KONTOOR BRANDS

NYSE: KTB

ABSTRACT

Kontoor Brands is a spinoff of VF Corp that has recently undergone indiscriminate selling, forcing its share price well below its intrinsic value.

Porcupine

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Kontoor Brands

Ticker: KTB

Price: $27.37

Shares Outstanding: 56.4 million

Market Cap: $1.5 billion

Cash: $100K

Interest Bearing Debt: $1.2 billion

Enterprise Value: $2.6 billion

Company Description

Kontoor Brands (KTB) is a spinoff that generates a significant amount of cash flow and has a long history of being a profitable and resilient business. They are an apparel company that owns the Wrangler, Lee, and Rock & Republic Brands. They also operate the VF Outlet stores. KTB is currently undervalued at $27.37 per share (as of close on Tuesday, June 18th, 2019) due to indiscriminate selling by institutions and investors who simply do not want exposure to the stock due to its differences with its parent company, VF Corp (VFC).

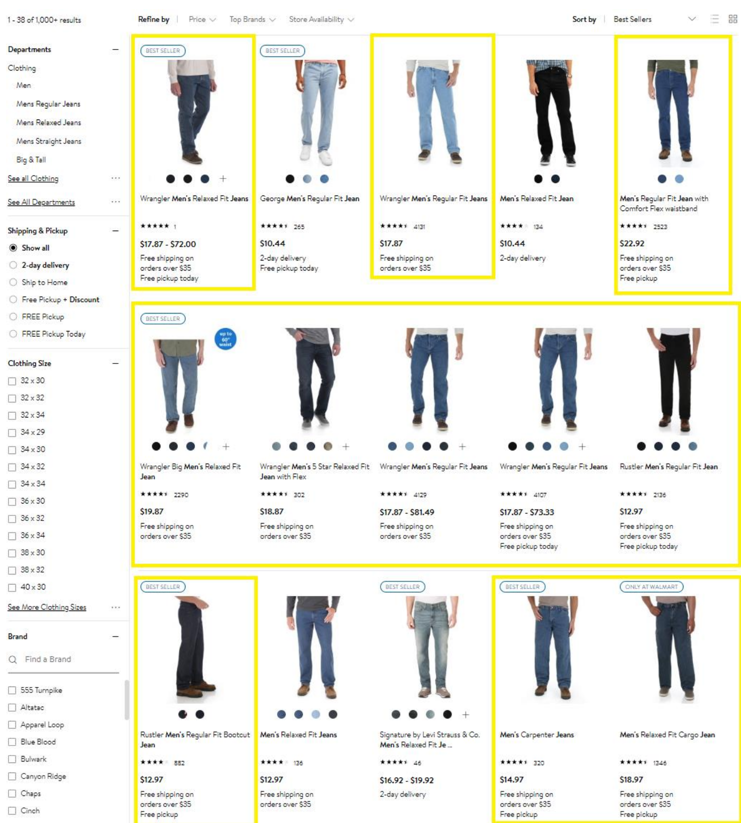
Market Opportunity

KTB was spunoff from VF Corp, owner of brands such as Timberland, Vans, and The North Face ("The Big Three" as management calls them), on 5/22/2019. Shareholders received 1 share of KTB for every 7 shares of VFC that they held. VFC management said that they spunoff KTB to employ greater strategic and managerial focus, deploy capital more efficiently, and to provide investors a choice between the two companies. The third reason is the most telling. VFC's "Big Three" brands have been growing. KTB's brands have not been. From 2014 to 2017, VFC revenues increased 2.93% per year including the jeanswear business. Excluding the jeanswear business, revenue growth would have been 4.72%.

The reason KTB shares are currently undervalued is due to indiscriminate selling from institutions that held VFC stock. The market cap of VFC is currently $32.95 billion, while Kontoor brands market cap is only $1.6 billion. Therefore, those funds that have a large cap mandate are not allowed to hold Kontoor brands because KTB is not a large cap stock. Additionally, KTB is not included in the S&P 500 (it is in the S&P Small Cap 600), while VFC is. Those index funds with an S&P 500 mandate also needed to sell their shares of KTB.

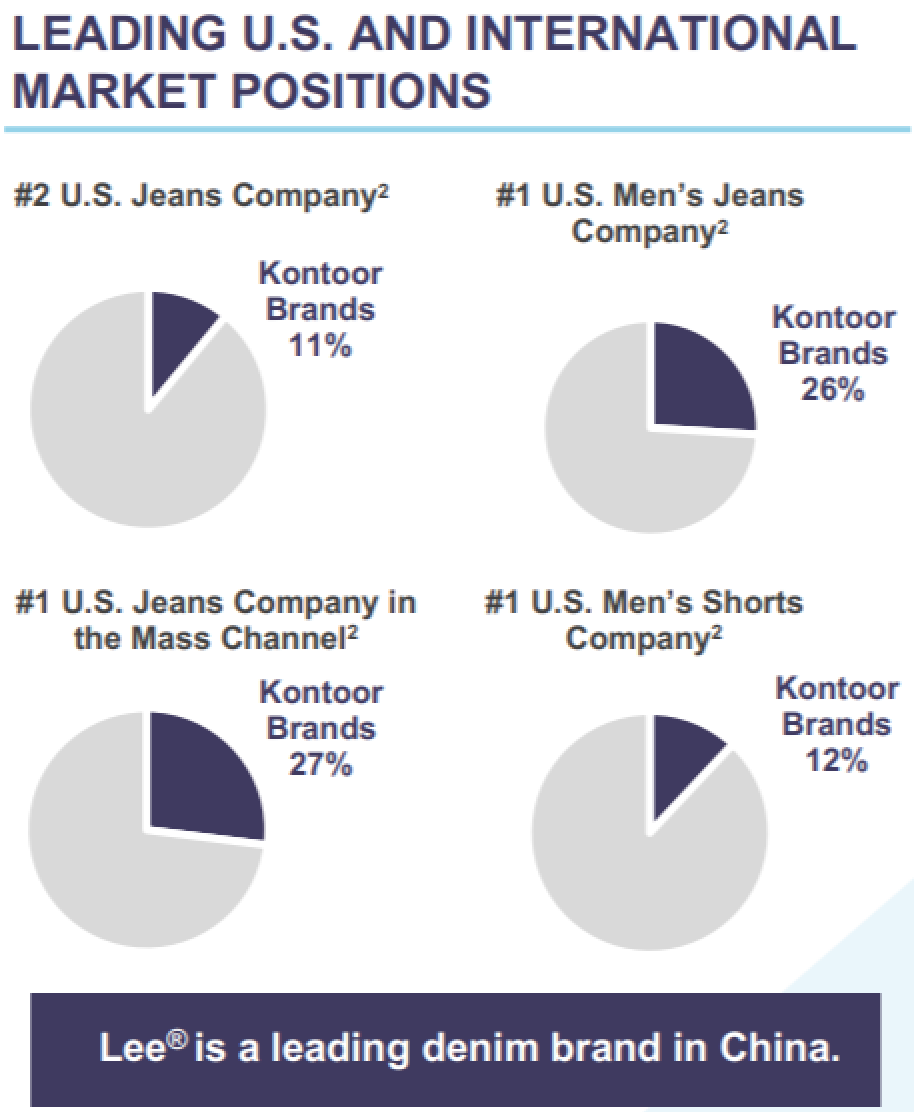
Kontoor Brands has a few headwinds that it needs to address. One of their strategic goals is to increase their presence in foreign countries, particular in China. Asia in general presents a unique opportunity, as they only have one warehouse facility in all of Asia (located in China). If you haven't been living under a rock, you know that relations with China are not the best right now, and that the Chinese may see American brands with disdain now and in the future. 47% of Lee revenues in 2018 were derived outside the U.S., mostly in China and certain countries in Europe. Lee has developed a leading market position in China over the years, so this should help soften the blow if things really take a turn for the worst. However, this could be a big problem for Wrangler, which has a smaller presence in China, but is arguably a more "western" brand than Lee. This may make it difficult for Wrangler to penetrate the Chinese market during trade talks, a strategy that management plans on implementing in the future.

Another headwind that KTB faces is the closure of retail stores and the destocking of their inventory. As a result, a greater proportion of KTB's revenue will come from fewer stores. Their ten largest customers represented 53% of total revenue in 2018, with Walmart making up 32% of their total revenue. However, they have had partnerships lasting at least 25 years with their top three brick and mortar wholesale customers, which include Walmart, Target, and Kohls. These companies have proven to be resilient during the retailpocalypse thus far and I doubt that the 25+ year relationship Kontoor Brands has forged with them will come to an end any time soon. KTB's brands dominate the "best seller" section for men's jeans on the Walmart website.



They are also on the Target best sellers page, but not nearly to the extent as Walmart. Target's private line, "Goodfellow & Co.", and Levi's are the top competitors in Target. Lee and Levi's tend to compete at Kohls for the top sellers, with Levi's being the main seller. However, Wrangler and Lee are the cheaper brand. Although LEVI sells their jeans at a higher price point, KTB has them beat in the operating profit margin department, suggesting that KTB can afford to lower the price even further if they needed to.

One secular tailwind that Kontoor Brands has at its back is the growth in the jeans industry itself. The global jeanswear market has a ~5% projected CAGR. In the U.S., the jeanswear market is projected to grow at ~3%. KTB is already a market leader in the U.S., and there is room for improvement within foreign markets for the Wrangler brand.



Outside of international markets, Kontoor brands could also seek to establish a brand that is geared more toward women (other than Rock & Republic). As seen above, they already represent 26% of the U.S. Men's Jeans market. Therefore, they need to start targeting a different demographic in order to jump start sales growth again, in my opinion. Management has stated that this is one of their strategies going forward.

Share Structure

KTB has 56.6 million shares outstanding and a current market cap of 1.6 billion. They have 7.5 million shares registered to be provided in the Kontoor Brands 2019 Stock Compensation Plan (includes stock options, restricted stock units, and performance-based stock units) and 100,000 registered for issuance related to their 401K plan.

They plan on implementing a similar compensation structure as VFC, in that a high percentage of executive's compensation will be based on equity in the company. Although I would much prefer management to buy shares in the open market, this still aligns management and shareholder interests. Currently, management owns about .53% of the stock (~$8.6 million at risk), with the majority of the ownership coming from CEO, Scott Baxter, who owns 182,070 shares (~$5.2 million at risk).

Management

Management has an extensive record with VF Corp. The most recent addition to the management team was Laurel Kreuger (General Counsel), who joined VFC in 2019. Scott Baxter (CEO) has been with VFC for 12 years, Russ Welton (CFO) for 7, Chris Waldeck (VP of Lee) for 2, and Thomas Waldron (VP of Wrangler) for 29 years. Thomas Waldron has quite the history of climbing the corporate ladder. Starting as a replenishment manager in 1995, he has worked his way up to become the VP of Wrangler. If anybody knows Wrangler, its Thomas Waldron. Management has had extensive experience within VF Corp's Jeanswear business and I'm confident they will steer the ship in the right direction.

2018 total compensation for management seems low when compared to Levi's management team. For example, The CEO of Levi's salary in 2018 was $1.4 million, versus $743K for Scott Baxter. Total compensation for the CEO of Levi's was $12.1 million, whereby Scott Baxter received $4 million total. However, this compensation may change due to the fact that management is now running an independent company. They have assumed larger positions, and with that will likely come a compensation boost. Hopefully they are true to their word and make at risk compensation (equity) a large proportion of total comp.

Competition

The jeanswear apparel industry is characterized by low barriers to entry and significant competition. There has also been a recent trend in retailers creating private label brands. Target and Amazon have rolled out such in direct competition with KTB. Wrangler and Lee are already largely established and well recognized brands that provide great value for consumers. Therefore, I don't see these private label brands being a huge threat to future sales.

Kontoor Brands' competitors include Calvin Klein (PVH), Tommy Hilfiger (PVH), Carhartt (private), Diesel (private), Levi Strauss & Co. (LEVI), Guess (GES), and Uniqlo (FRCOF). Their most similar competitor is Levi Strauss & Co., which recently just went public. LEVI has grown revenues ~4% over the past four years and trade at a significantly higher EV/EBITDA multiple than KTB. While KTB's revenues have been declining over the same period, Kontoor has been able to generate significantly more in operating profit per unit of sales (15.5% on avg. for KTB and 9.7% for LEVI).

When looking at the pricing of their best-selling items on online retailers such as Target and Walmart, Wrangler is sold in the high teens to low twenties, whereas Levi's is sold in the mid to high twenties. The fact that Kontoor is able to generate a significantly higher operating margin while pricing their products at lower price speaks to the efficiency and scale of their operations. They seek to improve upon their operations by centralizing their management team in Greensboro, NC and are currently determining the areas where distribution centers and warehouses would be better suited in order to better meet their customers' needs.

Kontoor Brand's competitive advantage lies in their ability to provide brand name apparel for prices below their competitors. In order to be the price leader, one must also be the cost leader. KTB's operating profit margin vs. their competitors supports this claim.

Financials

Wrangler makes up a significant portion of Kontoor's revenue, at 57% in 2018, with Lee making up 34% of that revenue in that same year. Managerial efforts should be focused on pursuing a strategy to expand the Wrangler brand, as it is the higher margin brand (17.9% v. Lee's 11.5% from 2016 to 2018). Management believes that there could be an opportunity for Wrangler to demand a higher price point overseas, which would lead to greater profitability. However, headwinds from the trade war may impact this.

When one looks at the form 10 to see past financials, a dismal scenario is painted. Sales have declined ~3% per year for the past 4 years. This decline can be attributed to the destocking of inventory and loss of sales to brick and mortar stores that have closed their doors. This is certainly a problem, but as mentioned before, they have longstanding relationships with retailers who will likely survive the retailpocolypse. On a positive note, direct to consumer sales and e-commerce sales have been increasing as they have invested in their online sales platform and continue to do so in the future.

Over the long-term, the jeanswear business has been extremely resilient. Sales decreased ~13% total from 2007 to 2009 and they managed to maintain a strong operating margin of over 14% in that same time period. This speaks to the quality of their brand and the value that they provide for their customers.

The long history of Lee and Wrangler, on top of the profitability of Kontoor Brands compared with competitors, makes me believe that these brands have staying power. People buy the jeans because they are extremely affordable and of high quality. I don't see this changing in the near term. The business also has extremely low maintenance, as CAPEX has averaged 1.32% of sales since 2010.

Financing Risk

Kontoor Brands is heavily indebted compared to their peers. They carry a Ba2 rating from Moody's due to their reliance on very few large customers, lack of product diversification, and fashion risk. To put things in perspective, LEVI was given a Ba1 rating from Moody's for similar reasons. This is simply one notch above that of KTB's, though LEVI doesn't carry nearly as much debt. Moody's must not think of Kontoor Brands' debt as a major problem due to their ability to consistently generate significant free cash flow.

Kontoor Brands issued a $750 million term loan A facility and $300 million term loan B facility to fund a $1.05 billion cash transfer to VF Corp as part of the restructuring and to pay fees and expenses related to the restructuring. In turn, VFC plans on using the cash transfer to pay down their short-term obligations and to fund acquisitions. The weighted average interest rate at the time the form 10 was published was 5.1%. The term loan A comes due in 5 years and the term loan B comes due in 7 years. The interest on the term loan A is floating and likely carries a lower interest rate currently due to interest rates falling. They're required to paydown a portion of each term loan quarterly until the final maturity date, where the majority of the debt will come due.

Management has stated that one of their goals is to pay down debt. According to the debt repayment schedule, they will have a significant amount of leverage on their balance sheet for at least five years when compared to their competitors. Their interest coverage ratio cannot be less than 3x and their net leverage ratio cannot exceed 4x adjusted EBITDA. If LEVI and VFC are of any indication, Kontoor's D/A ratio of .87 is most likely not their optimal capital structure. LEVI's D/A ratio stands at .28, while VFC is at .27. Therefore, Kontoor's optimal capital structure should likely be somewhere around .28 D/A.

Current Valuation

Management has guided for a mid-single digit sales decline for FY 2019 and low single digit increases for FY 2020 and 2021. Given that the jeanswear businesses' CAGR for the past 24 years has been effectively 0, I projected that future revenue would not grow. I believe this to be a likely scenario over the long-term and incorporated it in my valuation. However, I did consider a 5% drop in sales for FY 2019 within my model.

The FCFF method was used for valuation purposes. The next two years are likely to be challenging for Kontoor Brands, as they'll need to establish certain administrative departments that VF Corp. previously took care of. As such, margins have been adjusted downward within my valuation. After two years, management expects general and administrative expenses to increase by $10 million over what they would have otherwise been while operating as a subsidiary of VF Corp. Management expects there to be between $110 million and $125 million in expenses associated with being a public company for the first two years as well. These numbers have also been incorporated in my valuation.

KTB's cost of capital will be relatively low for the first five years of operating as a standalone company due to the amount of debt in its capital structure. As stated previously, the effective interest rate on the debt was about 5.1% at the time the final form 10 was published. The cost of capital will increase over time as they pay down their debt.

After considering these factors, I arrived at a fair value of ~$38.50. At the current price of $27.37, this represents a margin of safety of ~40%.

When comparing KTB to pure play jeanswear peer LEVI, there seems to be a chronic mispricing. LEVI is trading at ~13.4x 2019 EV/EBITDA, while KTB is trading at ~7.8x 2019 EV/EBITDA. In my opinion, LEVI should absolutely demand a higher multiple due to its past growth story. However, I think that this discrepancy is far too wide.

Finally, the matter of debate within the seeking alpha comments section, the dividend. If you read the form 10, you would see that management stated that they plan to distribute a $2.24 dividend.

This currently represents an ~8.1% yield. This seems steep for a company that has minimal capital expenditures that can cover the dividend quite easily. Management plans on delivering a dividend based on a 60% payout ratio going forward. The dividend has yet to be declared, but if they're following in the same footsteps as VFC, the dividend will likely go ex in early September.

The reason for undervaluation is simple: VFC is widely held by institutional investors. There was a large market cap discrepancy between VFC and KTB, forcing those with a large-cap mandate to sell KTB. Along these same lines, KTB isn't included in the S&P 500, but rather the S&P Small Cap 600. Those institutions that have a mandate to hold only S&P 500 funds were forced to sell. For other investors, this stock simply isn't as sexy as the brands that VF Corp. currently holds. A value jeanswear manufacturer that has had declining sales for the past four years doesn't quite get investors excited, whereas "the big 3" brands that VFC still owns do get people excited.

Catalysts

Several catalysts could propel the stock up to what I believe fair value is. There have been 3 analyst reports that have come out since the spinoff. More positive analyst reports would likely propel the stock price.

Bank of America gave a price target of $24 on June 6th. They cite multiple contraction to 6x 2020 EBITDA to get to this valuation. Interestingly enough, they set a 12x 2020 EV/EBITDA multiple for LEVI. I'd like to hear how the analyst reconciles these two valuations. Susquehanna assigned a price target of $36 on June 13th. Stifel set a price target of $46 on May 28th.

On the fundamental side of things, any reversal in the revenue story should send a positive signal to investors that management can turn the ship around. At an 8% dividend yield, there clearly isn't much growth priced into the stock.

An official declaration of a dividend is the final short-term catalyst. As stated previously, commenters on seeking alpha seem skeptical of the $2.24 per share dividend. I see no reason to be skeptical of it at all. They have the free cash flow to cover this amount, and more, and it is blatantly stated in the form 10 that it is their intention to pay out $.56 per quarter. When this dividend is announced, not only will you be receiving an attractive yield at current levels, but you should also see some price appreciation to reflect an appropriate yield. Additionally, when the term loan A is paid off in 5 years, much of their interest burden will be lifted. If sales are flat, then they should be able to raise their dividend significantly based on the 60% payout ratio dividend target.

Kontoor Brands is currently undervalued due to indiscriminate selling by institutions. The business is not very sexy and has not been growing. However, it has solid long-term relationships with its customers and pricing power over its competition. KTB provides customers with brand name jeans at a great value, just as the stock does to investors.

Disclosure: Long KTB. No position in any other securities mentioned in the above article.