Stock to Watch: Home Retail Group

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Does a 33% bounce in the FTSE 250 shares of Home Retail Group (HOME) suggest the market has misread the situation at this operator of Argos and Homebase stores?

The price jumped from a recent 69p low into a 90p range after a 19 June interim management statement (IMS) showed sales at Argos had not plunged according to rumours.

Brokers have been overwhelmingly bearish, with Reuters showing 15 of 22 analysts covering HOME rated it a "sell" with only four positive. A massive 22% of the shares have been out on loan, i.e. engaged in short selling. So the bounce is partly explained by this extreme of "market technical" situation: the company has only needed to say things are not as bad as feared for the market to anticipate shorts closing.

The shares have soon drifted to a mid-80p area showing continued market unease. They do indeed have a tough future if the UK recession grinds on for years and management is not adept to thrive on it. Yet the company has strength of cash flow and balance sheet and if it can deal with the challenges ahead, then with improved consumer spending HOME can be a multi-bagger recovery share.

Comparisons with HMV (HMV) are largely false because Argos - which makes over 70% of group revenue and nearly 80% of profit - trades in essential household items, not just pricey electricals, and offers a convenient means of spotting and reserving items online then collecting at your chosen store.

The chief executive sees value, recently buying 160,000 shares at 76.87p, taking his holding over three million. Mind that the directors also made the disastrous move last year of spending over £150 million of shareholders' money buying back shares at an average price of 233p. Hopefully the chief executive is wiser with his money.

Short sellers have fairly assumed wet weather put people off buying garden furniture from Homebase, and austerity has hit sales of stereos and TVs from Argos. But the IMS for the March/April/May quarter revealed only a 0.2% slip in like-for-like sales at Argos even though Homebase dipped 8.3% (better performance than B&Q, its immediate rival). TV and video/audio sales were offset by continued strong growth in laptop and tablet computers; the question is whether this is a blip by "must have" buyers which will consolidate, or there is longer-term demand. It is one reason why the shares are speculative until there is more evidence, the second quarter update being due 13 September, then interims on 24 October.

Note also that Argos's online check & reserve grew 24%, representing 29% of its sales. A competitive advantage versus say Amazon (AMZN) is that you have a UK-based store you can visit and assert the Sale of Goods Act if something is faulty. My experience of Amazon is a one-month replacement policy - with the faff and cost of return post and packing - otherwise forget it.

The Argos approach will however lose appeal if a lot more stores need closing. Currently there are 746 compared with 340 Homebase, and management has affirmed its aim to shut a total 10 this financial year, but says it will close as many as 300 if they underperform. I have also seen one analysis that suggests winding down £1 billion of lease commitments (with an average length of seven years) could generate positive cash. Any conservative investor will recognise the speculation both ways.

So the key issue for the shares is whether Argos's problems are structural or mainly cyclical hence will fade if and when consumer spending improves. In 2008 the group made £446 million normalised pre-tax profit compared with a varying consensus around £75 million projected for the year to 3 March 2013. Mind, this compares times of a liberal attitude to credit versus people now inclined to limit their debts.

A dilemma for Homebase is its being highly leveraged to the level of housing transactions which have been running at half their long-term average for most of the last five years. So the profit contribution has averaged £34 million, compared with £85 million pre-2007. In the three months to 2 June, like-for-like sales fell 8.3% to £421 million and sales of seasonal products - representing about 40% of total sales - fell by 15% amid the wet weather.

Despite pressures on group trading, its 3 March 2012 balance sheet was as strong as you could realistically wish for, to manage through a recession. Net assets were 323p a share or 116p ex-goodwill and intangibles. Debt was minimal and the ratio of current assets to current liabilities over 1.7 times, very comfortable. Net cash was £181 million. Admittedly there could be a question over £933 million inventories, as to realisable value, but overall this is a robust balance sheet.

Omitting the final dividend for the year to 3 March 2012 was quite a blow to investing confidence. Compared with 14.7p per share in 2010/11, it left just 4.7p as the total payout, although basic earnings per share had fallen nearly 60%, along with pre-tax profit, to 8.7p. While it is certainly prudent to improve cover to earnings from 1.45 to 1.85 times, investors will be aware there are other companies - especially with a large cash reserve - maintaining their dividend or letting cover slip because they are genuinely confident of recovery.

So in a relative context this begs a question about Home Retail. The chairman says: "future dividends will be set at a level which is sustainable and which reflects the trading prospects and financial position of the group". 4.5p a share for the next two financial years, as brokers appear to have been guided, implies a prospective yield of about 5% - still competitive.

In conclusion, to buy you need confidence the UK won't slip further into recession, as this could prompt closures of Argos raising questions of the financial outcome and resulting competitive position. Conservative investors need more evidence both at the UK macro and company levels. But HOME remains a crowded trade on the short side, so if and when momentum does tip positively there will be serious upside. For enterprising investors it is fascinating to follow.

Link: www.iii.co.uk/articles/39501/stock-watch-home-retail-group