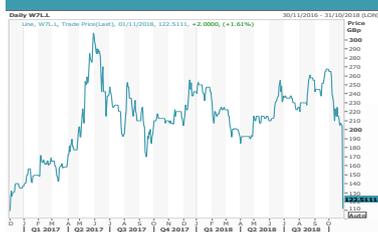




Personal Products



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	W7L
Price (p)	124
12m High (p)	274.8
12m Low (p)	112.5
Shares (m)	76.7
Mkt Cap (£m)	95.2
EV (£m)	90.6
Free Float*	37.0%
Market	AIM

*As defined by AIM Rule 26

Description

Warpaint is a UK-based colour cosmetics specialist that sells creative, design-focused and high-quality cosmetics at affordable prices. The company comprises of two divisions: own-brand (W7, Retra and others) and close-out. It has a presence in more than 60 countries worldwide.

Company information

Joint CEO	Sam Bazini
Joint CEO	Eoin Macleod
CFO	Neil Rodol
Chairman	Clive Garston

+44 1753 639 130

www.warpaintlondonplc.com

Key shareholders

Directors*	51.1%
Schroder Inv. Mgmt.	12.0%
BlackRock Inv. Mgmt.	9.9%
Hargreave Hale	3.1%
J O Hambro Capital Mgmt.	2.0%
Columbia Threadneedle	1.8%

*includes shares held by directors' wives

Diary

Apr'19	Full-year results
Jun'19	AGM

Analyst

Yingheng Chen 020 7194 7638
yc@hardmanandco.com

WARPAINT LONDON PLC

Trading update: softening UK market

Warpaint has released a trading update for the year ending 31 December 2018. The company has prudently signalled that group sales for FY2018 are likely to be lower than previously indicated, in the range of £48m-£52m, with adjusted PBT of £8.5m-£10m. The company says that trading conditions in the UK remain challenging but that it has seen strong growth in its overseas markets. The share price responded negatively to this trading announcement, plunging by over 45% to 112.5p on the day, from the 206.5p closing price on 26 October. We have lowered FY18E revenue to £50.0m, from £55.1m, with adjusted PBT of £9.1m, from £12.4m, but we retain a dividend forecast of 5.5p.

- ▶ **UK trading conditions:** During the interim results announcement in September, Warpaint stated that "trading conditions in the UK remain challenging, because of the UK high-street slowdown and ongoing Brexit anxiety." The company has seen a further softening in the past six weeks, with retailers reducing stock levels and delaying Christmas orders.
- ▶ **International operations:** Given the weak retail market in the UK, Warpaint's management has been putting specific emphasis on its international operations. Benefiting from the recent acquisition of Leeds Marketing, Warpaint saw a 60% increase in group sales in the US for the nine-month period to end-September 2018. The company has also reported its first sales to mainland China, as well as to Russia.
- ▶ **Valuation:** Despite the reduction in revenue and PBT forecasts highlighted above, Warpaint will still be profitable for FY18. With a strong cash position, the management team still intends to pay off the remaining borrowings. The company remains profitable and cash-generative, and it intends to maintain its progressive dividend policy.
- ▶ **Risks:** As shown in this trading update, Warpaint's success depends partly on the growth in the discount retail sector. Following the acquisition of Retra, which has significant exposure to the gifting market, Warpaint has better visibility in revenue forecasting, but Retra also increases its exposure to the struggling UK high-street retailers.
- ▶ **Investment summary:** Warpaint is benefiting from its two acquisitions, Retra and Leeds Marketing, which enable the group to enter the fastest-growing colour cosmetics market (China) and further expand into the largest colour cosmetics market (US) in the world. It offers investors the opportunity to invest in the fast-growing colour cosmetics sector, with a highly experienced management team, an attractive RoE and a high dividend yield.

Financial summary and valuation

Year-end Dec (£m)	2016	2017	2018E	2019E	2020E
Sales	22.5	32.5	50.0	56.8	62.3
EBITDA (adj.)	6.3	8.0	9.8	11.6	13.5
Operating profit (adj.)	6.2	7.3	6.8	8.6	10.6
PBT (adj.)*	6.1	7.7	9.1	11.3	13.3
Adj. basic EPS (p)*	7.9	9.7	10.2	12.6	14.7
DPS (p)	1.5	4.0	5.5	6.6	7.9
P/E (x)	15.7	12.8	12.2	9.8	8.5
EV/EBITDA (x)	14.4	11.4	9.3	7.8	6.7
Dividend yield	1.2%	3.2%	4.4%	5.3%	6.4%
RoE	-	20.0%	12.6%	15.8%	18.1%

*excludes amortisation of intangible assets

Source: Hardman & Co Research

A trading update

Warpaint has released its trading update to the market for the year ending 31 December 2018.

Key features of the update

- ▶ Sales in international territories remain strong, with continued significant growth in these regions, particularly in the US and the EU.
- ▶ Sales in the US were up 60% for the nine months to end-September 2018 compared with the same period in 2017.
- ▶ Sales in the EU (excluding the UK) were up 13% YoY.
- ▶ The company has recorded its first domestic sales in China and Russia.
- ▶ With a further softening in UK retail market conditions, the company is expecting a reduction in the Christmas running order book.

Sales

UK

Difficult trading conditions in the UK...

Because of the seasonality of the gifting market, Warpaint's sales are traditionally stronger in the second half of the financial year. During the interim results announcement in September, Warpaint stated that "trading conditions in the UK remain challenging, because of the UK high-street slowdown and ongoing Brexit anxiety." In this latest trading update, the company has signalled that it has seen a further softening in trading conditions in the past six weeks.

The UK retail market has been sluggish in general, and readers will have seen the news of store closures on the UK high street. With such sensitive market conditions, retailers are reducing stock levels, and delaying and reducing their Christmas orders. Warpaint is inevitably affected by the reduction in high-street footfall, given that the UK accounts for some 44% of group sales (1H'18). The company believes some of the expected orders are yet to come through in its home market.

What are the other cosmetics groups saying?

Subsequent to Warpaint's trading update, both L'Oréal and Estée Lauder echoed Warpaint's comments on the difficult trading environment in the UK in their latest financial statements on 30 and 31 October 2018, respectively:

...market slowdown in the UK...

- ▶ L'Oréal's summary on the Western Europe geographical zone stated: "The zone posted growth of -0.8% like-for-like and -1.4% based on reported figures. It is still being held back by the market slowdown in the United Kingdom."¹

...reduced consumer confidence ahead of Brexit...

- ▶ Estée Lauder said: "Lower net sales in the United Kingdom were impacted by reduced consumer confidence ahead of Brexit, House of Fraser door closures and lower traffic across brick-and-mortar stores that was only partially offset by higher online net sales."²

¹<https://www.loreal-finance.com/eng/news-release/sales-at-30-september-2018-1290.htm>

²<https://www.elcompanies.com/news-and-media/newsroom/press-releases/2018/10-31-2018-104513270>

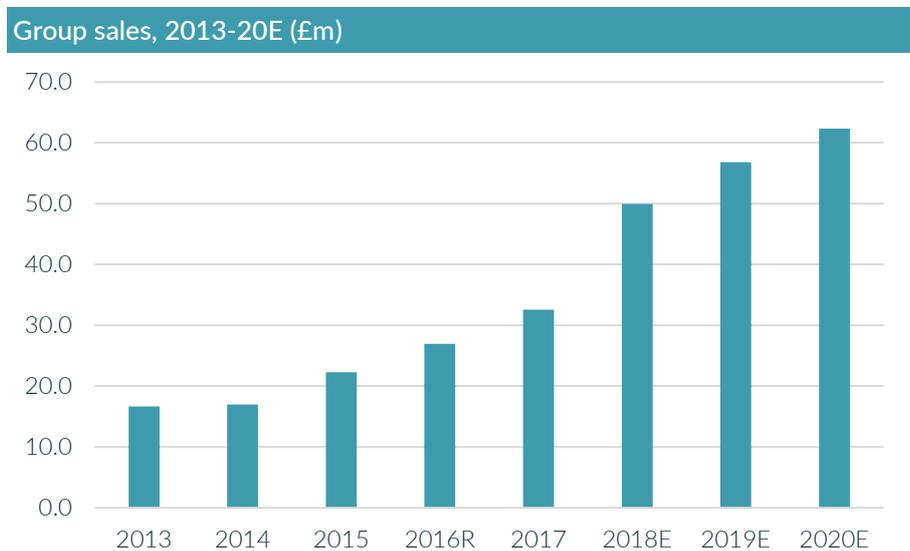
...but the picture is better overseas...

...and Warpaint is breaking into new countries (China and Russia)

Overseas

In overseas markets, however, Warpaint has reported some encouraging news. Sales continue to grow strongly in the US and the EU. For the nine months to the end of September 2018, group sales were up 60% in the US (74% in \$ terms) and up 13% in the EU (excluding the UK). China has been much talked about in previous results. The company has recorded its first business-to-business sales in mainland China, the fastest-growing colour cosmetics market in the world, from its newly established Chinese trading subsidiary, with an order of some 24,000 units of W7 products. Warpaint has also made its first group sales of £0.25m to a large Russian store group, which has over 650 stores in more than 180 cities across Russia.

Nevertheless, in terms of overall group revenue, the better-than-expected performance in overseas markets has been largely offset by the decrease in sales in the UK market.



We still expect healthy sales growth: 13.7% and 9.7% in 2019 and 2020, respectively

*R=restated
Source: Warpaint, Hardman & Co Research*

Order book

At the time of the 1H'18 interim results announcement in September, the company reported an order book of ca.£8.2m (including some orders for 2019) for own brands at the end of June 2018. Most of these orders have already been fulfilled.

Sales visibility and profitability

Sales and profitability prospects still positive

Warpaint's share price plunged by over 45% (92.5p) to 112.5p on the day of the trading announcement (29 October 2018). We question whether the market has over-reacted to this news, and we think maybe it has.

Warpaint's management has always stated that sales of the company's flagship brand, W7, are difficult to predict because of the company's just-in-time stock and order system. This convenience is valued by Warpaint's customers by reducing the need to predict and place forward orders. However, orders from the company's top clients have been consistent YoY. The acquisition of Retra, which has significantly increased the company's exposure to the gifting market, increases the visibility of the company's revenue forecasting ability because of the forward order book. This has enabled the company to better monitor both its sales and cashflow. In the current febrile UK retail

environment, retail buyers are being understandably cautious about their purchasing pattern. Of course, orders may pick up in the run-up to Christmas, but Warpaint's management team has decided to take a prudent approach and be transparent to investors. Warpaint's management team believes that more than 75% of the UK market remains unexplored – in particular pharmacy chains, and several high-street chains and grocers. The company is expecting to gain some traction in this area in 2019.

Retra's infrastructure in Hong Kong and its PRC subsidiaries have enabled Warpaint to make its first business-to-business sales into mainland China, the fastest-growing colour cosmetics market in the world. With the recent acquisition of Leeds Marketing (Warpaint's US distributor), the company has gained better access to, and control of, some of its key customers in the US, while also being a platform for further expansion in the Americas.

Financials

Profit & Loss

We have reduced our estimates for the forecast period.

- ▶ We are expecting relatively flat revenue from both W7 and Retra for 2018, and we have reduced our sales estimate to £50.0m for 2018 (from £55.1m) and to £56.8m and £62.3m for 2019 and 2020, respectively.
- ▶ The UK normally commands a higher gross margin than sales to the rest of the world, but, given the current weakness in the UK market, we expect the gross margin for the group to be down from 2017, to 36.3% for 2018.
- ▶ We expect no change to administration costs from our previous forecasts. Our adjusted PBT (excluding amortisation in connection with acquisitions and exceptional items) estimate is lowered to £9.1m for FY18, from £13.3m previously.

Profit & Loss account					
Year-end Dec (£m)	2016	2017	2018E	2019E	2020E
Own-brand division	21.9	26.9	44.3	51.2	56.7
Close-out division	0.6	5.7	5.7	5.7	5.7
Sales	22.5	32.5	50.0	56.8	62.3
Growth rate		45%	53%	14%	10%
Cost of sales	-13.7	-19.9	-31.8	-35.6	-38.8
Gross profit	8.8	12.6	18.1	21.2	23.5
Gross margin	39.1%	38.8%	36.3%	37.3%	37.8%
Admin. expenses	-2.5	-4.7	-8.4	-9.6	-10.0
Underlying EBITDA	6.3	8.0	9.8	11.6	13.5
Underlying EBITDA margin	28%	25%	20%	20%	22%
Share-based payments	0.0	0.0	-0.1	-0.1	-0.1
Depreciation and amortisation	-0.1	-0.7	-3.0	-3.0	-3.0
Underlying EBIT (before exceptionals & SBP)	6.2	7.3	6.8	8.6	10.6
Underlying EBIT margin	27%	23%	14%	15%	17%
Exceptional items	-1.7	-0.4	-0.1	0.0	0.0
EBIT (as reported)	4.4	6.9	6.6	8.6	10.5
Finance costs	0.0	0.0	-0.2	0.0	0.0
Adjusted PBT	6.1	7.7	9.1	11.3	13.3
Underlying PBT margin	27%	22%	13%	15%	17%
Pre-tax profit	4.4	6.9	6.4	8.6	10.5
Tax	-1.3	-1.4	-1.2	-1.6	-2.0
Underlying net income	4.9	6.3	7.8	9.7	11.2
Underlying net income margin	22%	20%	16%	17%	18%
Net income	3.1	5.5	5.2	6.9	8.5
Net income margin	14%	17%	10%	12%	14%
Adjusted basic EPS (p)	7.9	9.7	10.2	12.6	14.7
Growth rate		23%	5%	24%	16%
Basic EPS (p)	5.1	8.3	6.8	9.0	11.1
Growth rate		65%	-19%	33%	23%
Dividend (p)	1.5	4.0	5.5	6.6	7.9

Source: Warpaint, Hardman & Co Research

Balance sheet					
@ 31 Dec (£m)	2016	2017	2018E	2019E	2020E
Non-current assets					
Goodwill	0.5	8.0	8.4	8.4	8.4
Intangibles	1.4	10.7	9.0	6.4	3.7
Property, plant and equipment	0.2	1.5	1.2	1.1	1.0
	2.2	20.1	18.6	15.8	13.1
Current assets					
Inventories	7.7	11.5	12.6	13.7	14.9
Trade and other receivables	5.4	13.2	16.4	19.0	21.3
Derivative financial instruments	0.0	0.0	0.0	0.0	0.0
Cash and cash equivalents	3.5	3.4	3.5	6.4	9.6
	16.6	28.1	32.5	39.0	45.8
Total assets	18.7	48.3	51.1	54.9	58.9
Current liabilities					
Trade payables	-2.8	-3.5	-6.5	-7.3	-8.0
Loans and borrowings	0.0	-0.6	0.0	0.0	0.0
Corporate tax liabilities	-1.3	-0.9	-1.0	-1.1	-1.4
Derivative financial instruments	0.0	0.0	0.0	0.0	0.0
	-4.2	-5.1	-7.5	-8.5	-9.3
Non-current liabilities					
Bank loans	0.0	-0.8	0.0	0.0	0.0
Deferred tax liabilities	-0.3	-2.0	-1.6	-1.2	-0.8
	-0.3	-2.8	-1.6	-1.2	-0.8
Total liabilities	-4.4	-7.8	-9.1	-9.6	-10.1
Equity	14.3	40.4	42.0	45.2	48.8

Source: Warpaint, Hardman & Co Research

Cashflow					
Year-end Dec (£m)	2016	2017	2018E	2019E	2020E
PBT	4.4	6.9	6.4	8.6	10.5
Depreciation	0.1	0.2	0.5	0.3	0.3
Amortisation	0.1	0.5	2.5	2.7	2.7
(Profit)/loss on disposal	0.0	0.0	0.0	0.0	0.0
Share-based payments	0.0	0.0	0.1	0.1	0.1
Change in working capital	-0.1	-0.3	-1.3	-2.8	-2.9
Tax paid	-1.5	-2.1	-1.7	-1.6	-1.9
Net cashflow from operating activities	3.0	5.2	6.6	7.2	8.7
Purchase of intangible assets	-0.1	-0.1	0.0	0.0	0.0
Purchase of PP&E	-0.2	-0.6	-0.2	-0.2	-0.2
Acquisition of business	0.0	-16.2	-1.7	0.0	0.0
Bank balances acquired	0.1	0.2	0.0	0.0	0.0
Proceeds from sale of PP&E	0.0	0.0	0.0	0.0	0.0
Net cashflow from investing activities	-0.1	-16.5	-1.9	-0.2	-0.2
Proceeds from new share issuance	2.5	21.2	0.0	0.0	0.0
Share issue costs	-0.1	-0.9	0.0	0.0	0.0
Repayment in borrowings	-0.7	-7.3	-1.4	0.0	0.0
Dividend	-2.8	-1.9	-3.1	-4.1	-5.3
Net cashflow from financing activities	-1.1	11.2	-4.5	-4.1	-5.3
Net increase/(decrease) in cash	1.7	-0.1	0.1	2.9	3.2
Cash B/F	1.8	3.5	3.4	3.5	6.4
Cash C/F	3.5	3.4	3.5	6.4	9.6

Source: Warpaint, Hardman & Co Research

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