DIY industry benefits from self-improvement

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Home Retail Group (HOME) had a torrid time after the recession. With Argos struggling for several years, it was relying on Homebase to keep growing. However, the tide has turned and Argos has become one of the most promising brands on the high-street, while Homebase is suffering in a challenging market.

To ensure some security, Home Retail is revamping Homebase. It admits in its recent half-year results that the DIY chain suffers from "inconsistent store operating standards and a large estate with low sales densities that result in a challenged financial model."

That's why there will be a significant reduction and streamlining of the business - 30 stores are expected to close in the next financial year, with the aim of reducing its estate size by 25% by the end of FY2018 (roughly 80 store closures).

This is anticipated to result in a smaller, more secure company.

However, analysts at Citi Research believe that this could result in significant costs to an already struggling business, noting that there are "only 65 Homebase stores coming up for lease expiry or renewal over the next three years." This could result in "a high degree of paid lease exits."

UBS is of a similar mind-set, stating that "gross margins could remain down given clearance costs from closures."

"Click and Collect"

The rapid growth of online retailing in the home improvement sector seems to be the driving force behind the store closures. With consumers now more inclined towards a simpler shopping process - the click and collect method - it is becoming unnecessary to maintain warehouse sized stores. This already seems to be influencing sales at Homebase, with the first-half report highlighting a 46% increase in mobile device visits, partially helped by increase in use of the "reserve and collect" scheme. This resulted in a 12% "multi-channel" sales increase, now accounting for 7% of Homebase total sales.

But it is not just Homebase that is suffering from shifting consumer preferences. Kingfisher's (KGF) B&Q also has to reduce its estate portfolio, although it plans to reduce store size rather than quantity through its "Right size Right place" scheme. Parallel to this plan will be an increased emphasis on "Click, Pay and Collect", similar to Homebase's new strategy.

Travis Perkins' (TPK) Wickes brand is also downgrading its estate, as it too looks to embrace the online revolution.

It seems to be Kingfisher's Screwfix is the only DIY home improvement retailer to excel at the moment, announcing 23% growth in half-year sales. However, due to its appeal to smaller tradesmen, it is difficult to analyse how much of its success is down to the public's shopping preferences.

All of these companies have recently outperformed Homebase. They each experienced some level of growth in sales, as well as like-for-like sales. In the case of B&Q, this was a relatively small improvement, a 0.9% growth in sales in this year’s third quarter. Homebase, on the other hand, suffered a 2.8% decline in total sales during its second quarter to 30 August 2014 as a result of store closures. Like-for-like sales crept up by 0.1%. Says Nomura: "As with other DIY Sheds in the UK, Homebase is working against a market that is overspaced, a younger, less skilled DIY customer base, and growth in non-traditional formats (eg, Screwfix) and category specialists."

Embracing consumer preference by integrating digital marketing methods is already having an effect on Homebase, first half sales did at least rise by 1.5% to £835 million. It seems that Home Retail is on the right track with its repositioning as a digital marketer, as Argos is experiencing strong levels of growth. Furthermore, the plan to reinvent Argos' store model and the way in which consumers interact in store should drive sales higher.

"Hub & Spoke"

The new "hub & spoke" model, which has been rolled out to all of its stores, is designed to encourage online shopping. The system involves setting up smaller "Stoke" stores marketed towards "Click and Collect", with the larger "Hub" stores delivering the necessary products to the more numerous ‘stokes’. Only recently has this been fully implemented across the board, so the recent sales and profit improvement is not attributed to the strategy.

Analysts at Numis question whether Argos' new digital strategy will improve revenue and profit enough to outweigh the inherent costs in revamping a business.

However, Argos has been attempting to exploit the potential of "multi-channel sales" for several years now. It was in 2012, when it was already the UK's second largest online retailer, that it announced a five-year transformation plan. Since then, the percentage of total sales taking place through the internet has increased to 43%.

Several analysts, despite the potential problems found in revamping the business model, seem to have faith in the long term prospects of Home Retail, with Nomura, Investec and UBS all rating the company as a 'buy' following the half year results.

Analysts at UBS set a target price of 240p, as "the Argos plan remains on track, cash flow is better than expected [and] Homebase low reruns are being tackled."

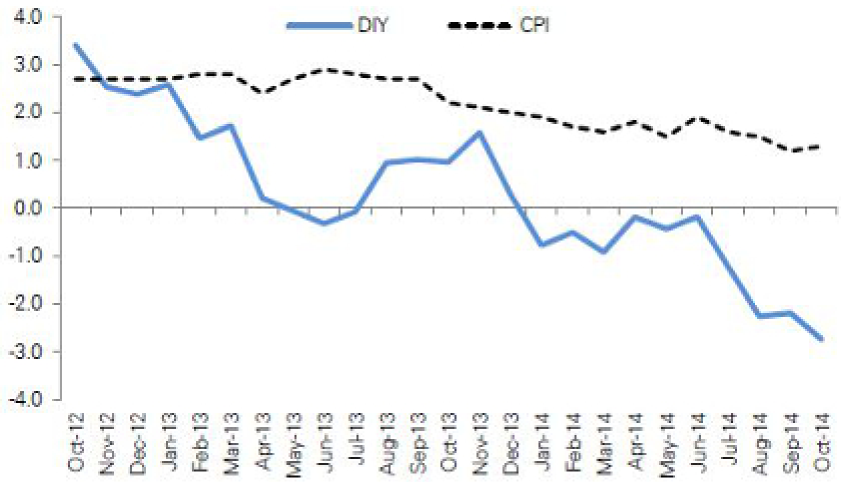
Yet, there are some in the Square Mile who believe the potential pitfalls are too much of a risk, with both Barclays and Numis recommending 'neutral/hold', although Barclays leans towards a 'negative' rating. Christodoulos Chaviaras, analyst at Barclays, attributes this to a "lack of clarity on the costs from Homebase’s restructuring."

Chaviaras' view helps highlight the sheer scale of lease exit costs that could affect the company as, despite the sale of the Battersea freehold resulting in a £30 million cash injection this year, there are still fears that margins could be significantly affected.

Shrinking market

In October 2012, the DIY home improvement market was growing almost one percentage point (ppt) faster than consumer price inflation (CPI) [see graph below]. However, by November that year, it had already fallen behind CPI, and since then it has continued to shrink (despite a small rally in the 2013 summer months). It is now sitting at -3ppt. This perhaps explains why Homebase began to struggle as the market began to shrink at the same time Homebase began to experience noticeable drops in sales.

Figure 3: The UK DIY market shop price index is running significantly below general inflation (CPI)



Source:Datastream, British Retail Consortium

Yet, despite Homebase and its market suffering, Home Retail was dragging its share price out of the gutter. This could be due to market belief in the five-year transformation plan for Argos, announced that year.

However, since reaching a respectable level in late 2013, and despite a decent start to the year, there has been some weakness in 2014. Between the 27 November 2013 and the 26 November 2014, the shares have been as high as 223p and as low as 159p.

Home Retail Group is changing. It believes it's for the best, while the opinion amongst the analysts seems split. But online retailing is a growth market, and Home Retail needs to upgrade its outdated and inefficient operating models to cope with the change. Whether it is making the right decisions is yet to be seen, and it will be a while before we know for sure.

Link: http://www.iii.co.uk/articles/208695/diy-industry-benefits-self-improvement