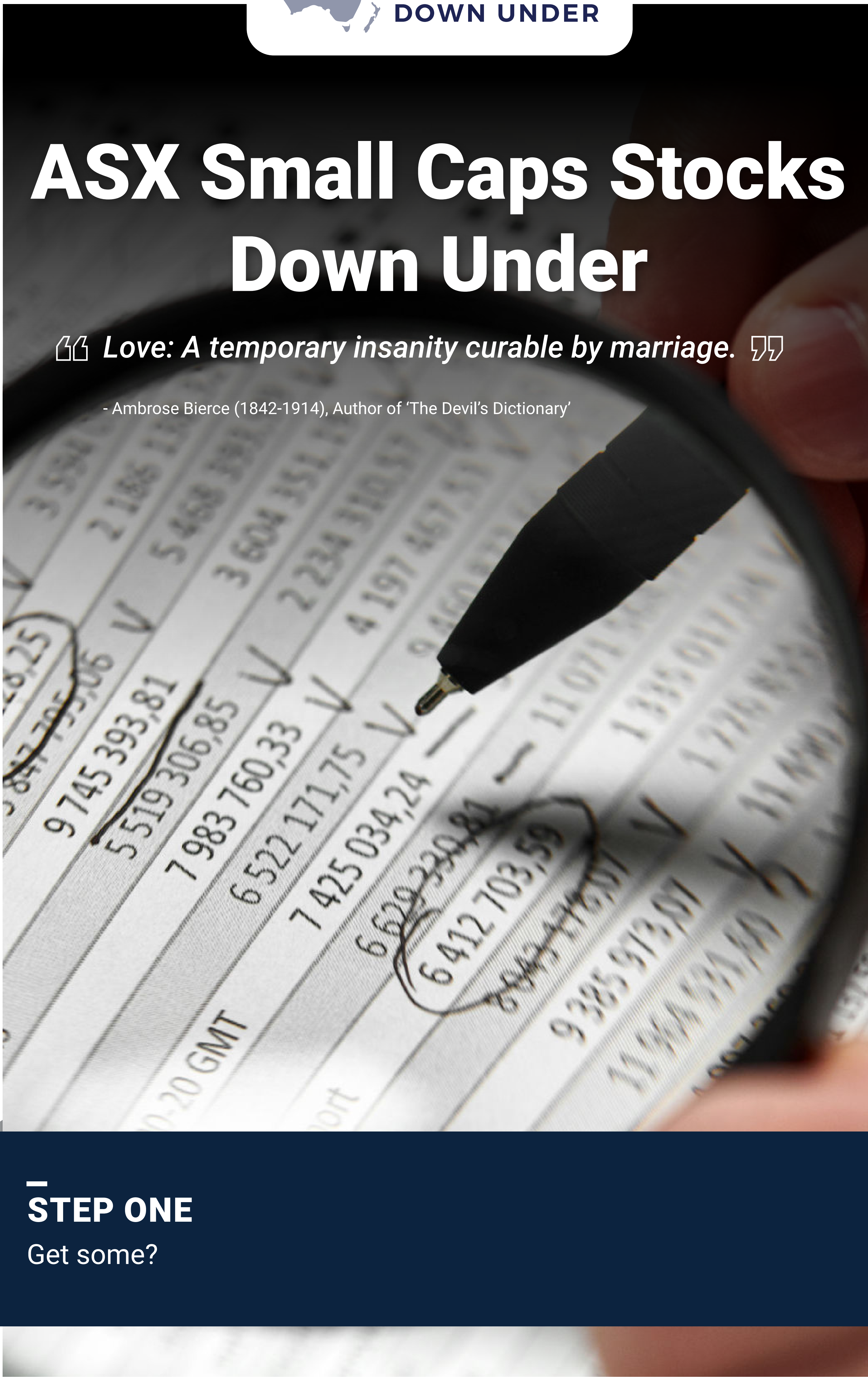
STOCKS DOWN UNDER

23 DEC 2022

ASX Small Caps Stocks Down Under

Love: A temporary insanity curable by marriage.

- Ambrose Bierce (1842-1914), Author of 'The Devil's Dictionary'



STEP ONE

Get some?

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Stocks Down Under rating: ★★

ASX: STP
Market cap: A$48.2M

52-week range: A$0.20 / A$1.77
Share price: A$0.28

Step One (ASX:STP) is making big moves on the underwear scene. The company recently expanded to the US market and launched new women's, thermal and sports underwear lines. Though Step One started out with high expectations, it seemed as if it wasn't immune from China's zero-COVID policy. The continuing supply chain and shipping issues of 2022 led to Step One missing its forecast revenue. The new women's line was well received, but the company couldn't restock until 3 months later. Now it is hoarding nearly $30 million worth of inventory. Step One also significantly underperformed in the US market, missing its target revenue by 41.9%, so the company is localising its marketing content. With Step One's shift towards bigger markets, there's no doubt that there's room to grow – but will it?

Share price chart

Source: Tradingview

Savvy marketing, poor supply chains

No doubt you will have seen this company's advertisements, particularly those with Lawrence Pola. For those who haven't, Step One sells underwear made from bamboo that is promised not to 'ride up', cause chafing or trap sweat. The company was founded in 2016 by Greg Taylor, a former Olympic rower, who still owns a majority stake post-IPO.

After listing at $1.51 a share, the stock enjoyed a good rise. There was a lot of FOMO, but also some legitimate excitement over its promise to enter the UK and US markets, and to launch a broader range of products (including women's and thermal wear). It all went pear shaped a few days before Christmas last year when the company identified an overclaim of GST credits and revealed that logistics challenges in the UK and Australia increased customer delivery times, which impacted media spend effectiveness.

You see, three of Step One's four manufacturing partners were located in China, so the port lockdowns of China's zero-COVID policy saw many supply issues arise. This was particularly seen when Step One experienced a backlog of orders over the Black Friday and Christmas trading period, forcing it to withhold its new colour launches and pre-Christmas campaign, reducing revenue from these key promotional events. It also delayed the release of the women's line to late January 2022. This sold out immediately. However, Step One failed to replenish stocks until 3 months later, losing initial sales momentum generated during the release of this new line.

Things failed to improve in CY22. The sustained lockdown in China and war in Ukraine were also linked to increased logistics costs and fluctuating foreign currency exchange rates, which was reflected in the 0.6% decrease in gross margins from 82.6% in FY21 and an increase in distribution costs to 12.3% of revenue in FY22, from 10.0% in FY2021. Despite Step One being able to increase its inventory from ~$15m to ~$25m, investors were cautious due to the large number of retail companies (most notoriously Kogan) that boosted inventory only to have to substantially discount it to have a realistic chance of clearing it.

Entering the UK and US easier said than done

Step One entered the US market in October 2021, forecasting an overall revenue of $6min FY22. However, its actual revenue came in at $3.5m — 41.9% below that of the previous year's forecast. Furthermore, its return on advertising spend was less than 1x, which contributed to a loss of $2.6m in the US. Step One's difficulty in entering the US was due to its need to develop more localised marketing content. It responded by undertaking a new content generation strategy in March 2022, indicating it would have product design releases around key events, promote brand awareness and ESG credentials through consumer led PR on social media platforms and have a localised ambassador strategy for different states by consulting local marketing specialists.

UK sales also flagged, generating revenue 4.5% below the previous year's forecast. Step One has introduced Refer-A-Friend and Loyalty rewards programs and localised brand ambassadors to combat this issue.

Both marketing initiatives in the UK and US focus on increasing brand visibility and on establishing a reputation to build long-term customer relationships. This focus on customer relationships is reflected in Step One's high customer retention rates with over 60% of Step One's customers in FY22 being returning customers, an increase from 45% in FY21.

Step One is also expanding its customer reach by using third party platforms, such as Amazon and other retailers with an ecommerce focus, to sell its products. Despite investing $32.1m into advertising and marketing, the company experienced a 22.6% decrease in new customers compared to FY21. This may be a symptom of slow growth in the underwear market with a predicted 2.0% CAGR for 2020-2025.

In Step One's favour

We like that Step One is diversifying and expanding its product range into women's, thermal and sports lines. These releases complement Step One's existing line of underwear and to market them, the company can draw on existing athlete affiliations. Of these new ranges, we are most excited about the entry into the women's underwear market, which is valued at $17.8bn globally. This opens up a major demographic and allows Step One to further grow its revenue and diversify to reduce risk.

Even though sales of the new women's line have not taken off to the extent investors would've hoped, it constituted a healthy 11.8% of overall 2HY22 revenue. Considering the aforementioned supply issues, its late launch and with the US expansion still to come, we expect the women's line to grow and contribute more to Step One's annual revenue into the future. We also think that there is a strong ESG element to Step One's products generally.

Working against it

However, we are concerned about how Step One will hold up in a recession due to its high retail prices relative to competitors ($20-$30 per unit). Investors buying the stock are hoping three things. First, that customers keep buying its products due to comfort as well as sustainable and ethical credentials. Second, that Step One can beat out more established, regular underwear companies, such as BONDS. And third, that supply chain issues resolve themselves. Even though China seems to be moving away from COVID zero ever so slightly, we doubt Step One can beat established brands head on.

So for us, Step One is two stars until there is clearer evidence that the company can carve out a sustainable niche, which will not be easy in a high-inflationary (or even recessionary) economy, especially since the company is unproven in that environment.

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