

Topps Tiles Plc (05/01/2017)

The fund bought a 4% position in Topps Tiles Plc in December 2016 at an average price of GBP 0.86.

Topps Tiles (Topps) is the largest UK based tile retailer, it is the second largest tile retailer in the world. Topps sources tiles from the UK, China, Turkey, India and South America. Topps has 351 company operated stores, which it is growing at about 10 stores per year.

The company has a 33% share of the “domestic” UK tile market and 18% share of the total UK tile market (the total tile market includes commercial tiles). Topps’ share of the domestic market has been steadily increasing. Their core business is selling tiles to trade (52%) and retail (48%) for kitchen and bathroom renovations.

The enterprise value of the business is GBP 190m (GBP 165m market capitalisation plus GBP 25m net debt), the business generated revenues of GBP 215m and EBIT of GBP 21m in year ending September 2016. Its cash generation is consistent with its earnings (adjusting for the store rollout and refurbishment investments).

What stood out to us when we initially looked at the business was its consistent high margins (the business generates gross margins in excess of 60%), consistent cash generation and the operating performance it generated both through the GFC and in the subsequent years. This operating performance has consistently been better and more resilient than we would have expected for a retailer exposed to UK consumer spending, UK consumer sentiment and housing.

To some extent, we think this operating performance has been obscured by Topps’ balance sheet. In August 2006 management returned GBP 122.4m (GBP 0.54/share) to shareholders. Topps’ balance sheet went from a net cash position of GBP 20m to carrying GBP 100m in net debt. The timing of this capital management initiative was poor (an understatement). The business has steadily reduced debt since. As of September 30, 2016 net debt was GBP 25m. The business raised GBP 15m from an equity issue in Nov 2009, the balance of the reduction has come from internal cash generation.

More recently the company has been increasing its internal investment. In 2012, they completed the expansion of their warehouse and distribution facilities in Leicester, more recently they have expanded their store rollout and store reinvestment program. As such, annual capital expenditure is running at around GBP 11m compared to a depreciation charge of GBP 6m.

When we think about the nature of the business, the attributes we are drawn to, which also contribute to its attractive economics are:

- Tiles are generally an infrequent purchase but an important decision.
- A tile is not a branded consumer good. It is also not a homogenous commodity.
- Tiling something is an opportunity to add a design element, it is an opportunity to do something that feels unique for a relatively low cost.
- There is a tactile nature to the purchase decision. It helps to see a tile, pick it up before you decide to buy it. The store base is relevant.
- The cost of the tiles alone typically is small compared to the cost of the total job.
- Topps provide virtually no credit to their trade business; there is no real demand for it.
- Fragment customer base.

Our impression of management is positive. They appear credible, transparent and focussed. The business has a 40 year history and has wandered down a few other paths (manufacturing tiles and selling related products including paint and flooring). Invariably these related activities have in isolation contributed little and in a broader perspective detracted from their core activity. The learnings from these missteps seem to have focussed management.

We spent some time in the UK in late November going through numerous Topps' stores, competitor stores and big box retailers. Our overriding impressions were that Topps seem well positioned to continue to consistently grind out market share gains, winning share from both other tile specialists and also from the big box retailers. Specifically our observations were:

- Topps' offering is differentiated from both the other tile specialists and big box retailers.
- Their retail execution was better. Displays, store layout and organisation differentiated.
- Their staff seemed knowledgeable and dependable. They were also appropriately trained with regard to approaching prospective customers and talking about the kitchen or bathroom project we were enquiring about. This was a consistent observation we had in each of the Topps stores we visited, and it was unique to them.
- Topps likely has a cost advantage versus their specialist competitors given the location and nature of their store base. Their stores felt busier, more productive and more functional than their peers despite their locations and physical structures.
- Observing the organisation and mechanics of a store delivery of tiles from their warehouse / distribution centre reflected well on what is occurring in their warehousing and distribution functions.

There are clearly immediate macro risks around the UK economy and consumer. Topps is leveraged to both. The business is also negatively impacted by the weak Pound, due to it purchasing a meaningful portion of tiles in countries other than the UK. Our sense is the market is primarily focussed on these concerns.

The business is currently well capitalised, its stores are well presented. Its high gross margin provides a buffer against the weak Pound and resultant increase in cost of goods sold. We think the general negative macro focus is giving the fund an opportunity to invest in a defensible, high quality retailer that is differentiated from its peers at a reasonable price.

Terms and conditions

This document is only made available to wholesale clients as that term is used in sections 761G and 761GA of the Corporations Act 2001 (Cth).

Long Tail Asset Management Pty Limited holds an AFS Licence (number 341474). The information provided in this document is only intended to describe the activities of the Fund to existing and prospective investors. As such the information is generic in its nature and does not and cannot take into account an investor's objectives, financial position or needs. Investors should rely upon their own enquiries and analysis as to the merits and risks in deciding whether to make any investment and seek appropriate advice as necessary prior to making any investment decision. The document contains general financial product advice only.

You should understand that any forecasts or opinions in this document regarding the direction or prospects of any investment or market are based on a number of assumptions and may not be realised. Such forecasts or assumptions may change from time to time without notice to you.

Long Tail Asset Management Pty Limited has taken all reasonable care and believes that the information in this document is correct and accurate but no warranty or assurance is made with respect to its completeness, currency or accuracy, and neither Long Tail Asset Management Pty Limited nor its related bodies corporate, agents, Directors, officers, employees or advisers are, to the extent permitted by law, responsible for loss or damage suffered as a result of reliance by any investor or prospective investor on any statements, opinions or data contained in this document.

Copyright on the information in this document is owned by Long Tail Asset Management Pty Limited. You may use and copy the information for your personal use only. Long Tail Asset Management Pty Limited expressly prohibits the reproduction, transmission, or distribution of this information for any other purpose without the written permission of Long Tail Asset Management Pty Limited.

Investors should be aware of the risks of investing in products offered by Long Tail Asset Management Pty Limited. Prior to investing in a Fund operated by us you should read the Information Memorandum carefully and fully understand the risk factors.

Long Tail Asset Management Pty Limited does not guarantee or assure the return of all or any capital invested, nor the performance or profitability of its Fund. Investors should be aware that past performance of the Fund is not indicative of the performance which may be achieved in the future and is not a reliable indicator of future performance. No representation is made that profits will be achieved on behalf of the Fund or losses will be avoided in the future.

To the maximum extent permitted by law, the information and opinions contained in this document are provided without any warranty of any kind. Long Tail Asset Management Pty Limited and its associates expressly disclaim all liability for any loss or damage of any kind (including direct, indirect, special and consequential loss and damage of business revenue, loss of profits, loss or corruption of data, failure to realise expected profits or savings or other commercial or economic loss of any kind), whether reasonably foreseeable or not, incurred or suffered by any person arising out of or in any way related to this document.