FORSYTH BARR

Kathmandu Holdings

NEUTRAL

Catching the Next Wave

We incorporate Rip Curl into our Kathmandu (KMD) earnings forecasts for the first time following the recent acquisition, driving material upgrades. We view the acquisition positively given (1) the ability to leverage channel expertise across the businesses to accelerate growth and (2) opportunities to drive margin expansion within Rip Curl through improved retail operations. However, we note the challenging retail backdrop in the key domestic markets, additional exposure to fashion risk through Rip Curl, and high degree of uncertainty around earnings contributions from its international expansion. At 12x forward PE, broadly in line with Australasian peers, we view risk/reward as balanced. NEUTRAL.

What's changed?

- **Earnings:** Adjusted for Rip Curl acquisition
- **Target Price:** Increase to NZ$3.00 from NZ$2.95
- **Rating:** NEUTRAL

Earnings changes — Integrating Rip Curl forecasts

We have integrated Rip Curl into our earnings forecasts. We expect Rip Curl to achieve sales growth in line with the broader surf category of ~+3% in the near term. We forecast FY20 EBITDA margin expansion on the back of cost savings (~NZ$4m) relating to the reduction of its European employee cost base. KMD is targeting further margin expansion over the medium term as it leverages its retail expertise across Rip Curl; we forecast FY22 EBITDA margin of 13.0% (adjusted FY19 11.7%).

Revenue opportunities exist through channel and market diversification

Rip Curl's wholesale channel experience and exposure, particularly within the European market, offers potential revenue opportunities should KMD successfully leverage relationships and accelerate its international growth plans. Of Rip Curl's top 20 European wholesale customers, 17 also stock broader outdoor apparel and could carry Kathmandu and Oboz product. It is worth noting KMD is early into its international wholesale launch, having only begun selling its Kathmandu brand through the channel in the US in recent months. Although minimal cost synergies exist, there appears to be some relatively straight forward margin gains within Rip Curl from realising employee restructure benefits and optimising its Ozmosis footprint.

EPS accretive

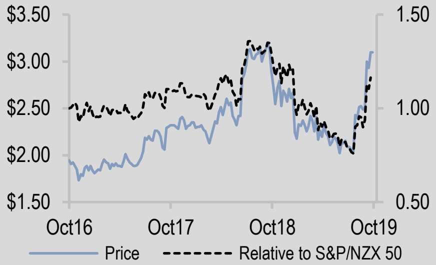
The deal is +10% EPS accretive in FY20 on management's estimates, which we estimate implies earnings upside to our pre-deal forecasts. Whilst the deal is earnings accretive, we calculate first year ROIC of 8.5%, below WACC and therefore value creation from the deal is reliant on underlying earnings growth at Rip Curl.

Investment View

KMD operates strong brands with market leading positions in Australasia. Key strengths include its loyalty database and vertically integrated model. KMD operates in a competitive sector and earnings are seasonal. The core business is in good shape, with focus now on integration of its recent Rip Curl acquisition and the opportunity for the Kathmandu brand further afield. International is the key area of focus, with material capital committed (via acquisitions) to accelerate growth plans. NEUTRAL.

NZX Code	KMD
Share price	NZ$3.10
Target price	NZ$3.00
Risk rating	High
Issued shares	284.4m
Market cap	NZ$882m
Average daily turnover	234.6k (NZ$593k)

Share Price Performance



Financials: July	19A	20E	21E	22E
NPAT* (NZ$m)	56.8	77.0	90.6	95.2
EPS* (NZc)	25.1	27.1	31.8	33.5
EPS growth* (%)	4.8	7.7	17.5	5.2
DPS (NZc)	16.0	17.0	19.0	21.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	9.1	7.0	6.2	5.9
EV/EBIT	10.8	8.5	7.5	7.2
PE	12.3	11.4	9.7	9.3
Price / NTA	12.5	16.4	9.8	n/a
Cash dividend yield (%)	5.2	5.5	6.1	6.8
Gross dividend yield (%)	7.2	7.6	8.5	9.4

*Historic and forecast numbers based on underlying profits

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Kathmandu (KMD)	Priced as at 08 Oct 2019: NZ$3.10		July year end

Forsyth Barr valuation			
Valuation methodology	Weighted DCF and sum of the parts valuation		
12-month target price (NZ$)*	**3.00**	**Spot valuations (NZ$)**	
Expected share price return	-3.2%	1. DCF	2.44
Net dividend yield	5.6%	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	1,124
Equity beta	1.16	(Net debt)/cash	(250)
WACC	10.4%	Value of equity	874
Terminal growth	1.5%	Shares (m)	284

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	497	546	892	1,086	1,118
Normalised EBITDA	**90**	**100**	**139**	**170**	**177**
Depreciation and amortisation	(15)	(15)	(24)	(30)	(31)
Normalised EBIT	**75**	**84**	**115**	**141**	**146**
Net interest	(1)	(3)	(4)	(10)	(9)
Associate income	-	-	-	-	-
Tax	(23)	(24)	(34)	(40)	(42)
Minority interests	-	-	-	-	-
Normalised NPAT	**51**	**57**	**77**	**91**	**95**
Abnormals/other	-	-	-	-	-
Reported NPAT	**51**	**58**	**77**	**91**	**95**
Normalised EPS (cps)	24.0	25.1	27.1	31.8	33.5
DPS (cps)	15.0	16.0	17.0	19.0	21.0

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	11.7	9.7	63.5	21.8	2.9
EBITDA (%)	26.7	10.9	39.9	22.3	4.2
EBIT (%)	31.2	12.7	36.4	22.4	4.1
Normalised NPAT (%)	33.2	12.2	35.6	17.5	5.2
Normalised EPS (%)	28.4	4.8	7.7	17.5	5.2
DPS (%)	15.4	6.7	6.3	11.8	10.5

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**90**	**100**	**139**	**170**	**177**
Working capital change	6	(9)	24	(36)	8
Interest & tax paid	(21)	(29)	(38)	(50)	(51)
Other	-	-	-	-	-
Operating cash flow	**76**	**62**	**126**	**84**	**134**
Capital expenditure	(17)	(16)	(34)	(34)	(37)
(Acquisitions)/divestments	(83)	(22)	(368)	-	-
Other	(22)	22	-	-	-
Funding available/(required)	**(46)**	**46**	**(276)**	**50**	**98**
Dividends paid	(27)	(34)	(48)	(54)	(60)
Equity raised/(returned)	49	-	177	-	-
Increase/(decrease) in net debt	**25**	**(12)**	**147**	**4**	**(38)**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	53	62	166	203	195
Fixed assets	64	60	107	111	116
Intangibles	390	386	596	596	596
Other assets	27	5	31	31	31
Total funds employed	**534**	**514**	**900**	**941**	**938**
Net debt/(cash)	31	19	171	175	137
Other non current liabilities	82	52	80	80	80
Shareholder's funds	420	442	649	686	721
Minority interests	-	-	-	-	-
Total funding sources	**534**	**514**	**900**	**941**	**938**

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	10.0	9.1	7.0	6.2	5.9
EV/EBIT (x)	12.0	10.8	8.5	7.5	7.2
PE (x)	12.9	12.3	11.4	9.7	9.3
Price/NTA (x)	21.8	12.5	16.4	9.8	7.0
Free cash flow yield (%)	6.7	5.2	10.4	5.7	11.1
Net dividend yield (%)	4.8	5.2	5.5	6.1	6.8
Gross dividend yield (%)	6.7	7.2	7.6	8.5	9.4
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	63	64	63	60	63

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	70.6	28.9	27.8	13.5	15.6
Interest cover EBITDA (x)	84.8	34.2	33.7	16.3	18.9
Net debt/ND+E (%)	6.9	4.2	20.8	20.3	15.9
Net debt/EBITDA (x)	0.3	0.2	1.2	1.0	0.8

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	12.2	14.2	11.1	12.8	13.3
Return on equity (%)	12.1	13.0	11.9	13.2	13.2
Return on funds employed (%)	13.3	12.9	12.6	11.7	11.9
EBITDA margin (%)	18.0	18.2	15.6	15.7	15.9
EBIT margin (%)	15.0	15.4	12.9	13.0	13.1
Capex to sales (%)	3.4	2.9	3.8	3.1	3.3
Capex to depreciation (%)	112	103	139	114	118

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Divisional sales (NZ$m)					
New Zealand	143	139	141	144	147
Australia	334	339	350	358	370
International (incl Oboz)	21	68	73	80	84
Rip Curl	-	-	328	505	517
Total store sales	**497**	**546**	**892**	**1,086**	**1,118**
Gross profit	315	332	527	640	657
Gross margin	63	61	59	59	59
Divisional EBITDA (NZ$m)					
New Zealand	35	34	31	32	31
Australia	58	60	60	60	64
International (incl Oboz)	2	9	13	18	20
Rip Curl	-	-	38	63	67
Unallocated	(5)	(3)	35	60	63
Total EBITDA	**90**	**100**	**139**	**170**	**177**
EBITDA margins (%)					
New Zealand	24.6	24.5	22.1	22.0	20.9
Australia	17.3	17.6	17.1	16.9	17.2
International (incl Oboz)	8.9	13.4	18.0	23.0	23.4
Rip Curl	-	-	11.7	12.5	13.0
Total EBITDA margin	**18.0**	**18.2**	**15.6**	**15.7**	**15.9**
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 integration

KMD recently announced the acquisition of Rip Curl for NZ$368m, funded through a combination of debt and equity (capital raise and vendor script). We view the acquisition positively given (1) Rip Curl's wholesale channel experience and global in market relationships providing possible revenue synergies and (2) management's retail track record and opportunity for margin expansion within Rip Curl. However, we note the additional exposure to fashion risk, in our opinion, and more mature nature of the surf category.

Earnings changes

Earnings upgrades are driven by the inclusion of Rip Curl to our forecasts. We forecast Rip Curl revenue growth of ~+3%, in line with broader category growth in the near-term. First year EBITDA margin expansion is driven by the reduction of employee costs restructured out of the business through FY19 of ~NZ$4.2m. Going forward we forecast margin expansion from normalised (adjusted for employee costs) 11.7% in FY19 to 13.0% in FY22.

Figure 1. Earnings changes

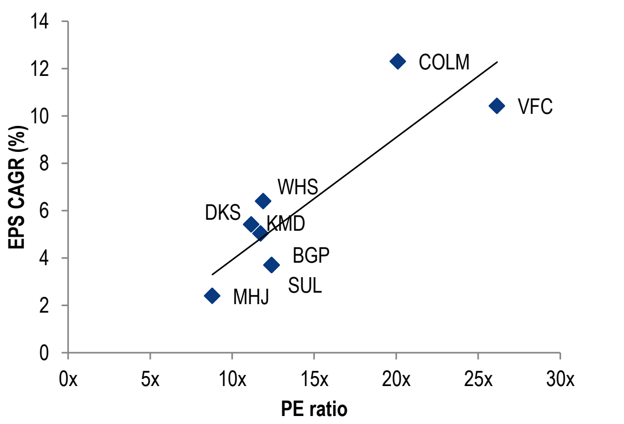
	2020E			2021E			2022E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales	562.7	891.9	58.5%	580.2	1,086.5	87.3%	599.3	1,118.3	86.6%
EBIT	**83.9**	**115.0**	**37.0%**	**89.8**	**140.7**	**56.7%**	**92.8**	**146.4**	**57.9%**
Normalised NPAT	**57.7**	**77.0**	**33.6%**	**62.3**	**90.5**	**45.1%**	**64.9**	**95.0**	**46.3%**
Underlying EPS	25.5	27.1	6.1%	27.6	31.8	15.3%	28.7	33.4	16.2%
DPS	17.0	17.0	-	18.0	19.0	5.6%	19.0	21.0	10.5%

Source: Forsyth Barr analysis

- **Rip Curl growth:** KMD expect to be able to grow Rip Curl earnings through ongoing category growth, employee costs savings, and improving the retail offering. KMD is targeting EBITDA margin expansion to mid-teens over the medium-term (FY19 10.8%).
  - The European wholesale channel has recently been rightsized following a period of underperformance. KMD expects to achieve employee costs savings within Rip Curl of ~NZ$4.2m in FY20.
  - A number of Ozmosis stores, Rip Curl's multi-brand retail offering, have been loss making with store closures expected to provide incremental EBITDA improvement.
  - KMD management has a strong track record in retail management, with opportunities to leverage its expertise to drive improvements in Rip Curl's retail channel. This includes possible promotional events and more efficient in store.
  - The surf category is expected to grow in line with to above that of the outdoor category at ~+3%-4%. Inclusion of surfing at the 2020 Olympics may provide a short term uplift.
- **Channel expertise:** Rip Curl offers KMD wholesale channel experience with ~40% through the channel and existing relationships in a number of international markets.
  - Opportunity for revenue synergies as KMD leverages wholesale expertise to accelerate international expansion for the Kathmandu brand, a key area of potential upside for investors.
  - Of Rip Curl's top 20 wholesale accounts in Europe, 17 also distribute other outdoors product and could carry Kathmandu and Oboz gear.
- **Product slate:** Rip Curl product and brand affinity align well with Kathmandu and its outdoor adventure ethos focussed on technical products.
  - Rip Curl is considered a market leader in the wetsuit category, which is a high price point product and requires consumer research. Although ~40% of Rip Curl sales are considered technical products, there is additional risk associated with increased fashion exposure, in our opinion.

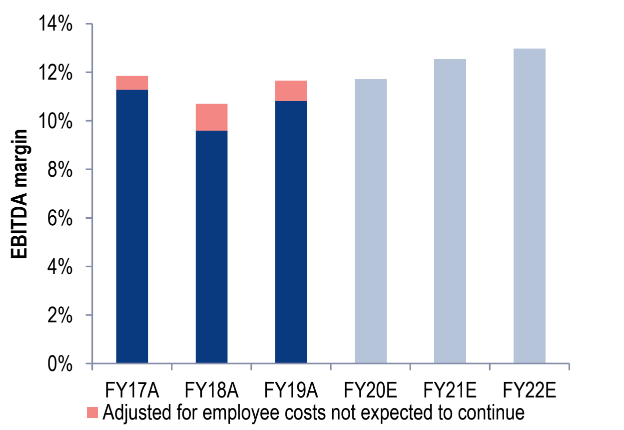
Rip Curl in charts

Figure 2. Consensus fwd PE ratio vs EPS growth



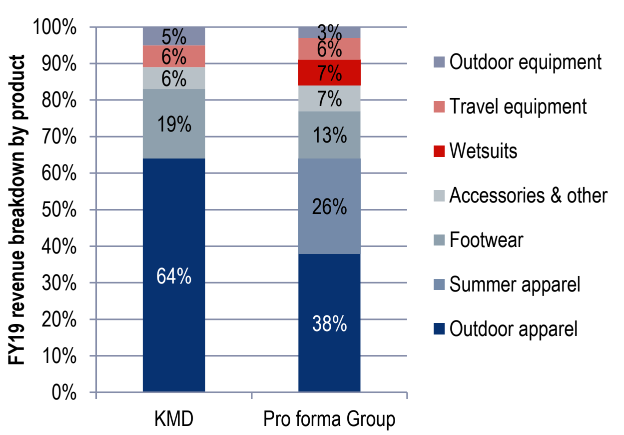
Source: Bloomberg, Forsyth Barr analysis

Figure 3. Rip Curl EBITDA margin



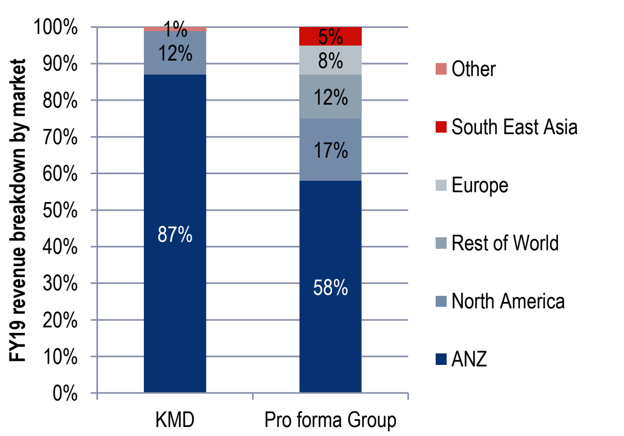
Source: Bloomberg, Forsyth Barr analysis

Figure 4. Sales breakdown by product



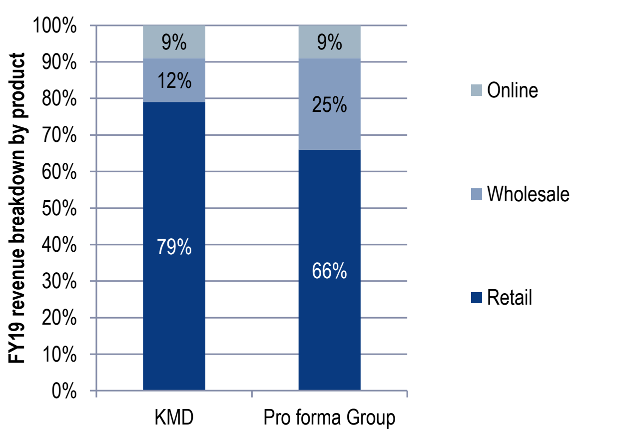
Source: Company reports, Forsyth Barr analysis

Figure 5. Sales breakdown by market



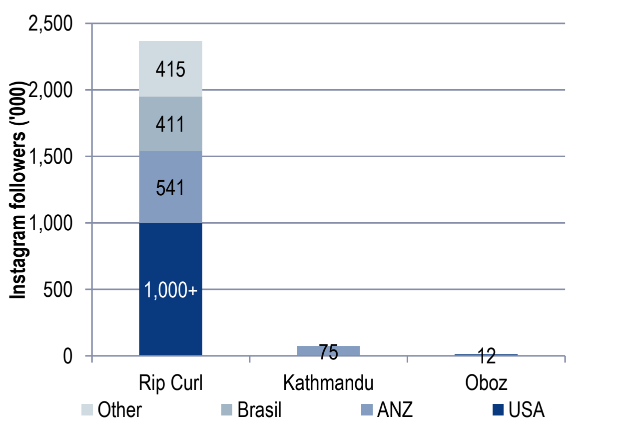
Source: Company reports, Forsyth Barr analysis

Figure 6. Sales breakdown by channel



Source: Company reports, Forsyth Barr analysis

Figure 7. Social media brand presence (Instagram)



Source: Instagram, 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 from which to leverage existing wholesale channel relationships to drive growth of the Kathmandu brand internationally.
- **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 a 16% 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.

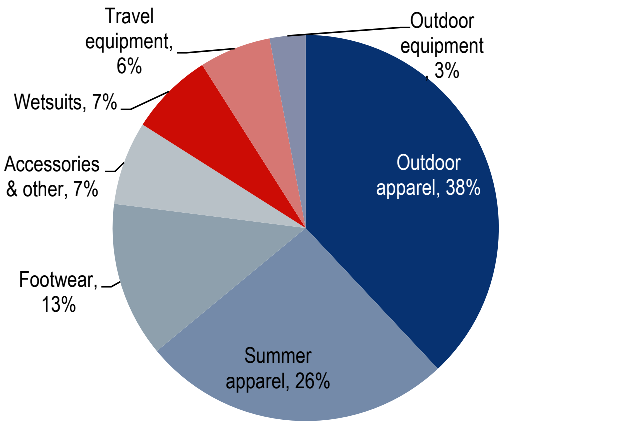
Risk factors

- **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

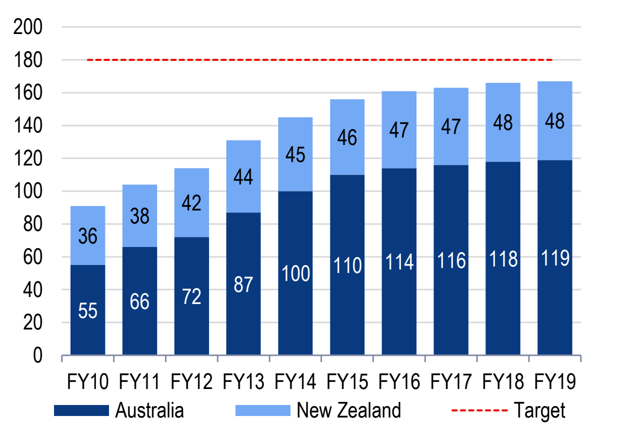
Kathmandu is the largest Australasian travel and adventure clothing and equipment retailer, with 119 stores in Australia and 48 in New Zealand and plans to expand its Australasian footprint to 180 stores. The company is looking to expand in International markets through wholesale and online channels,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

Figure 1. FY19 pro forma revenue breakdown (incl. Rip Curl)



Source: Forsyth Barr analysis, Company reports

Figure 2. Australasian store footprint



Source: Forsyth Barr analysis, Company reports

Figure 8. 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%

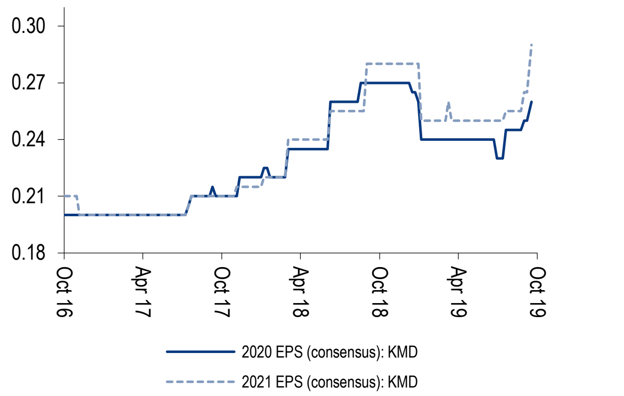
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 9. 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$3.10**	**NZ$882**	**11.4x**	**9.7x**	**6.5x**	**5.3x**	**7.8x**	**6.4x**	**6.1%**
Briscoe Group *	BGP NZ	NZ$3.61	NZ$802	12.3x	12.6x	7.6x	7.7x	8.1x	8.3x	6.2%
Michael Hill Intl *	MHJ NZ	A$0.61	A$237	9.3x	9.2x	4.5x	4.4x	6.7x	6.6x	8.5%
Restaurant Brands NZ *	RBD NZ	NZ$11.39	NZ$1,421	28.4x	25.0x	14.0x	12.9x	21.2x	19.1x	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$38.16	US$3,449	11.0x	10.7x	10.0x	10.0x	16.1x	16.5x	3.2%
Premier Investments	PMV AT	A$18.96	A$3,004	20.9x	18.7x	13.9x	12.6x	16.8x	14.9x	4.3%
VF Corp	VFC US	US$88.45	US$35,219	25.1x	22.0x	18.8x	17.0x	22.4x	19.8x	2.3%
Columbia Sportswear Co	COLM US	US$96.06	US$6,490	19.1x	17.3x	12.1x	12.9x	14.6x	13.0x	1.2%
			Compco Average:	**17.2x**	**15.6x**	**10.8x**	**10.3x**	**14.2x**	**13.2x**	**4.2%**
EV = Current Market Cap + Actual Net Debt			**KMD Relative:**	**-33%**	**-38%**	**-40%**	**-49%**	**-45%**	**-51%**	**+48%**

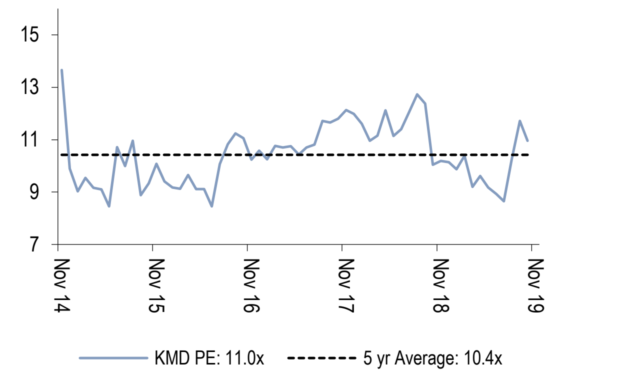
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (KMD) companies fiscal year end

Figure 10. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 11. 12 Month Forward PE



Source: Forsyth Barr analysis