FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | RETAIL | OUTDOOR APPAREL & EQUIPMENT
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Kathmandu Holdings
FY20 Result — The Outdoors Beckon

GUY HOOPER
guy.hooper@forsythbarr.co.nz
+64 4 495 5255

OUTPERFORM

Kathmandu (KMD) delivered a solid FY20 result, materially ahead of guidance and market expectations, as a surge in post-lockdown activity and favourable category exposure provided tailwinds. Outlook commentary was limited given the backdrop of fluid COVID-19 restrictions, however, we lift our near-term margin expectations on the back of cost out execution. We expect KMD to continue to benefit from favourable category exposure, helped by its brand portfolio and strong technical offering. We view current multiples (11x two year forward PE) as an attractive entry point and reiterate OUTPERFORM. Our target price increases +10% to NZ$1.65 following cost of capital changes.

NZX Code	KMD
Share price	NZ$1.21
Target price	NZ$1.65
Risk rating	High
Issued shares	649.2m
Market cap	NZ$785m
Avg daily turnover	1,697k (NZ$1,973k)

Financials: Jul/	20A	21E	22E	23E
NPAT* (NZ$m)	36.1	44.1	72.1	83.9
EPS* (NZc)	4.5	6.8	11.1	12.9
EPS growth* (%)	-74.6	52.6	63.5	16.3
DPS (NZc)	0.0	4.0	7.0	9.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
PE	27.2	17.8	10.9	9.4
EV/EBIT	14.2	11.2	7.1	6.2
EV/EBITDA	9.6	7.7	5.6	5.1
Price / NTA	8.1	7.8	6.7	5.7
Cash div yld (%)	0.0	3.3	5.8	7.4
Gross div yld (%)	0.0	4.6	8.0	10.3

FY20 result ahead of expectations as sales surge post-lockdown

KMD reported FY20 underlying EBITDA of NZ$83m, well ahead of guidance (in excess of NZ$70m) and market expectations (consensus NZ$72m). Following weeks of home confinement, consumers were left longing for the outdoors, supporting adventure retail, with both Kathmandu and Rip Curl experiencing a significant acceleration in sales post-lockdown. Timing was favourable for the Kathmandu brand, with the surge of activity coinciding with its key winter sales period, reducing any clearance stock burden, favourable for margins. KMD also achieved reasonable cost out/cost synergies across the group, which are expected to deliver c. NZ$15m in annualised savings. Unsurprisingly, online sales surged, up +63% for the group against the prior comparable period. Online penetration increased to 15.7% of direct to consumer sales (FY19 8.8%), led by the Kathmandu brand.

Healthy balance sheet

KMD has significantly reduced its gearing (FY20 net debt to EBITDA 0.1x), with c. NZ$380m of headroom under its current facility. Good cost control and better than expected trading enabled strong cashflows. Inventory levels appear reasonable, as KMD executed inventory management, lowering the risk of heightened clearance activity. KMD will not pay a final dividend. We expect to see dividends reinstated in FY21.

Outlook uncertain but positive signs

KMD did not provide any formal guidance but signalled mixed recent (first seven weeks) trading. This includes the impact of a number of locations still exposed to significant COVID-19 disruption and represents a seasonally low sales period for KMD. Forward commentary was more encouraging with 2H21 wholesale orders approaching pre COVID-19 levels. We maintain our FY21 assumption that group sales remain below pre COVID-19 levels, although have lifted our margin expectations accounting for 1) annualised cost savings realised in FY20, and 2) partial reversal of foreign exchange headwinds. Any signs of sustained positive same store sales represents upside to our forecasts. Our FY22 forecasts assume a recovery to comparable pre COVID-19 (FY19) group earnings.

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Kathmandu (KMD)

Priced as at 23 Sep 2020 (NZ$)	1.21

12-month target price (NZ$)*	**1.65**
Expected share price return	36.4%
Net dividend yield	3.7%
Estimated 12-month return	40.1%

Spot valuations (NZ$)	
1. DCF	1.68
2. Sum of the parts	1.40
3. n/a	n/a

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	1.16
WACC	8.3%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	1,163
(Net debt)/cash	(73)
Less: Capitalised operating leases	
Value of equity	1,090

Profit and Loss Account (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Sales revenue	545.6	801.5	922.8	993.8	1,033.0
Normalised EBITDA	**99.6**	**83.4**	**102.7**	**140.8**	**154.5**
Depreciation and amortisation	(15.3)	(103.0)	(32.2)	(30.6)	(27.9)
Normalised EBIT	**84.3**	**56.2**	**70.5**	**110.3**	**126.7**
Net interest	(2.9)	(23.4)	(7.1)	(6.5)	(5.9)
Associate income	0	0	0	0	0
Tax	(23.7)	(13.6)	(19.4)	(31.7)	(36.8)
Minority interests	0	0	0	0	0
Normalised NPAT	**56.8**	**36.1**	**44.1**	**72.1**	**83.9**
Abnormals/other	0.8	(16.9)	0	0	0
Reported NPAT	**57.6**	**19.2**	**44.1**	**72.1**	**83.9**
Normalised EPS (cps)	17.6	4.5	6.8	11.1	12.9
DPS (cps)	16.0	0	4.0	7.0	9.0

Valuation Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EV/EBITDA (x)	8.1	9.6	7.7	5.6	5.1
EV/EBIT (x)	9.6	14.2	11.2	7.1	6.2
PE (x)	6.9	27.2	17.8	10.9	9.4
Price/NTA (x)	7.0	8.1	7.8	6.7	5.7
Free cash flow yield (%)	5.9	19.1	4.9	8.9	9.1
Net dividend yield (%)	13.2	0.0	3.3	5.8	7.4
Gross dividend yield (%)	18.4	0.0	4.6	8.0	10.3

Capital Structure	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Interest cover EBIT (x)	28.9	2.4	10.0	17.0	21.3
Interest cover EBITDA (x)	34.2	3.6	14.6	21.7	26.0
Net debt/ND+E (%)	4.2	1.2	-0.4	-3.5	-5.2
Net debt/EBITDA (x)	0.2	0.1	n/a	n/a	n/a

Growth Rates	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Revenue (%)	9.7	46.9	15.1	7.7	3.9
EBITDA (%)	10.9	-16.2	23.2	37.1	9.7
EBIT (%)	12.7	-33.3	25.5	56.4	14.9
Normalised NPAT (%)	12.2	-36.5	22.1	63.5	16.3
Normalised EPS (%)	4.8	-74.6	52.6	63.5	16.3
Ordinary DPS (%)	6.7	-100.0	n/a	75.0	28.6

Key Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Return on assets (%)	14.2	3.6	4.6	7.2	8.3
Return on equity (%)	13.0	2.5	5.6	9.0	10.2
Return on funds employed (%)	12.9	6.3	6.3	9.9	11.4
EBITDA margin (%)	18.2	10.4	11.1	14.2	15.0
EBIT margin (%)	15.4	7.0	7.6	11.1	12.3
Capex to sales (%)	2.9	2.5	3.3	3.4	3.3
Capex to depreciation (%)	103	19	93	110	121
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	91	0	59	63	70

Cash Flow (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EBITDA	**99.6**	**83.4**	**102.7**	**140.8**	**154.5**
Working capital change	(8.8)	123.4	(7.9)	0.6	(6.6)
Interest & tax paid	(29.1)	(37.0)	(26.4)	(38.2)	(42.8)
Other	0	0	0	0	0
Operating cash flow	**61.7**	**169.8**	**68.4**	**103.2**	**105.2**
Capital expenditure	(15.7)	(19.9)	(30.0)	(33.7)	(33.7)
(Acquisitions)/divestments	(22.3)	(376.1)	0	0	0
Other	22.3	76.7	0	0	0
Funding available/(required)	**46.0**	**(149.4)**	**38.4**	**69.5**	**71.5**
Dividends paid	(33.9)	(27.2)	(26.0)	(45.4)	(58.4)
Equity raised/(returned)	0	340.6	0	0	0
(Increase)/decrease in net debt	**12.1**	**164.0**	**12.4**	**24.1**	**13.1**

Operating Performance	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Divisional sales (NZ$m)					
Kathmandu	477.3	426.4	438.7	469.8	490.3
Oboz	68.3	59.4	61.7	67.8	70.6
Rip Curl	0	315.7	422.4	456.2	472.1
Total store sales	**545.6**	**801.5**	**922.8**	**993.8**	**1,033.0**
Group gross margin	**63%**	**61%**	**58%**	**58%**	**59%**
Divisional EBITDA (NZ$m)					
Kathmandu	93.4	69.9	74.3	91.9	97.9
Oboz	9.1	6.6	8.7	10.0	10.9
Rip Curl	0	11.7	24.7	44.1	51.1
Unallocated	(3.0)	(4.8)	(5.0)	(5.2)	(5.4)
Total EBITDA	**99.6**	**83.4**	**102.7**	**140.8**	**154.5**
Divisional EBITDA margin					
Kathmandu	20%	16%	17%	20%	20%
Oboz	13%	11%	14%	15%	15%
Rip Curl	n/a	4%	6%	10%	11%
Total store sales	**18%**	**10%**	**11%**	**14%**	**15%**

Balance Sheet (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Working capital	62.4	158.8	166.7	166.1	172.6
Fixed assets	60.3	90.7	88.5	91.7	97.5
Intangibles	386.1	682.6	682.6	682.6	682.6
Right of use asset	0	258.0	224.3	195.1	169.6
Other assets	5.0	7.8	7.8	7.8	7.8
Total funds employed	**513.8**	**1,197.8**	**1,169.9**	**1,143.2**	**1,130.2**
Net debt/(cash)	19.3	9.4	(3.1)	(27.2)	(40.2)
Lease liability	0	297.9	278.9	258.8	238.4
Other liabilities	52.4	111.3	111.3	111.3	111.3
Shareholder's funds	442.1	779.2	782.7	800.2	820.7
Minority interests	0	0	0	0	0
Total funding sources	**513.8**	**1,197.8**	**1,169.9**	**1,143.2**	**1,130.2**

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

FY20 result

Key result take outs

- **COVID-19 impacted FY20**
  - Kathmandu largely in line — FY20 sales fell -12% on the prior comparable period (c. +5% after adjusting for store closures), broadly in line with our expectations. Gross margin declined to 62.2% (FY19 64.8%) as a result of foreign currency movements, and sales mix.
  - Rip Curl less worse than expected — FY20 sales fell -17% on the prior comparable period (equivalent nine months). The wholesale channel experienced disruption through its sell-in period for the Northern hemisphere Autumn/Winter season.
- **Sales accelerated as markets emerged from lockdowns** — Following lockdown, consumers emerged with a longing for the outdoors, leading to an acceleration in sales.
  - Kathmandu direct to consumer (DTC) same-store-sales (SSS) increased +6.9% post lockdown (+14.4% pre-lockdown).
  - Rip Curl DTC SSS increased +14.4% post-lockdown (+2.6% pre- lockdown). Australia and Europe were particularly strong, however, Hawaii remains at subdued levels with more exposure to tourism spend.
- **Online sales penetration surged** — FY20 direct to consumer group online sales increased +63%, driven by a surge in April to July, where Kathmandu and Rip Curl online sales increased +96% and +115% respectively on the prior comparable period.
  - Online penetration increased to 16% of total DTC (Kathmandu 18.5%, Rip Curl 10.6%).
- **Cost out execution** — KMD delivered a mixture of cost savings and cost synergies across the Kathmandu and Rip Curl brands. These are expected to result in annualised group savings of c. NZ$15m.
- **Wage subsidies** — Included in the period is NZ$16m in wage subsidy. In addition there was NZ$4.2m received as part of the paycheck protection program loans in the US. This is currently recognised as a liability but is expected to be forgiven and flow through comprehensive income in FY21.
- **Balance sheet** — FY20 net debt NZ$9.3m, better than expected. Supported by good inventory control, cost out execution, and rent accurals (c. NZ$15m).

Outlook comments

KMD did not provide any formal guidance, and outlook commentary was limited given the level of market uncertainty. KMD expects to be in a position to resume dividends in FY21.

- **Recent trading commentary** — *"The Group has experienced mixed same store sales performance over the first seven weeks of FY21."* Mixed trading is largely as a result of ongoing COVID-19 disruption, such as secondary lockdowns in Victoria and Auckland. Positive demand in other areas is encouraging. To provide context, a flat FY21 sales outcome would represent upside to our forecasts.
  - The first seven weeks is a seasonally low point for KMD, in addition it is cycling a reasonable comparable period. We currently assume sales remain at suppressed levels in FY21, with any signs of positive same store sales upside to our forecasts.
- **Wholesale order book improving** — Commentary suggests KMD is seeing a recovery in its forward order book (2H21) with scope to be at pre COVID-19 levels (upside to forecasts).
  - First half orders are largely infill, and therefore we have more limited insight.
- **Margin expectations** — 1H21 gross margin expected to be in line with FY20 with some improvement in 2H21 (c. +100bp) as foreign exchange headwinds unwind. We take a slightly more conservative view at this stage, given the risk of recurring lockdowns and possibility of higher clearance sales mix.

Earnings changes and valuation

We lift our FY21E margin expectations accounting for 1) annualised cost savings realised in FY20, and 2) good inventory control reducing the need for discounting. Our earnings assumptions remain behind pre COVID-19 (i.e. FY19) levels in FY21E, reflecting ongoing COVID-19 disruption risk and economic uncertainty. Following a strong end to FY20, we now expect dividends to be reinstated at 1H21. Our underlying EBITDA forecasts are on a pre IFRS-16 basis.

Figure 1. Earnings changes (NZ$m)

		FY21E			FY22E			FY23E	
	Old	**New**	**% chg**	**Old**	**New**	**% chg**	**Old**	**New**	**% chg**
Sales	921.5	922.8	0.1%	989.6	993.8	0.4%	1,035.4	1,033.0	-0.2%
Underlying EBITDA	**93.3**	**102.7**	**10.1%**	**138.5**	**140.8**	**1.7%**	**155.9**	**154.5**	**-0.9%**
Normalised NPAT	40.4	43.5	7.6%	71.4	71.7	0.4%	83.1	83.6	0.6%
Underlying EPS (cps)	6.2	6.7	7.6%	11.0	11.0	0.4%	12.8	12.9	0.6%
DPS (cps)	3.0	4.0	33.3%	7.0	7.0	-	9.0	9.0	-

Source: Forsyth Barr analysis

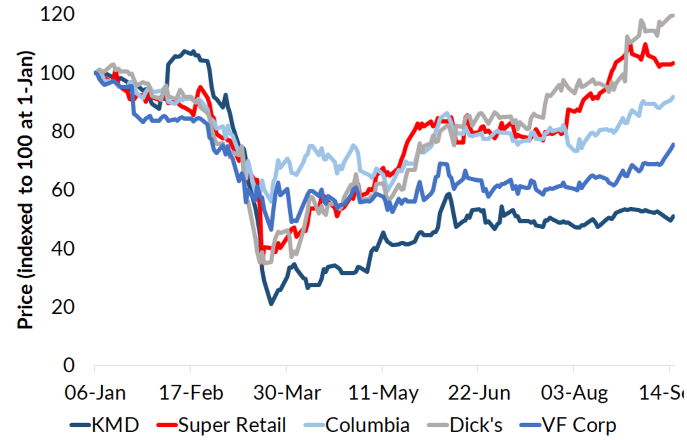
Target price increased to NZ$1.65; Reiterate OUTPERFORM

We lift our target price +NZ$0.15 to NZ$1.65 (+10%), largely reflecting our cost of capital changes. Our WACC estimate has fallen from 10.4% to 8.3% following changes to our risk free rate (from 2.0% to 1.3%) and market risk premium (from 7.5% to 6.0%), consistent with our strategy report, *The Cost of Capital Conundrum When TINA Came to Our Shores*, published 7 August 2020.

We expect the outdoor category to maintain its recent relative strength, with ongoing border restrictions in the key markets of Australia and New Zealand, supporting domestic adventure tourism. KMD offers exposure to the category through leading brands, supported by a loyal customer base, with a good track record. Although fluid social distancing restrictions in key markets and an unfolding economic picture create a level of uncertainty, we believe investors are compensated for that risk. KMD is trading at 11x two year forward PE, a discount to retail peers, and has lagged the post-lockdown rally of the sector. OUTPERFORM.

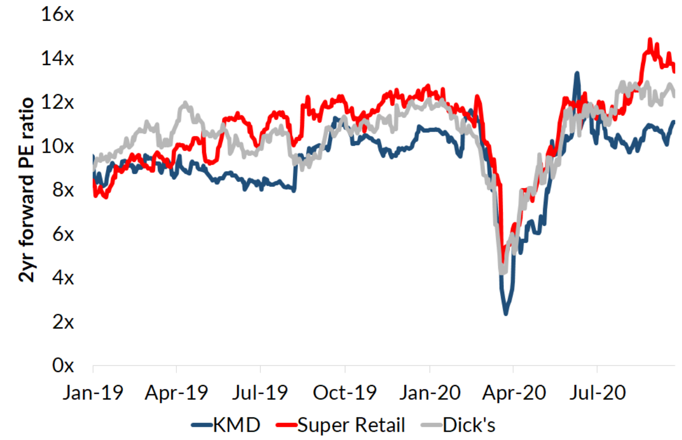
Charts of interest

Figure 2. KMD has lagged recovery in outdoor retail peers



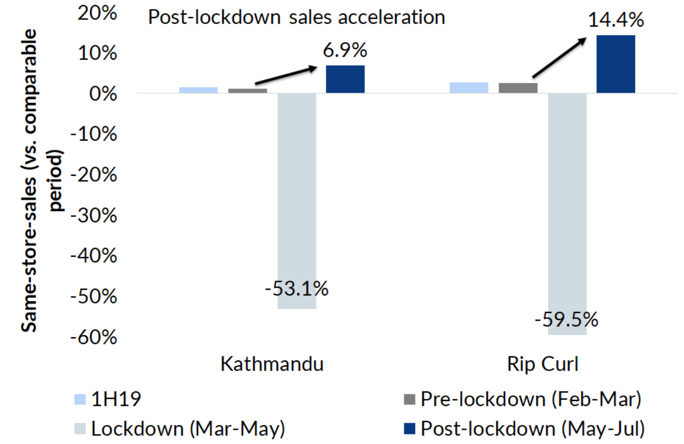
Source: Bloomberg, Forsyth Barr analysis

Figure 3. And is trading at a discount — two year forward PE



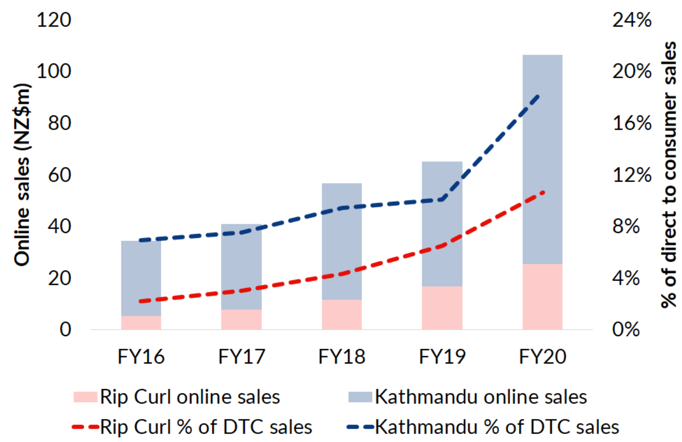
Source: Bloomberg, Forsyth Barr analysis

Figure 4. Sales accelerated post-lockdown — particularly surf



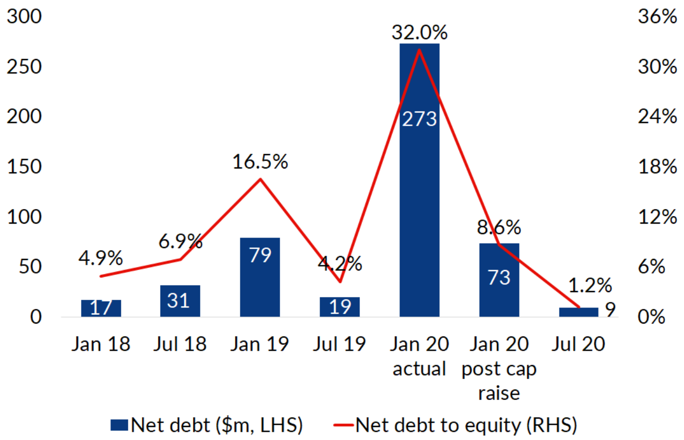
Source: Company reports, Forsyth Barr analysis

Figure 5. Online accelerated — led by Kathmandu brand



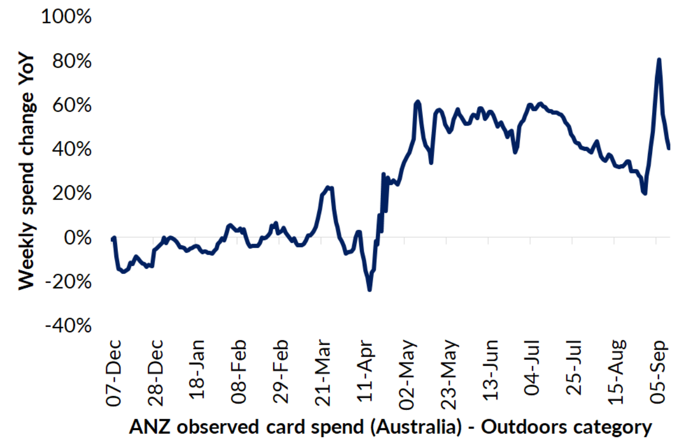
Source: Company reports, Forsyth Barr analysis

Figure 6. Balance sheet in good position



Source: Company reports, Forsyth Barr analysis

Figure 7. Consumer spending on outdoors remains strong



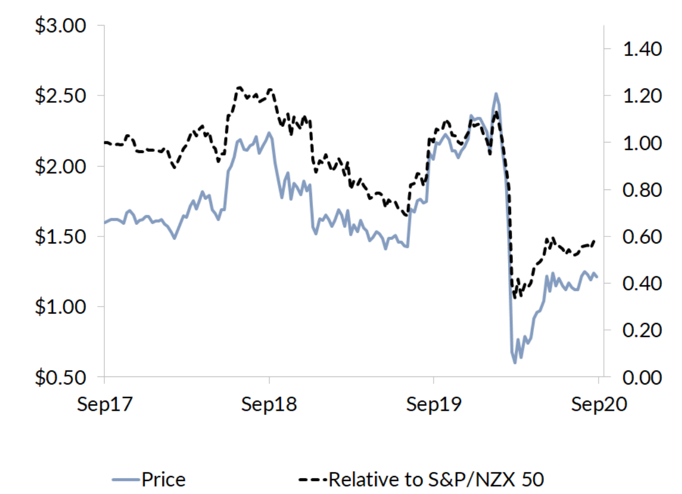
Source: ANZ, Forsyth Barr analysis

Figure 8. FY20 result breakdown (NZ$m)

	FY19	FY20	% chg	Comments
Profit and Loss Account				
Sales	538.9	801.5	+48.7%	Nine months of Rip Curl contribution
Cost of Sales	(206.4)	(334.5)	-62.1%	
Gross Profit	**332.5**	**467.0**	**+40.5%**	Margin 58.3% (FY19 61.7%)
SG&A Costs	(234.0)	(383.7)	-64.0%	Wage subsidy provided a c.$16m net benefit
Underlying EBITDA	**98.4**	**83.4**	**-15.2%**	Reported EBITDA NZ$149m (NZ$82m IFRS 16 uplift, less NZ$16.2m in adjustments)
Depreciation & Amortisation	(15.2)	(27.2)	-78.9%	
Underlying EBIT	**83.2**	**56.2**	**-32.5%**	Margin 7.0% (FY19 15.4%)
Interest & Tax	(26.4)	(24.7)	+6.3%	Higher interest costs due to borrowings related acquisition of Rip Curl
Normalised NPAT	**56.8**	**31.5**	**-44.6%**	Adjusted for IFRS 16, Rip Curl transaction costs, and office restructure costs
Reported NPAT	57.6	8.9	-84.6%	IFRS-16 NZ$2.6m, transaction NZ$16.9m, restructure costs NZ$3.2m
Underlying EPS	17.6	4.9	-72.4%	
DPS	16.0	-	n/a	Dividend suspended. Reinstatement anticipated in FY21
Balance Sheet & Cashflow				
Operating Cashflow	61.7	93.1	+50.1%	c. NZ$15m rent accurals on balance sheet, pre IFRS16
Fixed Assets	60.3	90.7	+50.4%	Rip Curl inclusion. FY21 capex guidance NZ$25m to NZ$30m
Working Capital	62.4	158.8	+154.4%	Inventory control, clearance stock at low levels
Net Debt	19.3	9.4	-51.3%	$207m capital raise and working capital management (net debt/EBITDA 0.1x)
Shareholders Equity	442.1	779.2	+76.3%	
Divisional Analysis				
Sales - Kathmandu	472.3	426.4	-9.7%	c.$50m impact from store closures in Apr. and VIC closures in Jul
Sales - Rip Curl	-	315.7	-	c.$70m impact from pressure on wholesalers/retail trade
Sales - Oboz	44.6	37.8	-15.2%	Sales to online-wholesale customers grew despite COVID-19
Margin and Efficiency Analysis				
EBITDA - Kathmandu	89.6	66.9	-25.3%	Impacted by currency & mix. Some benefit from cost out
margin	*19%*	*16%*	*-3.3ppts*	
EBITDA - Rip Curl	-	11.7	-	$2.8m benefit from cost out (c.$8.8m annualised)
margin	*c. 10%**	*4%*	-	**comparable margin*
EBITDA - Oboz	7.9	4.8	-39.2%	Opex investment (pre COVID-19) in people/distribution
margin	*18%*	*13%*	*-5.0ppts*	

Source: Company reports, Forsyth Barr analysis

Figure 9. Price performance



Source: Forsyth Barr analysis

Figure 10. Substantial shareholders

Shareholder	Latest Holding
TA Universal	10.2%
Harbour Asset Management & Jarden Securities Limited	8.1%
Briscoe Group	6.8%
ACC	5.2%

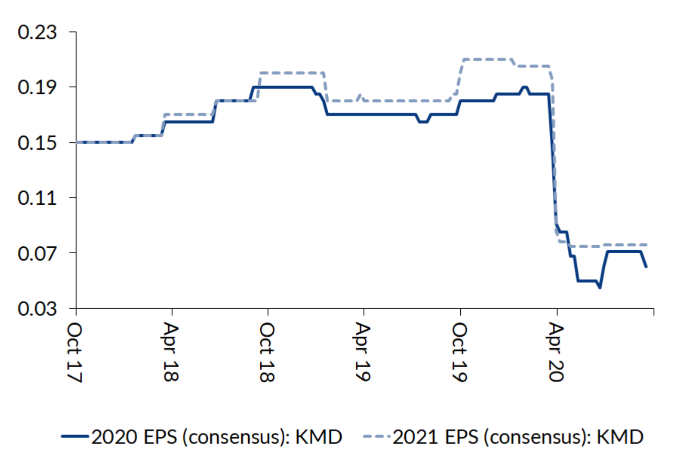
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 11. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect KMD's balance date - July)			(m)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Kathmandu Holdings	**KMD NZ**	**NZ$1.21**	**NZ$785**	**17.8x**	**10.9x**	**7.7x**	**5.6x**	**11.3x**	**7.2x**	**5.8%**
SUPER RETAIL GROUP	SUL AT	A$10.24	A$2,312	13.6x	13.5x	6.1x	6.0x	11.3x	11.3x	5.0%
VF CORP	VFC US	US$69.40	US$27,040	>50x	25.7x	27.6x	17.7x	44.3x	23.9x	2.9%
COLUMBIA SPORTSWEAR CO	COLM US	US$89.34	US$5,910	32.1x	20.5x	16.1x	12.5x	25.0x	16.8x	1.4%
DICK'S SPORTING GOODS INC	DKS US	US$56.28	US$5,016	13.5x	12.5x	10.2x	10.0x	15.3x	14.8x	2.4%
PREMIER INVESTMENTS	PMV AT	A$18.50	A$2,936	20.7x	21.1x	11.5x	12.0x	17.1x	18.3x	3.5%
MICHAEL HILL INTL *	MHJ NZ	A$0.43	A$165	7.3x	6.8x	1.8x	1.7x	4.2x	4.0x	9.0%
BRISCOE GROUP *	BGP NZ	NZ$3.91	NZ$870	14.1x	14.3x	6.5x	6.4x	8.3x	8.3x	5.9%
THE WAREHOUSE GROUP *	WHS NZ	NZ$2.05	NZ$711	9.6x	20.3x	4.7x	6.9x	7.1x	14.2x	2.9%
			Compco Average:	**15.8x**	**16.8x**	**10.6x**	**9.2x**	**16.6x**	**14.0x**	**4.1%**
EV = Current Market Cap + Actual Net Debt			**KMD Relative:**	**12%**	**-35%**	**-27%**	**-39%**	**-32%**	**-48%**	**40%**

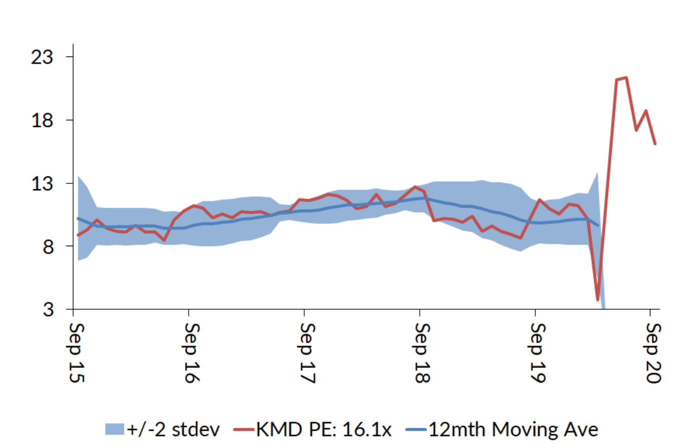
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (KMD) companies fiscal year end

Figure 12. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 13. One year forward PE (x)



Source: Forsyth Barr analysis

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