How to spot a dud retailer

by Roger Montgomery

A discretionary retailer has a life cycle that is reasonably (but not 100%) predictable. This allows investors to form a view of the future, and hence, determine a valuation. The complexity of some businesses on the share market would make any projections meaningless, and when you are unable to make confident assumptions, how can you confidently invest?

With this in mind, retailing as a business model is really dependent on just a few key metrics. How many stores does the business have open? How many stores can be opened? How much can sales grow within each store? And, can margins be maintained?

This may seem simple, but understanding these main drivers of a retailer can be powerful in forming investment decisions. When these key metrics align positively, it often translates into strong earnings and hence a positive share price response. The reaction can be just as powerful in reverse, due to high fixed costs and operational leverage. Carefully watching these metrics can therefore help an investor capture the upside and potentially avoid the downside.

The Kathmandu example

An ideal case study to demonstrate this framework is Kathmandu (ASX: KMD), the specialty retailer of outdoor gear and clothing.

Over 12 months ago, Kathmandu was operating 139 stores in Australia and New Zealand. The first-half of 2014 was tracking very well – sales in existing stores were up 5.4% in constant currency terms, the gross margin had expanded to 63.9% and management upgraded the store rollout target from 170 to 180.

With potential sales growth of 30% from store openings alone, the market was forecasting a bright future, implied by a rising share price.

Fast forward to today, and a profile of the company has completely inverted. At the most recent half-year result, gross margins had declined to 59.3%, sales within stores are declining, and management has lowered the store rollout plan. With the share price subsequently halving, what could you have done to pick up the signs of an impending decline?

The issues appear to have emerged when Kathmandu announced in 2014 that its winter promotional campaign was weaker than expected due to warmer, drier and sunnier weather. As a specialist seller of outdoor clothing, Kathmandu is not immune to seasonal fluctuations, and in isolation the performance could be viewed as cyclical.

It's important to understand that a poor promotional campaign may not be isolated to a particular period. If a retailer is forced to discount aggressively to clear excess stock, this can draw forward demand from future periods. The flow-on effects from the weak-winter period were well-publicised by management in the subsequent full-year result. From the surface, it would have been difficult to determine if the underperformance was more than cyclical.

The signs

It was a trading update in December 2014 that indicated the problem was more than cyclical. Not only had the winter promotion disappointed, but the Christmas promotion in Australia was below expectations. At this point, the red flags have well and truly been raised. One poor season is not enough to make a trend, but subsequent periods of underperformance should necessitate a review of the operating assumptions.

The most important consideration for any retailer is the value of its brand. Kathmandu's business relies on pricing quality products high, then offering discounts during key trading periods. If poor inventory management or intensifying competition forces Kathmandu to pursue more aggressive pricing strategies, then Kathmandu may lose the connection with its core market that are happy to pay a premium. This could result in lower store growth, lower sales growth, lower margins or a combination thereof.

Kathmandu went on to report a disappointing first-half 2015 result, but it was the commentary by management that was most troubling. Management was unable to confirm if the falling sales were cyclical or structural, and commented that consumers appeared to be waiting for more aggressive discounting before making a purchase.

It is an inopportune time for Kathmandu to assess its business model because its currency hedges are beginning to roll off. Kathmandu purchases the majority of goods in US dollars and while earnings have been protected for the past 12 months, it will be difficult for the company to pass on higher costs to the consumer while resolving its discounting strategy.

An intimate understanding of a retailer's operating metrics can afford investors with the confidence to value a company's prospects. But these metrics can change quickly, and unless you have a keen awareness of a company's performance and its drivers, the share price may not work in your favour. Which is why first and foremost, it pays to stick to simple businesses that we can understand readily.