

This month's *"Class is in Session"* will look at Decker's Outdoor (DECK) to provide investors an overview of the clues revealed in the Merriam Report analysis of the footwear and apparel maker released prior to Q1 2011 earnings.

Quick Take: Although DECK Q1 results beat analyst estimates, management caught investors off-guard with a forecast for a surprise Q2 loss. DECK shares tumbled more than 12% following the news and are currently (as of 6-3-11) near the May 2nd lows.

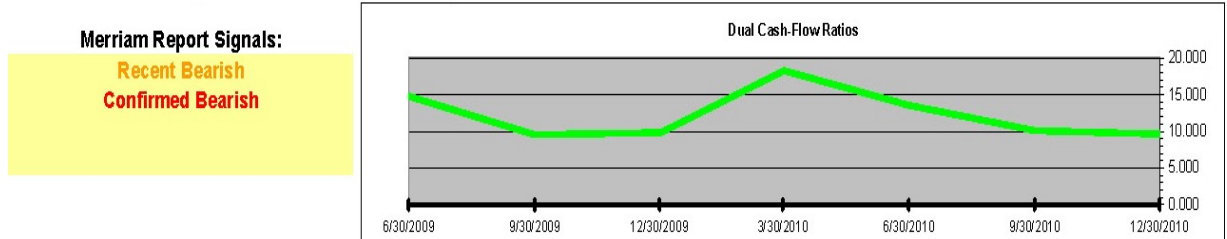


What clues did the Merriam Report reveal that might have provided early warning leading up to DECK's Q1 earnings report?

The first clue to a possible future hit on earnings could be seen in the deteriorating dual cash-flow ratio trend beginning back in Q1 2010.

The Merriam Report

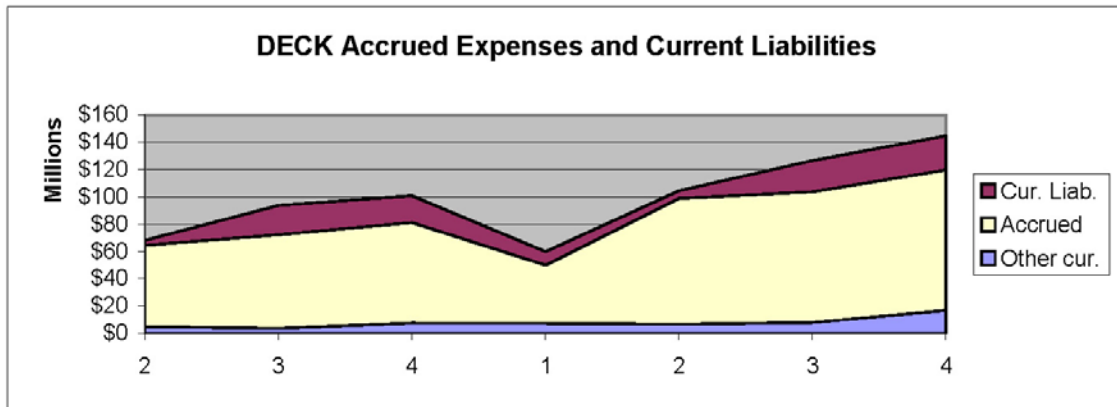
DECKERS OUTDOOR CORP	DECK	12/31/10	6.406	8.147	-21.37%				
Quarterly period ending:		6/30/09	9/30/09	12/31/09	3/31/10	6/30/10	9/30/10	12/31/10	-3.05%
MR Dual Cash-Flow Figure		14.757	9.523	9.817	18.230	13.541	10.066	9.609	



Although DECK was generating positive operating cash-flow, the spread or differential to the amount of non cash adjustments declined to a level not seen since Q3 of 2009. The implication being that while sales growth was rising steadily, the level of pure operating cash-flows supporting earnings were declining.

Growth companies often incur bumps in cash-flow and liquidity, but the longevity of this decline was quite noticeable by Q4 of 2010. We would also point out that while this in no way suggested DECK was running out of cash, the dual cash flow ratio indicators were telling us that the cookie jar was lighter despite a surge in sales.

The Merriam report analysis also revealed structural shifts in the balance sheet which hinted to potential earnings bumps. Evidence of this can be seen in the dramatic rise in current liabilities, accrued expenses and to a lesser extent increased “other” current liabilities.



In the chart above, you can see this trend also appears to originate in Q1 2010 and continues through Q4. More important, the correlation of the adjustments being made in the cash flow statement didn't appear similar to the changes represented in the balance sheet.

For example, between Q1 2010 through Q4 2010, accounts payable and accrued expenses grew 197%. In contrast, revenue growth during the same period was only 177%. Most analysts might consider this pointless niggling, but it does play into the outcome ultimately manifest in the surprise expected Q2 2011 loss.

Another warning sign emerged in Q4 2010 which can be seen in the adjustments to net cash used/provided by operating activities (circled below). Accounts payable and accrued expenses were equivalent to almost **26%** of the company's net reported cash at year-end.

Changes in operating assets and liabilities, net of assets and liabilities acquired in the acquisition of businesses:

<i>Trade accounts receivable</i>	<i>(39,449)</i>	31,527	(38,153)
<i>Inventories</i>	<i>(41,107)</i>	5,247	(45,749)
<i>Prepaid expenses and other current assets</i>	<i>(6,766)</i>	(3,408)	(465)
<i>Other assets</i>	<i>(1,651)</i>	(1,012)	115
<i>Trade accounts payable</i>	<i>19,742</i>	3,790	6,739
<i>Accrued expenses</i>	<i>16,468</i>	2,583	9,049
<i>Income taxes payable</i>	<i>5,480</i>	(6,525)	7,120
<i>Long-term liabilities</i>	<i>2,187</i>	2,421	3,847
Net cash provided by operating activities	139,922	185,474	53,276

This indicates that not only was management stretching out payments to vendors, they were also deferring accrued expenses to be rationalized at a future date. Such accounting maneuvers are perfectly legal under GAAP rules, but it suggests a company may be struggling to preserve cash by postponing current obligations.

“Temporary perhaps, but an investor who heeded changes in the relationships and the story being told in the financial statements might have been able to adroitly avoid the big hit following the Q1 earnings report”.

DECK was also in the process of a big push into foreign markets and at the same time, transitioning to a wholesale model in the UK and Benelux region. We pointed this out in an earlier report on DECK released on January 27th of this year.

Conclusion: Regardless of how sensational a growth story might be a company’s ability to manage liquidity and ultimately earnings will be impacted fundamentally by the source of and adjustments to cash-flow.

“Just because a company may be reporting growth in shareholder equity alongside rising reported sales does not guarantee that equity returns are supported by cash from paying customers”.

Keep in mind that analysts had been raising price targets based on enterprise value estimates and discounted cash-flow models. Meanwhile, the stock price kept rising until management shocked investors by telling them Q2 was going to be a bummer.

Momentum markets often ignore fundamentals until they become glaringly obvious, but moral of the story is fundamentals do matter! Discounted cash-flow models wouldn’t have seen this coming.

Stay tuned for more installments of “*Class is in Session*”, and feel free to explore the Merriam Report website and learn how our innovative and affordable investment research products and services can help to improve your investment results.

Class dismissed.

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Complete Merriam Report analysis for DECK can be viewed [here](#).

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