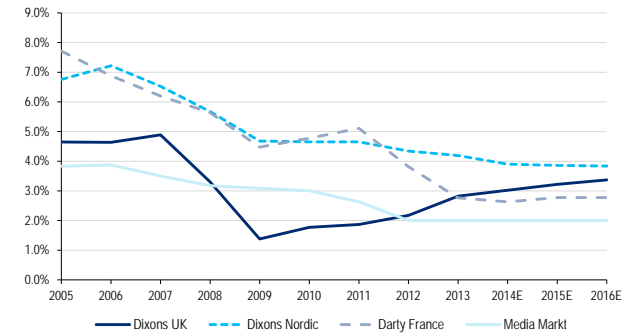
Source: Company Reports and Citi Research Estimates

Figure 121. Electricals LFL Gross Profit Rebased to 2007



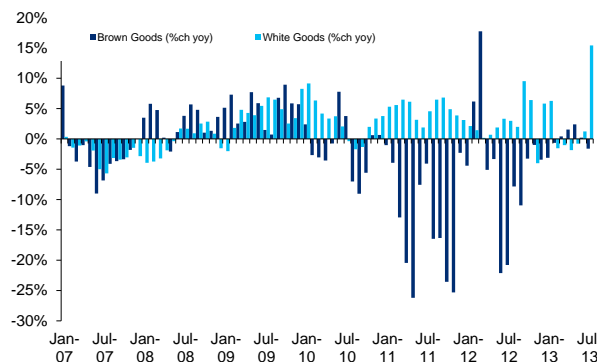
Source: Company Reports and Citi Research Estimates

Figure 122. Operating Margins, 2005-2015e



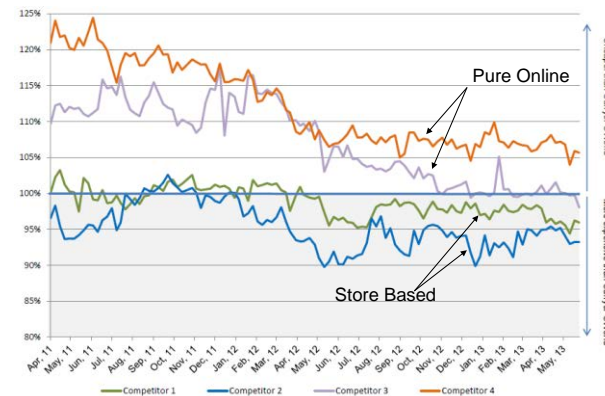
Source: Company Reports and Citi Research Estimates

Figure 123. UK ASP yoy% Trends (White and Brown Goods). ASP Inflation in White Goods Has Helped Offset Weakness in Brown



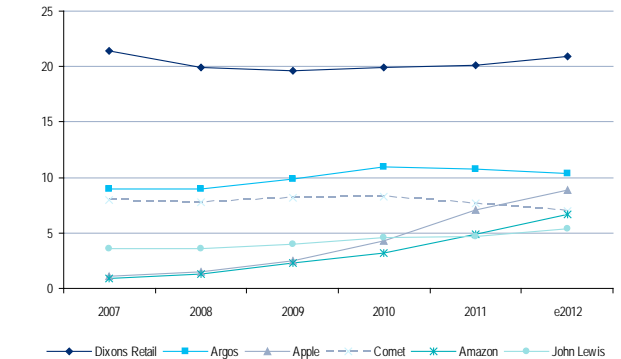
Source: GfK

Figure 124. Dixons Is Narrowing Its Price Gap Between Both Pure Online and In-store Competitors in the UK



Source: Company Reports

Figure 125. Electrical Retailers Market Share - Comet Administration - c£1.1bn Sales Support to Incumbents



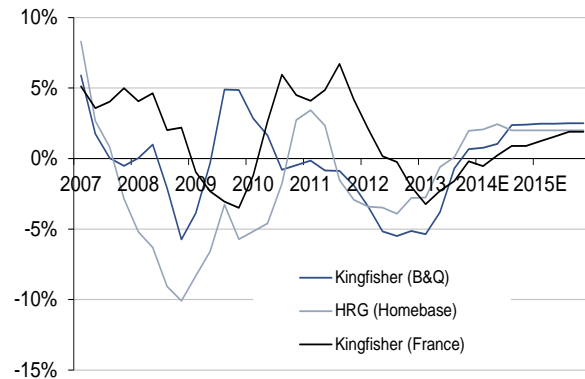
Source: Verdict

Improving UK HAC adds tailwind to our Dixons investment thesis (Buy, TP 53p)

Consistent with our cautious approach to this retail sub-sector, we continue to have a net underweight stance on the European Electrical retailers: Home Retail Group (Sell), Darty (Sell) and Dixons (Buy) – of these Dixons is the only one where the operating margin trend (UK) has seen improvement over the last three reported years and is potentially the largest beneficiary from the administration of Comet, in our view, alongside strong supplier support. We continue to regard Carphone Warehouse (Buy) as more of a special situation, given its focus on higher-growth categories (smartphones, tablets).

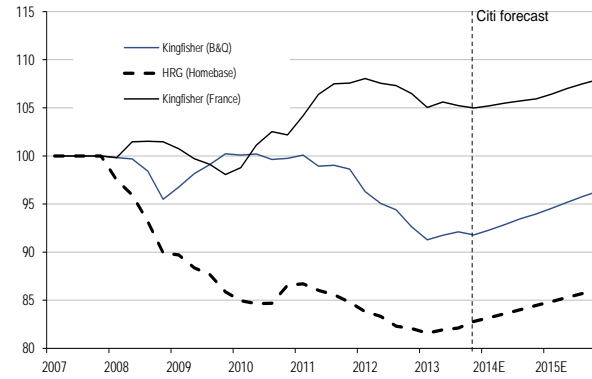
European DIY

Figure 126. DIY LFL Gross Profit Trends (Cal Years 2008-14e)



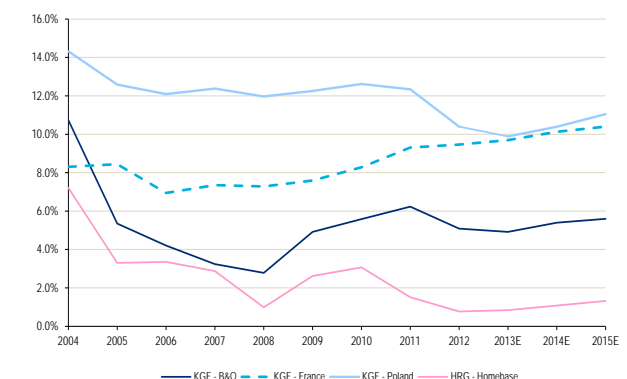
Source: Company Reports and Citi Research Estimates

Figure 127. DIY LFL Gross Profit Rebased to 2008



Source: Company Reports and Citi Research Estimates

Figure 128. DIY Operating Margins, 2005-15E



Source: Company Reports and Citi Research Estimates

DIY has remained relatively stable since 2008. This is supported through the analysis of LFL gross profit trends (a combination of LFL sales and gross margin movements, yoy), as shown in Figure 125 and Figure 126. The one exception here is within the UK, with the sharp deterioration suffered by Homebase in 2008 and 2009 as it repositioned its price architecture relative to B&Q.

We expect some improvement in UK DIY trends in H2 2013. Looking past the softer 2012 trading period (KGF UK LFL -5.6%) for the retailer, which saw LFLs heavily weather-impacted and some gross margin pressure due to additional clearance activity, particularly in H1, and then muted demand trends in H2, we expect 2013 to be more constructive given the weaker comparatives with improvement into 2014 given our more positive view on household cashflows and potential benefits from a stronger UK housing market (particularly Help to Buy in 2014). To this extent 2Q trends have shown some improvement (KGF UK LFL +2.0%). We expect some gross margin progression at B&Q and flat gross margins at Homebase, and still expect medium-term outperformance at Kingfisher, given direct sourcing and common product initiatives.

Within France, we expect the market to remain concerned about the macro-economic impact on Kingfisher France in the near term. While most of the DIY-related indicators have softened through the beginning of 2013, more recently housing starts data for France has shown stabilisation (+7% yoy in May vs flat in April) and Banque De France data and KGF France comparatives get significantly easier from through H2. Whilst we still expect this to have some drag on Kingfisher's French LFL we would note that DIY in France tends to be more defensive vs other discretionary sub-sectors (such as electricals) and that Kingfisher France has tended to outperform the French DIY market on average by about 100bp.

Kingfisher remains one of our top picks in the sector (Buy, TP 455p)

We continue to believe that longer term Kingfisher should be the beneficiary of strong market positions, material efficiency gains primarily from direct sourcing initiatives and International space growth, all underpinned by a strong balance sheet and management team. We maintain our Buy rating, given prospects on our forecast agenda still for 10% CAGR EPS growth across FY 2013E - FY 2016E, medium-term potential for cash returns and ongoing strategic initiatives.



Notes

Citi Research

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

An employee of Citigroup Global Markets or its affiliates is a Sales Consultant of Next Retail Ltd.

Citigroup is acting as Bookrunner in relation to Dixons Retail plc's announced offering of sterling - denominated fixed rate guaranteed notes with expected maturity 2017. Citigroup is also acting as Dealer Manager in the announced Tender Offer for existing notes.

BEST IDEAS UNIVERSE: The best ideas universe from which Kingfisher PLC (covered by Assad M Malic) were chosen comprises: Inditex (ITX.MC, €102.85), Hennes & Mauritz AB (Hmb.ST, SKr246.5), Next Group PLC (NXT.L, £49.74), Sports Direct International Plc (SPD.L, £6.9), Marks and Spencer Group PLC (MKS.L, £4.8), Debenhams Plc (DEB.L, £1.04), ASOS Plc (ASOS.L, £49.82), adidas Group (ADSGN.DE, €80.76), Carphone Warehouse (CPW.L, £2.4), Dixons Retail PLC (DXNS.L, £0.44), Home Retail Group (HOME.L, £1.44), Inchcape PLC (INCH.L, £6.11), Darty Plc (DRTY.L, €0.8), WH Smith PLC (SMWH.L, £8.47), Jumbo Babyland (BABr.AT, €7.83), CDON Group (CDON.ST, SKr20.2), Zooplus (ZO1G.DE, €49.5), Halfords Group Plc (HFD.L, £3.63), Dunelm (DNLM.L, £9.59), N Brown (BWNG.L, £5.56), Steinhoff International Holdings Ltd (SHFJ.J, R29.3), Delticom (DEXGn.DE, €37.41) and Kingfisher PLC (KGF.L, £3.96). All prices as of 3 Sep 2013.

Within the past 12 months, Citigroup Global Markets Inc. or its affiliates has acted as manager or co-manager of an offering of securities of Dixons Retail PLC.

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Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from Inditex, Hennes & Mauritz AB, Halfords Group Plc, Debenhams Plc, ASOS Plc, Steinhoff International Holdings Ltd, Inchcape PLC, adidas Group, Next Group PLC, Dixons Retail PLC, Marks and Spencer Group PLC, Home Retail Group in the past 12 months.

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Data current as of 30 Jun 2013

| 12 Month Rating | | | Relative Rating | | |
|-----------------|------|------|-----------------|------|------|
| Buy | Hold | Sell | Buy | Hold | Sell |

| | | | | | | |
|---|-----|-----|-----|-----|-----|-----|
| Citi Research Global Fundamental Coverage | 48% | 40% | 12% | 6% | 88% | 6% |
| <i>% of companies in each rating category that are investment banking clients</i> | 53% | 50% | 45% | 58% | 51% | 49% |

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