Transcription for Q2 2019 Financial Results Webcast

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Corporate Participant

Cüneyt Yavuz
Mavi – CEO

Presentation

Operator
Ladies and gentlemen, welcome to Mavi Q2 2019 Webcast conference call and webcast. I will now hand over to your host, Cüneyt Yavuz, CEO. Sir, please go ahead.

Cüneyt Yavuz
Hello everybody, welcome to our conference call regarding the financial results for the first half of 2019, which is spring/summer 2019 season for our business. I will be taking you through our operational and financial results for the period and I will provide insights on the current trading environment and our expectations for the rest of the year. Also, I have already received some of your questions and we will try to address them throughout the presentation. Should you have any further questions, as always, I will be happy to answer them at the end of our call.

Before going into the key highlights for the period, I would like to do a quick overview of the second quarter in terms of market and consumer trends in Turkey. You will recall in the first quarter review, I mentioned we witnessed different dynamics playing out every month and saw the adverse impacts of competitive environment, weather conditions and other macro uncertainties on our traffic and transaction figures. I am happy to report that in the second quarter our strong sales performance was back on track, like-for-like growth realised at 25% including both traffic and transaction growth year-on-year. The two encouraging facts that we reported in Q1 continued to hold true for the whole spring/summer 2019 season, which is our women collection and our denim category, continued to deliver positive volume growth, highlighting the strength and resilience of Mavi as the jeans brand of Turkey.

Now, let's move onto slide two with our key highlights. As you know, we have started applying IFRS 16 reporting standard as of 2019. However, throughout this presentation, I will be sharing the results without the IFRS 16 impact to provide a more meaningful comparison with the previous year. You may find the full IFRS 16 impact in detail in the appendix of the presentation.

In the first half of 2019, our consolidated revenue grew by 26% to TL 1.340 billion. Nominal EBITDA grew by 14% to TL 178 million, resulting in 13.3% of EBITDA margin. Net profit in the first half contracted 14% year-on-year to TL 46 million. We opened nine stores and closed three stores resulting in six net openings this quarter. As of end July, we have 306 own-operated stores in Turkey, and in total 433 monobrand stores globally, including franchisees. With a very strong second quarter performance, Mavi Turkey retail business delivered a like-for-like revenue growth of 20.8% in the first half of 2019. As a loved and trusted brand, we continue to acquire new customers, with an addition of 637,000 in 2019. We now have 5.5 million active loyalty cardholders that have shopped with us over the last two years.

Moving onto slide three, with the strong contribution of Q2 sales, which grew 31% year-on-year, consolidated first half global revenue grew by 26% reaching TL 1.340 billion, out of which 65% was in retail, 31% in wholesale and 4.1% in ecommerce. As a result of our continued efforts and focus on our online business, we delivered a solid 112% sales growth in the first half of 2019, generating from mavi.com and Marketplace sales. Sales in Turkey grew by 25% compared to the same period of 2018, with 24% growth in retail, the main driver of our domestic business. We are on the right path with our ecommerce business in Turkey that grew by 91% year-to-date in 2019. International market grew by 31% in Turkish lira terms. As you are aware, we have been closing down retail stores in Europe since last year where we target future growth to be driven mainly by wholesale and online channels. The strategic focus on E-com is paying back and our international ecommerce sales grew by 141% to date.

Moving onto slide four, let us focus on Turkey retail business. Recall that we guided for net 15 new store openings and 10 expansions for 2019. We are on track to deliver this guidance for square metre expansion. We have closed two inefficient stores, plus the Ataturk Airport store this quarter, and opened nine new stores. Additionally, nine stores went through expansion in the first half of 2019. As of end July, we have 306 own-operated stores totalling 153,000 square metres of selling space in Turkey, with an average store size of 500 square metres.

Turkey retail revenue growth of 25% was mainly driven by like-for-like growth and new store openings in the first half of 2019.

Now, to elaborate further on our like-for-like performance, let's move onto page five. With a very strong performance of the second quarter, our like-for-like revenue in the spring/summer 2019 season grew by 20.8%. Since the second half of last year, given the cost inflation and the need to reflect this to pricing, we have been reiterating the fact that like-for-like growth in 2019 would be driven by basket growth. As per our plans, we delivered 22.9% growth in basket size this season. It is worth noting that this basket price increase is in line with the market and we continue to maintain our price positioning in the Turkish apparel market as per our strategy. We achieved 3% transaction growth year-on-year in the second quarter, making up for most of the weakness in the first quarter. This brings the year-to-date transaction to -1.7% for the first half of the year. As we continue to offer the right product at the right price and continue to deliver an excellent shopping experience, we remain confident that we will continue to retain our happy shoppers and gain new Mavi customers.

Now, let's take a closer look at our category-based performance and move to slide 6. As I mentioned in the beginning of the call, our denim category continued to achieve positive sales volumes and grew 22% in value in the first half of 2019. The knits category, which consists of t-shirts and sweaters, grew 30% in the first half of 2019, shorts 20%, jackets 23%, and accessories 17%.

On slide seven, we again highlight our online growth performance as this channel now has a significant and growing share in our total sales. In addition to our direct to consumer sales covering mavi.com and Marketplace, our customers can also buy Mavi products through third-party digital platforms, to which we wholesale. Including the wholesale E-com, our total online sales grew by 86% and reached TL 107.4 million globally, constituting 8% of total revenue. We are putting a great effort to improve our online presence in Turkey, especially over the last two years. We are continuously adding new features and benefits for our shoppers. For example, most recently, we launched click-and-collect function and introduced our Mavi Store app. We are immediately seeing the returns from such features. The 73% growth in total online sales this year is evidence of more to come. The share of online in Turkey increased from 2.4% in the same period last year to 3.3% in the first half of 2019. As of first half of 2019, we are deriving 29% of our total international sales from online, which grew 93% year-on-year.

Let's move on to review our margin performance on slide eight. As you know, we guided for continuous improvement in margins and have been able to deliver beyond our commitments against all the challenging externalities in the previous years. For 2019, we have been guiding for significant increases in the cost of goods resulting from currency devaluation impact on raw materials and high inflation. Including all mentioned impacts, our gross margin contracted 310 basis points in the first half of 2019. We are taking many actions to improve our operational efficiency to offset product cost pressures. Our EBITDA excluding IFRS 16 realised at TL 178 million in the first half of 2019 with 13.3% EBITDA margin, 140 basis points lower than the same period last year. It is important to point out that we have managed to gain back 170 basis points of margin by improving our OpEx/sales ratio.

As you can see, the efficiency gains are even more visible in quarter two with an EBITDA margin of 15%. Net profit grew by 9% in the second quarter, bringing the first half net profit to TL 46 million, excluding IFRS 16. Including the IFRS 16 adjustments, EBITDA increases to TL 297 million, and net income decreases to TL 32 million in the first half of 2019.

Now, I would like to move onto page nine to take you through our working capital progress. Our working capital at the end of the first half stands at 5.8% of revenue, implying a slight increase compared to last year despite the challenges in the trading environment. Given the volatile consumer sentiment, we have further increased our focus on inventory management this year. As a result of our efforts to improve our speed-to-shelf, responsive and efficient open-to-buy management and effective supply chain planning, inventory level as a percentage of revenue is even better than last year. The nominal increase in inventory is mainly due to an average 30% of higher unit cost.

In half one 2019, we have generated TL 130 million of operating cash flow, resulting in a cash conversion of 73%.

Let's now move onto the next slide (slide 10), opening nine stores and expanding nine stores, we have spent TL 53 million on capital expenditure in half one 2019, resulting with a CapEx ratio of 3.9%. Our net debt level is TL 108 million as of end of July 2019, this implies a leverage multiple of 0.3 times of last 12 months EBITDA.

Looking into the currency composition of our debt, 21% of total consolidated debt belongs to Mavi U.S., Mavi Canada, Mavi Europe and Mavi Russia, all in local currencies. As of end of July, 10% of debt is in foreign currency and is totally covered with foreign currency assets and receivables from subsidiaries. Therefore, we have no open positions on our balance sheet as of today, and we aim to continue to carry zero short foreign exchange exposure going forward.

Moving onto slide 11, I would like to provide some outlook to Q3 and remind you of our official guidance for the year 2019.

For the financial year 2019, we are targeting 25% consolidated net sales growth. In our Turkey retail business, we target 18% like-for-like sales growth along with 15 net new store openings and 10 expansions of store square metres. As you know, we have experienced a first quarter that was weaker than our expectations, and a second quarter beating our expectations.

Looking into the third quarter and the second half of the year, I would like to highlight a few points.

We have started our fall/winter season as of August. This season, once again, our revenue growth will be mainly driven by like-for-like basket growth, but compared to the first half, we expect better transaction growth on a lower basket growth. The season to date like-for-like growth in Q3 trends in line to deliver our target.

In terms of pricing, we continue to prioritise traffic growth and market share gains along with customer satisfaction. This implies that we expect the gross margin pressures to continue until the end of the year. We will work very hard to continue to bring efficiency gains on the OpEx management.

On the other hand, please note that quarter three last year was an extraordinary quarter in terms of sales growth and operational profitability. Also, there was a significant contribution from international operations, both to top line and to bottom line given the very high currency exchange levels. With the currency impact reversing this quarter, there may be a downside risk of lower contribution of international sales. We are aware that Q3 is a challenging quarter to beat and the whole team is very focused on delivering.

Another point worth noting here is the impact of interest rates on "interest on purchases" on EBITDA. Although this is more a technical reporting issue rather than operational, it may have an adverse impact on our guided EBITDA as the interest rate for the rest of the year will come in lower than our initial projection. This, I believe, is a short-term comparative challenge, but a long-term benefit to our business.

Having laid out the challenges, as of Q2, we would like to keep our guidance of a 14.5% EBITDA margin as our target. Regarding leverage and CapEx, we retain our strategic base target of staying below one times net EBITDA multiple, and we still expect our CapEx spending to be around 4% of total sales.

With this final note, I am happy to take any questions you may have, so it is over to you. Thanks for taking the time and listening to my presentation.

Question and Answer Session

Operator
[Operator instructions]

We have a question by phone from Görkem Göker, Yapi Kredi Yatirim. Please go ahead.

Görkem Göker
I have questions about your online business, as we witnessed a huge growth on that front. Could you provide us more information about the basket sizes on that front and how profitable it is currently? I mean, you may be making some CapEx on that front as well. Because my second question is 53 million CapEx sounds a little high, although it is within your guidance, I guess, but when compared to last year, there is an increase. Could you please provide a breakdown of your CapEx?

Lastly, your guidance implicitly says 15.5% EBITDA margin in the second half of the year. Do you see risks on the upside front or on the downside front regarding your guidance? Thank you very much in advance.

Cüneyt Yavuz
Thank you. Let me take it one by one. Let me just take a look at the CapEx breakdown here. First and foremost with E-com, in terms of our E-com tracking, our strategy in Turkey is to maintain Turkey E-com profitability at the levels at our store contribution. I am happy to report back that net-net, although there might be slight variances between the two channels, our retail and E-com, our E-com channel in the Turkey business model is as profitable as our retail operations.

As we continue to grow our E-com, and as we gain economies of scale and introduce a lot of the good features of click and collect, the app, better product lining and grow our category, I am very much confident that our E-com total business will be even more profitable down the line.

Our digital footprint outside of Turkey in international holds the same story, although we don't have as big a retail presence internationally. It is mostly denim-centric growth model that we have, and if you look at U.S., Canada, European businesses, they are growing disproportionately fast and we have many more white space to cover, so we are very bullish in terms of what we can deliver there. Also, from a profit perspective, they are also doing pretty well.

Russia just started, so the numbers are not in. Hopefully, as the Russia business picks up, our .ru business and our WildBerries, Lamoda collaborations, which are equivalent of Amazon and Trendyol in this part of the world, I think it will only fuel our business. I said a few more words than probably necessary, but overall, our E-com business both domestically and internationally is most profitable. The basket size, conversion, UPT (units per transaction) are very similar to the markets that they are operating in, therefore, we are very much encouraged to continue to grow both domestically and internationally to cover more ground with our E-com business.

On the side of the CapEx business, you are right, when I say TL 53 million, clearly, that is also indicating everything in it. Within that there is IT and digital and supply chain related other investments that are coming through. Typically, the split is – if you look at it, it is an 80:20 rule, so 80% of what we are investing has historically been behind retail and 20% by technology and digital and supply chain related areas. In SS19, this 80:20, was 70:30, so 70% of that 50+ million went behind store operations and some takeovers and expansions, and 30% on other... so there was a little more disproportionate investment, as you were rightly smelling and figuring out behind – in preparation for future growth that will be coming through our digital, better reporting supply chain and E-com related areas. Also, some of the investment came through in the digital front in USA and Russia across the first half of this year.

In terms of my guidance, it is a very bumpy ride, therefore, I tried to outline the current situation year-to-date with quarter two transactions picking up and business was going through a more normal season. We are encouraged for the rest of the year. Having said that, we are trying to be, as a team, very realistic about quarter three, which is coming off of a very high comparable year. Both Turkey performed very strong, and also the international contributed due to the exchange rate last year, so I am trying to take a consolidated second half perspective. Rather than say that the upside or downside risk is that we remain spot on at 14.5% for the EBITDA with the challenges being noted. If anything, we are going to keep – our number one focus is keep the traffic, maintain the consumer, maintain our competitive environment.

From a Turkey perspective, we have just, as you are aware, started our consumer communication with the Kıvanc/mens campaign, which will be followed by the second wave of campaign, which will be focused more on women. Our investment behind digital, both in Turkey and across the globe will continue, so some of the weaknesses, left and right, we hope to capture through better new product innovations, better product offerings and international expansion. Again, another point to underline is the currency vis-à-vis many of the forecasts and budgeted currencies are running at a lower rate, which is for the mid to long run a better situation for us, because it makes us more affordable. But having said that, of course, the international contribution vis-à-vis last year brings up a sort of downward challenge. As management, we are committed to use all the tools we have and all the different channels that we operate in to bring all ends to come to our guidance number.

I think we will have a much deeper insight as we go through this most challenging quarter three, for me to be able to tell you (our investors), my board, whether there is an up or a down trend, but it is too early to call, therefore, I choose not to change any of our guidance principles.

Operator
We have another question by phone from Cemal Demirtaş from Ata Invest. Please go ahead.

Cemal Demirtaş
My question is related to the latest months, such as September, we are maybe in the middle of. I know the base effect, but do you have any perception about consumer behaviour, because in some certain areas we see soft demand, and I am trying to understand do you have any indications you are receiving in your segments you versus your competition.

The interest rate environment, now, we see interest rates are coming down, but we didn't see the impact. What kind of impact do you expect any how long it will take to reflect to your domestic demand side. Thank you.

Cüneyt Yavuz
We are guiding for 18% LFL retail indicator, the key indicator for retail business. We finalised the month of August, which is in line and we had a very good August that is behind us. With September, the back to school season in Turkey begins, and as we have more people walking in and there is another come-back to the city that is taking place, we have just started our campaign or communications, media communications above the line, below the line, social media to enhance this period and capitalise on the traffic that is taking place.

As of, I would say, the beginning of this week, if I were to say at a macro level how we are performing, as expected, most of the gains we are tracking is coming from basket size. But I am a numbers and volume person, I am not a value person, because we are in the game of market share and making sure that we are gaining new customers and selling to them more products so that our wardrobe penetration and market share is increasing. I am also happy to say that as of mid-September, we are tracking with positive traffic and positive transactions on the volume side. Thank you.

Cemal Demirtaş
Any comment about the interest rates?

Cüneyt Yavuz
Interest rates, it is too early to make any statement left and right at this point in time. The interest rates hopefully are going to come in as a net benefit to us, especially in terms of our financing costs, and mostly, I think, down the road as we are purchasing more and in terms of running the business with our business partner suppliers, it will have a positive impact.

Your question was pure consumer-driven and consumer sentiment-driven. For me, without or without the current fluctuations, it is too early to say whether it has a positive or a negative impact. All I can say is month-to-date, season-to-date our numbers are tracking in line, so let's see how it goes. We have another halfway to go through and, again, as we mentioned it is an uphill battle this quarter, vis-à-vis comparables. Oherwise business is OK, but from a comps perspective it is coming on top of very huge numbers for quarter three last year. That is the beauty of being in retail and like-for-like business, so we take that challenge wholeheartedly and we will see how it goes, but so far, very good.

Operator
We have another question from Berna Kurbay from BGC Partners. Please go ahead.

Berna Kurbay
My question is about the gross margin. You mentioned that you expect to see pressure until the end of the year on the gross margin side and hopefully some operating leverage benefits will come through. On the gross margin, are you still seeing a lot of pressure from the cost side, meaning the high cost inventory from August/September last year? Is that pretty much cleared now and are you seeing some benefits from a more reasonable exchange rate in the last couple of months? Is the gross margin challenge now becoming more of a pricing issue and keeping traffic high? What exactly is the challenge or the main challenge in the second half of the year for you on the gross margin side?

Cüneyt Yavuz
We went through a process or a period where the cost base increased 30+ percent, and as you can see in many of the industries, not only in retail, but many across. Probably with the exception of food industry in Turkey, the cost increase and what we were able to transfer to the consumer, because the consumers have not had the opportunity to have a similar purchasing power parity increase, there has been a delta. Our job has been therefore to make sure that our inventory management, speed-to-shelf and sell-through rates are improving. I am happy to report back that from a working capital perspective, we ended the first half of the year with better than forecasted inventory, with solid sell-through rates, with improvements in markdown management.

Now, coming into this season and moving forward, as the exchange rates are coming down, of course, the cost pressures that we have are easing off, so that is a positive, of course. We welcome the fact that the currency is now trading at 5.7-5.8 ratio. Vis-à-vis, at this point in time, we were hedging at 6.9-7 etc for spring/summer 2019.

I think the imminent exchange rate has more to do with what is to come, so if I were to model Mavi, with what you see today as an exchange rate, this is mostly going to have a good news impact for spring/summer 2020, because as we are finalising our plans for the spring/summer buys and the cost base is there. So it will give us room, breathing space to do a lot of the catch-up that we have lost, let's say, along the year with step-by-step price adjustments and making sure that we capture the consumer.

For the rest, from a pure quarter three, quarter four, second half of the year, we do expect the gross margin pressure to continue, but the contraction that we have seen, this 310 basis points that have come should be much lower than the first half, and we are still prudent in terms of our expected EBITDA margin. The operational leverage impact on EBITDA last year will be hard to beat.

Internally, I think it would be fair to say that we will continue to look into opportunities and rent ratios and overhead ratios, in sell-through, in markdown management, these are all nice areas that through this first half of the year, around 170 basis points that I mentioned, that we were able to make gains at. This is only making Mavi and my team much more fluid and stronger, and some of these good practices, clearly, we will carry into the second half also. Net-net, of course, it all starts with the consumer and their price and purchasing power. What is important is that we keep the traffic, which is right now trading positive, that we keep the transactions positive, these are two indicators that are tracking positive. As long as we have the footfall coming in, we do aspire to catch up and improve on our gross margin area sooner than later.

Again, a bit wordy, if you have more detailed questions, I am more than happy to elaborate, but I hope that covers your question.

Berna Kurbay
That was very helpful. Thank you.

Operator
[Operator instructions]

We have another question from Görkem Göker from Yapi Kredi Yatirim. Please go ahead.

Görkem Göker
As a follow-up question, you have already talked about it, but could you please provide more information about the competitive environment and your competitors' pricing policy. Do you see any material changes on that front both including foreign and local players? Thank you.

Cüneyt Yavuz
The competitive environment same period last year went a little out of control with all the exchange rate changes, where some of the international brands who did global pricing priced out of the market, while the Turkish competitors maintained their TL positioning. But as of today, in terms of Mavi's strategic blueprint pricing metrics vis-à-vis the competition, we are back to normal. What does back to normal mean?

Back to normal for us means from an Inditex perspective, to be around 100 index in what we call the Tops categories and to be 110-120% on the denim front, more premium on the Inditex brands, vis-à-vis the denim category. Vis-à-vis the competition with the locals players, which is typically Koton, LC Waikiki, DeFacto are – we also have certain golden ratios vis-à-vis their denim and tops products, whether it is the t-shirts, the sweaters, dresses, jackets that we sell. As the season has recently opened up and what we see on the self that we are back into our historical trading multiples or position vis-à-vis the competition.

Typically, what happens, if anything, that we witnessed a bit last year is, when there is a big crunch, especially on the low end of the trade, some of the bigger players might have more inventory left in their hands, which may prolong their discount period, which might have an adverse impact on us, but that was past. Right now, I am guessing also they are more prudent and better managing their inventory. In terms of the communication, promotion and customer activity vis-à-vis what Mavi is offering and what we are offering, one could say is back to normal trading environment.

Individually, how one is performing vis-à-vis the other, how their traffic etc is doing, I am not fully aware, but I am happy to report that, as I mentioned, we had to do some pricing catch up, which we did. With regards to that, finally, we are not seeing any transaction and footfall negatives on that, which is doing a very positive like-for-like. If we can maintain that, that is also good news, because that is where we are eyeing for the spring/summer and fall/winter of 2020. Because this year, with all the externalities, turned out to be much of a bridge year where we had to deal with the externalities, protect our balance sheet, protect our consumer and customer.

As I was answering on the CapEx front, to put a lot of our good efforts behind technology, global, digital expansion in preparation and continued growth for the international business.

That is all I have to say for now.

Operator
[No further questions]

Cüneyt Yavuz
I would like to thank everyone who attended. The Mavi IR team, my finance team who has been part of the presentation and myself, we are at your service should you have any further questions. Hope to catch up with you, if not sooner, at the latest at the end of our quarter three presentation.

All my best. Thank you.
