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Best Foot Forward

After nearly 20 years in business, trend-conscious shoe company Skechers has built a nicely profitable and well-diversified franchise. So why is the market treating it as a troubled one-hit wonder?

Such is the nature of dynamic economies – and fickle investors – that even the strongest bull markets bypass certain stocks entirely. Lists of stocks hitting new lows may shrink, but they never dry up completely.

Fashion-forward shoe company Skechers finds itself among this unhappy cohort today. Since topping out near $45 a year ago, its stock now sits at a recent $17.70 after the company reported three straight quarters of unexpectedly high inventories and unexpectedly low earnings. The culprit: a rapidly cooling market for so-called "toning" sneakers, thick-soled shoes with rounded heels that had taken off in popularity when Skechers entered the market in 2009 with its lower-priced Shape-Ups line. As claimed benefits ranging from reduced cellulite to improved circulation have come under increased scrutiny, toning shoes day in the sun appears to have passed.

Though hardly good news for Skechers – toning shoes accounted for an estimated 20% of the company's 2010 revenues of $2 billion – David Kessler of Robotti & Co. believes the decimation of its share price has been overdone. "The market's reaction implies the company is a one-trick pony, but it's not," he says.

While capable of creating its own product hits, such as the Twinkle Toes line of kids' shoes, Skechers bread-and-butter has been quickly adapting others' trendy products into stylish footwear sold at mid-tier prices. It spends heavily on celebrity-endorsed advertising and then takes full advantage of its strong distribution network of independent retailers and nearly 300 company-owned stores. In the ten years before toning shoes came along, the company increased revenues at an 8% annual clip, earned consistent gross margins in the low-40% range and averaged 13% returns on equity.

Looking forward, Kessler believes 6-8% average annual top-line growth in the rest of the business – from international expansion and opening 25-30 new U.S. stores per year – will offset the decline in toning-shoe revenue, which he does not think will go entirely away. He expects marketing spending to be maintained at a high 9% of revenues, but believes operating margins can increase to around 8%, driven by operating leverage and savings from a new distribution center opening this year. Add it all up and he estimates the company can earn $2 per share within the next two to three years.

The potential stock upside? Shoe companies such as Nike, Deckers and Wolverine trade today at 18-20x earnings, but even at 13-15x his estimate of "normal" EPS – plus more than $2 per share in net cash on the balance sheet – Skechers' shares would be worth closer to $30.

"The next couple of quarters may not be pretty," says Kessler. "But once the inventory issues are resolved and attention shifts back to the core business, it's highly unlikely the shares will be such a bargain." VII

INVESTMENT SNAPSHOT

Skechers
(NYSE: SKX)

Business: U.S. designer and marketer of casual footwear sold through independent retailers and company-owned stores.

Share Information (@5/26/11):

Price	**17.70**
52-Week Range	17.41 – 44.90
Dividend Yield	0.0%
Market Cap	$881.3 million

Financials (TTM):

Revenue	$1.99 billion
Operating Profit Margin	6.5%
Net Profit Margin	4.6%

Valuation Metrics
(@5/26/11):

	SKX	S&P 500
Trailing P/E	9.4	16.6
Forward P/E Est.	16.7	13.5

Largest Institutional Owners
(@5/26/11):

Company	% Owned
Wellington Mgmt	7.2%
Cadian Capital	6.3%
Perkins Inv Mgmt	5.6%

Short Interest (as of 5/13/11):

Shares Short/Float	16.7%

SKX PRICE HISTORY

THE BOTTOM LINE

With solid revenue growth in the rest of its business offsetting fading toning-shoe sales, the company can earn $2 in EPS in the next two to three years, says David Kessler. Applying a less-than-market multiple to that, the shares would be worth closer to $30.

Sources: Company reports, other publicly available information

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& COMPANY, LLC

6 E. 43rd Street 23rd Floor New York, NY 10017 *(212) 986-4800*