Conference Transcription

29 September 2015

Kathmandu Ltd

Full Year Results Release Investor Call

Time & Date of Recording: 10:00 AEST 29 September 2015

Subject/Title: Kathmandu Full Year Results Release Investor Call

Length of Conference (minutes): 33 minutes

Turnaround: 24 hours

Billing Code:

Company Name: Kathmandu Ltd

Moderator Name/Client ID: Sheree Dixon/1216220

E-mail recipients of transcript:

Other notes:

Start of Transcript

Operator: This is PGi. Please stand by. We're about to begin. Good day, everyone, and welcome to the Kathmandu full year results release investor call. This call is being recorded. At this time, for opening remarks, I would like to turn the conference over to your moderator for today, Mr Xavier Simonet. Please go ahead, Mr Simonet.

Xavier Simonet: Thank you, Rob, and welcome, everybody. With me today on the call is Reuben Casey, or Chief Financial Officer and we're going to be discussing our results for the 12 months ended 31 July 2015.

We'll be talking to the results and full year presentation that we filed this morning on the ASX and NZX and also on our corporate website. I presume most people have either got that or can access to that and follow me as I work my way through the flow.

We'll be presenting the results throughout in our reporting currency, which is the New Zealand dollar. The presentation will be about 20 to 30 minutes, and then we will have time for questions, with the allocated time of approximately 35 minutes.

So let me start by just running through an outline of the topics to be covered. Reuben will be presenting a number of the slides as well. He'll just take up the presentation when it's his topic to cover. I'll be starting by overviewing the results, and Reuben will run you briefly through the numbers.

Please allow me to introduce myself. I'm Xavier Simonet. I tend to say I'm the new CEO at Kathmandu, but today's the anniversary of my third month so, probably, I can't say that anymore. I can't say I'm new anymore. Let's start with the results overview.

Please turn to page 4 of the slide presentation. So we had a challenging year in FY15, which was impacted by aggressive clearance in Q1 and market downturn in the first half, but we returned to comparable sales growth at improved margins in Q4. There's nothing really new in there versus what we stated in the target Company statement.

So our sales were up 4%, but that was just driven by new store openings in Australia, while our like-for-like store sales were down in both countries. Our gross margin suffered with an improvement in the last quarter, and operating expenses were up 5.5 percentage points last year.

Reuben Casey: Okay, thanks, Xavier. Just to reinforce there's actually nothing really new in the numbers on - so the results overview. Our target statement we had a net profit after tax and after any non-recurring items of $20 million, and the final result came in at $20.4 million with - so there's really nothing new to talk about there.

[If we] move to the second half, we did have an improved gross margin outcome for the second half year-on-year, so it was really driven by less discounting in the winter period and note that our full year result includes $1.4 million post-tax non-recurring items which relate to the relocation of our Australian distribution centre and our Christchurch office, and also some costs associated with the Briscoe takeover process.

If we look at sales in a bit more depth on slide 8 you can see we did have sales growth overall, but on a same store basis we had a reduction slightly, which I'll talk to in a second. Online sales did grow by 28% year-on-year and it's now 6.2% of total sales. We opened 10 new stores during the year, and they all opened in Australia.

On a same store basis, on slide 9 - so the overall result at constant currency was a reduction in same store sales of 1.9%. You can see there the store only was a reduction of 3% in online on a like-for-like basis grew 23%.

If you think about the year, Q1 was a period of same store sales growth, and we had our aggressive clearance campaign running, as has been previously highlighted. In Q2 and Q3 we struggled, and Q4 we saw a return to same store sales growth with our winter season of 1.4% and constant currency.

Looking at gross margin now on slide 10, the key point really here is that winter we had a significant increase in our gross margin year-on-year, so up 354 basis points. This is largely due to less discounting during our winter sale. We had an increase in average selling price across that of roughly 11% which offset any currency impacts and increase in cost of product there.

Cost of doing business, on slide 11, as previously stated in our target statement and our trading update, we have had an operating increase, expense increase over and above the rate of sale increase. Half of the increases is due to operating the cost of 25 stores that were opened in the last two financial years, so the full year impact of stores open in FY14 and a part year impact of stores open during FY15. Also we increased some store labour, advertising and other head office costs in anticipation of sales growth which didn't eventuate.

Moving on to the country results, Australia - slide 14 - we had - the biggest reduction in margin was - been in Australia, particularly in the first half. We did open 10 new stores, eight in the first half and two in the second half. The cost of operating remains a lot higher in Australia than in New Zealand, which had an impact on our overall EBITDA margin.

In New Zealand - on slide 15 - we had an overall increase in gross margin, which was pleasing, but the same store sales reduction contributed to a lower EBITDA overall.

The UK, on slide 16 - so same store sales grew by 15% for the country stores - modest at 7% given the level of advertising that we were carrying out - but online grew by 79% in the full year impact of operating on Amazon UK, [Next] and also eBay UK.

Move through to cash flow. We actually had an improvement in our cash conversion year-on-year, which meant our operating cash flow wasn't as significantly impacted by the reduction in sales and profit as it could have been. We continued to invest in our store network, so we spent $20 million, which was down on last year's spend of $24 million.

You can see on the slide how that breaks down. It's important to note this is the last significant year of our core systems project, so the [ISP Microsoft Dynamics AX] Project was completed in FY15, so we did spend less on our core systems than in previous years.

Moving on the balance sheet, slide 19, we had a - we've got a small year-on-year increase in stock per store when we finished the year, 1% at constant exchange rates. Contributing to this is the timing of new season deliveries, fewer new store openings than we planned and online growth. So we need to hold more stock to support the online business.

It's important to note that we finished the year with 40% less aged stock, so stock that was still not cleared from previous selling seasons. So 40% less than the year before, which was pleasing. When we finished winter sale we had 15% less clearance year-on-year.

The final dividend is $0.05 per share, which brings our full year payout to $0.08 per share versus $0.12 per share last year. That will be paid on 20 November and the record date is 9 November.

Foreign currency: the impact of the depreciation of the Australian and the New Zealand dollar against the US dollar there. Hedging rates are approximately 10% below FY - hedging rates for FY16 are approximately 10% below FY15 and 11% below in New Zealand.

I'll hand back to Xavier to talk about what he's been doing in the last three months and what we plan to do, going forward.

Xavier Simonet: Thank you, Reuben. Based on the performance of the business we decided to take decisive action with three key focusses for FY16.

The first one is to cut costs and drive efficiencies in all areas of the business. The second is to become more customer centric in whatever we do in the stores, but also in head office, on products and also in our customer service.

The last one is to drive brand distinctiveness because, at the end of the day, yes, we are a retailer, and a very successful retailer in Australasia, but if we want to go further than that we need to drive our distinctiveness and to be able to show to customers what we stand for versus global competitors.

So the four key actions we've taken over the last three months - the first one is to look at the cost base, and we have lowered the cost base with a restructuring plan for our Australian and New Zealand support offices, which was announced last month. The restructuring plan has been completed with 10% reduction in support office staff. So the plan is now completed.

We also went through a review of our UK business and have made the decision to close all physical stores. The UK has been an unprofitable business for us for a long period of time and the Company's invested lots of money there in terms of CapEx, in terms of operating cost and also in terms of [media] investment. I think it's the right time now to refocus on our basic and to cut our losses.

So we decided to close the UK stores in the next coming months. The fact that we're closing the UK business as it is structured today - that means that we do not have an international ambition. It's quite the contrary. I've got huge international ambitions, and that's why I joined the Company and the brand three months ago. I just believe that the structure we chose for the UK business was not profitable and the business in the UK is structurally unprofitable, and decisive action needed to be taken there.

So we're going to focus this year in the UK on the business through our own online shop and also third party websites we started working with and where we're experiencing growth, with a strong focus on profitability.

The third action we are taking is we are currently going through a review of our pricing architecture and promotional model. It's widely known that we have had some complaints from customers who are saying that our offers are complex and they're a bit lost when they go to the stores, not really understand how it works.

On the other side, we know that, from our point of view, we're probably giving away too much growth margin versus what we should do. So we are currently going through this review, which should be completed in the middle of October. What we are expecting is to optimise [unclear] promotions further. It's also to review our discount architecture and our pricing model based on a review of the pricing elasticity, a review that we are doing in a very granular way at the moment.

Also we want to re-look at our regular prices versus discounted prices and take into account segmentation in terms of the product categories - what is a fruitful driver, what is a margin driver, what is a core product - and take action in terms of pricing based on that. So we will review the conclusions of the analysis in the second half of October and will take action from there.

The last action is I'm immensely excited to have joined Kathmandu because, yes, we're a great retailer, but also because I see much more potential for the brand to grow as a distinctive brand. We've already started working on activities to build the brand and to build up the brand equity with two initial tactical campaigns that are currently executed, particularly online, through social media and Summit Club, which are Spend Responsibly and Trade For New.

So these are the actions, decisive actions, we've taken in the last three months. Let me talk a bit about my view, moving forward, of the strategy. I must say that I'm now taking some time with a strong focus on reviewing the strategy, moving forward, now that the [risk] process is over.

So I've not finalised a full strategy for the business, but I'd like to highlight a few things that we're going to focus on. The first one, obviously, is to offer customers great products at accessible prices, and there is going to be a very strong focus on innovation from the team, particularly on technology, performance, but also sustainability, which is a core asset of the Company.

The second aspect is a very strong focus we're going to put on Australasia. We need to fix the business here and, in order to be able to expand internationally, we need to make sure that we have a sustainable success story in Australasia.

The first aspect is to drive efficiencies. We have cut costs already in head offices, but we need to drive efficiencies further. That means optimising labour costs in the stores. That means focussing our marketing spin on what is efficient for the business with clear metrics and a clear return on investment.

It's also, for me, very important that the teams have very clear KPIs and metrics to drive their business and the different areas in the business. Also, in terms of efficiencies, we're certainly going to put a strong focus on the buying margin and the need for us to stretch and improve our buying margin.

I've talked about the promotional model and the pricing architecture, so that's the ongoing review we're going through at the moment. I'm not going to talk about it more. What I want to discuss is the focus we're putting on like-for-like sales growth in the stores. The focus has been for the Company over the last few years to open stores and to open a large number of stores very quickly and, at the same time, drive promotions to form the store openings.

We have reached already a number of stores which is, for us, a good base. We're going to continue opening stores as the opportunities arise, but the very strong focus this year is to optimise like-for-like sales growth and P&L in the existing stores. It's basically about getting the basics right and coming back to the basics in terms of visual merchandising, in terms of labour cost, in terms also of review of densities by category and space allocation.

And last, but not least, as we want to grow the brand we will open two flagship stores with a strong store experience, customer experience, in these new stores, so one in Melbourne and one in Adelaide.

In terms of marketing, as I mentioned before, it's all about building a distinctive brand and making sure that customers don't just come to the stores because we are offering great prices and promotions and great product at accessible prices.

That's good value and that's part of the DNA of the brand, and we continue offering customers great prices and great value because that is what has made us successful. But I believe there's more value to be given to the customers than just great prices and discounts. I think there's also the value of an inspirational and exciting and distinctive brand.

The whole focus for the marketing team at the moment is on driving - delivering on emotional content, content about the brand, about the roots, about the DNA, the heritage of the Company, about sustainability, social responsibility, which are great, important things for us. This is a very strong focus, and to be able to drive that, not just through mass media, but with a very strong sense of return on investment through online, digital, and in a very targeted way.

Very clearly, there's a lot of - there's a big opportunity to grow our market share in Australia. Our market share in Australia is significantly lower than in New Zealand, and I see Australia as a big market opportunity for us.

Also we're going to focus on a younger customer. So we want to keep the loyalty of our existing customers, which are families, and we offer them great discounts and great offers, but we're going also to focus on what we call the aspirational achiever.

This younger customer is ready to spend more money, but they want to see engagement from the brands. They want see inspirational stuff. They want to be engaged on social media. We need to acquire that segment and that population, for which we're actually under-indexed versus the market at the same time as we continue to retain our core customers.

Last, but not least, I want to say a few words about online and international. We are at the moment working on an international strategy which will have an impact on our online business. We're going through this process and I will not confirm anything further this point in time.

What I want to say on the online business is we are improving functionalities as we go. We've introduced click and collect in our stores, and that's working well. We're also improving content and we are working hard in terms of acquisition on social media websites.

In terms of international my focus is going to be on building a capital [light] model, which means franchising, which means online and, potentially, wholesale, with a focus on a few markets. I want to present to you and to the markets a holistic approach, once we're ready, so I won't go further at this point in time.

Last, I just want to say a few words on supply chain and sourcing. As I said before, we're going to focus on the buying margin and also making sure that we're manufacturing in parts of the world where we can get less margin at the same time as remain a sustainable business.

In terms of supply chain we've introduced JustEnough, a new software which is helping us in terms of stock reduction, but also stock availability. A big focus going to be put this year on stock reduction in the stores and stock availability from the warehouse and proper replenishment. We also work on reducing the lead times.

So that's all from me.

So if you go to page 27, FY16 outlook, so there's a new CEO, he's not here anymore from today. So plans are being developed with - I mean for - FY16 plans are there and we know what we're doing, and we've got the strong focus and have taken decisive action, but further plans are being developed, moving forward for the future.

August, September in terms of trading to date has been on track with improved gross margin outcome, as expected. The achievement of the FY15 margin recovery will come through profitable sales growth in Australia and New Zealand and also, obviously, cost efficiency measures for which we have already taken action. We really remain committed to the FY16 forecast that we put in the target Company statement a month ago.

Is there any question for us?

Operator: Ladies and gentlemen, if you wish to ask a question please press star one on your telephone. Once again, if you wish to ask a question please press star one on your telephone. Your first question is from the line of Chelsea Leadbetter from Forsyth Barr. Your line is open. Please go ahead.

Chelsea Leadbetter: (Forsyth Barr, Analyst) Thanks, moderator, and hi, guys. Just two questions from me, if I can? Firstly, just looking at the UK and the plan to exit those stores, could you give us a bit of an understanding on what the cost to exit those stores will be in that FY16 year, and then what you're focussing on now? Will you still be spending advertising in that market to try and grow that online channel?

Reuben Casey: I'll talk to the costs and Xavier will talk to the advertising. In terms of the cost to exit we're currently going through a process with the landlords of the two further stores that we have to shut. One is Spitalfields - which we think we should have a good chance of getting out of with minimal cost - and the other store is Kensington, which will cost us, but we don't know exactly what it's going to cost us yet until we finish the negotiations. So our target Company forecast is probably the best guide in terms of what we think the impact on the - or the UK impact on the P&L will be.

Xavier, can you talk about advertising?

Xavier Simonet: Yes, we'll continue that in the UK but in a very targeted way, particularly digitally, and through social media.

Chelsea Leadbetter: (Forsyth Barr, Analyst) Okay. Thank you. So that UK cost of the store closures was already in the previous guidance?

Reuben Casey: Well, it wasn't in the guidance, but we think it'll balance out to be - to end up in the same place, yes.

Chelsea Leadbetter: (Forsyth Barr, Analyst) Okay. Then just changing tack a bit and looking at Aussie in particular, I notice that versus your guidance statement the Australian EBITDA result seems quite a bit weaker and the New Zealand and UK results seem a bit stronger. Is there something with the divisional mix that's changing that? Or is that just margins in Aussie were quite weak in that July period?

Reuben Casey: There's some transfer pricing adjustments that have gone through that have altered our view from the target statement.

Chelsea Leadbetter: (Forsyth Barr, Analyst) Okay. And just a last question, growing market share in Australia, you mentioned a bit about that, Xavier. Just wondering do you think the product mix in that Australian market in your stores is the right one? Is that one of the key things to drive market share or - I mean how do you plan to grow market share in that market?

Xavier Simonet: One is marketing. The other one is Summit Club, [so it's] in terms of customer acquisition. You're right, in terms of stores, particularly in shopping malls, we need to work on the product mix and make sure that we allocate the right space to the right products.

Chelsea Leadbetter: (Forsyth Barr, Analyst) Okay, great. Thank you very much.

Operator: Your next question's from the line of John Stavliotis from Morgan Stanley. Your line is open. Please go ahead.

John Stavliotis: (Morgan Stanley, Analyst) Hi, guys. Just on that $7 million of cost savings, I just first want to clarify that $7 million of costs will come fully through in FY16, and also to get a breakdown. Can you tell us - talk through exactly how that $7 million comes from?

Reuben Casey: Hi, John. The $7 million is the FY16 impact so, obviously, that'll be slightly more when we annualise it, probably about $9 million when we annualise across [six] years. It's come from a range of factors. There's obviously headcount reductions which we have acted on in September, and there is ongoing reductions, or efficiencies, in store labour, so optimising our store labour resource.

But, probably, the biggest portion is more efficient use of our advertising spend; so not necessarily traditional - [less traditional] channels - but more digital and just more targeted spend.

John Stavliotis: (Morgan Stanley, Analyst) That target - what gives you comfort that there won't be a sales response to changing the advertising expenditure or the mix of advertising?

Reuben Casey: Well, we've done some trials of that already and it's been very successful for us. We measure our share of voice in both markets, and we think we're over-indexing in some times of the year in some parts of the market.

Xavier Simonet: Also, John, we've been doing some analysis on regional investment by media channel for some time, and we're taking action on that, realising that the media channels have evolved and the media world has evolved. Some media channels we've been using in the past are not efficient anymore in terms of getting us the return.

John Stavliotis: (Morgan Stanley, Analyst) Maybe just moving to inventory, you saw - so a 1% increase at a store level. Can you tell us how much of that is from the timing of new season deliveries and new stores and all that; so just to get a bit of comfort that it's actually clean inventory that has caused that increase?

Reuben Casey: So round about $7 million is from timing of new season deliveries and around about $2 million is from store openings. When I say $2 million, that's just the amount that we'd need to open the stores.

John Stavliotis: (Morgan Stanley, Analyst) And just when you say 40% less aged stock on hand versus last year, last year was obviously a bad year at July '14. If you compare this year to '13 what does that look like in terms of aged stock?

Reuben Casey: I haven’t done that comparison so I can't tell you off the top of my head.

John Stavliotis: (Morgan Stanley, Analyst) And lastly, just on CapEx, can you - so systems CapEx should be down to a much more normalised level next year and mainly around store openings. Would that be the right way of looking at it?

Reuben Casey: Yes, mainly store openings, but also there's Australian - there's two things next year. The Australian distribution centre gets completed next year, and also the New Zealand Christchurch support office also gets completed in this current year. In terms of systems, that spend will be significantly reduced.

John Stavliotis: (Morgan Stanley, Analyst) Can you give us a number for the Aus distribution and New Zealand support office?

Reuben Case: The Australian distribution centre's going to be around about $5 million and the support office is around about $3.5 million to $4 million.

John Stavliotis: (Morgan Stanley, Analyst) Okay. Thanks a lot.

Operator: Once again, if you wish to ask a question please press star one on your telephone. Your next question's from the line of Wassim Kisirwani from Deutsche Bank. Your line is open. Please go ahead.

Wassim Kisirwani: (Deutsche Bank, Analyst) Good morning, guys. Just a follow-up question on the UK; if you could give us, perhaps, a little bit more colour on what you're committing to spending there. You've previously outlined a pretty firm target of what you're willing to spend in terms of marketing. Did you have that visibility at this stage?

Xavier Simonet: We're not going to keep a fixed cost structure in the UK. We're just going to trade online from Australia with, probably, some third party involved in New Zealand to support us in terms of SEO, PPC and all the digital activities. And we'll work also through third party websites, and we're starting to work in with some of them in terms of marketplaces.

The investments we make will be digital investments focussed either on Summit Club or our target customer, with an expected written on sale so that it's immediately profitable; which doesn't mean, actually, that it's not going to help us build up the brand in long term, but will have clear metrics, and we'll give it in clear metrics to make sure that the return on investment is happening very quickly.

We're not talking - to answer your question, if you're referring to the $5 million, that the Company plans to spend in the UK. We're not talking about this money anymore. We're talking about advertising money to drive the online platform sale.

Wassim Kisirwani: (Deutsche Bank, Analyst) Okay, it makes sense. And just in terms of that inventory position again, just to follow up on that, you are coming off a particularly high base of aged inventory. So that reduction, how does that compare to your own expectations, and how does that set up your expectations of Christmas trading period for you guys in terms of the guidance that you've given?

Reuben Casey: So the inventory position at year end was higher than what we had planned for, and we are - this year we're targeting a 10% to 15% reduction on a per store basis by the end of FY16.

In terms of how it affects our Christmas trading, we don't see that has a major impact on what we've previously planned for because we're not [layering] - last year we layered clearance inventory from winter on to clearance inventory that was already there, whereas we managed to clear most of that during FY15.

Wassim Kisirwani: (Deutsche Bank, Analyst) Okay. Thanks, guys.

Xavier Simonet: Thank you.

Operator: There are no further questions at this time, Mr Simonet. Please continue.

Xavier Simonet: Rob, I think, on our side, we're done.

Operator: Ladies and gentlemen, thank you for your time. The conference has now concluded.

END OF TRANSCRIPT