EDISON

Gear4music Holdings

Initiation of coverage

Marching to an online beat

Retail

Gear4music (G4M) is marching to the beat of the online opportunity in the niche area of musical instrument retailing. Traditional competition is fragmented and only partially online, so the market is wide open. With sales growth of 46% in FY16, G4M now has 3.5% of the UK market, and is focusing on the European market, which is six times larger. We think the company has scope for significant revenue growth and, assuming undemanding economies of scale at operating margin level, we value the shares at 186p based on peer comparison and DCF modelling.

Year end	Revenue (£m)	EBITDA (£m)	PBT* (£m)	EPS* (p)	P/E (x)	EV/EBITDA (x)
02/15	24.2	0.8	(0.6)	(4.1)	N/A	N/A
02/16	35.5	1.7	0.6	3.1	41.8	14.1
02/17e	48.7	2.5	1.6	6.5	20.1	9.4
02/18e	60.3	3.8	2.7	10.8	12.1	6.1

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Disruptive niche retailer

G4M is a disruptive online retailer selling tangible product in a specialist interest space. Management is focused on realising its substantial opportunity. The musical instrument market is fragmented, and online competition is limited. With 10 million unique visitors in FY16 and a 34% jump in active users, G4M continues to invest in its platform of 19 international websites, customer marketing and service capabilities, together representing a growing competitive lead and barrier to entry.

Growth led by brands and European markets

Maiden prelims show the first year growth that was expected at the June 2015 IPO being realised. G4M is seeing the benefits of competitive pricing and best-in-class service and delivery, with 57% H2 sales growth in third-party brand sales, which form three-quarters of its business. Its own brands are developing well with 35% H2 growth, and European penetration is rapidly expanding with sales up 79% in H2.

Growth forecasts should be attainable

In the light of G4M's progress to date and the European market opportunity, we initiate with an FY17 growth forecast of 165% in PBT and 108% in EPS, and FY18e growth of 66% in both. Yet these are driven by undemanding assumptions of sales growth flattening from 46% to 24% over the next two years (of which, at least in Q1, there is no sign) and by a modest rise in EBITDA margin from 4.8% to 6.4%.

Valuation: Average valuation of 186p

At a calendar 2017e P/E of 13.0x and EV/EBITDA of 6.5x, G4M shows discounts of 22% and 15% respectively to online retail peers, after adjusting for relative size and liquidity. On this basis, the peer valuation is 160p. Our DCF valuation is 212p, within a forecast scenario range of 119-299p. Averaging these two metrics indicates a valuation of 186p, equivalent to a CY17 P/E of 18.4x and EV/EBITDA of 9.5x.

10 May 2016

Price	**131p**
Market cap	**£26m**

Net cash (£m) at end February 2016	2.6
Shares in issue	20.2m
Free float	35%
Code	G4M
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	0.8	(4.7)	N/A
Rel (local)	2.1	(12.3)	N/A

High/low	147.0p	130.0p

Business description

Gear4music is the largest dedicated, UK-based online retailer of musical instruments and music equipment. It sells branded instruments and equipment, alongside its own brand products, to customers ranging from beginners to professionals, in the UK and into Europe.

Next event

Interims	October 2016

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Edison profile page

Gear4music Holdings is a research client of Edison Investment Research Limited

Investment summary

Company description: Strong growth, going for more

Gear4music (G4M) is the largest dedicated UK-based online retailer of musical instruments and equipment. It is growing rapidly with a strategy of continued growth, including geographical expansion. It is committed to expanding its lead over a fragmented competitive market by providing a best-in-class online service. It has strong e-tail KPIs, with 10.1m unique visitors in FY16, a 34% increase in active users to 226,000 and a 30bp increase in conversion rate to 2.28%.

Valuation: Average level of 186p

G4M trades on an FY17e P/E of 20.1x and EV/EBITDA of 9.4x, falling rapidly on our growth expectations to 12.1x and 6.1x respectively in FY18e. We value the shares based on peer comparison and DCF. Most quoted retailers are fundamentally terrestrial operations giving a poor comparison; however, comparison with the smaller group of online-based retailers, taking into account, where appropriate, size, liquidity and established growth record, suggests a market value of 160p for G4M. Our DCF, based on equity-only cost of capital of 10%, a conservative assumption of annual sales growth fading from our 2019 forecast of 18% to terminal growth of 2% and a terminal EBITDA margin of 9%, results in a valuation of 212p, within a forecast scenario range of 119-299p on varying growth and margin assumptions. Averaging our two metrics indicates a valuation of 186p, equivalent to a calendar 2017e P/E of 18.4 and EV/EBITDA of 9.5x, attractive levels considering G4M's radical earnings growth potential.

Financials: We forecast dramatic earnings growth

Results to February 2016 show G4M's strong revenue growth at 46%, driven by the seasonally important second half (49% growth). EBITDA doubled to £1.7m, contributing to a pre-tax turnaround from £0.6m loss to £0.6m profit. In the light of continuing progress and the opportunity – particularly in the European market – we initiate with a FY17e forecast of £1.6m PBT (165% growth) and 6.5p EPS (growth of 108%). For FY18, we look for 66% growth in both to £2.7m and 10.8p respectively. Yet these are driven by undemanding assumptions of sales growth flattening from 46% to 24% over the next two years, and by a modest increase in EBITDA margin from 4.8% to 6.4%. Current trading is buoyant, and if sustained could lead to forecast upgrades. Net cash at February 2016 was £2.6m and on our forecasts will increase to £3.1m by the end of FY17e. At IPO, G4M said it intended to retain distributable profits in the business, but dividend policy is to be reviewed in the current year.

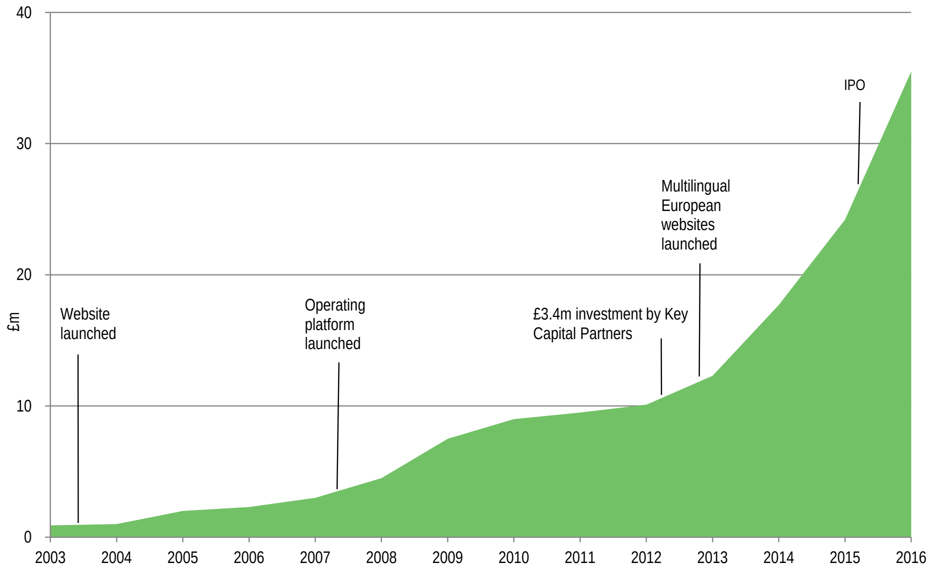
Sensitivities: A small, technical, international company

- **Growth and market share gains:** the sustainability of market share gains is key to the investment case. The strategic focus on European expansion may entail higher risk.
- **Currency:** around 25% of products are sourced outside the UK, priced in US$, and European sales are likely to increase from their current 27% of total sales. There is net margin risk.
- **Technological:** Gear4music is dependent on the web for revenue generation and has limited physical presence. Revenue is also sensitive to any online advertising rates.
- **Inventory:** inventory is the largest asset on the balance sheet, and its management and security are significant risk factors.
- **Key man:** the company is closely associated with the vision of its founder and CEO, Andrew Wass. However, it has already built a substantial management structure and a relevant non-executive board, providing significant assurance, in our view.
- **Liquidity:** as the CEO and former private equity owners hold 65% of the shares, the free float is correspondingly limited.

Company description: A pure-play online retailer

Gear4music (G4M) is the largest dedicated, UK-based online retailer of musical instruments and music equipment. It is growing rapidly, with 37% revenue growth in FY15 and 46% in FY16. Its strategy is continued growth, including expansion of its geographical markets. The company sells own-brand musical instruments and music equipment alongside premium third-party brands including Fender, Yamaha and Gibson, to customers ranging from beginners to enthusiasts and professionals, in the UK and Europe. Strategy is focusing on the opportunity to take significant market share in the European market for musical instruments and equipment, estimated by management at £4.3bn.

Exhibit 1: Revenue development and milestones



Source: G4M

Expansion strategy

G4M set out clear strategies at its IPO in June 2015. These, together with progress to date, are:

- **Accelerated development of the bespoke ecommerce platform:** G4M aims to drive higher website traffic and conversion, and increase fulfilment efficiency. It has added significant new features including online consumer finance, a European payments platform, weekend delivery and dispatch (now covering 90% of in-stock products) and on-page customer comments, as well as numerous smaller design and functionality upgrades. In FY17, development teams will focus on projects to increase operational efficiencies and further enhance customer convenience, engagement and loyalty.
- **Intelligent marketing to new and existing customers:** G4M has improved marketing return on investment, with spend falling from 10.0% of sales in FY15 to 8.7% in FY16 on higher website conversion and more effective targeting. A new in-house video production facility adds an extra dimension to own-brand marketing and has already produced some 500 product videos to demonstrate the own-brand product range to potential customers on the international websites. A digital personalisation platform will be deployed during FY17 and FY18 to ensure customers receive specifically targeted information and offers, including follow-up sales.
- **Product range extension:** G4M has extended the range of products for next-day delivery from around 27,000 at IPO to c 32,000 currently. Management believes 80,000 products could be suitable and is investing to further expand the product range, both branded and own-brand.

- **International expansion, in both existing and new geographical markets:** the company is developing its international websites and has invested into its multilingual teams, marketing, website localisation and fulfilment systems. Management is also actively considering establishing satellite distribution hubs on the mainland to reduce product delivery times and costs.
- **London showroom:** G4M said at IPO that it would seek to open a flagship London showroom to improve penetration in the area, and enhance suppliers' perception of the company as a key retailer. However, to date London property prices mean that this remains a strategic ambition.

We do not believe that acquisitions are likely to form part of the company's strategy anytime soon.

History and origins

The operation effectively started in 2003 with a consignment of guitars placed on the website. The website generated £0.65m of revenue in its first full year of trading. Revenue accelerated from 2013 when the operation went international, to its current £35m. The company raised £10.3m gross (£9m net) at 139p in its June 2015 IPO on the AIM market.

Current status and strategic focus

G4M is the largest UK online retailer in its field (FY16 revenue of £35m, compares with its two more specialised competitors at £28m and £25m – see Exhibit 4). Its website www.gear4music.com saw 10m visits and took nearly 300,000 orders in FY16. The company is now focused on European markets, and on developing its online and fulfilment service to best-in-class standards, at a time when most retailers in its sector have less developed capabilities.

International operations

Continental European sales have accelerated rapidly to become 27% of total sales in FY16, and are still growing almost twice as fast as UK sales.

Exhibit 2: Revenue summary

£000s	FY13	FY14	% of total	Growth %	FY15	% of total	Growth %	FY16	% of total	Growth %
UK	11,188	14,757	83.5%	31.9%	18,763	77.4%	27.1%	26,016	73.3%	38.7%
European	1,078	2,921	16.5%	171.0%	5,477	22.6%	87.5%	9,473	26.7%	73.0%
Total	12,266	17,678	100.0%	44.1%	24,240	100.0%	37.1%	35,489	100.0%	46.4%

Source: G4M

Europe is becoming a higher strategic focus as the estimated addressable market is £4.3bn compared with £750m in the UK alone. G4M maintains 18 country websites to ensure that its offer is authentically represented in all markets: this includes not only language translation, but also other national conventions and a firm pricing offer in each currency, in contrast to competitors.

Management is actively considering setting up small distribution centres on the European mainland to trial the potential customer service benefits of shorter delivery times. The cost should be covered by our forecast capex, working capital and overhead forecasts.

Strong e-tail KPIs

The power of G4M's online platform is demonstrated by the fact that in FY16, the websites had 10.1 million unique visitors, a 25% increase from FY15. There were 226,421 active users, a 34% increase on FY15's 169,117. Conversion increased from 1.96% to 2.28%, with an average basket size of £116, up 6%. Mobile is growing fast with mobile visitors up 39%, and in FY16 39% of traffic came from mobile sources (FY15: 34%). The proportion of repeat customers increased from 24.8% to 25.5% in FY16, while returns rates are less than 4%, which is consistent with the situation at IPO. Revenue per £1 of marketing spend grew 15% to £11.53.

Products – the full range

The product range extends over all categories and features top brands such as Fender, Gibson and Yamaha, as well as in-house brands. G4M's ability to span the complete range is a point of difference against other online specialist operations. It also faces competition from aggregators like Amazon, but aggregators cannot provide the specialist service that G4M does, including product advice, video illustration and returns. Amazon is also a sales channel for G4M's own-brand products.

Exhibit 3: Product mix

		FY15 (%)	FY16 (%)	L-f-l growth (%)
Guitar and bass		32	28	30
Keyboards and pianos		18	18	48
Drums and percussion		14	13	38
PA, DJ and lighting		15	20	94
Recording and computers		11	11	45
Woodwind, brass and strings		9	8	28
Other		1	2	n/a
Total		100	100	47

Source: G4M

The total number of SKUs listed had been grown 16% y-o-y to 31,500 at February 2016. However, this still leaves enormous headroom to management's estimate of 80,000. The leasehold 135,000 sq ft. York warehouse and 9,000 sq.ft. showroom has capacity for revenues of c £50m, a level that we forecast G4M will pass in FY18, and management is considering options for its successor site.

Own brands – growing steadily

Own-brand products, at £9.2m, were 26% of FY16 revenue and achieved growth of 33% (FY15: 27%). G4M has eight brand names: *gear4music* is the generic value brand and the others – SubZero (guitars and amplification equipment), RedSub (bass guitars and amplification equipment), Minster (digital pianos), WHD (drums), Archer (strings), Rosedale (woodwind) and Coppergate (brass) represent step-up concepts in each product area. Own-brand gross margin is not disclosed, although we understand it is higher than branded products. However, own-brand products require some investment in development, although this is not heavy and tends to relate to more superficial design features, as the products are built from generic designs by the OEMs. As a result, we do not believe that their development carries a substantial overhead. These products, however, require a stock investment that is higher than their revenue mix, as they are all held in warehouse stock and are typically delivered from OEMs by container load. To smooth cash flows, they are financed by short-term trade finance loans (£0.8m at February 2016). A selection of own-brand products is available via Amazon, which functions as a sales channel complementing the company's websites.

Order fulfilment

G4M's value range is very wide, from a kazoo at £0.99 to a grand piano costing £28,000. Fulfilment operations cater for the entire range and the company retains six courier firms, as well as Royal Mail. As the online market becomes more sophisticated, in part led by majors such as Amazon and Argos, delivery times are becoming critical to competitiveness. G4M's systems ensure that the customer is offered up to eight delivery options and only c 25% of its sales are on standard delivery terms, with some 75% on premium terms such as next-day, named day or 10.30am delivery.

Supplier relationships

G4M purchases its products from a large range of UK and international suppliers including a number of global brand owners. Having traded since 2003, it has built up long-established and positive relationships. COO Gareth Bevan, who has 16 years' experience in the musical instrument and equipment industry, has longstanding relationships with key individuals. The company operates with its major branded suppliers on annual dealership agreements. Supply agreements include settlement discounts and retrospective rebates linked to volume targets. The company is a top tier customer for all the major players.

Online retail market: Structural change develops

Online retailing continues to drive structural change in the industry. In the UK, online sales were forecast to grow at 12% in 2015, compared with overall growth in retail sales of c 2% (source: www.statista.com). Traditional retailers are facing challenges, with MFI recently closing, and BHS and Austin Reed filing for administration. In the January 2016 edition of Edison Insight (Consumer Sector Focus), Edison wrote: "Online operators' cost advantages are pressurising store sales and margins, exacerbated by government mandated cost increases…the risk is that more outlets, and potentially, entire destinations, tip into unprofitability." Physical store numbers are set to decline 22% in the five years to 2018, according to forecasts by the Centre for Retail Research.

E-tailers positioned to take share

An e-tailer is an online retailer without physical stores. Amazon is the most prominent example. As yet, of the top 50 online retailers listed by Digital Strategy Consulting for 2015, only 17 were e-tailers, and of those only eight (Amazon, Apple, ASOS, Hewlett Packard, Telefonica O2, Littlewoods, notonthehighstreet.com) sell physical products (the rest are mainly travel companies like EasyJet). Nonetheless, as Amazon, ASOS and Boohoo (FY16 revenue £195m) demonstrate, e-tailers selling physical product are positioned to take share and are actively doing so.

Specialist, and special interest retailers

A market opportunity is opening for specialist retailers. Clothing and footwear is forecast to overtake electricals to become the largest online category by 2020, with five-year CAGR of 79% (source: www.verdictretail.com). ASOS has five-year sales CAGR of 23% to 2015, and Boohoo 51% to FY16.

There is now a market opportunity in special interest areas: an example is The Hut Group (small personal products), which has 33% continuing annual growth over the last three years and, although unquoted, has estimated 2015 revenue of £330m. Other examples (few of them yet quoted) can be found throughout recreational areas such as gardening, cooking, jewellery, all forms of sport, bird-watching, diving and antiques. Despite a lacklustre underlying retail environment, such areas provide opportunities for a value-added driven service to succeed.

The musical instrument and equipment market

The UK musical instrument and equipment market is worth approximately £750m in the UK at retail value, according to management estimates based on research by consultants in 2012. Of this, G4M management estimates that around £180m is online. The European market is estimated on the same basis to be worth £4.3bn. Different sources have different definitions, particularly since, although the definition of instruments is fairly clear, there is no firm definition as to what is included in musical equipment. However, on these estimates, G4M has a UK market share of 3.5% but only 0.8% in Europe. The musical instrument (only) market is forecast to grow by a compound 1.7% over the next five years, according to ibisworld.co.uk.

A survey conducted by Nexus Research in 2014 suggests significant latent demand:

- 28% of the population over five years of age currently play a musical instrument;
- 47% of all UK households have at least one musical instrument player;
- there are 13.6m lapsed players, of whom 58% (7.9m) would like to start playing again; and
- of non-players, 58% (14.6 million) would like to learn to play a musical instrument.

The UK market is highly fragmented: the UK Music Industries Association lists c 250 members, mainly independents. Other sources identify up to 1,800 businesses on wider definitions. G4M's two largest UK competitors, S&T and GuitarGuitar, had estimated 2016 revenue of £28m and £25m respectively, but neither competes with G4M on range.

European markets are attractive because of their greater size: management's estimates of European markets (as at 2012) are Germany at c £1.2bn followed by France at c £860m. After the UK, Italy is estimated at c £580m. Other notable markets include the Netherlands (£200m), Austria (£180m), Spain (£165m), Switzerland (£140m), Sweden (£110m) and Norway (c £80m). Hence G4M's market opportunity is substantial. There is more established competition in Europe, particularly from thomann.de, which has estimated turnover of £417m; however, only two other companies are ranked higher than G4M by Alexa's web traffic analysis.

Exhibit 4: European competitors

Competitor	Country	Estimated revenue (£m)	Alexa traffic rank*	Est European market share (%)
Thomann	Germany	546	2,905	12.8
MRH/4 Sound/Luthman	Sweden	75	n/a	1.8
Bax-shop	Netherlands	69	37,585	1.6
MusicStore	Germany	35	22,778	0.8
Gear4music	UK	35	23,549	0.8
Woodbrass	France	35	23,934	0.8
S&T Audio (PMT)	UK	28	161,333	0.7
GuitarGuitar	UK	25	79,470	0.6

Source: G4M. Note: *October 2015.

Management

The management team is headed by Andrew Wass, CEO. Andrew has over 20 years' business management experience, having founded Gear4music (then called Soundpro) in 1995. In 1998 he began selling IT systems for the audio recording market before launching Gear4music in 2003. Between 1992 and 1998, Andrew set up and ran his own recording studio business, having studied Popular Music and Sound Recording at the University of Salford.

Chris Scott, CFO, joined G4M October 2012. He was previously finance director at Officers Club, overseeing the sale of the business to Blue Inc. Chris joined the audit team of KPMG in Leeds in 1997, qualified as a chartered accountant in 2000 and spent nine further years in KPMG's advisory practice, including a year on secondment at Barclays Bank. He holds an Executive MBA.

Gareth Bevan, chief commercial officer, joined Gear4music in July 2012. He was previously at DV247, a £36m turnover musical equipment retailer, where he was responsible for purchasing, sales and marketing. He has 16 years' experience in musical equipment retail.

Sensitivities

Other than commercial risk, the main issues that we regard as sensitive for the valuation are:

Growth and market share gains: key to the investment case will be the sustainability of market share gains on the back of the strategies of improved online and fulfilment service and European expansion, which may be viewed as higher risk than the UK. Growth could be different from our forecast assumptions: we explore in the Valuation section below the effects of varying growth rates.

Exchange rates: currently, c 25% of products are sourced outside the UK from the Far East, priced in US$. European sales are likely to increase from their current 27% of sales. Both factors make margins sensitive to exchange rate fluctuations. The company does not hedge currency flows.

Technological: as a pure-play internet retailer, G4M is dependent on the normal working of the world-wide web for its website and associated functions such as payment and delivery. In the event of any disruption, there is little in the way of physical presence to fall back on. Similarly, revenue would be sensitive to any change in rates by net-based suppliers such as Google AdWords.

Inventory: inventory is the largest asset on the balance sheet, with approximately 110 days of sales in stock. Management believes that availability of stock for next-day delivery is a major competitive advantage and that excess cash is well invested in stock that can produce a higher return than cash. Management of stock, including its physical security, is a significant risk factor.

Key man: the company is closely associated with the vision of its founder and CEO, Andrew Wass, representing a key man risk. Against this, a substantial management structure has been developed reporting to the operating board (see Management section above) and the non-executive structure also provides, in our view, substantial assurance.

Liquidity: as the CEO and former private equity owners hold 65% of the shares, the free float is correspondingly limited.

Valuation

We value G4M on two metrics: peer comparison and DCF.

Peer comparison: Discount to online peers

Against retail sector peers as a whole, the comparison is mixed. In Exhibit 5 we summarise all UK-quoted retailers with a market cap between £30m and £1bn. Against this group, G4M, with its rapid growth forecast, falls to a P/E and EV/EBITDA discount by CY17e and CY18e respectively, although after substantial earlier premia. On EV/Sales, G4M is valued at significant discounts in all periods, indicating that its revenue growth is not fully recognised by the market.

Exhibit 5: Mixed comparison to sector as a whole

All calendarised	Market cap (£m)	P/E (x)			EV/Sales (x)			EV/EBITDA (x)		
		2016e	2017e	2018e	2016e	2017e	2018e	2016e	2017e	2018e
Average (small/mid-cap retailers)		15.8	14.1	13.2	0.6	0.5	0.6	6.1	5.5	5.5
G4M	26.4	22.0	13.0	10.2	0.5	0.4	0.3	10.0	6.5	4.9
Premium/(discount) to peers		39%	-8%	-23%	-12%	-27%	-46%	62%	18%	-11%

Source: Bloomberg, retailers with market cap £30m-1bn. Note: Nil results and outliers excluded.

However, most of the constituents of the above group are terrestrial retailers, with varying degrees of complimentary net presence. A better comparison is provided by going outside the above size range to focus on the smaller but defined group of online retailers. We allow a 30% discount against ASOS and Boohoo for size, liquidity and an established growth record against the more limited potential of G4M's niche market (we do not consider the same considerations apply to N Brown or AO World). Against this group, G4M stands at 2017e discounts of 15-50% on the multiples shown.

Exhibit 6: Strong upside against online retailers

All calendarised	Market cap (£m)	P/E (x)			EV/Sales (x)			EV/EBITDA (x)		
		2016e	2017e	2018e	2016e	2017e	2018e	2016e	2017e	2018e
ASOS (30% dis)	3000.1	40.2	31.1	23.7	0.9	0.7	0.6	13.8	10.7	8.4
Boohoo (30% dis)	558.8	24.6	20.2	16.4	1.0	0.8	0.6	9.8	7.7	6.2
N Brown	779.4	10.4	9.5	8.6	0.9	0.9	0.8	6.5	6.0	5.5
Findel	146.1	7.2	6.1	na	0.7	0.7	na	6.8	6.0	na
AO World	755	na	na	na	1.0	0.8	0.7	na	na	na
Koovs	35.1	na	na	na	1.9	1.0	0.6	na	na	10.3
Average		20.6	16.7	16.2	1.1	0.8	0.7	9.2	7.6	7.6
G4M		22.0	13.0	10.2	0.5	0.4	0.3	10.0	6.5	4.9
Premium/(discount) to peers		6.9%	-22.4%	-37.3%	-51.8%	-50.2%	-51.8%	7.9%	-15.2%	-35.7%

Source: Bloomberg, Edison Investment Research

Despite our assumed discount to larger online retailers, the above 2017e P/E and EV/EBITDA average multiples imply a value for G4M of 169p and 152p respectively, an average of 160p.

DCF valuation

G4M is rapidly growing its share of a substantial market through its disruptive competitive position. It has yet to develop sustained returns on its central overhead and investment in its brand. For these reasons, we believe a DCF approach is a relevant metric on which to value the shares.

Our DCF model is based on our three-year forecast, extended for a further seven years and to a terminal year. We fade forecast revenue growth from 2019e (+18%) on a straight-line basis (c 2% pa) to terminal growth of +2%. We assume that EBITDA margin will grow gradually from 6.6% at 2019e, on economies of scale, to a terminal 9%. We use an equity-only cost of capital of 10% based on risk-free 4%, small company premium of 6% and a conservative beta of 1. We also assume that capex increases at a constant proportion of revenue, taking it from £1.9m in FY19e to £3.7m in FY26e, reflecting our assumption that the company will continue to invest in its platform and expand significantly in Europe.

These assumptions result in a valuation of 212p. Terminal value accounts for 66% of EV.

Exhibit 7 shows the effect on this valuation of differing assumptions for cost of capital and terminal growth, in all cases above the current share price, which is equivalent to a zero terminal growth rate and a 13% cost of capital.

Exhibit 7: DCF scenarios

		Terminal growth rate				
		0.0%	1.0%	2.0%	3.0%	4.0%
WACC	15.0%	108	111	115	119	124
	14.0%	118	122	127	133	139
	13.0%	131	136	142	149	158
	12.0%	146	152	160	170	182
	11.0%	163	172	183	196	214
	10.0%	185	197	212	231	256
	9.0%	213	229	249	277	315
	8.0%	247	270	300	342	406
	7.0%	292	326	372	442	557
	6.0%	354	405	481	609	863

Source: Edison Investment Research

We also test scenarios for differing medium-term growth rates and terminal margin. This indicates that the current price would be equivalent to a step-down of c 4% in the 2020 growth rate (declining then to our terminal 2%) and a terminal margin of c 7%, which is close to our 2019 forecast of 6.6%.

Exhibit 8: Medium-term growth and terminal margin scenarios

		2020e vs 2019e revenue growth				
		0%	-1%	-2%	-3%	-4%
Terminal EBITDA margin	11.0%	299	290	281	272	264
	10.5%	280	272	264	256	248
	10.0%	262	254	246	239	232
	9.5%	243	236	229	222	216
	9.0%	225	218	212	205	199
	8.5%	206	200	194	189	183
	8.0%	188	182	177	172	167
	7.5%	169	164	160	155	151
	7.0%	150	146	142	139	135
	6.5%	132	128	125	122	119

Source: Edison Investment Research

On averaging our two valuation metrics, we derive a share valuation of 186p.

Financials: H216 profit banked, dramatic growth ahead

G4M's maiden full-year results showed rapid sales growth driving sharply higher H2 profitability. The H2 increase was particularly driven by third-party brand sales, up 57%, although growth in own-brand sales was also impressive at 35%, still exceeding management's expectations. H2 European sales were up by a dramatic 79%, after 60% in H1, reflecting the roll-out of the European payments platform in H1, with particularly strong l-f-l performance in Scandinavian countries.

Exhibit 9: Results: sharp profit increase in H216

£000s	H115	H215	FY15	H116	H216	FY16	Growth H1	Growth H2	Growth FY
Revenue	8,767	15,473	24,240	12,493	22,996	35,489	42.5%	48.6%	46.4%
Gross profit	2,332	4,425	6,757	3,305	5,881	9,186	41.7%	32.9%	35.9%
Gross margin (%)	26.6%	28.6%	27.9%	26.5%	25.6%	25.9%	-0.1%	-3.0%	-2.0%
EBITDA	(240)	1,082	842	219	1,469	1,688	N/A	35.8%	100.5%
Operating profit	(470)	846	376	(143)	1,046	903	N/A	23.6%	140.2%
Operating margin (%)	-5.4%	5.5%	1.6%	-1.1%	4.5%	2.5%	4.2%	-0.9%	0.9%
PBT	(914)	282	(632)	(447)	1,067	620	N/A	278.4%	N/A

Source: G4M, Edison

Gross margin was down 300bp in H2 due to competitive pre-Christmas pricing and a mix swing towards third-party brands; however, Q117 indications suggest this is correcting. Marketing costs of £3.1m were 8.7% of revenue, down from 10.0% in 2015, while administrative costs totalled £8.3m, 23.3% of revenue (FY15: 26.3%). Operational gearing of these costs meant the FY16 operating margin was up 90bp. These factors resulted in a pre-tax turnaround from loss to profit, both £0.6m.

Cash flow: Investment in inventory and online platform

Operating cash flow was reduced by a £1.4m working capital swing as inventory increased by £1.5m, receivables by £0.5m but creditors by only £0.7m. Lower inventory days, down from 122 to 104, are likely to be more typical of the future: however, the smaller reduction in creditors resulted from the regularised financing environment post-IPO. As a result, net operating cash flow was £0.3m against operating profit of £0.9m. After accelerated capitalised platform investment of £0.9m and warehouse capex of £0.6m including the video studio, totalling £1.5m (FY15 capex: £1.0m), with £0.7m of pre-IPO interest costs in H1, net cash outflow before IPO-related items was £2.0m.

Balance sheet: Net cash of £2.6m

Following IPO, the balance sheet is sensibly structured, with fixed assets of £4m and net current assets of £5m, totalling net assets of £9m. Unlike terrestrial retailers, there is no hidden property lease debt; however, net cash of £2.6m is net of £0.9m of borrowings, mainly used to smooth cash flow on own-brand stock consignments. Fixed assets include intangibles of £3.2m, which is acquired goodwill £0.4m, brand value £0.3m and capitalised software platform costs £2.5m. Management regards this as the company's main asset and it is amortised over 3 - 8 years, with FY16 amortisation of £0.5m.

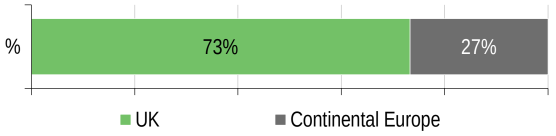
Forecast: Earnings to double

In the light of G4M's continuing progress and particularly the European opportunity, we initiate with a forecast of 165% FY17e PBT growth to £1.6m and 108% EPS growth to 6.5p. For FY18e, we look for 66% growth in both, to £2.7m and 10.8p respectively. Our forecast is driven by assumed FY17 revenue growth of 37% against the FY16 actual of 46%: we cautiously anticipate UK growth flattening from 39% to 25%, with European growth staying at around 70%. We understand that the first 13 weeks of FY17 are exceeding these assumptions which, if sustained, could result in upgrades to our forecasts later this year. We assume a partial recovery of gross margin from 25.9% to 26.3% in FY17 on a more normal mix of own-brand to other brand products. We assume that marketing costs rise by 35% to £4.1m based on the continued marketing drive, the further development of the European capability, targeted customer personalisation, website localisation and fulfilment systems. This would still represent a reduction in the revenue percentage of 20bp to 8.5%. We allow for a similar increase in administrative expenses, to include part-year costs of a European distribution hub, and a full year of plc costs. As a result, we forecast operating profit to rise 82% in FY17. With continued development of the software platform representing an investment of £0.9m (FY16: £0.5m), which should take intangibles to £4.0m, and some working capital growth, we expect FY17 net cash to bottom out at £2.5m, before increasing to £3.1m in FY18.

Exhibit 10: Financial summary

£000s	2015	2016	2017e	2018e	2019e
Year end: February	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT					
Revenue	24,240	35,489	48,710	60,311	71,075
Cost of Sales	(17,483)	(26,303)	(35,915)	(44,351)	(52,269)
Gross Profit	6,757	9,186	12,796	15,960	18,806
EBITDA	842	1,688	2,544	3,846	4,707
Normalised operating profit	376	903	1,646	2,729	3,354
Amortisation of acquired intangibles	0	0	0	0	0
Exceptionals	(165)	(606)	0	0	0
Share-based payments	0	(8)	(92)	(107)	(125)
Reported operating profit	211	289	1,554	2,622	3,228
Net Interest	(1,008)	(283)	(4)	(4)	1
Joint ventures & associates (post tax)	0	0	0	0	0
Exceptionals	0	0	0	0	0
Profit Before Tax (norm)	(632)	620	1,642	2,725	3,354
Profit Before Tax (reported)	(797)	6	1,550	2,617	3,229
Reported tax	111	(49)	(328)	(545)	(671)
Profit After Tax (norm)	(521)	571	1,314	2,180	2,683
Profit After Tax (reported)	(686)	(43)	1,222	2,072	2,558
Minority interests	0	0	0	0	0
Discontinued operations	0	0	0	0	0
Net income (normalised)	(521)	571	1,314	2,180	2,683
Net income (reported)	(686)	(43)	1,222	2,072	2,558
Basic average number of shares outstanding (m)	12.7	18.2	20.2	20.2	20.2
EPS - basic normalised (p)	(4.1)	3.1	6.5	10.8	13.3
EPS - diluted normalised (p)	(4.1)	3.1	6.5	10.8	13.3
EPS - basic reported (p)	(5.4)	(0.2)	6.1	10.3	12.7
Dividend (p)	0.00	0.00	0.00	0.00	0.00
Revenue growth (%)	37.1	46.4	37.3	23.8	17.8
Gross Margin (%)	27.9	25.9	26.3	26.5	26.5
EBITDA Margin (%)	3.5	4.8	5.2	6.4	6.6
Normalised Operating Margin	1.6	2.5	3.4	4.5	4.7
BALANCE SHEET					
Fixed Assets	3,755	4,477	5,232	5,849	6,436
Intangible Assets	2,764	3,238	3,977	4,556	5,095
Tangible Assets	991	1,239	1,255	1,293	1,341
Investments & other	0	0	0	0	0
Current Assets	6,458	11,194	13,941	17,085	20,563
Stocks	5,326	6,906	9,534	11,826	13,871
Debtors	216	740	1,016	1,258	1,482
Cash & cash equivalents	916	3,548	3,391	4,002	5,210
Other	0	0	0	0	0
Current Liabilities	(5,842)	(6,022)	(7,957)	(9,646)	(11,153)
Creditors	(4,522)	(5,188)	(7,023)	(8,712)	(10,219)
Tax and social security	0	0	0	0	0
Short term borrowings	(1,320)	(834)	(934)	(934)	(934)
Other	0	0	0	0	0
Long Term Liabilities	(4,660)	(290)	(90)	(90)	(90)
Long term borrowings	(4,570)	(127)	0	0	0
Other long term liabilities	(90)	(163)	(90)	(90)	(90)
Net Assets	(289)	9,359	11,126	13,198	15,756
Minority interests	0	0	0	0	0
Shareholders' equity	(289)	9,359	11,126	13,198	15,756
CASH FLOW					
Op Cash Flow before WC and tax	842	1,688	2,544	3,846	4,707
Working capital	1,012	(1,416)	(927)	(845)	(763)
Exceptional & other	(304)	(607)	(92)	(107)	(125)
Tax	0	0	0	(545)	(671)
Net operating cash flow	1,550	(335)	1,524	2,348	3,178
Capex	(953)	(1,509)	(1,650)	(1,733)	(1,941)
Acquisitions/disposals	0	0	0	0	0
Net interest	(185)	(130)	(4)	(4)	1
Equity financing	0	9,535	0	0	0
Dividends	0	0	0	0	0
Other	(377)	0	0	0	0
Net Cash Flow	35	7,561	(130)	610	1,208
Opening net debt/(cash)	4,694	4,974	(2,587)	(2,457)	(3,068)
FX	0	0	0	0	0
Other non-cash movements	(315)	0	0	0	0
Closing net debt/(cash)	4,974	(2,587)	(2,457)	(3,068)	(4,276)

Source: G4M, Edison Investment Research

Contact details	Revenue by geography
Gear4Music Kettlestring Lane, Clifton Moor, York, YO30 4XF +44 (0)330 365 4444, www.gear4music.com	

Management team

CEO: Andrew Wass	CFO: Chris Scott
Andrew has over 20 years' business management experience, having founded Gear4music (then called Soundpro) in 1995. In 1998 he began selling IT systems for the audio recording market before launching Gear4music in 2003. Since then Andrew has retained overall responsibility for driving the group's growth. Between 1992 and 1998, Andrew set up and ran his own recording studio business, having studied Popular Music and Sound Recording at the University of Salford. Andrew is a keen pianist.	Before joining Gear4music in October 2012, Chris was the FD at Officers Club, overseeing the sale of the business to Blue Inc. Chris joined the audit team of KPMG in Leeds in 1997, qualified as a chartered accountant in 2000 and went on to spend nine further years in their advisory practice including a year on secondment at Barclays Bank. He holds an Executive Master's in Business Administration.
COO: Gareth Bevan	**Chairman: Ken Ford**
Gareth joined Gear4music in July 2012. He was previously at DV247, a £36 million turnover musical equipment retailer, where he was responsible for purchasing, sales and marketing. He has 16 years' experience in musical equipment retail.	Ken was previously chief executive of Teather & Greenwood, the investment bank, becoming deputy chairman and chairman of corporate finance. Ken brings a strong understanding of shareholder value, strategic planning and corporate transactions. He was chairman of the UK Society of Investment Analysts and a former chairman of the Quoted Companies Alliance (QCA) and member of the EU Advisory Committee to the Corporation of London. Previous directorships include Aberdeen Asset Management and Morgan Grenfell. He is currently chairman of AIM-quoted companies BrainJuicer Group, Nakama Group and Scientific Digital Imaging.

Principal shareholders	(%)
Andrew Wass	41.1
Key Capital Partners	24.0
Octopus Investment	5.1
Artemis Investment Management	4.6
Seneca Partners	4.6
Panmure Gordon Prop Trading/Mark	3.6
City Financial Investment Company	3.3
Share Centre	3.3
Hargreave Hale	2.7

Companies named in this report

Yamaha (YCA), Royal Mail (RMG), Amazon (AMZN), Apple (AAPL), ASOS (ASC), HP (HPQ), Telefonica (TEF), EasyJet (EZJ), Boohoo (BOO), N Brown (BWNG), Findel (FDL), AO World (AO), Koovs (KOOV), BrainJuicer Group (BJU), Nakama Group (NAK), Scientific Digital Imaging (SDI)