CONTRARIAN STOCKS

Wolverine World Wide Inc

Classic 21st Century Value Investing

As I explained in a brief primer on my website, Wolverine World Wide is contrarian, value investing. There's nothing too hard about it. For those of you who didn't read it or weren't aware of it, here's the essence:

Wolverine World Wide is clearly a cyclical company and my understanding of cyclical companies is simple - buy them at high P/Es or when they're unprofitable. This way, the situation is most favourable to you.

... With a new CEO (Chris Hufnagel) and a new focussed strategy, the long-term outlook regarding Wolverine World Wide looks strong and a bounce-back looks likely.

...It's only now that the share price has slumped that people are questioning the strength of the underlying business, the high levels of debt and the ability of management. Well, Wolverine World Wide have arguably always had these problems and few people bothered shorting their stock.

In fact, long-term debt in 2013 stood at over $1b - today, it's a little over $700m... you'd be paying over 1.25x revenues compared to less than 0.3x today.
What is the difference between now and ten years ago? I think you already know the answer. Market conditions seemed more favourable to investors - rates were at all-time lows, market confidence was high and retailers were booming! Put simply, investors believed that the company had perfect conditions to flourish.

The market was wrong - in fact, they were wrong about almost all cyclical companies. By 2015, Wolverine World Wide's share price had halved and it took until 2017 for that 2013 valuation to regain its lost ground.

In recent months, I've scaled into Wolverine World Wide aggressively. As weeks go by, I am more confident in management's ability to cut out the cancer, delever and return it to the high margin company it really is.

Buy - Overweight

NYSE: WWW

Price: $9

Price target: $20

Date: 22/12/2023

Asset management

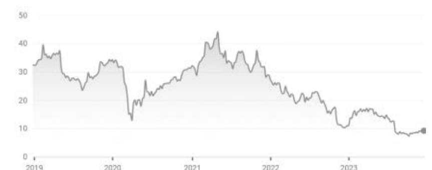
Harshu Vyas

harshu.vyas@*******.com

+(44) 73*******

contrarianstocks.com

Price Performance



Brief Metrics (ttm)

P/E: n/a

P/B: 2.13x

P/S: 0.31x

EV/EBITDA: n/a

ROE: n/a

Debt/Equity: 3.73x

*Source: Google Finance, Stock Analysis

Share Data

Price: $9.16

Shares outstanding: 80m

Market cap: $728m

EPS (ttm): n/a

Dividend yield: 4.45%

*Source: Finviz

IMPORTANT: Please see the back page for important disclosures. It is important you note that none of the contents of this piece is financial advice and it is purely an educational piece.

Overview

For those of you who have never heard of Wolverine World Wide, they are (primarily) a shoe manufacturer that operates in four main subsects.

1. Active Group – Merrell, Saucony, Sweaty Betty and Chaco.
2. Work Group – Wolverine, CAT, Bates, Harley Davidson and Hytest
3. Lifestyle Group – Keds (discontinued), Sperry (looking to be sold) and Hush Puppies
4. Other – leathers business, Stride Rite, Sourcing and Multi DTC divisions

Of these, the Active Group generates the bulk of the revenues (over 65% YTD) with the Work Group generating 21%. I hear some analysts suggest that because Wolverine has a group dedicated to Work it somehow reduces their cyclicality. I couldn't disagree more. Wolverine is as cyclical as they come. Not only do trainers (or sneakers) make up the majority of sales, construction work is definitely cyclical.

As I commented a few months ago, the worst possible situation is broke consumers and a recession. But, as you'll see, Wolverine have survived similar situations in the past and come out ok.

Risks

The primary risk to Wolverine's business is the leverage embedded in the operations.

It's worth noting that $370m worth of Wolverine's $1.1b debt burden is "current" debt (i.e due within one year). The $370m due has been borrowed under a revolving credit facility and the company has the ability to borrow an aggregate amount of $1b.

The next large debt obligation comes from a $183m Term Facility due October 2026. $10m in payments is required in the next twelve months.

Finally, the company has borrowed $550m at 4% due in April 2029.

After considering debt, it is vital when looking at cyclicals to determine the risk that the leases carry. Wolverine have $141m in long-term lease liabilities (and $38.7m in current lease liabilities).

Already, year-to-date, Wolverine have used over $32.6m (cash) in lease costs. To put this in perspective, in 2022 the overall lease cost was $45.3m (with a cash outlay of $39.5). The difference in the total lease cost and the cash paid for operating leases comes down to noncash charges (i.e the amortisation of the ROU asset).

On a run-rate basis, this means that Wolverine could end up paying more than $52m in lease costs this year with a cash outlay of over $40m.

Personally, I'm not a massive fan of lease accounting and I don't trust it. Rather, I watch the cash figure closest. That's the true indicator of what's going on.

For those of you who haven't fully learned lease accounting, let me explain it to you. The accountant has three knowns – the lease term, the commencement date and the end date. The accountant must work out a discount rate that works out what the rate of return on the lease the lessor gets (aka the implicit interest rate) to deduce a net present value (which becomes the lease liability). As you can probably guess, the accountant cannot work the implicit rate out accurately.

Therefore, the accountant uses a new measure known as the incremental borrowing rate (which the auditors of Wolverine use). This is the rate that a lessee would pay over a similar term, on a collateralised basis, in a similar economic environment and with an amount equal to the lease payments. Again, it's impossible to accurately work out and it wouldn't surprise me if over the next few years it turns out that many firms have gotten it wrong in their favour (accidentally, of course).

Wolverine has an average discount rate of 5.1% with an average lease term of 8.1 years. To be clear, the lower the discount rate applied, the higher the obligation recorded on the balance sheet (and vice versa). Your job as an analyst is to play with this figure and come up with multiple scenarios.

Again, your time may be wasted trying to predict how much Wolverine pay to lessors but it has to be considered properly by the analyst. I can skip the process and tell you it's highly unlikely Wolverine go bankrupt but if you conservatively allow for a cash outlay of $50m/annum (at worst, assuming all things equal) it's very hard to get it wrong, from a valuation standpoint.

Finally, Wolverine have another pesky obligation that needs fulfilling. Due to litigation, Wolverine must pay $22.8m in the next twelve months for environmental remediation costs (estimated) and another $21m over 25 years. This obligation must also be considered by analysts.

Recent History

Wolverine have taken a different approach under the new CEO, Chris Hufnagel. By different, I mean better. Before Chris took the head spot, Wolverine were in a state. They had no vision, no strategy and continued to make poor managerial decisions.

After the Board terminated Brendan Hoffman from the top spot, Mr Hufnagel has acted decisively, aggressively and in the best interests of shareholders. Mr Hoffman didn't do badly – after all, he did get rid of the Keds brand for $90m (to Designer Brands Inc). Nor he did stay very long (less than two years). The Board just wanted more. This pressure created by the Board for the CEO to act decisively, quickly and get it right is exactly the culture that shareholders should demand.

Just a month after becoming CEO, Mr Hufnagel sold the Hush Puppies trademarks in China, Macau and Hong Kong for $58.8m and also divested its US Wolverine Leathers business for $6.6m.

More recently, on December 18, Wolverine announced that they wanted to optimise the already successful Merrell and Saucony in China by allowing Xtep the option to purchase 40% of the entity that owns the Saucony IP in China. Wolverine will sell its equity interest in the Merrell and Saucony joint venture entities to a subsidiary of Xtep, simplifying the business from a joint venture model to a license and distribution rights model. Xtep will carry out the development, marketing and distribution of footwear, apparel and accessories for the Saucony and Merrell brands in China. Wolverine get $61m from this deal.

Further, they sold their Asia-based Wolverine Leathers business for $9m.

This means this year Wolverine have gotten over $225m just from divestitures. Not bad at all. We also know that Wolverine are looking at strategic initiatives with the Sperry brand.

Balance Sheet

It's obvious that the balance sheet of a footwear company will not be pretty. This statement is truer when you consider the number of terrible acquisitions that ex-management partook in.

With $161m in cash and $245m in net working capital, liquidity does not seem to be a concern.

The problem is when we arrive at long-term assets. $126.5m of property, plant and equipment – largely made up of depreciated furniture, fixture and equipment, leasehold improvements and capitalised software costs.

Now, Wolverine do own a small amount of real estate.

Firstly, a sales and marketing operating of 307k feet in Rockford, Michigan:

Secondly, an owned distribution facility in Louisville, Kentucky of 520k feet:

Besides these two pieces of real estate, Wolverine own very little and lease the rest of their facilities. And, *if* the company were to experience stress, these two buildings would likely not get sold. After all, the first building is the corporate headquarters and the second building is the largest distribution centre they have access to. Therefore, whilst it's useful to know of the real estate owned, it probably won't result in any "unlocking" of value to shareholders.

Aside from PP&E, we have $149m of operating ROU assets (worthless), $465m of goodwill (historical cost), $237m in indefinite-lived intangible assets (historical cost), $57.4 in amortisable intangible assets (worthless, but tax deductible), $26.3m in deferred taxes and $72.9m worth of other assets. Other assets include retirement plans, equity method assets and derivatives.

Graham advises you to adjust assets and keep liabilities equal. Despite me being slightly sceptical of the lease liabilities, I am happy to continue with Graham's approach.

The truth is that Wolverine have virtually no tangible book value. This is ok provided that the intangible assets do earn high returns going forward. The quickest way of checking whether this is or isn't the case is to look at the retained earnings line item which stands at $934m.

We can also adjust equity to a more real figure by adding back share buybacks, retained earnings and dividends whilst subtracting common stock, paid in capital and accumulated other comprehensive losses. Since I cannot be bothered to go back through many filings and add back years of dividends that increasingly get smaller, I just added back the last decade's worth of dividends. The adjusted equity figure stood at more than $1.5b. There is a noncontrolling interest of $20.3m but I find that to be immaterial.

If you look at the adjusted equity figure and then compare it with the debt of around $1.1b, you realise that even with value destructive practices, the business has done decently. Those intangible assets that

usually are made up off fluff have made exceptional returns. Let's see just how incredible those returns are…

Profitability and Cash Flows

The truth is that using GAAP earnings to try to value a cyclical company is unwise. The earnings will constantly be all over the place and the pandemic amplified that effect. It's also why using return on equity just doesn't work. A cyclical company making peak returns on equity is usually a "get out" signal.

The best way to measure a cyclical is to look at the cash flows of the company and work out exactly what the sustainable free cash flow of the operation amounts to.

There are problems to this method – firstly, cyclicals do well in "boom" years which usually results in acquisitions. When they're doing poorly, they look to divest the worst performing assets. What you're let with is a constantly changing business that is either growing rapidly or downsizing. Wolverine is no exception and, in this period, it should be clear that Wolverine are attempting to downsize to improve the quality of earnings. These divestitures will no doubt hit revenues in coming quarters.

If we look at Wolverine's GAAP cash flows from operations over just the last five years, the result is a $179m cash use in 2022, $87m generated in 2021, $310m generated in 2020, $223m in 2019 and $98m in 2018. If we adjust for stock-based comp, gains on sales of trademarks, one-time pension costs, debt extinguishment and temporary environmental litigatory in/outflows, the cash flows fluctuate a little less.

The result is an operating burn of $100m in 2022, and generations of $9m in 2021, $244m in 2020, $149.3m in 2019 and $133m in 2018.

Further, if we deduct capital expenditures to get an idea of "free cash flow", the numbers are:

2022: $(134.5)m, 2021: $(8.4)m, 2020: $234m, 2019: $114.9m, $2018: $110.8m

The problem with this is it still doesn't really help. We need to look much further back – say, to a downturn, to see the full effects of a business cycle.

If you look at the table on the next page, you will see that Wolverine have generated free cash flow successfully every single year except for the last two fiscal years. The keener analysts amongst you will question why 2022 was such a poor year and it comes down to one simple component of working capital – inventory. Inventories increased dramatically on the balance sheet of Wolverine for two reasons – firstly, 2021 was a pretty good year as pent-up demand and excess savings stimulated the economy. Secondly, perhaps more importantly, there were supply chain constraints. The company assumed that transit times would remain poor throughout the year, overstocked and paid the price… big time!

As the economy returns to more normal (albeit tougher) conditions, Wolverine's management should have an easier job managing working capital. (Their earnings this year prove that it's very easy to stock up on inventory but much, much more difficult to reduce stock just as fast! However, management are doing a good job and I applaud their efforts.)

I'll admit that I'm not a massive fan of forecasting. I don't like being wrong. Wolverine's business is a cyclical which makes the job even tougher. Whilst the cash flows are fairly consistent, predicting how the economy and the business react to changes is nigh impossible. And management are making material changes every few months. For that reason, I'll refrain from sharing my personal model (that has multiple scenarios). I'll also admit that I haven't used a cash flow model. Instead, I used an old favourite – the two-stage dividend discount model.

However, it's not as simple as discounting dividends for five years and then into perpetuity. I went back and mapped out how each component of working capital changed in relation to revenues. Work out the trends and figure out how that affected cash flows and then dividends. Since I'm not completely sure whether we enter a recession or inflation comes back, I'm not keen on sharing my thoughts.

Wolverine World Wide Cash Flow 2006-2022

$ in mm	**2022**	**2021**	**2020**	**2019**	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**	**2007**	**2006**
Net earnings	$ -189	$ 67	$ -139	$ 129	$ 200	$ -1	$ 88	$ 123	$ 134	$ 101	$ 81	$ 123	$ 105	$ 62	$ 96	$ 93	$ 84
D+A	35	33	33	33	32	37	44	49	53	56	28	16	16	18	21	23	22
Deferred tax	-106	-15	-57	-9	22	-76	-6	-27	-19	-28	-4	8	-4	-8	0	-6	-9
SBC	33	38	29	25	31	25	23	19	25	28	15	14	12	9	8	8	7
Tax benefit SBC	0	0	0	0	0	0	-1	-5	-6	-3	-10	-3	-1	-1	-2	-3	-4
Pension contributio	0	0	0	0	-61	-11	-2	0	-4	-2	-27	-32	-10	-2	1	3	7
Pension expense	9	14	9	6	12	15	10	28	12	37	28	18	16	16	0	0	0
Debt ext	0	6	6	0	1	0	17	2	1	13	0	0	0	0	0	0	0
Restructuring	0	0	0	0	0	82	43	33	27	8	0	0	4	36	0	0	0
Cash restr	0	0	0	0	0	-65	-19	-10	-8	-1	0	-1	-8	-21	0	0	0
Imp	429	0	222	0	0	69	7	5	0	0	0	0	0	0	0	0	0
Environm	-23	34	32	49	-6	32	0	0	0	0	0	0	0	0	0	0	0
Trademark sale	-90	0	0	0	0	-7	0	0	0	0	0	0	0	0	0	0	0
Other	-3	-2	-13	-12	5	-11	-6	-2	12	-4	5	11	-4	-8	14	4	4
AR	85	-49	65	31	-95	-3	32	6	77	-41	15	-25	-33	10	3	-22	6
Inv	-429	-77	107	-24	-45	45	110	-69	3	35	-29	-28	-51	45	-39	23	-19
Other assets	-21	-2	7	-5	-18	0	2	15	-18	13	-17	-19	1	3	0	3	-3
AP	63	23	-19	0	41	11	-50	53	16	-27	6	-7	22	-7	-5	3	5
Income tax	2	2	1	4	-2	46	1	-1	0	0	0	0	-12	13	0	0	0
Other liab	26	16	28	-2	-19	13	3	-2	9	17	2	4	8	5	-4	-7	9
CFFO	$ -179	$ 87	$ 310	$ 223	$ 98	$ 203	$ 296	$ 216	$ 315	$ 202	$ 92	$ 79	$ 61	$ 170	$ 94	$ 123	$ 110
ACFFO	-99	9	244	149	133	163	258	200	298	167	113	100	61	163	86	115	99
Capex	37	18	10	34	22	32	55	46	30	42	15	19	16	12	24	18	17
FCF	**$ -136**	**$ -8**	**$ 234**	**$ 115**	**$ 111**	**$ 131**	**$ 203**	**$ 154**	**$ 268**	**$ 125**	**$ 98**	**$ 81**	**$ 45**	**$ 152**	**$ 62**	**$ 97**	**$ 82**

So far, in the first three quarters of 2023, Wolverine have generated $7m in GAAP OCF. Adjusted, that is really $142.8m – much, much better than what it seems. After capex of $18.5m, free cash flow is still over $120m. If we assume, conservatively, that Wolverine also generates $40m in the final quarter, Wolverine will have generated $160m in FCF over the course of the year. That's a multiple of under five times the current market cap – and this isn't a company anywhere near peak earnings!

As I've mentioned a few times in this piece already, it's still incredibly important to make sure that you don't assume the trend has bottomed. As the late Munger used to say "Always invert." Always be conservative and think about the worst-case scenario. But don't fall into the trap of thinking about the economy. Work out how it would look if Wolverine had their worst year and then consider what valuation you would pay for that business.

Management

In case you haven't realised so far, I am a massive advocate of Chris Hufnagel and his approach to turning around Wolverine World Wide to the business it should be. In earning calls he's been straightforward, raw and honest. He has admitted that the turnaround won't be complete in a "quarter or two" given the market environment. As for strategy, Mr Hufnagel has admitted that in recent years Wolverine have lacked strategy and described Wolverine as a "transactional" business.

But it's not just about the CEO. The whole team needs to get behind the CEO and drive his strategy to create a successful business. Mike Stormant, CFO since 2015, has gotten behind Mr Hufnagel's strategy and has made it clear that this way is the correct way to approach the situation.

On the 21st of December 2023, Bishu Jayaram was promoted to Chief Supply Chain Officer from SVP of Global Sourcing and Jim Zwiers, EVP and President of Global Operations was let go. Shareholders should be encouraged by moves like these. Letting go of a 25-year veteran to promote someone with only two years of experience at the company is bold.

Board of Directors

We wouldn't be in this position if it weren't for a strong board. When opening the Proxy statement, the first two members you read about (Will Gerber and Nick Long (Chairman)) are both private investment managers. That's useful and I'd bet that they are the people that are applying the pressure on management.

A second interesting "coincidence" I saw was that in the last five years there have only been two directors purchasing shares. Nick Long has purchased a little over $170k and Jeff Boromisa has purchased close to $1m. (Jeff Borimisa, who has been a director since 2006, retired in 2009 as EVP of Kellogg.)

What I also noticed was that three of the ten members had been appointed in 2023 by ex-CEO, Brendan Hoffman. I guess it wasn't enough to keep him on as CEO.

The problem with reading the Proxy is that you can sometimes fall into the trap of making up stories in your head. I have an idea of how the board operates but since none of my thoughts can be proved, I will refrain from sharing them.

Setup

The chart tells an interesting picture. With a new CEO, restructuring and divestitures, the market has treated Wolverine unkindly. However, since October, the stock has rallied quite nicely to be in a recent uptrend. Perhaps the market's initial sell-off on bad news was unjustified. Maybe. Or perhaps the market anticipates rate cuts and healthier consumers next year. More likely.

Given that the 200day ma is above $20/share and the current share price is more than half of the value, Wolverine's stock is clearly "cheap" on a technical basis.

The three-month average volume has been about 1.1m shares. This means that every 70 trading days Wolverine turns over its float – there aren't many long-term investors in this stock and there are many speculators trying to find a profit.

My Final Thoughts

There are many reasons to like Wolverine World Wide. It's hated, so buying it is contrarian and, perhaps more importantly, cheap! They have proactive management so you can be sure that action will be taken relatively quickly. Their underlying business is a proven model with historical success which should give you some confidence (given that the footwear market is unlikely to change dramatically over the coming years). Their last two years have been their worst years since the mid-1990s (in terms of cash flow generation) and 2023 has looked to be much stronger.

During those two years, despite all of those troubles, Wolverine have continued to pay out a dividend to shareholders when they could very easily turn off the taps and be as conservative as possible.

If we assume incredibly conservatively that management want to rid themselves of the Lifestyle brand and keep only the Active and Work brands, you're left with a company that will still do revenues of close to $2b in normal economic conditions.

It's entirely possible that all of the doomsayer economists are correct and consumers do go broke, inflation does come back and we have a recession – all in the next two years. But this is where you have to ignore the economy and look at the business you have in front of you. Based off the business opportunity you see in front of you, it would be ludicrous to pass up on such opportunities because "something bad may happen."

This is also where a margin of safety becomes so important. Many analysts make the mistake of thinking that a margin of safety has to be found on the balance sheet. I disagree. The margin of safety, in this case, has to be found within the cash flows of the company. Wolverine has no balance sheet value to the shareholders. To to a private equity firm looking to buy-out Wolverine, Wolverine definitely has some value – and the only way PE derive some value from Wolverine is using a discounted cash flow method. (Ok, the financial engineering to get to a final figure will likely be questionable, but that's a topic for another day.)

All in all, I think this is a much longer term play than many of my other picks. I'm buying as the business cycle is declining and the business may get worse, but if Wolverine live to see the next consumer-driven boom where profits return and multiples expand, I've no doubt this will compound quite nicely.

Best investing,

HV

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