# Kontoor Brands Inc. (KTB)

*Updated June 21st, 2019 by Nick McCullum*

## Key Metrics

| | | | | | |
|---|---|---|---|---|---|
| **Current Price:** | $28 | **5 Year CAGR Estimate:** | 10.8% | **Volatility Percentile:** | 0.1% |
| **Fair Value Price:** | $23 | **5 Year Growth Estimate:** | 7.0% | **Momentum Percentile:** | 40.2% |
| **% Fair Value:** | 122% | **5 Year Valuation Multiple Estimate:** | -4.3% | **Growth Percentile:** | 66.6% |
| **Dividend Yield:** | 8.1% | **5 Year Price Target** | $32 | **Valuation Percentile:** | 27.0% |
| **Dividend Risk Score:** | NA | **Retirement Suitability Score:** | NA | **Total Return Percentile:** | 15.9% |

## Overview & Current Events

Kontoor Brands markets itself as a "global lifestyle apparel company". The company, which was spun off from V.F. Corporation (VFC) on May 22nd, 2019, owns some of the world's most iconic denim brands, including *Wrangler, Lee,* and *Rock & Republic.* Last year, the company generated $2.7 billion in revenue, with 27% of its revenue generated outside of the United States. Kontoor Brands currently employs approximately 17,000 people and trades with a market capitalization of $1.5 billion.

In late June, Kontoor Brands reported (6/20/19) financial results for the first quarter of fiscal 2019. Revenue declined by 3% in the quarter while both cost of goods sold (COGS) and selling, general, and administrative expenses (SG&A) increased meaningfully, causing Kontoor Brands' operating income to decline 73% year-on-year. Pretax earnings and net income declined by 70% and 81%, respectively, while diluted earnings-per-share also decreased by 81%.

Kontoor Brands also reaffirmed its 2019 financial guidance with the publication of its first quarter earnings release. The company expects 2019 revenue to exceed $2.5 billion, which reflects a mid-single digit decline compared to 2018's comparable figure. The revenue decline is attributable to foreign exchange fluctuations (1% to 2%), prior year customer bankruptcies, and strategic business exists. Further down the income statement, adjusted EBITDA is expected to range between $340 million and $360 million, which reflects a mid-single digit to low double-digit decline year-on-year.

Kontoor Brands' guidance also included some information on reasonable expectations for financial performance over the medium term. More specifically, the company expects revenue to increase at a low single-digit compound annual growth rate over the next three years, while adjusted EBITDA is expected to grow at a mid-single-digit CAGR during the same time period. Capital expenditures are expected to range between $105 million and $110 million in aggregate over the period.

## Growth on a Per-Share Basis

| Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2024 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EPS** | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | ***$1.50*** | ***$2.10*** |
| **DPS** | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | ***$2.24*** | ***$2.24*** |
| **Shares** | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | ***56.6*** | ***56.6*** |

Kontoor Brands reported diluted earnings-per-share of $0.27 in the first quarter of fiscal 2019, which represented an 81% decline year-on-year. We do not believe that ~80% earnings declines are going to reoccur for this company throughout the remainder of the fiscal year. Instead, we believe the rest of the year is likely to be better for Kontoor Brands and are estimating $1.50 in earnings for the full fiscal year. In the near-term, the company is likely to experience some meaningful earnings growth as it sheds the one-time costs associated with its restructuring and begins operating as a steady-state publicly-traded company. Beyond that, Kontoor Brands is likely to grow *very* slowly because (1) its brands and products are inherently slow-growth and (2) it distributes more than all of its earnings as dividend payments to shareholders. We are estimating 7% earnings growth over the next five years, which includes a meaningful post-spinoff consolidation. Earnings growth beyond that point is likely to be materially lower.

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## Valuation Analysis

| Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | Now | 2024 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Avg. P/E** | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | ***18.5*** | ***15.0*** |
| **Avg. Yld.** | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | ***8.1%*** | ***7.1%*** |

Performing a valuation analysis on Kontoor Brands is slightly more difficult than your typical marketable security because it does not have any history as a company for us to rely on. With that said, one useful tool is to look at the historical valuation of its prior parent company, V.F. Corporation. VFC has traded at an average price-to-earnings ratio of 17.6 over the last decade. Given that Kontoor Brands was created to separate V.F. Corporation's slow-growing legacy brands from its faster-growing core businesses, we believe a slightly lower valuation multiple is warranted for the spinoff security. More specifically, our fair value estimate for Kontoor Brands is a price-to-earnings ratio of 15. Using our 2019 earnings estimate of $1.50 (which is admittedly conservative), the company is trading at a price-to-earnings ratio of 18.5 today. If Kontoor Brands' price-to-earnings ratio contracts to our fair value estimate of 15 over the next five years, this will reduce the company's total returns by 4.1% per year during this time period.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

| Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2024 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Payout** | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | ***149%*** | ***107%*** |

Kontoor Brands' competitive advantage lies in its ownership of some of the world's most popular denim brands. Indeed, *Lee's* and *Wrangler* in particular control a large amount of market share in the denim category.

From a dividend perspective, the company has reaffirmed its goal of paying a $2.24 annual dividend, which equates to quarterly dividend payments of $0.56. We do not expect the company to begin growing its dividend until its operations reach the point where earnings cover the dividend with a margin of safety.

With Kontoor Brands, the company's dividend safety is an extraordinarily important component of its investment thesis because the company's total returns will be heavily reliant on the continued distribution of its dividend payment. While Kontoor Brands' earnings did not cover its dividend in its first quarter as a public company, looking at its statement of cash flows can provide additional insight. Kontoor Brands generated $206.5 million of cash flow from operation activities in the first quarter of fiscal 2019 and spent $5.3 million on capital expenditures for free cash flow of $201.2 million. While the company did not pay a quarterly dividend in the first quarter because it was still owned by V.F. Corporation, its 56.6 million of shares outstanding combined with its $0.56 quarterly dividend payment implies total dividends of $31.7 million – or a free cash flow dividend payout ratio of just 16%. While we still recommend investors monitor the safety of the company's dividend closely moving forward, Q1's statement of cash flows suggests that the company's distribution is sustainable for the time being.

## Final Thoughts & Recommendation

Kontoor Brands is an interesting investment opportunity that has a very asymmetric risk/reward profile. We believe that the company's earnings are likely to rebound meaningfully in the years following the spinoff. Moreover, the company's juicy 8% dividend yield appears to be covered by the firm's free cash flow. Kontoor Brands seems capable of delivering low double-digit returns, comprised of earnings growth (7%), its dividend yield (8.1%), and some valuation contraction (-4.3%). The company earns a buy recommendation from Sure Dividend at current prices.