Conference Transcription

21 March 2012

Kathmandu Ltd

Kathmandu First Half Year Results Announcement

Time & Date of Recording:	**21/3/12 at 08:30**
Subject/Title:	**Kathmandu First Half Year Results Announcement**
Length of Conference (minutes):	**60**
Turnaround:	**24 hours**
Billing Code:	
Company Name:	**Kathmandu Ltd**
Moderator Name/Client ID:	**Mark Todd/ 9518892**
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 First Half Year Results Announcement. Today's call is being recorded. At this time for open remarks, I'd like to turn the conference to the CEO of Kathmandu, Mr Peter Halkett. Please go ahead.

Peter Halkett: Thank you. Welcome everybody, to the call today. With me is Mark Todd, our Chief Financial Officer. We're going to be discussing our results for the six months ended 31 January 2012. We'll be talking to the results and the half year presentation that we filed this morning on the NZX and our corporate website and it will also be available on the ASX when it opens. I presume most people have either got it or can access and follow me as I work my way through the presentation. We'll be presenting the results in our reporting currency, which is New Zealand dollars.

The presentation will take approximately 30 minutes and then we'll have about the same amount of time, 30 minutes for questions. So we've allocated a total of one hour for the call. So let's just start by running through the contents of the presentation that we'll be talking through. We'll give a quick overview of the results. We'll go into a little more detail with the key line items and then we'll step into each country's results. Mark will be going through the cashflow, balance sheet and the dividend. We'll be talking and providing an update on our growth strategy and then a little bit of an outlook for the remaining of the year and then we'll all open up for questions.

Just the results page, which is page four, I'm just going to read through these, but the sales growth was NZD19.6 million which was 15.4% above last year. The same store sales growth was 8% and 7.8% for the constant exchange rate basis. The gross margin was 62.7%. Just pointing out that I guess over the last couple of years, those people that have followed us that that's within the range that we've always said. We've said between 62% and 64%. However, it is down 200 basis points on last year.

The first year's operating expense has increased by 470 basis points as a percentage of sale. This is clearly an area where we will get a lot of questions and focus for the people today. Within that increase in operating expenses, NZD2 million was related to one off costs incurred in relation to our new ERP system and warehouse management system and the continuation of our brand refresh rollout.

EBIT reduced by NZD7.2 million or 36.2% below last year. We opened five new stores. Three stores were relocated or upgraded in some way, and two stores were expanded. We also grew out Summit Club membership in line with our long term plan which I will recap at the end of this presentation.

So just going through the results, NZD146 million up from NZD127.1 million last year. That's NZD19.6 million increase, 15.4%. The gross profit, the key point there is we achieved NZD62.7 million which was down from NZD64.7 million last year. So we did add NZD9.8 million gross profit which was 11.9%. The operating expenses, they grew to NZD75 million from NZD59 million. That's NZD16 million increase or 27%. We'll context that in a little more detail shortly. The EBITDA was NZD17 million down from NZD23.2 million or NZD6.2 million, down 26.7%. EBIT, much the same story, NZD12.7 million down from NZD19.9 million, NZD7.2 million, 36%. The net profit after tax was NZD6 million down from NZD10.5 million, NZD4.5 million down, 42.9%. This year we had 14 more stores than the same time last year at the end of the half year period. So we've gone from 100 to 114 stores.

So just moving through the key line items on page 7. Once again, I'm not going to read things I've already covered. I'll point out that the Australian growth was 18.1%, the New Zealand growth was 13.7% and the UK was down 13.6%. At a constant exchange rate basis it was a NZD19.4 million or 15.2% growth. I think the key point you can see on that slide is that Australia is growing of a proportion of our total business which isn't surprising because that's where the majority of the new stores are now being placed.

Moving through to the next slide, this may come as a surprise to some people, particularly when we provided our update in December, it wasn't looking as rosy. But same store sales growth was 8% or 7.8% on a constant currency basis. New Zealand and Australia movements in terms of same store were pretty similar to the retail discretionary apparel spend in both countries. The UK was a particularly poor result. However, we've got to bear in mind the prior period, the previous year, they had record cold temperatures and also there was a VAT increase pending so we had very high levels of sale and we envisage that we were always going to have difficulty matching up to that.

What the result really shows here is that if you look back, certainly at a group level over the last two years, we were matching up against some very, very high same store sales at 13.7% two years ago and 12.1% last year. So it wasn't as if it was a walk in the park to beat some very low numbers posted last year. I'm just moving through the gross profit margin. I made the point that this is within our target range but there was a higher proportion in clearance in discount activity than we undertook last year. If I reference back to the previous slide, given the same store sales increase we had last year of 12%, clearly we didn't need to purse as much discounting. So while it's a reduction last year, it's still a very good gross margin.

Also, as we increase our Summit Club membership, our loyal customers, we give them a buying advantage. They're a greater proportion of our turnover.

Our margin is also impacted. It's within our range, as I've said before. There was very limited impact of FX gains and any cost increases from our suppliers. They weren't particularly a major contributor. It was all about the price we sold our goods for. I think it was a pretty satisfactory result despite the reduction. So, so far we've covered all sales, which I think shows very healthy growth, and we've covered the margin which I think sits within, once again, a very healthy band. It's now all about the cost of doing business which is a nice time for me to hand over to Mark Todd.

Mark Todd: Thanks Peter. Morning everybody. Talking about the cost of doing business, total operating cash expenses increased by NZD16 million in the year budget in the half year, and we budgeted an increase of NZD12 million. We've identified and slide the line items where the rate of increase in percentage terms was greater than the rate of sales increase and those would primarily tactical advertising driven mainly by the need by additional activity in January to meet the sales target and same store sales growth that Peter's already talked about.

The ongoing cost of our brand roll out program and the write off associated, I'll bring signage and associated assets. The increase of ongoing cost and increase of rentals, primarily driven by the continuing growth of store numbers in Australia but also one off costs associated with delays in the timing of opening of several stores, and the cost distribution that involved the change from the old to new management warehouse management system and getting to grips with that in the first six months, again probably only in Australia.

Those are the line items that basically drove all of the increase in percentages and percentage of sales terms from 46.4% of sales to 51.1%. In those costs, and in the NZD4 million cost above budget, approximately NZD2 million of those costs, we've estimated to be non recurring mainly around obviously the brand roll out and the distribution expenses.

We keep highlighting year on year that as we continue to move more of our business to Australia the cost of doing business for us in percentage terms will increase. Australian sales on this half year was 60% of sales but 69% of retail OpEx and that's up 270 basis points on the previous year and similarly, when you look at the country by country results you'll see that in overall terms Australian OpEx is up about 700 basis points year on year in total.

Then just talking quickly about the non cash items. Depreciation increases primarily the first half of the first year, right up until about the new systems investment and that's the reason why that's increased at a greater rate than the rate of sales. Then just to reinforce what happens in terms of OpEx in the pattern, year on year, because obviously the rate of increase in OpEx in the first half year has driven a substantial portion of the shortfall in first half year earnings.

Kathmandu's business, as we've said several times in the past, is a business where most of our earnings is derived in the second half of the year and OpEx is therefore always a higher percent in the sales in the first half year than the second half. Indicatively, historically OpEx in the first half is 45% to 50% of full year and generally closer to 50% than 45%. Sales is always less than 45% and generally closer to 40%.

So you will always expect this business to basically achieve as a percentage of sales performance, a much greater performance in the second half year and that should also benefit the second half year from this impact from one off costs. To highlight the reference in terms of our expectations for the first half year, we actually budgeted approximately a 200 basis point percentage in OpEx as a distinctive sales in the first half year, again because of the movement in the business to Australia and the structure of the cost that we had budgeted in that first half year with new stores. Therefore, our actual budget ourselves, for the first half year was forecasting a reduction of earnings in the first half of 12 compared to last year.

Then just moving quickly on the summarisation on the next slide of earnings and EBITDA and EBIT impact level is already what we've talked about before. Very little impact year on year this year in terms of exchange rate impact. The rest of that is very self explanatory. Moving on to the country's results and I don't need to talk through all three of those. But just to highlight in aggregate terms that the earnings shortfall for the period is virtually all derived from the Australian performance, as we've already said. A lesser same store sales performance and an OpEx operating cost performance which in percentage sales terms was up at a much higher rate for New Zealand. Hence, there's a shortfall in Australian earnings for the period of over 40% of the EBITDA level. Whereas in New Zealand when you actually look at the New Zealand performance, we're actually just down on first half year earnings and had we not had timing issues relating to particularly outdoors in Auckland where we've been delayed in our new market store, and we've had forced closure around that Victoria Street store by the landlord, we would have expected our first half year earnings in New Zealand to actually increase year on year. Operating costs, as a result, we're flat if you took out the one offs in that period.

UK performance continues to be disappointing given the market over there but the same store sales result primarily reflected the shortfall in December this year compared to December the previous year, which was just before the VAT increase in the UK and at a time when they had record low temperatures. So we weren't particularly surprised at same store sales short fall in that month. The UK continues to be a business with [unclear].

Just moving on into cashflow, first half operating cashflow reflects the shortfall in earnings but more particularly the planned capital investment program and the planned growth in inventories. The second half year surplus in cashflow would bring us an operating surplus for the year that won't be dissimilar to that achieved in the previous year, other than the impact of a much larger capital expenditure program in FY12 compared to FY11.

Talking on our balance sheet, planned growth in inventories and growth on a per store basis is pretty much in line with our actual budget. Our growth per store from NZD674,000 compared to NZD555,000 in the previous year is large in percentage terms but in actual fact our skew count increased by more than 20%. As we've talked about in previous presentations, that reflects our commitment to an increase in the breadth of our range overall. And also, because we opened a couple of less stores than we expected to in the first half year and we had more goods and trends at 31 January this year, about 30% more compared to last year, our overall inventory level, although slightly higher was actually less than 5% away from our original forecast. I don't think there's anything else too much noticeable in our balance sheet.

Hedging, we had an approximately 10% improvement in hedging rates for the first half year compared to the same period last year and that pretty much offset the cost of product increases in the same period and we have a similar improvement, slightly less coming through in the second half year of around 5% to 6%, so again, we don't anticipate any significant impact on change in base cost of product in US Dollar terms for the second half year in the benefit of the improved hedging rate that's factored in.

Finally, dividend. We're declaring a consistent dividend with last year of NZD0.03 per share and we confirm that our payout ratio, we expect to remain within the 50% to 60% of NPAT as we talked about in the previous year with the balances of earnings being reinvested in the business and our capital investment program and investment of stock, and those dividends will be full franked in Australia and fully imputed in New Zealand. Back to Peter.

Peter Halkett: Thank you, Mark. If we move through to the growth strategy section, which is slide 23, I'll just talk through each one. First of all, you will have seen these boxes, you're probably even getting bored with them now. But they've been here since we launched our prospectus two and a half years ago. New store rollout, 150 stores remains our target. New stores continue to perform to our expectation. They're still very profitable. While we may not have our target of 15 this year, we expect somewhere between 11 and 15. It's important that we continue with the strategy and in fact, it's one of the ways to assist in getting our operating leverage. So hence the reason we're still committed to our capital program.

Having said that, we can see in our P&L that rents area key driver of some of our overheads and some of the lack of operating leverage. So getting the balance between the right size footprint and rental cost is a key for us. So that is an area that we are spending a lot of time analysing. Further to that, the trend towards multichannel which we're benefiting from on one side of our business, means we need to be very careful on the property side. So getting the right size stores in the right location with the right rent equation is a big area of concentration and analysis. But every new store we open is still contributing significant profit so we want to continue down that path.

Improving the existing store network, as you will have seen, we've relocated and upgraded many stores. We're getting generally good results from that so we need to continue that strategy to maximise our market potential and to fully optimise each of the store locations. We'll probably do approximately the same number each year, which is around six or seven. There's still a lot of our existing portfolio that has to be fully optimised yet. Online and digital, we want to take full advantage of what's happening in that space. We have a project to replatform our existing site. That will occur in the early part of FY13. We want to increase the capability and functionality and one of the key requirements of that is to be able to sell globally which once again, is a great opportunity for Kathmandu.

Our existing site is showing tremendous year on year growth and it's really only constrained by our ability to deliver rather than the concern of the demand at the moment. Our vertical model and the control of our own brand is what's unique about that compared to some other retailers in this part of the world. As I said before, a new platform will enable us to go global.

Moving to the next slide, enhance our product offering, clearly this is the very core and essence of Kathmandu, having products that people want to buy and people fall in love with. So we want to increase our sales through product range growth. We want to launch new products into new categories and we want growth and range choice.

However, we need to ensure our inventory investment is targeted at key performing product lines, not just lines for the sake of having growth. We are putting a lot of investment, and once again, this is what's not exactly helping our overhead structure but it's an area that I'm committed to ensuring we have world class products as ongoing investment and research into product development. However, with our range growth, this is tending to drive our store size requirements and therefore driving our rent and driving a number of costs within the business. So we are at a point where we're determining at what point should we stop our skew range growth to ensure our store network doesn't become a burden to us. So clearly store network and product range put together, and probably within the next six to 12 months, the next time we talk to you, we'll be able to give you a further update of what we think that's looking like.

Summit Club, a great success. We're targeting one million members. We're well and truly on track to that. We're investing more and more in our loyalty program. Once again, you can see a convergence between what's happening with digital and online and having customers and customer email addresses and customer details and customer insights. We couldn't finish growth strategy without coming back and talking about the cost of doing business because it's a key thing coming out of the presentation and our half year result.

We do need to have a focus on getting that operating leverage. It's made more difficult because as we grow into Australia, Australia's operating costs are higher so the weighted average pulls us up. But we have made investments in systems and infrastructure which will gain efficiency improvements. Right at this moment in time they haven't helped us, that's been the reverse. But there's no doubt in time the benefit of those will flow through and you will see that in our cost of doing business in the future.

So moving onto the outlook. I've really divided this into a couple of sections. First of all, what's happening with Kathmandu for the next six months. We're going to open at least six more stores, bringing the total to a minimum of 11. Hopefully we'll get closer to 15 but that's a matter of whether the landlords are prepared to come to the party. So far we've got sites at Tamworth, Moorabbin, Shell Harbour, the Rocks and there's a couple of others that are very close to board sign off. We have two major relocations planned. One was New Market, which anybody that's been tracking Kathmandu will know that I promise this is going to open before Christmas and just after

Christmas. Well, good news, it's going to open next Tuesday, next Monday, next Tuesday. Fantastic store.

We are relocating our Perth store from I guess, a less than optimum position right into the middle of the Hay Street Mall. We'll be continuing to improve our stock availability despite the fact that we've increased our investment in stock, we still run out of certain key lines. It means that we need more stock. It means that we need a greater proportion of our investment into the lines that are really driving our turnover. Not much more to say about online except we do, even within this P&L we have the implications of the investment and the work we're putting into delivering a new platform.

Management of our operating expenses. We should point out that since 31 January, same store sales are ahead of the first half. But bear in mind this is only a very small proportion of our annual sales. From a market point of view, I think we're unlikely to see any significant change and by change, I mean improvement to the current retail conditions, certainly in the second half. It's an attractive sector, it's a growing sector certainly globally, and as a result it's attracting more and more competition. Our second half will be influenced by the weather, whether the weather works for us or against us. Generally colder is certainly preferred.

So there's a number of things that can influence what our end of year result is going to look like. So in summary, if we just turn to page 27, the final slide, maintaining or growing our market share is a primary focus in this environment. We understand the importance of continuing to grow. We know that operating leverage will come with that growth. Despite the lower first half earnings, the board and management are very confident in the Kathmandu business model and the ongoing growth strategies. Clearly growth is working for us.

With two large promotional campaigns still to come, the impact into possible range of the full year result as a range of outcomes still possible with those two events remaining. We have just started our Easter campaign today so I'm watching sales at the same time as talking to you. Given the difficult market conditions, we don't believe it's possible to provide specific guidance.

So we are actively managing our operating costs and we are well prepared for our Easter and winter sale events. So all in all, it's going to be an important second half, but we've done a lot of work to ensure we're as successful as we possibly can be.

Just one other point before I cross over to take questions, I'd just like to take this opportunity, because I know a lot of our team listen to this. The effort that certainly the Christchurch team has put in to deliver the result with the background of the Christchurch earthquake and the impact on our business as well as their personal life has been truly amazing and once again, I just take this time to say thank you to all the Kathmandu Christchurch staff. Moderator, can we open up for questions now please?

Operator: (Operator Instructions) The first question comes from David Cook from Nomura. Your line's open, please go ahead.

David Cook: (Nomura, Analyst) Hi guys, thanks for taking my question. I just want to concentrate if I can on inventory and implications that that might have. I recognise that your skew counter was up but I would have thought an increase in skew count would have potentially reduce the number of units you were holding each skew, particularly some of the, I'll call it the B&C skew range, and therefore wouldn't have had that much of an impact on your total inventory, inventory per store. So I suppose I am a bit concerned at the level of inventory growth particularly considering how much better sales did in the back end of the half, I suppose your guidance before Christmas, which suggests to me, and particularly with the gross margin implications, suggests to me that effectively you are buying sales to try and get rid of an inventory position and you still ended up with significantly higher inventory.

My concern is that that then will have an implication should that sort of scenario continue on your cost cover ratio, which if we lose the EBITDA first half/second half split of prior years against this first half EBITDA, with your lead costs et cetera, it looks as though you could be in breach of what I consider to be general banking governance. Can you just give us a bit more comfort that the inventory is not out of control and that your debt metrics and facilities are well within control?

Mark Todd: Well, I'll answer the last point and say that there's absolutely no issue in respect to that last point. I think probably then just particularly we renegotiated our facilities a couple of months ago and the governance that we're measuring here which are measured at the end of July, it can be at the end of our working capital cycle and our level of stock. So moving on from that point, Peter might want to talk about the sales.

Peter Halkett: Yeah, you made a lot of points, comments, questions and assumptions in there. I guess we're very comfortable with the level of stock. I think it's given the gross margin that we have achieved for the six months and the gross margin that we've achieved from what we provided and update at the end of December, and how we've been tracking since then, we're very comfortable with our margin performance. We don't believe we're buying business in the terms that you would describe it. I would have thought that NZD62.7 million was a very healthy margin. For us, having stock is like having ammunition. Margin does have to be a little variable in these difficult times. You need to respond. Customers are getting more demanding. Having stock allows us to deliver gross profit which is actually the key. So we don't see it as an issue. We see it as an asset. So no, no issues coming from banking.

David Cook: (Nomura, Analyst) So we should therefore expect inventory per store and in effect, inventory as a percentage of sales, so inventory cover, increase going forward?

Peter Halkett: Well, I think Mark talked about that in the presentation. We said that the current inventory levels were about 5% above our expectation at this point in time, partly due to the fact that we had received stock earlier. Once again, Mark did go through this. We had received a significant amount of stock earlier than we had at the same time last year. Also, we've got less stores. We expected a couple more stores. So if you take the total and divide it by the number of stores, you'd get a higher amount. So we're very comfortable with that stock position.

David Cook: (Nomura, Analyst) My last question is, just on your operating costs, you talked about rent increases. Are you looking and are you getting any rent reductions in any of your rollover stores? Then also on wages, I'm a bit bemused as to why your salary costs in Australia grew on a personal basis ahead of 8%. If you could just explain to us what's happened there, an EBA or something like that that came through.

Peter Halkett: Well, on rollover, we're not really getting any significant rent reduction at all. So our stores are all very profitable. So it's a bit of brinkmanship to suggest that we'd walk away from a highly profitable store to reduce our rent by 1% or 2%. So you know, it'd be great to think we were but that's just not happening and I know there's a lot of talk out in the market. That structural change you know, prime sites are getting more expensive and secondary sites are getting cheaper. But that's going to take some time and landlords need to come to grips with that and at this point in time, they're not. We're not prepared to walk away from profitable sites.

On the second point, when we're referring to Australian salary increases, they are the sort of awards that are coming through in Australia are significant. Our same store sales increase in Australia was 6%. We weren't using the 8%. I think if you look at retail generally in Australia, if you took the average retailer, sorry the average increase in retail around the 2% or 3%, the sort of increases we're getting through the award structures is more like 4% or 5%.

David Cook: (Nomura, Analyst) Okay, thanks for that.

Operator: Your next question comes from Ken Wagner from Octa Phillip. Your line is open. Please go ahead.

Ken Wagner: (Octa Phillip, Analyst) Good morning, thanks very much for taking my question. Just on gross margin, I think back in the trading update in December, you commented then that it had held up pretty well, similar to last year at that stage. Does that mean that it was outside the bottom of the range in the last six weeks as you discount to move inventory?

Peter Halkett: Well, I think if you take any selected period, you can have ups and downs below the bottom of the range, so it may well have been slightly below. But you know, from our point of view, January clearance is historically below the bottom of the range anyway.

Ken Wagner: (Octa Phillip, Analyst) Right, okay. Do you have an expectation to stay within the range in the second half?

Peter Halkett: Well, I think, once again, we've sort of indicated that we see not a lot of change from where we sit today.

Ken Wagner: (Octa Phillip, Analyst) Okay, and if you could expand a little, you're managing operating costs actively. If you could expand a little on what you're doing there other than the investment and systems infrastructure, please?

Peter Halkett: Well, when we look at our business, there's sort of three big boxes, well there's four big boxes of expense. There's store rent, which within the next six months, there's very little we can do about that. There's staff wages which we have been reluctant to be too aggressive on cutting the store labour but we need to be very careful. So we have an opportunity to be a little tighter on our store labour and of course, in total millions, that's quite an amount even if we save a very small percentage. We haven't had the aggressive assault that other retailers have had on our store labour.

The next one is marketing and what we've found with marketing it's the life blood of the business if we stop spending and advertising and encourage. If customers come to the store, we don't make sales that's actually 65% gross margin. So we're reluctant. But we can fine tune that and be a lot more focused. As we get bigger and bigger, we can realise the benefits of having a Summit Club database where it's at cost less to market to them. The fourth area, which is probably the one that's caused us the most pain within the first six months has been the distribution cost as we've cut over to our new core system and our new warehouse management system, there have been associated costs in terms of extra labour and our DCs because of the disruption cutting over to the new systems. We see that is probably one of the biggest areas we can say relative to the first half. But there's lots of other things in our business. It's really partly about grow the focus on a lot of small things, plan for some of the big chunky bits and continuing to open new stores so the operating leverage also comes with volume.

Ken Wagner: (Octa Phillip, Analyst) Okay, that's good. One final question on store rollout, can you just confirm of the 11 to 15 you expect to do in the full year, that includes relocation, is that correct? How many of those will be relocations?

Peter Halkett: No, they don't include relocations. They're 11 incremental new stores and there's New Market that's going to open next week in Perth, for the relocations within the second half.

Mark Todd: They only include relocations if you actually keep the existing store open and out there, which we chose to do with two of those stores.

Ken Wagner: (Octa Phillip, Analyst) Understood. Okay. Thanks very much.

Operator: The next question comes from Ian Graham from ACC. Your line's open. Please go ahead.

Ian Graham: (ACC, Analyst) Morning, guys. Just a couple of questions. You haven't given guidance per say for this year, and you're trading up data, I think you used the phrase, full year profit growth remains achievable or words to that effect...

Mark Todd: That was in the previous statement, not in this one.

Ian Graham: (ACC, Analyst) Correct. That was in the previous statement. So the question is, do you see any scenario or any sort of reasonable scenario for success in the two coming sales periods for you to achieve profit growth this year or are you conceding really that flat, slightly down is a more likely scenario?

Peter Halkett: Once again, we're not providing any guidance. However, if you look historically at the second half, if you look at the fact we've got an Easter sale and a winter sale and the proportion they contribute, there is a relatively wide range of possibilities that means we can still actually do quite well this year, or if things get really difficult, we can do quite poorly. So certainly we haven't eliminated that as a possibility. But as far as providing specific guidance, we're just not prepared to do that anymore.

Ian Graham: (ACC, Analyst) Right, okay. Just finally on that, and I'm not trying to hen pick you on this, or back you into a corner, but you know, looking at consensus forecasts in the market I think an Aussie Dollar tends around an EBIT of NZD55 million I think, the figure I know is NZD61.5 million is effectively where consensus is for the full year, the second half f NZD46 million, ahead of NZD44 million last year. So I suspect that's probably a little ambitious on behalf of consensus forecast at the moment.

Peter Halkett: Well, once again, we're just not providing guidance. I think clearly there are a range of scenarios that could occur over the next six months and it's obviously, we can't provide, we have no better view potentially on what's going to happen in the external environment and the weather. So we're just not prepared to go there.

Mark Todd: I think Ian, you'd well appreciate the variability in this business with weather alone in winter, which is our biggest promotion, is so substantial that to be really truthful, giving you a guidance on that would actually be a bit meaningless given that variability on the front which we just don't control.

Ian Graham: (ACC, Analyst) Sure. But you'll be following guidance and once you get a bit of feel for it, you'll be obligated to provide an update anyway.

Mark Todd: Correct. Let's say, I mean the weather today in New Zealand and forecast for the next week looks shocking so it should be a good start to the Easter sale.

Peter Halkett: History, bad weather certainly helps Easter. So I mean, there's just so many variables. We certainly seem to cop a lot of criticism when we do have an expectation and fall short of it, despite the fact that the business is clearly a very, very good business, it seems to cop more than it deserves. So we will deliver what we deliver.

Ian Graham: (ACC, Analyst) I understand. Well done on the sales, that was a good figure. Thanks.

Peter Halkett: If those sales continue to grow at that rate, and we will get operating leverage, clearly the long term future looks very promising. Thank you, Ken.

Operator: The next question comes from George Batsakis from Goldman Sachs. Your line is open, please go ahead.

Peter Halkett: Hi George.

George Batsakis: (Goldman Sachs, Analyst) Good morning, can you hear me now?

Peter Halkett: Yes. You forgot your mute button, didn't you George?

George Batsakis: (Goldman Sachs, Analyst) Yes, that's correct.

Peter Halkett: That's embarrassing in front of everybody, isn't it?

George Batsakis: (Goldman Sachs, Analyst) It is embarrassing. I apologise, everyone. Just a question on the operating expenses. You highlighted a couple of million dollars of one off non recurring type expenses. Is there anything else similar to that that might occur in the second half, you know, related to the brand relaunch?

Mark Todd: There's still going to be a bit of spend on brand as we continue to rollout the stores, George. But to be fair, we've had the bulk of that. We've got three quarters of the stores rebranded now, just under. The rest of the stores, we won't do at the same rate that we did in the last part of last year and the first half of this year because we'll probably align a lot of those with lease renewals when we decide whether we're actually going to renew or relocate.

Peter Halkett: It will be a lot less significant in the second half.

George Batsakis: (Goldman Sachs, Analyst) Okay, just a further question on inventory. I hear what you're saying about the rise year on year, but what about aged inventory, given the softer sales leading up to mid December.

Did you end up clearing or have any significant aged inventory at the end of the period?

Mark Todd: Going back to David's comment too, just highlighting that. I mean, just fundamentally, when you actually go and do the numbers and the metrics and we've said skew count was greater than 20% and the answer is it was substantially greater than 20%, if you sit down and just do those numbers in your head you'll realise that on a per store basis that actually, if you take a long term view, that number in aggregate terms is a very consistent and sensible number. So that's the first one. But then just coming back to your point, yes we did have more clearance in the business this year than last. Not a lot more, and substantially more than two years ago when we didn't have enough. So the point is when stock then becomes clearance of course is not necessarily just the point in time at Christmas, it's then the point in time after Christmas and ongoing through until Easter and winter. Those numbers at this point in time, not substantially different than they were this time last year. So in the end, we've had stock available to sell through clearance but we haven't got a lot more per store today than we did this time last year.

George Batsakis: (Goldman Sachs, Analyst) Okay, and just a further question on the operating expenses. You highlighted there about the wage cost increases for the period, but looking at your total wage expense for the period, it was up 26% to NZD28 million across the whole group. It was well above sales growth. Can you get wages growth to be more consistent with sales growth? What's going on there in the wages?

Peter Halkett: I guess I made that point before. There's probably more we can do with our store labour.

Mark Todd: Yeah, can I add a couple of other points to that. Obviously part of that is all around the cost of labour in our DCs which we've talked about. Another point is when we do relocations like we do and we have a number of large ones, we basically carry the cost of two stores for a reasonable period of time, and they're not small stores, so that's an impact on it. The third thing is that when we have to run additional campaigns as we did post

Christmas, we've obviously got to gear up to those and staff them accordingly so they're all part of the same thing.

George Batsakis: (Goldman Sachs, Analyst) Okay. Just one last question, you made the comment there you were budgeting for a decline in profit in the first half of the year?

Mark Todd: Yes.

George Batsakis: (Goldman Sachs, Analyst) What are you budgeting for in the second half?

Peter Halkett: [Unclear]

George Batsakis: (Goldman Sachs, Analyst) Okay, thanks guys.

Peter Halkett: Nice try.

Operator: The next question comes from Ray David from UBS. Your line is open, please go ahead.

Ray David: (UBS, Analyst) Good day guys. On the last trading update you actually talked about some reduction in potential cost and I know you mentioned on this call that there's some stuff that you can do around store wages. Can you give us maybe an idea of the quantum of the savings that you could achieve if the current sort of conditions continue and you gear your business a little bit more conservatively?

Peter Halkett: I mean, our view is that we want to reduce costs but that's really going to be on an annualised basis. I mean, the half year view of our business is always very tricky. But I mean, we do have an opportunity to probably improve our labour costs. We do have an opportunity to improve our marketing cost as we get more Summit Club members. We certainly have an opportunity to improve distribution costs as our new core systems kick in. The one really substantial cost going up marching forward is obviously the cost in rents and annual rent increases. So we feel pretty good about this, of all our costs, rent's the big one we have to watch very closely.

Ray David: (UBS, Analyst) The guidance for cost of doing business, the first half being typically 45% to 50% of the full year, is the swing factor the marketing expense?

Mark Todd: No, not really. The swing factor, all of the factors that are there, there's no one. We talk about those four bullet points, brand refresh is the one off. If you go through our [unclear] all of those three variables, the rent, the advertising, the labour, they can all vary. But the swing factor is as much the sales growth.

Peter Halkett: And number of new stores we open.

Mark Todd: Number of new stores. So there's no potentially one swing factor there.

Ray David: (UBS, Analyst) Alright guys. Thanks for that.

Peter Halkett: Thanks, Ray.

Operator: The next question comes from James McBeath from Bligh. Your line is open. Please go ahead.

James McBeath: (Bligh Capital, Analyst) Hi guys, just a quick one on your gross margins. You sort of made the comment that your product costs are going up but basically the benefits you're picking up from your currency have more or less offset that. If we think about an environment say 12 months down the track where we're not getting an incremental currency benefit, but that cost pressure seems reasonably ingrained in the business. We're already punching at the bottom half of your gross margin range. I'm just trying to get an understanding of how you think about that if we're still in a really fairly mundane type sales environment.

Peter Halkett: The supplier cost that we see over the next 12 to 18 months are very stable now. There are the odd exceptions in certain fabrics and materials that we use. But that ramp in increase in the last couple of years has actually slowed down and in some cases, reversed. So from a cost pressure, we don't see that continuing. From an FX point of view, we've still got some gain still to go. Beyond that, it's very hard to comment because it's all about whether we're getting incremental sales, whether we're able to have our sales target, how many Summit Club members we've got. There's so many interrelated factors that impact that gross margin. But in terms of FX and cost of goods or supplies, we don't see a significant change in the next two to three years from what we're doing today. It's really all about how much we can charge customers, not about how much we pay for goods.

James McBeath: (Bligh Capital, Analyst) Alright. Thanks guys.

Operator: The next question comes from Adam Simpson from Macquarie. Your line is open. Please go ahead.

Adam Simpson: (Macquarie, Analyst) Good day guys, just on the comment of sales are up strongly so far in the second half, has there been much change in your promotional activity so far this half compared to last half? It appears to be in and around the gear up so it felt like there was a little more sale activity.

Peter Halkett: Well, we've run the same events as last year. We have the gear up, actually we get active, we go into a sort of member's month and then we head into our Easter sale which launched today. So we've essentially got the same promotions but each year as we grow we can spend a little more on them, give them more profile. We learn from the previous events about the product price points we need to have. We're always introducing new lines. So there are differences of the same campaigns but we'd like to think we're getting smarter and wiser each year we go through those events.

Adam Simpson: (Macquarie, Analyst) Okay, so the campaigns are effectively the same. Just going back to Ray's question on the 45% to 55% cost of doing business split, does that hold this year given that sort of the actually NZD2 million non recurring expense you've had in the first half or should we sort of be stripping that out if we're thinking about those costs split?

Mark Todd: [Unclear] second half it's about the sales side of the equation isn't it, really, rather than the...

Peter Halkett: The NZD2 million should be struck out.

Mark Todd: [Unclear]

Adam Simpson: (Macquarie, Analyst) I'm not looking at it as a percentage of sales, I'm looking at absolute dollar terms. Then in terms of your cost initiatives, you've come in NZD2 million above budget. Can you get those down in the second half or is that going to be a longer term sort of plan to get your cost base back down towards where you were budgeting?

Peter Halkett: Realistically it's longer term. We'll be able to make some small impact in the second half but you know, the sales and the margin are biggest around that expense, saving we might be able to generate.

Adam Simpson: (Macquarie, Analyst) On the employee expenses, obviously you had a very strong year last year. With bonus payments and all of that, were they in this first half result, relating to last year?

Mark Todd: There were some provisions in short term in last year's first half but not this year. They won't likely be there this year.

Adam Simpson: (Macquarie, Analyst) So sorry, they're not in this year but they were in last year?

Mark Todd: Yeah, at this point in time, correct. They're not this year, but they were last year. Yes.

Adam Simpson: (Macquarie, Analyst) Okay, last one. Employee numbers, talk about store, what's been the sort of ramp up in head office and in centralised employee numbers and are you having to, with what's gone on in Christchurch, having to increase your headcount in Melbourne?

Peter Halkett: From a head office point of view, we've definitely got operating leverage. We have not increased our costs or our headcount by the rate of sales which is 15%. I think we're less than 10%.

Mark Todd: There are slightly more people in Melbourne than Christchurch. There's about four or five positions, because they might have been in Christchurch but now in Melbourne.

Adam Simpson: (Macquarie, Analyst) Okay, thanks very much.

Peter Halkett: Thanks Adam.

Operator: Your next question comes from Sarndra Urlich from First New Zealand Capital. Your line is open, please go ahead.

Sarndra Urlich: (First New Zealand Capital, Analyst) Good morning guys. Just my first question around the competitive environment that you're seeing at the moment, the GP margins would suggest that there hasn't been too much aggressive competitive activity, so just if you could talk to that. I know you've spoken about it for a hundred times so I'm just going to pre-empt Peter saying we've already spoken about that but I've been busy writing. Just the NZD4 million OpEx above original budget, can you just please one more time explain what that was for me? Thank you.

Peter Halkett: Well, I'll get Mark to go back to the OpEx because he did it in the presentation. As far as the competition's concerned, there are a number of new stores within our space that have opened, some that are very similar to us and some that have a product overlap but maybe only 20% or 30%. I'm referring to the BCFs and the FCOs and the overlap, you know they're primarily family camping businesses, sell a lot of equipment and they don't sell a lot of apparel. Whereas we are apparel and footwear which you know, from past you know is in the order of 60% to 70% of our business whereas equipment which is really packs and bags, sleeping bags, travel accessories for us. So there's certainly a lot more shops competing in the board space. They are competitors most like us, probably the Mountain Designs and the Mack Packs. Both of those businesses are opening lots more stores and clearly that's a headwind we need to battle against.

Sarndra Urlich: (First New Zealand Capital, Analyst) Are you still viewing the outdoor sector or the leisure sector as being on trend at the moment? As much as you can see or look at it, do you say, I don't know how much the overall market is growing for example, in Australia, but even [unclear] 6% are pretty decent. Do you still think that sector is outperforming versus other apparel?

Peter Halkett: Yes, we do. That's the trend we see globally. When we think of all those competitors, just the ones I listed there, I don't know what Mountain Design and Mack Pack do but my perception is that they're opening more stores so they'll be getting more sales one way or another. How much costs that generates, I just don't know. But BCF, FCO, so clearly there's a lot of people pouring into the space and given that you could argue we've been around a long time and we're still growing, it must be a pretty healthy space relative to what's happening in the rest of retail.

Sarndra Urlich: (First New Zealand Capital, Analyst) Again last year, you said that there was the whole phenomenon of travel, people travelling particularly with the strong Aussie Dollar and buying merchandise, for example, to do that. Do you still see that happening?

Peter Halkett: Well, the travel, as you're probably aware, we sort of have the adventure side and the travel side and roughly adventure means sort of outdoor sports and participation and hiking and climbing and more of those active things, and travellers jumping on a plane. So both sides of our business are pretty healthy at the moment. The travel side, the strength of the Aussie Dollar means that there's in particular, there's a lot of outbound but inbound's been affected. So all in all, I think a strong outbound is slightly better for us than necessary a stronger inbound because Aussies know our brand and buy our brand before they go whereas if maybe visitors coming in, they've already got their gear and they don't want to load up and take it back.

Sarndra Urlich: (First New Zealand Capital, Analyst) Thanks again Mark, just for repeating the NZD4 million, what that comprises for the hundredth time.

Mark Todd: Yeah, so the bullet point in the presentation highlight where the rate of increase and expenses has heightened the rate of increase of sales so that's the main reason why the expenses have gone up from NZD46.4 million to NZD51.1 million. The NZD4 million that's above our original budget also sits within most of those line items. Then of that NZD4 million, we assess approximately NZD2 million of that is non recurring, primarily all the costs are around the brand and the cost around distribution expenses.

Sarndra Urlich: (First New Zealand Capital, Analyst) Okay, so the NZD4 million includes the NZD2 million nonrecurring? It's not NZD4 million plus NZD2 million?

Mark Todd: No.

Peter Halkett: Sandra, I think another way to look at it would be, on that cost of doing business page, we've got total operating expenses of NZD75 million. NZD59 million last year, and the difference is NZD16 million. What we're saying is that we would have expected an increase of NZD12 million. Mark has explained the difference of NZD4 million through the grievance. So clearly as we open new stores you'd expect our expenses to go up and the turnover went up by NZD15 million so as a minimum you'd expect them to go up by NZD15 million in that particular line. Of course, because of the weighting of the first half is roughly say 40% of our sales, any additional costs have a greater impact on the operating leverage in the first half negative impact on the second half. So it's quite difficult to explain the concept but I think if you just take that line and say under normal circumstances we would have wanted that line to be NZD12 million, that would be NZD16 million. Of the NZD4 million, that's explained too and shouldn't come back to us again in the second half in the future.

Sarndra Urlich: (First New Zealand Capital, Analyst) Okay, thanks.

Peter Halkett: Did that help? Everyone can collectively say, no. Thank you, next question please.

Operator: Your next question comes from Jennifer Kruk from Deutsche Bank. Your line is open. Please go ahead.

Jennifer Kruk: (Deutsche Bank, Analyst) Hi guys. I'm just one quick question from me. Just on the gross margin seasonality, would you be expecting to get similar seasonality first half/second half as you have been previously?

Mark Todd: If you look generally at the second half of the year because of the greater weight in the winter apparel, stronger margins we get out of that, yes you'd like to think we would improve second half margins. [Unclear] that's historically the general trend. It depends obviously on sales performance and in particular the weather, I'd have to say, particularly winter.

Jennifer Kruk: (Deutsche Bank, Analyst) Great. That was all, thanks.

Peter Halkett: I think we've got about two or three minutes to go. So we'll pass back to the moderator for the remaining questions.

Operator: Your next question comes from Jacqui Fernley from Wilson HTM. Your line is open, please go ahead.

Jacqui Fernley: (Wilson HTM, Analyst) Good morning guys. Just one quick question on tax rate. It seems a little high at 38%. Was there a reason there? The second question was with respect to the NZD2 million one off, can you just flip that between the Aussie and the New Zealand business for me, please?

Mark Todd: I wouldn't do the later one sorry, Jacqui. But most of us in Australia, [unclear] questions. The P&L's there but not the breakdown of the one offs. But it does remain in Australia. The distribution costs issues are mainly in Australia and the brands are mainly in Australia because that's where most of the stores are. So it's primarily an Australian number. The tax rate, well you've got to factor out the UK losses in the first place which basically bring the effective tax rate up to just the New Zealand and Australian businesses on their own.

Jacqui Fernley: (Wilson HTM, Analyst) Okay. No problem. Thanks.

Operator: Your next question comes from [Tony Scana from Selecta Funds]. Your line is open. Please go ahead.

Tony Scana: (Selecta Funds, Analyst) Thanks guys. Just a quick question if I can. Just on the segmental information where you've highlighted details and contributions from various areas, I'm just asking the question on return from capital employer. Can you just talk specifically about Australia and what capital or what return you expect on your capital?

Mark Todd: I probably can’t answer that straight off the top of my head Tony, to be fair. I’m happy to take a more specific question and answer that to you later.

Tony Scana: (Selecta Funds, Analyst) The reason I’m asking is when I look at your sales and again, looking at this segmental, your gross margins in Australia shown here in New Zealand Dollars is in the order of 66% to 67% versus your New Zealand business. But your contribution bottom line is just not there. You talk about...

Mark Todd: Well it’s specifically not there for this period.

Peter Halkett: It’s a half year view.

Mark Todd: It’s a half year view as well.

Tony Scana: (Selecta Funds, Analyst) I understand that. But if you look at the environment in which you operate, and you talk about wages, you talk about rent, you talk about increase in competition and the fact that in Australia it is going to be tough on business because of the cost of doing business is higher. To me you know, I want to get my handle and my mind around what is the company’s view on the return that it expects on the capital.

Peter Halkett: Yeah, well the answer to that is I’d be happy to answer that on a full year basis if you were measuring effectively the returns on a full year basis compared to a half year and you were actually taking one off. You wouldn’t have an issue, I don’t think you’d ask the question Tony, don’t get me wrong. I’m just saying that wouldn’t be a question you’d ask.

Tony Scana: (Selecta Funds, Analyst) Okay, so it’s a question to ask at the full year then.

Peter Halkett: That’s a question to ask, given that our historical contribution on sales is above 20%, I’d be...

Mark Todd: New Zealand is a little higher than Australia...

Peter Halkett: Yeah, and I'm not growing on that but if you ask that question of us, you have to ask that question of every single retailer below the lowest really, truthfully.

Tony Scana: (Selecta Funds, Analyst) Okay, can I ask another question then just a general question on retailing, where things are. Do you think that retailers should have debt on the balance sheet considering that you've got operating leases in terms of the business you run? I'm not suggesting you've got high debt levels but it's just a general question. Would you be comfortable with Kathmandu having no net debt but simply having the debt in the inventory at least?

Mark Todd: Yeah, I think that's a fair question and generally speaking we aim for not very little debt in our annual workings capital cycle at the end of any year. But you have to look at that working capital and see that cycle and realise that that actually is what most of our debt level is there to fund, 80% of it.

Tony Scana: (Selecta Funds, Analyst) Thank you.

Peter Halkett: Thanks. I think that's time. Apologies if anybody's missed out on any questions. Mark and I begin, we're on the road for the next basically two and a half days and we will make ourselves as available as we can. Mark has historically responded to emails as well. So thank you for your time, everybody and I look forward to catching up with many of you over the next two and a half days.

Operator: That does conclude our call for today. Thank you all for your participation. You may all disconnect.

END OF TRANSCRIPT