Gildan Activewear Inc (GIL CN): Hold Recommendation

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Date: April 21st 2021

Situation

Gildan Activewear is a mature business in a highly competitive, deflationary industry where cost drives profitability, and unethical labor practices are overlooked to improve the bottom line. Despite this the company has differentiated itself and adapted well in the race to the bottom price, remaining a sustainable leader while controlling costs through vertical integration. I believe a long position in GIL common shares presents a favorable risk/reward opportunity with upside optionality driven by:

1) **Effective implementation of an operational strategy designed to restructure the company into a simpler more efficient machine to increase margins**
2) **Renewed confirmation of ESG leadership as investors become increasingly selective towards ESG leading firms**
3) **Additions to production capacity and resumption of capital distribution programs through deleveraging operations.**

I believe this opportunity exists because the financial consequences of the COIVD-19 pandemic have coincided with dramatic changes in the company's operational structure, accelerating the effects of restructuring on operating margins while delaying the effects of capacity expansion.

Currently Canoe Financial holds 10,038 shares of Gildan Activewear which represents a 0.02% weighting in the EIT Income Fund (EIT-U CN Equity). Since entering the Gildan position on Dec 31st 2020, the stock has risen 16% from $35.59 back to pre-covid COVID levels (Fig. 1) which represents a more complex, less consolidated state of business operations.

On a proforma FY21E basis and at its existing cap stack, Gildan trades at a 3.8x EV/Sales multiple representing a sizeable premium to its peers (1.8x), a reflection of its sustainable operations and cost leadership (Fig. 2). **Assuming this premium remains warranted, Gildan is trading near its fair value.**

Ticker	**GIL CN**
Share Price	$41.43
52-Wk H / L	$16.91 - $42.92
YTD Total Return	18.41%
Proforma Shares Out	198,423
Options / RSUs	53
Total	**198,476**
FD Market Cap.	**$8,222,876**
+ Debt	1,345,091
- Cash	454,986
Enterprise Value*	**$9,112,982**
FY20A EV / Sales	3.08x
FY21E EV / Sales	3.76x
1mo. avg Volume	520,790

*Converted to CAD, values in 000's

Fig. 1 Gildan stock performance since 31/12/2020

Business Overview

Gildan Activewear ("Gildan", "GIL", "Company") is a vertically integrated manufacturer of apparel, headquartered in Montréal, Canada. The Company focuses on the manufacture and sales of activewear, underwear and hosiery. Gildan sells products through brick-and-mortar retailers, and is growing its online sales channel presence by leveraging networks such as Amazon to overcome prohibitive shipping costs. The Company also owns a portfolio of 15 retail brands which include the notable American Apparel brand. Over 90% of Gildan's sales are derived from self-manufactured products which all start from spinning cotton into yarn in the United States. Knitting, sewing and dyeing are primarily performed in Gildan owned facilities in Honduras, Dominican Republic and Bangladesh, although third-party sewing contractors in Haiti and Central America are used to supplement production.

Gildan's activewear products are sold in as blanks to wholesale to distributors, screen printers and embellishers. These wholesale distributors subsequently decorate the blanks with designs and logos for end consumers. Gildan sells activewear blanks, underwear and hosiery to retailers such as department stores, national chains, sport specialty and discount stores, as well as pure-play online retailers. Gildan also manufactures for leading global athletic and lifestyle brands such as Under Armor.

The majority of Gildan's sales are in North America (89%), with international sales mainly in Europe and Latin America (11%).

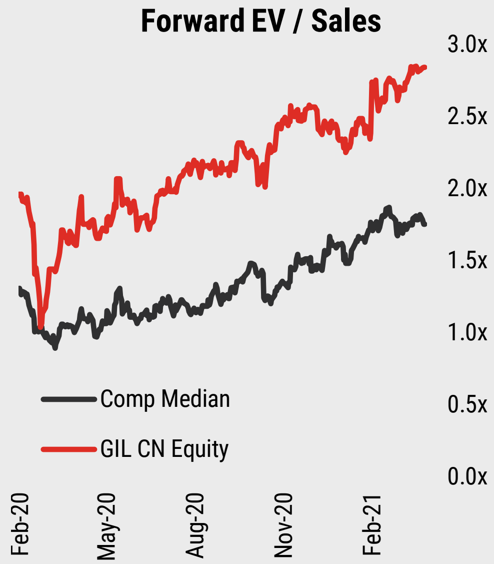

Fig. 2 Historical forward EV/Sales performance of GIL and peers

1. Parsimonious restructuring to drive margin expansion

In 2018 Gildan shifted its corporate strategy into a new direction with the implementation of a plan dubbed 'Back to Basics'. Management determined that Gildan was becoming excessively complex with 15 distribution centers in the United States that had built up through historical acquisitions.[1] The 'Back to Basics' strategy focused on the following three goals:[2]

1. Reduce complexity and lower SG&A
2. Simplify product offering and drive organic growth
3. Reduce manufacturing costs and improve gross margins

In Q1 2020, 11 of the 15 distribution centers were closed and all manufacturing facilities in Mexico were closed, with production shifted towards lower cost manufacturing in Honduras and Bangladesh. The remaining four distribution centers are concentrated across three neighboring states, further helping to reduce distribution costs which was a primary driver of the 19% y/y reduction in SG&A for 2020.[3] <u>Gildan's has been aggressively targeting operating margin expansion by reducing SG&A to less than 12% of sales as part of the 'Back to Basics' strategy (Fig. 3) but this goal continues to elude management</u>.

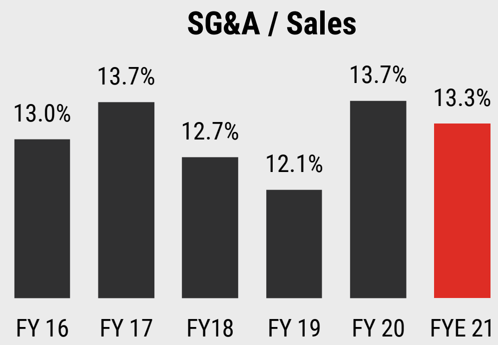

Fig. 3 Historical SG&A / Sales performance has trended towards the elusive sub 12% target; becoming disrupted by COVID-19.

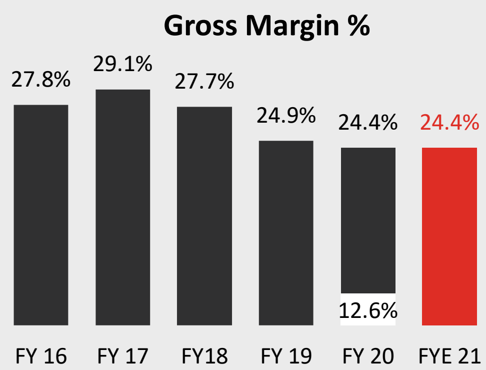

Fig. 4 Historical gross margin performance exhibiting a downward trend. Adjusted margin shown for 2020.

Further business simplifications have been completed in Q2 2020 with approximately 60% of imprintable clothing stock keeping units (SKUs) eliminated from the production line[4]. Management subsequently shifted its attention to retail, eliminating 70% of SKUs in Q4 2020. <u>These eliminations are expected to drive further reductions in manufacturing costs and bring Gildan closer to its long-term 30% gross margin target (Fig. 4)</u>.[5]

Point of sales (POS) growth during Q2 of 2020 was -80% q/q as a result of the pandemic, but Gildan saw an uptick in Q4 sales through their online channel, bringing sales within 30% of pre-pandemic levels. Online sales channels with large partners provide a low-cost alternative to POS, and access to a larger market which Gildan believes will also drive topline growth.

As Gildan expands their operating margins, they further strengthen their position as a cost leader, increasing efficiencies of vertical integration. Because of this, Gildan is able to price T-shirts at an ~11% discount to competitors (Fig. 5) while providing a high-quality cotton product of 4.5 oz/sq yd[6] which is considered more luxurious due to its lightweight compared with a typical 5.0 oz/sq yd T-shirt.[7]

Fig. 5 Gildan's pricing vs competitor pricing

[1] 2019 Institutional Investor & Analyst Conference Deck
[2] 2019 Institutional Investor & Analyst Conference Transcript
[3] 2020 Gildan 10k
[4] 2020 Q2 Earnings Call
[5] 2020 Q4 Earnings Call
[6] https://www.gildanbrands.com/en-us/gildan-64000
[7] https://toddshelton.com/blog/products/t-shirts/t-shirt-weight

2. The only apparel company to receive inclusion in a major ESG index

Gildan is the only apparel company listed on the Dow Jones Sustainability North America Index.[8] In Nov 2020 it was announced that the company was included in the updated member weightings, marking the 8th consecutive year that the Company was included in the index.[9] Currently Gildan ranks in the 91st percentile of S&P Global ESG scoring and holds a 73rd percentile rank from Sustainalytics.[10] Several ESG based ETFs include Gildan in their membership; notably Vanguard and Blackrock have allocated 0.03% and 0.62% exposure to Gildan through their VSGX and XESG CN tickers. An explosive inflow of capital to ESG funds in the last two years (Fig. 6) has helped fuel growth in companies with high ESG ratings. With Blackrock leading the path in ESG investments, many other large asset managers are beginning to follow suit,[11] driving prices higher for high scoring ESG firms

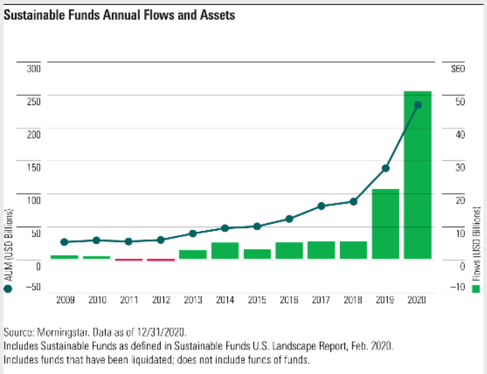

Fig. 6 Historical trend showing flow of funds from 2009 to 2020.[11] In 2020 flows reach $51.1 billion, a 138% increase over 2019.

The apparel industry is plagued with unethical work practices and poor controls on manufacturing. Over 1,000 people died in the 2013 collapse of a sewing factory in Bangladesh,[12,13] where manufacturing was illegally outsourced by a contracted third-party manufacturer for a Canadian based apparel line. In contrast to its peers, Gildan is fully vertically integrated which allows for a higher degree of control on manufacturing. By building and owning its own facilities Gildan has provided laborers with a comparatively safter environment, and has internal control on product quality. In Dec 2020, the *Fundación Hondureña de Responsabilidad Social Empresarial* awarded Gildan with their Corporate Social Responsibility award for the 13th year in a row. While this award is not unique (and was issued to HanesBrands for the 9th consecutive year)[14] it reflects a long-standing commitment of Gildan to deliver best practices in workplace standards.

[8] https://portal.csa.spglobal.com/survey/documents/DJSIComponentsNorthAmerica_2020_.pdf
[9] https://gildancorp.com/en/media/news/2020-dow-jones-Sustainability-index/
[10] Bloomberg
[11] https://www.morningstar.com/articles/1019195/a-broken-record-flows-for-us-sustainable-funds-again-reach-new-heights
[12] https://youtu.be/onD5UOP5z_c
[13] https://youtu.be/nxhCpLzreCw
[14] https://newsroom.hanesbrands.com/newsreleases/news-details/2020/hanesbrands-global-corporate-social-responsibility-achievements-earn-two-highly-recognized-awards-for-work-in-latin-america/default.aspx

3. Manufacturing optionality and capital distribution policy reinstatement

Management has indicated that additional sales capacity will be added in 2023 as Gildan's recent expansion efforts in Bangladesh are expected to come online in late 2022. This expansion has been delayed several times since it was originally scheduled to support sales in 2022. Management insists that its existing ground team in Bangladesh have a firm grasp on the cultural aspects of conducting business in a different nation, and understand the risks well. They have cited social distancing and lockdown measures as sources of these construction delays. The new plant is expected to support sales capacity expansion by $500M with labor rates and energy costs estimated to be 25% and 50% of Honduras manufacturing costs respectively.[2] This land originally purchased in 2019 is large enough to support an additional secondary expansion in Bangladesh (Fig. 7) which is roughly the equivalent size of the plant currently under construction in Bangladesh. Management has not alluded to constructing this secondary location, but has clearly indicated that the optionality to support an additional $500M in topline capacity exists. <u>This optionality would bring the total topline capacity additions in Bangladesh to $1Bn per annum.</u>

In 2020 management suspended dividend payments and the 5% p.a. repurchase plan initiated in their 2016 normal course issuer bid, as a result of pandemic uncertainty. Historically the quarterly dividends have grown by roughly 20% p.a. (Fig. 8) and share repurchasing has been quite consistent at the 5% level. During the Q4 2020 earnings call, management expressed commitment to the share repurchase and dividend distribution program, citing a strong liquidity position to support reinstatement. Despite a strong liquidity position, the net debt leverage rate ratio must fall within the historical range of 1.0x to 2.0x (Fig. 9). Currently this ratio sits at 3.5x largely due to Q2 of 2020. Reducing this ratio is managements top priority, and is going to be primarily driven by margin growth[5]. <u>By improving Adj. EBITDA margins, the net debt leverage ratio will be reduced without de-levering the balance sheet, enabling capital distribution plans to resume.</u>

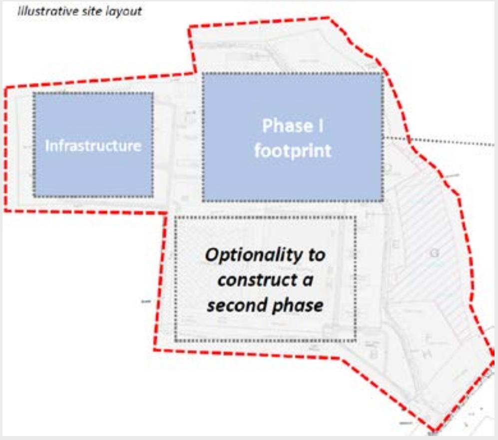

Fig. 7 Bangladesh land plot depicting room for second plant.

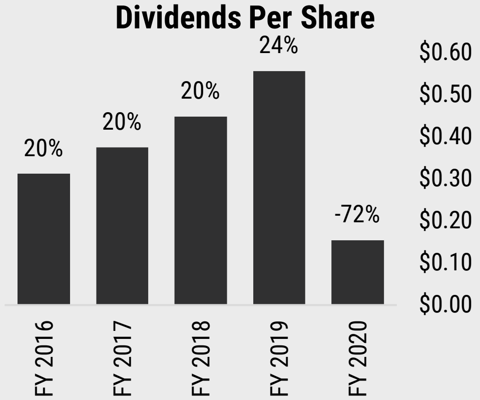

Fig. 8 Historical dividend per share growth stunted by COVID-19 liqudity protection measures.

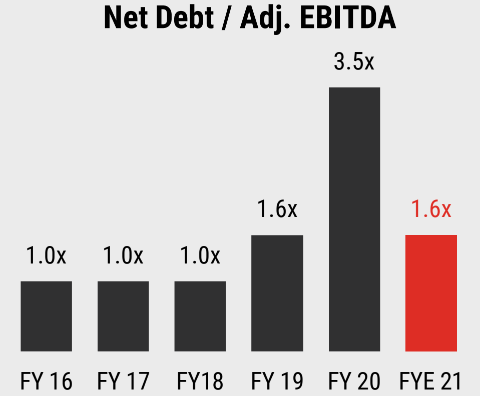

Fig. 9 Historical net debt leverage ratio has remained stable around 1.0x until COVID-19

Valuation & Risk Profile

Given Canoe Financials' current position in Gildan, holding onto the stock presents an interesting optionality potential with a reasonable risk profile. Management targets are focused on driving profitability by reducing costs and expanding margins. With control over the manufacturing chain from yarn to garment, Gildan not only enjoys compounded benefits from restructuring inside a vertically integrated supply chain, but also controls operational quality which directly impacts their ESG ratings. I believe that Gildan Activewear is fairly valued at its current Forward EV/Sales multiple which is in line with its historical premium to public comparable companies (Fig. 10).

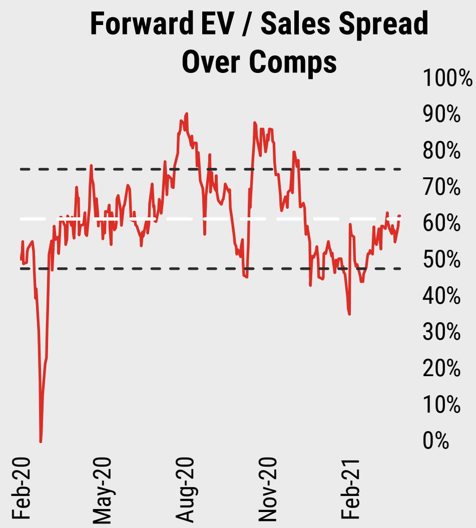

Fig. 10 Gildan's historical premium to comps over last year indicates it currently sits near the average premium.

Based on my reported findings, I applied a blended approach of DCF and multiple analysis to determine a risk reward profile of -10% to 17% (Table 1 and Table 2) at these current price levels. **I recommend that the stock is held in order to capitalize on possible upside optionality unless a better opportunity presents itself or a material adverse change in the business occurs.**

The full DCF model is available for download here

		Forward EV / Sales				
		2.6x	**2.7x**	**2.8x**	**3.0x**	**3.1x**
	$2,361	-14%	-10%	-5%	-1%	4%
	$2,485	-9%	-5%	0%	5%	10%
Sales	**$2,616**	-4%	1%	6%	11%	16%
	$2,747	1%	7%	12%	17%	22%
	$2,884	7%	12%	18%	23%	29%

Table 1 Implied premium/risk based on Gildan's forward EV/Sales with respect to comparable firms

		Terminal Growth Rate				
		2.0%	**2.5%**	**3.0%**	**3.5%**	**4.0%**
	7.3%	-15%	-9%	-3%	3%	10%
	7.8%	-16%	-10%	-4%	2%	9%
WACC	**8.3%**	-17%	-11%	-5%	2%	8%
	8.8%	-18%	-12%	-6%	1%	8%
	9.3%	-19%	-13%	-6%	0%	7%

Table 2 Implied premium/risk based on a DCF analysis using back-to-basics targets

Catalysts

- Announcement of construction for a 2nd manufacturing facility in Bangladesh
- Reinstatement of share repurchasing & dividend

Risks

- The majority of Gildan's manufacturing is performed internally but to meet demand, third party manufacturing is contracted primarily in Haiti and some other Central America locations.[3] Lack of oversight for third party manufacturing has been responsible for many public relations nightmares in the apparel industry. Gildan is no stranger to this having been accused of underpaying Haitian workers in 2014.[15]
- Gildan has a lot of analyst coverage, failures to resume dividend and share repurchasing programs within a timely manner could cause downside overreaction.
- Gildan management has committed to several margin expansion targets which are incorporated in the valuation presented. Failure to obtain these targets could cause material downside.

Source: All charts and data are sourced from Bloomberg L.P. and the author unless otherwise stated.

[15] https://www.thestar.com/news/world/2014/02/11/haitian_garment_workers_low_pay_has_them_still_going_hungry.html