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CUBEWEALTH

DULUTH HOLDINGS EQUITY REPORT

JULY 12TH, 2020

DULUTH

BY THE NUMBERS

TICKER: DLTH
PRICE: $7.09

Duluth Holdings Inc. sells casual wear, workwear, and accessories for men and women under the Duluth Trading brand in the United States. It provides shirts, pants, underwear, tanks, outerwear, footwear, accessories, and hard goods. The company offers its products under various trademarks, trade names, and service marks, including Alaskan Hardgear, Armachillo, Ballroom, Cab Commander, Crouch Gusset, Dry on the Fly, Duluth Trading Co, Duluthflex, Fire Hose, Longtail T, No Polo Shirt, No Yank, Wild Boar Mocs, and Buck Naked.

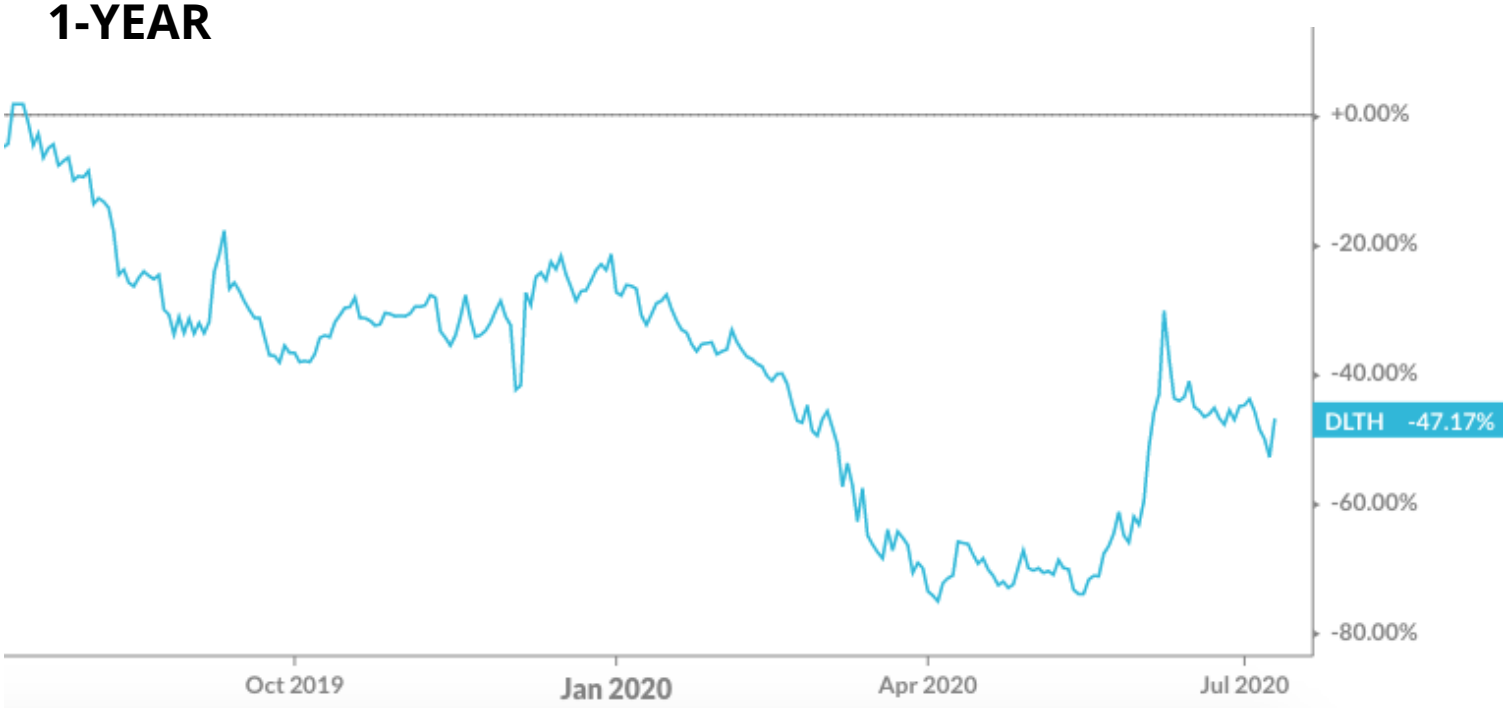
The company was formerly known as GEMPLER'S, Inc. Duluth Holdings Inc. was founded in 1989 and is headquartered in Mount Horeb, Wisconsin.

N/A	-33%	$232M
DIVIDEND YIELD	YTD RETURN	MARKET CAP

DLTH

SHARE PRICE PERFORMANCE

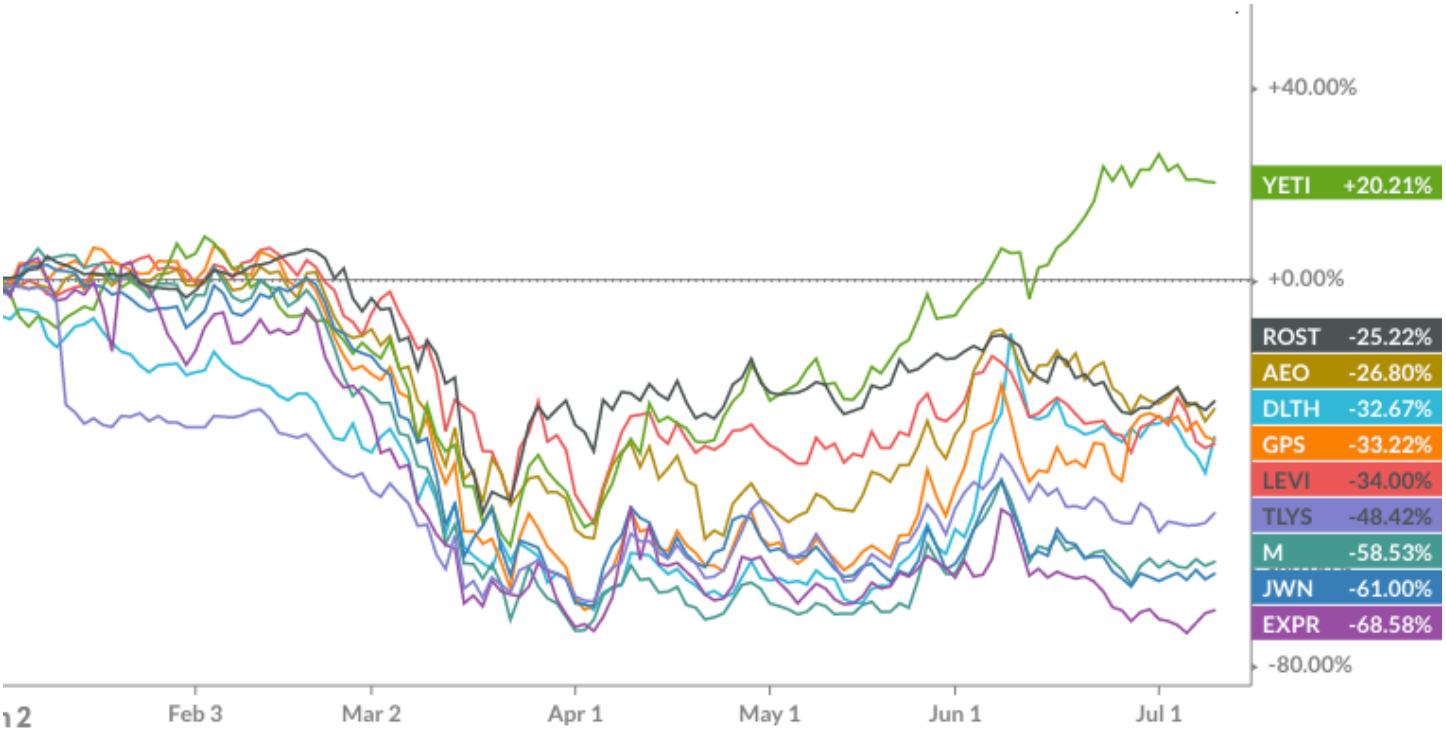
1-YEAR



ALL-TIME

ANALYSIS

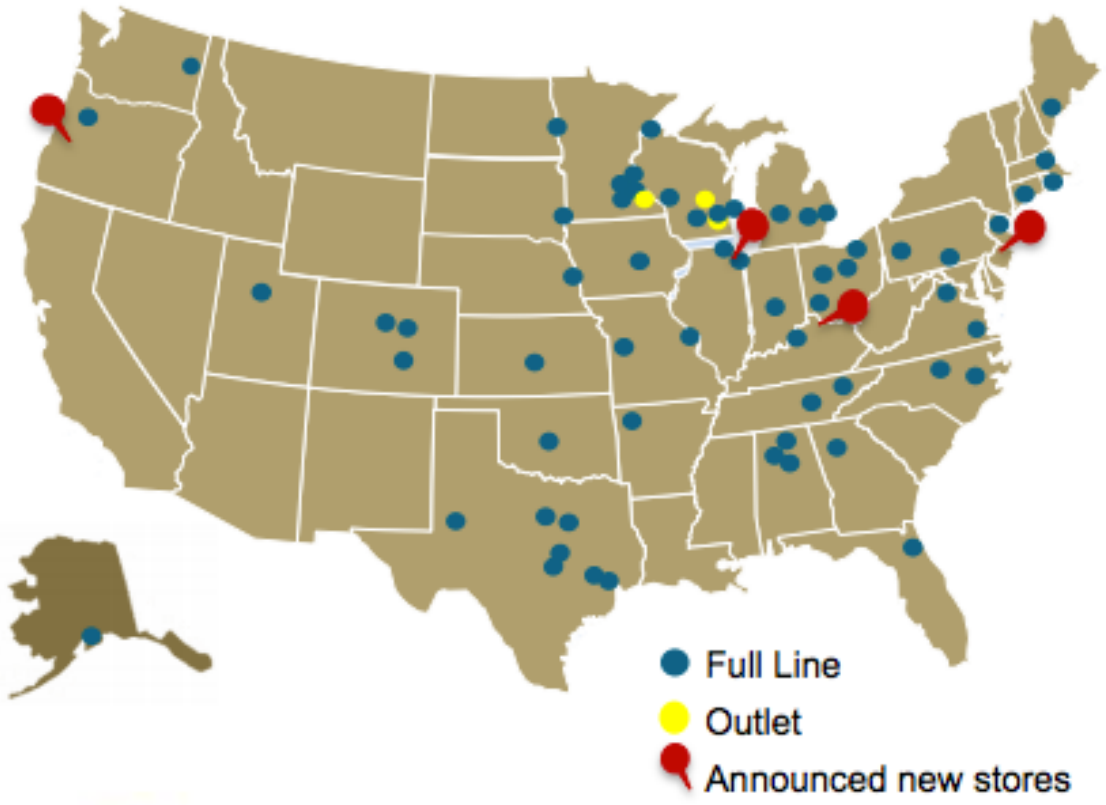
Unlike many companies CUBE covers, Duluth (DLTH) has a very simple and easy to understand business model. The company is a retailer with an online presence and has been susceptible, like virtually every other retailer, to COVID19. Fortunately for Duluth, there are a few aspects that make their business better suited for this hardship. Some of these examples include having a good online presence and also catering to more of the "outdoorsy" lifestyle. if we look below at the performances of DLTH vs. other retailers we will see that their niche background has been helping a lot but we do want to make it clear that while DLTH is a niche player they are not to the extent of a company like YETI which only sells coolers, bags, and mugs.



If we look at the performance chart YTD for many retailers, we see that DLTH kind of the falls towards the upper middle range. Granted the stock is still down 33% YTD but much of the reason for this outperformance when compared to Tilly's, Macy's, Nordstrom, and Express has a lot to do with DLTH's smaller physical footprint.

In fact, DLTH didn't have a physical location until 2010. Now the company has 62 locations as seen in the map below. Before COVID19, DLTH was planning on 5 new store openings in 2020 but has since knocked that down to 4. This caught us by surprise as we figured the company would be less aggressive in expansion into physical locations.

The 4 new locations will be in:
- Cherry Hill, NJ (11,441 sq. ft)
- Springfield, OR (20,388 sq. ft)
- Orland Park, IL (10,000 sq. ft)
- Florence, KY (11,441 sq. ft)



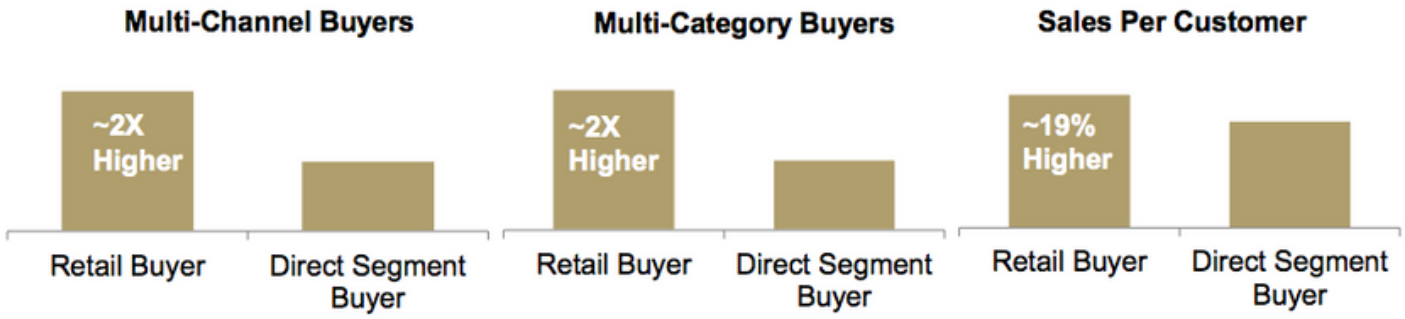
There's a good amount to talk about here with regards to physical locations. First, if we dive a little deeper into the revenues numbers for their fiscal year ending Feb 2nd, 2020 vs Feb 3rd, 2019 we see that revenue from physical locations came in at 43.1% while digital came in at 56.9% - digital sales fell from 61.7% of revs in the year prior.

After diving into Macy's for their last two fiscal years, digital sales only made up 23% (2019) and 21% (2018) of revenues. Nordstrom (JWN) only saw 33% and 30% of revenues coming digitally, respectively for the same years. In other words, DLTH's digital revenues is a big pro for them despite it falling.

	Fiscal Year Ended	
	February 2, 2020	February 3, 2019
(in thousands)		
Direct net sales	$ 350,371	$ 350,638
Retail net sales	265,253	217,464
Net sales	615,624	568,102
Cost of goods sold (excluding depreciation and amortization)	287,475	257,700
Gross profit	328,149	310,402
Selling, general and administrative expenses	300,041	273,221
Operating income	28,108	37,181
Interest expense	4,471	5,949
Other income, net	291	383
Income before income taxes	23,928	31,615
Income tax expense	5,429	8,450
Net income	18,499	23,165
Less: Net (loss) income attributable to noncontrolling interest	(422)	9
Net income attributable to controlling interest	$ 18,921	$ 23,156
Percentage of Net sales:		
Direct net sales	56.9 %	61.7 %
Retail net sales	43.1 %	38.3 %
Net sales	100.0 %	100.0 %
Cost of goods sold (excluding depreciation and amortization)	46.7 %	45.4 %
Gross profit	53.3 %	54.6 %
Selling, general and administrative expenses	48.7 %	48.1 %
Operating income	4.6 %	6.5 %
Interest expense	0.7 %	1.0 %
Other income, net	— %	0.1 %
Income before income taxes	3.9 %	5.6 %
Income tax expense	0.9 %	1.5 %
Net income	3.0 %	4.1 %
Less: Net (loss) income attributable to noncontrolling interest	— %	— %
Net income attributable to controlling interest	3.1 %	4.1 %

We will get into gross margins and the rest of the stats more for the most recent quarter in later pages but the focus right now remains on physical locations.

CUBE finds it interesting that DLTH wants to continue their physical location growth and a lot of this comes from the following data trends they are seeing in their business.

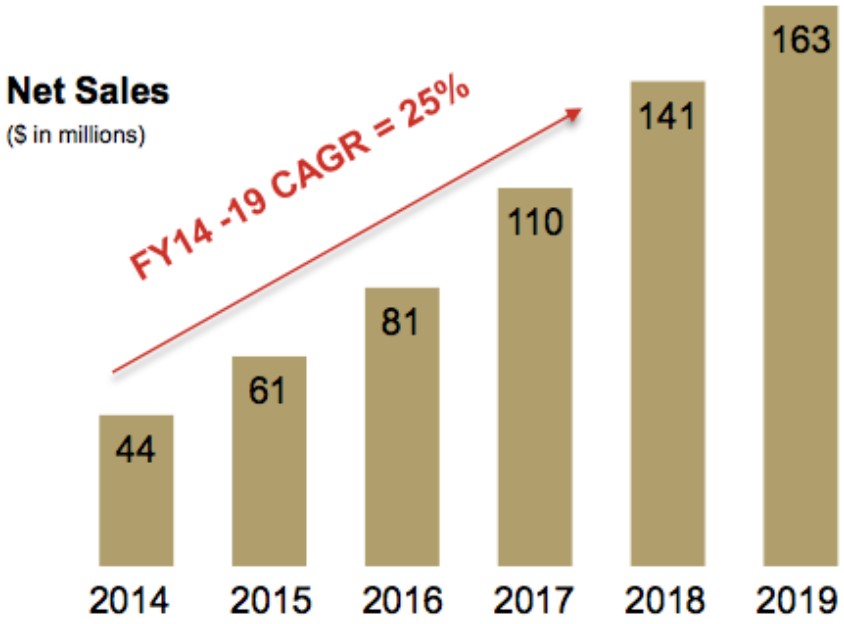


The company sees 19% higher sales checkouts in physical locations, 2x higher buyer in multiple categories of apparel, and 2x higher multi-channel buying. This has to be why DLTH is pursuing more locations when many competitors are going the opposite direction.

Based on CUBE's ecommerce experience, we worry that much of the reason for these stats could actually be a greater representation of missing a lot of sales online as opposed to management's thoughts of more retail locations being the right answer. Across the board with many companies, we are seeing a completely different narrative where CMO's and CFO's are pounding the table that they are able to upsell different items and garner higher checkout carts digitally. This is somewhat of a head scratcher when we look at DLTH as much of the reason for their outperformance is because digital makes up a majority of sales. Put simply, investors want less to see more on the digital front due to higher gross margins and less overhead - not the other way around.

Moving along, there are some other areas where DLTH can shine and that is the female demographic.

Below is a chart that shows that female apparel sales have been growing at 25% CAGR from 2014 to 2019 and accounted for 26.5% of sales in 2019 vs. 24.8% in 2018 and 23.3% in 2017.



In 2019 alone, their female segment grew revenues 17% Y/Y vs. total revenue growth of 8.4%. Getting more granular, plus-size female apparel now makes up 10% of total female sales which also presents another unique opportunity for DLTH. The point being made here is that there is a lot of opportunity that DLTH can still tap into similar to how LULU is now trying to do the opposite and tap into the male demographic. The one thing we wish we knew but unfortunately don't have any data on is what percentage of female sales come from online. CUBE personally believes women would be more inclined to shop online as opposed to visiting a DLTH physical location.

Before moving to the financial statements, one thing we need to highlight when it comes to this type of business is that it is highly susceptible to seasonality.

If we look at the image below, 42.2% of DLTH's sales for the year comes in the 4th quarter and 128.8% of profits do as well.

This revenue percentage is less than 2018 and 2017, but the profitability percentage is much higher. In 2018 profits for the year that came solely from Q4 were 89% and in 2017 were 83.6%.

Fiscal Year	4Q Net Sales	4Q Net Sales % of Fiscal year	4Q Net Income	4Q Net Income % of Fiscal Year
(in thousands)				
2019	$ 259,649	42.2 %	$ 24,375	128.8 %
2018	$ 250,541	44.1 %	$ 20,620	89.0 %
2017	$ 217,805	46.2 %	$ 19,528	83.6 %

Long story short, Q4 is the money maker for DLTH and thankfully for them COVID19 has hit Q1 and Q2. If things get better and cities and states start to see numbers come down and ease policies, DLTH might be able to have another solid Q4 that drives all of their profits and cash flow.

CUBE'S TOP PROS FOR DLTH

HEALTHY DIRECT TO CONSUMER REVS

SMALLER PHYSICAL FOOTPRINT

NICHE PLAYER IN APPAREL SPACE

CUBE'S TOP CONS FOR DLTH

DECREASING MARGINS

MANAGEMENT'S GROWTH STRATEGY

SEASONALITY

FINANCIAL STATEMENTS

BALANCE SHEET

ASSETS	May 3, 2020	February 2, 2020
Current Assets:		
Cash and cash equivalents	$ 8,854	$ 2,189
Receivables	3,459	1,470
Inventory, less reserve for excess and obsolete items of $1,707 and $1,826, respectively	175,037	147,849
Prepaid expenses & other current assets	9,473	9,503
Prepaid catalog costs	167	1,181
Total current assets	196,990	162,192
Property and equipment, net	137,253	137,071
Operating lease right-of-use assets	117,330	120,431
Finance lease right-of-use assets, net	46,469	46,677
Restricted cash	446	51
Available-for-sale security	5,701	6,432
Other assets, net	1,423	1,196
Total assets	$ 505,612	$ 474,050

LIABILITIES AND SHAREHOLDERS' EQUITY	May 3, 2020	February 2, 2020
Current liabilities:		
Trade accounts payable	$ 34,421	$ 33,053
Accrued expenses and other current liabilities	35,525	29,464
Income taxes payable	—	3,427
Current portion of operating lease liabilities	10,433	10,674
Current portion of finance lease liabilities	1,638	1,600
Current maturities of TRI long-term debt	573	557
Total current liabilities	82,590	78,775
Operating lease liabilities, less current maturities	104,112	106,120
Finance lease liabilities, less current maturities	37,361	37,434
Duluth long-term debt, less current maturities	84,750	39,332
TRI long-term debt, less current maturities	27,646	27,778
Deferred tax liabilities	8,302	8,505
Total liabilities	344,761	297,944
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, no par value; 10,000 shares authorized; no shares issued or outstanding as of May 3, 2020 and February 2, 2020	—	—
Common stock (Class A), no par value; 10,000 shares authorized; 3,364 shares issued and outstanding as of May 3, 2020 and February 2, 2020	—	—
Common stock (Class B), no par value; 200,000 shares authorized; 29,417 shares issued and 29,380 shares outstanding as of May 3, 2020 and 29,191 shares issued and 29,172 shares outstanding as of February 2, 2020	—	—
Treasury stock, at cost; 37 and 19 shares as of May 3, 2020 and February 2, 2020, respectively	(514)	(407)
Capital stock	91,451	90,902
Retained earnings	72,454	87,589
Accumulated other comprehensive (loss) income	(330)	188
Total shareholders' equity of Duluth Holdings Inc.	163,061	178,272
Noncontrolling interest	(2,210)	(2,166)
Total shareholders' equity	160,851	176,106
Total liabilities and shareholders' equity	$ 505,612	$ 474,050

Before we tackle the balance sheet, here is a list of measures DLTH is taking to handle the pandemic:

- Six-month pay reduction for senior leadership ranging from 10 to 20%.
- CEO Steve Schlecht will waive all cash compensation for the balance of fiscal 2020.
- The Board of Directors will forego cash retainers for the second and third quarters.
- Furloughs of varying lengths with benefits intact for 68% of salaried staff.
- A permanent 10% reduction in corporate staff.
- All operating expenses are under review including price concessions with vendors and reductions in lease expense for its fleet of retail stores.
- As mentioned, to curtail capital expenditures DLTH now plans to open four stores in fiscal year 2020, reducing its previously disclosed plan by one store.

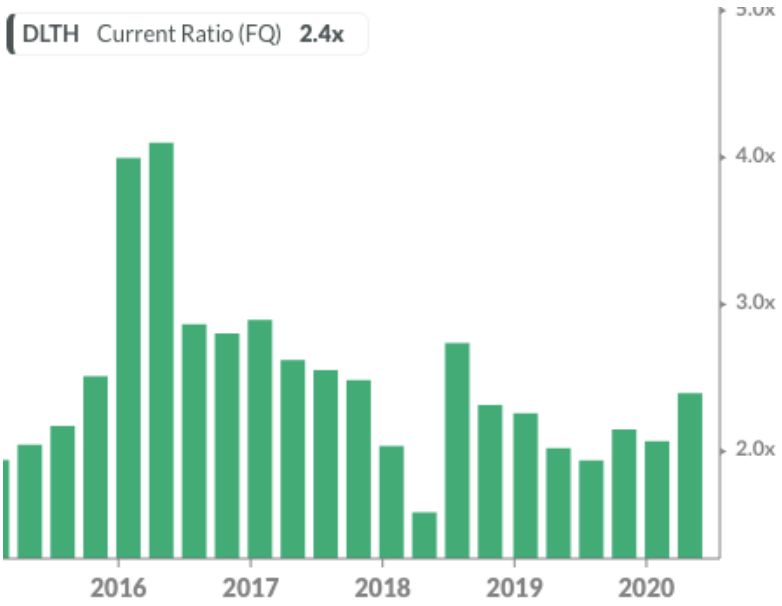
The company has $8.9M in cash and cash equivalents which isn't a whole lot. At the surface, initial thoughts go immediately to default but thankfully DLTH has access to a total of $150.5 million in their credit facility ($80 million line of credit and $70.5 million of term loan capacity). In other words, if the company needs cash it is there for them to tap into.

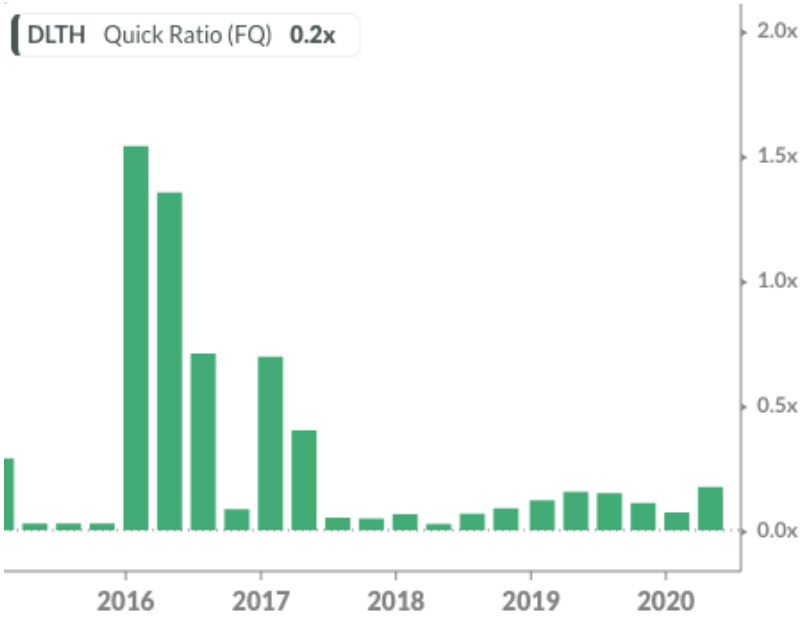
Total debt currently stands at nearly 10x cash, or $84.8M, which is a bit alarming. During Q1, DLTH amended its credit agreement to include an incremental delayed draw term loan of $20.5 million and amended the loan covenants to provide greater flexibility during peak borrowing periods in fiscal 2020.

($ in millions)		As of May 3, 2020
Cash	$	8.9
Debt:		
Line of Credit		35.0
Term Loan		49.8
Total Debt		84.8
Total Shareholders' Equity		160.9
Total Capitalization	**$**	**245.7**
Debt to Capital ratio		34.5%

At the end of the quarter, they also had an inventory balance of $175.0M, net working capital (current assets - current liabilities) of $114.4M, $49.7M outstanding on its $70.5M term loan, and $35.0M outstanding on its $80.0M revolving line of credit.

If we look at their current ratio (current assets/current liabilities), DLTH has a healthy ratio of 2.4x. This is $197M in current assets and $87M in current liabilities. Unfortunately, the same cannot be said about their quick ratio which is ([Cash & equivalents + marketable securities + accounts receivable] / Current liabilities). The reason this is 0.2x and so much lower than the current ratio is because much of DLTH's current assets are sitting in inventory. DLTH will most likely need to keep tapping that line of credit for the foreseeable future or may look for alternatives to raise money like that of secondary equity offerings.





FINANCIAL STATEMENTS

INCOME STATEMENT

	Three Months Ended	
	May 3, 2020	May 5, 2019
Net sales	$ 109,917	$ 114,244
Cost of goods sold (excluding depreciation and amortization)	57,585	53,326
Gross profit	52,332	60,918
Selling, general and administrative expenses	71,306	70,609
Operating loss	(18,974)	(9,691)
Interest expense	1,350	841
Other income, net	59	204
Loss before income taxes	(20,265)	(10,328)
Income tax benefit	5,086	2,683
Net loss	(15,179)	(7,645)
Less: Net loss attributable to noncontrolling interest	(44)	(73)
Net loss attributable to controlling interest	$ (15,135)	$ (7,572)
Basic loss per share (Class A and Class B):		
Weighted average shares of common stock outstanding	32,372	32,281
Net loss per share attributable to controlling interest	$ (0.47)	$ (0.23)
Diluted loss per share (Class A and Class B):		
Weighted average shares and equivalents outstanding	32,372	32,281
Net loss per share attributable to controlling interest	$ (0.47)	$ (0.23)

(in thousands)	May 3, 2020	May 5, 2019
Direct-to-consumer	$ 86,530	$ 65,701
Stores	23,387	48,543
	$ 109,917	$ 114,244

We already looked at the full year numbers a bit earlier where revenues in 2019 vs 2018 grew 8.4% but let's now dive deeper into the most recent Q1 that ended May 3rd, 2020. It was actually a pretty impressive quarter in our eyes. Duluth reported Q1 Non-GAAP EPS of -$0.42 beating estimates by $0.06 on revenue of $109.92M (-3.8% Y/Y) beating by $17.97M. While EPS was pretty nasty, we were pleased to see revenues only fell 3.8% Y/Y.

Here is some more color:

- Net sales decreased 3.8% to $109.9M compared to $114.2M in the prior-year first quarter
- Retail store net sales decreased 51.8% due to the temporary closure of all stores for approximately seven weeks
- ***Website and catalog net sales increased 31.7%, including a 69.0% increase in website and catalog sales since the stores closed on March 20, 2020 as compared to the same six-week period in the prior year***
- ***April total net sales exceeded last year by 5.3%, while stores were closed***
- Gross margin decreased to 47.6% compared to 53.3% in the prior-year first quarter
- Operating loss of $19.0M compared to operating loss of $9.7M in the prior-year first quarter
- Net loss of $15.1M, or $0.47 per diluted share, compared to a net loss of $7.6M, or $0.23 per diluted share, in the prior-year first quarter. The current quarter net loss included $1.6M, or $0.05 per diluted share of non-recurring COVID-19 related expenses
- Adjusted EBITDA of -$11.6M compared to -$4.4M in the prior-year first quarter
- Opened one retail store in Short Pump (Richmond), VA adding approximately 17,000 gross square feet
- All stores were closed March 20, 2020 and began to re-open May 3, 2020. As of June 4, 2020, they have re-opened 58 of 62 retail stores in some capacity

CUBE has bolded two key highlights from the quarter and that is the fact that online sales increased 31.7% Y/Y and 69% Y/Y when stores officially closed down. Secondly, sales for the company actually grew 5.3% Y/Y in month of April while stores were completely closed.

This is what strikes us as so odd. Look at the success for DLTH online, why is management so adamant on opening another 4 stores this year when cash is tight and their customers have shown their willingness to shop online?

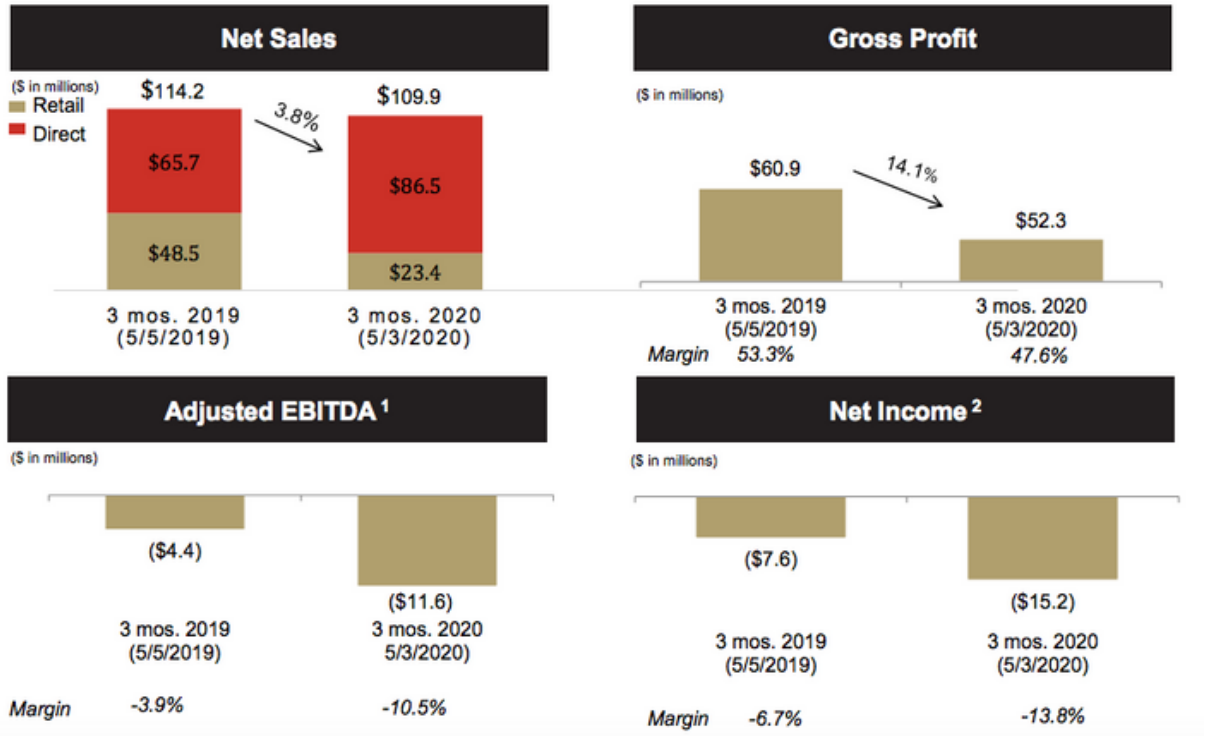
Also, we pulled this snippet from their earnings call. "The increase in the website and catalog net sales was driven by a shift of existing customers to online, as well as new buyer growth particularly within our women's products. New buyer growth increased 58.8% compared to the same period a year ago."

So this begs the question, is a bigger physical presence really the answer for DLTH? We don't think so and the data appears to be saying the same thing if new buyer growth is up nearly 60%. The company has some very interesting commercials and marketing and we think that's the angle they should be playing and diving deeper into. CUBE believes the ROI is much higher on digital advertising in the long-run than it is opening up more 20,000 sq. ft stores across the USA.

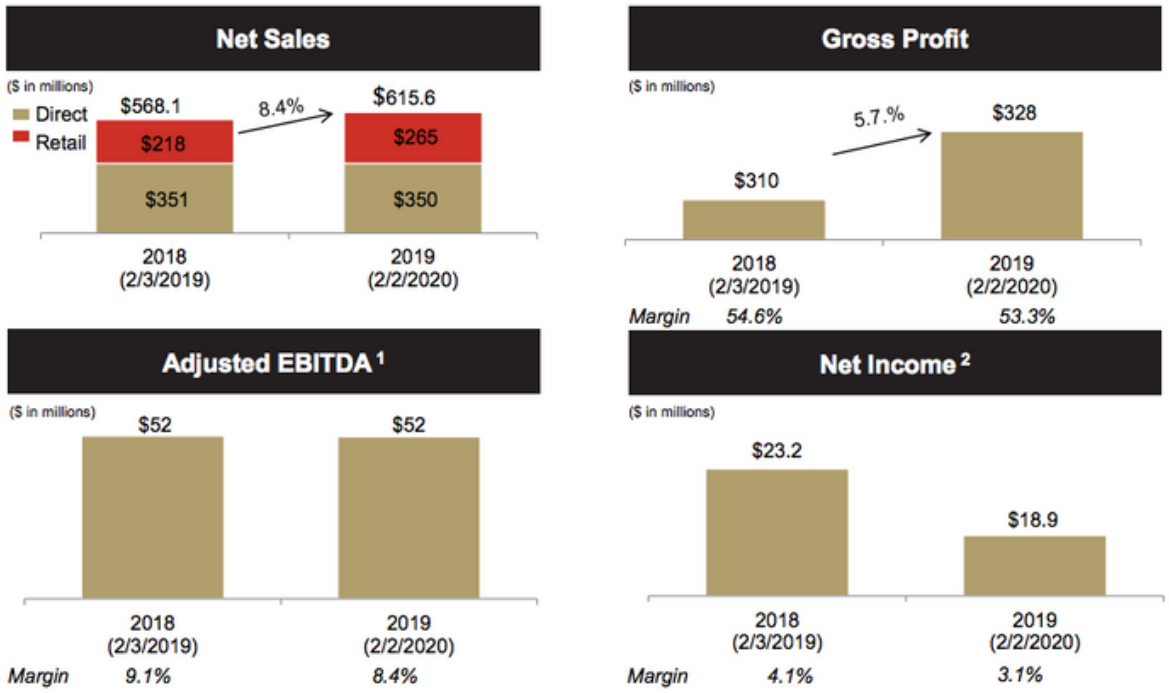
We figured with the success they've been seeing online, the company would reduce their planned openings by more than 1 store from 5 to 4. At that point why even reduce the count?

Below is a breakdown of Q1's financial metrics and also their recent FY for reference. The gross margins are what is concerning CUBE a bit and it is very linear to their new store openings as GM has now fallen 54.6% in FY19 to 47.6% in their most recent quarter. We anticipate this figure to fall with each additional store opening.

Q1



FY



FINANCIAL STATEMENTS

CASH FLOW

	Three Months Ended	
	May 3, 2020	May 5, 2019
Cash flows from operating activities:		
Net loss	$ (15,179)	$ (7,645)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	6,689	4,392
Stock based compensation	463	474
Deferred income taxes	(21)	(302)
Changes in operating assets and liabilities:		
Receivables	(1,989)	(4,012)
Inventory	(27,188)	(6,604)
Prepaid expense & other current assets	2,196	2,577
Deferred catalog costs	1,014	2,301
Trade accounts payable	(1,842)	1,221
Income taxes payable	(3,427)	(218)
Accrued expenses and deferred rent obligations	5,126	(5,295)
Noncash lease impacts	667	—
Net cash used in operating activities	(33,491)	(13,111)
Cash flows from investing activities:		
Purchases of property and equipment	(4,059)	(8,015)
Capital contributions towards build-to-suit stores	(74)	(1,788)
Principal receipts from available-for-sale security	31	28
Change in other assets	—	13
Net cash used in investing activities	(4,102)	(9,762)
Cash flows from financing activities:		
Proceeds from line of credit	37,484	70,172
Payments on line of credit	(21,816)	(47,474)
Proceeds from other borrowings	30,000	—
Payments on other borrowings	(250)	—
Payments on TRI long term debt	(116)	(119)
Payments on finance lease obligations	(392)	(37)
Shares withheld for tax payments on vested restricted shares	(107)	(277)
Other	(150)	93
Net cash provided by financing activities	44,653	22,358
Increase (decrease) in cash, cash equivalents and restricted cash	7,060	(515)
Cash, cash equivalents and restricted cash at beginning of period	2,240	3,085
Cash, cash equivalents and restricted cash at end of period	$ 9,300	$ 2,570
Supplemental disclosure of cash flow information:		
Interest paid	$ 1,447	$ 986
Income taxes paid	$ 37	$ 2,179
Supplemental disclosure of non-cash information:		
Unpaid liability to acquire property and equipment	$ 2,000	$ 846

Operating cash flow burn came in at $33M in Q1 and if we add the $4M in capex, total free cash flow burn was around -$37.5M in Q1 vs. -$21M in Q1 of last year. This is pretty alarming and is why CUBE believes DLTH will have to continue to tap into that line of credit to keep everything in motion.

It's also another reason why we find it so odd that the company, with its cash flow burn and little cash on hand, still wants to open up 4 more locations during these unprecedented times.

The only reason cash increased Y/Y was because they raised a net $44M in cash flow from financing activities that included $67M in borrowings - $21.8M of which was used to pay down other debt.

We dug into their 10Q and did find this snippet though:

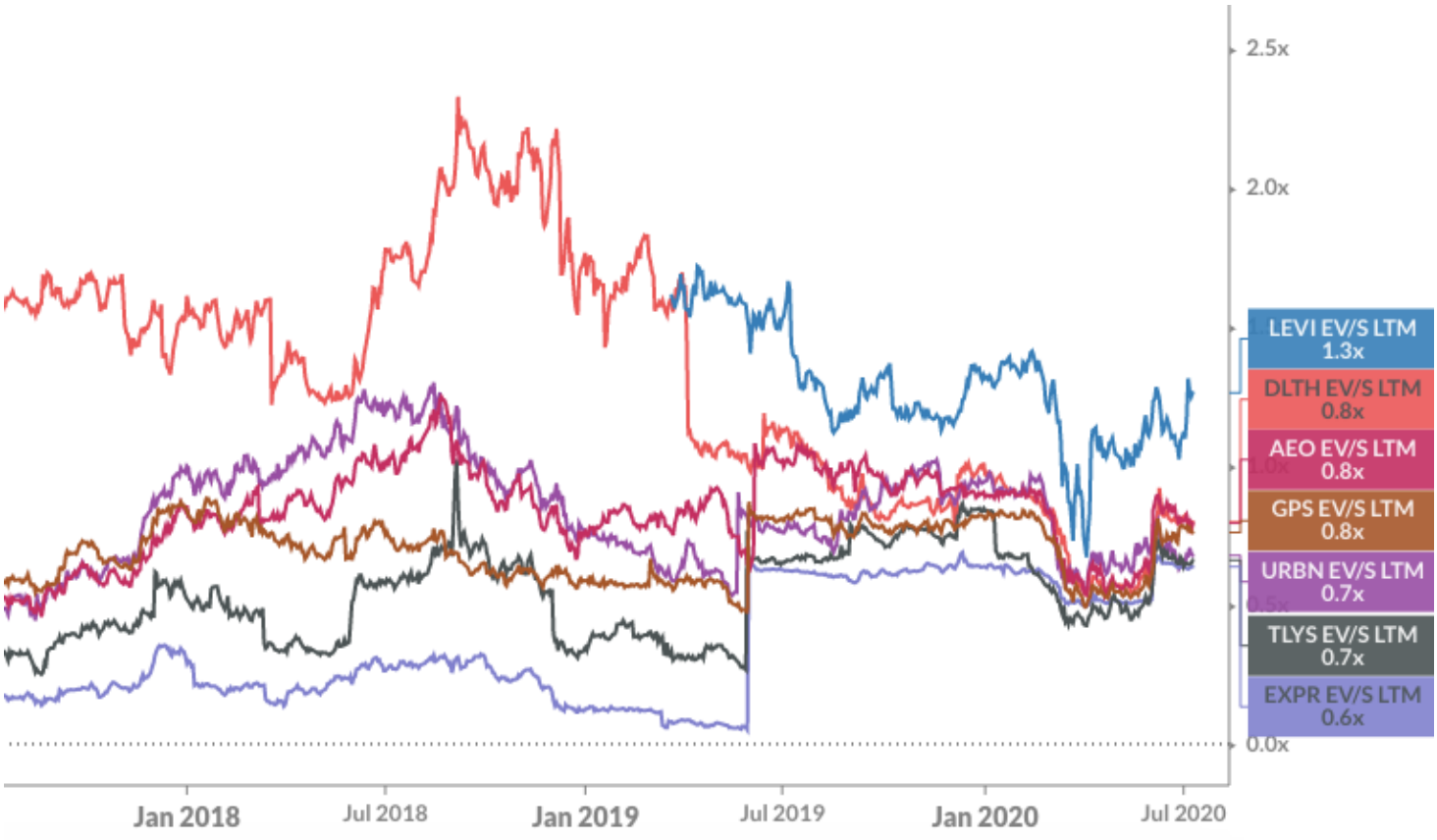
"While our cash flows from operations for the three months ended May 3, 2020 is negative, despite disruptions due to COVID-19 and the seasonal nature of our business, we expect cash flows from operations for the full year fiscal 2020 to still be positive from operating performance and seasonal reductions in working capital during the fourth quarter of our fiscal year, which is consistent with previous full fiscal years."

The company still expects positive operating cash flow but we imagine this assumes COVID19 clearing up in time for that big Q4 season we mentioned earlier that makes up a majority of their profits and cash flow. If COVID19 is still an issue come Q4, DLTH could be way off with their projections.

DLTH FUNDAMENTALS

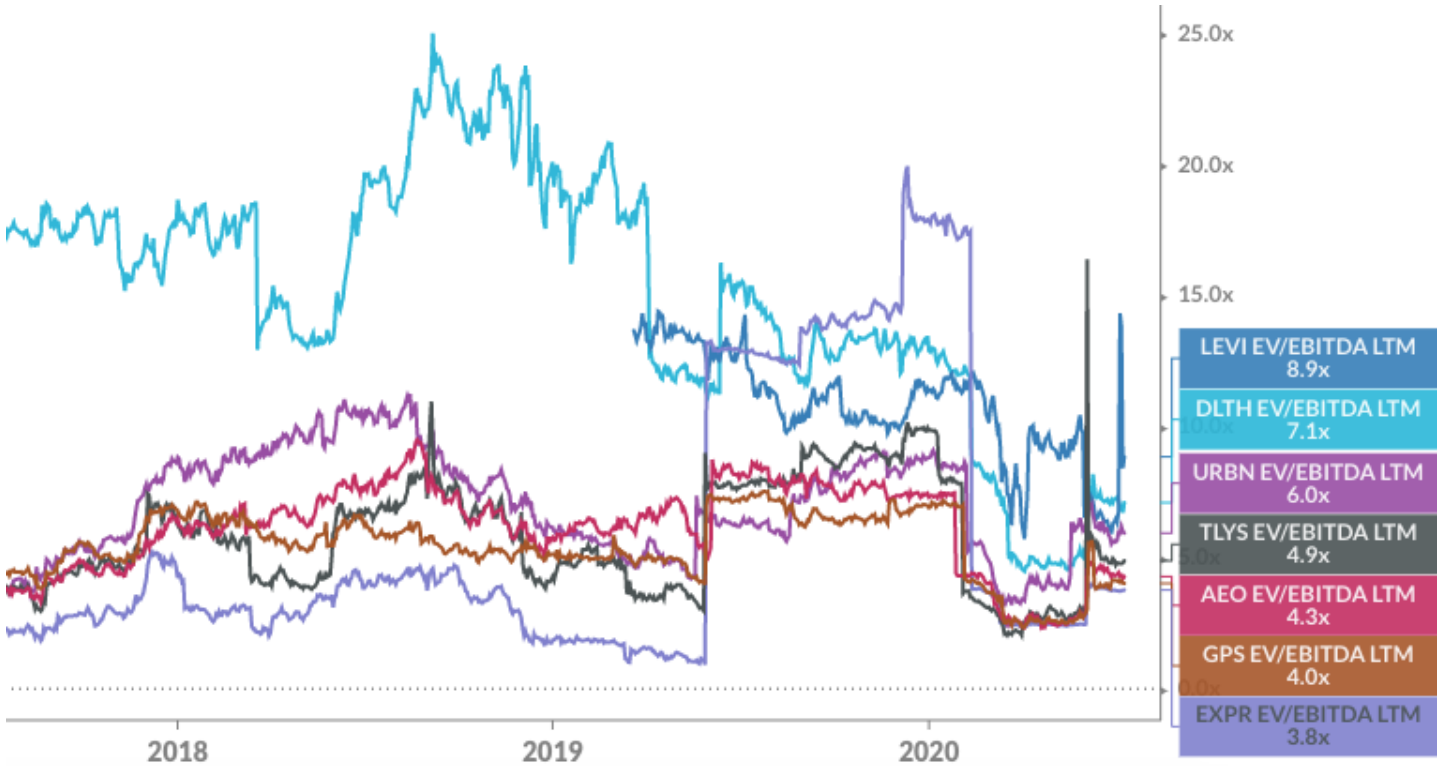
CUBE is going to compare DLTH to Levi (LEVI), American Eagle Outfitters (AEO), The Gap (GPS), Urban Outfitters (URBN), Tilly's (TLYS), and Express (EXPR).

From an enterprise value to sales standpoint, DLTH is towards the top at 0.8x, only cheaper than LEVI at 1.3x. All of them are roughly in the same ballpark, though, aside from the ever struggling EXPR which is at 0.6x.



DLTH FUNDAMENTALS

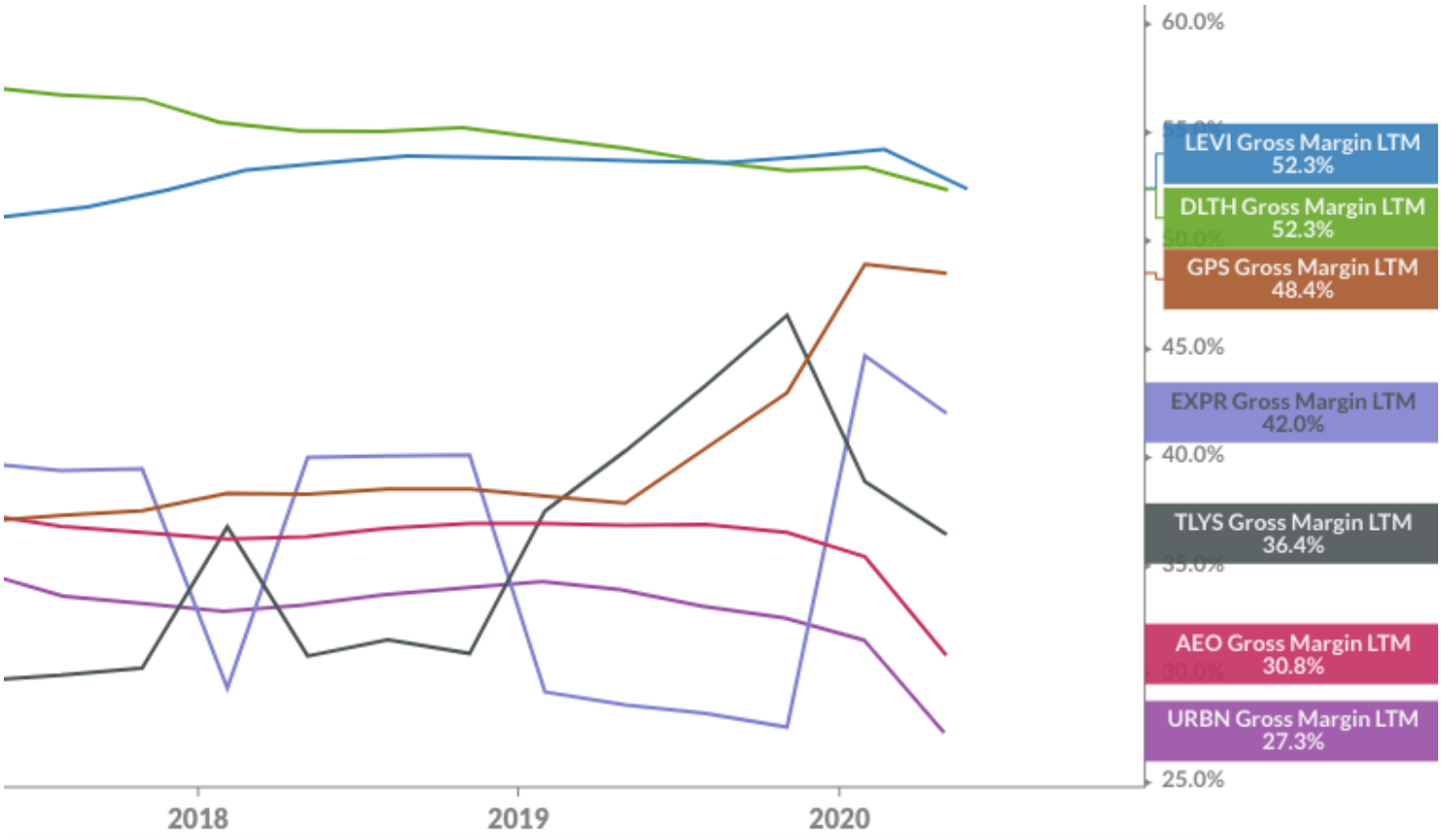
Along the same lines, DLTH trades at 7.1x EV/EBITDA (earnings before interest, taxes, depreciation, and amortization). This is also on a last twelve months basis and in the grand scheme of things is not expensive. Only LEVI trades higher at 8.9x while many of the others trade under 5x. As we can tell with ease, retail has been taking a beating and investors have been losing major trust in their ability to survive and thrive.



DLTH FUNDAMENTALS

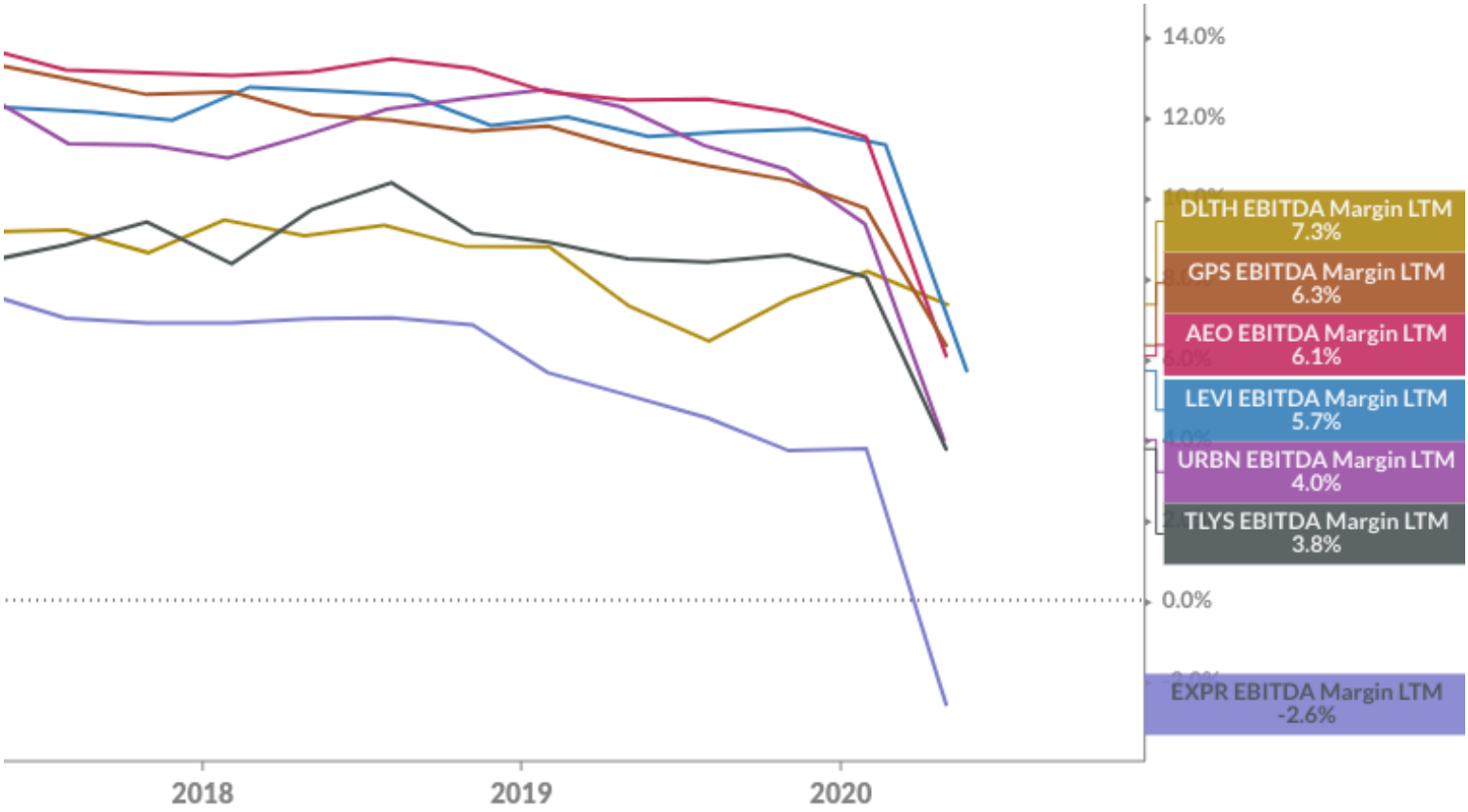
As we continue to mention, margins are so important especially as it relates to retail and DLTH is right in line with LEVI at the top. This is most likely a large reason why they have a premium valuation vs. the others because we are looking at margins as low as 27.3% at URBN.

The issue we have is that we think over the next 12 months DLTH will see margins near 40-45% due to their growing physical presence. If they dedicated strictly to online or at least slowed down their physical expansion, they could see margins near 60%+.



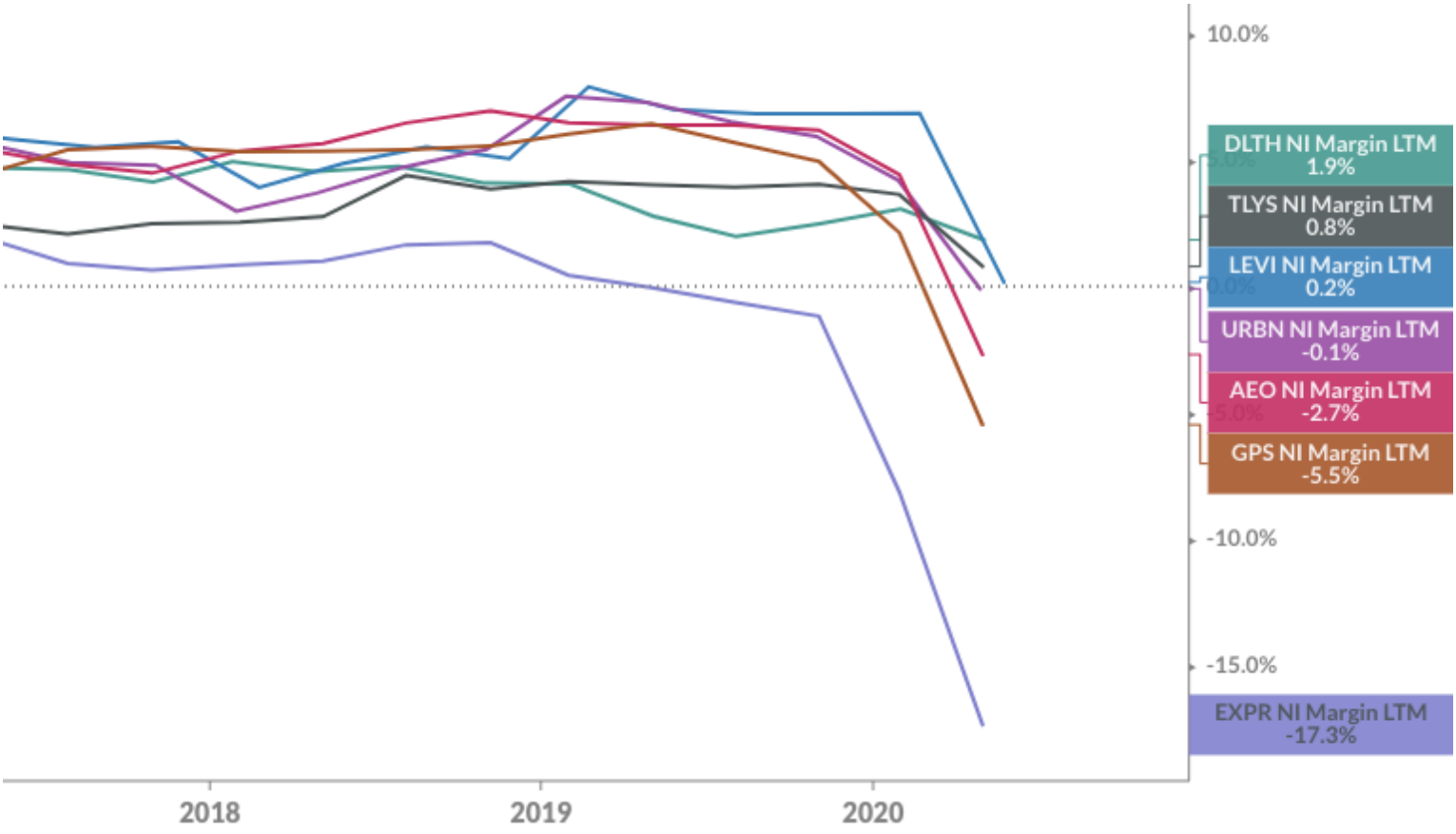
DLTH FUNDAMENTALS

As we move down the income statement, we see that DLTH is at the top with EBITDA margins. This is great to see and is one of their highlights. Please keep in mind this is also over the last twelve months. As Q2 earnings get released there is a good chance these margins are no where near the ones we are seeing below.

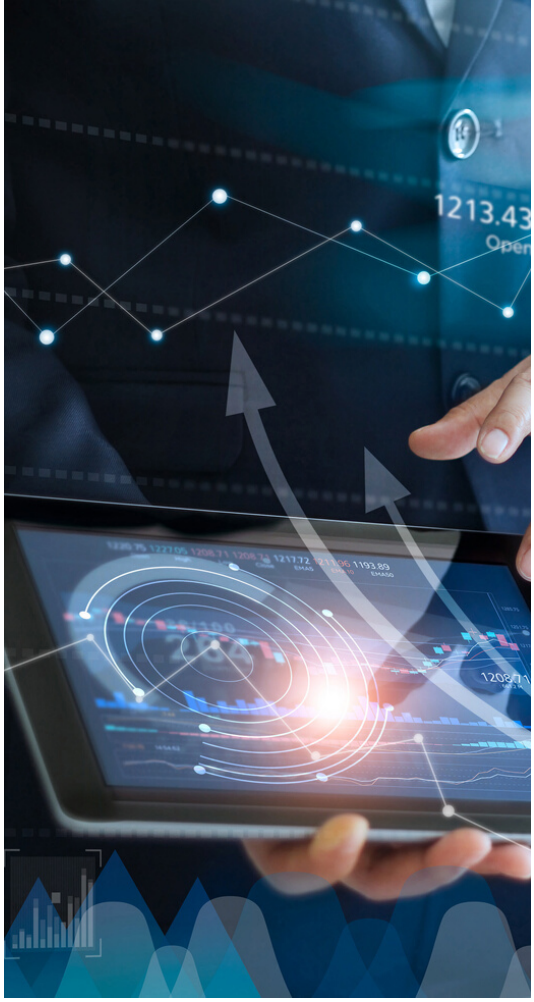


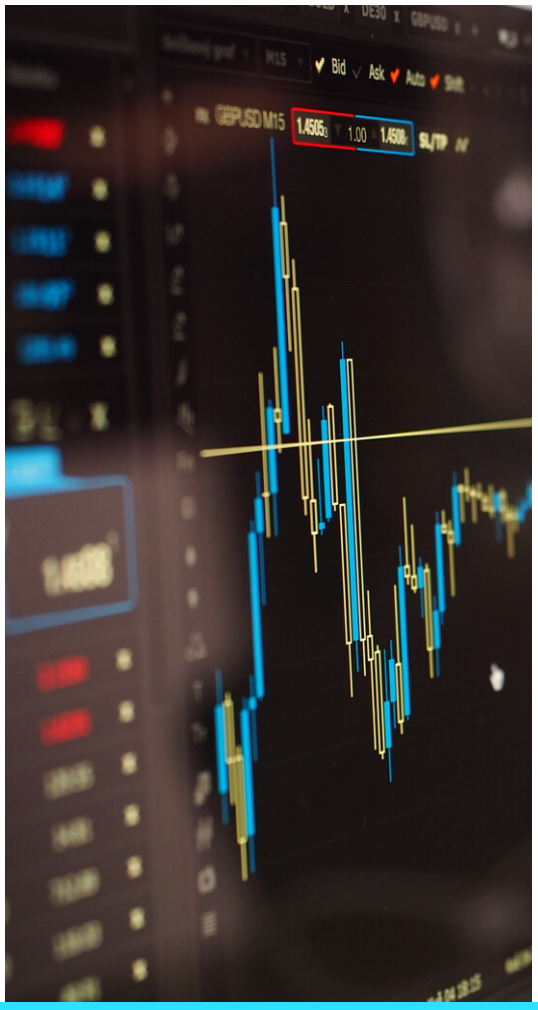
DLTH FUNDAMENTALS

And at the bottom, we have net income margins. Here DLTH is also at the top with 1.9% profit margins. To no surprise, this is not the most profitable industry to be in but at least DLTH is positive and can hopefully tap into new markets to keep growing this numbers once COVID19 settles down.



DLTH
TECH ANALYSIS





TECH ANALYSIS SUMMARY

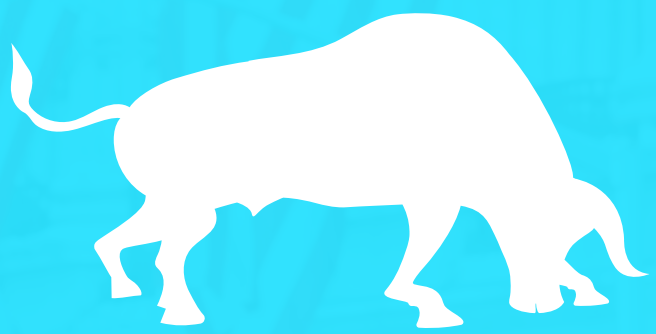
Based on the technicals, CUBE expects shares to make a push for the 20DMA and 200DMA of $7.21 and $7.31. We think shares may temporarily get passed $7.31 and hit $7.40 based on the hourly fibbonaci levels.

Ultimately we see this area being denied and shares pulling back to the $7.03 range where there is support. If this range does not hold, CUBE believes shares will drop to $6.59.

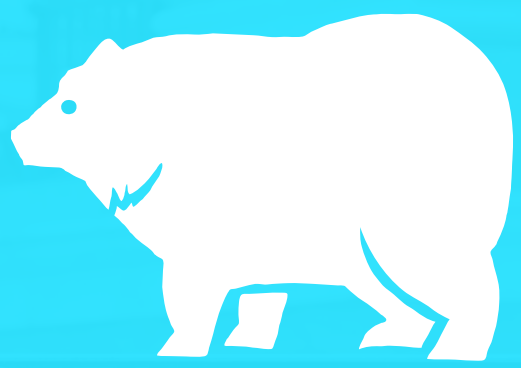
In the case that DLTH is able to break the 20DMA, 200DMA, and fibbonaci level we believe shares will head to $7.86.

We believe the $7s will be a big battleground between bulls and bears.

BULLISH OR BEARISH?



VS.



MORE BULLISH (POSITIVE)

MORE BEARISH (NEGATIVE)

cube

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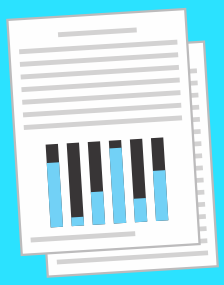

DLTH CONCLUSION

All in all, CUBE is neutral on Duluth (DLTH). We favor the company for their margins, unique marketing, niche products, and revenue mix but are unsure if management is making the right decision with growing their store locations.

We worry that this will dampen relatively strong margins, as it already has over the last couple of years, and we are also concerned that this is counterintuitive to tapping into their fastest growing market which is women. As we saw in Q1, their digital sales skyrocketed and much of it came from females. On top of this, female sales growth has been surpassing that of total sales for years.

DLTH's valuation is more than fair right now and we are not bearish on the company but rather have a different view on how they grow the business. We think they may be drawing the wrong conclusions from their data that retail leads to larger purchases as many across the retail space have been saying the exact opposite.

Other concerns circle around cash on hand and growing interest expenses. Thankfully, DLTH does have the capital there to tap into so solvency and liquidity should not be an issue. We simply find shares to be fairly valued given everything we discussed at this $7 range.

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