EXECUTIVE SUMMARY

Deckers Outdoor Corp. ("Deckers") has experienced a period of exceptional earnings growth from $30.6 million in the full year ending December 31, 2006, to $201.9 million for the full-year ending December 31, 2011. Operating cash flow, however, has fallen short of the company’s earnings improvement. This cash flow deficiency can be attributed to several factors, including:

- Increasing inventory – due primarily to higher material costs, increase in product offerings, early delivery of spring inventory, and new store openings, inventory increased to 67.12 revenue days in 2011, up from 45.58 revenue days in 2010 and 38.31 revenue days in 2009.

- Increasing accounts receivables – due primarily to increased sales and Deckers’ new wholesale European business, receivables increased to 51.25 revenue days in 2011, up from 42.54 revenue days in 2010 and 34.30 revenue days in 2011.

- Increasing prepaids and other current assets – due primarily to deposits with respect to purchase commitments made pursuant to suppliers for sheepskin contracts, prepaids and other current assets increased 849% to $84.5 million in 2011 from $8.9 million in 2010.

Analysts and investors interested in Deckers Outdoor Corp. will want to pay close attention to the cash flow shortfalls the company is experiencing.
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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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Earnings Quality: Summary Reports on Individual Companies

Lennar Corp.: A Case of Lagging Cash Flow

Earnings Quality: Background and Definition

Earnings quality is an evaluation of the extent to which a firm’s earnings are generated from sustainable sources that are backed by cash flow. There are two dimensions to earnings quality: the persistence and cash flow dimensions. In examining the persistence dimension of earnings quality, we identify whether reported earnings have been boosted by nonrecurring items. For example, earnings increased by a nonrecurring gain from an asset sale or a one-time reduction in the effective tax rate due to a tax-loss carryforward would impair earnings quality on the persistence dimension. In evaluating the cash dimension of earnings quality, we seek to determine whether reported earnings are supported by cash flow. For example, cash flow would lag earnings for a company that has provided its customers with extended payment terms or that has accumulated inventory in anticipation of increased future sales. Such lagging cash flow would impair earnings quality on the cash dimension.

Earnings that are of low quality increase the likelihood that future earnings will decline from current levels. This is not to say that future earnings will decline, but the likelihood of a decline is increased for companies with low earnings quality. For example, in the case of the nonrecurring gain or the low effective tax rate, future earnings will decline when that gain is excluded or the tax-loss carryforward is no longer available. For the firm that has provided extended payment terms or that has accumulated inventory, future earnings will decline if the resulting receivables or accumulated inventory cannot be realized and writedowns ensue.

In assessing earnings quality, the balance sheet also plays an important role. We use the term position quality to refer to the effects of the balance sheet on earnings quality. We say that position quality is impaired when assets are carried at amounts that exceed fair value or when obligations are carried at less than the amounts needed to liquidate them. Companies that accumulate overvalued assets or undervalued liabilities will see their earnings decline when those overvalued assets are written down or those undervalued liabilities are written up. For example, at some point an investment in a debt security of a financially-troubled issuer that is held to maturity and carried at cost will need to be written down. Similarly, a charge will be needed to increase the balance of an underaccrued warranty obligation. In both instances future earnings will suffer.

The purpose of our summary reports on individual companies is to enable us to focus our attention on one or more dimensions of earnings quality. For example, we might identify nonrecurring gains that we think have impaired a company’s earnings on the persistence dimension. Or, declining cash flow may be our focus, impairing earnings quality on the cash dimension. Finally, for some firms we may look at the balance sheet where position quality may be impaired due to overvalued assets or undervalued liabilities.

A Caveat

In our reports we are not saying that we believe that the earnings or stock price of the company in question will decline. Rather, we are pointing out what we have found in publicly available filings that we think is worthy of closer scrutiny by analysts and investors.
Deckers Outdoor Corp.
Deckers is a designer and marketer of fashion-oriented footwear for both high performance outdoor activities and everyday casual lifestyle use. Deckers’ brands include, but are not limited to: UGG®, Teva®, Sanuk®.

The company’s fiscal year ends December 31. Amounts are reported in millions and are for the fiscal year ended December 31.

The Cash Flow Shortfall
Deckers has experienced a period of exceptional earnings growth for the years ending December 31st from 2006 to 2011. Net income (from continuing operations attributable to Deckers) has increased steadily to $199.05 million in 2011 from $158.24 million, $116.79 million, $73.95 million, $66.44 million, and $30.61 million, respectively, for 2010, 2009, 2008, 2007, and 2006.

![Net Income (from Continuing Operations)](image)

Source: Cash Flow Analytics, LLC

Operating cash flow, however, has fallen short of the company’s earnings improvement. From a recent high of $185.47 million in 2009, operating cash flow has fallen each year to $139.92 million in 2010 and $30.09 million in 2011.
With the decline in operating cash flow comes an accompanying decline in the company’s free cash flow, which turned negative in 2011. It is the first negative amount for free cash flow to be reported by the company since 1998.

The observed lag in operating cash flow relative to net income manifests as a decline in the earnings quality indicator, EQI. EQI measures the quality of earnings on the cash dimension. The metric incorporates changes in operating cash flow and net earnings in a single measure. It is calculated as cash provided by operating activities less income from continuing operations, all measured as a percent of revenue. The drop in operating cash flow that accompanied the increase in income from continuing operations is what pushed EQI lower and negative in 2010 and 2011.
Earnings Quality Indicator (EQI)

Calculated as (Operating Cash Flow – Income from continuing operations) / Revenue

Source: Cash Flow Analytics, LLC

Key Factors Contributing to the Cash Flow Shortfall

1. Inventory increased to $253.3 million in 2011, up from $125.0 million in 2010, and $85.4 million in 2009. These increases were primarily due to higher material costs, a larger spring 2012 assortment for the UGG brand, early delivery of spring inventory for the UGG and Teva brand, the additional inventory associated with the Sanuk brand, and increased retail store inventory due to 18 new stores.

Inventory is increasing faster than revenue, resulting in an increase in inventory days. Inventory days increased to 67.12 revenue days in 2011, up from 45.58 revenue days in 2010 and 38.31 revenue days in 2009.

Inventory Days

Source: Cash Flow Analytics, LLC

2. The increase in accounts receivable over the past two years has also been a negative factor impacting operating cash flow. Deckers attributes the rise in receivables to the increased level of sales and their new wholesale European business. Receivables increased by $76.7 million in 2011 and $40.2 million in 2010, reducing operating cash
flow. Receivables days increased to 51.25 in 2011 from 42.54 in 2010 and 34.30 in 2009.

**Receivables Days**

![Receivables Days Chart]

*Source: Cash Flow Analytics, LLC*

(3) The significant increase in prepaids and other current assets for the year ending December 31, 2011 reduced operating cash flow. According to Decker, the larger increase in these assets was primarily due to deposits with respect to purchase commitments made to a supplier pursuant to their sheepskin contracts. In the year ending December 31, 2011, prepaids and other current assets increased to $84.5 million from $8.9 million in 2010.

(4) The company did delay payments to vendors more in 2011 than in previous years. At the end of 2011, trade accounts payable were $110.9 million, up from $67.1 million, in 2010. This increase in trade accounts payable helped to boost operating cash flow and free cash flow, offsetting other working capital increases that lowered cash flow. At the end of 2011, trade payables measured in revenue days were 29.38, up from 14.95 at the end of 2010.

The Effects of Acquisitions

Deckers did complete a significant acquisition in 2011. On July 1, 2011, the company completed an acquisition of the purchased assets and the assumption of the assumed liabilities of the Sanuk brand. Deckers’ results include the operations of Sanuk beginning with July 1, 2011.

The cash consideration paid for Sanuk was $125.2 million, less a receivable from the seller of $1.7 million. In addition there is a contingent purchase consideration outstanding in the amount of $88.1 million. The effects of the acquisition on revenues and operating income in 2011 were not that significant. Had the results of Sanuk been included with Decker’s consolidated results for all of 2011 (not just the period July 1, 2011 through December 31, 2011), Deckers’ reported revenues would have been $1,419.6 million versus the $1,377.3 million reported. Income from operations would have been $297.8 million versus the $284.8 million reported.
We mention the acquisitions because, at times, they can unduly increase working capital metrics like receivables days, inventory days and trade payables days. Based on the company’s disclosures, however, acquired receivables, inventory and trade payables were $12.8 million, $7.5 million and $5.5 million, respectively, at the acquisition date. As of year end, 2011, the company’s balances in receivables, inventory and trade payables were $193.4 million, $253.4 million and $110.9 million. As such, balances of the acquired accounts are immaterial to the ending balances and we can attribute the increases noted in these accounts to operations and not to the effects of the acquisition.

One other point to note, company-reported operating cash flow and free cash flow exclude the effects of acquired working capital. Cash paid for all acquired accounts, including working capital accounts, are reported as an investing use of cash. Keep in mind, though, that the liquidation of acquired balances, the $12.8 million in receivables and the $7.5 million in inventory, less the $5.5 million in trade payables, provides a one-time boost to operating cash flow and free cash flow for a net amount in this example of $14.8 million ($12.8 + $7.5 - $5.5). The effects in this example are not that significant. However, given the decline in operating cash flow during 2011, they do comprise 49.2% of operating cash flow of $39.5 million for the year. Stated another way, had the company purchased or acquired this $14.8 million of working capital through operations instead of through an acquisition, operating cash flow in 2011 would have been lower by $14.8 million or 49.2%.

**Overall**

Analysts and investors interested in Deckers Outdoors Corp. will want to pay close attention to the cash flow shortfalls the company is experiencing. In particular, for the reasons cited, the earnings improvements the company has enjoyed have not been accompanied by improvements in operating cash flow and importantly, free cash flow, which has now turned negative.

It certainly is possible that the cash flow shortfall seen in 2010 and 2011 is due to nonrecurring factors that will lessen through time. For example, inventory needed to stock new retail stores results in an operating use of cash that may result in increased operating cash flow in future periods. Analysts and investors will want to watch developments at the company closely.