FORSYTH BARR

Kathmandu Holdings

NEUTRAL

Surf's Up—Acquisition of Rip Curl

Kathmandu Group (KMD) has entered into an agreement to acquire Rip Curl for NZ$368m; to be funded by a mixture of debt and equity financing, including an NZ$145m capital raise. On the face of it we view the acquisition as sound given (1) the multiple paid appears undemanding relative to comparable transactions, (2) management's track record and successful integration of Oboz, and (3) brand alignment and the ability to leverage expertise across the two businesses in different channels. However, we are less enthused by the lacklustre growth profile, more mature nature of the surf/beach category with greater exposure to fashion trends, in our opinion, and minimal cost synergies to provide any buffer. NEUTRAL.

Acquisition of Rip Curl

KMD has entered into a binding agreement to acquire global surf wear brand Rip Curl for NZ$368m (A$350m). The transaction is expected to be completed within the calendar year, although remains subject to shareholder approval (50% majority) with a Special Shareholders' Meeting scheduled for Friday 18 October. At this stage we do not incorporate Rip Curl into our forecasts.

Key points to note

- **Multiple paid:** 7.3x EV/EBITDA (FY19 pro forma) appears undemanding when compared to recent transactions and key peer Billabong, which was acquired in 2018 for 7.4x trailing EV/EBITDA.
- **EPS accretion:** KMD expects the acquisition to be +10% EPS accretive in FY20. Based on that assumption and our earnings estimates for Rip Curl, implies upside risk to consensus base EPS (pre Rip Curl).
- **Historic earnings depressed by one-offs:** Historical Rip Curl pro forma EBITDA includes costs relating to employee expenses of ~NZ$4.2m which are not expected to be incurred on a go forward basis.
- **Financing:** The deal will be financed through a combination of debt (NZ$231m), equity (NZ$145m), and vendor scrip (~NZ$32m), which is escrowed for 12 months.
- **Gearing:** Post acquisition pro forma FY19 net debt/EBITDA is 1.5x (27% geared). KMD expects to de-lever to a target range of 0.9–1.1x by FY21.

Strategic rationale linked to brand strength and wholesale exposure

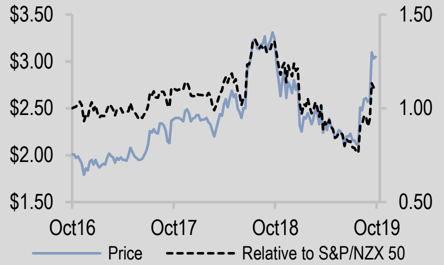
At first glance this does not appear to be a deal based on obvious cost synergies. Instead, strategic rationale is linked to the alignment of the brands and the ability to leverage core competencies across the two businesses, being Rip Curl's wholesale relationships and Kathmandu's success in loyalty schemes. We see the potential for revenue synergies where Rip Curl's product is sold through wholesale customers with broader outdoor apparel exposure, particularly in Europe, as well as the possible acceleration of the Kathmandu brand international expansion, a key area of earnings upside.

Investment View

KMD has a strong brand and market leading position in Australasia with its loyalty database and vertically integrated model also key strengths. KMD operates in a competitive sector and earnings are seasonal. The core business is in good shape, with focus now on the opportunity for the brand further afield. International is the key area of focus, with material capital committed (via acquisitions) to accelerate growth plans. Our rating is NEUTRAL.

NZX Code	KMD
Share price	NZ$3.05
Target price	NZ$2.95
Risk rating	High
Issued shares	226.0m
Market cap	NZ$689m
Average daily turnover	216.7k (NZ$560k)

Share Price Performance



Financials: July	19A	20E	21E	22E
NPAT* (NZ$m)	56.8	57.7	62.3	64.9
EPS* (NZc)	25.1	25.5	27.6	28.7
EPS growth* (%)	4.8	1.5	8.1	4.1
DPS (NZc)	16.0	17.0	18.0	19.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	7.2	7.0	6.6	6.4
EV/EBIT	8.5	8.4	7.7	7.5
PE	12.1	12.0	11.1	10.6
Price / NTA	12.3	9.2	7.1	n/a
Cash dividend yield (%)	5.2	5.6	5.9	6.2
Gross dividend yield (%)	7.3	7.7	8.2	8.7

*Historic and forecast numbers based on underlying profits

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Kathmandu (KMD)		Priced as at 01 Oct 2019: NZ$3.05								July year end

Forsyth Barr valuation			
Valuation methodology	Weighted DCF and sum of the parts valuation		
12-month target price (NZ$)*	**2.95**	**Spot valuations (NZ$)**	
Expected share price return	-3.3%	1. DCF	2.44
Net dividend yield	5.7%	2. Sum of the parts	2.55
Estimated 12-month return	2.4%	3. n/a	n/a
Key WACC assumptions		**DCF valuation summary (NZ$m)**	
Risk free rate	2.00%	Total firm value	711
Equity beta	1.16	(Net debt)/cash	(19)
WACC	10.5%	Value of equity	692
Terminal growth	1.5%	Shares (m)	226

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	497	546	563	580	599
Normalised EBITDA	**90**	**100**	**100**	**106**	**109**
Depreciation and amortisation	(15)	(15)	(16)	(16)	(16)
Normalised EBIT	**75**	**84**	**84**	**90**	**93**
Net interest	(1)	(3)	(1)	(0)	1
Associate income	-	-	-	-	-
Tax	(23)	(24)	(25)	(27)	(28)
Minority interests	-	-	-	-	-
Normalised NPAT	**51**	**57**	**58**	**62**	**65**
Abnormals/other	-	-	-	-	-
Reported NPAT	**51**	**58**	**58**	**62**	**65**
Normalised EPS (cps)	24.0	25.1	25.5	27.6	28.7
DPS (cps)	15.0	16.0	17.0	18.0	19.0

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	11.7	9.7	3.1	3.1	3.3
EBITDA (%)	26.7	10.9	0.2	6.2	3.1
EBIT (%)	31.2	12.7	-0.4	6.9	3.3
Normalised NPAT (%)	33.2	12.2	1.5	8.1	4.1
Normalised EPS (%)	28.4	4.8	1.5	8.1	4.1
DPS (%)	15.4	6.7	6.3	5.9	5.6

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**90**	**100**	**100**	**106**	**109**
Working capital change	6	(9)	(1)	(2)	(2)
Interest & tax paid	(21)	(29)	(26)	(27)	(28)
Other	-	-	-	-	-
Operating cash flow	**76**	**62**	**73**	**76**	**79**
Capital expenditure	(17)	(16)	(21)	(17)	(18)
(Acquisitions)/divestments	(83)	(22)	-	-	-
Other	(22)	22	-	-	-
Funding available/(required)	**(46)**	**46**	**52**	**59**	**61**
Dividends paid	(27)	(34)	(38)	(41)	(43)
Equity raised/(returned)	49	-	-	-	-
Increase/(decrease) in net debt	**25**	**(12)**	**(13)**	**(18)**	**(19)**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	53	62	63	65	67
Fixed assets	64	60	66	67	68
Intangibles	390	386	386	386	386
Other assets	27	5	5	5	5
Total funds employed	**534**	**514**	**520**	**523**	**526**
Net debt/(cash)	31	19	6	(12)	(31)
Other non current liabilities	82	52	52	52	52
Shareholder's funds	420	442	461	483	505
Minority interests	-	-	-	-	-
Total funding sources	**534**	**514**	**520**	**523**	**526**

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	7.9	7.2	7.0	6.6	6.4
EV/EBIT (x)	9.5	8.5	8.4	7.7	7.5
PE (x)	12.7	12.1	12.0	11.1	10.6
Price/NTA (x)	21.4	12.3	9.2	7.1	5.8
Free cash flow yield (%)	8.5	6.7	7.5	8.6	8.9
Net dividend yield (%)	4.9	5.2	5.6	5.9	6.2
Gross dividend yield (%)	6.8	7.3	7.7	8.2	8.7
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	63	64	67	65	66

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	70.6	28.9	88.8	>100x	n/a
Interest cover EBITDA (x)	84.8	34.2	>100x	>100x	n/a
Net debt/ND+E (%)	6.9	4.2	1.3	-2.6	-6.5
Net debt/EBITDA (x)	0.3	0.2	0.1	n/a	n/a

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	12.2	14.2	13.9	14.6	14.5
Return on equity (%)	12.1	13.0	12.5	12.9	12.9
Return on funds employed (%)	13.3	12.9	12.7	13.4	13.7
EBITDA margin (%)	18.0	18.2	17.7	18.3	18.2
EBIT margin (%)	15.0	15.4	14.9	15.5	15.5
Capex to sales (%)	3.4	2.9	3.7	3.0	3.0
Capex to depreciation (%)	112	103	133	108	108

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Divisional sales (NZ$m)					
New Zealand	143	139	141	144	147
Australia	334	339	349	356	368
International (incl Oboz)	21	68	73	80	84
Total store sales	**497**	**546**	**563**	**580**	**599**
Gross profit	315	332	337	347	356
Gross margin	63	61	60	60	59
Divisional EBITDA (NZ$m)					
New Zealand	35	34	31	32	31
Australia	58	60	59	59	62
International (incl Oboz)	2	9	13	18	20
Unallocated	(5)	(3)	(3)	(4)	(4)
Total EBITDA	**90**	**100**	**100**	**106**	**109**
EBITDA margins (%)					
New Zealand	24.6	24.5	22.1	22.0	20.9
Australia	17.3	17.6	16.8	16.7	17.0
International (incl Oboz)	8.9	13.4	18.0	23.0	23.4
Total EBITDA margin	**18.0**	**18.2**	**17.7**	**18.3**	**18.2**
Currency assumptions					
NZDAUD	0.95	0.92	0.95	0.94	0.95
NZDGBP	0.56	0.52	0.52	0.53	0.51

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Rip Curl acquisition

Kathmandu (KMD) has announced it has entered into a binding agreement to acquire global surfing brand Rip Curl. The deal is expected to close within this calendar year.

On the face of it we view the transaction as reasonable given (1) the price paid appears undemanding when compared to listed retail peers and recent transaction multiples, (2) strong management track record, and (3) opportunity to leverage the respective companies' expertise in different channels. However, cost synergies appear to be minimal and we note the more mature nature of the surf/beach category with greater exposure to fashion trends, in our opinion. Rip Curl has exhibited no earnings growth over the three-year history provided.

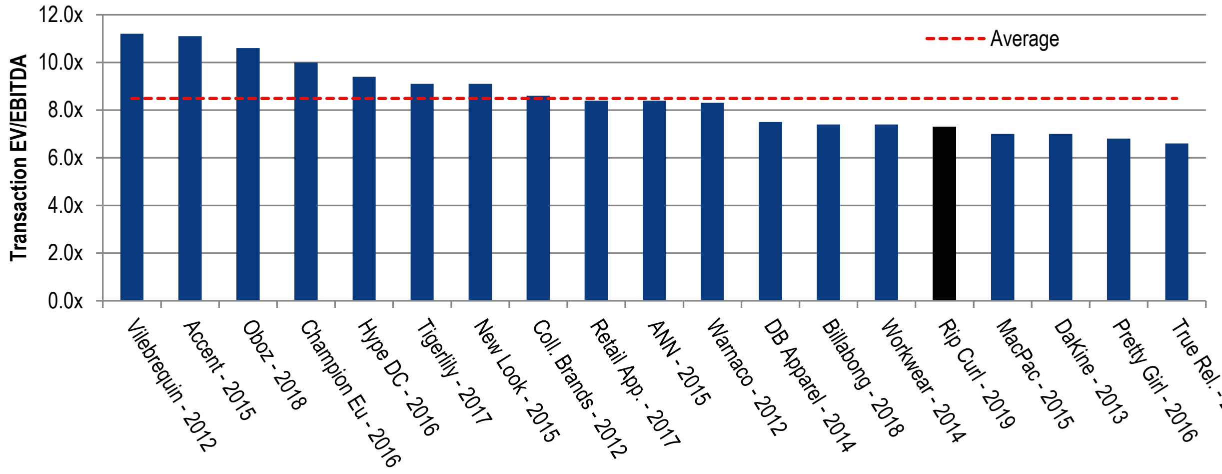
At this stage we do not incorporate Rip Curl into our forecasts.

Acquisition details

The key acquisition details are:

- **Price:** KMD will pay NZ$368m (A$350m)
- **Funding:** The acquisition will be financed via a mixture of debt and equity funding. Post the transaction, pro forma net debt/EBITDA (FY19) is expected to be 1.5x. KMD expects to reduce debt to within the range of 0.9x to 1.1x by FY21
  - A 1 for 4 pro-rata accelerated entitlement offer to raise NZ$145m (A$138m) at an application price of NZ$2.55 (A$2.37)
  - A placement of ~NZ$32m (A$31m) new KMD shares to the founders and CEO of Rip Curl which will be subject to escrow for a period of 12-months
  - NZ$231m (A$220m) from new senior secured debt facilities
- **Acquisition conditions:** Remains subject to shareholder approval by simple majority (50%). A Special Meeting of shareholders is scheduled to be held Friday 18 October.
- **Multiple paid:** The headline EV/EBITDA (FY19 pro forma) multiple of 7.3x appears reasonable on the face of it (Figure 1). Adjusting for one-off costs in FY19 relating to employee expenses we estimate the transaction EV/EBITDA is 6.9x.
  - Billabong, a key competitor, was acquired in January 2018 for A$380m at a similar multiple of 7.4x trailing EV/EBITDA.

Figure 1. Recent retail transaction multiples (EV/EBITDA)



Source: Forsyth Barr analysis

EPS accretive, upside to group forecasts

KMD has indicated it expects the acquisition to be +10% EPS accretive in FY20, based on this we suspect there may be upside to consensus group EBITDA forecasts.

Our FY20E Rip Curl EBITDA forecast in Figure 2 is based on no underlying growth but stripping out ~NZ$4.2m of costs in FY19 that relate to employee expenses that have been restructured out of the business and are not expected to reoccur from FY20. Making assumptions around the cost of debt and depreciation expense for Rip Curl, as outlined in the table, implies EPS accretion of +12% (ahead of guidance). FY20E consensus EBITDA is NZ$100.8m, based on this number and our base case forecast for FY20 Rip Curl, implies ~+5% earnings upside to consensus. Incorporating an underlying growth rate of +3% (in line with historic category growth) to Rip Curl EBITDA forecasts implies upside risk of ~+9%.

We do not expect to see any material cost synergies although recognise the potential for revenue synergies through the international wholesale channel as well as through leverage of the different businesses current expertise — being Rip Curl's wholesale relationships and Kathmandu's success in loyalty schemes.

Figure 2. EPS accretive in Year 1 (NZ$m)

FY20E	KMD FB est.	Rip Curl	Pro forma group	Comment
Pro forma EBITDA	**99.7**	**53.2**	**152.9**	**Growth on FY19 due to removal of one-off costs of NZ$4.2m, no underlying growth**
Depreciation	(15.8)	(12.7)	(28.5)	We assume Rip Curl depreciation in line with FY19
EBIT	**83.9**	**40.5**	**124.4**	
Net interest	(0.9)	(6.2)	(7.1)	Assumes cost of incremental debt (NZ$205m) of 3%
PBT	**83.0**	**34.4**	**117.4**	
Tax	(23.2)	(10.3)	(33.5)	Assumes Rip Curl effective tax rate of 30%
NPAT	**59.8**	**24.0**	**83.8**	
Shares (m)	226.0	56.7	282.7	
EPS (cps)	**26.4**		**29.6**	**Implies EPS accretion in year one of +12% (KMD guidance +10%)**
EV		368.0		
ROIC		7.7%		Below our KMD WACC estimate of 10.5%
Fwd EV/EBITDA		6.9x		KMD fwd EV/EBITDA pre announcement of 7.2x

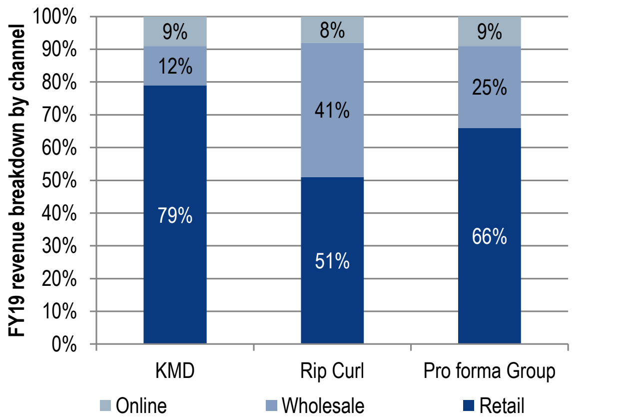
Source: Company reports, Forsyth Barr analysis

Strategic rationale

The strategic rationale from KMD is focussed on the alignment of brands and ability to leverage core competencies across the two businesses, with little emphasis on cost synergies, which appear likely to be limited.

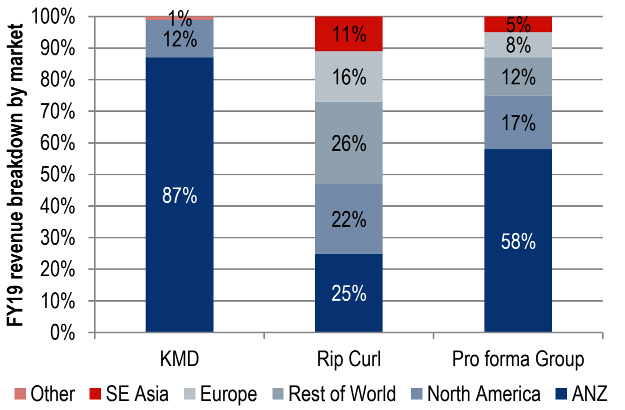
- **Outdoor brand led business:** The Kathmandu and Rip Curl brand offerings have strategic alignment in that both offer technical led outdoor sports equipment. Although, we note Rip Curl's higher exposure to fashion and more mature nature of the surf/beach category.
- **Wholesale experience:** KMD's ability to leverage Rip Curl's wholesale expertise, relationships, and global network to assist in expanding its wholesale business could provide upside to growth forecasts.
- **Loyalty scheme:** KMD has had success with its Summit Club and its omni-channel approach. Rip Curl has no loyalty scheme to date with possible growth to be achieved through expertise sharing.
- **Accelerates Kathmandu brand international expansion:** Rip Curl's global presence provides an opportunity to accelerate the Kathmandu brand's international expansion, particularly through continental Europe where it did not previously have a sales base. There are also revenue synergies with 17 of Rip Curl's European wholesale customers also stocking broader outdoor apparel.

Figure 3. Revenue breakdown by channel



Source: Company reports, Forsyth Barr analysis

Figure 4. Revenue breakdown by market

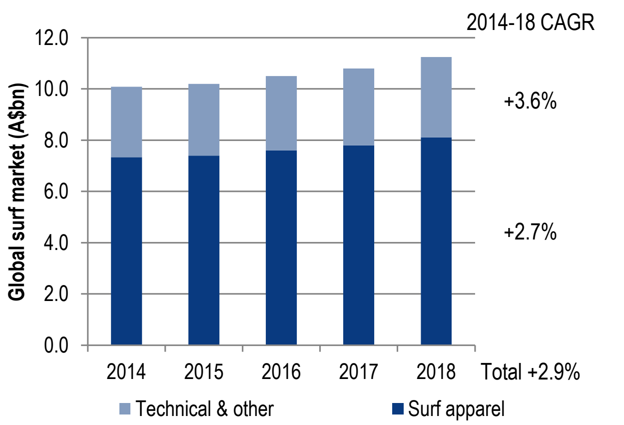


Source: Company reports, Forsyth Barr analysis

Rip Curl

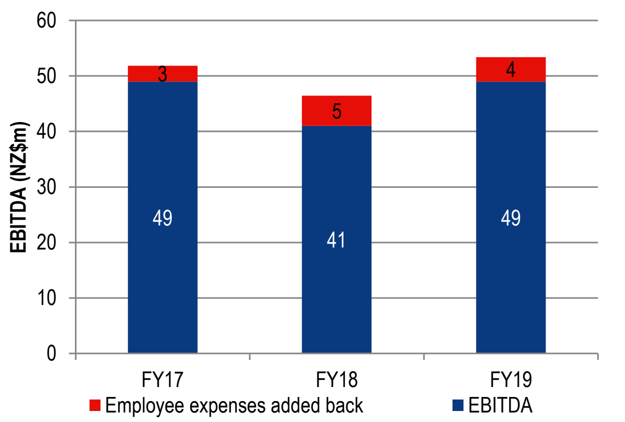
- Rip Curl is an Australian based global action sports retailer with exposure to the beach/surf category.
    - The Rip Curl brand is well-established with a top two positioning in its category in Australia, and a number of European, South American, and Asian markets. In North America the brand has a top five net promoter score ranking.
- Rip Curl's technical product offering is centred around wetsuits, which are manufactured in a company owned facility. KMD guides to ~40% of Rip Curl revenue from technical products which also includes the sale of board shorts.
    - We note the ~60% revenue exposure to surf apparel and womenswear, which lifts the fashion risk of the company, in our opinion.
- The company operates a multi-channel model across the wholesale, retail, and online channels with a global brand presence.
    - The wholesale channel represents ~41% of Rip Curl's sales and is a key area of expertise KMD may look to leverage given its international expansion plans.
- Historic growth has been limited in the three year period provided.
    - The step down in FY18 relates to issues in the European wholesale market as competition from athleisure lifted. The company made efforts to rightsize that business, driving a recovery in FY19.

Figure 5. Historic global category sales growth



Source: Company reports, Forsyth Barr analysis

Figure 6. Pro forma Rip Curl historical performance



Source: Company reports, Forsyth Barr analysis

Investment summary

Kathmandu Holdings (KMD) has a strong brand, market leading position and its vertically integrated model is a key strength. The key area of optionality is KMD's international expansion strategy, with Oboz and Rip Curl expected to help accelerate this pathway. We view risk/reward as broadly balanced, with upside potential if delivery of international earnings moves faster. NEUTRAL.

Earnings and cash flow outlook

- **Store rollout:** The long-term target Australasian store footprint is 180, up from its current 167 stores (119 Australia: 48 NZ).
- **International expansion strategy:** This is the key avenue of optionality for growth with its 'capital light' wholesale model. Oboz and Rip Curl provide platforms in international markets, and KMD is also trialling with a UK and Swedish retailer.
- **Oboz and Rip Curl acquisitions:** The strategy is to leverage the companies' wholesale relationships in the US and European markets while also providing product and market diversity.
- **NZDUSD and hedging:** Given the competitive retail backdrop and price conscious consumer, we don't expect retailers to be able to pass on the full impact of unfavourable FX movements.

Business quality

- **Strong base:** KMD has a strong brand, vertically integrated model, valuable loyalty database and a market leading position. Continued investment in IT will also support growth and working capital management.
- **Management:** Execution over the last three years has been strong, with the company delivering a turnaround in its profit trajectory.
- **Briscoe Group's stake:** BGP's full takeover offer in 2015 was unsuccessful; however, it has maintained an 18.9% stake.

Financial structure

- **Gearing:** Subject to Rip Curl acquisition approval, net debt has lifted to 1.5x net debt/EBITDA (~27% geared). The company is targeting a reduction to the range of 0.9x to 1.1x by FY21.

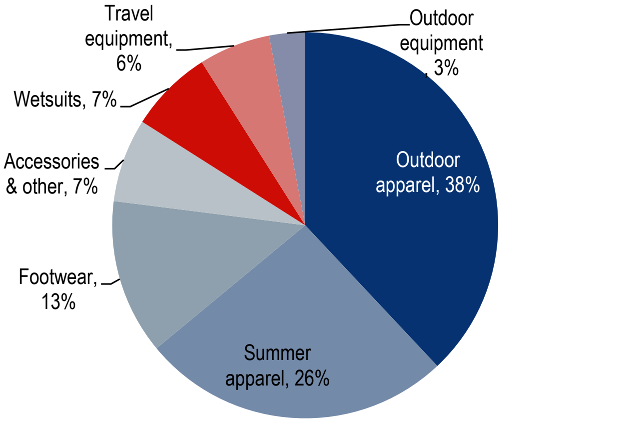
Risks factors

- **Earnings predictability:** A risk given the high seasonality and lumpy nature of earnings which are weighted to its winter sale.
- **Consumer sentiment and cost inflation:** Deterioration in economic conditions. Cost inflation, particularly rising wages and rent.

Company description

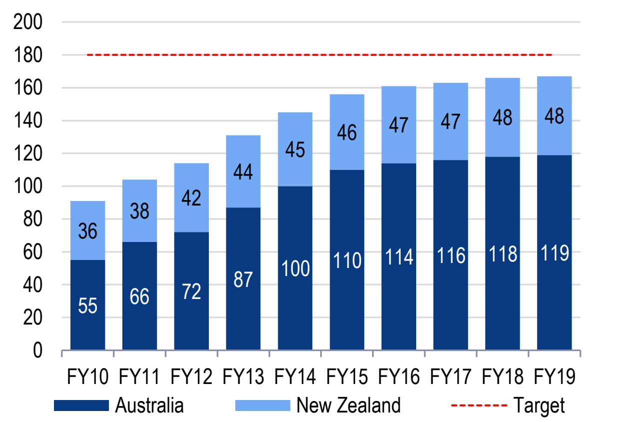
Kathmandu is the largest Australasian travel and adventure clothing and equipment retailer, with 119 stores in Australia and 48 in New Zealand and plans to expand its Australasian footprint to 180 stores. The company is looking to expand in International markets through wholesale and online channels, supported by the recent acquisition of Oboz. KMD offers a wide range of products, including specialist technical products, lifestyle products and general merchandise.

Figure 7. FY19 pro forma revenue breakdown (incl. Rip Curl)



Source: Forsyth Barr analysis, Company reports

Figure 8. Australasian store footprint



Source: Forsyth Barr analysis, Company reports

Figure 9. Substantial Shareholders

Shareholder	Latest Holding
Briscoe Group	18.9%
Harbour Asset Management & Jarden Securities Limited	12.0%
TA Universal	12.0%
Commonwealth Bank of Australia	6.3%

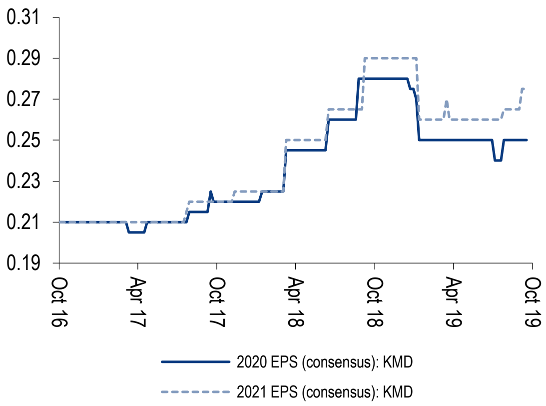
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 10. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect KMD's balance date - July)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Kathmandu Holdings	**KMD NZ**	**NZ$3.05**	**NZ$689**	**12.0x**	**11.1x**	**7.1x**	**6.7x**	**8.4x**	**7.9x**	**5.9%**
Briscoe Group *	BGP NZ	NZ$3.64	NZ$809	12.4x	12.7x	7.6x	7.8x	8.2x	8.3x	6.2%
Michael Hill Intl *	MHJ NZ	A$0.62	A$240	9.4x	9.3x	4.5x	4.4x	6.8x	6.7x	8.4%
Restaurant Brands NZ *	RBD NZ	NZ$11.30	NZ$1,410	28.1x	24.8x	13.9x	12.9x	21.0x	19.0x	0.0%
The Warehouse Group *	WHS NZ	NZ$2.50	NZ$867	11.3x	9.8x	5.4x	4.7x	8.2x	7.2x	7.4%
Dick's Sporting Goods Inc	DKS US	US$40.69	US$3,678	11.8x	11.4x	10.4x	10.4x	16.7x	17.0x	3.0%
Premier Investments	PMV AT	A$19.36	A$3,067	21.4x	19.1x	14.1x	12.8x	17.1x	15.2x	4.3%
VF Corp	VFC US	US$89.17	US$35,509	25.3x	22.1x	19.0x	17.1x	22.5x	20.0x	2.3%
Columbia Sportswear Co	COLM US	US$97.21	US$6,567	19.4x	17.5x	12.2x	13.1x	14.7x	13.1x	1.2%
			Compco Average:	**17.4x**	**15.8x**	**10.9x**	**10.4x**	**14.4x**	**13.3x**	**4.1%**
EV = Current Market Cap + Actual Net Debt			**KMD Relative:**	**-31%**	**-30%**	**-35%**	**-36%**	**-41%**	**-41%**	**+44%**

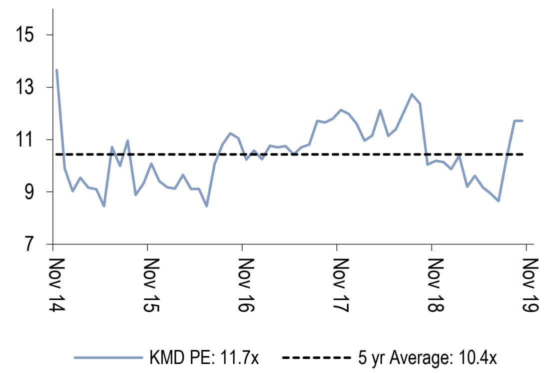
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (KMD) companies fiscal year end

Figure 11. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 12. 12 Month Forward PE



Source: Forsyth Barr analysis