Disciplined Growth Makes This a Quality Holding

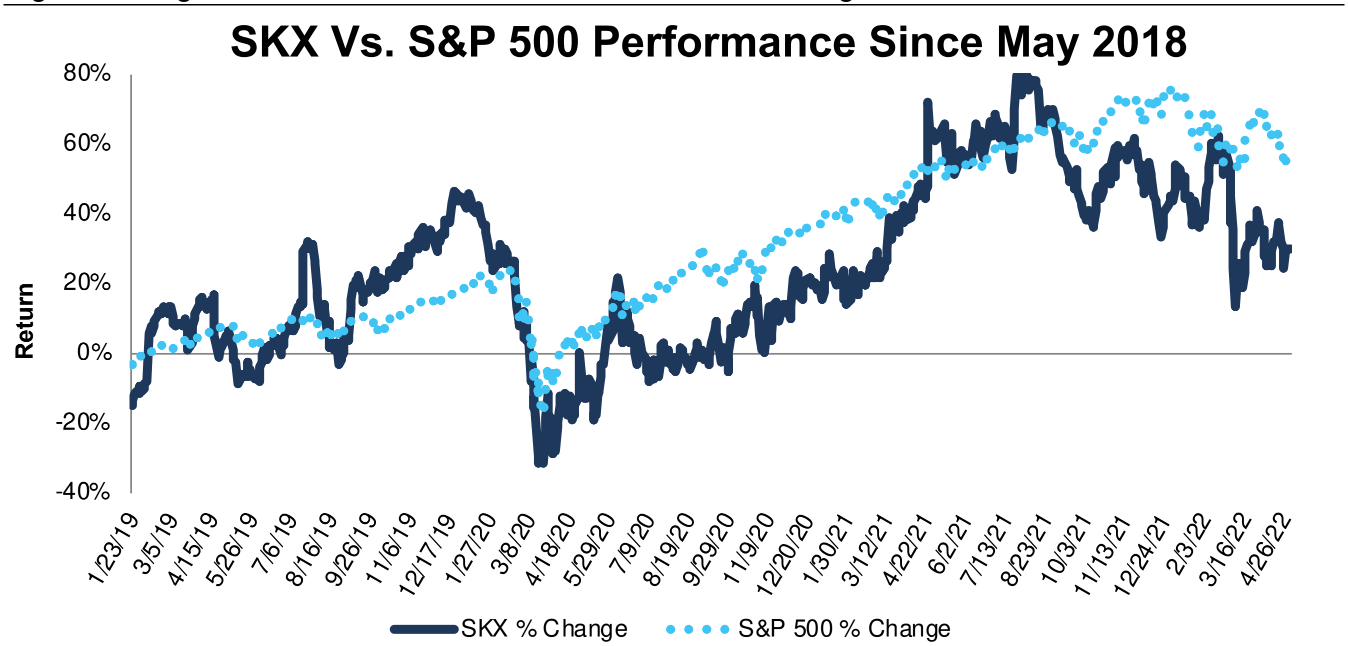
We first made Skechers USA, Inc. (SKX: $39/share) a Long Idea in April 2016 and closed the position in March 2018 to lock in its 5% outperformance of the S&P 500. Shortly thereafter, we made the stock a Long Idea again in May 2018. Since then, the stock is up 29% compared to a 53% gain for the S&P 500. The stock still presents excellent risk/reward and could be worth $70+/share today – a 79%+ upside. See our most recent report from April 2021 on Skechers here.

This report leverages our cutting-edge Robo-Analyst technology to deliver proven-superior[1] fundamental research and support more cost-effective fulfillment of the fiduciary duty of care.

Skechers' Stock Has Strong Upside Based on:

- the company's large physical store footprint
- consistent market share gains
- large scale advantages the company enjoys as the third largest global footwear brand
- ability to reach its niche market with comfort and value
- current valuation of the stock implies profits will permanently fall 20% below current levels.

Figure 1: Long Idea Performance: From Date of Publication Through 5/2/2022



Sources: New Constructs, LLC

What's Working

Stores Drive Growth: Skechers operates a wholesale business that supplies traditional department and specialty retail stores. Additionally, Skechers operates a direct-to-consumer segment that boasts a large network

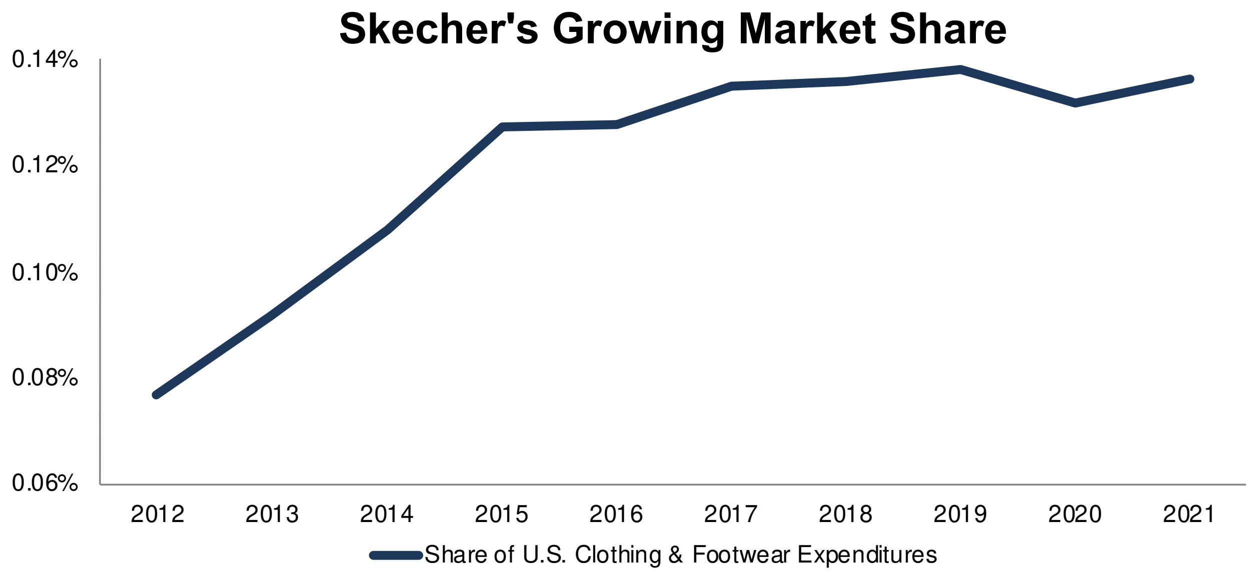
[1] Our research utilizes our Core Earnings, a more reliable measure of profits, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan and published in The Journal of Financial Economics.

of 4,308 Skechers-branded stores across the world. The number of Skechers stores is more than four times the ~1,048 global retail stores of footwear giant Nike (NKE).

Skechers' large distribution network is a key advantage in the highly fragmented apparel and footwear market. While there are few barriers to entry in the footwear industry, reaching customers in the way Skechers can is much more difficult. Skechers' strong distribution network has fueled the company's sales and profit growth historically and positions it for continued growth going forward.

Market Share Gains: Skechers is the third largest footwear brand in the world and the company is still growing. The company's U.S. sales grew from $1.1 billion in 2012 to $2.6 billion in 2022, or 10% compounded annually. Over the same time, Skechers' share of U.S. clothing and footwear expenditures rose from 0.08% to 0.14%, per Figure 2.

Figure 2: Skechers' Share of U.S. Clothing and Footwear Expenditures: 2012 – 2021



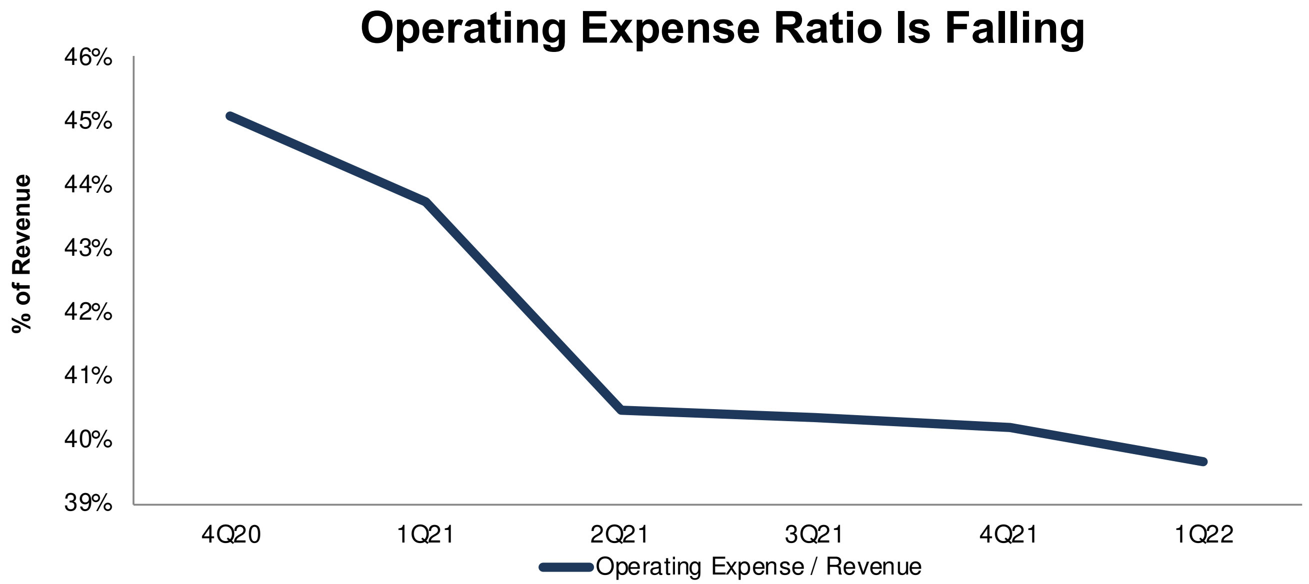
Sources: New Constructs, LLC, company filings, and Statista

International Sales Are Even Stronger: Skechers has a strong global brand in over 180 countries. While the company's domestic business is strong, its international segment accounted for 57% of total sales in 1Q22 and is growing even faster than its domestic segment. Since 2016, Skechers' international revenue grew at an 18% CAGR, and last year alone, the company's international revenue rose 37% year-over-year (YoY).

Looking ahead, if Skechers can grow sales in line with its historical rates, the company is positioned to grow its share of the global casual footwear market, which Research and Markets expects to grow at just a 2.6% CAGR through 2026.

Costs Are Falling: The company's disciplined approach to growth differs from many of its competitors. Allbirds (BIRD), for example, adopted a "grow-at-all-costs" strategy. Skechers, on the other hand, is growing revenue and gaining market share while lowering its operating expense ratio. Skechers' trailing-twelve-month (TTM) operating expenses as a percent of revenue have fallen quarter-over-quarter (QoQ) in each of the past five quarters, from 45% in 4Q20 to just under 40% in 1Q22.

Figure 3: Skechers' Operating Expense as Percent of Revenue: 4Q20 – 1Q22



Sources: New Constructs, LLC and company filings

Core Earnings Keep Growing: Skechers' top-line growth gains also leads to consistent bottom-line results. Skechers improved Core Earnings YoY in nine of the past ten years with only 2020 experiencing a YoY decline during that time. The company's Core Earnings rose from $6 million in 2012 to $434 million in 2021.

What's Not Working

Highly Competitive Industry: The footwear industry is fragmented and has very few barriers to entry. Large competitors, such as Nike and Adidas (ADDYY) have strong, well-developed brands and large marketing budgets. Nike's ability to spend millions of dollars on endorsements is a long-running competitive advantage the company enjoys in keeping its brand relevant. For reference, Nike's total selling and administrative expense over the trailing-twelve-months (TTM) of $14.5 billion is 2.2x Skechers' TTM revenue.

Though it may have a smaller marketing budget, Skechers is still able to close endorsement deals and even run Super Bowl ads on its way to developing a well-known global brand centered around comfort and affordability. The company knows how to hit where it counts when it comes to using limited marketing resources. Furthermore, as already mentioned, Skechers biggest advantage in the footwear industry is its distribution network.

China Risk Is Real: Most of Skechers' footwear is manufactured in China and Vietnam, which means the company could face large disruption to its operation should political tensions affect commerce with those countries. However, much of the international footwear industry faces similar exposure. For example, during Nike's fiscal 2021, China and Vietnam accounted for ~72% of its NIKE brand footwear manufacturing.

Beyond manufacturing, China is Skechers' second-largest market and accounted for 19% of the company's sales in in 2021. The COVID-related lockdowns in China will have a detrimental effect on Skechers total sales from the region in 2022. Although the pandemic presents some near-term risk, rising geopolitical tensions could potentially lead to a more detrimental and permanent decline in sales if Skechers were forced to exit China. A breakdown in global trade relations is clearly a risk to any company dependent on a low-cost manufacturing model. That said, the leaders of China and the United States are not unaware of the risk that political tensions represent to economic prosperity.

Stock Is Priced for Permanent Profit Decline of 20%

Importantly, we argue the risk of Skechers losing all its sales in China is already priced into the stock. Skechers' price-to-economic book value (PEBV) ratio of 0.8 means the stock is priced for profits to fall, permanently, by 20% from current levels. Below, we use our reverse discounted cash flow (DCF) model to analyze the expectations for future growth in cash flows baked into a couple of stock price scenarios for Skechers.

In the first scenario, we assume Skechers':

- NOPAT margin falls to 7% (10-year average vs. 9% in 2021) from 2022 – 2031, and
- revenue falls by -0.2% compounded annually from 2022 – 2031.

In this scenario, Skechers' NOPAT falls 2% compounded annually over the next decade and the stock is worth $39/share today – equal to the current price. For reference, Skechers grew NOPAT by 10% compounded annually over the past five years and 23% compounded annually in the ten years before the pandemic from 2009 – 2019.

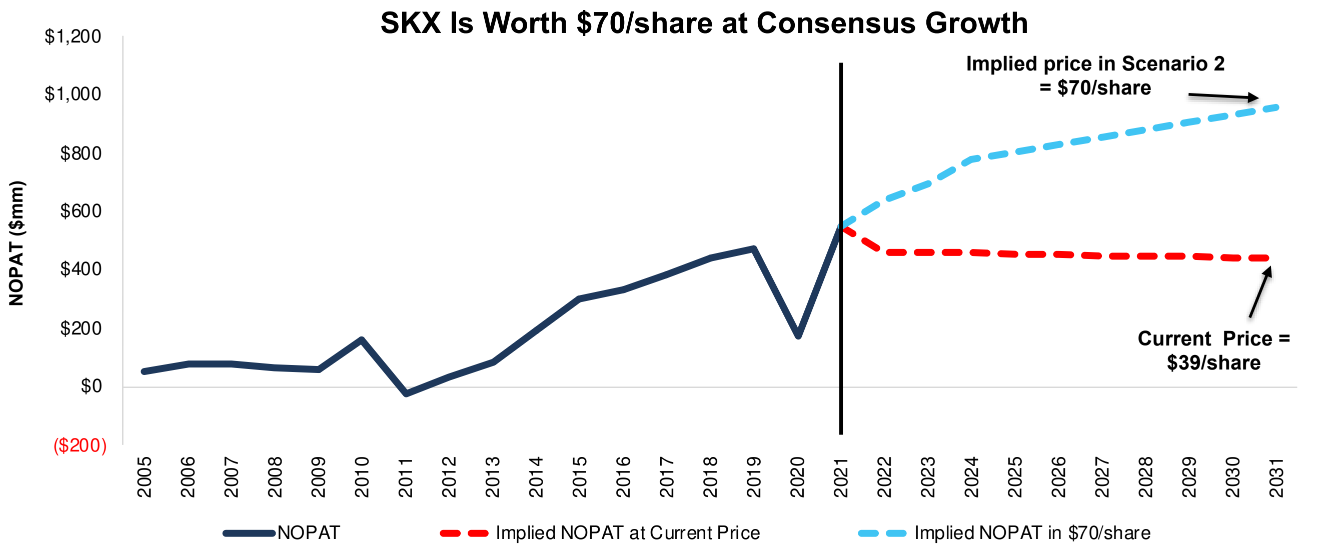
Shares Could Reach $70 or Higher

If we assume Skechers':

- NOPAT margin remains at 2021 levels of 9% in 2022 – 2031,
- revenue grows at consensus estimates of 17% in 2022, 9% in 2023, and 12% in 2024, and
- revenue grows by just 3% compounded annually from 2025 – 2031, then

the stock is worth $70/share today – 79% above the current price. In this scenario, Skechers grows NOPAT by just 6% compounded annually from 2022 to 2031. Should Skechers grow NOPAT more in line with historical growth rates, the stock has even more upside.

Figure 4: Skechers' Historical and Implied NOPAT: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings

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

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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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