Company: **Kathmandu Ltd**

Conference Title: **Kathmandu Half-Year Result Analyst Call**

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Operator: Good day and welcome to the Kathmandu Half Year Result Analyst Call. Today's call is being recorded. At this time, I'd like to turn the conference over to Xavier Simonet. Please go ahead, sir.

Xavier Simonet: Good morning. Thank you very much and welcome to the First Half FY17 result presentation for Kathmandu Holdings. My name is Xavier Simonet and I am the CEO of the company. I'm joined on the call by Reuben Casey, our CFO. We'll be talking to the presentation, which you can find on the NZX and ASX this morning. Most of the numbers are in our reporting currency, the New Zealand Dollar, unless when it is specifically mentioned that they are in Australian Dollars or British Pounds.

Now, let us move to slide three, strategy recap. Before we read you the first half numbers, I want to spend a moment on our growth initiatives. We defined key growth strategies last year. The strategies have not changed and they remain a constant focus for us. The first strategy is on products. We are a design-led business and our core strategy is to design great, innovative, distinctive and sustainable quality products.

Customer-centricity is the key aspect of our strategic approach. Last year when we reviewed our promotional model and pricing architecture, it was all about understanding the customer journey and making sure that we get customers excited about our commercial activities. Customer-centricity is also an essential element of our work on products. We bring market products that offer solutions to our customers who go to the outdoors and on adventure travel.

Our products answer the functional needs of our customers, but we also want them to be beautiful and stylish. I have talked about products. We then have two buckets of key strategies: continuous improvement initiatives, and growth initiatives. Continuous improvement strategies are about doing better, what we do every day, and optimising our existing assets, strengthening our brand equity, optimising sales and profit densities per square metre in our stores, engaging with our customers partly online and through social media and digital marketing and last, driving cost efficiencies with a relentless focus on cost control.

New growth initiatives are about capturing international opportunities, and marketplaces, and about continuing to open stores in Australasia, when the right opportunities come up. I will come back to our strategies and give you an update later in the presentation but I wanted to set the scene.

If you now go to slides five and six, Result Overview. In a few words, I would like to highlight our key results of the first half of FY17. Now, sales and gross margin. What I consider the main achievement of the first half of FY17, is that we grew same store sales in both core markets, Australia and New Zealand. Overall, same store sales went up 3.4% on last year at constant exchange rates. More specifically, we managed to deliver strong same store sales growth in Australia, our biggest market by 5%. Over the last few years, we have invested significant amounts of money in Australia and opened many stores. Now is the time to leverage our investments, drive market penetration and generate growth.

Our gross margin was 61.6% in the first six months of FY17. Our business was significantly impacted by a stronger US dollar. Moving to costs and efficiencies, we kept a strong focus on keeping costs tight and on delivering efficiencies. We also believe that our company should be lean and agile. As an example, we restructured our retail operations at the end of last year to cut the number of layers and we put in place a leaner and more streamlined organisation. The objective was also to become a more agile business with a short decision-making process between the stores and the head office.

Coming back to costs, during the first six months of FY17, operating expenses decreased by 100 basis points as a percentage of sales, or $1.8 million and we improved our operating leverage. Profit-wise, net profit after tax was up 6.4% at $10 million.

Slide eight, Sales. Total company sales were flat on last year at actual exchange rates but up 3% at constant exchange rates. It is worth noting that UK sales were heavily down on last year due to the closure of bricks and mortar stores, as per the strategic decision we made last year. Online sales continued to enjoy a healthy level of growth at +18% and account for 7.4% of total company sales.

Reuben Casey: And just to clarify on slide nine, the Australasian sales growth rate is +4.2% on a constant currency basis, so just taking out the effect on the year on year change in the Australian and New Zealand dollar exchange rate.

Xavier Simonet: Slide 10, same store sales result. Same store sales growth is a key performance indicator for us and one of our key strategic pillars. I'm pleased to report that both our core markets, Australia and New Zealand delivered same store sales growth in the first half of FY17. Total company same store sales were up 3.4%. Same store sales growth was particularly strong in Australia at +5%. It is interesting to note that growth accelerated and that we gained momentum in the second quarter of FY17.

On 18 November 2016 at our AGM, we indicated that total company same store sales growth was 1.4% for the first 15 weeks of our financial year. We saw strong momentum through the key Christmas trading period, particularly after Christmas, and so finished the half with 3.4% growth. The improvements we have made in the business with a very customer-centric view have contributed to this result. In particular, all the work that has been done to simplify our promotional calendar, to review pricing architecture, to improve our visual merchandising and to connect and engage with our Summit Club members through digital marketing and much improved content. I also want to highlight the great job done by our product and design team in New Zealand and by our retail store teams.

Reuben Casey: Moving on slide 11, gross margin, which is obviously a key driver of our bottom line profitability. We did expect to be below last year's first half-year in this half by around about one percentage point as we had favourable hedging rates rolling off. We did a lot of work with supplier negotiations, new product introductions which we can introduce at the margin we'd like to introduce, pricing changes and had improved stock management to offset any currency impact, which we largely did.

However, we still had a decline versus last year and probably can attribute half a percentage point due to FX impact, half a percentage point due to having more clearance this year than last year and the remainder due to timing of sales. We had a good Christmas period but the sales did come slightly later than we planned, which had a slight degradation on our margin achieved.

Moving on to slide 12 Cost of Doing Business. As Xavier said at the beginning, this is an ongoing focus for us and we remain very vigilant on costs. We have managed to achieve operating leverage versus last year and that's even allowing for the approximately $1 million one-off cost that we incurred in last year's result. The main challenge in our cost base is rent, particularly in Australia where rent continues to increase. In New Zealand, we haven't seen the same level of increase that we see in Australia.

We have made good progress in this half in targeting effective market spend, optimising our use of retail labour, which is a benefit of investments we made in rostering systems, and also maintain head office cost control after our restructure last year.

Let us move on to the earnings summary on slide 13. The main thing to point out is when we look at constant exchange rates EBITDA and EBIT, it's $22 million for EBITDA and $15.2 million for EBIT. That's at a constant New Zealand / Australian reporting exchange rate.

Okay, if you look at the country results, starting with Australia on slide 15. We operated two additional stores during this half, both in Queensland, Gold Coast Harbour Town and North Lakes. In addition, we completed relocations in some major redevelopments of shopping centres at Pacific Fair, Warringah and Doncaster, and expanded our space in Essendon DFO. As you can see, the cost of operating in Australia continues to produce a lower EBIT margin than New Zealand.

And if you look at New Zealand on slide 16, we saw a return to historical gross margin levels after positioning ourselves last year with pricing to offset the US dollar impact that we knew was coming. We had good operating leverage which helped to offset the margin decline and we continued to invest in refurbishments in Queenstown and Sylvia Park.

The UK on slide 17, we are cycling store closures as Xavier mentioned earlier, so that's the main reason why sales have dropped and we are striving to achieve a breakeven position, which we have done.

Looking at cash flow on slide 19, we made some large CAPEX investments in FY16 on our Australia distribution centre, which is based in Melbourne and flagship stores in

Melbourne CBD and Adelaide Rundle Mall. So although the CAPEX we spent this half is a big reduction on last year, it is simply not a reduction in activity, it's just that we had some major investments last year. Operating cash flow remains healthy and we will continue to invest in future growth where a return on investment warrants it.

If you look at the Balance Sheet now on page 20, we continue to achieve a reduction in inventory year on year. On a per store basis at the half-year point, we are actually below our FY13 levels and this is a decrease from last year of 3.8% on a constant currency basis. This is really helping us to have a low level of net debt, which of course means a low level of borrowing costs. Stock turns, we have to acknowledge are still below what we would like them to be, but we expect them to improve for the year-end position.

Moving on to Dividends on slide 21, we have declared an interim dividend of NZ 4 cents per share which is an increase on last year's NZ 3 cents per share. It's fully imputed, but not franked and is payable on 16 June 2017. I'll hand back to Xavier now for our strategy update.

Xavier Simonet: Thank you Reuben. Moving on to slides 22, 23, 24, and 25. Strategy Update. Our five focuses remain the same as last year. Customer-centricity, creating distinctiveness, delivering great value to our customers, inspiring through our brand, cost control and efficiencies. As I said earlier, designing great, innovative, distinctive and sustainable quality products and solutions remains our first and core strategy. Our focus is very clear. It is to answer the needs of our customers related to adventure travel.

We are very proud. We got earlier this year, the ISPO Gold award for our Terrane Adapt Pack. ISPO is the main sports and outdoor show in Europe where we exhibited for the first time this year. The Terrane Adapt Pack is a technical breakthrough, and it is patented. Now, last year we defined two sets of growth strategies: continuous improvement strategies and new growth initiatives. Continuous improvement strategies will deliver sales and profit growth in the next couple of years at the same time as we start executing new growth initiatives, which will take more time to get traction and scale.

Let me give you a few examples of what we have done in regards to continuous improvement initiatives. As for brand and customer, I believe that more than just a retailer, Kathmandu is a great brand. We said last year that we wanted to improve our communication and engagement with our customers, particularly by bringing to life through digital and social media channels distinctive and inspirational stories about our heritage, roots, values, our products and our expertise in adventure travel. In the first half of FY17, we increased our social media reach by 26%, six million people viewed our videos and we had an increase of 366% in click throughs to our website.

In regards to Summit Club, we continued growing the number of loyal customers from 1.5 million last year to 1.7 million active customers this year. In February, we've sponsored for the first time the iconic Coast to Coast race in New Zealand, which has become the Kathmandu Coast to Coast. We generated huge content and engagement from this event with customers and our teams. As a customer-centric organisation, we have put in place in all our stores, the tools that enable us to measure our net promoter score. The net promoter score was about 74% in New Zealand and Australia in the first half of FY17, a really good performance.

Now, moving on to store optimisation. We have conducted trials in a few stores, which were successful and are now implementing the lessons learned, particularly with regards to range and space and location with a strong emphasis on metrics like sales and gross profit densities by square metre. In terms of pricing architecture and commercial model, well, the high-low model has been successful for Kathmandu in Australasia. In FY17, we continue the work that we initiated in FY16, defining a more efficient and clear promotional calendar, adjusting our price points, updating our promotional messaging, making our promotional mechanisms more interesting and surprising.

Connected customer journey, well we're continuing to invest in online and digital capabilities as online sales continue to grow at a faster pace than brick and mortar sales. Online sales accounted for 7.7% of total sales in Australia in the first half of FY17 and 6% in New Zealand. Our ambition remains for online to generate 10% of total company sales.

As an example of a significant investment we made, we launched at the end of 2016, a responsive website which integrates content and commerce and gives customers access to inspirational content as they browse on our website and shop. We also deployed marketing cloud tools in the first half of FY17, which provide targeted email capability and give us the opportunity to leverage our Summit Club database and the work we have done on customer segmentation.

In regards to cost efficiency, optimising our investments, controlling our cost base, simplifying the way we do business, and evaluating the return on investment are key to our approach. Let me give you a few examples. In FY16, we invested in footfall counters for all our stores. Footfall counters are giving us the ability to track traffic and customer conversion and provide us with very much needed data to make critical promotional decisions, marketing investments and adjust trading activities.

We have also just opened a new Australian distribution centre in Melbourne with automated sortation capabilities. We expect efficiency benefits to be realised from FY18. Last, we have continued to strengthen our supplier partnerships to enhance quality, innovation, sustainability and profitability to help offset exchange rates.

Moving on to new growth initiatives, and I would like here to particularly talk about international. For the first time we exhibited this year at ISPO the outdoor and sports trade show in Germany and travelled to Europe to engage with a certain number of European outdoor retailers. The story of our brand, the distinctiveness of our products and our success story in Australasia were well received. Some feedback we got from prospective customers is that our products offer good balance between functionality and style. The first stage in this process was to establish relationships with selected key European retail partners. I'm pleased to say that we are currently finalising agreements with a couple of strategic retailers in the UK and Germany to run trials in their stores for European winter 2017. Back to Reuben.

Reuben Casey: Thanks Xavier. I'm just going to say a few words about sustainability on slide 26. Something we don't really talk about enough is our commitment to sustainability and it's something that's inherently part of our company values, is very important to our customers and to our employees. Last November, we were honoured to receive a Large Business Sustainability Leaders award in Australia, awarded by the Banksia Foundation. And we've set ourselves some challenging goals to achieve around re-using plastic bottles in our products, zero waste to landfill, 100% use of sustainable cotton, and reductions in carbon emissions.

These are all challenges that involve a truly cross-functional effort by everyone in the company. We also remain committed to progressing to full Fair Labour Association accreditation, a Bluesign membership, minimising our carbon footprint, engaging with the community and investing in our team's training and development. For Kathmandu, we see this as not just window dressing or a box ticking exercise but it embodies who we are and how we operate and what we believe is the right thing to do. If you have not had the chance, I would encourage you all to read our 2016 Sustainability Report available on our investor website for more insight.

Xavier Simonet: Last slide of the presentation, slide 28, Outlook. In the industry, the outdoor industry is and will remain immensely competitive. At Kathmandu, we believe with passion that, more than just a retailer, Kathmandu is a great brand. Our own in-house product design team based in Christchurch, designs great, innovative, distinctive and sustainable quality products. We are up for the challenge to compete, not only in Australia and New Zealand, but also internationally.

The international wholesale opportunities are developing and we're really starting a journey that's going to take some time but the recent trip to Europe have given us confidence that both our brand and products have strong relevance, offer distinctiveness, and can have credibility internationally. We also remain committed to continuous improvements, and in the second half of FY17, we refocus on same store sales growth, particularly in Australia; strengthening the Kathmandu brand and customer engagement; connecting with customers through social media and digital channels; cost control, and efficiencies.

That is all from me. Thank you very much for joining the conference call this morning and we're going to take a few questions.

Operator: Thank you. Ladies and gentlemen, if you'd like to ask a question at this time, please press *1 on your telephone keypad. If you're on a speaker phone, please make sure you turn off your mute function so your signal can reach our equipment. Once again, for questions at this time, please press *1 now. And we do have a question from Chelsea Leadbetter from Forsyth Barr.

Chelsea Leadbetter: Thanks Moderator and morning, guys. If I can just start with - are you there? Can you hear me?

Xavier Simonet: Yes, good morning.

Chelsea Leadbetter: Okay, morning guys. Just start with outlook and I appreciate it's far too early ahead of winter to give any particular guidance but you did comment on improved momentum in the second quarter. Have you seen that continue since balance date?

Reuben Casey: We're not going to comment on trading since balance date, simply because the time of our autumn promotion is different to last year so it's really difficult to give an accurate picture of that.

Chelsea Leadbetter: Okay. Well, then I guess I'll ask another sort of question along the same lines. The backdrop that you're seeing in the competitive landscape in both Aussie and New Zealand, have you seen any meaningful changes over the last six months or going forward with respect to your competitors?

Reuben Casey: I might comment that our outlook is constantly changing and that's really what we're seeing. In Australia, we've seen adventure mega store open a few stores, that have the Colombia license, and Macpac have opened a few stores. There's not been a whole lot of change in New Zealand and Mountain Design are opening a few stores in regional centres. Rays have gone through kind of contraction and reformatting, so it's constantly changing.

Xavier Simonet: And all the brands and retailers are making efforts for continuous improvements – to make continuous improvements as well.

Chelsea Leadbetter: Okay, thank you. And just, you've touched quite a bit on the Australian rent profile and what you've seen in that market in particular. Does that change your thinking on the store footprint? I appreciate you haven't changed your target but on the store footprint size or any other sort of ways to offset that rent pressure that you're kind of seeing in that Australian market in particular?

Xavier Simonet: I think it's about finding a balance between these national stores where we can display all our products, particularly our camping and our tents. And shopping centres is where the traffic is. So it's really about finding the balance. It's difficult and we challenge ourselves all the time but we certainly see shopping centres as driving traffic.

Chelsea Leadbetter: Okay. So we shouldn't expect any material change on how you're approaching the store footprint at this point in time?

Reuben Casey: Not at this point, no.

Chelsea Leadbetter: And just last question, you've talked a bit about some of the ranging trials that you've been doing through the last six to 12 months, can you give us any sort of hard financial examples of what you've actually seen as a result i.e. EBIT uplift per store or per square metre or anything like that?

Xavier Simonet: Well, we don't want to share too much. We've really worked on improving sales and gross profit densities per square metre. It's about assortment and range to space allocation.

Chelsea Leadbetter: Okay. So you can't give us any hard sort of ideas of is it double digit or is it more material than sort of that?

Xavier Simonet: It's material.

Chelsea Leadbetter: Okay.

Reuben Casey: Yeah, we can't do that, I'm sorry.

Chelsea Leadbetter: Okay. That's all for me for now. Thank you.

Xavier Simonet: Thanks.

Operator: And once again, ladies and gentlemen, if you'd like to ask a question at this time, please press *1. Our next question will come from John Stavliotis with Morgan Stanley.

Xavier Simonet: Morning, John.

John Stavliotis: Morning. Just a question on - you talk a bit about this European opportunity obviously being in discussions. What does the partnership look like in terms of the contract and how it would be structured?

Xavier Simonet: Yeah, I can't comment yet. We're in the process of finalising agreements and it is just too early. We went to Europe in November, went back to Europe for ISPO in February and we've been engaging with potential partners since then and finalising those agreements. So it's just a bit too early to confirm. Sorry, John.

John Stavliotis: It's all right.

Xavier Simonet: It's also [inaudible].

John Stavliotis: Sorry?

Xavier Simonet: It is wholesale [inaudible].

John Stavliotis: And negotiations you're having now, are they about that kind of initial trials and stuff or is that actually about forming a kind of a full range for them? Or is it too early to talk about that as well?

Xavier Simonet: Yeah, I can't comment because we're in the middle of discussions with those partners.

John Stavliotis: Yes, so. Just on a different note, cost out opportunities, clearly have some good cost leverage in this half, is there any other sort of initiatives that you can sort of see cost reductions in the next six to twelve months?

Reuben Casey: We don't see significant opportunities for any cost outs, going forward.

John Stavliotis: Okay. And last question from me. You mentioned something about more promotional or more promotional days or more discounting during the half, can you just give a bit more detail on that? What drove that and what we should expect going forward?

Reuben Casey: Yeah, I don't recall actually saying that, John.

John Stavliotis: On gross margin – you split out movement on the gross margin between currency and discounting.

Reuben Casey: Yeah, half a percentage point is really the FX kind of headwind that we couldn't cover. Half a percentage point was down to more clearance than we had generally last year. We ended the year with slightly more clearance than was probably optimal and then that meant we had a slightly higher mix of clearance sales, particularly in the first quarter. And then there's 0.2% which is really due to timing of sales so Christmas was a bit of slow starter but then once it came, it came quite late but it's just had a small impact on our margin as well.

John Stavliotis: Okay.

Reuben Casey: The promotional days, the promotional days for the half is identical to last year in terms of the number of days we were on promotion, just the timing is different, that's all.

John Stavliotis: Yeah. Okay. Thanks a lot.

Xavier Simonet: Thank you.

Operator: And once again, ladies and gentlemen, if you'd like to ask a question at this time, please press *1 now. And once again that is a final reminder for questions at this time, press *1. And I show we have no further questions at this time.

Reuben Casey: Thank you.

Operator: We'll turn it back over to our speakers for any additional or closing remarks.

Xavier Simonet: Thank you very much for joining the conference call. Have a good morning.

Operator: That does conclude our conference at this time. Thank you for your participation. You may now disconnect.