



# **Conference Transcription**

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## Start of Transcript

Peter Halkett: Good morning everybody. It's Peter Halkett, CEO Kathmandu speaking. Welcome on the call this morning. With me I have our Chief Financial Officer, Mark Todd. We released our results for the half year to 31 January to the market earlier this morning and those results plus the supporting presentation is available on both the NZX and the ASX.

Just some housekeeping matters. Everybody at your end is on mute at the moment. When I get to the questions section you will un-mute your line by pressing hatch 6 and asking your question or star 6. I think the technology has trapped me yet again but, in the meantime, I'm just going to rattle through the presentation and allow plenty of time for questions.

I will be presenting the results throughout in New Zealand dollars. I'll be over-viewing the result and the key highlights of our trading in the first half. I'll then pass to Mark who'll provide further detail on country operations, cash flow and dividends. I'll then return to look at the outlook for the balance of the year and update on our key growth strategies.

So just turning the presentation itself, just a quick run through of the contents. The results overview, we do comment on some key line items; the country results, the cash flow, the dividend, the balance sheet, the FY11 outlook and key growth strategies update.

Moving to, first of all, the highlights section. It was a very solid first half performance for us; sales up 19.2% on the previous first half. The sales performance in December and January were particularly strong. The first half, F11 sales and EBIT result were slightly above the upper end of the range we provided in our market update on 19 January, so just a few weeks ago. We had a very strong final two, two and a half weeks from the time better than we had expected.

Just for your information, the top end of the range we provided at that time was NZ\$126 million in sales compared to the NZ\$127.1 we achieved. The top end of the EBIT target was 19.5% compared to the 19.9% we achieved so, yes, we did exceed that number.

The same store sales growth; there's 12.1% but at constant exchange rate, because of the movement in the Australian dollar, that's actually 9.5%. This was achieved on top of last year's 13.7% same store sales growth and, as you will see when you get into the detail, the Australian performance was a big contributor to the overall result.

We've opened 10 new stores since the first half of FY10 and in this particular period we've opened three so some were opened prior to this period, some were open as [unclear] this period but we've actually got a total of 10 new stores.

Other drivers of the first half performance were our gross margin which also sits above the top end of the range we've been targeting. Generally we have advised the market we're going to sit somewhere between 61.5%, 62% and 64%. This result came in at 64.7% and that was up from 61.3% the same period last year.

We attribute a lot of our improved performance to our investment in stock, improving our stock availability to customers, making sure we can satisfy the demand we have which historically we've generally run a little tight. We also made a conscious decision because we were expecting this period to be so difficult we would [up weigh] our advertising spend and put out more marketing, run some more promotions. That was an additional NZ\$1.7 million in the period and once again I'm pleased to say that that delivered the result and helped us achieve our sales and protect our margin. I think this result really demonstrates the strength of the Kathmandu brand and our continuing growth opportunity.

Just taking the results and just over-viewing specifically what they were I'm not going to read out the whole page. I'll just highlight, I guess, what I think are the key numbers within it. Total sales of NZ\$127.1 million. I'll just

remind you that that's in New Zealand dollars. That was up from NZ\$106.6 million for the prior period and that's a 19.2% increase.

The gross profit went up NZ\$16.9 million but what's significant is the percentage move from 61.3% to 64.7%. Our operating expenses also went up. They went up from NZ\$47.2 million to NZ\$59 million. Some of those increases are one-off in nature which we'll get to later in the presentation and some of them were conscious decisions, for example, to spend extra advertising. Our EBITDA went up from NZ\$18.1 million to NZ\$23.2 million, 28.2% and our EBIT went up from NZ\$15.5 million to NZ\$19.9 million and that's also up 28.4%.

You'll see that the EBIT percentage margin increase from 14.5% to 15.7% so that's a very healthy outcome. The net profit; this needs to be explained in a little more detail which Mark will do later in the presentation, but it went up from NZ\$4.4 million to NZ\$10.5 million.

The number of stores we had this time last year were 90. We now have 100.

Just moving through to the key line items. First of all sales, once again repeating that they went up 19.2% to NZ\$127.1 million but at a country level and total growth - not same store but at a total growth level - New Zealand was up 12.4%. Australia was up a whopping 20.8% and UK was down 0.9%.

On a constant exchange rate basis, our total overall growth was 16.6% and you can see the breakdown of the business for the first half periods over the last three years and what you will see now is that Australia is 50% larger than the New Zealand business so it's been outgrowing New Zealand, as you'd expect, because of our relative store numbers per head of population.

Just moving through to same store growth which, I guess, the financial market is always very interested in. Same store growth has been 12.1%; 9.5% a constant exchange rate which I've talked about. If we look back a number of years the aggregate same store sales over the past two years has actually been 22% so, once again, good healthy growth.

You can see the trend for the country there. Obviously UK's a challenge for us but New Zealand and Australia continue to do very well. Australia particularly so. The key reasons we put down to the same store growth has been, firstly, the increased investment in our stock and I've talked about how that's improved our stock availability satisfying demand. Advertising spend; we've grown our product offer so there's more choice for customers. There's more products for them to buy.

We've done a lot of store refurbishment and relocation and upsizing of our existing portfolio so it's not all about new store rollout and the weather was fairly damp in parts of Australia and that also assisted us. It wasn't a huge component of the increase but it certainly was a tail wind as opposed to a head wind. When we actually look at the category performance and we look at regional breakdown there isn't that much between products and regions that would have benefited from the rain versus those that wouldn't have received any benefit so it helped but it wasn't a major contributor.

Just moving through to the gross profit margin percentage. Our gross margins were up 340 basis points above the previous period. The gross profit margin, mainly due to lifting selected prices as we need to do as the price of goods coming out of China is going up and we need to start that process. Also very important has been our product mix. The more apparel and woven lines we sell the higher our overall margin goes and we also had a very strong Christmas trade which reduced the need for our January discounting so a number of reasons that that margin has improved.

The other thing I comment on is that the more we sell in Australia because it has a higher margin than New Zealand, the more the average outcome for the group goes up and so that's also contributed to the result.

At the top end of our target range there was no significant FX benefit to that. The second half is looking more challenging for us as we face quite considerable cost increases coming out of China because of what's happening in that part of the world.

I'm going to pass over to Mark now who's going to take us through some of the costs and then the balance sheet et cetera.

Mark Todd: Just to summarise the change in operating costs this year as percentage of sales increased by 210 basis points and the primary reasons for that are a conscious decision to up the spend in advertising which is 6.2% of sales in the half year, planned increases in the cost of supply chain, distribution to stores as a consequence of our build of inventory and the aggregate effect of the increase in cost to the business of being a listed company as opposed to the previous ownership structure. This year also the other primary changes compared to last year are provisioning for management incentives in this year's result. Add that to profit levels that we're anticipating achieving this year and adjusting for non-recurring items in respect of foreign currency translation gains last year that don't occur this year.

At the country level, an improvement in profitability in country level in both New Zealand and Australia primarily in Australia. The performance in Australia obviously attributable mainly to the improvement in gross margins that Peter's already referred to.

In the UK, a slight deterioration in performance at the bottom line but the UK represents about 3% of total group business at gross profit level so the actual UK result overall not particularly significant to the full group result.

In terms of cash flow, operating cash flow negative NZ\$8.8 million for the half year which is to be expected because we had a build in inventory of over NZ\$16 million in the half year compared to the same period last year and that was a constant decision made by the business once we had the opportunity as a listed company to improve our stock levels and we've built our stock levels per store as reflected in our balance sheet to a level similar to that of two years ago and we carry approximately 25% more per store this time this year than we did last year. That's been a key factor for the improvement in overall sales performance stock availability generally.

We've declared a first interim dividend of NZ\$0.03 per share which is at a payout ratio of between 50% and 60% of NPAT for the year and that's fully imputed for New Zealand shareholders but not franked for Australian shareholders.

Our foreign currency position is that our hedging rates - we're a business that's basically fully hedged against US dollar purchase commitments up to approximately 12 months ahead of - [before] date of today and our hedge rate for the first half year that we achieved was similar to that in the first half year and our second half year rate to come is also again a similar level.

Thanks Peter.

Peter Halkett: Thank you Mark. Just going through to the outlook for the balance of the year, F11 outlook. I've really broken this down into three sections; (1) what we're doing internally in Kathmandu and the tactics and strategies we have in place, our view of the market not that we're economists and given the volatility of what's been going in the world over the last year - two years. It's very difficult for us to predict what's happening and then what we think the summary of all that means to the next few months.

So, at a Kathmandu level, we're continuing our store rollout. We're going to hit our target of 15. We've got a big refurbishment relocation and resizing and we've done a lot of our central stores and that's delivering very good results for us. So that's, if anything, going to be accelerated. We're continuing to grow our range and expand and, as Mark's alluded to, our inventory levels are approximately at the go-forward position now. They won't grow that much but that, and recent inventory investment, we'll maintain for Easter sale and winter sale and promotions thereafter.

We have a brand refresh project under way. It's really about making sure Kathmandu remains, I guess, up-to-date and relevant to customers so there's a lot of work around design and store design and even logos and bits and pieces.

Gross margins will probably be more challenging for us in the second half because of the cost increases coming out of China. Most of those increases actually apply for our last eight weeks of the year so we're hoping to get a little bit of that price increase through that's required.

Operating costs as percentage of sales will potentially be slightly higher than the FY10 reflecting investment and advertising. We have more people on board in terms of designers and product people and just resources generally, there's a lot of work going on in our back office with our IT systems.

The other thing we need to bear in mind is that the second half for us last year was very difficult. It was very difficult for the whole market and we performed relatively in line with the market which meant our performance was flat. Given our first half performance we think there's an opportunity to do better than that.

From a market point of view, clearly, there's a lot of uncertainty for all the events that have occurred and I think it's made consumers much more cautious and certainly they've been reducing debt and, given what's happened recently, I don't see any let up on that in the short term.

The New Zealand economy will be impacted by the earthquake and that will extend the recessionary period. Our view is that the Government is going to have to fund some of that and they're going to have to increase taxes or cut costs, cut spending. One way or another it's going to reduce customer spending power.

China internally is driving demand, aspirations are changing, cost increases in both raw materials and labour is coming through so that's something that we need to be aware of and manage. We continue to have more and more people enter the outdoor sector, not just in terms of offering outdoor goods but retailers that are looking at developing their own brands and brands that are looking at developing their own retail networks. So, in other words, the vertical model that we operate where we design, we manufacture through our partners in China and distribute through our own stores, that's becoming more prevalent.

So there's a lot of good things happening within Kathmandu. There's a lot of uncertainty and volatility in the market but for all of our first half performance and continued store rollout provides confidence that an improvement in both our second half performance and our overall year-on-year profitability can be achieved.

I just want to finish the formal presentation by reminding you of Kathmandu's key strategies. These are, I guess, the three main ones. We have a number of other things we're doing in terms of online and in terms of our database and so forth. Our primary growth strategies are our new store rollout. We're going to have our 15 this year. We're still targeting the 150 in total and, in fact, we're investigating additional formats that may take that total above the 150.

From an existing store network optimisation, we have a portfolio of 100 stores today. Many of those stores are three to five years old but are not fully optimised in terms of their location, their size or their fit out and we have been making lots of changes to that and it's been delivering good results and you'll see in the update exactly what we're doing in terms of what we've done in terms of Melbourne, Sydney, Canberra and what we're planning to do in other locations.

The final, probably the most significant of all these strategies, is about growing the product range in terms of both width and depth with more products, more categories, more options within each category. There's so much opportunity for Kathmandu. We don't have to step outside of what we do today. We just have to do more and more of, I guess, what we'd consider we're already very good at and we've given some examples of that in the update column.

That brings to a close the formal part. I'm going to take questions or Mark and I will take questions now. It's going to be a bit of a free-for-all so it's really first in first served. What I'd ask you to do is just to give your name so we can then indicate who has got in first so they can ask their question.

To do this you will have to press star 6 and then come on the line so ready, steady go. So far no questions. I presume star 6 is working. I'll just give it a minute or two just in case it is a technology issue otherwise we'll end up bringing the call to a conclusion and maybe the media will want to call us direct. I know there's a few people on the line now.

Tim Boreham: (*The Australian*, analyst). It's Tim Boreham here from *The Australian* Peter. How are you?

Peter Halkett: Hi Tim.

Tim Boreham: (*The Australian*, analyst). You can hear me? Good stuff. Just with the weather-related effect, just to sort of clarify, you seem to be saying the wet weather particularly in Australia was sort of neither here nor there because your wet products and your sort of non-wet products experienced similar sales. Have I got that right?

Peter Halkett: Well, more or less. The way I describe is if you take the total of same store sales increase in Australia around that 12 mark, a very small portion of that would have been because we had the assistance of some good damp weather in certain states in Australia. You wouldn't want to form the view that our 12% increase was, you know, that 90% of it was due to the weather. So we're saying there are probably five key things that contribute to that. Weather was a component of that but [unclear] those categories and when we look at regions that didn't get that benefit there's only a small difference.

Tim Boreham: (*The Australian*, analyst). I'm just sort of interested in why fundamentally your sales are going against the trend of most other retailers. Is there some sort of ingrained consumer trend, sort of getting out more and assuming other activities [which are more expensive]?

Peter Halkett: Well, I think we need to bear in mind that in our life cycle as a business we're still relatively immature. We're part way through a store rollout in Australia. We have a lot of opportunity to grow our business in terms of what I said before about range growth and store numbers and existing portfolio. Plus our categories generally are positive on trend

categories so I guess what I ultimately say is that the market overall is quite a strong headwind for us. There's no doubt it's very difficult and we've never had to work harder in the history of Kathmandu but against that is that we have some good strategies that are proving successful that are offsetting what would otherwise be very challenging.

A lot of other retailers are much - they've been around a lot longer, they're much bigger, they're more mature. They don't have those [tactics] and opportunities available to them. They maybe took advantage of those some years ago so it's really about business maturity and where we are in our life cycle and hence the reason you'll see a better performance from Australia than New Zealand because New Zealand is relatively more mature certainly in terms of penetration and number of stores per head of population.

Tim Boreham: (*The Australian*, analyst). Given that, how did you avoid the discounting over the Christmas period?

Peter Halkett: I think, first of all, because we had very good stock availability and we up-weighted our advertising campaigns we met our sales target. So we didn't need to we're missing so what are we going to do. We didn't put ourselves in a position where we had to step back and start discounting whereas this time last year, even though we had a very good increase, we did extra discounting in January whereas this year we didn't need to do that.

Tim Boreham: (*The Australian*, analyst). Thanks for that Peter.

Peter Halkett: Thank you. Any other questions?

Carrie LaFrenz: (*The Financial Review*, analyst). It's Carrie LaFrenz here from *The Financial Review*. Can you hear me?

Peter Halkett: Hi Carrie. Yeah, I can...

Carrie LaFrenz: (*The Financial Review*, analyst) Hi. How are you?

Peter Halkett: Good thank you.

Carrie LaFrenz: (*The Financial Review*, analyst) I just wanted to quickly touch on some of your commentary around China and costs coming out of China.

What does this mean for prices in shop? Are you expecting to lift prices that consumers are paying and, if so, by how much?

Peter Halkett: I think the whole industry - well, anyone in the apparel industry for a start, faces significant cost increases from cotton and other materials as well as the labour rates in the Chinese factories. There may be some organisations that have the ability to offset that in some way. Certainly the people I've talked to are not able to do that and the choice is you either change your materials, you change your suppliers, you change your construction or you make the same products and you accept a lower margin or you pass those costs on.

For us there's a number of ways we can deal with that and so probably overall prices at a manufacture level might be going up 10% or more. At a retail level that's generally 2% or 3% because of the gross margin impact and most of that will either be passed on or products changed in a way that keep the same sort of price point. So it's not a case that price increases will be automatically passed on but in some cases there will be no choice unless companies accept a lower level of profitability.

Carrie LaFrenz: (*The Financial Review*, analyst) You're talking about various product ranges and offering more product. Are you talking also about changing materials used, what you've just mentioned there, about actually changing raw materials used to kind of compensate for some of these rising costs?

Peter Halkett: We're adopting a range of tactics depending upon the category. What we do with backpacks might be different from what we do with sleeping bags, might be different from what we do with wovens, might be different with what we do with down jackets. So there are some categories where you can change materials and there is no real difference and there are others where it would be a concern and we wouldn't make those changes. So there's no simple answer except there's a range of things we can do to reduce the impact on customers and we're doing that.

Carrie LaFrenz: (*The Financial Review*, analyst) So just to be clear, then customers can expect to pay 3% to 4% more in the shop as you lift prices to help deal with this issue?

Peter Halkett: What we're really doing here is talking about what's happening in the industry as a whole and you will hear that from other retailers. I don't think that it should be a case that Kathmandu is going to be out on its own lifting prices. The whole industry...

Carrie LaFrenz: (*The Financial Review*, analyst) No, that's not what I'm saying. I mean, obviously I'm talking to you guys about your business. I realise it's a sector issue. You're not by any means singled out but what I'm asking is what can customers expect as far as price rises at Kathmandu when they go in store?

Peter Halkett: When they come in store in the future, probably more in the later part of the year, there'll be some things that are slightly more expensive. There'll be some things that haven't changed at all and there'll be a whole bunch of things that are also cheaper because we're always looking at our balance of super deal and volume lines. We're looking at core lines but overall there'll be an average increase, I would expect.

Carrie LaFrenz: (*The Financial Review*, analyst) Okay, thank you.

Peter Halkett: No problem. Any more questions? I think we're just about out of time anyway so I'll call a close there. No doubt I'll get a few follow-up calls over the next few days. I really appreciate your time coming on and listening to us and hearing what we're up to. Once again, I appreciate your time and I may hear from you later. Thanks very much.

**END OF TRANSCRIPT**