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SurfStitch (SRF)

Shaping the Surf industry

Recommendation
Buy (unchanged)
Price
\$2.06
Target (12 months)
\$2.65 (previously \$2.60)

Expected Return

Capital growth	28.6%
Dividend yield	0.0%
Total expected return	28.6%

Company Data & Ratios

Enterprise value	\$486.0m
Market cap	\$538.4m
Issued capital	261.3m
Free float	82%
Avg. daily val. (52wk)	\$816,941
12 month price range	\$0.90 - \$2.13

GICS sector

Retailing

Disclosure: Bell Potter Securities acted as as co-lead manager for SRF's initial public offering in December 2014 and received fees for that service.

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	1.71	1.78	
Absolute (%)	20.47	15.73	
Rel market (%)	23.37	15.98	

Absolute Price



SOURCE: IRESS

Acquisition in Product drives credibility...

We believe SRF's acquisition of Surf Hardware International (SHI) adds incremental skillsets, relationships, distribution, product and customers to its network. It also adds to SRF's credibility with its core consumer group through the acquisition of brands that are synonymous with surf hardware. SRF's strategy continues to become more compelling and we believe that it still has unexplored potential to leverage its assets further to provide significant benefits to the group in the medium term. SRF also formalised its revenue target of \$1 billion in 5 years. We note this is above our current forecasts and while achievable, will not be easy to reach.

... however we have some concerns

While we like the direction this acquisition is taking SRF, however we have concerns over the pace at which deals are occurring, the price paid for SHI as well as whether SRF can avoid mistakes made by other surf wear retailers in the past with regard to its vertical retail strategy. SRF over raised, raising \$50m for a \$23.7m acquisition, suggesting its deal making days are not over, however the company confirmed that it currently had no other acquisitions on its radar.

Investment view: BUY, PT up 2% to \$2.65

We have updated our forecasts for both the acquisition and the \$50m capital raising. The acquisition adds \$3.2m to pro forma FY16 EBITDA. SRF intends to pro forma its results and therefore has increased its guidance by \$3m-4m from \$15m-\$18m to \$18m-\$22m. The result is an increase in eps by ~12% in FY16, ~5% in FY17 and ~7% in FY18. The varying effect on earnings is due to both the acquisition having less effect in outer years due to the growth rates of the businesses and our expectation of a greater gross margin impact on FY18 as SRF grows its vertical brands. Given SRF has effectively bought \$39m of pro forma revenue in FY16, we have lowered our EV/Sales multiple from 2.0x to 1.9x. The result of all of our changes is an increase in our Price Target to \$2.65 (previously \$2.60) SRF remains one of our key picks given its long-term growth outlook, strategy and current valuation.

Earnings Forecast

Jun Year end	2015a	2016e	2017e	2018e
Sales (A\$m)	199.4	321.7	433.1	553.1
EBITDA (A\$m)	7.7	22.0	43.5	63.2
EBIT (A\$m)	3.7	15.6	34.0	52.2
NPAT (normalised) (A\$m)	4.1	11.8	24.7	37.7
EPS normalised (cps)	1.9	4.5	9.0	13.7
EPS normalised growth (%)	na	138.4%	99.1%	52.7%
PER (on normalised EPS) (x)	109.0	45.7	23.0	15.0
EV/EBITDA (x)	63.1	22.1	11.2	7.7
Dividend (€ps)	-	-	-	-
Yield (%)	0.0%	0.0%	0.0%	0.0%
Franking (%)	0%	0%	0%	0%
ROIC (%)	2.5%	8.9%	15.5%	22.4%
ROE (%)	3.0%	6.9%	11.5%	15.3%

SOURCE: BELL POTTER SECURITIES ESTIMATES

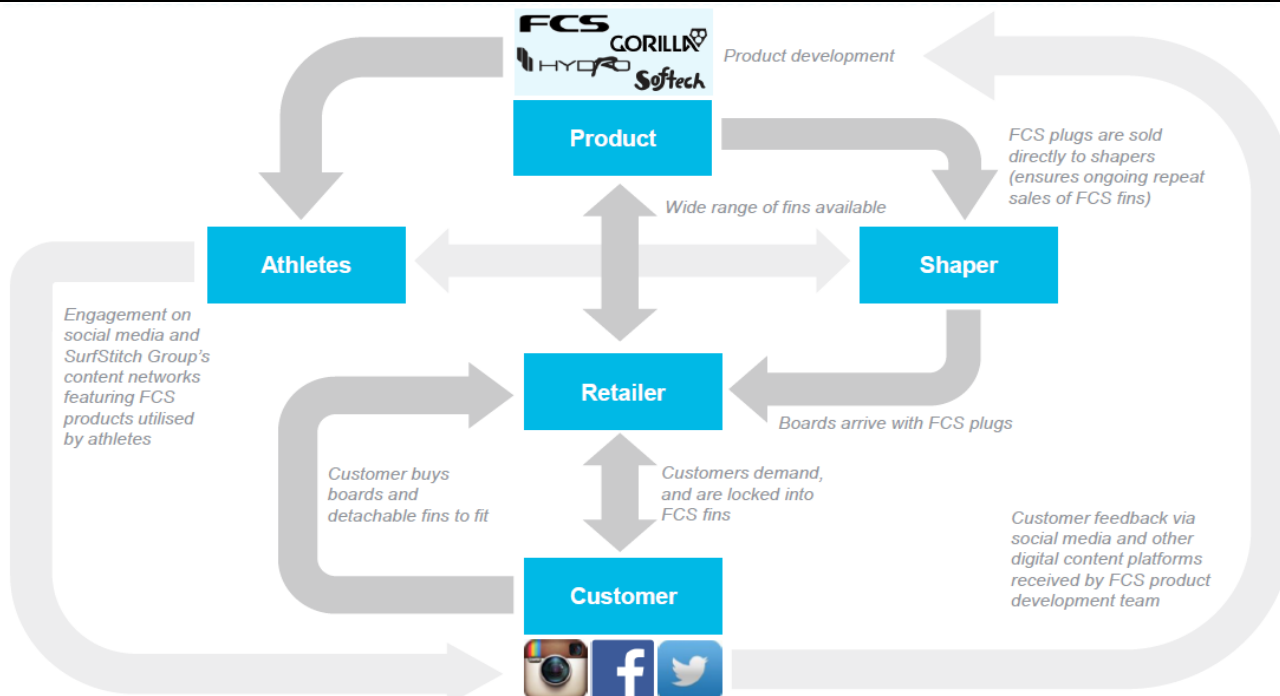
Another acquisition, this time in product

Acquisition in Product drives credibility

SRF has acquired Surf Hardware International for an Enterprise Value of \$23.7m in cash representing an FY16 EV/EBITDA multiple of 7.5x. SRF are undertaking a \$50m institutional placement at the same time. The key highlights are:

- **Accretive (on a pro forma basis):** The acquisition is 10%+ accretive in FY16 on a full year pro forma basis.
- **Adds credibility:** The acquisition buys a well-known surf business that has brands synonymous with surfing including FCS, Gorilla, Hydro and Softech. Hard Goods also signify credibility to the core customer surf demographic and trigger engagement.
- **Access to new markets:** FCS has a strong South American and Asian presence that will be beneficial to growing SRF's geographical reach.
- **Vertical brand strategy:** This acquisition will help launch a vertical brand strategy through leveraging existing well-known brands and legitimising the group. SRF has announced plans to grow a vertical line to 20-30% of SRF's revenues and expand the hard goods section.
- **3 Flagship stores to open:** SRF has announced that it is planning to open three flagship stores globally in the next 24 months. In our view this will have no material impact on SRF, however are supportive of the strategy to increase brand awareness. We believe there is a real opportunity for SRF to concentrate on bringing a fresh customer retail experience to Bricks & Mortar.
- **Additional retail expertise:** SRF also announced the appointment of Chris Athas, who has 30+ years of surfwear retailing experience including founder of Surflection. In our view this is much needed experience that will consolidate the online experience with surf retail experience. Chris's relationships in the surf industry will be crucial in supporting SRF's growth.

Figure 1 – Virtuous cycle strategy behind acquisition of SHI



SOURCE: COMPANY DATA

Strategy makes sense...

In our view SRF's strategy has multiple avenues and still has plenty of unexplored potential: Through this acquisition SRF continues to add incremental skillsets, relationships, distribution, product and customers to its network. The strategy continues to become more compelling and we believe that its business model can leverage its assets to a level not yet seen to provide significant benefits to the group.

... however we have some concerns

We are starting to have some concerns, including:

- **Too much too soon?** SRF have now made 4 acquisitions (Stab, MSW, Garage, SHI) since listing (less than 12 months). This is also just after acquiring Surfdomo and Swell before listing. That is a lot of acquisitions in a short space of time as well as re-branding the global business and we are growing concerned over SRF's ability to execute.
- **And hints of more to come?** SRF over-raised for a second time this year indicating to us that there could be more acquisitions to come. So far SRF's acquisitions have been squarely focused on Surf and it had previously indicated it needed to build out its content strategy focused on Snow. Management stressed on the conference call that it currently had no other acquisitions on its radar.
- **Acquisition price looks full:** We are well aware of the benefits that this acquisition will bring, however we believe that 7.5x EBITDA looks to be fully valued given the nature of the business. We believe this is by virtue of the private equity vendor.
- **Vertical brand strategy has risks:** Although early stages, there are risks around SRF expanding its own brand into its retail offering. It can be very attractive for the retailer to keep expanding its wholesale brands to get easy wins through extra margin. This is dangerous and, in our view, one of the mistakes Billabong and Quiksilver has made. (flooding its multi-branded stores with too much of its own product).

Investment view & valuation changes

We have updated our forecasts for both the acquisition and the \$50m capital raising. The acquisition adds \$3.2m to pro forma FY16 EBITDA. SRF intends to pro forma its results and therefore has increased its guidance by \$3m-4m from \$15m-\$18m to \$18m-\$22m. The result is an increase in eps by ~12% in FY16, ~5% in FY17 and ~7% in FY18. The varying effect on earnings is due to both the acquisition having less effect in outer years due to the growth rates of the businesses and our expectation of a greater gross margin impact on FY18 as SRF grows its vertical brands. Given SRF has effectively bought \$39m of pro forma revenue in FY16, we have lowered our EV/Sales multiple from 2.0x to 1.9x. The result of all of our changes is an increase in our Price Target to \$2.65 (previously \$2.60) SRF remains one of our key picks given its long-term growth outlook, strategy and current valuation.

Figure 2 – Earnings changes

Earnings Changes Jun Year End	2016e			2017e			2018e		
	old	new	% change	old	new	% change	old	new	% change
Sales (A\$m)	282.8	321.7	13.8%	390.4	433.1	11.0%	506.9	553.1	9.1%
EBITDA (A\$m)	19.1	22.0	15.3%	38.4	43.5	13.4%	54.7	63.2	15.6%
NPAT (underlying) (A\$m)	10.0	11.8	17.9%	21.3	24.7	15.9%	31.9	37.7	18.2%
EPS underlying (cps)	4.0	4.5	12.1%	8.5	9.0	5.1%	12.8	13.7	7.2%
Dividend (eps)	-	-		-	-		-	-	

SOURCE: BELL POTTER SECURITIES ESTIMATES

SurfStitch (SRF)

Company description

SurfStitch (SRF) is Australia's largest online retailer and the world's largest online action sports and youth apparel retailer. SRF manages a multi-brand action sports retail platform that offers over 900 brands to customers in Australia, USA and Europe. SRF acquired Swell.com from Billabong that sells a broad selection of Action Sports apparel and hard goods in the US market. It also acquired the leading online action sports retailer in Europe, SurfDome as part of its IPO.

Investment strategy and valuation

We expect SRF to deliver 3-year compound growth in revenue of 34%, with improving gross margins using an asset base with an estimated 50% spare capacity. Revenue and cost synergies from its recent Swell (USA) and SurfDome (Europe) acquisitions will allow for additional investment in marketing and IT infrastructure to aid continued revenue growth. We rate SRF a BUY with a Price Target of \$2.65 based on a blend of EV/Sales and discounted cash flow valuation (WACC 11.0%, Terminal growth 3%) methodologies.

Risks

Risks facing SRF include but are not limited to:

- **Decline in retail and e-Commerce sales generally, and in Action Sports products:** Factors that affect the category may be outside of SRF's control such as unemployment, interest rates and consumer confidence;
- **Increased competition:** Competition in Action Sports retailing is very high, however in pure-online Action Sports Retailing SRF is one of the few major players. Competition may arise from Omni-channel mono and multi-brand retailers that could cause loss of market share for SRF;
- **Foreign currency risk:** SRF has revenues, costs, expenses and investments denominated in multiple currencies and reports in AUD;
- **Reliance on 3rd party payment and logistics providers:** SRF relies on 3rd party providers for a number of its services. SRF has limited influence over these parties;
- **Acquisition integration risk:** SRF's strategy involves integrating its recent acquisitions Swell and SurfDome into its existing business. There is risk that SRF will not achieve the desired synergies and integrated network as expected;
- **Changes in fashion trends:** Changes in fashion trends affect all retailers. Brands are affected by changes in consumer preferences. SRF is exposed to risk that consumer preferences will move away from Action Sports apparel and accessories;
- **Regulatory and tax change risks:** Products sold by SRF are subject to GST or value added taxes in the countries it operates in. Changes to these taxes may influence SRF's competitive position in certain markets as well as its profitability;
- **Supplier relationships:** SRF has an extensive range of suppliers but still has a number of key supplier relationships that, if lost, would reduce SRF's product range and therefore its popularity; and
- **Key-man risk:** SRF founders Justin Cameron and Lex Pederson as well as SDUK founder Justin Stone have been integral to the company's success to date. Loss of any of SRF's key executives could have a negative impact on SRF's financial performance. All three have significant shareholdings in SRF somewhat mitigating this risk.

Table 1 - Financial summary

Jun Year end	2014a	2015a	2016e	2017e	2018e
Profit & Loss (A\$m)					
Sales revenue	153.7	199.4	321.7	433.1	553.1
... Change	40.8%	29.7%	61.4%	34.6%	27.7%
Gross profit	67.0	91.6	152.6	210.5	273.6
... Change	37.0%	36.7%	66.6%	37.9%	30.0%
EBITDA	(2.1)	7.7	22.0	43.5	63.2
... Change	na	na	186.1%	97.6%	45.3%
Deprec. & amort.	(4.6)	(4.0)	(6.4)	(9.5)	(11.1)
EBIT	(6.7)	3.7	15.6	34.0	52.2
Net Interest	-	0.5	1.2	1.3	1.7
Pre-tax profit	(6.7)	4.1	16.8	35.3	53.9
Tax expense	(0.5)	-	(5.0)	(10.6)	(16.2)
... tax rate	-7%	0%	30%	30%	30%
Associates	-	-	-	-	-
Minorities	-	-	-	-	-
Underlying Net Profit	(7.2)	4.1	11.8	24.7	37.7
... Change	-	-	-	-	-
Abs. & extras.	(0.9)	-	-	-	-
Reported Profit	(8.1)	4.1	11.8	24.7	37.7
Cashflow (A\$m)					
EBITDA	(3.0)	7.7	22.0	43.5	63.2
Change in working capital and other	13.2	(25.5)	(6.4)	(5.4)	(5.8)
Gross operating cash flow	10.2	(17.8)	15.6	38.1	57.4
Net interest	-	0.1	1.2	1.3	1.7
Tax	-	-	(5.0)	(10.6)	(16.2)
Pro forma cash adjustments	-	-	-	-	-
Operating Cash Flow	10.2	(17.7)	9.8	28.9	43.0
Capex	(4.3)	(0.6)	(9.7)	(12.1)	(15.5)
Free Cash Flow	5.9	(18.3)	0.2	16.7	27.5
Acquisitions	-	(61.3)	(43.7)	-	-
Disposals	-	-	-	-	-
Dividends paid	-	-	-	-	-
Other investing items	-	-	-	-	-
Equity	-	120.5	55.0	-	-
Debt increase/(reduction)	5.9	40.8	11.5	16.7	27.5
Balance Sheet (A\$m)					
Cash	31.3	40.8	52.3	69.1	96.6
Receivables	5.7	2.0	11.9	16.1	20.5
Inventory	46.7	43.3	70.8	95.3	121.7
Other current assets	-	2.5	2.5	2.5	2.5
Current assets	83.7	88.6	137.5	182.9	241.2
Fixed assets	5.6	3.3	6.5	9.1	13.5
Goodwill	78.9	73.8	117.5	117.5	117.5
Intangibles	6.1	7.9	7.9	7.9	7.9
Deferred tax assets	2.1	5.8	5.8	5.8	5.8
Other non-curr assets	-	-	-	-	-
Non Current Assets	92.7	90.8	137.8	140.4	144.8
Total Assets	176.4	179.4	275.2	323.2	386.0
Short term debt	-	-	-	-	-
Creditors	32.1	36.1	67.2	90.5	115.5
Other curr liabilities	3.3	5.5	5.5	5.5	5.5
Current Liabilities	35.4	41.6	72.7	96.0	121.0
Long term debt	-	-	-	-	-
Other non-curr liabilities	-	0.3	0.3	0.3	0.3
Non Current Liabilities	-	0.3	0.3	0.3	0.3
Total Liabilities	35.4	41.9	73.0	96.2	121.3
Net Assets	141.0	137.5	202.3	227.0	264.7
Share capital	150.2	248.3	303.3	303.3	303.3
Reserves	-	(63.5)	(63.5)	(63.5)	(63.5)
Retained earnings	(9.2)	(47.3)	(37.5)	(12.8)	24.9
Shareholders Equity	141.0	137.5	202.3	227.0	264.7
Net debt/(cash) \$m	(31.3)	(40.8)	(52.3)	(69.1)	(96.6)

Price	\$2.06
Recommendation	Buy
Diluted issued capital (m)	261.3
Market cap (\$m)	538.4
Target Price (A\$ps)	\$2.65

Jun Year end	2014a	2015a	2016e	2017e	2018e
Valuation Ratios					
Underlying EPS (eps)	(3.4)	1.9	4.5	9.0	13.7
... % change	na	na	138.4%	99.1%	52.7%
PE (on underlying EPS) (x)	na	109.0	45.7	23.0	15.0
EV/EBITDA (x)	na	63.1	22.1	11.2	7.7
EV/EBIT (x)	na	na	31.2	14.3	9.3
EV/Sales (x)	3.2	2.4	1.5	1.1	0.9
NTA (\$ps)	0.21	0.21	0.29	0.39	0.53
P/NTA (x)	9.6	9.6	7.0	5.3	3.9
Book Value (\$ps)	0.54	0.53	0.77	0.87	1.01
Price/Book (x)	3.8	3.9	2.7	2.4	2.0
DPS (eps)	-	-	-	-	-
... % pay-out	0.0%	0.0%	0.0%	0.0%	0.0%
Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Franking (%)	0%	0%	0%	0%	0%

Performance Ratios					
Revenue growth (%)	40.8%	29.7%	61.4%	34.6%	27.7%
EBITDA growth (%)	-	-	186.1%	97.6%	45.3%
EBIT growth (%)	-	-	321.5%	118.0%	53.5%
Gross profit margin (%)	43.6%	45.9%	47.4%	48.6%	49.5%
EBITDA/sales margin (%)	-1.4%	3.9%	6.8%	10.0%	11.4%
EBIT/sales margin (%)	-4.4%	1.9%	4.8%	7.8%	9.4%
Gross cash conversion (%)	-340.0%	-231.7%	71.0%	87.7%	90.8%
Free cash-flow yield (%)	-	-	-	-	-
ROE (%)	-5.1%	3.0%	6.9%	11.5%	15.3%
ROIC (%)	-4.3%	2.5%	8.9%	15.5%	22.4%

Leverage Ratios					
Net interest cover (x)	na	na	(12.7)	(26.0)	(30.2)
Net Debt/EBITDA (x)	14.9	(5.3)	(2.4)	(1.6)	(1.5)
Net debt/equity (%)	-22.2%	-29.7%	-25.9%	-30.4%	-36.5%
Net debt/net debt + equity (%)	-28.5%	-42.2%	-34.9%	-43.7%	-57.4%

Assumptions	2014a	2015a	2016e	2017e	2018e
Currency Assumptions					
AUDEUR	0.68	0.70	0.67	0.66	0.64
AUDUSD	0.91	0.83	0.73	0.70	0.72

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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Disclosure: Bell Potter Securities acted as co-lead manager for SRF's initial public offering in December 2014 and received fees for that service.

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