Aritzia, Inc. (ATZ-CA)
Re-Calibrating Expectations; Still See Healthy Long-Term Prospects

Maintain Outperform rating. Aritzia reported FQ4 (February year-end) results ~in line with expectations though investors have long since shifted focus to the pandemic. FQ1 guidance (quarter nearly complete), not surprisingly, pointed to a tough quarter as store closures curbed momentum (partially offset by digital surge). Aritzia has a strong brand, healthy balance sheet/liquidity, growing awareness, and rapidly expanding omni-channel capabilities. Bottom line, the company will endure and future prospects remain bright. However, patience may be required as stores reopen and management formulates its plan for the "new normal."

- **Strong finish to F2020.** Aritzia reported FQ4 (February quarter-end) results ~in-line with expectations (adjusted-EPS $0.21 vs. Baird/consensus $0.21 consensus, -3% Y/Y) driven by comps (+8.9% vs. +7.7% consensus), offset by higher SG&A (+50bp vs -60bp). All in, adjusted-EBITDA $’s exceeded consensus by ~5% (margin 15.6% vs. 14.7%).

- **Stores closed through much of FQ1.** Aritzia's FQ1 runs from March-May; needless to say momentum in stores ground to a halt as the pandemic took hold in North America. All stores closed March 16 and remained closed through most of the quarter; initial reopenings began May 19 and the company expects to have 30 of its 96 boutiques open by this Sunday (which marks the end of FQ1). On a brighter note, digital demand has surged ~150% in FQ1 as management maintained its full staff to support fulfillment capacity, and worked aggressively to clear excess spring inventory. All in, the company guided to FQ1 revenue of $105-$110M (-44-47% Y/Y; above our model on the strength of digital but in the range of recent expectations) and an adjusted-EBITDA loss of ($24M)-($28M), implying significant merchandise margin pressure and fixed cost deleverage (we previously modeled a loss of $21M, though clearance actions appeared to be more aggressive and no staff were furloughed). Furthermore, the cash balance sits at $102M (vs. $118M at the end of February), implying minimal cash burn despite unprecedented pressures through FQ1.

- **Path to recovery.** With many of Aritzia's stores concentrated in major cities / urban centers, and management focused on the health & safety of customers and employees, the re-opening process could take time. As of today, ~45 of the company's 96 boutiques are eligible to reopen per state/local rules, but management stuck a generally cautious tone on the path beyond the initial 30 stores, as well as the overall consumer backdrop once reopened (management "pleased" with initial reopenings). The company plans to flow fresh receipts for Fall and return to its traditional sale calendar.

- **Outlook.** Near-term visibility is undoubtedly lower than we would like but amid a rapidly evolving retail landscape, Aritzia's differentiated concept, lean footprint, and growing omni-channel capabilities position the company to emerge stronger. We trimmed our estimates as we refine our sales recovery/margin assumptions but continue to like longer-term risk/reward (~15x our normalized F2022 EBITDA estimate).
### Q4 VARIANCE

#### ATZ-TSE


<table>
<thead>
<tr>
<th>(C$ millions, except per share data)</th>
<th>Q4-20</th>
<th>Q4-19</th>
<th>Y/Y</th>
<th>Baird Est. vs. Est.</th>
<th>Cons. Est. vs. Cons. Est.</th>
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</thead>
<tbody>
<tr>
<td>Net revenue</td>
<td>$275.4</td>
<td>$259.1</td>
<td>6.3%</td>
<td>($5)</td>
<td>$278.6 ($3.2)</td>
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<tr>
<td>Cost of goods sold</td>
<td>$178.3</td>
<td>$165.2</td>
<td>7.9%</td>
<td>$180.3 (2)</td>
<td>$174.4 $3.9</td>
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<tr>
<td>Gross profit</td>
<td>$97.1</td>
<td>$93.8</td>
<td>3.5%</td>
<td>$100.2 (3)</td>
<td>$104.2 ($1.1)</td>
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<tr>
<td>Stock-based comp</td>
<td>$2.4</td>
<td>$2.6</td>
<td>-7.1%</td>
<td>$1.5</td>
<td>$66.9 ($2.4)</td>
</tr>
<tr>
<td>Operating income</td>
<td>$30.2</td>
<td>$31.9</td>
<td>-5.2%</td>
<td>$33.0 (3)</td>
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<tr>
<td>Finance expense</td>
<td>$1.0</td>
<td>$1.2</td>
<td>-14.0%</td>
<td>$1.2 (0)</td>
<td></td>
</tr>
<tr>
<td>Other (income) expenses, net</td>
<td>($1.4)</td>
<td>$4.4</td>
<td>NM</td>
<td>($2.3)</td>
<td></td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>$30.9</td>
<td>$30.3</td>
<td>16.3%</td>
<td>$32.1 (2)</td>
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<tr>
<td>Income taxes</td>
<td>$8.8</td>
<td>$7.5</td>
<td>17.0%</td>
<td>$9.4 (1)</td>
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<tr>
<td>Net income</td>
<td>$21.7</td>
<td>$18.7</td>
<td>16.0%</td>
<td>$22.7 (1)</td>
<td></td>
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</tbody>
</table>

#### EPS

- Adjustments to Net Income:
  - Stock-based comp: 2.4% vs. 1.5%
  - Mgmt fees & exp: -5.1% vs. -100.0%
  - Unrealized FX (gains) losses: (0.7) vs. (1)
  - Related tax effects: (0.0) vs. (0.4)

- Adjusted Net Income: 23.4% vs. 21.7%

- Adjusted EPS: $0.21 vs. $0.19

- W.A. Diluted Shares: 113.1 vs. 117.5

#### EBITDA Reconciliation:

- EBIT (reported): 30.2% vs. 31.9%
- D&A: 24.1% vs. 7.4%

- EBITDA: 61.6% vs. 34.8%

- Adjustments to EBITDA:
  - Stock-based comp: 2.4% vs. 1.5%
  - Other: (21.0) vs. (5.1)
  - Unrealized FX (gains) losses: - vs. -

- Adjusted EBITDA: 43.0% vs. 42.6%

#### Gross Margin

- Q4-20: 35.4%
- Q4-19: 36.2%
- Y/Y: -97 bp

#### Sales Metrics:

- Comparable Sales: 8.9% vs. 5.5%
- Sales by Region: 275.4 vs. 259.1
- Stores by Region: 96 vs. 91

#### Key Metrics:

- Inventory: 94.0 vs. 112.2
- Growth: -16.2% vs. 42.3%

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Source: Company Data, Baird Research
Investment Thesis

Headquartered in Vancouver, British Columbia, Aritzia is a rapidly growing design house and fashion retailer that designs, manufactures, and sells women’s apparel and accessories for a target female customer aged 15-45. The company operates physical retail locations across Canada and the United States as well as an expanding ecommerce platform (approaching ~18% of sales this year)—generating >C$870 million in sales (F2019). We believe ATZ offers investors a rare opportunity for exposure to a well-positioned apparel retailer with significant whitespace for growth. Aritzia has a differentiated assortment (owned brands), disciplined pricing strategy (not promo-driven), attractive real-estate (high-traffic locations, enticing environments), successful & incentivized team (founder-led, high insider-ownership), and careful expansion strategy (stores+ecommerce) that will allow flexibility as consumer channel preferences evolve. We see a credible multi-year runway for growth, driven by brand awareness growth and expansion into the U.S.--supporting attractive risk/reward and our Outperform rating. Investment highlights include:

- **Valuation.** Our price target of C$21 is based on ~15x our NTM+1 EBITDA, between current levels (19x depressed levels) and pre-COVID ranges (~16x). We believe will normalize as earnings recover from depressed levels, though acknowledge that to sustain valuation near pre-COVID levels will require Aritzia to return to a healthy growth algorithm.

- **Successful concept.** Aritzia has carved out a relatively unique position in a highly fragmented apparel landscape by offering high-quality product (premium design & materials), compelling fashion (in-house designers, 90% owned-brands) and enticing store environments (in premier locations) at still-attainable price points (above “fast fashion” but well below “affordable luxury” segments). This price/value equation has earned Aritzia a loyal customer base without relying on promotional activity to drive traffic.

- **Significant whitespace.** With <100 retail stores (67 Canada, 26 U.S. as of FQ2-20), Aritzia has significant room for geographic expansion without risk of being “over stored” and is well positioned to remain flexible with its real estate strategy as consumer channel preferences (stores vs. ecommerce) evolve. From F2020-F2021 we see Aritzia opening 6 stores/year (including its most significant expansion into the U.S. in the company's history in F2020) in both new and existing markets, and pursuing a store expansion strategy, driving a total square footage growth CAGR of ~HSD %+. Furthermore growing brand awareness and international investments support a substantial ecommerce opportunity (targeting ~25% penetration from ~18% this year).

- **Management/shareholder incentives aligned.** A founder-led team with significant ownership aligns management and shareholder interests—leaving us confident the company will stick to a disciplined expansion strategy.

- **Margin opportunity.** With growing scale Aritzia has the opportunity to drive merchandise margin improvement though sourcing efficiencies and realize fixed cost leverage. Adverse foreign exchange movements, raw material cost pressures, and significant investments (incremental infrastructure) represent near-term headwinds for the company’s margin profile (F2020). That said, we see a path to expanding margins over time -- a rarity in retail -- as Aritzia increases its scale.
May 29, 2020 | Aritzia, Inc.

Risks & Caveats

Aritzia sells women’s fashion apparel & accessories, an inherently discretionary category that is subject to unexpected shifts in consumer preferences and behavior. Key risk factors to consider include:

- **Competition.** The fashion apparel industry is highly competitive and low-growth. Aritzia’s growth targets imply market share gains in markets where the brand is relatively unknown today. Furthermore, competition in the Canadian market is growing with U.S. retailers (Nordstrom) and fast fashion brands (Uniqlo) adding stores.

- **COVID-19.** The COVID-19 crisis has led to intense pressure on revenue/earnings and the duration of the crisis is unclear.

- **Fashion risk.** Aritzia’s merchandising strategy is to offer a balanced assortment of proven winners and calculated bets on new fashion. Fashion miscues could lead to markdowns and brand depredation.

- **Canadian macro environment.** 70%+ of revenues are generated in Canada.

- **Currency.** Financial results are reported in Canadian dollars. Nearly ~30% of revenue is generated in US dollars and ~95% of inventory is sourced in US dollars (~one-half hedged). Fluctuations in CAD/USD exchange rates could have a material impact on results.

- **Real estate.** The company’s strategy depends on securing premier real estate for its stores. Furthermore, Aritzia is willing to pay higher-than-average rent to ensure top-tier locations—setting up potential fixed-cost deleverage if new stores perform below plan.

- **Key person risk.** Aritzia has an experienced management team led by Founder and CEO Brian Hill. Loss of key managers could affect performance of the business.

- **Other operational risks.** Aritzia in the process of transitioning/ramping distribution centers, rolling out international shipping, and implementing a new ERP system.

- **Modeling risk.** Management has outlined 5-year growth targets (to F2021) but guidance surrounding near-term expectations has been rather limited each quarter. As such, we could see high variability in Street estimates at times as there may be some disconnect between internal/external expectations regarding quarterly performance.

- **Dual class structure.** Aritzia has a dual class share structure that results in voting power concentrated with entities owned and controlled by CEO Brian Hill. Post-IPO and secondary offerings, the public float accounts for >70% of basic shares outstanding but controls only ~25% of voting power.

Company Description

**Aritzia, Inc.** is a rapidly growing design house and fashion retailer that designs, manufacturers, and sells high-quality women’s apparel and accessories at attainable price-points for a target female customer aged 15-45. The company operates 93 retail stores in premier locations across Canada (67 stores) and the United States (26) as well as an expanding ecommerce platform (approaching ~18% of sales).
## Aritzia, Inc.  
(ATZ-TSE)

<table>
<thead>
<tr>
<th>Income Statement ($ millions)</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2019</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2020</th>
<th>Q1E</th>
<th>Q2E</th>
<th>Q3E</th>
<th>Q4E</th>
<th>2021E</th>
<th>2022E</th>
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<tr>
<td><strong>Net sales</strong></td>
<td>377</td>
<td>427</td>
<td>542</td>
<td>667</td>
<td>743</td>
<td>167</td>
<td>205</td>
<td>243</td>
<td>259</td>
<td>874</td>
<td>197</td>
<td>241</td>
<td>267</td>
<td>275</td>
<td>981</td>
<td>109</td>
<td>189</td>
<td>250</td>
<td>272</td>
<td>820</td>
<td>1,020</td>
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<td>13%</td>
<td>27%</td>
<td>23%</td>
<td>11%</td>
<td>15%</td>
<td>15%</td>
<td>18%</td>
<td>19%</td>
<td>18%</td>
<td>18%</td>
<td>18%</td>
<td>17%</td>
<td>10%</td>
<td>6%</td>
<td>12%</td>
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<td>-22%</td>
<td>-7%</td>
<td>-1%</td>
<td>-16%</td>
<td>24%</td>
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<td>56</td>
<td>65</td>
<td>85</td>
<td>118</td>
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<td>28</td>
<td>33</td>
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<td>45</td>
<td>42</td>
<td>66</td>
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<tr>
<td><strong>Y/Y Growth</strong></td>
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<td>18%</td>
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<td>15.7%</td>
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<td>17.0%</td>
<td>16.1%</td>
<td>23.5%</td>
<td>16.4%</td>
<td>18.4%</td>
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<td>15.5%</td>
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<td>49 bp</td>
<td>197 bp</td>
<td>22 bp</td>
<td>46 bp</td>
<td>419 bp</td>
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<td>(90 bp)</td>
<td>56 bp</td>
<td>101 bp</td>
<td>(100 bp)</td>
<td>(164 bp)</td>
<td>(81 bp)</td>
<td>(75 bp)</td>
<td>(4,237 bp)</td>
<td>(1,232 bp)</td>
<td>(404 bp)</td>
<td>(9 hp)</td>
<td>(967 bp)</td>
<td>739 bp</td>
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<tr>
<td><strong>Adjusted EPS</strong></td>
<td>$0.17</td>
<td>$0.25</td>
<td>$0.39</td>
<td>$0.55</td>
<td>$0.65</td>
<td>$0.13</td>
<td>$0.16</td>
<td>$0.31</td>
<td>$0.21</td>
<td>$0.81</td>
<td>$0.17</td>
<td>$0.18</td>
<td>$0.32</td>
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<td>$0.87</td>
<td>($0.22)</td>
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<td>59%</td>
<td>41%</td>
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<td>27%</td>
<td>14%</td>
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<table>
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<th>Key Metrics</th>
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<th>2018</th>
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<th>Q2</th>
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<th>Q4E</th>
<th>2021E</th>
<th>2022E</th>
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<tbody>
<tr>
<td><strong>Comparable Sales</strong></td>
<td>-4.9%</td>
<td>7.6%</td>
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<td>6.5%</td>
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<td>12.9%</td>
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<td>9.8%</td>
<td>7.9%</td>
<td>8.4%</td>
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<tr>
<td><strong>2-year Comps</strong></td>
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<td>-4.9%</td>
<td>-3.9%</td>
<td>-11.8%</td>
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Source: Company reports and Baird estimates; Research disclosures can be accessed at http://www.rwbaird.com/research-insights/research/coverage/research-disclosure.aspx

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