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GLOBAL IDEAS

14 March 2013

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Crocs Inc. — A shoe-in? $16.01

Investment thesis

Crocs is not the typical global company we would recommend for clients, but we think this small business represents an exciting opportunity. While this company no doubt has a brand well-recognised to many (who hasn't seen or owned a pair of their odd-looking sandals?), it has a relatively short operating history and one which has been peppered by a shocking downturn in the 2008/09 global financial crisis which seriously hindered the group's growth trajectory (but, importantly, didn't bring it close to bankruptcy).

Since the dark days of four years ago, Crocs has enjoyed a sharp rebound in sales and profitability with the group now delivering an ROE of ~25%. In addition, the balance sheet is in far better shape—net cash on hand amounted to $288m at 31 December 2012 (47% of equity; 20% of market cap). We detail later in this note that we expect strong turnover growth based on the group's communicated store roll-out plans.

Crocs Inc. forecasts				
December y/e	FY12	FY13	FY14	FY15
Diluted HEPS ($)	1.45	1.58	1.81	2.09
% growth		*9%*	*15%*	*15%*
DPS				
PE	11.x	10.1x	8.8x	7.7x
DY	0.0%	0.0%	0.0%	0.0%
Share price	$16.01			
Market cap ($'m)	1 451			
12-mnth fwd PE	9.2x			

The good news is that, while the share price has recovered dramatically off its "doomsday" lows of ~$1.30 in January 2009, at $16.01 it still represents good value in the context of the group's earnings power—we estimate it trades at a **P/E multiple of 10x to December 2013**.

In our view, there is ***room for 25% annual returns from this stock over a three year period***, but with higher-than-average forecast risk as this is premised on a steady improvement in the global economy as the group's sales remain economically sensitive.

Figure 1: Crocs share price ($)

Source: iRess

Global Ideas is a newsletter published four times a week (Monday, Wednesday-Friday) and available only to clients of Investor Campus and Anchor Capital. Once a week we also feature an in-depth analysis of a company on our focus list. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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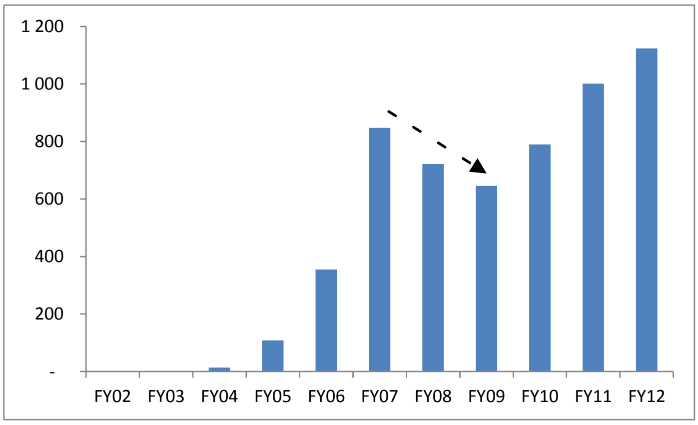
A brief history of Crocs:

- ⇒ Company founded in 1999 as a limited liability company
- ⇒ In 2002, Crocs launched the marketing and distribution of their original "clog style" footwear in the US.
- ⇒ Crocs listed their common stock on the Nasdaq exchange in February 2006.
- ⇒ The company now sells their footwear and accessory products in more than 90 countries through a network of third-party retailers (wholesale channel) and company-owned retail stores, as well as the internet.

A less-than-rosy operating past…

As indicated in the charts that follow, Crocs has experienced somewhat of a rollercoaster few years since it began operating. Starting off a zero base in FY02, sales of the group's footwear products grew rapidly to ~$850mn in FY07. The global economic downturn then arrived, and revenues plummeted by 25% between FY07 and FY09:

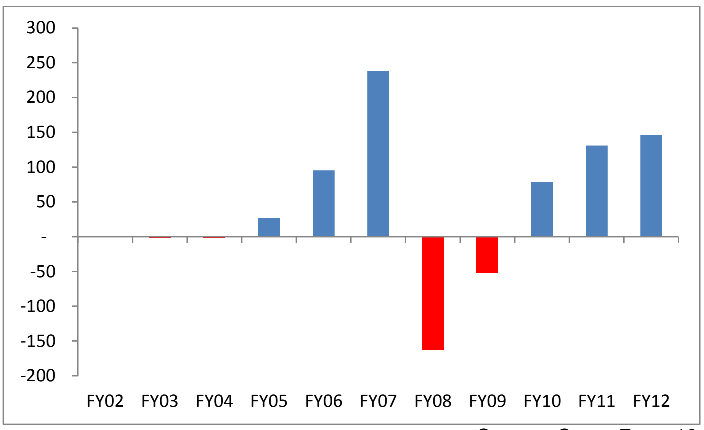
Figure 2: Crocs annual revenues ($mn)



Source: Crocs Form 10-K

While the company successfully reduced costs in FY09, expenses had already climbed dramatically from FY07-08 (S,G&A grew 32%) as the company increased production capacity, warehouse space and inventory in anticipation of previously expected growth. The net result was massive operating losses (including a $76mn inventory write-down in FY08).

Figure 3: Crocs operating profit ($mn)



Source: Crocs Form 10-k

Over this time period, shareholder's equity of the group declined from $444mn to $287mn (NAV = $3.37/share in FY09), including the proceeds of a small rights offer ($16mn). Importantly, however, operating cash flows during FY08-09 remained positive and the group's liquidity position remained firm, with cash at year-end FY09 of $77mn and long-term debt of only $1.5mn.

So, in hindsight it appears that the market probably overreacted at the bottom of the crash and priced in an almost certainty of the group going bankrupt.

… followed by a swift recovery back to decent profitability

Fast forward four years, and Crocs finds itself in a far healthier position: after sales growth of 25% p.a. on the depressed base from FY09-10, robust growth continued—albeit at a slower rate—of 12-15% from FY10-12, resulting in the group delivering EBIT of $146mn and EPS of $1.45/share in FY12.

An attractive business model, but not without risks

As a fashion-oriented designer, manufacturer and marketer of footwear, Crocs certainly has no shortage of competition. However, its current operating metrics still make for very attractive economics:

- **High GP margins**: most of the group's products are produced by third-party contract manufacturers, many of which are based in China. As the owner of the brand, Crocs has the ultimate pricing power and mark-ups are clearly good as evidenced by the group's <u>54% GP margin in FY12</u>.

- **Strong cash generation**: at December 2012, Crocs had inventories of $165mn, accounts receivable of $92mn and accounts payable of $64mn plus accrued expenses of $81mn. So, net working capital amounted to ~$110mn versus annual sales of $1.1bn. This results in strong cash generation—over the past three years, cash generated from operating activities has averaged 110% of operating profit.

- **High ROE; even higher ROCE**: given the above margin and balance sheet dynamics, Crocs generated a very respectable return on average equity of 23.7% in FY12. This included a net cash balance of $288m in FY12 (equity amounted to $612mn), so <u>returns on capital employed are currently north of 50%</u>. This makes investment in additional inventory and retail stores very attractive, but should market demand not support this the group's strong cash flows can be utilised to buy back shares.

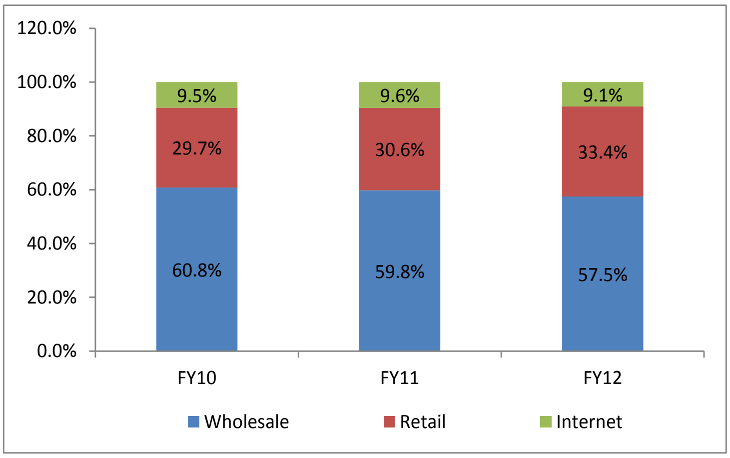
Figure 4: Crocs model income statement & balance sheet—with sales based to 100

Revenue	**100.0**	**Equity**	**55.0**
Cost of sales	-45.5	Net cash	25.6
Gross profit	**54.5**	NWC	9.9
S, G & A	-41.0	Other	19.4
EBIT	**13.5**		
Interest / other	-0.1	**ROE:**	**22%**
PBT	**13.5**	**ROCE:**	**46%**
Taxation	-1.3		
PAT	**12.2**		

Source: Anchor Capital calculations, Crocs Form 10-k

The group sells its products via third-party retailers (wholesale) and company-owned retail stores. While the wholesale channel represents the majority of the group's sales, the group has been steadily growing its retail presence around the world (where it achieves higher GP margins and can control the "brand experience" for customers) and this channel now represents 33% of its sales, with internet sales accounting for a further 9%:

Figure 5: Crocs sales % by channel type



Source: Crocs Form 10-k

Geographically, the group is fairly well diversified from a sales perspective:

Figure 6: FY12 geographical sales split

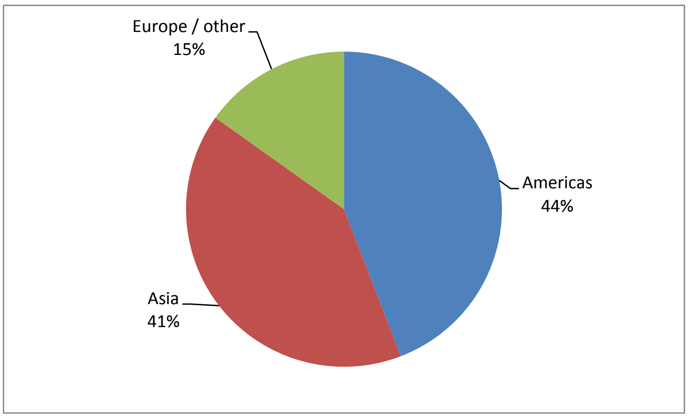
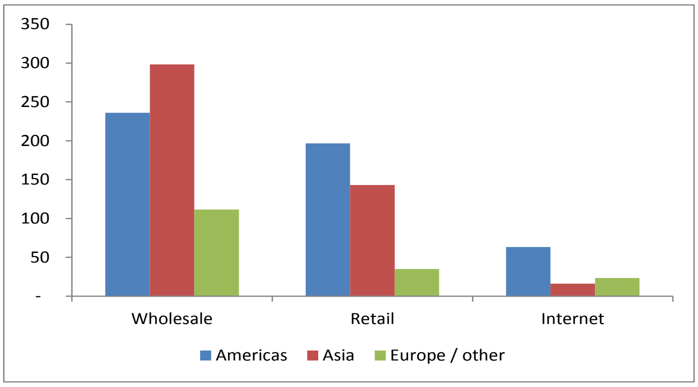
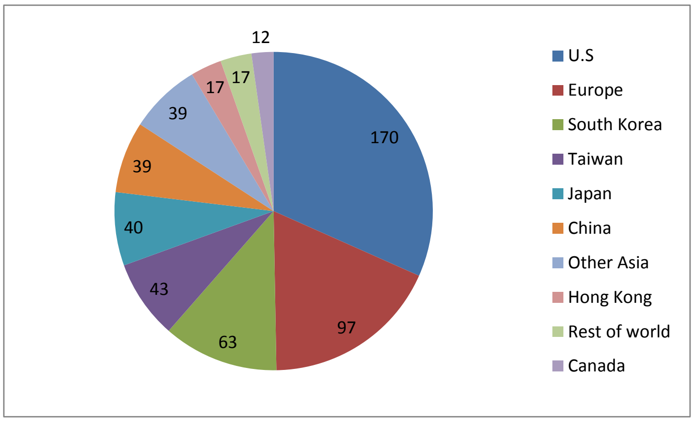


Figure 7: Geographical sales split by channel (FY12)



Source: Crocs Form 10-k

Figure 8: Crocs retail store numbers by region (FY12)



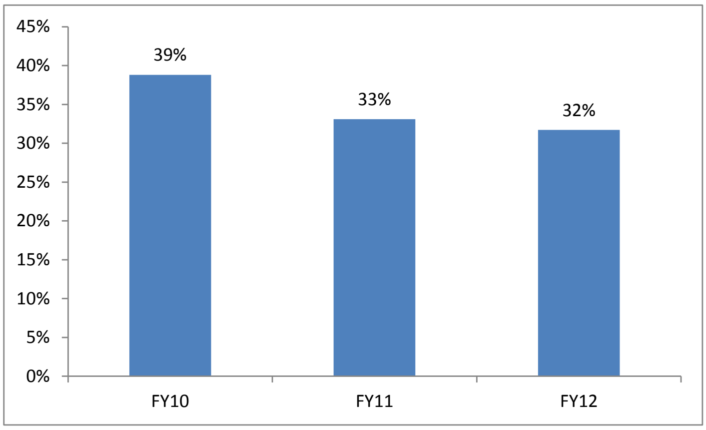
Source: Crocs Form 10-k

Aside from the obvious macro risks to growth, we think the most important risks to Crocs' business model are the following:

- **Fashion risk**— there is the possibility that Croc's unique footwear products bear an element of "fad risk" which may make their sales volatile and susceptible to the risk that they go out of fashion or lose their appeal. As a result, we think the group may need to continually introduce new products and accessories to complement their core "clog-style" sandal products.

- **Crocs does not control its supply chain:** while the group has manufacturing facilities in Italy and Mexico, the vast majority (80%) of its products are produced by third-party manufacturers. Importantly, roughly 32% of the group's footwear unit volume was produced by one supplier in China. The group does not have written supply agreements with its Chinese suppliers. This poses the risk that these agreements could be cancelled, necessitating the group procuring alternative supply sources—potentially at higher cost. The other obvious risk that flows from this is that the group's trademarks may not be respected by third party producers.

Figure 9: Slowly diversifying manufacturing risk: largest single Chinese supplier as % of Crocs unit volume



Source: Crocs Form 10-K

In addition, while not a risk specific to the business model, we note that the group's effective tax rate was very low at 9.8% in FY12. The group comments that this included the reversal of certain tax provisions (accounting for 8.4% points), but is mainly influenced by "tax rate differences between US and foreign jurisdictions." We estimate a tax rate of 17-18% excluding the reversal of these provisions, but we believe the risk to this still-low tax rate over time is probably to the upside.

Outlook and potential

Crocs stated in its FY12 annual report that it **expects to open an additional 70-95 new retail stores globally in FY13 (+13-18% on FY12 base),** and based on pre-season wholesale customer orders, the group expects to have "increased revenues driven by higher volumes and higher average selling prices." In addition, the group has guided for margins to "continually increase in FY13" as retail and internet channels expand. This should result in increased earnings, despite the company's guidance that the investment in a new ERP system will negatively impact diluted EPS by $0.08-0.10.

We expect the group to report EPS of $1.55-1.60 (+7-10% growth), but this rate of growth is negatively influenced by our expectation of a higher tax rate (17% vs 9.8% in FY12) - we expect mid-teen growth in PBT.

Bloomberg consensus EPS estimates are $1.51 for FY13 (+3%), $1.72 in FY14 (+14%) and $2.10 in FY15 (+22%). If anything, these estimates could be conservative as they would imply a declining ROE trend (the group has guided to not pay any dividends for the foreseeable future, investing in growth)

Figure 10: Returns/ PE multiples implied by Bloomberg consensus estimates

$/share	FY12A	FY13e	FY14e	FY15e	CAGR
Starting NAV	5.47	6.92	8.43	10.14	
EPS	1.45	1.51	1.72	2.10	13.1%
DPS	-	-	-	-	
Ending NAV	6.92	8.43	10.14	12.24	
ROE	23.4%	19.7%	18.5%	18.8%	
Share price	$16.01				
P/E multiple	**11.0**	**10.6**	**9.3**	**7.6**	
P/NAV	**2.3**	**1.9**	**1.6**	**1.3**	

Source: Bloomberg, Crocs data, Anchor Capital calculations

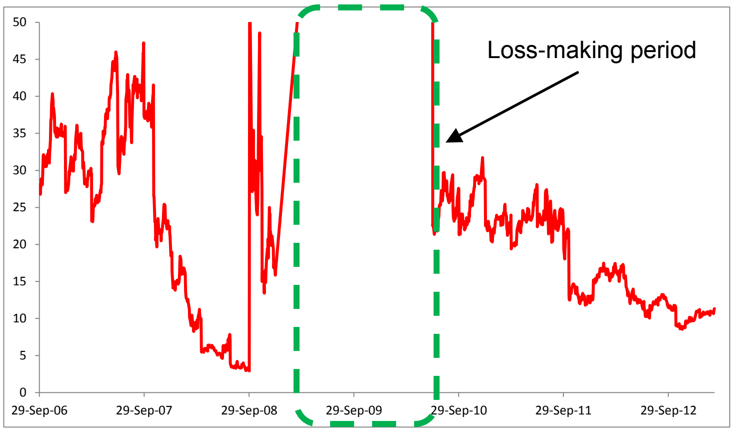
So what does this all mean for potential returns?

We think that the group has the potential to deliver 15-20% + earnings growth for a few years from the FY13 base, but this is premised on its ability to sustain at least 10-13% sales growth and steadily increase EBIT margins—recent trends seem to indicate this is achievable, and the group's retail expansion plans are indicative of strong demand potential.

In addition, the stock remains cheap relative to its history—it has in the past traded at P/E multiples in excess of 20x when the market had confidence in the growth story, or when earnings were growing quickly off a depressed base (see Figure 11). While we don't believe the share should necessarily deserve these heady multiples, we think there remains scope for a re-rating.

In our view, EPS of >$2/share and a share price of $30 (15x trailing P/E) are achievable over a three-year period (i.e. FY15 figures) - this would translate into a 3-year return of ~25% per annum. However, it should be borne in mind that this company's products are economically sensitive and the above figures are premised on a gradual improvement in the global economy, so risks remain.

Figure 11: Crocs trailing P/E multiples



Source: Bloomberg

Sean Ashton

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