

NASHVILLE NOTES

HEYDUDE, buybacks and acquisition debt

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For whatever reason, our daughters have always made fun of my all-time favorite non-athletic shoes — Crocs. I presently have four pairs. They do not like my Merrells either, allegedly because they wore them in fourth grade. They are both in their mid-20s today.

Crocs Inc. is not a stock I have ever followed. The company caught my attention on Dec. 23, 2021, when its shares fell 12% following the announced acquisition of footwear company HEYDUDE for \$2.5 billion.

What I mostly follow are banks. Each year there are a handful of deals that get a Bronx cheer from investors. Bank of Marin Bancorp and First Interstate BancSystem Inc. each dropped about 7% on news of acquisitions in 2021 though most buyers in 2021 saw their shares decline modestly or even rise. At the other end of the spectrum is First Citizens BancShares Inc. that saw its shares rise by 34% in the five trading days following the announcement that it would acquire CIT Group Inc.

Digging a bit deeper, the HEYDUDE deal speaks to two facets supporting the equity market: buybacks and debt.

The deal value (on an enterprise value basis) equates to less than 15x EBITDA and less than 5x 2021 estimated revenue of \$570 million. Crocs as of Dec. 28, 2021, had an enterprise value of 10.6x LTM EBITDA and 3.7x LTM revenue.

Crocs will finance the purchase via the issuance of a \$2.0 billion Term Loan B (a leverage loan that appeals to institutional investors given a structure that is like a high yield bond), \$450 million of common shares to be issued to the seller and \$50 million drawn from a credit facility.

S&P Global Ratings and Moody's rate Crocs as a middle-of-the-road (my interpretation) high-yield issuer with respective ratings of BB- and Ba3. Both put the company on review for a downgrade.

Debt investors have a deserved reputation as being smarter than equity investors who have unlimited upside versus debt investors who aspire to be paid contractual interest and principal at maturity. It is a tough existence when rates are near zero. Crocs has two \$350 million bonds that were issued in 2021 that have coupons of just 4.125% and 4.25% that are well below the current inflation rate.

Crocs does not strike me as overly levered though maybe the bar is lower for apparel companies where what is fashionable can turn on a dime. As of Sept. 30, 2021, its gross debt equated to 1.2x LTM EBITDA and net debt was just 0.6x. Crocs' leverage as measured by net debt is projected to be about 3x pro forma 2021 EBITDA. The punchline for equity investors but not debt investors is that the company will suspend share repurchases in 2022 until gross leverage is less than 2x.

Leaving aside the issue of gross vs. net debt, Crocs like many companies has been a heavy purchaser of its shares. Year-to-date the company repurchased \$518 million of its common shares compared to about \$430 million during 2017-2020 and \$184 million of convertible preferred shares repurchased in 2018. Cash generation has been great. Revenues have doubled from \$1.0 billion in 2017 to \$2.1 billion in the LTM period ended Sept. 30, 2021, while the EBITDA margin rose from about 5% to 31%.

Heavy buybacks and improving fundamentals are a backdrop for an awesome stock. The shares rose from about \$7 per share as of year-end 2016 to a high of about \$181 per share in mid-November 2021. The 12% drop on the HEYDUDE announcement is nothing viewed over this period, although the shares stumbled by over 30% from the November high through Dec. 23.

Over the years market structure has evolved to favor equities. In 1982, the SEC enacted Rule 10b-18 that created a safe harbor for open market repurchases. U.S. public companies have used the since modified rule to distribute excess cash and in the process acquire a massive amount of shares. Through Sept. 30, 2021, Apple Inc. has acquired \$93 billion of its shares year-to-date and \$348 billion since 2017. The comparative repurchases for Alphabet Inc. are \$37 billion and \$100 billion.

It is not just market leading tech companies that are heavy share repurchasers. The large banks are, too. JPMorgan Chase & Co. and Bank of America Corp. have each repurchased over \$80 billion of their shares since 2017, amounts that probably would exceed \$90 billion had repurchases not been curtailed in 2020 to preserve capital given then unknown impact COVID-19 would have on credit quality.

During the past decade, increasing passive flows into equities also have added another element of price support for companies that are included in major market indexes. For many mid-cap and large-cap companies, two or three of the top five owners are passive funds. These funds buy regardless of fundamentals.

Also, extremely low rates and a dearth of low-risk income alternatives for fixed income investors have allowed companies to issue debt to fund share repurchases, a strategy that makes sense to a point given the nominal cost of debt.

All of this is not to say that equity markets are on borrowed time or are on the cusp of a major fall before the "Fed put" is triggered. Rather, I note that a lot of big structural trends for equity investors have gone right in recent years — corporate profitability, buybacks, the rise of passive investing, falling interest rates and the availability of cheap debt to fund acquisitions and repurchases.

If one or more of these supports changes, the environment for equities and the multiples at which they trade could be quite different.

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