



**Conference Transcription**  
**Kathmandu**  
**First Half Year Results FY11**

## Start of Transcript

Peter Halkett: Good morning, everybody. It's Peter Halkett, CEO. I've no doubt we'll still have a few people joining the call, but it is time to start. Just a small point, we don't have a moderator today so I'd ask all participants to keep their phone on mute until we get to question time.

With me this morning is our Chief [inaudible]. We released our results for the half year to 31 January 2011 to the market this morning. Those results and supporting presentation that we'll talk to ... website now and will be viewable on the ASX later in the morning when it opens.

We'll be presenting the result throughout in New Zealand dollars [inaudible] overview and then the key highlights of our trading ... pass over to Mark who will provide further detail on country operations, cash flow and dividend. Then I'll return for the outlook for the balance of this year and update on our key growth strategies. We'll then take some questions.

Just once again, as people join the call, please put your phones on mute. We don't have a moderator but will be conducting questions later in the session as well.

So just if we can move over to today's presentation, the results overview. The key line items we dive a little deeper. We'll go through each country and how each country performed, look at cash flow, dividend and balance sheet, the outlook for the year, key growth strategies and questions again, as I mentioned before.

The results overview, the highlights, there was a very solid first half sales performance, up 19.2% on the previous half. The sales performance in December and January were particularly strong. First half sales the result was slightly above the upper range we actually provided in our update on 19 January with the sales being NZD127.1 million and the EBIT being NZD19.9 million.

At that time, the top end of our range was NZD126 million. The top of the EBIT range was NZD19.5 million so we've done a little better than that. The last few weeks trading prior to the end of the year was stronger than our expectations.

The same store sales growth across the Group was 12.1% and at a constant exchange rate basis it was 9.5%. Bear in mind this was achieved on top of 13.7% same store sales growth in the first half of FY10. When you see the detail, if you haven't already browsed, the Australian performance was a very strong contributor to the [inaudible]. We've opened 10 stores since the end of FY10. We've actually opened three in the first half period.

Other drivers of the first half performance were our strong gross margins and that was actually at the top end, in fact above our target range that we've talked to many of you about in the past, and that compared 61.3 from the same period last year.

Our investment in stock grew by 28.5% in total, sorry, per store basis and we're going to go into a little more detail on that later. That was a key driver to our result, as we said. We also spent additional advertising money. I guess we felt that the period was going to be very difficult so from day one we planned to spend more to promote more and that would protect both our sales and margin and that came to pass.

The result really demonstrates the strength of the Kathmandu brand and continuing growth opportunity.

This is going through the actual result itself. I'm not going to read the whole page, I'm just going to pull out the key points again. Total sales were NZD127.1 million. The same number last year was NZD106.6 million and this was a 19.2% difference.

The gross profit was NZD82.2 million up from NZD65.3 million. That's a 16% increase, but it's really the story at the margin, 64.7% versus 61.3%.

Our operating expenses grew significantly. They were NZD59 million versus NZD47.2 million. That's up NZD11.8 million or 25%. Once again we'll go through the reasons there are not [inaudible] costs in that total.

EBITDA was NZD23.2 million compared to NZD18.1 last year. That's up 28.2% and at the EBIT line NZD19.9 million versus NZD15.5 million, up 28.4%.

Our net profit after tax, once again we'll go into the detail of this figure [inaudible] NZD10.5 million versus NZD4.4 million last year, up a whopping 138.6%, but bear in mind there are a number of factors in relation to that.

Store numbers; this time last year we had 90 stores. We now have 100.

Just moving through to the key line items, I talked about sales up 19.2% or NZD127 million. You can see the breakdown per country there. Sales growth, absolute sales growth was 12.4% in New Zealand, 20.8% in Australia and down 0.9% in the UK.

Our total growth on a constant exchange basis was 16.6%.

The only other comment I'd like to make about that page is you can now see that the Australian business is at least 50% greater than New Zealand contribution.

From a same store point of view we've decided a good way to illustrate the result is to go back, look at the first half periods over the last two years and so same store growth was 12.1%, as I mentioned, constant exchange rate 9.5%, but the aggregate total over the past two years at constant exchange was actually 22% and you can see for Australia is really strong and contributes to that. The same store growth was enabled primarily with increased investment in stock. That's just having satisfying demand and improving stock availability to our customers, increasing our advertising spend, expanding our product range offer, having more choice for customers.

Another important contribution has been upgrading our existing portfolio stores with relocations, refurbishment and upsizes and I think we also got [inaudible] in Australia.

Just moving through the gross profit margin, the margin was up 340bps over the equivalent period. This was a combination, in simple terms, of lifting some prices and also product mix. Different products attract different

margins and depending upon at what ratio they sell will actually shift the margin.

Also, you should be aware that the more business we do in Australia that lifts our average margins well because it's so much higher than New Zealand. We had a particularly strong Christmas trade period which meant our January end of season clearance we didn't need to be as aggressive, so that also helped our margin. It is above the top end along long term range. We're also balancing advertising versus discounting versus sales, so we're pretty happy with this result.

There was no significant FX benefit in this because we're hedged and the second half, it's going to be a bit tougher because we do face a number of cost increases from suppliers, coming out of China in particular, however we do intend to continue to lift prices and, as you can tell from this first half, we are getting those price increases through.

I'm just going to hand over to Mark now and Mark's going to talk about some additional key line items and then other financial matters. Thank you.

Mark Todd: Thanks, Peter. We were at slide 10 in the presentation in relation to the increase in operating costs for the year, which is 220bps. That's a mix of both planned and volume related lift in expenditure and a couple of one offs when comparing year on year. We've highlighted on the slide the five key line items that make up the vast majority of that spend. The advertising spend for the half year was up to 6.2% of sales, which is at a similar level.

Peter Halkett: Sorry to butt in, could we just ask, there's still quite a lot of background noise I've been told. We can't hear it from our end because we're speakers, but if everybody could ensure they're on mute please.

Sorry, Mark. Carry on.

Mark Todd: That's fine. So, as I said, the advertising spend is 6.2% of sales which historically is our high level in the first half year to the second half year. The lift in supply chain costs primarily around the planned inventory volumes and the movement of that stock out to our store network, as well as

the challenge of rate increases in freighting in both countries and the full year effect of being a listed company this year versus last year.

The changes that we look at year on year in comparison we've provided in this year the cost of short term and long term management incentives on the basis of achieving the company's targeted expiration results for the year.

There was no provisioning for that last year and we also in the period prior to the IPO last year were accounting for translation gains and losses on our Australian intercompany loan account through the profit and loss account.

That's now passed through foreign currency translation reserve, so last year first half year NZD0.5 million gain to operating costs for that.

So then if you pass on through the presentation of earnings for the last three years and we talk about the country results overall, in New Zealand the profile of the store network in New Zealand is relatively unchanged in terms of new stores year on year. We've highlighted that we completed several major refurbishments and relocations in the store network. Our Queen Street store in Auckland is partially complete and we've had great returns from those projects.

The operating costs in New Zealand as a percentage of sales are higher than the increase in Australia, but that's at this stage before the allocation that we do at the end of the year of intercompany service charging given that the bulk of our head office costs are domiciled in New Zealand. The operation, we year on year do a correction of charge of those costs to Australia and we do that exercise once only at the end of the year. So both countries have actually improved their trading result year on year. It is correct to say the Australian performance, which is on the next page, is better than New Zealand and there's a reconciliation of those trading results to the actual segmental results in the interim financial statement at the back of the presentation.

Just in relation to Australia, Peter's already commented on the improvement in sales. It's fair to highlight again in Australia that the brand is still maturing and that's particularly evident when we look at the opportunities that still exist in the central cities and particularly in the main metropolitan

areas in Australia and the results we've had from the new stores we've opened in central cities such as Brisbane and Canberra and the improvements we've done in places like Bourke Street in Sydney.

UK, which this year is down to being 3% of Group gross profit for the year, there's a one off cost there relating to incentivisation of the management team for performance and share incentives that were linked to the IPO but had a retention period. If you take out the one off cost effects the year on year result is pretty much flat with FY10, recognising that same store sales were down slightly in the UK and that primarily occurred post the VAT increase on 1 January.

Operating cash flow for the year as you define it by the accounting standards is negative NZD8.8 million, for the half year sorry, compared to a positive NZD0.5 million last year. Just highlighting two matters in relation to the cash flow the build in the inventory levels for the half year year on year at NZD16.5 million and we've managed to recoup half of that through obviously increased profitability in the period and the CapEx spend for the half year which is NZD4.1 million is still expected to be higher than in the full year than the NZD13.6 million of CapEx that occurred in FY10. The bulk of that spend will definitely occur in the second when we talk soon about the store network plan.

Peter Halkett: Just to remind people, please mute your phones. I can hear some background noise now so it must be quite bad for others.

Mark Todd: The interim dividend; the first interim dividend is NZD0.03 per share interim dividend which is within the payout ratio that we previously advised, and we note at this stage there's no expectation that the payout ratio will change to be within that 50% to 60% range.

The interim dividend is fully imputed in New Zealand, but it's not franked in Australia. We're at this stage uncertain we can fully frank interim and final dividends 100%, but we expect to be able to do so every two or three years so we don't always fully frank the final dividend and leave the interim dividend unfranked until we have years where we have enough franking

credits available to frank the dividend 100%. That is the most advantageous outcome on a net basis for Australian shareholders as well.

Just on the balance sheet, just the key line item to talk to in terms of balance sheet is the stock build and that is what we previously said to investors that we were to build our inventory levels in this period. We have built them to a level that's pretty equivalent to that of two years ago. The per store calculation as you see there on slide 19 is slightly less per store at the end of this half year than it was at the end of the half year in 2009 and this is indicatively the level of inventory that you could expect to see in the business going forward. We'd expect our year end inventory levels per store to be similar again to those that existed at the end of FY09 year.

Hedging and the hedging profile; we've already mentioned that the hedging performance in the first half year was similar to the first half of FY10. Our profile for the second half of FY11 is also similar to the first half. We have, you may note, approximately 15% to 20% of our offshore spend unhedged in relation to duty and freight and other import costs, but all base purchase costs in US dollars are generally 100% [unclear] period.

Looking to the first half of FY12 the hedging rates in place for both Australia and New Zealand are at better rates than those that we've just gone through in the first half of FY11.

In terms of translation gain, the results from New Zealand to Australia, last year's full year rate was NZD0.80. For each NZD0.01 below that that we might or are, of course, if the Kiwi actually strengthens, for each NZD0.01 differential there's approximately a NZD0.3 million EBIT [unclear] in New Zealand dollar terms to the second half year result.

Peter Halkett: Thank you, Mark. Just before I start on the outlook, once again just the mute buttons.

I've broken the outlook down into three components; one, what Kathmandu is doing internally, which I think has been the key for our result over the last six months, what our view of the market is, not that it's terribly scientific, it's just so volatile, what we think that means in total.

So we're on track to achieve our target of 15 stores within the full financial year. Our store refurbishment program continues and, as Mark has highlighted, is getting good results so, if anything, we're going to accelerate that. The product range expansion and the increased inventory investment will continue. As Mark said, at the end of the year it will be similar to two years ago, so you shouldn't form the view that there's a situation where inventory is going to continue to grow and grow and grow at a per store level.

We have a brand refresh project underway which we'll start to see some of that material flow through at the tail end of this financial year.

Our gross margins will be a bit more of a challenge to us for the reasons I mentioned before; cost increases coming out of [inaudible] the largest ones of those are our winter sale.

Someone who's just jumped on, please go on mute.

The operating costs as percentage of sales may be slightly higher than FY10, reflecting our increased investment in advertising, our people and our resources.

Sorry, someone needs to mute please.

One thing to point out is that we're actually cycling against a very flat second half performance last year. I think people are well aware that was a difficult period for the market and for us so yes, overall we'd see that as an opportunity.

From a market point of view there's so much uncertainty worldwide it seems to be seeping through to the Australian consumer now and obviously with that and reducing debt and trying to become more secure it's not helping discretionary spending. The New Zealand economy will be impacted by the earthquake that the government somehow is going to have to fund that through the tax increases or cutting programs, so that will be less disposable income.

China; the internal economy in China is on fire. That's creating cost increase, labour increases that flow through to us and competition, plenty of

people getting into our space and people see the outdoor sector as attractive and more and more of those players, whether they be suppliers setting up retail stores or retailers developing their own brands, are moving towards the vertical business model.

But for all of those things, I think in summary the first half performance and the continued store rollout provides us with a great deal of confidence that we can improve both the second half and the year on year profitability.

Mark Todd: Sorry, there's somebody specifically who's joined the call in about the last three minutes who's definitely not got their phone on mute. Could they please either put their phone on mute or if they can't take it off, delete the call because we're still getting feedback.

Peter Halkett: I'm going to move through to the growth strategy page now. I'm really just highlighting three of our main growth strategies. The first one is our new store rollout which I think everyone's very familiar with. This year we'll the plan as I've already mentioned. Our total targets remains 150 but we're also investigating other new store formats which will probably take us beyond that level, but that's in its early phases.

I'm not going to read through the details of the stores, however, we have actually just confirmed another two stores today.

Mark Todd: Okay, the lady who just said three months and that's a nice dress, could you please [inaudible] the call? Sorry, the lady who's just said three months, that's a nice dress, can't afford it, could you please get off the call?

Peter Halkett: You're just going to have to bear with us. We'll take questions soon. I guess we can handle other questions one on one.

The next part of our growth strategy is the existing store network optimisation. This involves refurbishments, relocation and increasing our store sizes to accommodate the growing range we have. This is really important to us. This is about leveraging our existing hundred store [inaudible] and then product range growth. There continues to be more and more products, more and more categories we can add to our range. Once

again that's going very well and again I'm not going to go through the detail of that.

That sort of completes the outline of where we're at. I'm now going to take questions. This is going to be quite a difficult process. First of all, we do have someone who doesn't know how to mute their phone, but it's going to be first in first served. What I'd ask you to do is to say your name and then obviously address your question. If you don't get in first, please mute your phone again.

So, ready, steady, go.

Mark Todd: Guys, can I just say before we start, to mute your phone, guys, if you don't have a button it's star six.

Ray: (Analyst) Good day, guys. It's Ray [inaudible] question.

Peter Halkett: Okay, I've got a question from Ray, so go ahead.

Ray: (Analyst) Just the tax rate was quite high this first half result. What do you expect the tax rate to be going forward?

Mark Todd: The specific reason for the tax rate, Ray, is the translation gain in the Australian company account is provided for at the normal company tax rate in Australia. So the effective tax rates are the effective tax rates, it's just that when you consolidate it that gain actually gets taken out of the Australian result because it's eliminated on consolidation and passes through reserve.

On a consolidated basis the tax rate looks high, but it's basically just company tax rate on an individual company level.

So if that gain reverses, obviously the tax rate would adjust accordingly. I can work through that later with you if you need.

Ray: (Analyst) Okay, thanks for that.

Mark Todd: Next question, please.

Rob Freeman: (Nomura, Analyst) Good day, guys. It's Rob Freeman from Nomura.

Peter Halkett: Hi, Rob. Go ahead.

Rob Freeman: (Nomura, Analyst) Good day. So just two questions to get started. Just looking at the one half '11 performance, obviously cycling a record one half '10. If I think back to one half '10 it was record sort of warm temperatures, particularly in Australia. You obviously had the unseasonable wet and cool weather for one half '11. Can you just talk about how that 12% comp store sales growth in Australia works?

Peter Halkett: Well first of all, on a weather basis we think that's provided a little bit of a tailwind but not as much as you may think, because when we look at it as a per category basis we don't see those categories that would get that support from wet weather, particularly that much stronger than other categories.

Then also, when we look at it on both a New Zealand and regional basis it isn't just a case that places that received the weather have done disproportionately better than those that had more consistent weather. I'm not really sure that that addresses specifically, but the weather is not a massive contributor to it. I think it's been more about stock availability and range growth, those other factors that have driven most of that increase.

Mark Todd: Yeah, and if I just add as a general example for you, Rob, one of our strongest categories in both countries has been our lightweight woven category across the whole market in both countries and certainly in some areas like east coast Australia, you wouldn't have necessarily expected that to be the case. So we attributed what we think to be the main reasons in the presentation and weather's a contributor but not a significant contributor. It's more about what we've done on the product and the depth of product overall.

Rob Freeman: (Nomura, Analyst) Can you maybe just spend some time talking us through the mix changes one half '11 versus one half '10, which categories you've up weighted, down weighted, et cetera?

Peter Halkett: I'm not sure that that's appropriate for this call, Rob, and a lot of that information we haven't historically disclosed.

Mark Todd: And we've got 20 major categories, Rob, so it kind of gets into a lot of detail.

Rob Freeman: (Nomura, Analyst) No, that's fine. I'm just trying to get my head around 12% comps, cycling double digit when the rest of the retail market in Australia's doing low single digit or, in most cases, negative.

Peter Halkett: Well I guess what we'd say is we've provided those explanations. We're unlikely to want to go to a detail which our competitors would find really, really useful, Rob.

Rob Freeman: (Nomura, Analyst) Yeah, okay, that's fine. So just two more. Firstly, just on second half '11 are there any stock mobility issues through New Zealand just with infrastructure being down in Christchurch?

Peter Halkett: It's certainly been a big challenge for our BC team to get back up to speed and potentially some minor impact for our Easter sale which commences next week. However, beyond that I don't see any major concerns.

Rob Freeman: (Nomura, Analyst) So everything should be back up and running for winter?

Peter Halkett: Well everything's up and running now, but it's just we're working double shifts and making sure that the right amount of stock is in the stores for the launch of our Easter sale and the guys are working very hard to achieve that and I think we'll largely be there within 95% to 100%, somewhere in that range.

Once [inaudible] within the next three weeks we'll be operational normal again [inaudible].

Rob Freeman: (Nomura, Analyst) Okay. Just looking at, I suppose, outlook commentary, you've mentioned you're hoping to get, obviously, profit growth on PCP. If I just have a quick look at consensus, the market's got you growing EBIT at 26%. That's obviously a lot more than just growth that you're commenting on in outlook.

I suppose, are you comfortable with that figure at this stage and what downside risks should we look for for achievement of that?

Peter Halkett: I think we've sort of quantified some of those risks in the detail of the pack such as the weather again impacting our winter sale. We're clearly reluctant to put an actual figure on it. We've done that before and got ourselves into a bit of difficulty when we're in such a volatile environment, but no, I think what we're really saying is we grew our business by a decent amount on a prior period that was very high. If we can continue just this same momentum through the second half I think we'll deliver a very strong figure.

But there's no certainty. It's very hard to predict what's going to happen next. There's no doubt [inaudible] it looks very positive. We don't want to go back there again.

Rob Freeman: (Nomura, Analyst) Yep, and then if we could just spend a little bit of time just talking about the cost increases coming through from China. Could you just remind us, I suppose, what proportion of your cost base is cotton, polyester, et cetera?

Peter Halkett: Well I think probably at the high level, the sort of increases we're facing across the range are probably between 10% and 20% and so when you look at our gross margin of around that 64, that level of increase probably requires us to sort of increase our retail costs of 3% or 4%. So it's quite a lot coming through in terms of increases because there are not just increases in raw materials, there are increases in labour rates.

Basically everything's going up in relation to China, but we've already factored those price increases into our pricing for winter sale and, as I said, we've already made good progress in summer of getting some of those increases through, but it's quite significant. I think you could say that the average is somewhere between 10% and 20% across the board.

Rob Freeman: (Nomura, Analyst) Ten to 20% of your range will be affected?

Peter Halkett: No, the increase. If you took our entire range you would apply at least a 10% increase to our cost base across everything we buy.

Rob Freeman: (Nomura, Analyst) Year on year.

Peter Halkett: Year on year.

Rob Freeman: (Nomura, Analyst) Okay, thanks guys.

Peter Halkett: Next question, if there are any.

George Batsakis: (Goldman Sachs, Analyst) Hello, Peter and Mark. It's George Batsakis from Goldman Sachs. I just wanted to ask a question on the New Zealand results. The relatively, or the flat profit, are you saying that was just related to intercompany service cost recovery or was some extra discounting there in New Zealand?

Mark Todd: Well the margin in Australia is a greater rate of increase than the margin in New Zealand, George, but the gross margin did improve. At the EBITDA margin level there's a very small increase which will be slightly better when we do correct all of our intercompany service charges. But in the end that rate of increase, which at the moment's only about 3% year on year, is not going to be as high as the Australian one.

George Batsakis: (Goldman Sachs, Analyst) And the reason for that?

Mark Todd: Because the gross margin increase rate is much higher in Australia than in New Zealand. We've only gone up one percentage point in gross margin in New Zealand.

George Batsakis: (Goldman Sachs, Analyst) Right, okay.

Mark Todd: With the cost base it's increasing at a similar rate year on year to the Australian rate.

George Batsakis: (Goldman Sachs, Analyst) Okay, great. That was all from me. Thank you.

Peter Halkett: Thank you, George. Next?

Adam Simpson: (Macquarie, Analyst) Adam Simpson from Macquarie. Just following on from George's question, are there more of the one off costs borne in that New Zealand result which you will then back out of the full year result?

Mark Todd: Correct, because if you take examples say like the management incentive, Adam, they're all, both of the management and executive team are all domiciled in New Zealand, so you've got all of those costs provisioned in New Zealand but we haven't done a year on year correction and an allocation of those to Australia until we get to the end of the year. That's right.

Adam Simpson: (Macquarie, Analyst) Had time to quickly work it out. Looks like your operating costs are only up about three and a bit million in New Zealand. No EBIT including for that? Is that correct?

Mark Todd: Well off the top of my head I wouldn't know the answer to that, but you keep going and I'll see if I think you're about right.

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

Peter Halkett: Any other questions? Mark will probably get back to you directly, Adam, on that. I haven't heard anyone coming in. I apologise for the background noise. I'm not exactly sure how bad it was from the participants' end but we really do appreciate your time in dialling in. We're meeting many of you on our roadshow over the next three days and I look forward to that and no doubt you'll have some more questions for us then. So thank you very much and we'll see many of you shortly.

**END OF TRANSCRIPT**