SIENA college

Crocs, Inc.

NASDAQ: CROX

Analyst: Marianne Staudt
Sector: Consumer Disc.

SELL

Price Target: $7.42

Key Statistics as of 4/27/2016

Market Price:	$9.83
Industry:	Textile-Apparel Footwear
Market Cap:	$717.69M
52-Week Range:	$8.09-16.05
Levered Beta:	.81

Thesis Points:

- Unclear patent situation opens the door to competition and poses a serious threat to Croc's revenue stream.
- Crocs is destroying value through shrinking margins and a shrinking ROIC/WACC.
- Market is overly optimistic on Croc's operating cost/revenue.

Company Description:

Crocs, Inc. (CROX) designs and manufactures shoes for men, women, and children. It was founded in 2002 in Boulder, Colorado as the maker of a simple rubber clog. Since the company's founding, it has developed several other shoe designs, all of which maintain the soft, lightweight, non-marking, slip and odor-resistant qualities that made the original Crocs so successful.

Thesis

Crocs was once a highly successful and popular shoe company, however, the rubber clog fad has come to an end, leaving Crocs in a very precarious financial situation. Its unclear patent situation opens the door to competition and poses a serious threat to Croc's revenue stream. Crocs margins continue to shrink, as its shrinking top-line cannot sustain expenses, and is causing serious negative income implications. These declining margins, paired with a shrinking ROIC/WACC, mean value destruction for the once iconic shoe brand. The market is overly optimistic on Croc's operating cost/revenue, the largest driver in its stock value. When this is adjusted to a more appropriate level, it becomes clear that Crocs is significantly overpriced, making it a SELL.

Competition

Over the last five years, Crocs has underperformed when compared to its major competitors, as well as the Nasdaq Composite Index.

The chart above compares Crocs five year stock performance to that of Nike (red), Michael Kors (green) and VF Corporation (pink). While the competitors have seen some significant growth over the years, Crocs has remained stagnant.

The Chart below demonstrates Crocs underperformance relative to the Nasdaq composite index. The index has grown 100% over the last five years, while CROX price has only grown 14% (and has declined since this chart was created).

Patent Litigation

A recent decision by a patent examiner denied Croc's sole claim in its design patent covering overall shape and design of the clogs. The design patent was rejected because Crocs had made the shoes available for sale more than a year before seeking patent protection.

This is a big problem for crocs, because without this patent, many other companies can pop up, offering a very similar product under a different name, potentially for less, causing a further decline in sales. Dan Hart, the chief legal and administrative officer, told Bloomberg BNA that the company is prepared to appeal to the U.S. Court of Appeals for the Federal Circuit. Meanwhile, the Crocs competitor that initiated the re-examination proceeding said it would continue to fight Crocs in pending federal district court proceedings, in which it is arguing not only that the design patent is invalid and unenforceable, but also that Crocs has violated antitrust law in taking action against other footwear companies.

This continuing litigation battle will come at a high price, which is a serious problem for a company with already shrinking margins. When asked about this in its 2015 earnings call, executives stated it was a "non-issue," and refused to answer exactly what the patent covered or what percentage of sales is related to this particular patent.

The fact that management feels this is not an issue, to me, is alarming, as both the possibility of increased competition and high legal fees would have a significant impact in the bottom line, which they are not projecting or addressing. Because they are not acknowledging this potential loss, it is likely Crocs will miss on earnings moving forward, causing a further decline in stock price.

Losing Revenue

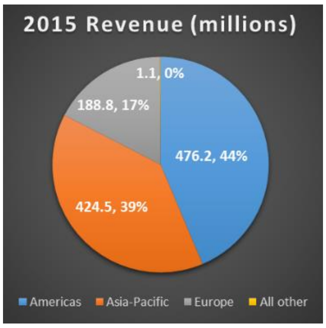
During the last five years, Crocs has been showing lower-than-average results. Its revenue growth has decreased from 27% in 2011 to almost 0% in fiscal 2014, while the recent quarter statements show a negative 8% revenue growth and a more than 6% decline in gross profit. Net income has also decreased to sub-zero values. I expect this trend to continue in the future.

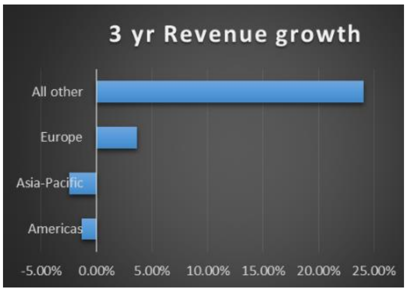
In 2016, Crocs plans on closing several stores, which will undoubtedly impact their top line, as fewer stores means fewer sales. Crocs revenue is already too low to support its operations, so store closures could have some very serious implications.

Additionally, Croc's South Africa operations were held for sale as of December 31, 2015, and subsequently sold on January 19, 2016. Management estimated that South

African sales revenue for 2016 would be double-digit, so Crocs will be losing more revenue.

Additionally, Management expects to see a decline in growth in Europe, which is the only significant revenue stream that is currently experiencing positive growth (sales in “all other” regions are growing rapidly, but still only make up $1.1M, a fraction of 1% of sales).

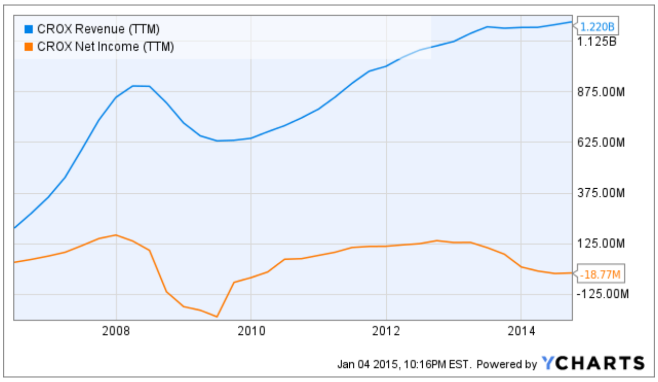




The company's assumption that revenue will growth in the high single-digit percentage range through 2018 is overly optimistic given recent performance as well as the difficult global retail environment. Crocs has had an "uninspiring" early-spring sales outlook, and early spring U.S. retail checks aren't suggestive of building brand momentum.

Shrinking Margins

In addition to shrinking revenues, Crocs margins have been declining, and will continue to do so in the future. The chart below shows the growing gap between revenue and income, which is a result of declining margins.



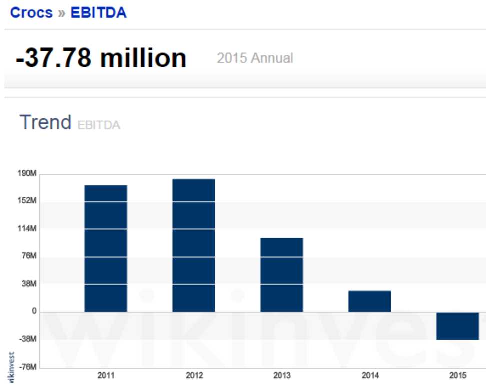
I expect this trend to continue moving forward, as management acknowledged they may be overly optimistic for the first half of fiscal 2016, and projects 2016 Q1 margins to be negatively impacted.

Additionally, future growth and openings will be exclusively focused on outlets. Outlets offer extreme price discounts, which will have a further negative impact on profit margins.

Financials

With a 5-year ROIC/WACC below the industry average (1.63 vs. 2.02, respectively), and falling dramatically (fallen below 1 to .63 in last twelve months), Crocs is not only creating less value than its competition, but it is destroying value.

Additionally, EBITDA has been steadily declining since 2012, and fell to -$37.78M in 2015, leading to a negative bottom line. This negative earnings is unsustainable, and poses a serious threat to Croc’s financial stability.



Valuation

The market is currently pricing Crocs according to its historical operating costs/revenue of 87.5%, however, I believe this to be too low. Last year operating costs were 99.6% of revenue. While I do not believe this will always be the case, I think assuming the ratio will resort back to historical levels while revenue continues to decline is overly optimistic and unreasonable. Realized revenues have been approximately 1.5% lower than expectations over the last several quarters. Assuming this trend continues and operating costs remain approximately in line with estimates, operating cost/revenue, perhaps the largest value driver for Crocs, will remain high. I added a 1.5% premium to the ratio the market it using to price Crocs, to get operating costs/revenue of around 89%. I then added an additional 1% premium to factor in the revenue decline that will come as a result of the selling of the South African business and the closure of retail locations, as well as increased legal fees. This 90% operating cost/revenue ratio dropped the intrinsic value down to $5.43 and a 1 year target price of $7.42.

Conclusion

While Crocs has had some success diversifying away from its trademark rubber clogs, ultimately the company seems to be a bit of a one-hit wonder, and is likely to continue struggling to find meaningful sales and profit growth. The company's weaknesses can be seen in multiple areas, such as its deteriorating revenue and net income, declining margins, value destruction, and overall poor stock performance. With a current price of $9.83, and a 1 year target price of $7.42, Crocs offers a negative return of 24.47%, making it a definite SELL.

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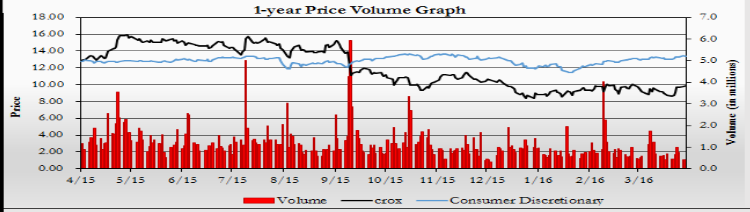
Crocs, Inc. (crox) — **BEARISH**

Analysis by P.C. Principal	Current Price: $9.83	Intrinsic Value $5.43	Target 1 year Return: -24.47%
4/30/2016	Divident Yield: 0.0%	Target Price $7.42	Probability of Price Increase: 25%



Description

Crocs, Inc., together with its subsidiaries, designs, develops, manufactures, markets, and distributes casual lifestyle footwear and accessories for men, women, and children worldwide.

General Information

Sector	Consumer Discretionary
Industry	Textiles, Apparel and Luxury Goods
Last Guidance	November 3, 2015
Next earnings date	May 6, 2016
Estimated Country Risk Premium	6.00%
Effective Tax rate	31%
Effective Operating Tax rate	18%

Market Data

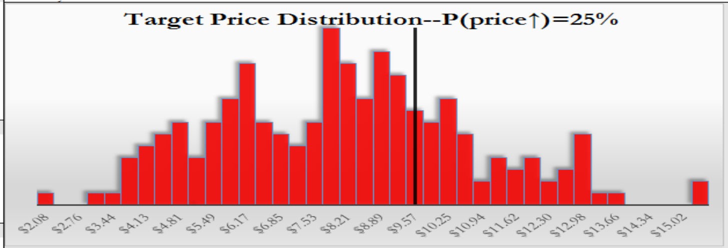
Market Capitalization	$717.69
Daily volume (mil)	0.66
Shares outstanding (mil)	73.01
Diluted shares outstanding (mil)	75.60
% shares held by institutions	78%
% shares held by investments Managers	95%
% shares held by hedge funds	8%
% shares held by insiders	2.64%
Short interest	12.15%
Days to cover short interest	10.94
52 week high	$16.05
52-week low	$8.09
Levered Beta	0.81
Volatility	49.14%

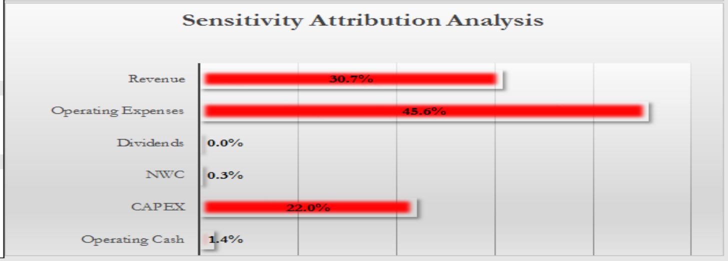
Past Earning Surprises

Quarter ending	Revenue	EBITDA
12/31/2014	-1.67%	-356.00%
3/31/2015	-1.28%	-21.04%
6/30/2015	-0.87%	-32.84%
9/30/2015	-1.82%	-118.42%
12/31/2015	2.04%	-257.44%
Mean	-0.72%	-157.15%
Standard error	0.7%	65.2%

Peers

Steven Madden, Ltd.
Wolverine World Wide Inc.
Deckers Outdoor Corp.
Finish Line Inc.
Genesco Inc.
Skechers U.S.A., Inc.
NIKE, Inc.
Foot Locker, Inc.

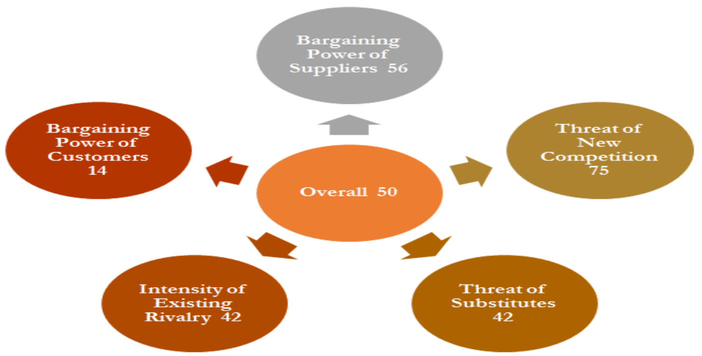




Management	Position	Total compensations growth	Total return to shareholders
Ribatt, Gregg	Chief Executive Officer and	2139.33% per annum over 1y	-18.01% per annum over 1y
Rees, Andrew	President	-25.19% per annum over 1y	-18.01% per annum over 1y
Hart, Daniel	Chief Legal & Administrative	N/M	N/M
Teffner, Carrie	Chief Financial Officer, Exe	-4.06% per annum over 6y	19.29% per annum over 6y
Reilly, Terence	Chief Marketing Officer and	N/M	N/M
Sullivan, Greg	Senior Vice President of Glo	N/M	N/M

Profitability	crox (LTM)	crox (5 years historical average)	Industry (LTM)
ROIC	5.1%	17.52%	16.98%
NOPAT Margin	7%	15.26%	9.9%
Revenue/Invested Capital	0.71	1.15	1.72
ROE	5.2%	20.74%	18.77%
Adjusted net margin	4%	13.65%	9.4%
Revenue/Adjusted Book Value	1.48	1.52	2.00
Invested Funds	**crox (LTM)**	**crox (5 years historical average)**	**Industry (LTM)**
Total Cash/Total Capital	11.5%	20.7%	19%
Estimated Operating Cash/Total Capital	11.5%	19.6%	N/A
Non-cash working Capital/Total Capital	11.3%	12.2%	29%
Invested Capital/Total Capital	114.6%	104.8%	81%
Capital Structure	**crox (LTM)**	**crox (5 years historical average)**	**Industry (LTM)**
Total Debt/Common Equity (LTM)	0.79	0.41	0.13
Cost of Existing Debt	9.69%	7.30%	3.85%
Estimated Cost of new Borrowing	3.77%	1.95%	3.85%
CGFS Risk Rating	BB	AA	A
Unlevered Beta (LTM)	0.58	1.13	0.76
WACC	8.13%	10.76%	8.35%

Porter's 5 forces (scores are out of 100)



Valuation

Period	Revenue growth	NOPAT margin	ROIC/WACC
Base Year	-9.0%	7.2%	0.63
12/31/2016	3.8%	10.4%	1.27
12/31/2017	4.4%	11.6%	1.09
12/31/2018	8.3%	12.2%	1.17
12/31/2019	2.1%	12.8%	1.15
12/31/2020	2.1%	12.3%	1.04
12/31/2021	2.1%	12.1%	0.98
12/31/2022	2.1%	11.8%	0.94
12/31/2023	2.1%	11.7%	0.90
12/31/2024	2.1%	11.5%	0.86
12/31/2025	2.1%	11.3%	0.83
Continuing Period	2.1%	11.3%	0.83

Period	Invested Capital	Net Claims	Price per share
Base Year	$757.76	$778.67	$5.26
12/31/2016	$923.26	$930.90	$7.73
12/31/2017	$1,213.94	$788.19	$10.25
12/31/2018	$1,388.93	$678.24	$12.81
12/31/2019	$1,533.61	$553.43	$15.35
12/31/2020	$1,424.47	$388.80	$17.88
12/31/2021	$1,804.72	$226.52	$20.37
12/31/2022	$1,884.66	$65.72	$22.84
12/31/2023	$2,014.13	-$93.49	$25.30
12/31/2024	$2,129.96	-$251.17	$27.76
12/31/2025	$2,193.19	-$407.20	$30.21
Continuing Period			