Aritzia

Consumer Discretionary
TSX: ATZ
Market Perform | Hold

ARITZIA

June 30, 2021

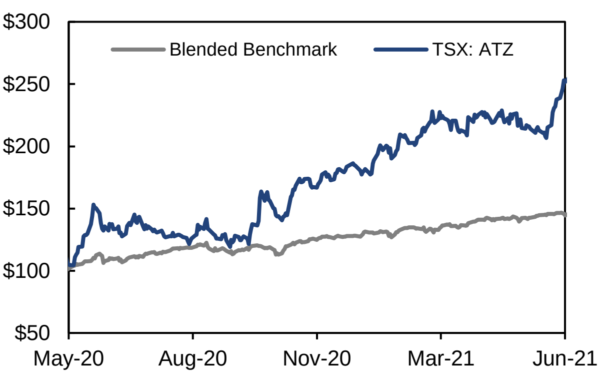
Jack Morgan, Portfolio Manager

Return on Investment	
Current Share Price	$37.08
Target Price	$39.00
Dividend Yield	0%
Implied Return	5%
Conviction Rating	2

Market Profile	
52-Week Range	$16.32 - $37.19
Market Capitalization ($mm)	$4,383
Net Debt ($mm)	$421
Enterprise Value ($mm)	$4,804
Beta (5-Year Monthly)	1.68

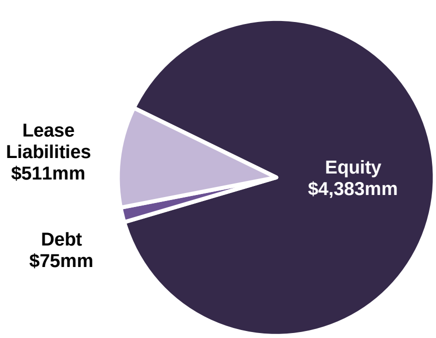
Metrics	2021A	2022E	2023E
Revenue ($mm)	$857	$1,235	$1,364
EBITDA ($mm)	$123	$268	$297
EPS	$0.17	$0.88	$1.01
EV/EBITDA	39.1x	17.9x	16.2x

Holding Period Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: Capital Structure as of FQ4 2021



Source: Company Filings, S&P Capital IQ

Business Description

Aritzia Inc. (TSX: ATZ) is a vertically integrated fashion house headquartered in Vancouver, Canada that designs and retails luxury apparel and accessories. ATZ focuses on innovative, aspirational women's fashion, with a target demographic aged 15 to 45. The Company operates 97 boutiques across Canada and the U.S.

ATZ was founded in 1984 by Brian Hill, who remains the current CEO and Chairman. The Company was majority owned and controlled by private equity firm Berkshire Partners from 2005 to 2016. In 2016, ATZ conducted an IPO to become a publicly traded company on the TSX.

Industry Overview

The apparel retail industry is a fiercely competitive sector that is especially demanding of fashion boutiques like ATZ. The industry was materially impacted by COVID-19 pandemic closures, forcing major players such as JC Penney, Brooks Brothers, and Ascena Retail into bankruptcy. These gaps left in the industry have allowed the survivors to gain market share as consumer demand recovers exiting lockdowns. In the boutique fashion industry, ATZ's direct competitors include lululemon (NASDAQ: LULU), Canada Goose (NYSE: GOOS), Ted Baker (LSE: TED), Roots (TSX: ROOT), and Tapestry (NYSE: TPR).

Original Investment Thesis

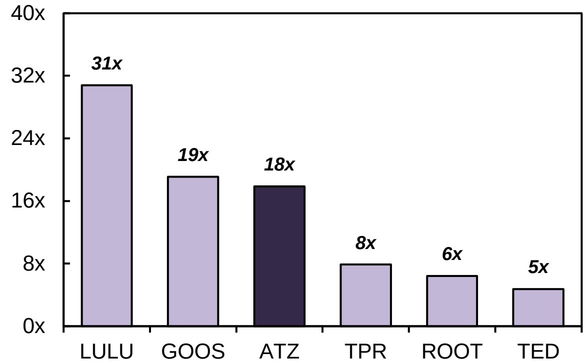
On March 16, 2020, ATZ closed all locations due to pandemic restrictions with no reliable timeline for reopening. This mass closing and surrounding uncertainty drove the share price down over 60%, providing the CPMT with an excellent entry opportunity into the name. ATZ meets the CPMT mandate as a resilient and flexible discretionary holding with low leverage ratios and growth potential. Its niche positioning as an "everyday luxury" brand promoted strong customer loyalty, and ATZ possessed an established management team with a proven track record of executing on targets and returning value to shareholders. The CPMT entered a position in April 2020 with a price target of $24.00 at a conviction rating of 2.

Mandate Fit

While the Company continues to perform at a high level, the name's fit with the CPMT mandate has undoubtedly shifted over time.

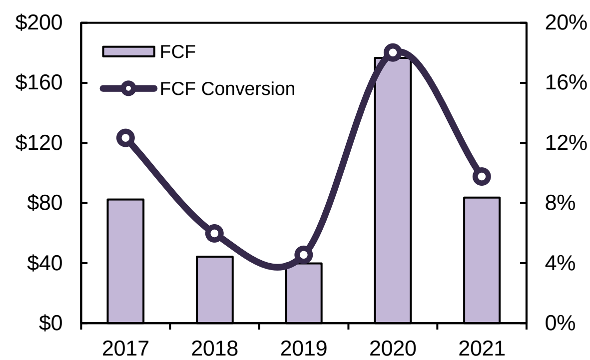
Quality Management: Brian Hill is known for his prowess as an entrepreneur and has received various accolades as head of the CEO and Chairman since its inception in 1984. His management team has led ATZ to become a fast-growing international brand whilst maintaining adaptability and responsiveness to change as demonstrated during the pandemic. ATZ recently acquired a 75% stake in menswear company Reigning Champ for $63mm and plans to purchase the remaining 25% by 2026, expanding its product line to support its already successful introduction of menswear in 2019. Investors approved of the acquisition and the deal is expected to contribute $25mm to yearly revenues. Management is committed to returning value to shareholders through share repurchases, however, they continue to refrain issuing dividends as its current focus is on reinvesting into the business to expand profits.

Figure 2: NTM EV/EBITDA vs Peers



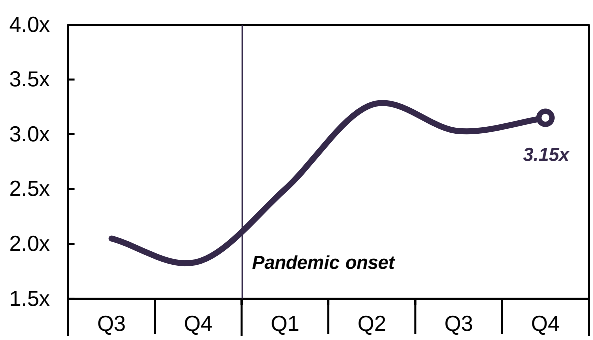
Source: Company Filings, Refinitiv Eikon

Figure 3: FCF (LHS,$mm) & FCF Conversion (RHS)



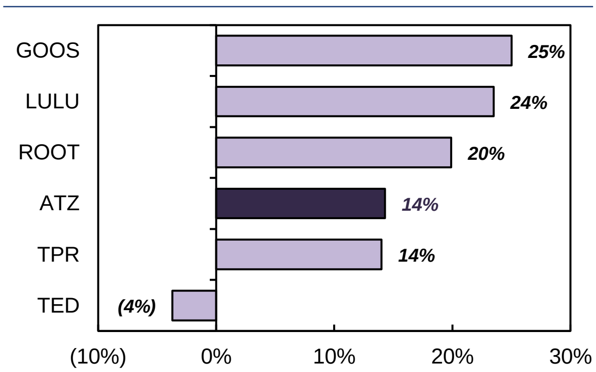
Source: Company filings

Figure 4: LTM Net Debt/EBITDA



Source: Company Filings

Figure 5: FY 2021 EBITDA Margin vs Peers



Source: Company Filings, Refinitiv Eikon

Competitive Advantage: ATZ outperforms its peers in customer retention as the Company has 12 proprietary brands, each with in-house design teams. These in-house brands represent over 96% of ATZ's revenue, elevating stores to becoming a niche provider of apparel not found elsewhere. The Company's pursued image of "everyday luxury" has settled into a trendy mix of fashion free from exuberance, one which has proven to be desirable to consumers.

Strong Balance Sheet: Despite the challenges brought forth by the pandemic, ATZ has been able to navigate lockdown restrictions without compromising its balance sheet. ATZ's Net Debt/LTM EBITDA grew slightly to 3.1x, now above the peer average of 2.2x. It maintains inventory turnover nearly double its peer average at 4.1x, and its current ratio remains in-line with peers at 1.4x.

Growing Free Cash Flow: While ATZ was able to leverage its e-commerce growth by nearly 125% through the lockdowns, its FY EBITDA margin of 14% is ~4% below peers. Q3 2021 had a promising FCF generation of $83mm, however, demand turbulence resulted in both levered and unlevered FCF down roughly 9% each as of Q4 2021. Given the circumstances, ATZ has shown resilience and is expected to reach pre-pandemic levels of cash generation as consumer demand continues to elevate as restrictions ease.

Attractive Valuation: The Company has performed well since the CPMT took a stake in April 2020, returning over 160% to date. As a result of the name's outperformance, ATZ's NTM EV/EBITDA (Fig. 2) now rests above the peer average of 13.7x at 17.9x. ATZ was valued using a 5-year DCF analysis at a WACC of 7.36%. The target price of $39.00 was derived from a 50/50 blend of a Gordon Growth model with a terminal growth rate of 2.5% and an EV/EBITDA exit multiple of 17x. Key assumptions reflect high growth expectations for the Company as consumer spending tailwinds will continue to drive profitability through Q2. Although a 5% implied return represents a relatively low potential for price appreciation, the Company does remain an innovative competitor and shown exceptional resilience to sector downturn.

Risks and Catalysts

The national distribution of COVID-19 vaccines bodes well for growth in consumer demand, as the Consumer Price Index has risen 4.7% since February 2020. However, Delta and Epsilon variants have appeared in North America and could prove resistant to the current vaccines, driving a reinstatement of lockdowns. ATZ's strong financial positioning and balance sheet flexibility reduces solvency risks of negative short-term performance, however the transition into summer and back-to-school shopping is expected to contribute positively to margin growth heading into the second half of the year.

Revised Thesis and Outlook

ATZ has been an exceptional post-pandemic performer and remains one of the top names in the CPMT portfolio in terms of total holding period return. Its cash flow resilience and brand expansion strategy have proven successful in an intensely competitive environment. While the valuation does not reflect a market outperform, the CPMT is recommending a hold on ATZ as the name has considerable growth potential despite its elevated market value. If management can continue its strong execution on growth goals and margin expansion, we believe the name will continue to deliver long term upside. We will continue to watch ATZ and surrounding industry dynamics to remain vigilant toward opportunities or threats that may influence the Fund's perspective toward the future of the Company.