Kogan.com's Best Bargain May Be Its Own Shares

Kogan to ride the online shopping wave as tide turns on brick-and-mortar retailing.

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Contents

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A Rare Opportunity to Invest in a Secular Winner at a Steep Discount

Extreme volatility in sales and earnings growth offers an attractive opportunity to invest in undervalued Kogan. The market can struggle to price high growth companies with uncertain earnings trajectories and Kogan is a prime example. Significant volatility in e-commerce demand, as Australians move in and out of lockdowns, adds a layer of complexity in estimating Kogan's earnings growth and worth. We acknowledge the near-term risks weighing on sentiment—including elevated marketing expenses and stock—but we expect the firm to navigate these temporary issues.

Our long-term outlook for relatively strong sales growth underpins our Kogan valuation. We forecast Australian retail to normalise in fiscal 2023 as most disruptions from the pandemic likely abate. Following negative growth, we expect e-commerce growth to revert to the long-term trend of high-single digits. While this is much lower than the 24% posted for the two years to fiscal 2021, we predict e-commerce to meaningfully outperform brick-and-mortar retailing sales growth over the long term. Kogan is well placed here—we expect the online pure-play's superior earnings growth to be largely underpinned by the structural shift away from physical stores and its ability to protect market share.

Key Takeaways

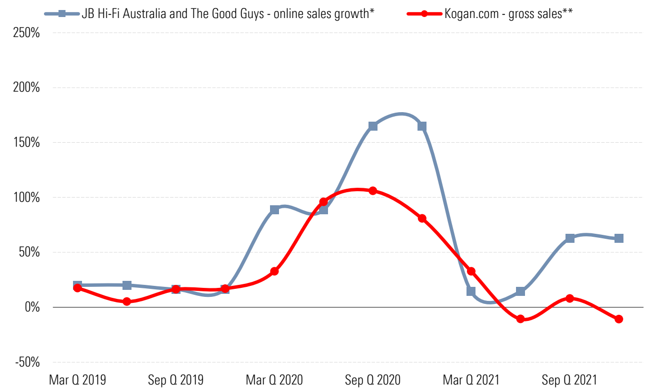
- We maintain our AUD 11.70 fair value estimate and no-moat rating. We estimate earnings to more than double in fiscal 2023, from a cyclical low of AUD 0.21 per share in fiscal 2022.
- Kogan remains leveraged to the long-term secular trend towards e-commerce and has a proven ability to protect and grow its market share, as evidenced by Kogan's market share recently increasing despite its key competitors JB Hi-Fi and The Good Guys growing online sales strongly.
- Catalysts for Kogan's share prices include a stabilisation of sales growth, a recovery in margins, and a reinstatement of the dividend. Greater than expected inflation could be a short-term wildcard—we expect CPI increases by 3.5% in fiscal 2022.

Companies Mentioned (Share Prices as of Feb. 8, 2022)

Name/Ticker	Economic Moat	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap (Bil)
Kogan.com KGN	None	AUD	11.70	6.25	High	★★★★★	0.65
JB Hi-Fi JBH	None	AUD	32.00	48.71	High	★★	5.50
Best Buy BBY	Narrow	USD	116.00	99.46	High	★★★★	23.47
Amazon AMZN	Wide	USD	4,100.00	3,228.27	High	★★★★	1,607.29

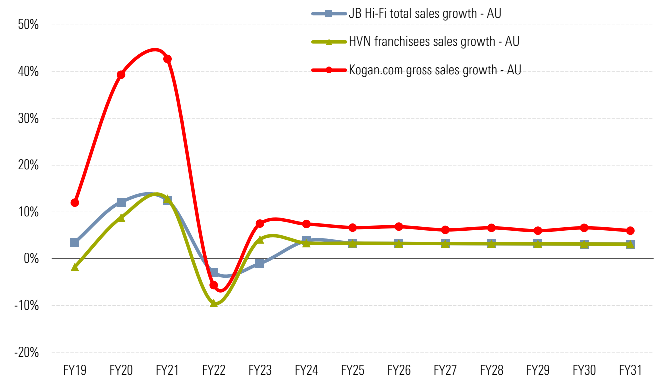
Exhibit 1 Our Thesis in Pictures: We See Kogan's Sales Growing at a 5-year CAGR of 5%, While Margin Expansion Drives 14% EPS CAGR

Kogan, Like Other Retailers, is Grappling with a Sales Boom Hangover…



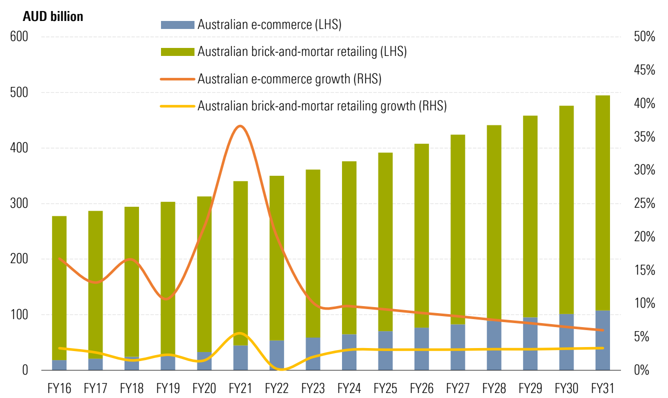
Source: Company filings, Morningstar estimates.

…But is Expected to Grow Sales Faster Than Omnichannel Competition



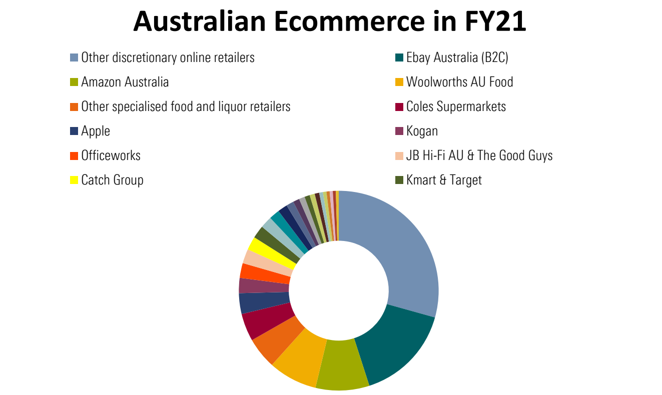
Source: Company filings, Morningstar estimates

Kogan's Outperformance Underpinned by Structural Shift to Online…



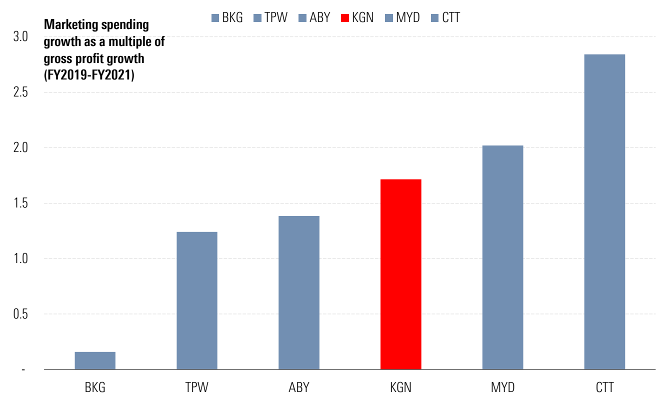
Source: NAB Online Retail Sales Index, Australian Bureau of Statistics, Morningstar estimates

…While Within the Online Channel Kogan Maintains Its Market Share



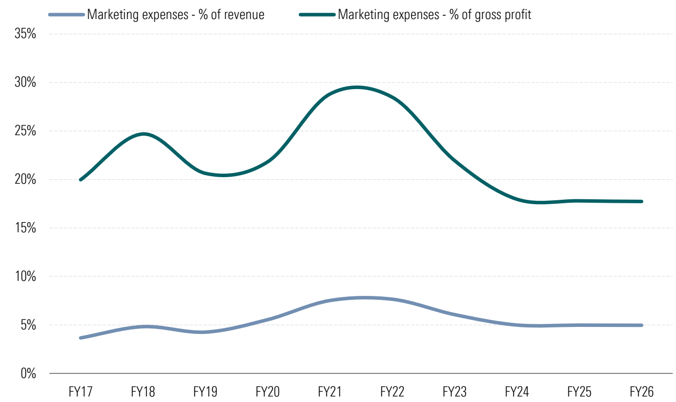
Source: Company filings, Morningstar estimates.

Sales Boom Saw Marketing Expenses Elevated…



Source: Company filings, Morningstar estimates

…But Kogan's Marketing Costs to Moderate as With Sales Growth

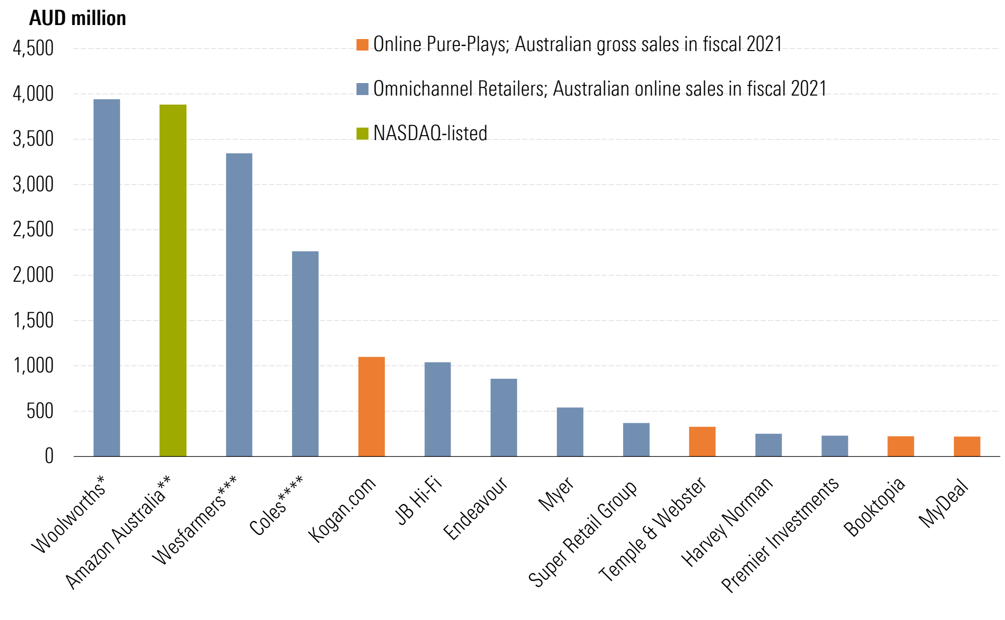


Source: Company filings, Morningstar estimates

Near-Term Earnings Weakness Creates Opportunity to Invest in a Long-Term Growth Story
In the eyes of the market, Kogan's earnings growth prospects peaked in late 2020, along with the share price of around AUD 25. Since then, market sentiment has soured, and the shares are down more than 70%. But we think the baby should not be thrown out with the bathwater. The market appears focused on the challenging near-term outlook for Kogan but is perhaps underestimating the material long-term growth potential of one of Australia's leading online retailers.

We discount the temporary earnings weakness. Investors should overlook the unusually volatile trading conditions and fixate on Kogan's attractive long-term potential, which underpins our intrinsic value. Our more constructive outlook on earnings growth, relative to the broader market, suggests shares in Kogan are materially undervalued and offer investors a substantial margin of safety. As Australia's largest listed online pure-play, Kogan is poised to benefit from the structural shift of retail sales to the online channel. We expect the online segment of the retailing market to grow strongly and outperform the traditional brick-and-mortar channel by an average of five percentage points over the next decade.

Exhibit 2. Kogan Is the Largest Australian-Listed Online Pure-Play With Virtually Undiluted Exposure to E-commerce



Source: Company filings, Morningstar estimates.
Note: *Woolworths AU Food, BIG W; **AMZN AU includes first- and third-party sales on its Australian website, as well as sales transacted on its U.S and Book Depository websites destined for Australia; ***Bunnings, Kmart, Target, Officeworks, Catch; ****Supermarkets, liquor.

Currently there is a land grab for online customers, and consequently, Kogan's marketing expenses have been elevated. However, in our view, the market is overestimating this impost in the long term. In our base-case valuation, we estimate Kogan scales back marketing expenses as the growth in the Australian online channel normalises and the competitive land grabbing eases. Longer-term, we expect Kogan to grow its sales in line with the greater discretionary e-commerce market as the market normalises.

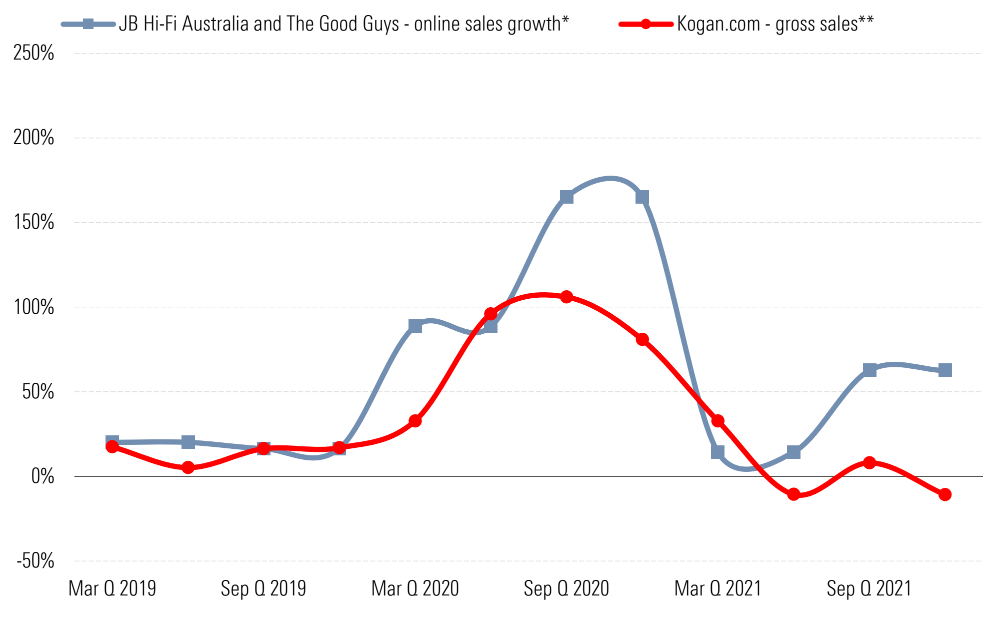
However, Kogan's management envisages a much brighter future, with twice the gross sales than our medium-term forecast. Compounding sales at a greater rate is conceivable with higher reinvestment rates, but we expect Kogan's top line growth potential to be constrained by diminishing returns on incremental marketing expenses, coupled with more moderate, albeit less volatile, industry sales and intense competition from omnichannel retailers and online pure plays, including Amazon Australia.

Kogan.com to Continue Growing from fiscal 2023, After a Year of Consolidating Exceptional Gains.

The top line growth of Kogan's Australian platform, or Kogan.com, faltered as the group lapped last year's booming sales growth. Gross sales growth peaked at over 110% in August 2020 but has weakened since and Kogan's share price has followed.

Back in mid-2020 we cautioned the market may be mispricing the prospects of slowing sales and that the "current elevated growth is unsustainable.[1]" While Kogan.com posted two quarters of declining gross sales in the June and December quarters of 2021, the contraction was largely due to lapping massive sales growth in the previous corresponding periods, which we estimate at over 80%.

Exhibit 3 We Expect Kogan.com's Sales Growth to Rebound Once the Boom Has Been Cycled.



Source: Company filings, Morningstar estimates.
Note: *Half yearly averages applied for JB Hi-Fi. **Gross sales is synonymous with gross merchandise value, or gross transaction value.

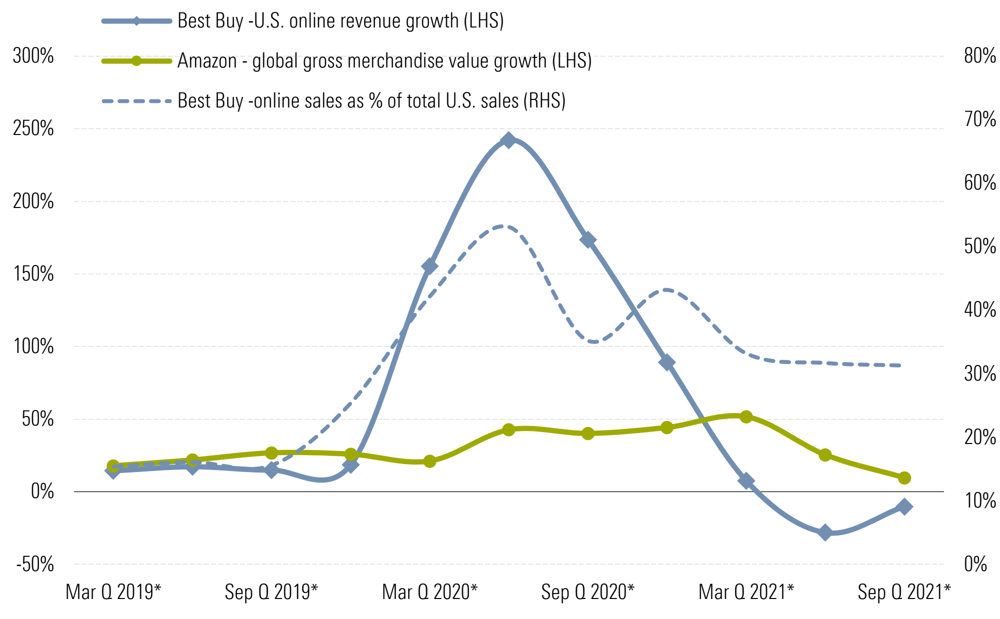
1 For more detail, please refer to our analyst note "Kogan's Recent Trading is Strong but Still Expected to Slow" published Aug.17, 2020.

The market is now skeptical on the long-term outlook for Kogan, given weak sales, but we think this is overly pessimistic. Kogan is not alone in cycling extraordinary sales growth. Kogan.com's largest domestic consumer electronics and home appliances competitor, omnichannel retailer JB Hi-Fi, reported a steep drop in online sales in the March and June 2021 quarters. Nevertheless, we estimate JB Hi-Fi has gained share online more recently. Its e-commerce growth of over 60% significantly outperformed Kogan.com as well as online pure-play Catch's Group in the first half of fiscal 2022—both reported virtually flat sales versus the previous corresponding period.

JB Hi-Fi's click-and-collect option facilitated by its extensive store network presented a valuable option for online customers during the omicron wave in late 2021. However, we estimate its online sales growth came at the expense of its in-store sales and we anticipate a material portion of its recent incremental online sales to revert to JB Hi-Fi's brick-and-mortar channel as foot traffic normalises, and JB Hi-Fi therefore will concede some of its online share gains in the online channel.

U.S online retailing dynamics paint a similar picture to Australia's. The largest U.S. consumer electronics retailer, Best Buy, reported two consecutive quarters of declining online sales growth in 2021. This was despite growth in its total sales, as some of its shoppers shifted back to its physical stores.

Exhibit 4 In the U.S., Best Buy and Amazon Are Also Experiencing a Post-Boom "Hangover"



Source: Company filings, Morningstar estimates
Note: *Best Buy's financial year starts at, or around, the beginning of February. Amazon's financial year commences on Jan. 1.

We expect Kogan.com to return to sales growth in the June 2022 quarter, after cycling the last quarter affected by the pandemic-induced online sales boom. We contend, market sentiment on

Kogan is overly bearish and share prices are overshooting on the downside, contrary to the market exuberance less than two years ago.

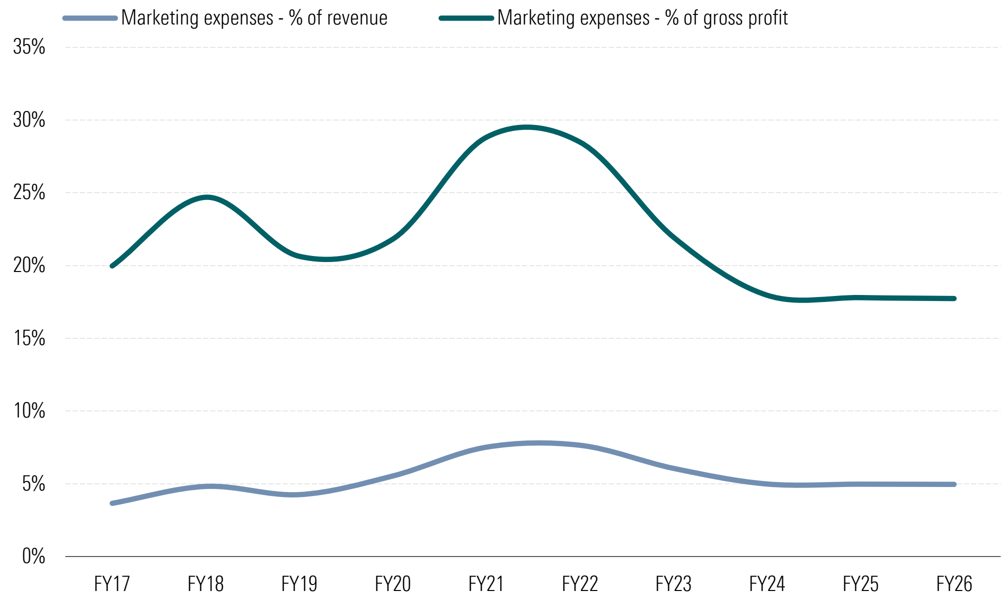
Temporary Spike in Marketing Expenses and One-Off Costs Hit EBITDA Margins Near-Term

The negative impact of the weakening sales growth on Kogan's profits has been exaggerated by unexpected trading volatility in calendar 2022. Unusually high inventory levels have not only significantly increased warehousing costs and lowered EBITDA margins by about 100 basis points in fiscal 2021, but also weighed on cash flows. We estimate inventories were elevated in the first half of fiscal 2022, some 40% higher than before the pandemic began in the first half of fiscal 2020—measured as total inventories divided by estimate first party sales. We expect logistic costs to remain elevated in fiscal 2022, before normalising in fiscal 2023.

Marketing expenses increased significantly in fiscal 2021. Measured as a percentage of gross profits, Kogan's marketing expenses increased by 200 basis points, driving underlying EBITDA margins down to 8% in fiscal 2021, from 10% in fiscal 2020. We forecast Kogan's advertising costs to stay high in fiscal 2022, given intense competition in the online channel as online players try maintaining the pandemic-induced boost to sales. However, after a year of consolidating its sales, we expect Kogan's marketing expenses to revert towards prepandemic levels from fiscal 2023. The industry's bloated online marketing budgets are unlikely to remain elevated in the medium term and reduced competition for ad space could further lower marketing costs.

Kogan is not an outlier in its reduced profitability. For instance, Wesfarmers' Catch Group cited significant marketing expenses and inventory clearance as key cost factors weighing on its profits in the first half of fiscal 2022. Catch expects to report a pretax loss of at least AUD 43 million. This represents a decline in pretax profit margins as a percentage of gross sales of 470 basis points compared with the previous corresponding period. For comparison, we estimate Kogan saw a decline in pretax profit margins as a percentage of gross sales of 380 basis points versus the previous corresponding period.

Exhibit 5 We Expect Kogan's Lower Sales Growth to Accompany Lower Marketing Expenses From Fiscal 2023



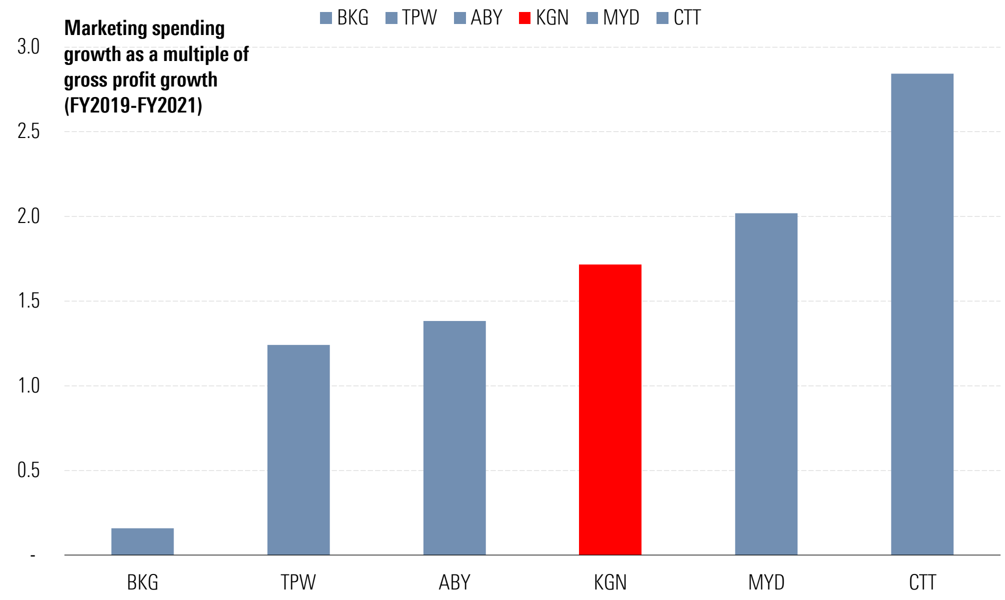
Source: Company filings, Morningstar estimates.

Many Online Retailers Grew Marketing Spend Faster Than Gross Profits During the Pandemic
Since the pandemic start, both online and traditional brick-and-mortar retailers have dramatically increased their online e-commerce marketing spend. While traditional brick-and-mortar retailers scrambled to offset store closures, pure-play online retailers sought to capitalise on the tailwind to their channel. Regardless, both pure-play online and brick-and-mortar retailers invested heavily to capture the fast-growing online commerce channel. For example, MyDeal and Cettire increased their marketing spend by over a whopping 1100% and 2700%, respectively, between fiscal years 2019 and 2021.

Between fiscal years 2019 and 2021, Kogan, Adore, Mydeal, Cettire, and Temple & Webster all saw their marketing spend grow at a multiple of the growth in gross profits. Due to the sudden rush into online marketing, like other places of the economy, a mismatch between demand and supply was created which resulted in marketing costs increasing and returns on marketing spend diminishing.

Nevertheless, there has been a distinct divergence in marketing efficiency among Australian listed pure-play online retailers. Whereas Booktopia grew gross profits around six times faster than its marketing spend, Temple & Webster increased its marketing spend at a similar rate to its gross profits, Cettire grew its marketing spend almost three times faster than its gross profits. Kogan was in the middle of the group, growing its marketing spend about 70% faster than its gross profits.

Exhibit 6 Marketing Spend Grew at a Multiple of Gross Profits During the Pandemic



Source: Company filings, Morningstar estimates.
Note: BKG = Booktopia; TPW - Temple & Webster; ABY - Adore Beauty; MYD - MyDeal.com.au; CTT - Cettire

However, this is not to say Kogan or the other pure-play online retailers have had negative returns on their marketing investments. We estimate that in absolute numbers, all the pure-play online retailers saw their gross profits increase by a higher dollar amount than their dollar amount spent on marketing.

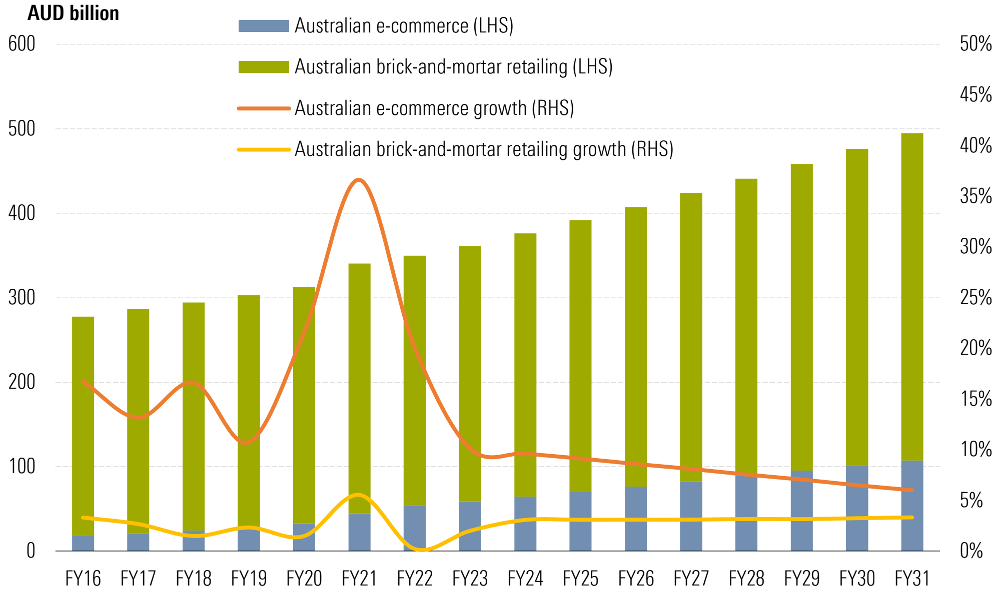
We see a divergence among the pure-play online retailers with Cettire and Temple & Webster seeing every dollar spent on marketing resulting in an average increase in gross profits of about AUD 1.60, and MyDeal, Adore and Booktopia seeing around a one dollar increase in gross profits for every dollar spent on marketing over the two-year period to fiscal 2021.

Although part of this marketing spend would result in maintaining or growing market share, and although there are certainly longer-term benefits from marketing than direct increases in gross profits, we expect a higher gross profit return to be an indicator of the presence of healthy returns on marketing spend. Kogan has been in the middle of the pack with a consistent increase in gross profits of around AUD 1.30 for every dollar spent on marketing over the two-year period to fiscal 2021.

Kogan Well Placed to Benefit From Structural Shift to E-Commerce

Our outlook on the Australian retail market is unchanged and we expect the online channel to do better than brick-and-mortar. Unlike physical stores, e-commerce experienced an acceleration of growth rates in fiscal 2020, as lockdowns inhibited foot traffic to non-essential retail stores and online sales began ramping up strongly from the month of March 2020.

Exhibit 7 Growth in E-commerce Consistently Outperforming Brick-and-Mortar Retail Sales.



Source: NAB Online Retail Sales Index, Australian Bureau of Statistics, Morningstar estimates

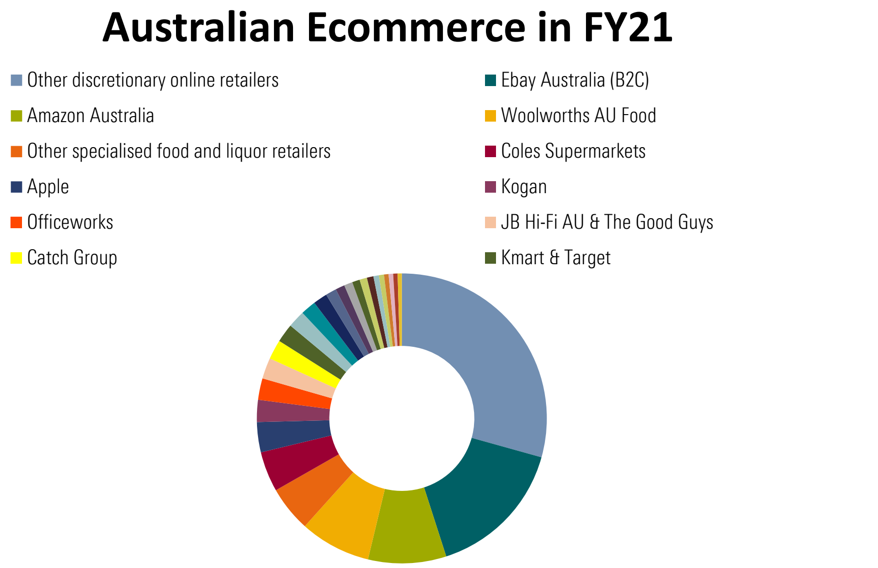
We expect the exceptionally high sales growth rates in fiscal 2021 to slow markedly in fiscal 2022. Fiscal 2021 was boosted by government stimulus and the removal of alternative consumption options like travel and entertainment. However, we forecast online sales growth to revert to our long-term growth trend from fiscal 2023, as customers return to stores and consumer spending moderates.

Despite the deceleration in online sales growth, we expect e-commerce to grow at a much faster rate over the next decade than in-store retailing sales. We estimate Australian online sales to increase at a CAGR of 9% to over AUD 100 billion by fiscal 2031, compared with a CAGR of 3% for brick-and-mortar sales. We forecast over 20% of all retail sales to transact digitally by fiscal 2031, compared with 13% in fiscal 2021.

Kogan and other Australian online retailers are well positioned to benefit from this structural shift in consumer shopping habits. We anticipate many Australian omni-channel retailers to rationalise their store networks as e-commerce grows and physical store profitability deteriorates.

We estimate Kogan.com is the fourth-largest Australian online discretionary retailer based on fiscal 2021 transaction values. Including grocers Woolworths and Coles, it is the sixth-largest Australian retailer overall.

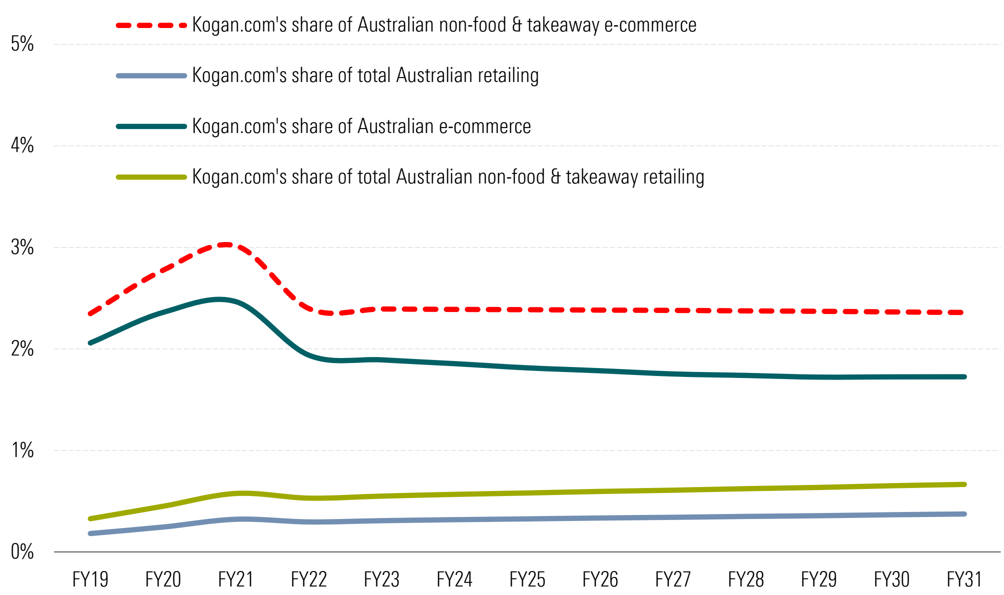
Exhibit 8 In Fiscal 2021, Kogan's Gross Sales Were Greater Than E-commerce at Officeworks, JB Hi-Fi, and Kmart



Source: Company filings, Morningstar estimates

We continue to forecast Kogan retains its share of the fast-growing Australian retailing channel over the next decade. We define Kogan.com's addressable market as Australian non-food e-commerce as it doesn't sell groceries or takeaway food.

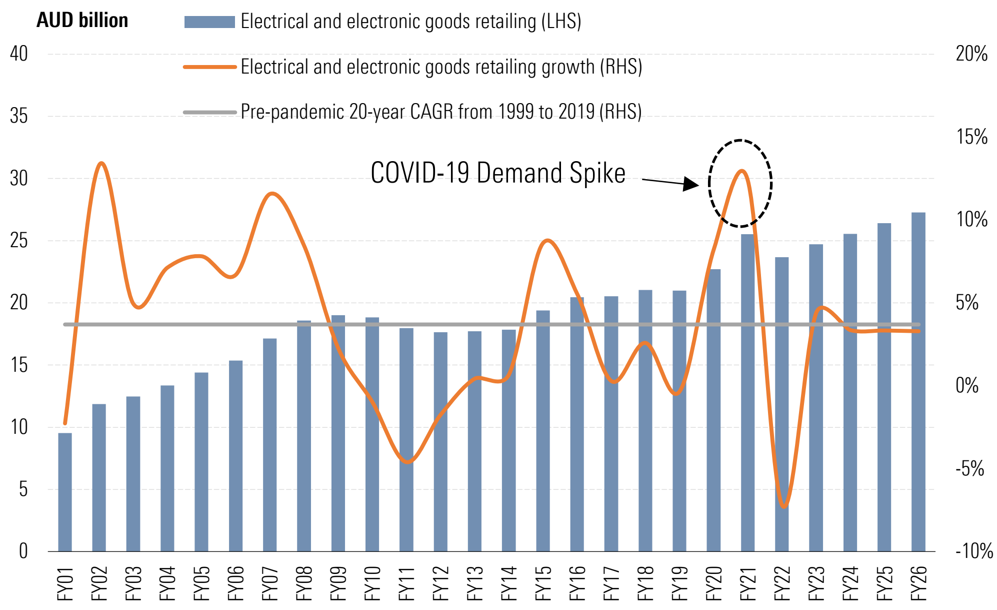
Exhibit 9 Kogan Should Hold Its Market Share Once Unusual COVID-19 Volatility Passes.



Source: Company filings, NAB Online Retail Sales Index, Australian Bureau of Statistics, Morningstar estimates

While we estimate Kogan.com's share of Australian non-food e-commerce was 3.0% in fiscal 2021—very similar to JB Hi-Fi's online sales—we expect its share to decline to 2.4% in fiscal 2022 with the cyclical downturn in demand for consumer electronics and home appliances--Kogan's top two categories. Both consumer electronics and home appliances experienced high levels of demand during the pandemic, as consumers invested in entertainment and workspaces in their homes with relatively slow replacement rates.

Exhibit 10 Waning Consumer Demand for Kogan's Top Two Sales Categories in fiscal 2022 Only Temporary



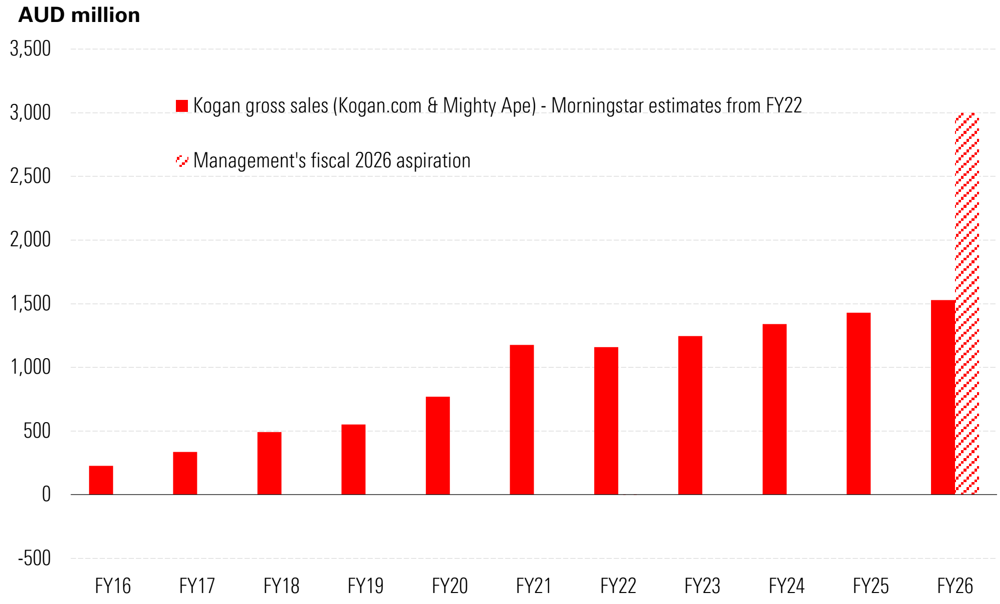
Source: Australian Bureau of Statistics, Morningstar estimates.

We expect declining consumer demand for consumer electronics and home appliances in fiscal 2022 to offset the ongoing underlying growth in overall Australian online retail spending. However, we forecast demand for consumer electronics and home appliances to normalise in fiscal 2023 and sales growth rates to revert to our long-term growth trend estimate, with growth rates averaging 3.6% between fiscal years 2022 and 2026. This is slightly below the 20-year average growth rate for the categories of 3.7%, according to the Australian Bureau of Statistics.

We forecast Kogan to grow its gross sales at a CAGR of 7% to AUD 1.5 billion between fiscal years 2022 and 2026, in line with the online retail market, excluding food. Kogan's management aspires to reach a much greater gross sales figure by fiscal 2026. At its annual general meeting in November 2021, Kogan announced an aspirational gross sales target of AUD 3.0 billion by fiscal 2026. This implies a CAGR of 21% based on fiscal 2021 sales, but an even more aggressive CAGR of 27% based on our fiscal 2022 gross sales estimate of AUD 1.2 billion—2% lower than in the prior fiscal year.

Meeting the aspirational goal would present material upside to our base-case fair value estimate, provided margins can be maintained. However, the introduction of a lofty goal also runs the risk of disappointing the market if the implied CAGR in gross sales is missed over the next few years.

Exhibit 11 Kogan's Aspirational Gross Sales Target Is Twice as Large as Our Base-Case Estimate



Source: Company filings, Morningstar estimates

Our gross sales estimates are based on a significant decline in return on marketing expenses compared with previous years. As channel growth declines and marketing spend experiences an overhang, we expect companies to have to spend significant sums on marketing to retain current sales levels. We assume marketing returns, defined as incremental gross sales for every dollar spent on marketing, to decline to 0.34 from fiscal 2022, and an average marketing expense to gross profit ratio of 21%.

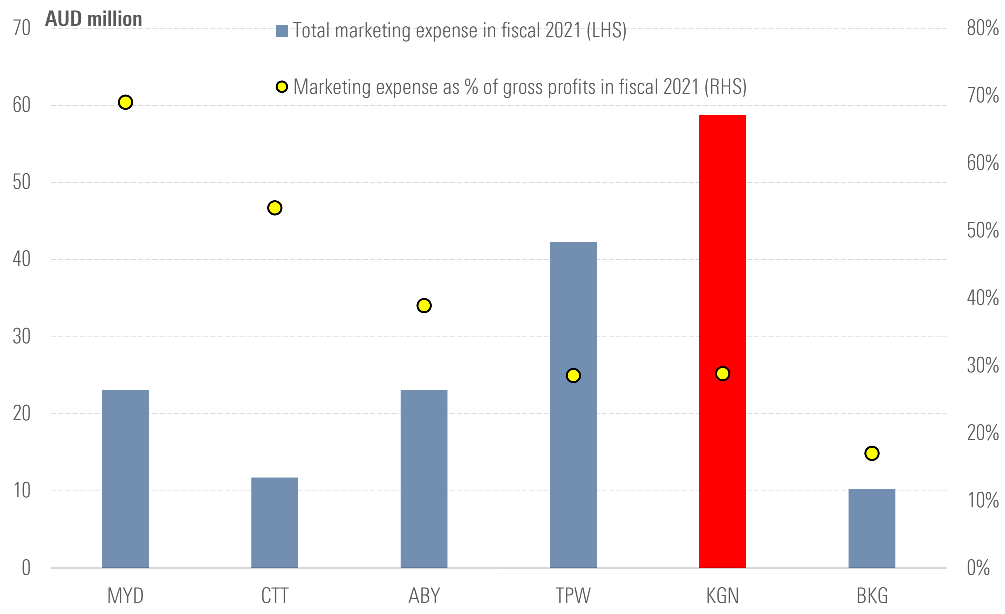
Compared with our base-case assumptions, we expect achieving management's gross sales target would require greater returns on marketing spend, higher marketing expense levels, additional acquisitions, material market share gains at the expense of physical stores, or a combination of these factors.

Potential to Reinvest More and Compound Gross Profits at a Greater Rate—but Not Our Base Case

Kogan has demonstrated disciplined marketing capital allocation, both during and prior to the pandemic. Although Temple & Webster and Cettire achieved higher returns on their marketing spend during the pandemic, we attribute the outperformance largely to their respective product categories—furniture and luxury goods—growing off a lower base. On average, Kogan has been increasing gross profits by about AUD 1.30 for every dollar spent on marketing during the pandemic.

Compared with its pure-play competitors, Kogan also has room to grow marketing as a percentage of gross profits, thereby potentially increasing the pace of compounding. While Kogan spent the most on marketing in absolute terms compared with its pure-play competitors in fiscal 2021, as a percentage of its gross profits it spent the least amongst its peers, except for Booktopia.

Exhibit 12 Kogan Has Room to Grow Its Marketing Expenses to Accelerate Top Line Growth



Source: Company filings, Morningstar estimates.
Note: MYD - MyDeal.com.au; CTT - Cettire; ABY - Adore Beauty; TPW - Temple & Webster; BKG = Booktopia

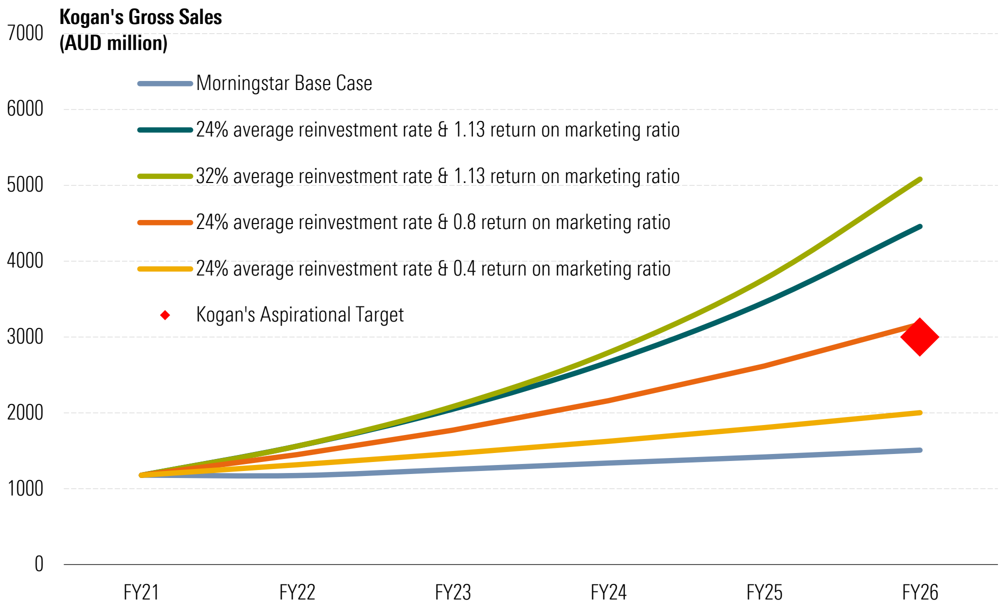
The combination of disciplined capital allocation in marketing, together with room to increase marketing as a percentage of gross profits, could provide Kogan with a compounding opportunity whereby additional marketing results in additional gross profits which results in additional marketing budget, and so on. However, we expect marketing spend to have diminishing marginal returns in the future as the online channel cycles down to trend growth. Based on our growth forecasts of the overall non-food online retailing market, and the underlying retail sales growth in Kogan's largest categories—consumer electronics and home appliances—we estimate Kogan's return on marketing spend will be around 0.4 once growth normalises in fiscal 2023. We calculate a

similar ratio of 0.37 for Kogan's Mighty Ape acquisition in December 2020, a further indication Kogan paid fair value for the New Zealand online player.
Nevertheless, we explored several scenarios in which Kogan could achieve its AUD 3 billion gross sales target. We've assumed that for every dollar Kogan invests in marketing, Kogan increases its gross profits by a set dollar amount between AUD 0.40, our base case, and AUD 1.13 which represents its average gross profit return from marketing spend since 2018. We also introduced a second factor, the reinvestment rates for these incremental gross profits.

If Kogan's reinvests 24% of its incremental gross profits back into marketing—which is Kogan's average of marketing spend as a percentage of gross profits since 2018—we estimate this to result in well north of AUD 4 billion in gross sales in fiscal 2026. This assumes an increase in gross profits of AUD 1.13 for every dollar spent on marketing, all else equal. Under the more likely return on marketing of AUD 0.40 in gross profits for every marketing dollar spent, we predict gross sales in fiscal 2026 to be AUD 2 billion. If Kogan reinvested 32% of its incremental gross profits back into marketing—in line with Australian pure-play online retailer peers over fiscal years 2018 to 2021—this could result in gross sales of more than AUD 5 billion in by fiscal 2026. This assumes an increase in gross profits of AUD 1.13 for every dollar spent on marketing. Without significant cost savings or operating leverage on fixed costs, Kogan's net profits would likely be around zero under this scenario during the five-year period.

We expect dividends to remain off the table for the foreseeable future. In August 2021, Kogan decided to temporarily pause its dividend to preserve its strong balance sheet, while it steps up investments in its business. We aren't opposed to Kogan reinvesting its capital instead of distributing it to shareholders if it generates a return greater than its cost of capital.

Exhibit 13 Kogan Could Achieve AUD 3 Billion in Gross Sales Under Several Reinvestment Scenarios



Source: Company filings, Morningstar estimates.

In our base-case scenario, we assume extrapolations of historical returns on marketing spend break down as the COVID-19-induced online spending boom subsides and the competitive environment intensifies, particularly driven by an aggressively expanding Amazon Australia.

For more detail, please refer to our special report "Amazon Upsizing Australia Spells Trouble for Consumer Electronics Retailers" published March 23, 2021.

Conducting a reverse calculation, we estimate that for Kogan to hit its AUD 3 billion gross sales target by fiscal 2026, and given a return on marketing spend of 0.8, Kogan needs to reinvest 24% of incremental gross profits back into marketing. However, current shares prices of Kogan's Australian peers suggest much lower returns on marketing, ignoring all other factors including size, category, and growth prospects.

Buy or Build? At Current Market Valuations We Prefer to Build

Kogan has another path to its AUD 3 billion gross sales target, namely acquisitions. Rather than increasing gross sales through marketing spend, Kogan can acquire competitors directly to increase gross sales. We measure the efficiency of this spend again as the return in incremental gross profits on a dollar spent. Kogan's Mighty Ape purchase saw an AUD 37 cent increase in gross profits for every dollar invested to acquire the company. In our view, this level is comparable to our estimate of Kogan's returns on marketing from fiscal 2023.

Exhibit 14 On Morningstar's Return Metric, Building Is Generally Cheaper Than Buying - Booktopia Most Attractive

	EV as of 1-Feb-2022	Gross profits in FY2021	Estimated acquisition price**	Return***
	AUD million	AUD million	AUD million	
Cettire	1,113	22	1,403	0.02
Temple & Webster	1,057	148	1,345	0.11
MyDeal.com.au	120	33	160	0.21
Adore	279	59	356	0.17
Booktopia	165	61	209	0.29
		Gross profits in FY2021 (pro-forma)	Acquisition price	Return**
Mighty Ape*		46	122	0.37
		Average incremental gross profits in year 1	Average marketing expenses in year 1	Average return**
Kogan - Morningstar estimate (average FY22-FY31)		19	56	0.34

Note: EV as of Jan. 31, 2022. *Mighty Ape pro forma gross profits in fiscal 2021. Acquisition cost is the headline purchase price as of Dec. 3, 2020. **Estimated acquisition price at 25% equity premium. ***Return defined as increase in gross profits from one incremental dollar spent on customer acquisition, either marketing or company acquisition.
Source: Company filings, Morningstar estimates.

However, compared with Mighty Ape, Kogan’s Australian peers largely trade at much steeper valuations when including takeover premia, implying Kogan would be better off pursuing gross profit growth organically. Booktopia screens as the least expensive on our return metric, offering AUD 29 cents in incremental gross profits for every dollar spent in a potential acquisition. We estimate MyDeal, Adore, and Temple & Webster generated AUD 21 cents, AUD 17 cents and AUD 11 cents, respectively, in incremental gross profits for every dollar spent. Cettire offers a paltry AUD 2 cents for every dollar invested. Although we acknowledge Kogan's target is a gross sales target and not gross profits, we would expect Kogan's experienced management to also pay attention to the cost of buying incremental gross profits, in addition to price to sales ratios, were it to run the ruler over potential targets.

Kogan First: An Underappreciated Dark Horse

In addition to Kogan’s transactional business growth as described above, we also see great potential in Kogan’s relational business growth through its Kogan First membership model. We assess that valuing Kogan purely through the lens of Kogan First could warrant an enterprise value which is higher than Kogan's current enterprise value of around AUD 650 million due to fast adoption of this high-quality recurring revenue stream.

Kogan First is a loyalty subscription service that allows users to pay less for products and delivery and gives access to exclusive offers. Kogan First has seen impressively fast user adoption since it launched in 2019. In December 2021, Kogan First had 274,000 members, up by 39% from Sept. 30, 2021 and more than double the level in June 2021.

Given that this impressive user growth is after the big jump in online sales, we consider it is likely that this user growth is resonating with Kogan's customers and will continue to do so in the post-COVID-19 era. We expect Kogan.com to continue converting its active customer base of over 3 million to Kogan First members. Management is targeting 1 million members by fiscal 2026, implying about one-in-three of its current active customers joins Kogan First, or a penetration rate of about one-in-10 Australian households. Although not a like-for-like comparison with Kogan First in terms of benefits and products on offer, we estimate Amazon has already signed up about 50% of all U.S. households as Amazon Prime members. We estimate Kogan will sign up some 500,000 members by fiscal 2026, equating to a CAGR of 14%.

Exhibit 15 Kogan First's Potential Recurring Revenue Stream Alone Could Be Worth More Than Kogan's Current EV

		WACC	P/E Multiple		
		7%	25	30	35
Kogan First Members	250,000	125	219	263	306
	500,000	250	438	525	613
	1,000,000	500	875	1050	1225

Source: Company filings, Morningstar estimates.

We understand Kogan First is profitable in absolute terms, with much higher spending rates per customer together with membership fees offsetting the negative impact of meaningful membership benefits crimping its gross margins.

Another benefit for Kogan creating a relatively sticky subscription business is the reoccurring revenue associated with successful membership models. Whereas discretionary retailers such as Harvey Norman and JB Hi-Fi trade at forward P/E ratios of 13 and 14, respectively, companies with less volatile and higher-quality recurring revenue streams like Telstra and TPG trade at forward P/E ratios of 27 and 34, respectively. In other words, Kogan may generate similar revenue and earnings as it does currently, but the higher quality of this revenue and earnings due to lower volatility may increase the multiple on these earnings.

We have explored several scenarios to value Kogan through the lens of Kogan First using different user numbers and different multiples. We assume Kogan will maintain prices of AUD 50 per year and that user benefits are offset by higher spending rates, as discussed above. Based on these assumptions, we surmise Kogan's valuation through the lens of Kogan First as a standalone business could be worth between AUD 219 million and AUD 1,225 million, with AUD 525 million representing a mid-case based on 500,000 members and a P/E multiple of 30.

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