STOCK PICKS AND PANS
10/3/2014

Danger Zone: Oxford Industries (OXM)

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life and MarketWatch.com.

Oxford Industries (OXM: $62/share) is in the Danger Zone this week. Oxford is a clothing retailer that sells clothing under the Lilly Pulitzer, Tommy Bahama, and Ben Sherman brands. Over the past decade, acquisitions have boosted top line results and EPS while return on invested capital (ROIC) and economic earnings have declined. Unbeknownst to many investors, Oxford's aggressive acquisition strategy has caused the company to pile up hundreds of millions in off-balance sheet debt. Investors doing their homework also know that management has been destroying value as evidenced by the millions of dollars in asset write-downs. The stock, which makes our Most Dangerous list for October, is down 25% so far in 2014 and has more room to fall.

Top Line Growth Disguises Flat Profits

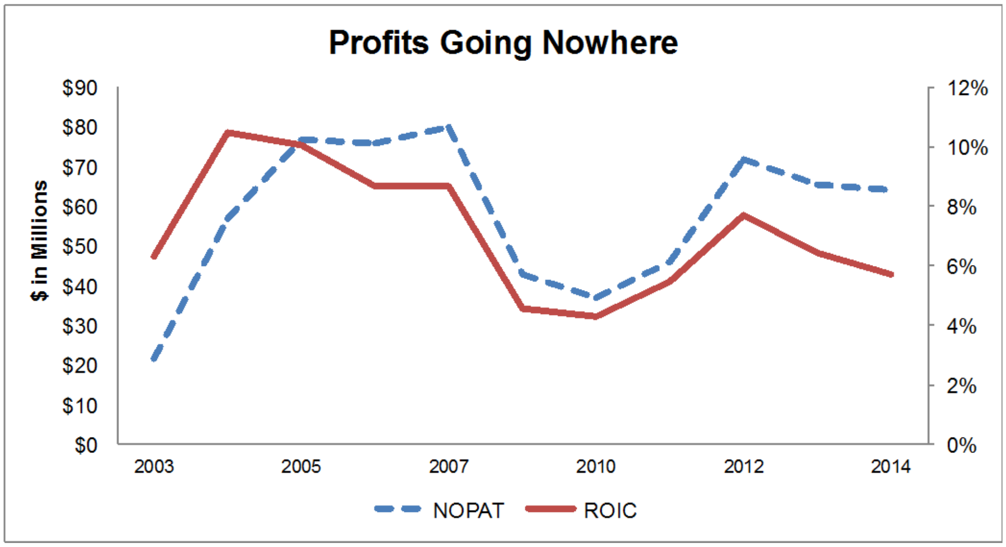
In looking only at Oxford's top-line growth, investors could be forgiven for thinking that this company is in excellent shape. In its most recent quarter, Oxford's Lilly Pulitzer brand posted 22% sales growth year over year, while Tommy Bahama reported solid growth at 3%. Oxford's two other segments, Ben Sherman and Lanier Clothing, have been sluggish. Ben Sherman sales tanked 18% last year while Lanier sales were up just 2%.

Same store sales for most of Oxford's brands are up in the most recent quarters, but this number has been lower than net sales growth as a result of the opening of new stores. For example, while Tommy Bahama net sales were up almost 11% last year, the number of new stores for the brand increased 24%. Lilly Pulitzer also saw its sales rise by almost 13% in 2013, but the number of stores climbed almost 50% from 15 to 23.

The long-term numbers tell a truer story about Oxford's capital allocation. Since 2002 — the year before the Tommy Bahama brand was acquired — Oxford has invested $942 million in capital to add just $55 million in after tax profits (NOPAT). Over this timeframe, the company has generated a net -$306 million in free cash flow. Despite growing sales, Oxford continues to struggle on the bottom line. The company's operating income is down 3% in 2Q14 over last year.

Oxford acquired its largest and best-performing brands, Lilly Pulitzer and Tommy Bahama, in 2010 and 2003 respectively. Figure 1 shows that these acquisitions coincide with the spikes in Oxford's profitability. Notice how that in each of the years following the acquisition, profits and return on invested capital have declined.

Figure 1: Acquisitions Lower ROIC



Sources: New Constructs, LLC and company filings.

As the company's long-term decline in ROIC demonstrates, Oxford's investment strategy has not been successful. The company has been destroying the value in its acquired brands and has been a poor user of its shareholders' money.

Hundreds of Millions in Hidden Debt and Value Destruction

Since 2010, Oxford's invested capital has risen by 41%. But as easily as Oxford grows its assets, it disposes of them. Oxford has accumulated asset write-downs of $300 million, or 61 cents for every dollar on its balance sheet. This sizable value destruction should be a warning flag to investors. It seems reasonable that the company may consider writing down its perennial-loser Ben Sherman brand in the future, which has posted an operating loss every year since 2008 and has $79 million in assets.

While Oxford reported $134 million in debt last quarter, this number is just the tip of the iceberg. Oxford is also hiding $320 million in off-balance sheet debt in the form of operating lease commitments. This $454 million in total debt is equal to over 45% of Oxford's market value and a staggering 72% of the company's total assets. Off-balance sheet debt helps Oxford keep its balance sheet looking healthy while hundreds of millions in cash obligations are hidden from investors.

Lagging the Competition

Oxford competes with other premium clothing retailers such as PVH Corp. (PVH), Perry Ellis (PERY), VF Corp. (VFC), G-III Apparel (GIII) and Ralph Lauren (RL). Despite management's frequent citation of an "undoubtedly difficult environment," Oxford's competition has been quietly outperforming the company over the past few years.

Figure 2: Lagging in Terms of Profitability

Company	Ticker	2-Year NOPAT CAGR	NOPAT Margin	ROIC
Ralph Lauren	RL	5%	11%	15%
VF Corp.	VFC	15%	12%	13%
G-III Apparel	GIII	26%	5%	11%
Oxford Industries	OXM	-5%	7%	6%
PVH Corp.	PVH	-2%	7%	5%
Perry Ellis	PERY	-31%	2%	3%

Sources: New Constructs, LLC and company filings.

Oxford's ROIC of 6% is comfortably in the bottom half of its industry, and unlike the strongest half of its competition its profits have declined over the past two years.

Oxford's management likes to trumpet the strength of its brands, but Oxford shares few of the characteristics of the strong brands of its competitors. Ralph Lauren, VF Corp. (7 For All Mankind, Vans, Nautica, Jansport) and G-III Apparel (Calvin Klein, Cole Haan, Dockers, Guess, Levi's, G.H. Bass) all have double-digit ROICs and have grown profits at a healthy rate over the past two years.

It follows that Oxford faces stiff competition in taking market share from these similarly upscale retailers. Tommy Bahama and Lilly Pulitzer are not new, upstart brands taking the market by storm. If taking market share proves as difficult as it appears on paper, Oxford faces an uphill battle in growing revenues without conceding severely on price or promotions, which will continue to depress profits.

Bull Case

Sales have been strong in some recent quarters. If Lilly Pulitzer and Tommy Bahama can continue to manage double-digit sales growth, the stock might rise or remain at its current level in the short term.

If Oxford announces plans to acquire another brand or competitor, the stock will rise. This is unlikely though, considering the company has just $6 million in cash and over $450 million in debt.

Valuation Ignores Recent and Long-Term Growth Trends

To justify its current valuation of $62/share, Oxford must grow NOPAT by 14% compounded annually for the next 12 years. We chose 14% because it equals revenue growth over the past two years. However, we underscore the fact that, especially for OXM, revenue growth does not translate into profit growth. Nevertheless, in this scenario, Oxford would eventually achieve a NOPAT of over $305 million, or almost four times the profits of its most profitable year, 2007.

More realistically, if Oxford can grow NOPAT by 10% compounded annually for the next 7 years, the stock is worth $36/share, a 42% downside. Even this less optimistic scenario seems unlikely when considering that Oxford has grown revenues by just 1% and net income by just 4% compounded annually over the past 15 years.

Oxford, in attempting to buy additional revenues, is killing cash flows and achieving progressively lower returns on capital. This strategy awards Wall Street and bankers but hurts shareholders. Those who do their homework can see that this company is tossing money at the wall and hoping it sticks. Do not be fooled by positive analyst ratings or recent revenue growth. Neither can create shareholder value as profits can.

Stupid Money Risk

Perhaps Oxford is trying to make itself an attractive candidate for a buyout. The company has two good brands that are generating healthy sales growth though they are not generating profit growth. However, a buyout seems extremely unlikely at Oxford's current lofty valuation. Investors can expect the stock to fall much further before expecting a buyout to save the day.

Short Interest

Short interest is 4,970,377 shares, or 3.8% of shares outstanding.

Insider Selling

Over the past 12 months, insiders have bought 20,357 shares and sold 121,964 for a net of 101,607 shares sold. This amount represents 1% of shares outstanding.

Funds That Hold OXM

No funds allocate significantly to OXM and earn our Dangerous-or-worse rating.

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3. A more accurate representation of the true underlying cash flows of the business.

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