Investment Focus:
Foschini: Where did the cashflow go post Jet

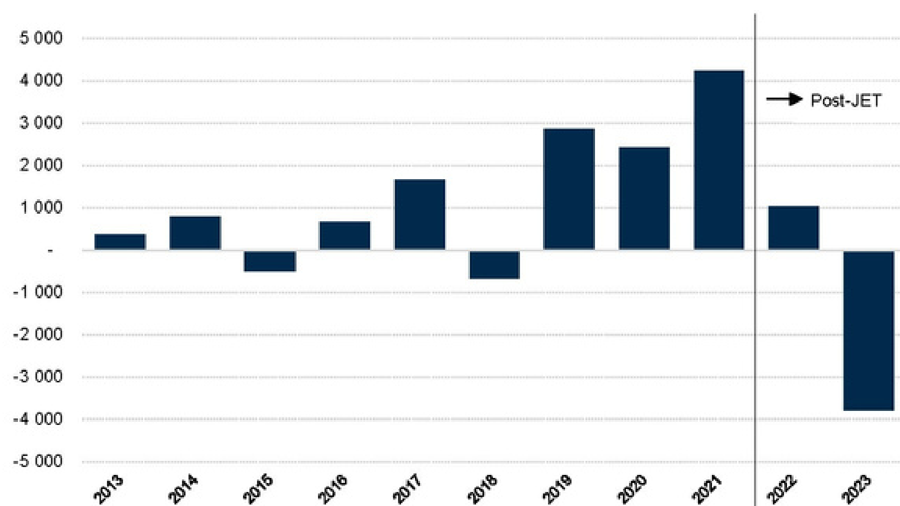
Foschini had generated strong free cashflows (FCF) for three years up to 2021 and for most of the years prior to that, FCF generation was positive. Since 2021 however, FCF declined and turned negative by the end of 2023 as shown in Figure 1. Which begs the question, where did the cash flow go post the acquisition of JET?

Elevated capital expenditure (Capex)

In Figure 2, a composition of FCF shows that post JET, FCF declined to significant capex and a working capital drag. A part of that capex was acquisition of other businesses, with the addition of Tapestry (the largest acquisition) and more than 5 other companies over the next two years, with the company spending over R2.5bn for these businesses. The group has been essentially buying its way to growth. But as we will see that growth has not translated to high operating cash, but only topline growth.

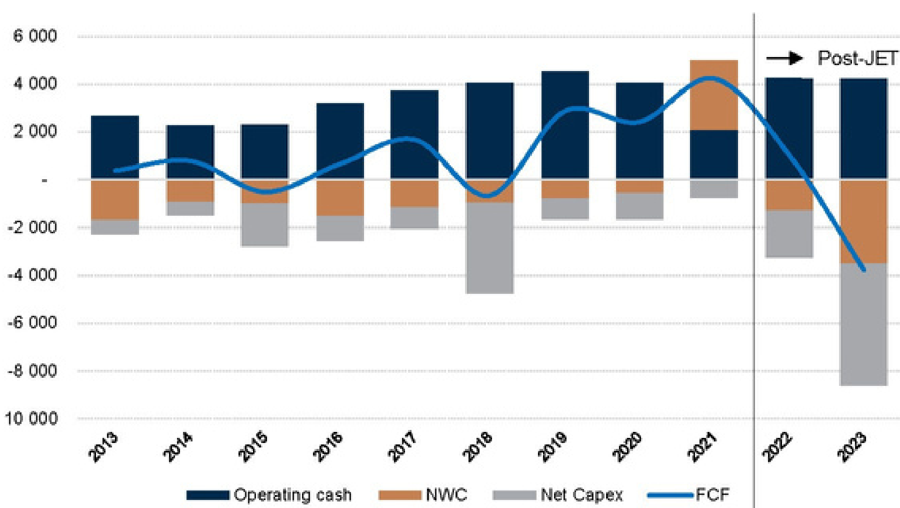
The second part of that capex (circa R4.3bn) has been invested on the existing business on initiatives such as store rollouts and expansions, de-velopment of DCs (Distribution Centre) and expansions and quick response manufacturing (QR). The onset of higher stages of load-shed- ding (stage 4 and above) meant the company had to spend R200m on backup power to cover more than 75% of the group store base. Thirdly, the group had to renovate stores that were looted in the July 2021 civil unrest that took place in Durban and Gauteng. It is also well understood that JET had been underinvested by Edcon which meant Foschini had to spend a considerable amount to turn that business around. As a result of these expenditures capex to sales (excluding acquisitions) has increased to 5.8% in 2023 the highest level in the past 10 years, as shown in Figure 3.

FIGURE 1: FCF



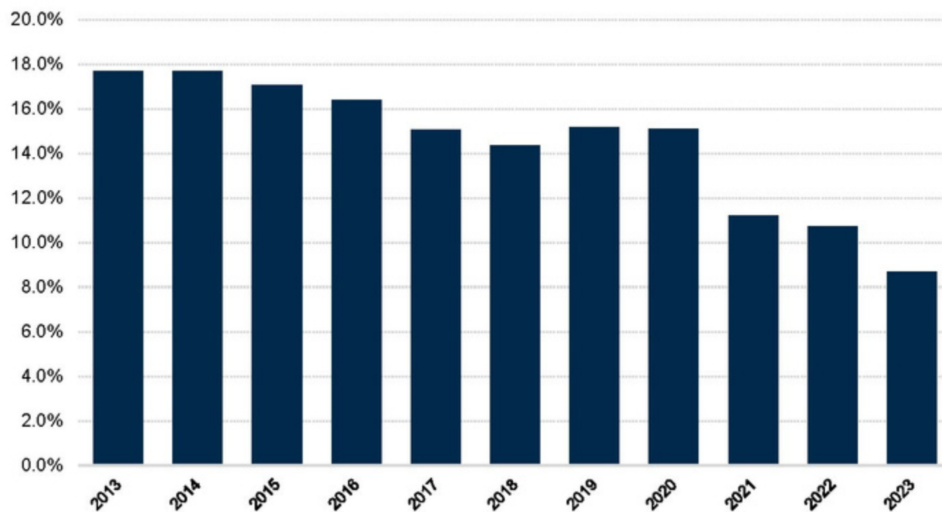
Source: Company, BlueAlpha

FIGURE 2: FCF Composition



Source: Company, BlueAlpha

FIGURE3 =Capex to sales (ex-acquisitions)



Source: Company, BlueAlpha

Working capital drag

Figure 2 shows the other driver of lower FCF's post JET acquisition is a negative working capital cash flow. R4bn of the cash flow has been tied up in inventories in the two years post the JET acquisition, driven by stock build ups for new acquisitions, higher merchandise inflation, normalisation of inventory levels in London and Australia due to COVID-19 lockdown restrictions being lifted and higher loadshedding levels. Merchandise inflation was reported at more than 10% and 15% in TFG Africa and London respectively for 2023, while the impact of intensified loadshedding was a negative 0.1% comparable store sales growth for the last quarter of 2023, having declined from a comparable store sales growth of 6.3% in the previous three quarters of 2023, meaning that the group had to keep more inventories that planned by year end.

In addition to high inventories, R1.5bn of cash flow was tied up in debtors. This occurred due to significant pressure on consumers given the tough economic environment resulting characterised by high interest rates and high inflation, driving consumers to opt for more credit purchases for their clothes than before. The group also started rolling out credit sales on the Tapestry business which, prior to being acquired by Foschini, had been purely trading on a cash basis.

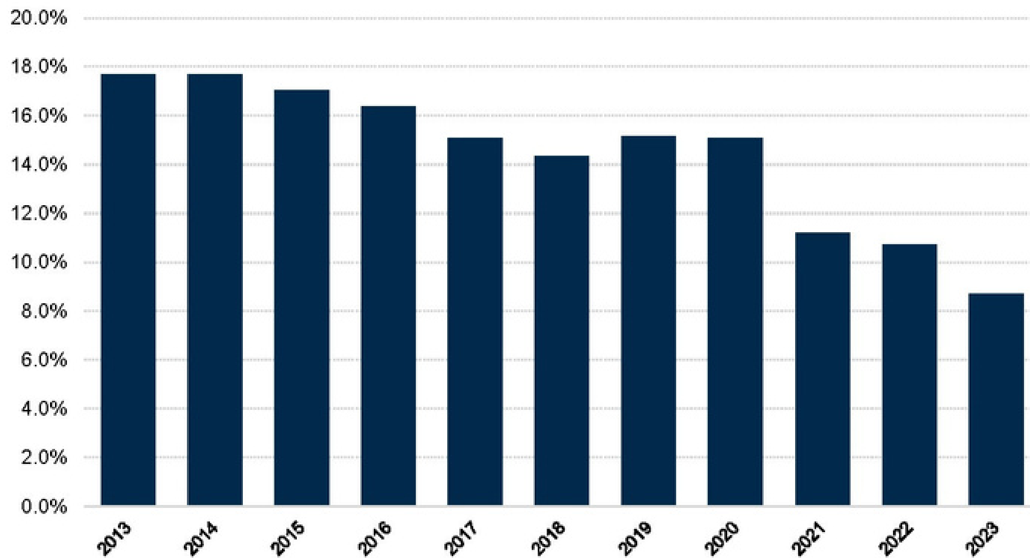
The cost of growth

The previous charts highlight that there is a cost to grow, not referring to the price paid directly to acquire the business, but other unforeseen costs. In the case of Foschini, it has been the decline on margins and efficiencies driven by significant post-acquisition capex, integrating the businesses with the rest of the group and inheriting an underinvested business in the case of JET, due to significant troubles with the previous owners. The effect of the decline on efficiencies has been a decline on return on invested capital (ROIC) and Economic profits.

Declining operating profit margins

Looking at Figure 2, one will also notice that operating cash, though it has been positive throughout the last 10 years, has grown at a snail's pace since 2019. We noted in previous passages that the company has made many acquisitions since then, rolled out many stores and embarked on other organic initiatives and yet operating cash has hardly moved. The main reason for this is due to the consistent decline in operating margins as shown in figure 4 below. The decline has been driven by higher employee costs and other operating costs increasing above sales growth, among other reasons. To put it into perspective, employee costs as a percentage of sales was 14.6% in 2013 by 2023 this ratio had gone up to 17.4% while other operating costs to sales increased from 10.4% to 12.5% in the same time horiz

FIGURE4: (TFG Africa operating margins)



Source: Company, BlueAlpha

Post Year end

In H1 2024, FCF will continue to be underpressure on the back of a difficult economic climate, which has had a significant impact on the consumer. The company has had to increase promotional sales, increase mark down of their inventories in order to reduce significant inventory levels they had at the end of 2023 resulting in a 300bps decline in margins in H1 2024. Secondly, the company spent R800m in capital expenditure in the H1 2024, towards the expansion of their DC capacity in Midrand and Riverfileds by 20,000 and 75,000 square metres respectively.

The group has communicated that they will consolidate their DCs from 15 to around 8, while also optimising their QR manufacturing to reduce their operating costs and inventory levels. They have further indicated that they will not pursue any further acquisitions in the next two years or embark on significant capital expenditure. Will this be sufficient to arrest the declining margins seen in the last 10 years, release cash tied up in working capital and consequently improve FCF? On the face of it doesn't seem enough, but the jury is still out.