

Kathmandu Holdings

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NEUTRAL 

Kathmandu Holdings (KMD) provided investors with an encouraging 1H20E trading update and greater detail on its new group strategy following the acquisition of Rip Curl. Whilst there is scope for some limited cost synergies, we believe the key benefit Rip Curl offers KMD is the opportunity to accelerate its international expansion plans through leveraging expertise and existing relationships in the wholesale channel, namely in North America and Europe. We lift our target price +NZ\$0.30 to NZ\$3.30 reflecting 1) peer multiple expansion and 2) a lower seasonal risk discount for KMD following the acquisition of Rip Curl. Given the early stages of the revised group strategy and acquisition integration risk, we currently see the risk/reward as balanced and retain a NEUTRAL rating.

NZX Code	KMD	Financials: Jan/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$3.44	NPAT* (NZ\$m)	56.8	77.0	89.9	95.2	EV/EBITDA	10.1	7.8	6.9	6.6
Target price	NZ\$3.30	EPS* (NZc)	25.1	27.1	31.6	33.5	EV/EBIT	11.9	9.5	8.4	8.1
Risk rating	High	EPS growth* (%)	4.8	7.7	16.7	5.9	PE	13.7	12.7	10.9	10.3
Issued shares	284.4m	DPS (NZc)	16.0	17.0	19.0	21.0	Price / NTA	13.9	18.3	10.9	n/a
Market cap	NZ\$978m	Imputation (%)	100	100	100	100	Cash div yld (%)	4.7	4.9	5.5	6.1
Avg daily turnover	246.7k (NZ\$682k)	*Historic/forecast numbers based on normalised profits					Gross div yld (%)	6.5	6.9	7.7	8.5

Trading update encouraging

KMD provided 1H20E EBIT (pre IFRS16) guidance, largely in line with our expectations, for growth of +40% on the prior year period. Growth reflects the acquisition of Rip Curl combined with underlying sales growth from both its Kathmandu and Oboz brands. We suspect investor sentiment shifted negative heading into the trading announcement, given the Australian bush fires and competitive retail backdrop, with the market likely positively surprised by 1H20 Kathmandu brand same store sales growth of +1.5%. We remain comfortable with our FY20E earnings forecasts, although see upside risk to medium-term forecasts should KMD execute on its international growth path faster/stronger than anticipated. KMD will release its 1H20 result on 30 March 2020.

Delving deeper into Rip Curl

The investor day showcased Rip Curl and provided greater detail on the group strategy, which we view positively. We expect Rip Curl underlying growth will be largely in line with the broader surf category; however, the brand's global reach and channel expertise offer opportunities to deliver group earnings growth through the following:

- **Revenue synergies** — Leveraging Rip Curl's expertise in the wholesale channel to accelerate international growth of the Kathmandu brand.
- **Supply chain efficiencies** — Scale benefits and systems integrations are likely to unlock modest efficiencies and be beneficial for gross margin.
- **Lower seasonal risk** — Rip Curl's geographic diversity and strength in summer apparel lowers the group seasonal risk profile, and offers opportunity to leverage seasonal expertise to grow the counter-seasonal range for the respective brands.

Kathmandu (KMD)

Priced as at 07 Feb 2020 (NZ\$)

3.44
12-month target price (NZ\$)*
3.30

Expected share price return

-4.1%

Net dividend yield

5.3%

Estimated 12-month return

1.2%

Spot valuations (NZ\$)

1. DCF

3.08

2. Sum of the parts

3.18

3. n/a

n/a

Key WACC assumptions

Risk free rate

2.00%

Equity beta

1.16

WACC

10.4%

Terminal growth

1.5%

DCF valuation summary (NZ\$m)

Total firm value

1,160

(Net debt)/cash

(250)

Less: Capitalised operating leases

Value of equity

910

Profit and Loss Account (NZ\$m)						Valuation Ratios					
	2018A	2019A	2020E	2021E	2022E		2018A	2019A	2020E	2021E	2022E
Sales revenue	497.4	545.6	891.9	1,086.5	1,118.3	EV/EBITDA (x)	11.1	10.1	7.8	6.9	6.6
Normalised EBITDA	89.8	99.6	139.3	170.3	177.5	EV/EBIT (x)	13.3	11.9	9.5	8.4	8.1
Depreciation and amortisation	(15.0)	(15.3)	(24.3)	(29.5)	(31.1)	PE (x)	14.3	13.7	12.7	10.9	10.3
Normalised EBIT	74.8	84.3	115.0	140.7	146.4	Price/NTA (x)	24.2	13.9	18.3	10.9	7.8
Net interest	(1.1)	(2.9)	(4.1)	(11.4)	(9.4)	Free cash flow yield (%)	6.0	4.7	6.3	8.2	10.0
Associate income						Net dividend yield (%)	4.4	4.7	4.9	5.5	6.1
Tax	(23.1)	(23.7)	(33.8)	(39.5)	(41.8)	Gross dividend yield (%)	6.1	6.5	6.9	7.7	8.5
Minority interests						Capital Structure					
Normalised NPAT	50.7	56.8	77.0	89.9	95.2	Interest cover EBIT (x)	70.6	28.9	27.8	12.4	15.5
Abnormals/other						Interest cover EBITDA (x)	84.8	34.2	33.7	15.0	18.8
Reported NPAT	50.7	57.6	77.0	89.9	95.2	Net debt/ND+E (%)	6.9	4.2	23.7	20.4	16.0
Normalised EPS (cps)	24.0	25.1	27.1	31.6	33.5	Net debt/EBITDA (x)	0.3	0.2	1.4	1.0	0.8
DPS (cps)	15.0	16.0	17.0	19.0	21.0	Key Ratios					
Growth Rates							2018A	2019A	2020E	2021E	2022E
Revenue (%)	11.7	9.7	63.5	21.8	2.9	Return on assets (%)	12.2	14.2	10.6	12.8	13.3
EBITDA (%)	26.7	10.9	39.9	22.3	4.2	Return on equity (%)	12.1	13.0	11.9	13.1	13.2
EBIT (%)	31.2	12.7	36.4	22.4	4.1	Return on funds employed (%)	13.3	12.9	12.3	11.5	11.9
Normalised NPAT (%)	33.2	12.2	35.6	16.7	5.9	EBITDA margin (%)	18.0	18.2	15.6	15.7	15.9
Normalised EPS (%)	28.4	4.8	7.7	16.7	5.9	EBIT margin (%)	15.0	15.4	12.9	13.0	13.1
Ordinary DPS (%)	15.4	6.7	6.3	11.8	10.5	Capex to sales (%)	3.4	2.9	3.8	3.1	3.3
Cash Flow (NZ\$m)						Capex to depreciation (%)	112	103	139	114	118
EBITDA	89.8	99.6	139.3	170.3	177.5	Imputation (%)	100	100	100	100	100
Working capital change	6.4	(8.8)	(6.2)	(5.7)	8.1	Pay-out ratio (%)	63	64	63	60	63
Interest & tax paid	(20.6)	(29.1)	(37.9)	(50.8)	(51.2)	Operating Performance					
Other							2018A	2019A	2020E	2021E	2022E
Operating cash flow	75.6	61.7	95.1	113.7	134.3	Divisional sales (NZ\$m)					
Capital expenditure	(16.7)	(15.7)	(33.7)	(33.7)	(36.7)	New Zealand	143.0	138.6	140.7	144.3	147.2
(Acquisitions)/divestments	(82.7)	(22.3)	(368.0)			Australia	333.7	338.7	350.3	357.6	369.9
Other	(22.2)	22.3				International (incl Oboz)	20.8	68.3	73.4	80.0	84.0
Funding available/(required)	(46.0)	46.0	(306.6)	80.0	97.6	Rip Curl			327.5	504.6	517.2
Dividends paid	(27.2)	(33.9)	(48.4)	(54.0)	(59.7)	Total store sales	497.4	545.6	891.9	1,086.5	1,118.3
Equity raised/(returned)	48.7		177.0			Divisional EBITDA (NZ\$m)					
(Increase)/decrease in net debt	(24.5)	12.1	(177.9)	26.0	37.9	New Zealand	35.2	33.9	31.2	31.8	30.8
Balance Sheet (NZ\$m)						Australia	57.7	59.5	59.8	60.5	63.7
Working capital	52.6	62.4	196.9	202.6	194.5	International (incl Oboz)	1.9	9.1	13.2	18.4	19.6
Fixed assets	63.5	60.3	106.7	110.8	116.5	Rip Curl			38.4	63.3	67.1
Intangibles	390.3	386.1	595.8	595.8	595.8	Unallocated	(5.0)	(3.0)	(3.3)	(3.6)	(3.8)
Right of use asset						Total EBITDA	89.8	99.6	139.3	170.3	177.5
Other assets	27.3	5.0	31.5	31.5	31.5	Divisional EBITDA margin					
Total funds employed	533.7	513.8	930.8	940.7	938.2	New Zealand	25%	24%	22%	22%	21%
Net debt/(cash)	31.4	19.3	201.2	175.2	137.3	Australia	17%	18%	17%	17%	17%
Lease liability						International (incl Oboz)	9%	13%	18%	23%	23%
Other liabilities	82.0	52.4	80.2	80.2	80.2	Rip Curl	n/a	n/a	12%	13%	13%
Shareholder's funds	420.4	442.1	649.4	685.2	720.7	Total store sales	18%	18%	16%	16%	16%
Minority interests											
Total funding sources	533.7	513.8	930.8	940.7	938.2						

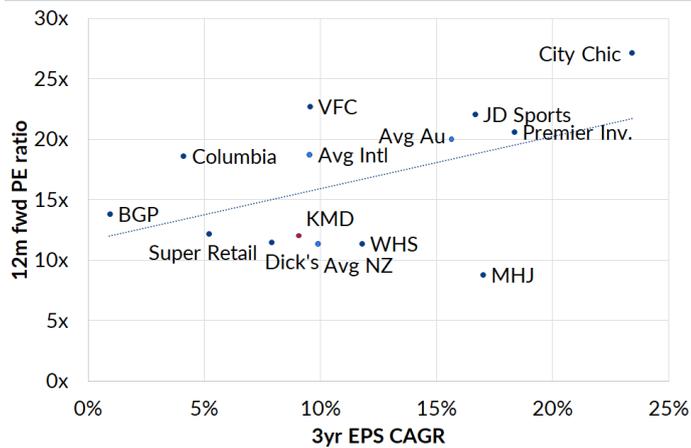
* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Investor day and trading update

KMD hosted an upbeat investor day with an encouraging trading update and greater detail on its revised group strategy following the acquisition of Rip Curl.

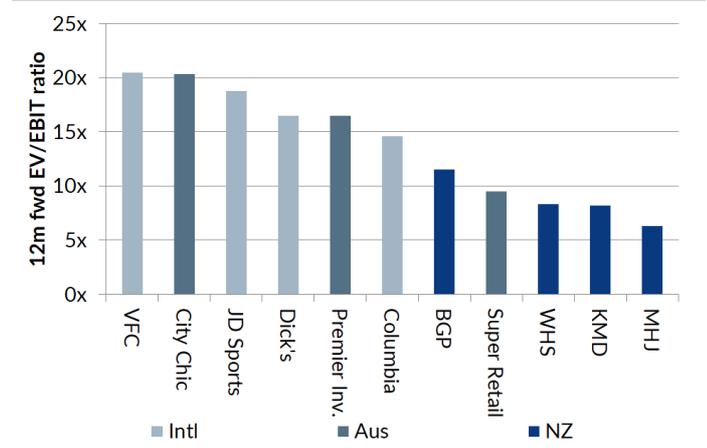
We lift our target price +NZ\$0.30 to NZ\$3.30 reflecting 1) peer multiple expansion and 2) a lower seasonal risk discount on the back of the Rip Curl acquisition. Given the early stages of the revised group strategy and acquisition integration risk we currently see the risk/reward as balanced and retain a NEUTRAL rating.

Figure 1. Consensus fwd PE ratio vs EPS growth



Source: Bloomberg, Forsyth Barr analysis

Figure 2. Consensus fwd EV/EBIT



Source: Bloomberg, Forsyth Barr analysis

1H20E trading update

KMD provided first time 1H20E EBIT guidance of circa +40% growth on the prior year period, implying 1H20E EBIT of NZ\$29.3m (FB NZ\$28.6m). Guidance is on a pre-adoption of IFRS16 basis and reflects both the acquisition of Rip Curl and underlying store growth from both its Kathmandu and Oboz brands. Sales growth across the group is encouraging given recent negative sentiment for Australian retailers from 1) the bushfire impact and 2) lacklustre trading updates from peers.

Following the trading update, we remain comfortable with our FY20E forecasts. However, we see upside risk to our medium-term earnings forecasts should KMD execute on its international expansion faster/stronger than anticipated.

Divisional detail

- Kathmandu** – The Kathmandu brand (Australia and New Zealand) achieved 1H20 same store sales (SSS) growth on +1.5% of the prior year period, largely consistent with our full year run rate. Whilst a positive sales outcome given the retail backdrop, 1H20E gross margins were suppressed at ~62.8% (in line with expectations). We note the key trading period is still to come with Kathmandu branded sales weighted to winter (2H20).
- Oboz** – Continues to perform strongly, albeit slightly behind our expectations, with 1H20 sales growth of ~+10% on the prior period.
- Rip Curl** – Having completed the acquisition of Rip Curl on 31 October 2019, KMD has a full three month period of contribution in its interim result. For this period, Rip Curl sales are up ~+2.7% on the prior comparable three month period, in line with our full year run rate. This includes a particularly strong, direct to consumer, Australia result, with sales up +8.3% on a comparable basis, encouraging for its key trading period (summer).

Coronavirus disruption has been limited to date

The coronavirus is an evolving situation and nigh on impossible to predict the financial impact. From a supply point of view, KMD sources product from a diverse range of sources across Asia, including China. There has been limited impact to date, with sufficient inventory levels held across the group and helped by the longer stock turn nature of certain product categories. KMD indicated it has a mitigation plan should there be any prolonged disruption. The company notes that it has yet to see any significant impact to demand.

Delving deeper into Rip Curl

KMD's investor day provided greater detail on its recent acquisition of Rip Curl and updated group strategy. Rip Curl is a globally recognised retail brand focussed on the surf category. Central to the business is its leadership in the wetsuit category, with the company showcasing its product innovation at the investor day. Although wetsuits only represent ~16% of Rip Curl's product sales, continued success in wetsuits is pivotal to sales success for the brand, in our opinion, as it creates sell through opportunities for its other products. We suspect Rip Curl has built significant brand equity in this area over the years.

Group earnings growth is expected to be driven through 1) an acceleration of the Kathmandu brand's international expansion, 2) some margin opportunities through scale benefits, and we also see benefits from 3) the reduction in seasonal earnings risk.

1. Leverage channel expertise and create revenue synergies

The opportunity for revenue synergies is a key area of upside for investors, in our opinion. International expansion is set to be a key growth driver for Kathmandu brand earnings, in particular through wholesale channels in North America and Europe. Rip Curl offers KMD experience in the wholesale channel (~40% of Rip Curl sales are wholesale) and existing relationships. Of Rip Curl's top 20 wholesale accounts in Europe, 17 also distribute other outdoors product and could carry Kathmandu and Oboz gear. Progression of international growth is likely to a key focus for investors going forward.

2. Costs synergies exist, although limited

Opportunities for modest cost synergies exist through integration of both supply chain and IT systems. Integration takes time and we do not expect to see material benefits in the near term.

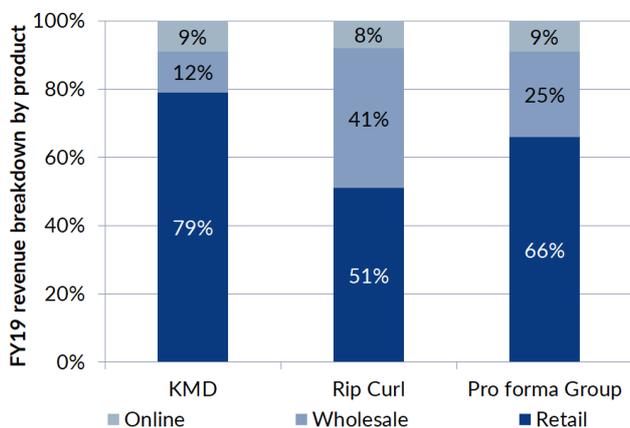
- **Supply chain** – The combination of Kathmandu and Rip Curl provides an opportunity for the group to both leverage its scale in product/material sourcing and streamline its supply chain in order to gain efficiencies and lift gross margin.
- **Systems and IT** – System integration across the three brands should create efficiencies. One opportunity is the online channel, where the Kathmandu brand is relatively more established with expertise applicable for other brands.

3. Leverage seasonal expertise and reduce seasonality risk

The acquisition of Rip Curl reduces the seasonal risk associated with the Kathmandu brand. ~75% of Kathmandu brand earnings (EBIT) are second half weighted given the all important Southern Hemisphere winter sales. By comparison, Rip Curl's geographic spread means it is a lot less seasonal, with a relatively even half split.

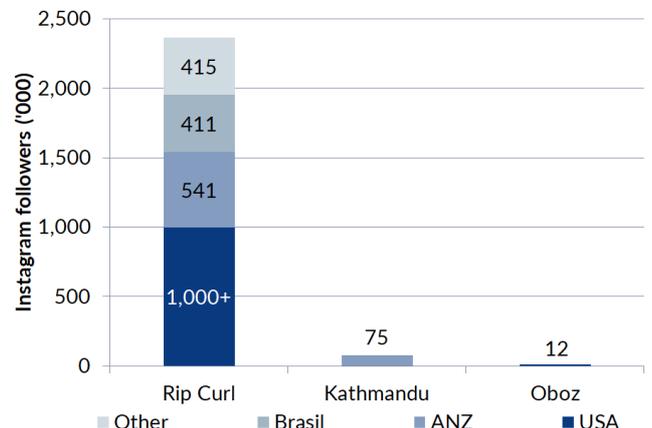
Group strategy involves expanding the counter seasonal product range of both brands (i.e. summer range for Kathmandu and winter range for Rip Curl) by leveraging product design knowledge across the group. Management emphasised that both brands will remain separate and true to the respective core competencies of outdoor and surf.

Figure 3. Sales breakdown by channel



Source: Company reports, Forsyth Barr analysis

Figure 4. Social media 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.

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 16.3% stake.

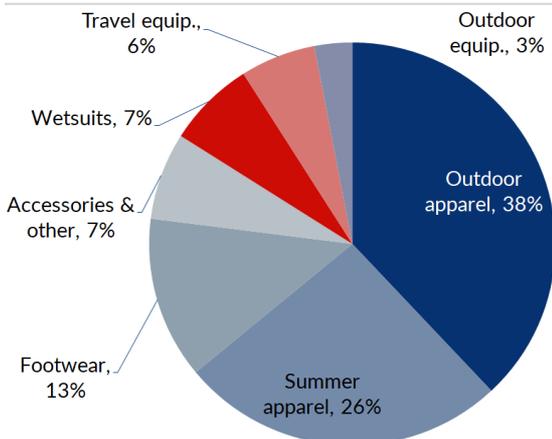
Earnings and cashflow outlook

- **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.
- **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.

Risk factors

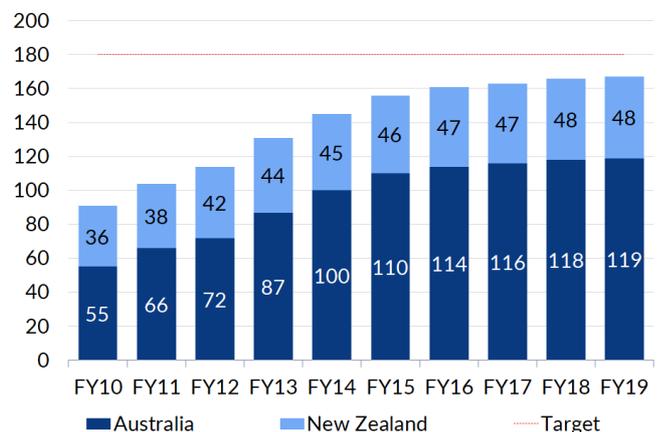
- **Earnings predictability:** A risk given the high seasonality and lumpy nature of earnings which are weighted to its winter sale. Rip Curl acquisition reduces singular season risk.
- **Consumer sentiment and cost inflation:** Deterioration in economic conditions. Cost inflation, particularly rising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

Figure 5. FY19 pro forma revenue breakdown (incl. Rip Curl)



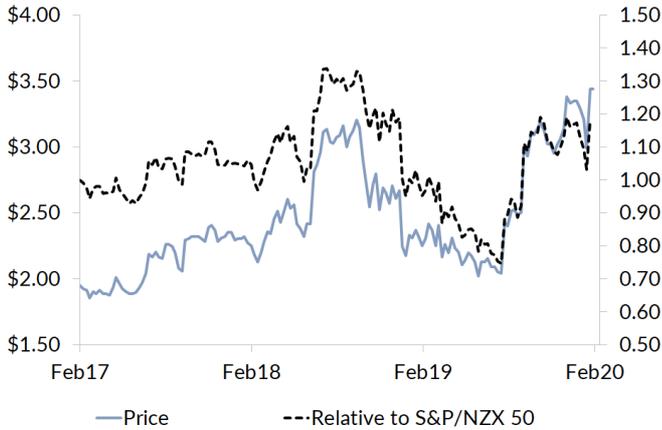
Source: Company report, Forsyth Barr analysis

Figure 6. Australasian Kathmandu store footprint



Source: Company report, Forsyth Barr analysis

Figure 7. Price Performance



Source: Forsyth Barr analysis

Figure 8. Substantial Shareholders

Shareholder	Latest Holding
Briscoe Group	16.3%
TA Universal	12.0%
Harbour Asset Management & Jarden Securities Limited	9.3%
ACC	5.0%

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

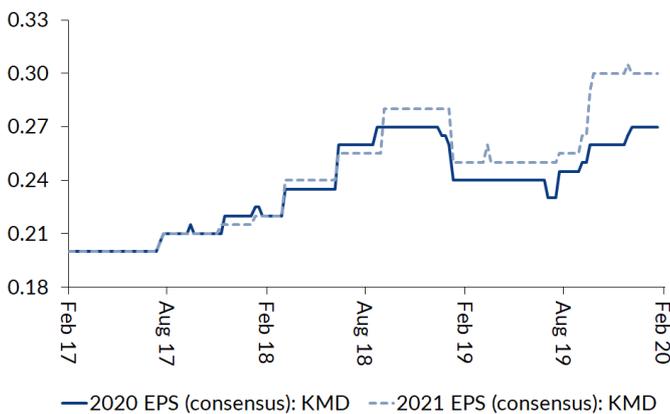
Figure 9. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
<i>(metrics re-weighted to reflect KMD's balance date - July)</i>										
Kathmandu Holdings	KMD NZ	NZ\$3.44	NZ\$978	12.7x	10.9x	7.2x	5.9x	8.7x	7.1x	5.5%
Briscoe Group *	BGP NZ	NZ\$4.00	NZ\$889	14.0x	13.9x	8.7x	8.6x	9.3x	9.2x	5.6%
Michael Hill Intl *	MHJ NZ	A\$0.66	A\$256	9.0x	8.8x	4.5x	4.3x	6.6x	6.4x	7.9%
Restaurant Brands NZ *	RBD NZ	NZ\$13.10	NZ\$1,634	36.8x	31.9x	17.4x	15.6x	26.8x	23.8x	
The Warehouse Group *	WHS NZ	NZ\$2.60	NZ\$902	11.8x	10.2x	5.6x	4.9x	8.5x	7.5x	7.1%
Dick's Sporting Goods Inc	DKS US	US\$46.26	US\$4,066	12.5x	11.7x	10.7x	10.5x	17.0x	16.6x	2.6%
Premier Investments	PMV AT	A\$20.11	A\$3,187	22.1x	19.7x	14.7x	13.3x	17.7x	15.7x	4.1%
VF Corp	VFC US	US\$84.51	US\$33,358	24.6x	21.9x	17.9x	16.7x	21.9x	19.8x	2.5%
Columbia Sportswear Co	COLM US	US\$94.71	US\$6,395	19.1x	17.8x	12.5x	13.2x	15.9x	14.7x	1.2%
Compcpo Average:				18.7x	17.0x	11.5x	10.9x	15.5x	14.2x	3.9%
KMD Relative:				-32%	-36%	-38%	-46%	-44%	-50%	42%

EV = Current Market Cap + Actual Net Debt

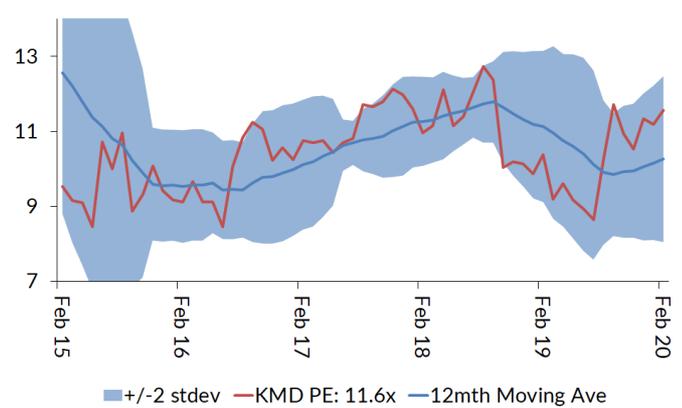
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcpo metrics re-weighted to reflect headline (KMD) companies fiscal year end

Figure 10. Consensus EPS momentum



Source: Forsyth Barr analysis

Figure 11. 12 Month Forward PE



Source: Forsyth Barr analysis

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