

Billabong downgrades - and is added to the portfolio

It's certainly not a monopoly but Billabong (BBG) is an example of one of those "few and far between" businesses referred to above. It is a company we have envisaged owning for several years. Previously price has stopped us. We had been observing from the sidelines and gathering information for some time. That changed with the macro driven downgrade on 4 December 2008. We used the downgrade as an opportunity to buy shares at very attractive valuations. Having started our research more than a year ago we were able to do this with some confidence.

Initially there were three catalysts for our research into Billabong;

- 1) Management;
- 2) Brand strength; and
- 3) Financials.

All three are important factors of our investment roadmap.

Firstly, post the Matthew Perrin (the previous CEO and lawyer by profession) and Gary Pemberton era (previous Chairman), Billabong installed a no nonsense, hands on management team. This team, led by very experienced retailers who have literally grown up in the surf as well as the surf industry. That was not the case previously. We now think the management box gets a big tick.

Secondly, it is clear that Billabong enjoys great brand loyalty. The core Billabong surf brand has stood the test of time. While its roots remain firmly established in youth board sports, it continues to hold appeal for the greying surfer (and surfer wannabe), who have worn the product since their youth. The brand appears to have developed longevity over two generations. That's certainly the case in each of the families at Selector.

Table 1. Surf apparel industry margin comparison for public companies

		FY 2006	FY2007	FY2008
Billabong	Gross Margin	53.5%	53.4%	54.9%
	EBIT Margin	21.4%	19.4%	19.7%
Quiksilver	Gross Margin	45.7%	46.0%	48.1%
	EBIT Margin	8.1%	9.9%	8.1%
Volcom*	Gross Margin	49.7%	48.4%	47.7%
	*08 SFM est EBIT Margin	21.2%	18.8%	16.5%

Thirdly, Billabong's financials suggest this is a world class business. Gross profit margins and earnings before interest and tax (EBIT) margins have consistently been strong and lead the industry. The recent downgrade, driven by the current global upheaval, presents some near term challenges but it is unlikely, in our opinion, to

damage the group's longer term earnings path. And Billabong may just fare a lot better than some of its peers.

Billabong has historically grown its bottom line in the high teens and has a strong and improving gross cash flow to EBITDA conversion rate of 80%. Return on equity is strong at 22% and when debt is accounted for, using a return on capital employed calculation, it is a very healthy 23%. In 2008, Australia represented some 30% of revenue and 38% of EBITDA. Herein lies the risk and opportunity. US sales represent circa 46% of revenue and 38% of EBITDA.

In October and November 2008, the US consumer finally threw in the towel. Retail sales tanked, retailers were frozen in the headlights and forward orders became the domain of the brave. And despite a better than expected foreign exchange-aided profit upgrade at the company's annual general meeting in August, the earnings downgrade that some of us were expecting, finally came.

On 4 December 2008, Billabong responded by downgrading expectations for the full year to around 8% net profit growth, down from an earlier 10-15%. Having tumbled all the way from an earlier peak of \$18.81 in June 2007, the group's share price closed the year at \$7.85.

With investors fleeing and the stock tumbling, we used the opportunity to accumulate a modest holding fully expecting that further opportunities may still await us. In the meantime and based on management's forecast, Billabong is expected to earn a net profit of around \$180M for 2009, placing the group on a PER of 9.1 and a yield of 7.4%.

Back in March 2008 we attended the Billabong investor open day. On that occasion we got to meet, surf with and listen to the operational heads from Australia / Asia Pacific, the USA and Europe. The investor day also showcased some of the key brands Billabong has acquired and nurtured, and included presentations from the founders of Element (Skate), and Nixon (Watches & Accessories). It was notable that the founders from these and other acquisitions have typically stayed to grow "their" businesses within Billabong. Both the Element and Nixon founders highlighted that Billabong had proven to be the ideal partner, allowing for both brand growth and business expansion.

Not surprisingly, Billabong view themselves as brand managers or the custodians of brands with the aim of owning a portfolio of eleven relevant businesses under separate brands. Billabong operates on a decentralised basis. All businesses are run regionally under regional heads. But importantly, each brand is run independently, in order to avoid commoditising the individual internal strengths that make the brand relevant. And this is the key to Billabong, it is a business built on maintaining true brand relevance, focused on the core market of action sports.

In March 2008, the US economy was already starting to unravel. We focused our attention on the presentation by Paul Naude, a straight shooting South African veteran of the surf industry and General Manager of Billabong North America. He was under no illusions that the market was tough but forward orders for spring and summer 2008 had held up. With no downgrade forthcoming and still expecting the worst, we held off.

From CEO Derek O'Neill, we learnt that the Australian/Asia Pacific region was Billabong's most mature and highly penetrated market, as one would expect. Sales per capita for this region sat at \$12 per person. In comparison, the ratio in potentially larger markets like South America dips as low as cents per person. This might suggest that the global action sports market remains under penetrated when compared to the traditional beach culture markets of Australia and New Zealand. While this certainly provides some scope for Billabong to pursue offshore growth, we are wary of simply extrapolating these numbers.

But what of Billabong's competitors?

Today, in revenue terms, Quiksilver is the market leader with sales of around \$US2.3 billion through the Quiksilver, Roxy and DC brands.

Separately, DC (shoes) is still delivering growth and Quiksilver Europe remains a formidable business with EBIT of circa €100 million. It appears that Europe is holding up the Quiksilver Inc empire.

Overall however, Quiksilver Inc is struggling under a (ski) mountain of debt, following the group's acquisition of the Rossignol Group (ski boots and apparel) in a deal consummated in 2005. As a result of poor ski seasons and a failure to transition a seasonal business into a year round offer, Quiksilver reported a \$US166 million write-off and a bottom line loss of \$US121 million during 2007. The sale of Rossignol was finally completed in November 2008 and will result in an additional non-cash loss of \$US150 million, to be reported in the first quarter 2009.

Having sold Rossignol, after trashing it, Quiksilver still hold the debt - a painful US\$1.07 billion reminder of a deal gone bad. In comparison, Quiksilver's market capitalisation stands at just \$US212 million.

We listened in to the Quiksilver Inc fourth quarter and full year conference call in late December. The call had a morbid tone. And most US analysts signed off saying "good luck" to the Quiksilver management team. Maybe that's just a nice American thing to say at Christmas time. But our suspicion is that with credit constraints, over \$US1.0 billion in debt, and three separate refinancings taking place in Europe, the USA and Australia, Quiksilver's equity base is severely overstretched. The market capitalisation suggests that investors are questioning Quiksilver's viability or they are pencilling in a very desperate and dilutive equity raising.

As the number one competitor to Billabong, Quiksilver isn't in a strong position to grow market share. In fact, Quiksilver plans to close 25 non-performing shops in the USA and capital expenditure on new shops rollouts (66 in 2008) is being slashed during calendar 2009.

Like Billabong, both Quiksilver and Volcom announced deteriorating outlooks with very little visibility even into the next quarter. Results in the short term hinge on holiday sales, the level of retail store discounting and any inventory overhang extending into the northern hemisphere spring season. A below par performance in one or more of these variables could easily lead to further downgrades throughout the industry.

Another competitor of interest is Hurley Inc, manufacturer of the industry award winning "phantom board short" which retails at \$130 a pair. In comparison, Billabong, Quiksilver and Volcom board shorts retail in the \$60 - \$90 price point range, while "dressy" board shorts such as the French Vilebrequin retail for up to US \$250 a pair.

Interestingly, Hurley Inc was founded in 1999 by former surfboard shaper Mike Hurley who had earlier headed the team running the US licensee operations of Billabong. At the time of its licence expiry, Mike Hurley built Billabong's USA sales to around \$US70 million per annum. Today, as a wholly owned subsidiary of Billabong, the number is closer to \$US557 million, while total global revenue (including acquisitions) for the group has mushroomed to \$A1.35 billion. In contrast, with Mike Hurley at the helm, Hurley Inc has taken revenue from a zero standing start to around US\$200 million. Our understanding from an employee is that Hurley Inc, now owned by sporting giant Nike Inc with a market capitalisation of US\$25 billion, continues to experience strong growth.

When looking at the current competitive landscape, one of the key take out points is the level of gross margins enjoyed by Billabong - *see Table 1*. At the EBIT margin level, Billabong's are double that of Quiksilver and a step above the much smaller Volcom, (Nike Inc do not split out results for Hurley Inc).

We have tried to understand the reasons why the Billabong EBIT margin stands head and shoulders above Quiksilver and importantly, if this margin is sustainable over the long run. The reasons as we see them are as follows;

- 1) Retail / wholesale mix
- 2) Geographic mix
- 3) Global structure and supply chain manufacturing strength
- 4) Management

Firstly, Quiksilver has a significantly larger retail footprint than Billabong. This requires upfront capital as well as additional ongoing working capital in the form of inventory, resulting in lower operating margins. Wholesaling to the independent retailers enjoys significantly higher margins without the added risk attached to any retail operation. Wholesaling was the traditional focus of Billabong.

If large independent retailers, such as the US based Pacific Sun, establish their own brands, they are able to gain the higher margins that are enjoyed by the wholesalers. This is a risk to wholesalers like Billabong and is one reason why they have and will continue to increase their own global retail footprint.

Secondly, it is more attractive for Billabong to sell into the Australasian market where it is a dominant local player, enjoying margins of circa 25%, compared to both US and European operations, which sit at 20% respectively. With Australian sales representing close to 39% of EBIT, this provides a positive skew for Billabong.

Thirdly, Billabong has history on its side and this translates into experience. Billabong was born out of manufacturing. They know intimately well what works and what doesn't work in relation to manufacturing. They also know what it takes to build a successful product and where the pitfalls are. This is critical information when a young brand like *Tigerlily* looks to ramp up production to meet growing demand. Today, Billabong source product for all eleven brands on a global basis. This provides buying power across the entire brand suite with China supplying approximately 33% of company product.

Supply chain is all about fulfilment – and Billabong state that 99.6% of business is supplied accurately. This is critical to success, as is the need to deliver goods on time. At the end of the day margins rely on it. Stores need to have inventory and they need confidence in the re-order process to manage their floor stock to maximise sales.

Management is the key driver, it wraps around each of the three factors listed above. Led by O'Neill, an employee since 1989, the group has embraced seasoned operators within its ranks. While a number of acquisitions have been undertaken over recent years, the vast majority of growth has come from within. Discounting is avoided at all costs and retail expansion is undertaken on a case by case basis. Collectively, directors speak for 37.3 million shares or some 17.8% of the issued capital, led by Billabong founder Gordon Merchant with 14.9%

Our key concern remains the fashion component of the business. Billabong has explained that fashion versus brand issue comes down to how it is managed. The Billabong brands must be relevant, they must be trusted and above all they must be consistent. Importantly, the group aims to avoid big swings in relevancy, having learnt from Merchant that changes are important but the buyer wants confidence that the look and feel of the product is timeless.

In short, when entering a new season of Billabong apparel the general rules that management follow typically include;

1. 50% of the new range carries a theme from the previous year
2. 25–35% of the range has a new feel
3. 10-15% of the range has more radical product options

The recent downgrade, driven by the current macro environment, is providing the opportunity to gain a stake in the Billabong growth story. While evidence provided by the company and its peers has suggested sales - are and will continue to be - slow in the near term, the current business valuation and buy in price open to investors more than compensates for the risk. The market upheaval is potentially providing a one-off buying opportunity because the long term growth prospects of Billabong are unlikely to be damaged by an economic recession.

Even though the lead Billabong brand was established 36 years ago we see strong potential for growth. Through acquisition, Billabong has added another ten brands to the portfolio, all focused on the youth market and covering some 80 product categories. As O'Neill noted, this translates into a possible 170 brands/country combinations. Today, less than a third of these opportunities have been exploited. While the Billabong brand is distributed in 100 countries the remaining ten brands are distributed in less than 40. The goal is to expand the ten additional brands into as many of the 80 categories and established global channels as possible over time. With more than 100 staff focused on product development categories, the list is also likely to expand.

Management seem quietly confident on the growth front. CEO O'Neill maintains that Billabong will continue to avoid giving forecasts. It's a policy that we agree with. He has noted, however, that the company took 33 years to earn its first \$1.0 billion in sales but that the next billion and beyond would take but a fraction of that time to achieve.