Aritzia

Consumer Discretionary
TSX: ATZ
Market Outperform | Hold

ARITZIA

June 30, 2023

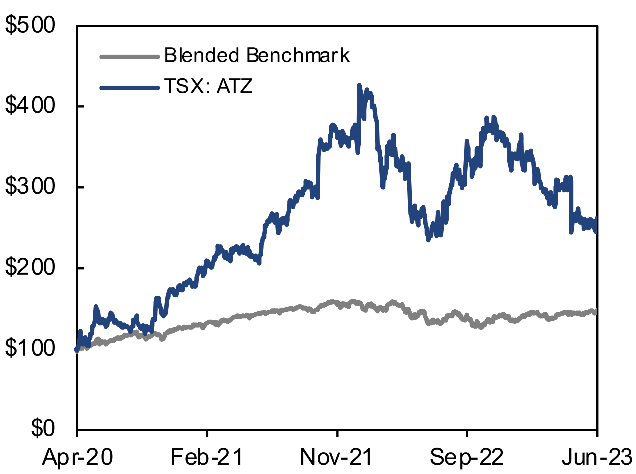
Sarah Adamjee, Investment Analyst

Return on Investment	
Current Share Price	$36.78
Target Price	$45.00
Dividend Yield	0.00%
Implied Return	22%
Conviction Rating	2

Market Profile	
52-Week Range	$54.21 - $33.64
Market Capitalization ($mm)	$4,222
Net Debt ($mm)	$691
Enterprise Value ($mm)	$4,913
Beta (5-Year Monthly)	1.62

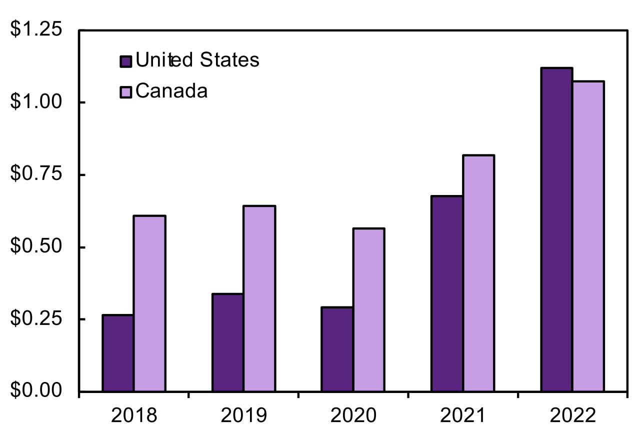
Metrics	2024E	2025E	2026E
Revenue ($mm)	$1,873	$1,944	$2,033
EBITDA ($mm)	$489	$672	$724
EPS ($)	$1.68	$1.85	$2.03
EV/EBITDA	10.1x	7.3x	6.8x

Holding Period Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: Revenue by Geography ($B)



Source: Company Filings

Business Description

Aritzia (TSX: ATZ) focuses on the design, production, marketing, and distribution of women's fashion apparel and accessories in North America. ATZ was founded in 1984 as an innovative design house and fashion retailer and is headquartered in Vancouver, Canada.

The Company's operational focus resides in the U.S. and Canada, representing ~51% and ~49% of LTM total revenue, respectively. ATZ targets its products toward women aged 15 to 45 through in-store boutiques and its eCommerce platform. In FY 2022, eCommerce revenue comprised 65% of total revenue, with the remainder from boutiques. ATZ boutiques are designed by an in-house team of architects and designers, with 114 store locations averaging ~6,000 square feet (sqft). ATZ earns ~$1,300/sqft, exemplifying its retail productivity, compared to the peer average of ~$1,000/sqft. ATZ is positioned to service boutiques and eCommerce clients through three distribution centers in Canada and the U.S. The Company's portfolio comprises exclusive brands supported by in-house design teams, representing ~97% of total revenue in 2022. ATZ brands include Wilfred, Wilfred Free, Super World, Reigning Champ, Babaton, Ten by Babaton, The Group by Babaton, Sunday Best, Tna, TnAction, and Denim Forum. Globally, the Company's major brands possess over 500 trademarks in more than 300 domains.

Industry Overview and Competitive Landscape

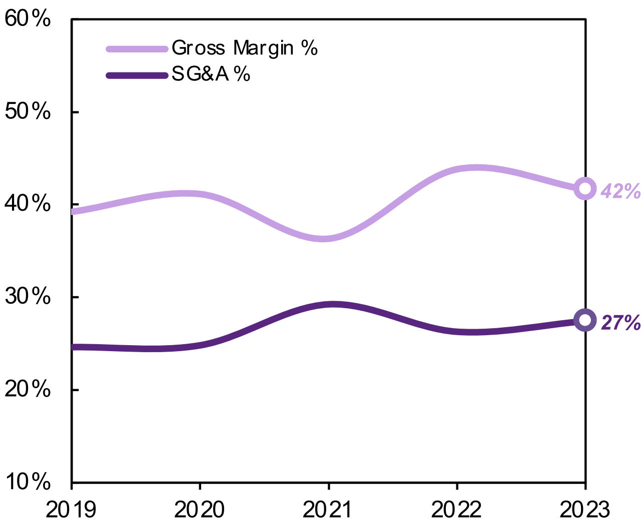
The women's apparel industry is highly competitive and fragmented, with competition surrounding brand image, marketing, quality, and overall customer service. The industry consists of retailers specializing in women's clothing, with the top five players holding 7% of the market share in the U.S. and 30% in Canada. This includes lululemon (TSX: LULU), Abercrombie & Fitch (NYSE: ANF), Revolve Group (NYSE: RVLV), and Tapestry (NYSE: TPR). Over the next five years, the women's apparel industry is expected to grow at a 2.6% CAGR to US$76.7B. Though the industry is threatened by competition from larger, affordable retailers, a significant focus on omnichannel capabilities is expected to disrupt brick-and-mortar competition between retailers. Technological investments in eCommerce optimization allow companies to position themselves strategically within the landscape of women's apparel. Additionally, women's fashion has shifted, favouring sustainable retailers over fast fashion alternatives; this allows competitors with socially responsible product offerings to further benefit from premium pricing.

Although disposable income has remained strong amidst an inflationary environment, the women's apparel industry and the consumer discretionary sector are expected to experience revenue instability in the near term. Specifically, this applies to boutiques servicing niche markets. Supply chain disruption from the pandemic and uncertain economic conditions have resulted in higher operating costs for manufacturers and retailers. In the short-term, profitability is expected to slow due to suppressed margins and excess inventory.

Mandate Fit

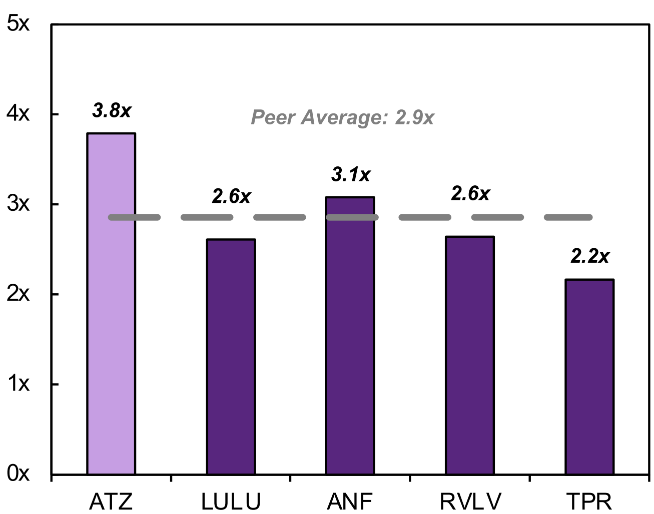
Quality Management: ATZ's CEO, Jennifer Wong, entered the position in May 2022. Wong began her career at ATZ (cont.)

Figure 2: LTM Gross Margin and SG&A Margin



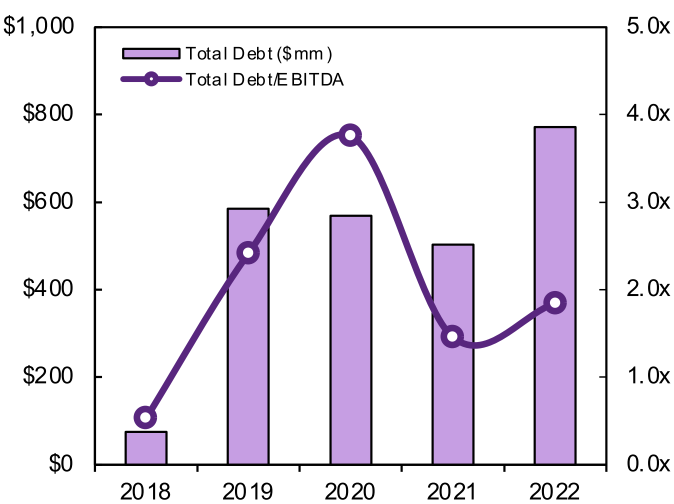
Source: Company Filings, S&P Capital IQ

Figure 3: FY 2023 Inventory Turnover vs Peers



Source: Company Filings, S&P Capital IQ

Figure 4: LHS Total Debt vs RHS Total Debt/EBITDA



Source: Company Filings, S&P Capital IQ

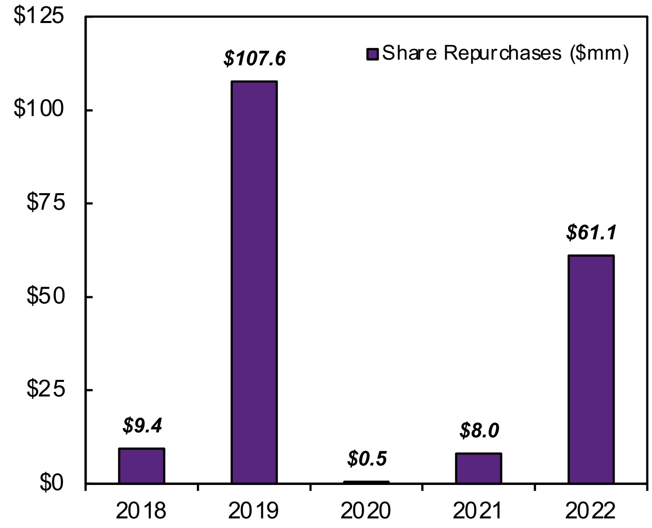
35 years ago and has gradually progressed through senior management positions. Wong gained extensive industry experience during her time as President in 2007 and COO in 2015. In 2023, Wong successfully led ATZ towards 2027 expansion targets by increasing U.S. clientele by ~54% and enabling growth in eCommerce revenue by ~35%. CEO compensation currently consists of a 25% base salary, with the remaining allocated towards incentive-based pay and stock options. Prior to 2022, ATZ Founder Brian Hill served as CEO for 38 years. His corporate vision remains core to the Company through his role as Executive Chair of the Board. ATZ's Board of Directors consists of 80% independent directors, of which 30% are women.

Competitive Advantage: ATZ's competitive advantage resides in its brand reputation as a best-in-class fashion retailer with a unique market position in "Everyday Luxury". The Company's product portfolio is differentiated from competitors such as LULU, ANF, RVLV, and TPR by appealing to diverse segments of clients across lifestyles and life stages. ATZ has accumulated customer loyalty through its multi-brand strategy, with its active client base increasing by ~100% and ~50% in 2021 and 2022, respectively. An extensive boutique network in high-traffic real estate locations further enhances the Company's customer engagement. ATZ's uniquely designed boutiques possess superior store economics, with an average payback period of 12 to 18 months upon opening, greater than the peer average of 18 months. The Company's vertical integration optimizes retail operations by providing inventory flexibility and quality control for its marketed products. In FY 2023, ATZ reported inventory turnover of 3.8x, compared to its peer average of 2.6x. ATZ has a 42% gross margin versus the peer average of ~59%. Though ATZ is witnessing lower margins due to higher warehousing costs, the Company's revenue growth supports an SG&A margin of 27%, versus the peer average of ~47%. ATZ's three distribution facilities in Canada and the U.S. allow the Company to adapt to multi-channel and omni-channel demand.

Strong Balance Sheet: ATZ possesses a Total Debt/EBITDA of 1.8x, versus the peer average of 1.2x. ATZ has achieved a leverage ratio lower than its peers due to its ability to continuously meet expansion targets. ATZ demonstrates its ability to meet debt obligations with an interest coverage ratio of 13.4x, versus the peer average of 10.8x. The Company's $175mm revolving credit facility provides ATZ with financial flexibility, which remains undrawn in 2023. Due to the Company's significant growth targets, ATZ holds a current ratio of 1.5x, compared to the peer average of 1.8x.

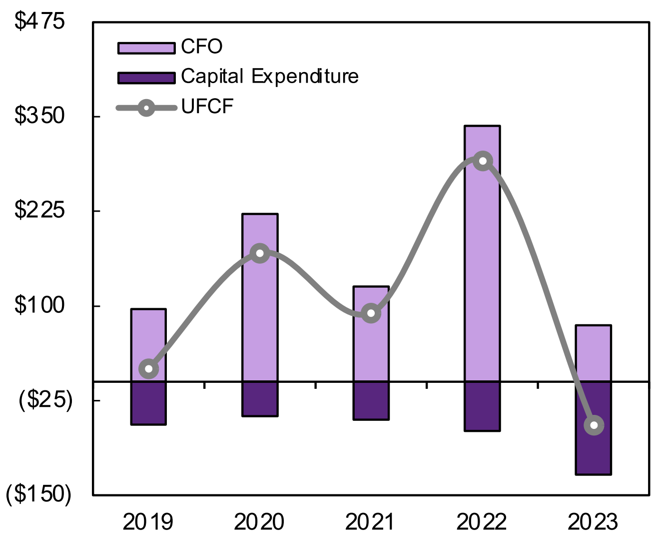
Growing Free Cash Flow: ATZ experienced significant FCF growth from FY 2018 to FY 2022, with a CAGR of ~64%. Growth during this period was primarily driven by boutique expansion and eCommerce penetration through aritzia.com. In FY 2023, cash flows were negatively impacted by operating constraints related to higher inventory purchases and increased income tax payments. Net working capital changes and cash taxes paid were $269.7mm and $123.4mm, respectively; this contributed to negative FCF in FY 2023. ATZ's capital allocation strategy focuses on funding operations, investing in expansion, and returning capital to shareholders. Management expects FY 2024 capital expenditures to equal ~$220mm, representing an ~80% increase from FY 2023. Overall, the Company has earned attractive returns on capital compared to peers, with ATZ possessing a LTM ROC of 14.4%, versus the peer median of 11.4%.

Figure 5: Return of Capital to Shareholders



Source: Company Filings, S&P CapIQ

Figure 6: Free Cash Flow Generation ($mm)



Source: Company Filings, S&P Capital IQ

Risks

To meet elevated demand levels, ATZ implemented new store inventory management strategies, resulting in higher inventory to meet store growth. Due to increased excess inventory at the end of the period, ATZ experienced suppressed FCF. Furthermore, efficient inventory management is required to optimize FCF levels in 2023 and beyond. Though ATZ maintains inventory to meet growth targets and higher demand levels, the impact of weakening consumer spending could damage the Company's ability to generate FCF. In addition to rising inventory levels, ATZ has witnessed margin pressures in relation to markdowns and warehouse costs. As top-line growth stagnates and cost inflation increases due to macroeconomic pressures, decreasing margins will materially impact operations.

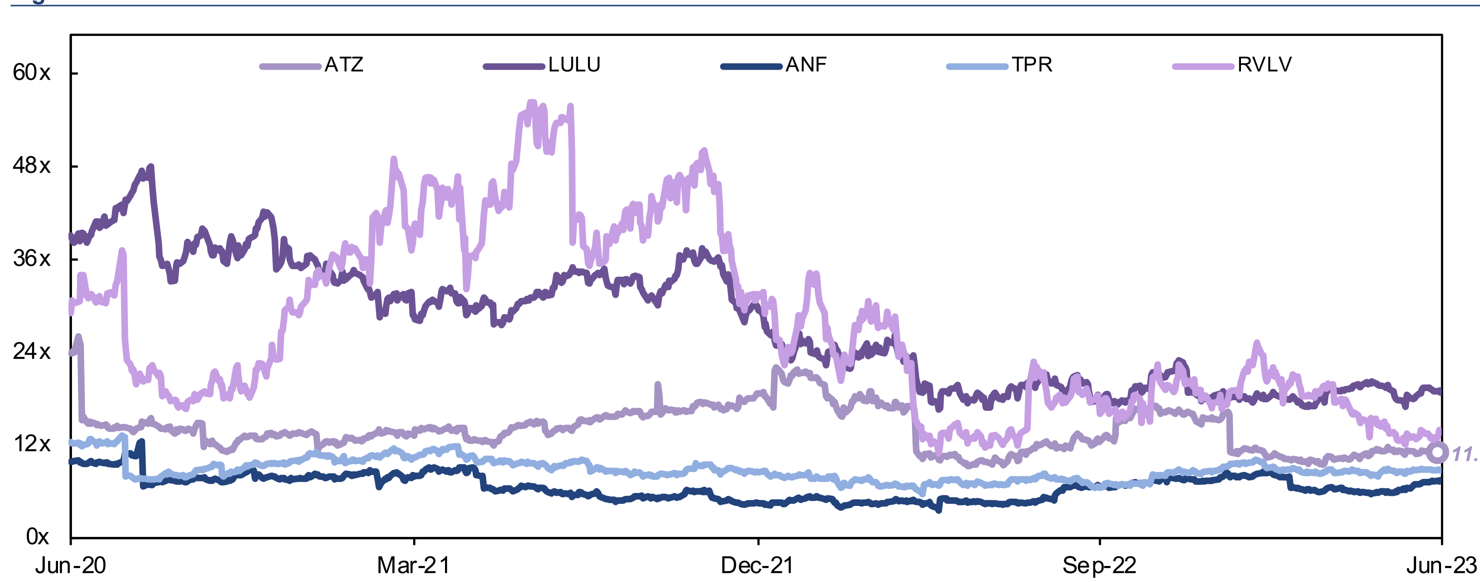
On a macroeconomic scale, potential threats stem from fluctuating consumer sentiment resulting from economic instability. Suppressed consumer spending will likely the effect profitability of boutiques compared to other consumer goods. The outlined risks are likely to impact margins and short-term revenue growth.

Valuation and Investment Thesis

The CPMT valued ATZ at $47, implying a return of 22%, using a five-year DCF with a WACC of 9.44%. The target price was derived using a 50/50 blend of (1) the Gordon Growth method with a 2% terminal growth rate and (2) an 8x EV/EBITDA exit multiple.

The CPMT initially invested in ATZ in January 2017, a position that was fully divested the following year due to concerns surrounding the Company's competitive edge in the e-commerce landscape. Subsequent to ATZ's execution of online growth targets and customer retention, the Fund re-entered its position in April 2020. The CPMT is confident in the Company's long-term growth strategy given its continued expansion and successful penetration into the U.S. market. The Fund remains confident in ATZ's tenured management team and operational excellence in a niche segment. The Company's brand has been rewarded with a loyal customer base and is expected to continue providing an elevated experience as it navigates store growth targets. Ongoing evaluation regarding ATZ's capital allocation and FCF profile will ensure that the name continues to execute on the CPMT mandate while navigating macroeconomic headwinds in the consumer discretionary sector.

Figure 7: NTM EV/EBITDA vs Peers



Source: S&P Capital IQ