TRANSCRIPTION

Company: **Step One Clothing Limited**

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Time: **10:30AM AEDT**

[START OF TRANSCRIPT]

Operator: Ladies and gentlemen, this is the operator. Today's conference is scheduled to begin momentarily. Until that time, your lines again will be placed on a music hold. Thank you for your patience.

Operator: Good morning, my name is Krista and I'll be your conference operator today. At this time, I would like to welcome everyone to the Step One Clothing Half Quarter Financial Results conference call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question-and-answer session. If you would like to ask a question during that time, simply press star followed by the number one on your telephone keypad. If you would like to withdraw your question, again, press star one. Thank you. I would now like to turn the conference over to Greg Taylor, Chief Executive Officer and founder. Greg, you may begin your conference.

Greg Taylor: Thank you, Krista. Good morning, everyone, and thanks for joining today's call. I'm Greg Taylor, CEO and founder of Step One. With me today is our CFO, Nigel Underwood. This morning, we announced our financial results, 1H24. I'm pleased to present our highlights. Turning to page 2, please. I'm now going to cover off the following topics in detail and hand over to Nigel, who will cover off our financial reports. Turning to page 3, please.

The highlights achieved by Step One during the 1H24 reporting period are as follows. Record first half revenue of $45.1 million, up 25.5% on PCP. Gross margin held above 80% at 81.2%, up 0.5% on PCP, demonstrating that Step One remains a strong margin business and have been able to navigate through recent supply chain challenges. Average order value, AOV, is up a further 4.7%, to an all-time high of $94.47. Record first half EBITDA was $10.1 million, equating to a 22.5% of revenue, and up 35.6% on PCP.

During the period, we added 182,000 new customers to our database, taking us to over 1.5 million customers globally, with a growth of 33% PCP. Step One will pay a fully franked $0.04 per share interim dividend. A $0.05 per share fully franked dividend was paid for the full year FY23. Our strong performance and return to growth during the first half of FY24 underscores the success of executing our plan of returning to growth when market conditions permit, as well as a profitable growth strategy. Turning to page 5, please.

I view our operational progress through three lenses, product, marketing, and processes and execution. We replicate strategies across each of our three markets as much as possible, with local customisation where required. Starting first with our product and pricing. We launched our women's SeamFree product during 1H24 and had immediate success. We sold out of the majority of stock we'd purchased. We did restock and sold again during that period. I am pleased, however, to say we now have ample stock to meet demand as we continue to grow the category.

The women's market is circa $1.1 billion, or nearly double that of the men's market in Australia. Step One products and expanding range continue to resonate with new and existing customers, not just providing extreme comfort, but solving for functional problems, which we continue to use to highlight our product benefits over traditional underwear. Amazon showed strong growth during the period. In addition to contributing to revenue growth, Amazon also provides credibility and reach to emerging Step One brand, particularly in the UK and US.

We continue to use our limited-edition colour releases as a way to drive sales across our existing customer base and attract new customers. This includes our recent partnership with Surf Life Saving Australia, which I will speak to later in the presentation. Moving on to marketing.

Step One focuses on a profitable and sustainable range of marketing channels that we adapt and change according to market conditions. Step One's main sale events continue to be successful, especially in attracting the bulk buyer and value segment customer. We improved our upsell offers, which has led to an increase in our cart size during the period. Moving on to indirect channels.

To deepen our reach into the UK market, Step One partnered with the national retail giant and UK institution John Lewis. Launching in January 2024, John Lewis boasts a very large member loyalty database and is a very beloved and reputable brand in the UK market, known for its quality products and strong customer service, which very much aligns with Step One's core values.

Surf Life Saving Australia is Step One's first official brand partnership, also launched in January 2024. Step One produced a bespoke and licenced print that promoted Life Saving Australia's swim between the flags message. {Unclear} collaboration to expose the STP brand to over 330 Surf Life Saving clubs and its members around Australia. $5 from every pair will be donated to Surf Life Saving Australia.

Finally, focusing on our processes and execution. We're incredibly proud to be named the first Australian clothing company with the FSC chain of custody certification, further cementing our commitment to sustainable practices and ethical manufacturing. I'm proud of what our team has managed to achieve in the ESG space. AI tools were implemented into Step One's marketing function during 1H24, which has delivered greater marketing efficiency. Turning to page 6, please.

Our markets. As you can see, we have a different approach to each market, depending on the level of brand awareness. In Australia, we have seen great success in returning to our grassroots marketing messaging, being funny, bold, and irreverent. Our approach of explaining our product USPs both simply and [communicably] has continued to drive results in our Australian market. In addition, our partnerships, including Surf Life Saving Australia, they have had a great impact on our brand and brand equity, and we continue to evaluate additional partnerships.

In the UK, we made similar changes that applied to Australia. We've continued to focus on our core USPs and brand positioning. We are very excited to see the impact of our John Lewis partnership and the additional brand recognition it will bring to Step One. In the US, we prioritise growth and expanding our brand presence, which was a success. While our expansion into this market required an additional expenditure ahead of revenue to acquire new customers, we've also invested into customer retention, which is now coming in line with other markets being close to 50% daily repeat customer rate.

Turning to page 7, please. Partnerships. Brand partnerships and collaboration will be used to expand new customer acquisition and brand awareness.

Turning to page 8. Our women's products. As mentioned, we've seen over a 40% growth on PCP in our women's range, largely driven by the launch of our SeamFree range, launched in August. We now offer women's products for all occasions, which improves our ability to pursue the women's market. Turning to page 9, please.

Our men's products. Whilst many exciting green shoots are being seen all over the women's side, our core market, our men's product, continues to sell both to new and existing customers. Turning to page 10.

The charts here show website visits for each half year period. There were a total of 8.3 million visits in the last six months, up over 18% on PCP. Our conversion rate has also seen an improvement, and it's currently sitting at 5.1%. Turning to page 11, please.

Our value proposition remains strong. Most people wear underwear every day, and being a product of need compared to want, this positions Step One as a product people do not need to justify in a tighter retail market. We continue to push the comfort factor of Step One, and the importance that most people spend up to or over 18 hours per day wearing underwear. Whilst average price has reduced, it was a deliberate decision to provide deeper discounts in exchange for higher conversion rates and higher average order values. Turning to page 12, please.

We reiterate the importance of the direct-to-consumer model. We invest a lot of time building interaction and having rapport with customers and listening to their feedback, whether that be direct or through customer reviews. We aim to respond to most reviews and take on customer feedback, and constantly analyse the data to make the best decisions to maximise our sales. We plan to continue to pursue growth in all markets with an approach that balances both growth and profitability.

I'm excited what the future holds and happy to report strong numbers in a challenging consumer retail spend market. I will now hand over to Nigel Underwood, our CFO, to run through our financial results for the six months ending 31 December 2023.

Nigel Underwood: Thanks, Greg, and good morning, everyone. I'll first turn to page 14. It's very pleasing to report that revenue for the first six months of FY24 was a record $45.1 million. The chart on the left illustrates the revenue by half year reporting period, which reflects sales seasonality and growth achieved in this period. Gross profit margin in the period was 81.2%, showing improvement on PCP and the maintenance of a very strong gross margin. The last chart shows our strongest EBITDA result so far, being $10.1 million.

Turning to page 15, 469,000 customer orders were fulfilled in the half, reflecting growth in the business volume. The growth in volume was achieved in addition to increasing the value of each sale, as shown by the increase in the average order value to $94. This has been driven by an increase in the average order quantity, which has more than offset the average price reduction, as discussed on page 11. Turning to page 16.

A key feature in our business model is that the advertising costs are variable. When advertising effectiveness is lower than target, we pull back as appropriate, noting that during this half, we increased advertising in the US as we saw success in the spend. The 1H24 advertising spend was $15.4 million, or 34.1% of revenue. The chart illustrates seasonal movements in advertising effectiveness, as well as its overall improvement. Advertising spend is directed at both new and returning customers.

As I've said in previous presentations, there is no way of separating these expenditures by customer type. So we calculate advertising as a cost to acquire new customer orders, as well as the cost to acquire all customer orders. The real answer falls between these two approaches; however, we monitor performance against the methodology that assumes all advertising costs are for new customer acquisition. The cost to acquire new customers decreased to $84 during the half, reflecting the more favourable advertising economics. Turning to page 17.

The income statement is provided on this page, showing revenue by market and each cost line down to net profit. As said earlier, overall revenue increased 25% on PCP from growth across all four markets, particularly in the US, which saw a 256% jump in revenue. Our gross margin also increased 0.5% on PCP, benefiting from the work directed to reduce our inventory position and inventory obsolescence provision. Advertising was 34.1% of revenue, representing a minor increase on the 33.2% level in the PCP. This cost line remains a key focus area. Cost pressure in global logistics and distribution costs remain as per prior periods. Turning to page 18.

The balance sheet represents a capital-light business with a strong cash position and no debt. Step One is holding over $43 million in cash and $17 million in inventory. Inventory reduced $5.7 million; however, $0.5

million of this was due to a reduced obsolescence provision. Whilst inventory is not perishable or seasonable, the provision is required to assist in a reduction of the SKU range.

Step One's Board has declared a dividend of $0.04 per share, resulting in a 100% payout ratio. This equates to a distribution of $7.4 million. The Company's funding level following this distribution is deemed sufficient to support future expansion and ongoing financial stability. The Company is targeting a full-year payout ratio of 100% of NPAT. The dividend is fully framed to the maximum extent possible, demonstrating the Board's commitment to aligning the interests of investors with the Company's financial success.

Turning to page 19. The cash flow statement shows how receipts increased in line with revenue after adjusting for movements in contract revenue. Cash outflows were favourably impacted by a reduction in inventory. I'll now hand you back to Greg.

Greg Taylor: Thanks, Nigel. Please turn to page 21. On the back of our strongest-yet EBITDA result, I would like to take the opportunity to reiterate our strategy and the size of the global opportunity. We look at our market in four pillars. Underwear is a need, not a want, and entering into the women's market has increased our total addressable market, or TAM, by an estimated 10X fold if we were also to include bras and lingerie.

Step One is a capital-light business. We don't own forests, factories, or warehouses, or expensive IT systems. Most importantly, we own the brand and the product. Over 50,000 five-star reviews show that the product is a clear market leader. We are a DTC-focused retail e-commerce business, which accounts for nearly 15% of retail spend in Australia and growing rapidly. Finally, we will continue to evaluate partnerships and third-party marketplaces.

Please turn to page 22. Our business model continues to run off four pillars: product, marketing, customer-first approach and ESG messaging. Please turn to page 23.

I've covered the importance of our ESG credentials throughout the presentation and reiterate the importance of these, not just from both a consumer and Company perspective. Step One's products, right up to and including our compostable packaging, have some of the strongest ESG credentials and sustainable practices of any company in the world. We see this as a vital practice to ensure our product is made with future generations in mind. Please turn to page 25.

Whilst we're not providing financial guidance, we do plan to execute a plan encompassing both growth and profitability. Looking forward, Step One is profitable, and we plan to share these profits with shareholders. We are well capitalised with over $43 million in cash at reporting date, focused on marketing channel expansion, partnerships, and licencing agreements. We look to accelerate growth in our women's line. We look to balance both profitability and growth, and maintain our best-in-class products, over 50,000 five-star reviews and still over 50% daily repeat customer rate.

We remain confident that growth in the US market is achievable but will require investment to build sufficient awareness and a customer database for this market to trade profitably. Pursuit of market share in the USA does not reduce or preclude the ability to grow in other markets and the returns are expected to make the risk worthwhile.

Above all, we have a world-class product, world-class brand, and now an end-to-end FSC certified supply chain which our customers love and puts us in a very strong position to grow this business. Thank you for your time. I'll now hand back to Krista, the moderator, for Q&A.

Operator: Thank you. If you would like to ask a question, please press star followed by the number one on your telephone keypad. We also ask that you limit yourself to one question and one follow-up, and then re-queue. Your first question comes from the line of Alexander Mees from Morgans. Please go ahead.

Alexander Mees: (Morgans, Analyst) Thank you very much. Good morning, Greg, and Nigel. I will restrict myself to one question and then get back into queue. That question is around pricing strategy. So, well done on a great result and great growth. I'm just wondering where we go to from here in terms of trying to sustain that high AOV. Are we happy to accept a lower unit cost to try and get those volumes by pushing deeper discounts and more volume-based purchasing? I'm just interested in your thoughts about where it goes from here.

Greg Taylor: Thanks for the question, Alex, and obviously a good one. We did - as I mentioned, we traded off a deeper discount during the sale period. That, however, as you can see, represented a much higher AOV at just over $94, and it's also increased our conversion rate. So, whilst we're happy to increase the discount, it's a way for us to look at how else can we grow revenue. But we've managed to do that both profitably and also increasing our conversion rate, which obviously shows the trade-off between a slightly lower price has paid off in terms of both revenue and EBITDA.

Alexander Mees: (Morgans, Analyst) Thank you very much.

Greg Taylor: Alex, you can continue asking questions until you're finished.

Operator: Alex, go ahead.

Alexander Mees: (Morgans, Analyst) Thank you. I've got a couple more. Just with regard to the lower cost of acquiring customers, I'm interested in your comment, Nigel, that advertising economics have changed. I'm just wondering how they've changed, and whether that's sustainable, whether we can expect to have that lower CAC into the future.

Greg Taylor: Alex, it is also partially to do with the US market. When we had success acquiring those new customers in the US, that actually improved it overall, the advertising economics. We also had some overall success in other markets as well, but the US was the key driver.

Nigel Underwood: What I'll also add to that, Alex, is that whilst we've gone into marketplaces as well, such as Amazon and John Lewis, these enable us obviously both brand awareness, but each one of those customers is purely on a CPA basis. So that obviously moving forward will continue to reduce our customer acquisition costs as we put new customers in at a pure performance or CPA level. This also includes things like the partnership with Surf Life Saving Australia as well. So that's the way we look at it, that there are other ways in which we can use channels, not just our own advertising mix, but other channels to offset higher CACs in certain places but reduce them in others.

Alexander Mees: (Morgans, Analyst) That makes good sense, which is a segue into the question I was going to ask next about John Lewis. I know John Lewis very well, coming from the UK, and it's a really top-class retailer. So well done getting on board with them. I'm just wondering what the economics of that arrangement are, as you say, purely a CPA-based arrangement?

Greg Taylor: It's a bit of both, Alex. Once it's up and running at a critical level, we would see that its economics is similar to Amazon, and we would be making money out of it.

Nigel Underwood: Just to reiterate, Alex, that is a pure CPA model, so we do not pay for - to be listed on the store, and it is a cost obviously from a percentage side that we do pay them. So it is a pure CPA cost, if you're to answer the question directly.

Alexander Mees: (Morgans, Analyst) Great, thank you. Just one more with regard to the US, obviously it's fantastic to see real traction happening over there, and I'm just wondering how the strategy is - how you describe the strategy at the moment. Obviously, we went into a more localised approach. Is that still very much what you're trying to do, is try and own certain local areas and then expand from there? Is that still the strategy?

Greg Taylor: There's a number of strategies we do adopt in the US, Alex, and what we've seen there is, unlike other markets, you do need to invest revenue ahead of revenue - sorry, you need to spend revenue ahead of - costing ahead of revenue, sorry. So brand awareness and importance sits much higher in the final consideration for consumers there. So what we've shown during the period is that we were able to grow PCP over 200% during the period. One of the things we have implemented now is we've managed to get one of our key metrics back in line with our UK and Australian business, and that's the repeat customer rate. That's coming close to levels near where we are in Australia, and it's sitting well over 40%.

So for us to get the retention rate, so we've put a bunch of customers into the funnel now, we've invested ahead of revenue, and what we're able to do now is use that customer base to retarget, to regrow, but also to use that knowledge and learning that we've taken from the first half, and then apply that in a profitable manner into the second half.

Alexander Mees: (Morgans, Analyst) Beautiful. Thanks very much, Greg, Nigel.

Operator: Again, if you'd like to ask a question, please press star one on your telephone keypad. We have no further questions in our queue at this time. I will turn the call back over to Greg Taylor for closing remarks.

Greg Taylor: Very pleased to report our record ever revenue and EBITDA growth. I appreciate everyone's time. I remain very positive about the Company and look forward to speaking to those individually who have booked a call and thank you very much for your time.

Operator: This concludes today's conference call. Thank you for your participation, and you may now disconnect.

[END OF TRANSCRIPT]