

Lovisa Holdings Limited (LOV.ASX)

Throughout the panic of March, the trust was able to build a decent position in a quality, high margin retailer at what I believed was a very attractive price considering its long-term growth prospects, cash generative nature and strong brand position. 5.5% of the trusts capital at the time was used to buy shares in Lovisa at an average cost of \$4.08. However, it turns out you could've bought almost any ASX or NZX listed retailer and made decent money through April and May as the sentiment surrounding the sector as a whole was just that negative. Aside from that remark, this report will try to lay out the thesis around the investment with as little hindsight as possible.

Disclaimer: None of this should be taken as personal or general financial advice and has been prepared for informational purposes only.

TLDR (Too Long Didn't Read) Summary:

- Lovisa's high ROIC is a result of a combination of its niche product, high inventory turnover and efficient use of store space – Lovisa achieved a ROIC of ~24% in FY19.
- Highly cash generative business
- Very high margin brick and mortar retailer, gross margins >75%.
- Very little direct competition
- Highly experienced and rational management team
- Large US market opportunity
- Potential to double free cash flows within 5 years
- Throughout the March panic, Lovisa was priced for a high probability of failure (which I thought was unlikely).
- Cost base of \$4.08 offered a significant margin of safety and attractive risk-reward ratio for investment.

Economics of a great retailer

With that said, I might just begin some general analysis of brick & mortar retailers. As a business owner will prefer a business that can produce higher profits in relation to the businesses assets and invested capital, I will use the basic return on asset (ROA) formula for illustrative purposes:

ROA = Net profit margin × Asset Turnover

$$ROA = \frac{NPAT}{Sales} \times \frac{Sales}{Assets}$$

Lets start with the first part of the equation, the *profit margin*. This is the most well understood part of the equation and is a general measure of how many cents in each dollar of sales you are converting to the bottom line on the income statement. For most retailers, this is affected by the following major costs:

- Cost of Goods Sold (COGS)
- Store lease and occupancy costs
- Employee costs
- Distribution costs

Depending on the type of product sold, whether cheap fashion jewellery (in Lovisa's case) or female clothing "basics", COGS will differ widely from 20% to 45% of the sale price. For traditional brick & mortar retailers, store lease costs are a large part of ongoing operational expenditure and thus makes a large impact on the bottom line. Understandably, the retailer that can buy or produce its

product the cheapest, employ the least amount of people, and have a larger online sales channel, can maximise its profit margin, and thus, its ROA or ROIC.

The second part of the equation, *asset turnover*, is what truly separates the great retailers from the good retailers. In its basic form, the asset turnover ratio shows how many dollars of sales are produced per dollar of assets in the business. As most brick and mortar retailers assets will usually comprise of right of use assets relating to stores leased by the business, maximising its asset turnover comes down to maximising the volume of product sold through its stores.

A business that can produce or source its product quickly, have it on the shelf quickly, and sell it quickly will have much higher returns on assets and invested capital than an equivalent business with lower inventory or asset turnover.

Comparison of ASX/NZX retailers

To illustrate the differences in profitability and returns on invested capital of different brick and mortar retailers, I've compiled a table comparing key performance information of a range of ASX and NZX listed retailers such as Lovisa (LOV.ASX), Michael Hill (MHJ.ASZ), City Chic (CCX.ASX), Premier Investments (PMV.ASX) and Hallenstein Glassons Holdings (HLG.NZX). The data used was the financial year of 2019, so as to give a fair comparison untainted by COVID-19.

Figure 1

Selected comparable Aus and NZ listed retailers - FY19	Lovisa	Michael Hill (NZD)	City Chic	Premier Investments	HLG Holdings (NZD)
Avg. sales per store (\$000s)	758	1,843	703	906	2,173
Avg. lease costs per store (\$000s)	98	196	99	184	266
Occupancy/store sales %	12.9%	<i>Insufficient</i>	14.1%	20.2%	12.2%
Occupancy/total sales % - inc. online and other channels	12.9%	10.6%	7.1%	17.9%	10.4%
Online % of total sales	0.0%	<i>Insufficient</i>	44.0%	13.4%	15.0%
Asset turnover - inc. ROU assets	1.1x	1.1x	1.3x	0.6x	1.6x
Inventory turnover	2.6x	1.2x	3.6x	2.9x	5.1x
Gross profit margin	80.5%	62.0%	57.8%	61.9%	60.0%
CODB	55.5%	54.6%	42.6%	46.9%	44.2%
EBITDA margin ex. unusual non-cash items	25.0%	7.4%	15.2%	15.0%	15.8%
NPAT margin	14.8%	2.9%	9.6%	8.4%	9.7%
ROA - inc. ROU assets	16.0%	3.1%	12.4%	5.0%	15.3%
ROIC - inc. ROU assets	23.7%	5.3%	27.9%	5.6%	23.2%

All ROA and ROIC calculations in *Figure 1* are based on asset bases and capital invested which includes a crudely estimated right of use asset value based on the AASB 116 Leases disclosure provided in each businesses recent financial statements, so I wouldn't take them as gospel.

When compared to the select group of retailers in *Figure 1*, Lovisa's business holds up quite strongly, boasting gross margins in excess of 80%, EBITDA margins of 25%, and ROIC comfortably exceeding 20%. City Chic, with its large online sales channel and capital light "omni-channel" model seems to also be a standout with a ROIC of 27.9% and EBITDA margin of 15.2%.

However, comparing Lovisa to Michael Hill, you can see the difference in returns of fashion jewellery vs. mid-range jewellery. Lovisa's model is essentially "affordable fashion jewellery" in price ranges of \$10-50 with high inventory turnover and store's jam-packed with products, whereas Michael Hill is selling lower turnover mainly \$150-600 value jewellery with fairly inefficient use of store space. On stores much smaller than Michael Hills, Lovisa makes around \$190k in EBITDA per store vs. Michael

Hill's ~\$140k. It's easy to see why Lovisa is getting much more bang for buck on its store leases than Michael Hill, and many other brick and mortar retailers in fact. However, bear in mind these direct comparisons are only using one year of financial data.

Lovisa Overview & Brief History

Lovisa Holdings is a global fast fashion retailer operating from over 439 stores across 15 countries. Its target customers are mainly young women ranging from late teens into their early 30's. Lovisa is strategically focused on the affordable jewellery segment with over 2,500 jewellery lines per store priced from A\$6.99 to A\$49.99. It was founded in 2010 by its CEO and Managing Director, Shane Fallscheer, and BB Retail Capital, the investment company established by successful retail entrepreneur Brett Blundy.

Lovisa became one of the core businesses in the BB Retail Capital portfolio after it was recognised that Lovisa was achieving higher returns on investment than Diva – another fashion jewellery and hair accessories retailer owned by BB Retail Capital which Shane Fallscheer was CEO of from 2004 until 2008. After a trial conversion of 21 Diva stores to Lovisa, higher returns on investment were confirmed through the Lovisa brand and by June 2014, a total of 114 Diva stores had been converted to the Lovisa portfolio.

By its IPO in December 2014, Lovisa had achieved significant scale in its core Australian market, with a mature network of 157 company owned stores. Since then, Lovisa has entered a new geography each year, growing ex. Aus/NZ revenues from 13.4% of total revenues, to just under 50% in the trailing 12 months to December 31, 2019 (T12M) whilst maintaining its position as the leading affordable jewellery retailer in its home markets.

Figure 2 – Revenue by Geography

Geographical Segment Information

Revenue from stores owned - (\$ millions)	2014	2015	2016	2017	2018	2019	T12M
Aus/NZ	91.5	102.2	108.4	122.6	132.0	137.7	142.5
% of total	86.6%	76.5%	71.0%	69.0%	61.3%	55.4%	51.3%
% growth pcp		+11.7%	+6.1%	+13.1%	+7.7%	+4.3%	+3.5%
Asia	9.8	20.8	25.5	28.3	34.6	34.4	33.7
% of total	9.3%	15.5%	16.7%	15.9%	16.0%	13.8%	12.1%
% growth pcp		+111.7%	+22.7%	+11.1%	+22.0%	-0.5%	-1.9%
Africa	4.4	10.7	18.2	21.9	30.5	33.4	36.2
% of total	4.1%	8.0%	11.9%	12.3%	14.2%	13.4%	13.0%
% growth pcp		+145.0%	+70.6%	+20.4%	+39.3%	+9.6%	+8.4%
Europe	-	-	0.5	4.8	17.9	36.7	48.1
% of total			0.3%	2.7%	8.3%	14.8%	17.3%
% growth pcp				+811.3%	+270.3%	+105.1%	+31.1%
North America	-	-	-	-	0.5	6.3	17.2
% of total					0.2%	2.6%	6.2%
% growth pcp						+1146.8%	+171.1%
Total revenue from stores owned	105.67	133.65	152.61	177.62	215.46	248.51	277.80
% growth pcp		+26.5%	+14.2%	+16.4%	+21.3%	+15.3%	+11.8%

Competitive Landscape

Lovisa has benefited from very little direct competition which is why it has operated with such high margins and returns on invested capital. In Australia, Lovisa's major competitors in the fashion jewellery space are Collette, Myers, Ozbling and Adorne. However, Collette and Myers sell more than just fashion jewellery and will sell handbags, accessories, clothes, etc.

Lovisa on the other hand is solely focused on selling fashion jewellery, an unwavering strategy that has allowed it to build a reputation for being the “one-stop shop” for fashion jewellery. Need a new pair of earrings for the party this weekend? Easy, just pop on in to Lovisa.

Similarly, in the US, there are few direct competitors. Most fashion jewellery is either sold online (Etsy) or sold in department stores such as Nordstrom and Neiman Marcus alongside other products in an experience similar to Myers.

Therefore, it may be possible at some point that some well-financed private equity backed competitor could come along and try to replicate Lovisa’s model, eating away at Lovisa’s margins. However, that would be a very difficult task and would require a very large amount of capital.

Interestingly, Collete, which has 140 stores in Australia, entered into voluntary administration in February 2020 before the COVID-19 crisis was in full swing due to “poor trading conditions” and a debt-refinancing deal gone wrong. There is probably not much to infer from this regarding any changes in Lovisa’s competitive position as Collete will likely trade on with new owners, however it does show how powerful Lovisa’s niche product focus is for its bottom line. Ironically, Collete was founded by Collete Haymen who also founded and managed Diva before selling it to Brett Blundy in 2007.

Economic Moat

It is well-known that retail businesses have some of the thinnest “economic moats” or competitive advantages out of all the different types of businesses. Customers can be fickle and fad products can be discarded quite quickly when it is no longer popular.

In my opinion, I do believe Lovisa has some form of economic moat, however it is at best thin and shallow. This moat is comprised of three key advantages; brand, bargaining power with suppliers, and its large store footprint.

The **brand**, as discussed before, is possibly its most important asset. In Australia, its brand has been highly successful with Lovisa being a household name amongst young urban women. Lovisa maintains this brand and relationship with its customer largely through social media engagements. To ensure that Lovisa maintains their brand position and the satisfaction of its customers, they boast a product team of 20 strong that is led by Andrea Hayes, who has been with Lovisa since it was founded over 10 years ago, that is continually designing new products and reacting to changes in customer preferences.

In combination with its large store footprint, Lovisa can remain at the top of the customer’s mind when it comes to affordable fashion jewellery. This is because customers can be confident that if they need to get a new pair of earrings for Splendour for example, you could be nearly anywhere in Sydney and be close to a store. Same with Brisbane, Melbourne, etc. The customer doesn’t have to waste time at a shopping centre searching for a comparable product when they know that there is a high probability that there is a Lovisa store there.

Lovisa’s **scale** also provides it with other benefits that provide a barrier to new entrants. The most obvious example is that its large store footprint is very hard to replicate and requires a large capital investment. Although this is a barrier for brand new entrants and not so much for existing retail businesses with a large store footprint that could position their brand and product offering to compete with Lovisa.

Lovisa's scale may also provide it with **negotiating leverage with suppliers** and is possibly responsible for achieving gross margins over 75% for many years now. However, this benefit could also be materially reduced if a large competitor negotiated with the same suppliers for the same products at lower prices as there does seem to be decent wiggle room between gross margins of 80% and the customary 60% that most retailers have.

Competence of Management/Capital Allocation

Warren Buffet has harped on at length in his annual reports to Berkshire Hathaway shareholders about the importance of finding "managers who think like owners". With Lovisa, I think we are blessed with just that. Shane Fallscheer has been at the helm of this business since he founded it in 2010 after pitching the idea to Brett Blundy, whom he has had a long and successful working relationship with since starting as music store manager for Brett Blundy's Sanity business in 1991. Fallscheer's idea of Lovisa reportedly came from a concern about the typical customer of Diva, which was young girls relying on their parents income. Blundy backed his idea and made Fallscheer a 15% partner in the new business. And the rest is history.

With regards to this partnership, Fallscheer was once quoted saying "there was enough money on the table to keep you awake at night if things didn't go well. Brett's a believer that if there's skin in the game then the behaviours are very different to someone who's a salaried employee."

BB Retail Capital, Brett Blundy's investment company, still owns over 40% of Lovisa's issued capital and it is one of the crowned jewels in his portfolio. Brett Blundy is an incredibly experienced retail operator and has a wealth of knowledge and capabilities that very few do. Brett Blundy, along with his large interest in the business, has stayed on as Chairman of the Board at Lovisa which is exactly where we want him to be!

Consequently, what's good for Shane Fallscheer and Brett Blundy will ultimately be good for us as long-term shareholders.

It's all well and good to have management aligned with the shareholders, but can they rationally allocate and invest capital? One exercise that speaks volumes for the management of a business is to go back and see what they promised several years ago and see how that compares with what has been achieved since.

In Lovisa's prospectus issued prior to listing in 2014, Lovisa's growth strategy was outlined quite clearly. Its strategy centred around mainly mid-term (1-3 years) and longer term (3-5 years) objectives.

Medium Term (1-3 years)	<ul style="list-style-type: none"> • Target 20 – 30 new stores per year • Remain opportunistic in markets with expected capacity of 15-30 stores • Build out current territories • Expand into new territories eg. Hong Kong • Continue to grow franchise territories
Longer Term (3-5 years +)	<ul style="list-style-type: none"> • Enter a major market in Northern Hemisphere; e.g. USA, UK or Europe • Upon achieving an initial footprint and achieving pre-determined KPIs then undertake a rapid store roll-out

Source: Lovisa Prospectus 2014

The continued international store roll-out was identified as the key driver of future growth. This is, in my opinion, a very important direct quote from Lovisa's prospectus: "It's (Lovisa's) success to date has been underpinned by its ability to remain nimble and opportunistic in expanding and moving to

new markets. The intention is to continue this as a listed company, such that if opportunities arise, it may accelerate its plans to enter a new market or continue to grow an existing market. Likewise it will **defer its entry** into a new market if it considers that appropriate opportunities aren't presented at the relevant time" (emphasis added).

Lovisa targeted 20-30 new stores per annum in the 1 to 3 years following 2014 with an initial focus on the Asian and South African markets. What happened over the following period? Lovisa opened up an average of 26 new stores per year to 2017, including the closure of 20 Australian stores in 2015. Big green tick there.

What happened with Lovisa's longer term objectives of entering a major market in the Northern Hemisphere? Well, its safe to say Lovisa has well and truly achieved that with further growth yet to come! The UK market was entered first, where 3 stores in 2016 turned to 42 stores at the end of December 2019. New stores were also opened in France and Spain, however there is yet to be any major success there. Last but definitely not least, Lovisa entered the US market in 2018, ending FY2018 with a mere single store. At the end of Dec 2019, that number now stands at 40. Another big green tick there.

However, when analysing store roll-out businesses, one must be cognisant that aggressive growth doesn't come at the cost of a poor bottom line and business KPIs. Too often, management teams will promise and deliver huge growth numbers to the top line to get investors excited and pump up the stock price. This can sometimes lead to poor long-run outcomes for shareholders and even fraudulent management behaviour. Just look what happened with the recent Wells Fargo account fraud scandal... *(On a side note, I highly recommend watching Senator Elizabeth Warren's brutal 2016 interrogation of former Wells Fargo CEO John Stumpf on YouTube).*

Going back to Lovisa's aggressive store roll-out strategy, I believe management have been measured in their approach and are not trying to achieve a short term "guidance beat". The bottom line speaks for itself, whereby investments relating to new stores have been funded purely from cash flows from existing and **profitable** stores, without the need for new equity capital.

Here is an excerpt from Ophir Asset Management's "Offshore Growers Report" regarding expanding business offshore:

*Lovisa's Fallscheer says that the key is to "move in slowly and allow yourself to learn from your mistakes". He says the biggest mistake going global is "letting ego get in the way". "It's not about flagship stores," he says. "You can't take the eye off the end goal – **profitability**."* (emphasis added)

Additionally, management has been very transparent to shareholders whereby they have detailed in great length Lovisa's business economics, key facts about their supply chain and products, and risks to the business in every annual report since the prospectus.

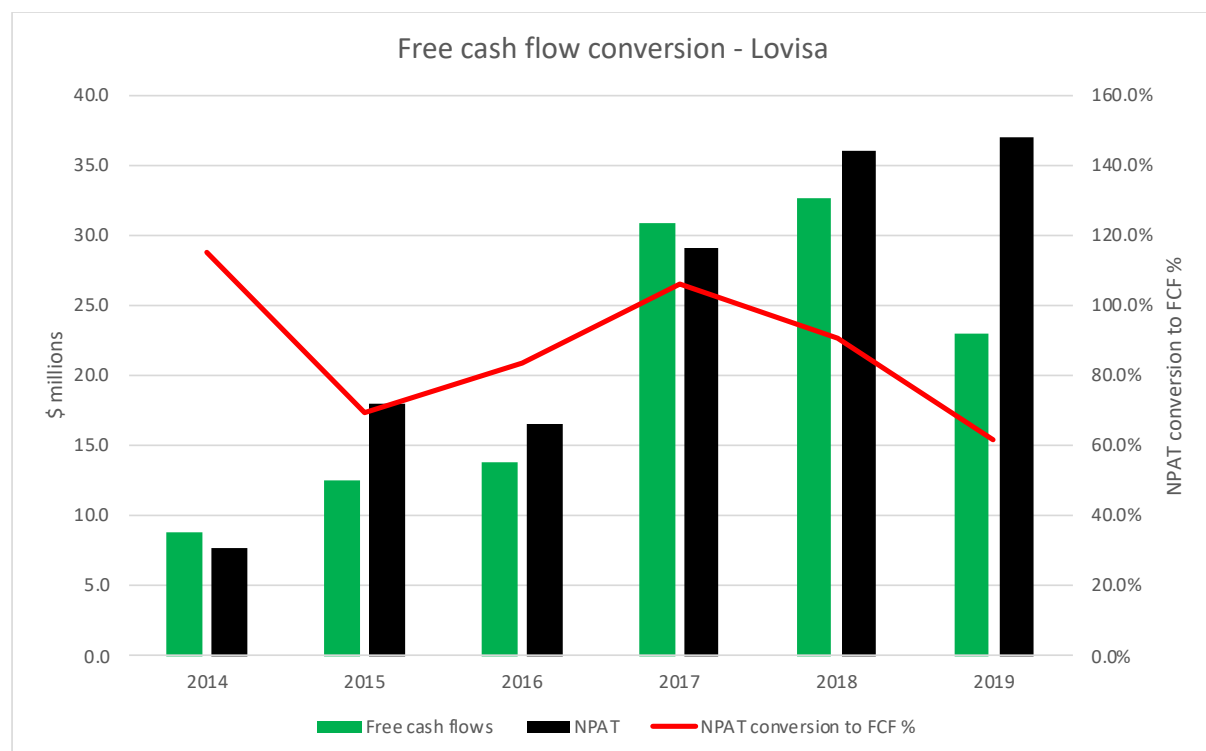
Considering all of the above, I am quite confident that Lovisa is in capable hands.

Cash flows and owner earnings

Lovisa is a highly cash generative business, posting very high returns on invested capital despite general headwinds to the brick and mortar retail industry. As mentioned earlier, Lovisa's store roll-outs have been funded by the profits of its existing store network and not from the issuing of new debt or equity. Even in Lovisa's 2014 IPO there was no new equity issued.

Lovisa's cash metrics	2014	2015	2016	2017	2018	2019
CFOBIT / EBITDA	108.7%	83.3%	107.1%	108.9%	104.1%	107.1%
FCF / NPAT	115.3%	69.3%	83.5%	106.1%	90.9%	61.9%
CapEx / Depreciation expense	109.7%	113.4%	157.6%	158.9%	214.4%	245.3%

The cash flow conversion check is passed with flying colours with CFOBIT (cash flows from operations before interest and tax payments) averaging over 103% of EBITDA from years 2014 through to 2019.



Due to management re-investing large amounts of retained earnings in further store roll-outs over the last six years since IPO, free cash flows have lagged that of Lovisa's NPAT. Despite this, Lovisa's free cash flows including all capital expenditures averaged around 87% of NPAT. As Lovisa is still in its growth phase, I expect it's capital expenditures to continue to materially exceed its depreciation expenses, however, as the business matures and store growth slows, this trend will likely reverse and cash will build far more quickly than what the income statement might suggest.

Liquidity & Balance Strength

In mid to late March when the trust bought Lovisa there were legitimate concerns surrounding brick and mortar retailers and their ability to survive the COVID-19 crisis and an a potentially extended period with no revenues. Due to social distancing measures and fears of catching or spreading the virus, store foot traffic materially declined leading many retailers, including Lovisa, to close their stores. Additionally, Lovisa's China-based supply chain had been experiencing delays due to the

COVID-19 outbreak in China and widespread lockdowns which added to concerns for Lovisa's ability to generate revenues because of their 8-10 week stocking cycle.

As at the 31st of December 2019, Lovisa had \$27.8m in cash and equivalents on its balance sheet. However, it also had \$15.2m in revolving cash advance and trade finance facilities maturing within the year as well as lease liabilities of \$36.2m to pay over the following year. In addition, Lovisa had a 15c interim dividend distribution per share, amounting to \$15.9m, payable by the end of April. With a looming period of no revenues for potentially 6-12 months, Lovisa's liquidity position was looking somewhat precarious.

However, my concerns for this balance sheet risk were eased materially upon Lovisa's business update on 26/03/2020 that, in an effort to reduce costs and improve the business's liquidity position they had announced the following key changes:

- The standing down of store teams in markets with store closures, temporary redundancies, etc– materially decreasing cash outflows relating to employee salaries.
- Deferral of the \$15.9m dividend payment, improving the near-term cash requirements.
- Maturity of the \$15.2m financing facility had been extended for a further 3 years and the limit had been increased, materially improving the liquidity position.

Additionally, if all else failed, I was reasonably confident that BB Retail Capital would provide the business with a working capital injection to get it through "to the other side" given Lovisa is arguably the crown jewel of its portfolio.

Looking Ahead

Once I was comfortable with Lovisa's ability to survive the COVID-19 crisis, I looked to the longer term in order to conservatively estimate future cash flows. With the US market still relatively untapped with regards to a focused, low cost, fashion jewellery retailer, I believed that Lovisa still had a very significant store roll-out opportunity ahead of it.

In the mature Australian market, Lovisa had 155 stores at the end of Dec 2019, which is 6.2 stores per million in population. As the US has a relatively similar competitive landscape to Australia with a lack of direct competition to Lovisa, it would not be too unreasonable for Lovisa to achieve the same level of market penetration in the US. Even if you apply 2 stores per million to the US population of approximately 320 million, you get to 640 potential Lovisa stores, which at approximately \$190k EBITDA per store, could be worth a whopping \$122 million in EBITDA from the US market alone. This is nearly double that of Lovisa's 2019 EBITDA.

However, as you'll see in the next section, I didn't need anywhere near 600 new stores to justify my valuation.

Valuation

To value Lovisa, I decided to primarily use a 5-year DCF model with a terminal value calculation at FY2025. Yes I know what you're thinking, "a minor change in WACC or terminal growth rate can widely change the valuation, blah blah blah..."

However, I believe that if you use conservative enough assumptions, discounted cash flow analysis can be a very valuable tool for valuation and for seeing how the economic value of the business changes in response to changes in certain key variables.

As the key driver of Lovisa's future cash flows is new stores, conservative assumptions needed to be made regarding change in stores over the next 5 years. Instead of the potential 600 additional US

stores, I assumed that new stores increased by only 85 until maturity of the business, waaaaay below the potential market opportunity.

To be able to reliably estimate the future cash flows available from those new stores, I had to go back over Lovisa's operating history and analyse its operating costs and per store metrics. Below is a table showing each major operating cost as a percentage of sales:

Lovisa's Cost of Doing Business

Operating costs as % of sales	2014	2015	2016	2017	2018	2019
COGS	23.9%	22.9%	26.0%	21.2%	20.0%	19.5%
Salaries and employee benefits expense	29.2%	26.2%	26.1%	25.3%	25.6%	26.5%
Property expenses	19.6%	17.3%	16.9%	16.0%	16.0%	17.0%
Distribution costs	0.0%	0.0%	2.8%	2.5%	3.3%	3.5%
Other expenses	11.8%	10.6%	8.4%	8.6%	8.1%	8.4%
CODB	60.6%	54.0%	54.2%	52.5%	53.0%	55.5%
Operating expenses / sales %	84.5%	77.0%	80.2%	73.7%	73.0%	75.0%

Lovisa's major costs of doing business such as employee remuneration and property expenses seem to be relatively constant at 26% of sales and 17% of sales respectively. Distribution costs relating to air-freighting stock to stores from its warehouses in China and Melbourne come in at around 3.5% of sales.

Lovisa per store metrics (\$000s)	2014	2015	2016	2017	2018	2019
Revenue/store						
Aus/NZ	508.4	638.8	669.1	752.0	772.0	782.3
Asia	577.4	692.7	772.7	708.0	803.7	799.8
Africa	-	-	505.1	437.9	544.6	547.8
Europe	-	-	353.3	644.0	831.8	852.8
North America	-	-	-	-	-	634.6
Average revenue/store	551.8	615.9	663.5	711.9	760.0	757.7
Salaries and employee benefits expense - <i>DIRECT</i>	161.0	161.8	173.8	181.5	195.8	202.3
Property expenses - <i>Indirect but fixed</i>	108.4	107.2	112.5	115.0	122.4	129.8
Distribution costs - <i>DIRECT</i>	-	-	18.9	17.9	25.4	26.8
Other expenses - <i>DIRECT</i>	65.3	65.3	56.3	61.6	61.8	64.4

Salaries and employee benefits expenses per store were assumed to be approximately \$138k for the calendar year 2020, which is a reduction of only 31% on 2019 figures. In reality I knew that they would reduce employee expenses a lot more than this but I wanted to be on the conservative side to see what Lovisa could withstand.

As nearly 90% of the DCF valuation came from the terminal valuation at 2025, those assumptions were the most important and will have the largest impact on the valuation. The 2025 key assumptions were as follows:

Revenue per store	\$ 755k
Gross margin %	79.0%
Lease & property expenses	\$ 125k per store
Salaries & employee expenses	26.5% of revenue / \$ 200k per store
Distribution expenses	3.5% of revenue / \$ 26.4k per store
Other expenses	8.5% of revenue
Capital expenditures per new store	\$ 450k

(Note that the CapEx assumptions are much higher than in reality and should be more in the vicinity of \$150-200k but that's what I used in the model).

Discounting the future cash flows back to the present date (assumed 31/12/19) by a cost of capital of 9% (an arbitrary number I pulled out of thin air that is well above the current near-zero risk-free rate), I had a conservative valuation of \$ 5.21 per Lovisa share.

NPV	579.9
Less: Borrowings	(15.2)
Add: Cash	27.8
Equity Value	592.4
Diluted shares outstanding	113.6
Value/share	\$ 5.21

Discount rate	9.0%
Terminal growth rate	0.5%

The 2AM Investment Trust's cost base of \$4.08 per Lovisa share offered an additional 22% margin of safety on an already very conservative valuation of \$5.21.

For those of you who like multiples, the cost base of \$4.08/share represented a trailing 12 month PE ratio of approximately **12.1x**. For a company with a high quality owner-oriented management team, competitive position in a niche market, very high ROICs and the potential to conservatively double its free cash flows within 5 years, I believed the March COVID-19 panic caused Lovisa to trade at an extremely compelling valuation offering a very attractive risk-reward ratio for investment.

Closing remarks

Upon building the 5.5% Lovisa position in the trust, I wrote down the following "thesis-breakers" that would cause me to reassess the valuation and most likely sell:

- US market opportunity turns out to be far less attractive than I had estimated due to any combination of factors relating to the US economy, rise of US-based direct competition, etc.
- Global shut-down due to COVID-19 for longer than 12 months causing insolvency risk for Lovisa to be materially higher than expected.
- Any whiff of a potential modern-slavery scandal relating to Lovisa's suppliers based in China, India and Thailand.

Now switching back to the hindsight provided by my writing of this at the end of May in 2020, it seems that thesis-breaker two is looking less and less likely as governments around the world have implemented measures to reduce the spreading of the coronavirus quickly and allow the reopening of many businesses. Out of all the developed nations, the US seems to be suffering from the highest number of cases, however they are defiantly opening up their economy. If the US does suffer a prolonged economic downturn, I believe that Lovisa will still be able to perform strongly given its geographic diversification and it may even provide an opportunity to expand its US stores with even less competition.

Markets currently seem to be quite optimistic about Lovisa's future, a severe contrast to March's sentiment, and as I write Lovisa is trading at \$8.60 per share, up 111% on the trusts cost base. This represents a diluted market cap of \$977 million and a trailing 12 month PE ratio of **26 times**.

Considering the potential risks to Lovisa's business, I can't comprehend how anyone could justify paying current prices. I guess the TINA rhetoric has gotten pretty strong...

In any case, the trust will not sell its position unless any material changes to the business occur, and we aim to reap significant returns in line with Lovisa's business performance for years to come.

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Appendix

Lovisa Key Metrics at Average Cost

Market Prices	
Average price of position in LOV.ASX shares	\$ 4.08
12 mth range	\$2.34 - \$14.13
Company Data & Ratios	
Issued capital (no. common shares)	113.6m
Market cap	\$ 463.6m
Net debt	\$ 142.7m
Enterprise value (inc. impacts from IFRS16)	\$ 606.3m
PE (T12M)	12.1x
EV/EBIT (T12M)	10.7x
Price to FCF (T12M)	30.9x
PE (FY20) - estimated	549.6x
FCF yield (T12M)	3.2%
Dividend yield	8.1%
5 yr NPAT CAGR to FY19	19.8%
FY19 ROE	79.9%
FY19 ROA	16.1%
FY19 ROIC	23.7%
<i>*All figures are in AUD millions</i>	

Lovisa Base Case DCF Assumptions

Lovisa DCF Base Case Assumptions	2018A	2019A	H1FY20A	H2FY20F	2021F	2022F	2023F	2024F	2025F
New stores	37	52	42	5	(10)	-	60	30	-
Revenue/store (\$000s)	760	758	431	100	350	600	750	750	755
Gross margins	80.0%	80.5%	78.9%	75.0%	77.0%	78.0%	78.0%	79.0%	79.0%
Lease & property expenses/store (\$000s)	122	130	49	65	125	125	125	125	125
Salaries & employee benefits % of sales	25.6%	26.5%	24.1%	50.0%	32.5%	30.0%	26.5%	26.5%	26.5%
Distribution expenses % of sales	3.3%	3.5%	2.9%	4.0%	4.0%	3.8%	3.5%	3.5%	3.5%
Other expenses % of sales	8.1%	8.4%	7.3%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%
Tax rate (% of PBT)	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%	30.0%
Capital expenditure/new store (\$000s)	416	463	471	450	450	450	450	450	450