12 JUNE 2020

Stocks Down Under

> *Camping is nature's way of promoting the hotel business.*
>
> **- Dave Barry (b. 1947) American author and columnist**

FREEDOM FOODS GROUP

Diversification and scale as hedge against COVID-19

KATHMANDU

The bust-out is coming

PRO-PAC PACKAGING

Out-of-the-box profits

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Diversification and scale as hedge against COVID-19

Stocks Down Under rating: ★★★★

ASX: FNP
Share price: A$ 3.73
Market cap: A$ 1.1BN

Headquartered in Sydney, Freedom Foods makes a range of food products from cereals and snack foods to dairy and plant-based foods. Freedom has been Australia's leading health food maker for more than 15 years by addressing people with gluten-free, nut allergen and other dietary requirements. Today, nutritionals, such as vitamins and protein powders, are becoming an important new revenue stream. Increasing scale and diversification have helped the company fare well during the coronavirus pandemic driving broad-based earnings growth in Australia, China and Southeast Asia. As economic conditions begin to normalise, Freedom is well positioned to become a major player in the global food and beverage industry.

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ASX: KMD
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Market cap: A$ 861M

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Share price chart

Source: Tradingview

Expanding product portfolio and global presence

Freedom Foods has been "making food better" since it pioneered the Australian health food movement back in 1986. With an early focus on producing nutritious food and beverages, it was one of the country's first entrants into the plant-based beverage market through its soy and rice milk, and breakfast drink offerings. It is also the owner of Paramount, Australia's oldest seafood company, and built the country's first allergen-free manufacturing facility over a decade ago.

The group's FY19 financial results were highlighted by a 34.9% sales increase to $476m. EBITDA increased to $55.2m as EBITDA margins expanded from 11.1% to 11.6%. Operating net profit of $21.9m was 40% higher than in FY18. The strong growth was driven by strength in key retail brands like Australia's Own and Freedom Foods as well as MilkLab in the out of home channels.

First half FY20 results were also robust as sales grew 32.6% to $277.1m, EBITDA of $32.7m was 56% higher and operating net profit increased 42% to $9.1m. The interim performance was led by 23% growth in Australian retail grocery and outstanding 58% growth in Southeast Asia. It launched 40 new product formats during the six-month period and doubled the capacity of its Shepparton facility to 500m litres per annum.

COVID-19 to impact near-term profitability, but demand remains strong

While the early stages of the COVID-19 crisis have had a meaningful impact on the group, overall, it has fared well. Early on, it experienced some supply-chain disruption in the China and Southeast Asia markets that resulted in significant sales declines in Q1 CY20. The underlying demand from key customers, however, remained unchanged. In fact, strength in the Southeast Asia market ultimately proved to provide a valuable hedge against the short-term market disruption.

In a 29 May trading update, management noted that sales in the Australian retail grocery channel normalised in May to pre-COVID volumes. It saw lower demand in the out-of-home and industrial channels throughout April and May but has since seen early signs of recovery as stay at home restrictions have eased. Absent the supply chain disruption, it is also seeing increasing export demand in the Southeast Asia and China retail grocery channels. Although demand is coming back online, the company expects an unfavourable channel and product mix to cause margins to decline and weigh on 2HY20 profitability. Despite the signs of normalisation, the company cancelled its dividend on 5 June to preserve cash.

Asia and Nutritionals represent key growth drivers

Freedom has been venturing into new markets since 2015 when it brought its healthier cereals, snacks and dairy products to North America and China. Today, the growth opportunity in China and Asia is as strong as ever amid demand for non-GMO, gluten-free and plant-based beverages and dairy. Freedom's recently established wholly owned foreign enterprise (WOFE) in China has had an immediate impact on sales and earnings due to improved efficiencies and customer service. Dairy remains the key growth driver in China although Freedom is gaining traction in the cereals and snacks segment.

In 1HY20, the group posted a remarkable 58% jump in sales in the Southeast Asia market driven by sales of its core Freedom Brand products which surged 221%. Freedom is penetrating further into the Southeast Asian market by expanding its distribution capabilities in Singapore, Vietnam, Malaysia and the Philippines. It has significant upside potential in Southeast Asia in both branded and contract products as existing customer relationships there are strong. China and Southeast Asia account for approximately 17% of group sales and there is plenty of room for growth in both regions.

Meanwhile, at home, the Australian nutritionals market is another area with significant upside potential. Freedom recently integrated its booming nutritionals business with its dairy segment and the move has contributed strongly to top and bottom-line performance. Lactoferrin and Native Whey Protein Isolate were key contributors to the massive 215% growth in the Industrial segment in 1HY20. The Vital Strength and Crankt nutrition brands have also performed well amid a ramp in pharmacy and convenience store penetration. The medium-term outlook for the Australian nutritionals market is favourable due to an increasing consumer focus on health and fitness-related products. Later this year, Freedom will launch a new line-up of nutritional products that will include several pre-workout and protein powders.

Modestly valued given the growth outlook

Freedom's balance sheet is a mix of positives and negatives. It has a cash balance of just $7.2m as strong 1HY20 earnings growth was offset by a heavy investment in PP&E of $68.8m. This compares to $195.7m in borrowings. On the positive side, the group restructured its syndicated banking facility in 1HY20 and had available facilities of $158m as of 31 December.

Management has made good progress on its inventory management initiatives. It is aiming to reduce inventory while maintaining the flexibility to manage increased second half demand in key product areas. We believe the shares, which are down 22% over the last 12 months, have an attractive growth profile stemming from opportunities in nutritionals and in overseas' markets.

Freedom Foods Group is trading at an EV/EBITDA multiple of 12.1x FY21 and 8.9x FY22, which we believe is very attractive given the expected EBITDA growth of 60% and 35% in both years respectively. The shares offer a projected 1.4% dividend yield in FY21.

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Share price chart

Source: Tradingview

Let's face it – when the Powers That Be are telling you that you shouldn't really be outside your house, your first port of call at the shopping mall is probably not Kathmandu. Even if that store's white mountain logo on a green field has come to stand for the best kind of outdoor apparel and equipment there is Down Under. And while the good people at Kathmandu can now also get you Rip Curl surf wear or Oboz hiking boots, you probably weren't in the market for that back in March either. No wonder Kathmandu stock crashed about 80% between 7 February and 23 March, just before it had to shut its Australian and New Zealand store network. Worst still, in April 2020 it had to raise NZ$207m at NZ$0.50 (A$200m at A$0.487) to make sure the balance sheet was COVID-proof.

The great outdoors bust-out is now

Now comes the recovery from the storm. People in the Australian state of New South Wales, for example, have been allowed to travel regionally for any reason, including holidays, from Monday 1 June. It's not hard to see a rush on Kathmandu as people in other jurisdictions get ready to enjoy their new-found freedoms. Indeed, the bust-out preparation may be already happening. On 5 May, Kathmandu reported that online sales in April were two-and-half to three times higher than the previous year. And that's without online sales in New Zealand where the Ardern government banned all ‘non-essential’ shopping and online delivery during the lockdown. Which was crazy, but all that means is a particularly strong sales bust-out for Kathmandu when Jacinda kindly says it’s okay.

What brings us to another reason we like Kathmandu … online. In the six months to 31 January 2020, Kathmandu’s ‘Outdoor Segment’ – the Kathmandu chain and Oboz – reported flat revenue and a 6% decline in EBIT, in what was generally regarded by all as a tough retail environment, and yet online sales were up 33%. Rip Curl was up 20%. Online at that point constituted about 9% of Outdoor’s gross profit and 5% of Rip Curl’s. This may look small, but it shows that this company has done the hard yards in terms of going online and has a customer base that is comfortable with it. We believe there will be more growth where that came from given the historic strength of all the Kathmandu brands and the fact that Rip Curl is a relative newbie in online channels.

Smart diversification

Online was an important initiative of the Frenchman Xavier Simonet when he took the helm at Kathmandu in 2015. The other was diversification. Simonet, who runs Kathmandu from Melbourne, has a background in apparel, where he previously had stints at LVMH and the British accessories brand Radley. The two acquisitions he has engineered at Kathmandu have kept that apparel focus. Oboz, a US business which does premium footwear, was acquired in March 2018 for US$60m, while Rip Curl was bought for A$350m late last year.

Those acquisitions were expected to reduce the impact on Kathmandu’s core chain of any changes in consumer taste and that has now proven to be the case. Oboz grew 10% at the revenue line in the January 2020 half and 11% at the gross profit line, where margins at 40% or so are very healthy for a business that wholesales its product. For Rip Curl we believe it’s too early to tell how Kathmandu will do but it will be hard to damage this brand given how well Brian Singer and Claw Warbrick nourished it from its 1969 founding. Indeed, one can say that surfing in Australia and the Rip Curl brand are almost synonymous.

Currently Kathmandu, with all that brand equity, is trading on an EV/EBITDA multiple of only 13x forecast FY21 numbers, dropping to under 5.5x by FY23. With the brands now set to prosper in a post-COVID environment, and EBITDA growth expected to reach more than 63% in FY21 and around 31% in FY22, we think 13x is a relatively small price to pay.

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Share price chart

Source: Tradingview

Comprehensive platform serves diverse customer base

Since 1993 Pro-Pac has been providing primary, secondary and tertiary packaging for a wide range of customers in the produce, food processing, agricultural, industrial, warehousing and retail markets. Since listing on the ASX in 2005, it has expanded its geographic footprint and diversified its portfolio through a series of acquisitions.

It acquired rigid bottle distributor PB Packaging in 2007 and purchased corrugated cardboard maker Creative Packaging in 2010 to solidify the base of the business. In 2013 it purchased Eco Food Pack, a manufacturer of thermoform produce trays. The 2017 acquisition of Integrated Packaging marked an important move into flexible industrial films. Pro-Pac then went on to complete a pair of acquisitions in 2018 buying New Zealand specialty meat packing business Polypak Plastics and Australia's Perfection Packaging to enhance its fast-moving consumer goods (FMCG) packaging capabilities.

As one of Asia Pacific's largest suppliers of packaging related products and services, Pro-Pac helps customers reduce costs, improve operational efficiencies, manage inventory and develop unique packaging solutions. The group's competitive advantage lies in its comprehensive packaging platform. It has its own offshore sourcing, procurement and consolidating facilities that allow it to provide complete packaging solutions at competitive prices.

Shifting business mix to higher margin products

After weak first half FY19 trading conditions weighed on revenues and margins, Pro-Pac turned in a stronger second half performance to deliver solid full-year FY19 results. Despite incurring large one-off costs and write downs and making a pair of acquisitions for a combined $55m, the group grew revenues 30.8% to $485.5m and EBITDA increased 72.2% to $28.1m. It did, however, record a statutory loss after tax of $151.3m, which included a non-cash goodwill impairment charge of $149m. Solid performance in the Rigid packaging unit was offset by weaker than expected agricultural sales and increased input costs in the Flexibles segment. Soft results in the Industrial packaging business also weighed on overall sales and margins.

The 1HY20 performance showed revenues were down 2.4% to $251m. A favourable business mix shift towards higher margin products in Flexibles was outweighed by reduced volumes, supply and service delivery issues in the Industrial business, and softer revenues in the health and wellness division of the Rigid segment. Statutory profit after tax was up to $7.6m after a net loss $144.3m in 1HY19 and EBITDA was up 4.7% to $18.1m. The EBITDA margin increased from 6.7% to 7.2% primarily due to operational efficiency gains and procurement savings.

Flexibles packaging to drive future growth

While the recent results have been mixed, the long-term outlook is positive largely due to Pro-Pac's opportunity in flexibles packaging. Issues related to drought conditions and higher raw material input costs that impacted in FY19 have subsided in FY20. In the first half of FY20 Flexibles comprised 61% of group revenue and had a 76% EBITDA contribution compared to 63% in 1H19.

We believe Pro-Pac's position as Australia's largest manufacturer of industrial, agricultural and horticultural flexible film packaging bodes well for future growth. Flexibles is expected to be a significant growth area of the packaging industry due to increasing demand for items like fresh produce bags to cover fruits and vegetables, sheet protection for the steel industry, pallet wrapping and flexible wrapping for grain, cotton and other agricultural commodities.

Pro-Pac recently announced plans to consolidate its manufacturing sites by relocating production from the Chester Hill facility in Sydney to other facilities in Sydney, Melbourne, Adelaide and Perth beginning August 2020. The volume transfer, which is expected to wrap up by March 2021, is designed to ensure that the key Flexibles division maintains a leading position in the flexible packaging products and services market. It is also expected to reduce the company's cost base and lead to improved profit growth.

Debt restructuring strengthens balance sheet flexibility

Pro-Pac has responded well to the challenging COVID-19 economic environment. Safety measures, including having non-operations staff work remotely, have helped the company remain fully operational from the onset of the pandemic. On 27 May it announced that trading conditions had been better than expected. As a result, the company expects FY20 EBITDA of around $30m which would represent a 6.8% increase over the FY19 EBITDA result.

Improving the balance sheet has been a strategic focus for management. On 23 March it completed the refinancing of its senior debt facility by extending the term through March 2023. This brought the group's total committed facilities to $95m and, amid uncertain economic conditions, gave it some breathing room to allocate capital between reduced gearing, growth investments and a potential dividend distribution. The group's net debt position has decreased by $22.2m since December 2018 to $76.6m as a result of disciplined cash management while earnings growth has helped gearing come down to 2.7x. Going forward, it plans to continue targeting working capital improvements and forecasts its net debt position to be approximately $60m by 30 June.

We believe management's focus on financial discipline should help the company grab some of the growth opportunities in flexibles packaging across its diverse customer industry base. Pro-Pac's ability to innovate and continue to deliver comprehensive, cost-effective packaging solutions should lead to a strengthened competitive position over time.

Pitt Street Research Pty Ltd

95 Pitt Street, Sydney, NSW 2000, Australia

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