This Footwear Stock Can Keep Running Higher

"In the short run, the market is a voting machine, but in the long run, it is a weighing machine."

-Benjamin Graham

Investors sometimes confuse a volatile stock for a volatile business. When a stock is up or down by 25% or more after nearly every earnings report, it's only natural to assume the company's cash flows are similarly volatile. Sometimes, though, a company's stock will move dramatically based on sentiment, geopolitical issues, or other factors even if the underlying business is stable.

Skechers has delivered consistent growth over the past five years, but its stock continues to swing wildly based on concerns over its long-term growth and, more recently, the potential impact of tariffs. Despite these swings, the stock has outperformed since we made it a Long Idea on 5/16/18 (up 20% vs. S&P 500 up 9%). The company's cash flows continue to grow, its valuation remains reasonable, and the stock remains a good pick for long-term investors. Skechers (SKX: $36/share) is this week's Long Idea.

Steady Profit Growth

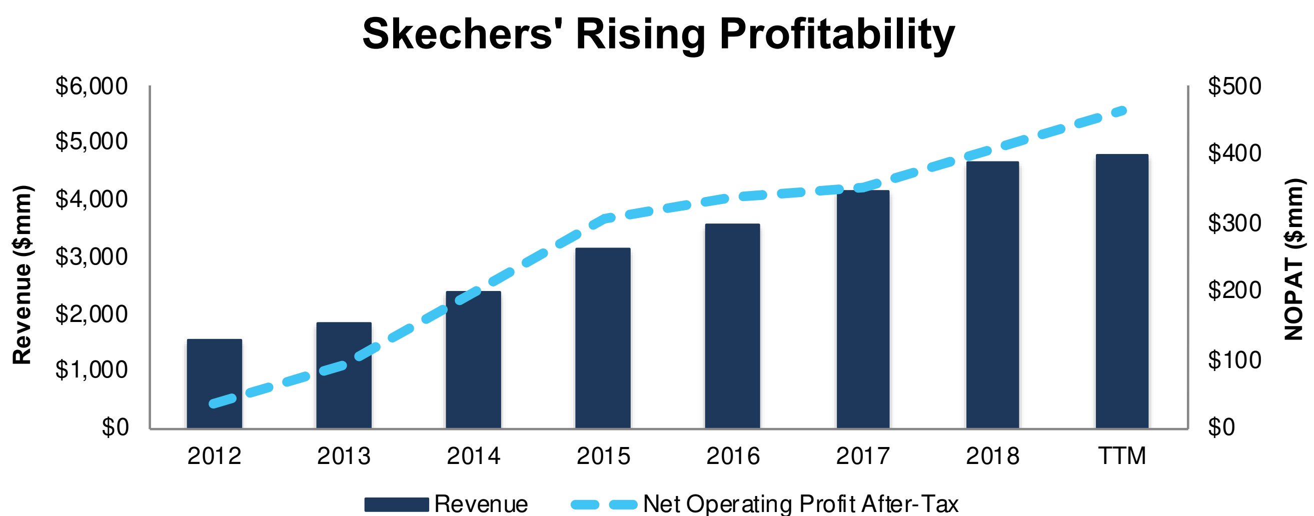
Skechers stock has been on a wild ride over the past five years. The stock gained 64% in 2015, fell 19% in 2016, gained 54% in 2017, and fell 40% in 2018. So far in 2019, the stock has rebounded and is back up 53%.

These swings create plenty of value opportunities for opportunistic investors. We first made Skechers a Long Idea on 4/20/2016. The stock quickly fell by 25% after its next earnings report, but it subsequently rebounded, and we closed the position on 3/21/18 for a 40% gain.

Two months after we closed our position, the stock fell by 30% – again on earnings – and we subsequently made the stock a Long Idea again. The position performed poorly in 2018, but the 53% gain so far in 2019 has it comfortably outperforming the market.

Through all of these swings in the stock price, the fundamentals of the business have remained remarkably consistent. From 2015 to 2018, Skechers grew revenue by 14% compounded annually and after-tax operating profit (NOPAT) by 10% compounded annually. Trailing twelve months (TTM) revenue is up 8% year-over-year and TTM NOPAT is up 17%. Revenue and NOPAT have improved every year since 2012, as shown in Figure 1.

Figure 1: SKX's Revenue and NOPAT: 2012-TTM



Sources: New Constructs, LLC and company filings

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Manufacturing and Distribution Strategies Drive Growth

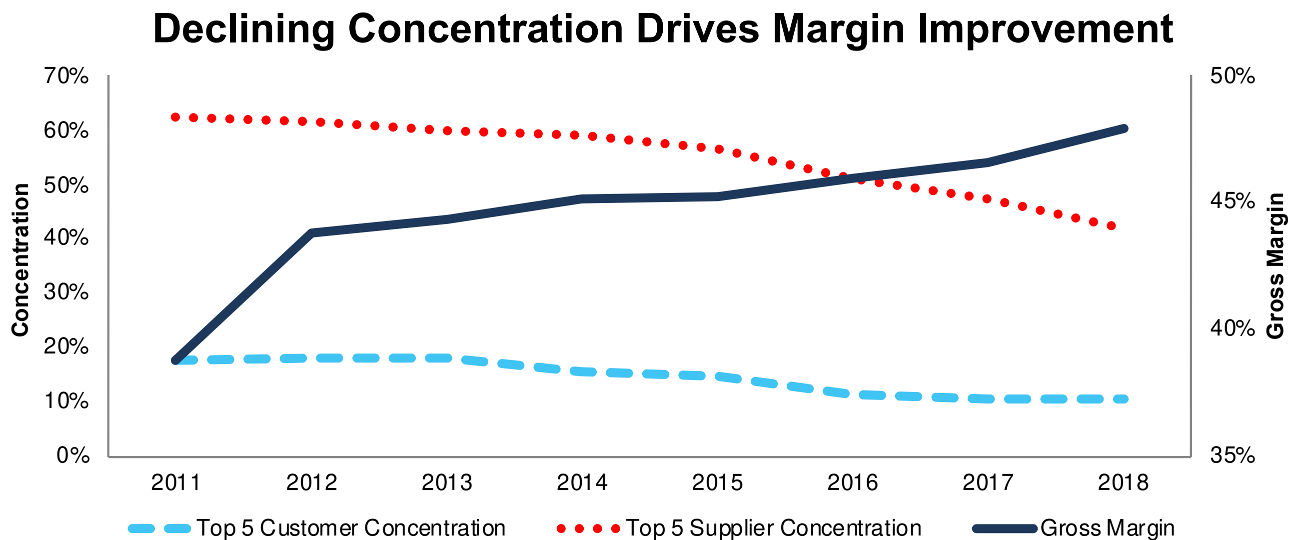
Since 2012, Skechers has dramatically expanded its international and company-branded retail (both brick-and-mortar and e-commerce) operations to reduce its reliance on the domestic and wholesale markets. The company recently opened its 3,000th store, more than triple its store count from five years ago. Meanwhile, the domestic wholesale segment has declined from 42% of sales in 2012 to 27% in 2018.

The shift to more retail and international sales provides Skechers with a number of key advantages:

- It gives the company more control over the marketing and branding of its products because it owns the customer experience and can customize advertising for different geographic markets.
- Retail has higher margins than wholesale because there's not a third-party taking a cut. Gross margin for the retail segment in 2018 was 59% compared to 48% for the wholesale business.
- It reduces the company's reliance on major domestic wholesale distributors, which lowers the risk that issues at a single distributor will impact cash flows and gives the company more leverage in negotiations with distributors.

In addition to taking more control over the customer relationship, Skechers has diversified its supplier base in order to support its retail and international strategy. As Figure 2 shows, the percentage of its products produced by its top 5 suppliers declined from 63% in 2011 to just 42% in 2018. The percentage of sales to its top 5 customers declined from 18% to 11% over the same time, while its gross margin improved from 39% to 48%.

Figure 2: Trend in Concentration and Margins Since 2011



Sources: New Constructs, LLC and company filings

Diversifying its supplier base provides similar advantages to diversifying its customer base. Skechers has greater flexibility to adapt its production to changing trends, it's not as vulnerable to disruptions to its supply chain if one or two suppliers has issues, and it has more leverage in negotiations.

We highlighted Skechers' declining customer and supplier concentration as a key bullish point in our original thesis, and it continues to drive improvements that give us confidence it can continue to grow profits in the future.

Targeting an Underserved Demographic Provides Competitive Advantages

In addition to expanding its manufacturing and distribution capabilities, Skechers has fueled its growth in recent years by targeting a demographic often ignored in the athletic shoe industry: women.

Nike (NKE), by far the largest company in the athletic shoe market, earns less than 25% of its revenue from women's products. Skechers, on the other hand, earns 54% of its revenue from women's products (compared to 33% from men and 13% from kids).

The company has sponsored a number of prominent female athletes, such as professional golfer Brooke Henderson and Olympic distance runner Kara Goucher, to solidify its position as a go to source for women's athletic footwear. UK fashion magazine Drapers has named Skechers the Women's Footwear Brand of the Year in three out of the past five years.

Nike is beginning to make a concerted push into the women's market, but its established branding may make that push more difficult. "It's very hard for a company like Nike ... that's very male, macho ... to make the turn" to focus more on women, Erich Joachimsthaler, CEO of branding agency Vivaldi, told CNBC.

Focused on Price and Quality

Skechers also differentiates itself from Nike by focusing on qualities such as price and comfort rather than trying to design the trendiest shoes.

Jens Jakob Andersen, a statistics teacher at Copenhagen Business School, recently undertook a systematic analysis of price and user rating for 391 different running shoes. His analysis delivered a striking result. Skechers' shoes were both the cheapest – averaging just over $90/pair – and the highest rated. Figure 3 has details.

Figure 3: Price and Customer Review Score for Running Shoe Brands

Sources: RunRepeat

Figure 3 shows how hard it will be for other shoe brands to take customers away from Skechers. It's hard to convince customers to pay more money to switch away from a product they already love.

Skechers may not have the "cool" factor of Nike or other high-end shoe brands, but its combination of quality and affordability gives it a strong, and defensible, market position.

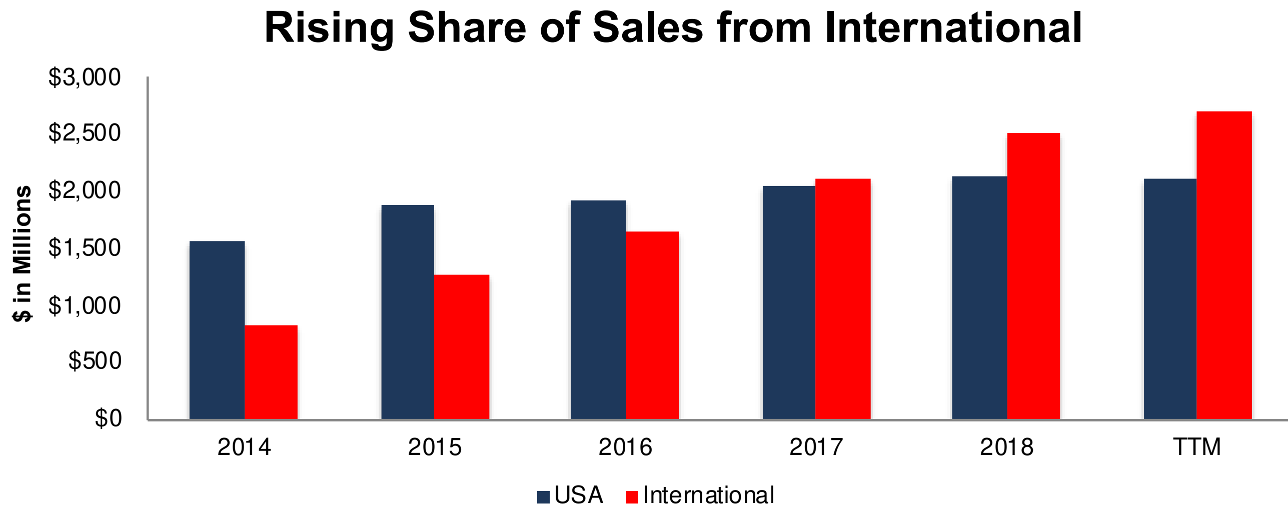
Bear Case: Tariff Threat is Overblown

Over the past two years, the threat of increased tariffs weighed heavily on Skechers' stock. The stock went up 20% in July of this year on the back of a strong earnings report, only to immediately crash back down after President Trump threatened new tariffs on China.

When investors respond to macroeconomic concerns like tariffs, they often ignore company-specific factors. In the case of Skechers, investors seem to be ignoring the company's international growth and diversified manufacturing base, which insulates it from most tariff pressure.

Skechers' share of revenue from the U.S. has declined from 66% in 2014 to 44% TTM, as shown in Figure 4.

Figure 4: Skechers Domestic vs. International Revenue: 2014-TTM



Sources: New Constructs, LLC and company filings

Skechers also has significant flexibility to avoid tariffs on the products it does sell in the U.S. As the company diversified its manufacturing base, it's shifted a great deal of its production out of China and into Vietnam. If the U.S. continues to raise tariffs on China, the company can shift the manufacturing of products it sells in the U.S. to Vietnam so they won't be subject to those tariffs.

CFO John Vandemore articulated this point recently at the B. Riley FBR Institutional Investor Conference, saying:

"we feel pretty good about the levers available to us to address any issue. It may not be immediate, but certainly withstanding a change in the existing tariff relationships between U.S. and China is not something that we're overly concerned about."

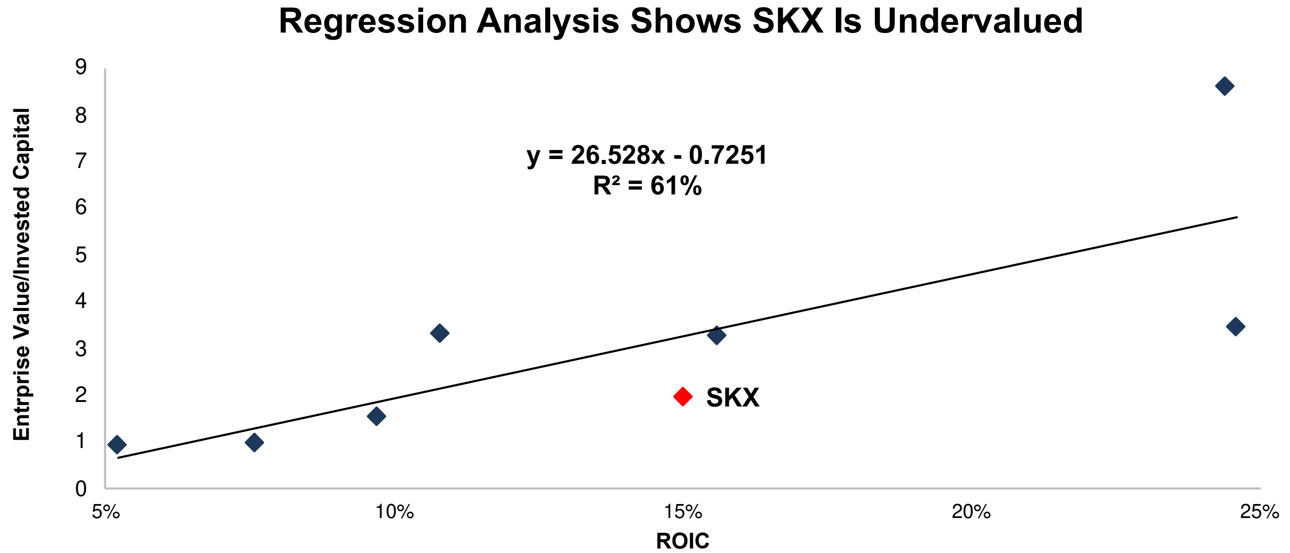
Skechers Remains Undervalued

Despite the 20% increase in the stock price since our original article (vs. the S&P 500 up 9%), Skechers remains undervalued.

Numerous case studies show that getting ROIC right is an important part of making smart investments. This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up. The technology that enables this research is featured by Harvard Business School.

Per Figure 5, ROIC explains 61% of the difference in valuation for the eight footwear stocks we cover. SKX trades at a discount to peers as shown by its position below the trend line.

Figure 5: ROIC Explains 61% of Valuation for SKX Peers



Sources: New Constructs, LLC and company filings

If the stock were to trade at parity with its peers, it would be worth $56/share – 55% above the current stock price. The company's current valuation implies that its ROIC will decline from 15% to 10%.

Skechers looks especially undervalued due its superior growth rate. The company's TTM revenue growth of 8% is well above the industry average of 5%.

The only company in the industry more undervalued than Skechers by this regression is Deckers (DECK), the maker of UGG boots and Teva sandals. While DECK looks very cheap, its profits have been much more volatile in the past, and it tends to be very sensitive to industry trends and fads.

Cheap Valuation Provides Upside

Skechers' cheap valuation means the stock still has significant potential upside. At its current valuation of $36/share, the stock has a price to economic book value (PEBV) of 1.0. This ratio means the market expects zero profit growth into perpetuity. Any profit growth Skechers delivers should translate into gains for shareholders. We use our reverse DCF model to quantify the stock's potential.

If Skechers can maintain its TTM NOPAT margin of 10% and grow revenue by 7% compounded annually for the next decade (in-line with industry forecasts) the stock is worth $54/share today, a 49% upside to the current stock price. See the math behind this dynamic DCF scenario.

That level of long-term revenue growth may seem overly ambitious, but it's significantly below Skechers' 12% revenue CAGR over the past decade and 13% revenue CAGR since 1999.

Even if you do think Skechers' growth appreciation period (GAP) is shorter than 10 years, the DCF scenario linked above shows that just 5 years of 7% growth at current margins justifies a fair value of $45/share, a 25% upside to the current stock price.

Sustainable Competitive Advantages That Will Drive Shareholder Value Creation

Here's a summary of why we think the moat around Skechers' business will enable the company to generate higher profits than the current valuation of the stock implies. This list of competitive advantages helps SKX offer better products/services at a lower price and prevents competition from taking market share.

- Strong brand reputation for quality and affordability
- Highly diversified manufacturing and distribution capabilities
- Unique marketing to an underserved demographic

What Noise Traders Miss with SKX

These days, fewer investors focus on finding quality capital allocators with shareholder friendly corporate governance. Instead, due to the proliferation of noise traders, the focus tends toward technical trading tends while high-quality fundamental research is overlooked. Here's a quick summary for noise traders when analyzing SKX:

- Stock volatility obscures steady growth in revenues and profits.
- Lack of "cool" factor doesn't matter. Skechers has a much different value proposition than Nike and other premium footwear brands.
- International expansion and diversified manufacturing base allow Skechers to minimize tariff threat

Catalyst: "Retail Apocalypse" Could Help Skechers

While the retail apocalypse narrative has been overblown, it's certainly true that a significant number of brick-and-mortar retailers – particularly poorly run retailers – are closing stores and going bankrupt.

Skechers' investment in its direct-to-consumer retail operations means these store closures can be an opportunity for more growth and margin expansion.

In particular, the bankruptcy of Payless ShoeSource, which closed all of its 2,300 U.S. and Canadian stores this year, creates an opportunity for Skechers to grow its store count by expanding into the areas that Payless has vacated.

Replacing a former Payless location with a Skechers store gives Skechers greater market share (since it doesn't have to share shelf space) and higher margins. As other brick-and-mortar retailers struggle, Skechers should have more opportunities to capture their business and grow its own direct-to-consumer operations. COO David Weinberg outlined this strategy on the company's Q2 earnings call. He told investors:

"As some of the weaker links move away, those that are left move stronger and will pick up the slack and will continue to grow."

If Skechers can capitalize on the decline of weaker retail brands, it should be able to deliver the profit growth necessary to send shares higher.

Corporate Governance Could Be Improved

Skechers gives little detail about its executive compensation practices. Annual incentives are tied solely to net sales growth. While sales growth doesn't take into account the importance of profitability or the balance sheet, it is harder to manipulate than other common target metrics such as Adjusted EBITDA.

Long-term equity grants are made periodically and are only time-restricted, with no performance conditions for vesting. We would like to see Skechers tie long-term compensation to ROIC so that management does not fall into a "growth at any cost" mindset that ends up destroying value for shareholders. There is a strong correlation between improving ROIC and increasing shareholder value, and tying exec comp to ROIC ensures that executives' interests are properly aligned with shareholders.

However, Skechers' compensation plan has not led to shareholder destruction so far. The company has grown economic earnings, the true cash flows of the business, from $29 million in 2007 to $233 million TTM.

Buybacks Provide Minimal Yield

Skechers continues to invest the majority of its cash flow into new retail locations and distribution facilities, so it does not return much capital to shareholders. The company does not pay a dividend, but it has bought back $112 million (2% of market cap) worth of shares over the past 12 months. As of June 30, the company had $20 million remaining on its repurchase authorization.

Insider Trading and Short Interest Trends are Mixed

Over the past twelve months, insiders purchased 641 thousand shares purchased and sold 1.2 million shares, for a net effect of 638 thousand shares sold. These sales represent less than 1% of shares outstanding

There are currently 8 million shares sold short, which equates to 6% of the float and 3 days to cover. Short interest has declined by 12% over the past month.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst[1] findings in Skechers' 2018 10-K:

Income Statement: we made $209 million of adjustments, with a net effect of removing $107 million in non-operating expense (2% of revenue). We removed $51 billion in non-operating income and $158 million in non-operating expenses. You can see all the adjustments made to SKX's income statement here.

Balance Sheet: we made $2.3 billion of adjustments to calculate invested capital with a net increase of $515 million. You can see all the adjustments made to SKX's balance sheet here.

Valuation: we made $2.3 billion of adjustments with a net effect of decreasing shareholder value by $1 billion. Despite this decrease in value, SKX remains undervalued. You can see all the adjustments made to SKX's valuation here.

Attractive Funds That Hold SKX

There are no ETFs or mutual funds that allocate significantly to Skechers and earn our Attractive-or-better rating. Investors looking for exposure to SKX should buy the stock directly.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

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2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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