

# CAPITAL ALLOCATION

*K-Swiss and dilemma of too much cash*

BY MAX OLSON

In this article, I'd like to examine a few aspects of capital allocation. Instead of just explaining them, I think it's useful to use K-Swiss Inc. as a case study. I choose K-Swiss because it is a company I have researched in the past and it provides some interesting examples. As this article is not specifically about the company, I won't go into any business details other than to say that K-Swiss is a niche footwear company whose competitive advantages lay in cost structure and local dominance of its product space.

K-Swiss has an amazing return on invested capital. It makes a lot of money without having to plow that cash back into hard assets in order to keep earnings up.

Here's the problem: K-Swiss makes too much money. Too much money you say? How can that be? Well, in and of itself it's not a bad thing; but, it becomes a problem when there is no place to put the cash but the bank. This is the capital allocation process at work.

Some businesses keep cash for a reason. They need that money to ward off competition or to weather a cyclical downturn in their industry. Microsoft is a shining example of using this to their advantage. At the moment, Berkshire Hathaway has too much cash for its own good (Warren Buffett has stated that they need only about \$10 billion). But, Buffett is in his own world and he has earned my patience—as I know that cash will be put to good use at some point.

I don't believe this is the case at K-Swiss. Do they really need almost \$200 million in cash earning four percent a year? Let's say that out of the \$190 million in cash they have, \$40 million is needed for running the day-to-day business (I think this is very conservative, considering their low

capital requirements & high cash generation). This leaves \$150 million in cash. The athletic shoe industry and K-Swiss (historically) do have some cyclicality. So, let's say they keep another \$50 million for a rainy day (or in this case, a rainy few years). That still leaves \$100 million, and in 2005, after share buybacks and other cash expenses, they added another \$50 million.

## CASH FLOW STATEMENT

Taking a look at the cash flow statement for 2005, depreciation approximates capital expenditures, which are most likely 99% used for maintenance and not growth. K-Swiss prefers to grow sales with advertising and other intangible assets—this is why they have such a high Return on Invested Capital (ROIC). In 2005, K-Swiss decreased working capital (as it had in 2004) and paid out \$6 million in dividends.

So now, with the retained earnings plus the decrease in working capital, what did they do with the money? They paid down some debt incurred in 2004, and bought back \$26 million in stock. After all this, there was still \$53 million that wasn't spent and went right into a money market account.

When you subtract excess cash when calculating ROIC, you have to assume management is going to reinvest earnings at those same returns in the future; otherwise, you might as well leave that cash in the equation. I like to think of the cash flow statement as the "capital allocation" statement. This is where you get to see how much money came into the business, and where management is putting that cash to use. Profitable growth? Unprofitable growth? De-leveraging? Share buybacks? Dividends?

*What Can K-Swiss Do With Its  
Excess Cash?*

There are a few options:

- 1) Buy back more stock, or do one large tender offer
- 2) Pay out a larger dividend (I'm not a fan of this option)
- 3) Reinvest in the core business through invested capital or more advertising

For any business that has barriers to entry and returns on capital in K-Swiss's range, the third option is my favorite choice by a large margin. But with K-Swiss, that might (I'm by no means an expert) do more harm than good. One advantage of K-Swiss is that it has for the most part stayed out of the range of bigger players like Nike and Adidas/Reebok. Getting bigger and bigger might make sense to grow earnings in the short-term; but, in the long-term, doing so would lead to direct competition with the big players. This leads to lower margins/lower volumes, and hence a lower ROIC. All of this essentially means that K-Swiss has reached the limits of their franchise. As a result, their returns on *incremental* capital are completely different from the ROIC of their core shoe business.

Assuming that the stock is cheap, the best option would be to buy back more stock or to invest more in the European business (the latter choice is preferable only if K-Swiss can create the same competitive advantages it enjoys in North America). Investing in other ventures like Royal Elastics could also be a good option if they can get the same returns.

Worst case scenario: if management cannot find high return investments within their competency range, and shares are not significantly undervalued, then returning capital to shareholders with a large one-time dividend becomes the only reasonable option.