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Time for a New Shirt?

Apparel industry investments translate into value for shareholders only when they generate revenue growth.

Gregory V. Milano, Steven C. Treadwell

Fashion can be exhilarating and trendy, but it's also often fickle and fleeting. In order to attract attention and drive sales, apparel companies must continually design new and exciting products for demanding and fussy consumers. While those things are true in most industries, product evolution in apparel is awfully rapid. Successful products from last year, last season, or even last week are frequently replaced in the hearts and minds of consumers as competitors both imitate and invent the latest fashion trends.

The multibillion-dollar apparel industry is rich with substantial sales and profitability. The 76 public companies operating in this industry and listed on major U.S. exchanges combined to generate $189 billion of sales and $25 billion of earnings before interest, taxes, depreciation, and amortization (EBITDA) in 2010.

Well-known companies such as Nike, Ralph Lauren, and Urban Outfitters compete to design, market, and sell products that draw the interest of an ever-changing customer while delivering value to shareholders. As the market and economy continue to recover, now is a good time to evaluate which strategies and performance characteristics have created the most value for shareholders.

We calculated the 2007–2010 total shareholder return (TSR) — dividends plus share price appreciation — for each company. We then divided the companies roughly equally into top performers (TSR above 14% per year), medium performers (TSR between zero and 14% per year), and bottom performers (TSR below zero).

The top performers employed a variety of strategies. The top-performing TSR company, Finish Line, had a 95% annualized TSR. Interestingly, however, the company lacked sales growth. Instead, Finish Line doubled its margins, boosting its EBITDA from 5.5% of sales in 2007 to more than 11% in 2010. In contrast, while G-III Apparel delivered 27% annualized sales growth — the second-fastest growth — it produced 34% annualized TSR.

Every company is unique, and as a result, the best path to strong share-price performance varies. To help executives in the apparel business consider strategic choices, we evaluated the top, medium, and bottom performers in terms of sales growth, profitability, return on capital, reinvestment rates, and distribution policies.

Perhaps not surprisingly, sales growth and returns on capital are strong drivers of value creation. The median three-year compound annual sales growth rate of the top performers was 6%, compared with 5% for the medium performers and sales declines for the bottom performers.

Not only did the top performers grow faster, they generated higher cash-on-cash returns on capital as well. The median return for the top performers was 18%, compared with 15% for the medium performers and 11% for the bottom performers.

In many industries, high growth is the result of reinvesting a high percentage of cash flow back into the business through capital expenditures, working capital, new lease obligations, acquisitions, or research and development. But that's not so in apparel. The top performers did not require significant investment to grow at above-average rates. In fact, as a percentage of their gross cash earnings (EBITDA plus rent and R&D, less taxes), this group reinvested a median of 73%, which is a lower reinvestment rate than the 89% and 95% medians for the medium and bottom performers, respectively.

The top performers delivered more sales growth with less reinvestment — in other words, they had better reinvestment productivity. They were able to achieve this because their business models are more capital efficient. Each dollar invested in working capital, fixed plant, capitalized operating leases, and the like by the top performers generated $1.24 of sales, which compares favorably with figures of $1.06 and $0.89 for the medium and bottom performers.

This difference in capital efficiency not only delivers more sales growth per dollar invested but also explains the differences in cash-on-cash returns. Across the three groups, the median gross cash earnings as a percentage of sales were the same, 14%. Thus, all of the differences in cash-on-cash returns on capital were attributable to differences in capital efficiency.

We also examined the propensity to distribute cash through dividends and share repurchases, and did not find any significant difference in policies between the top performers and the other two groups. The ability to create value in apparel seems to be much more related to the effectiveness of investments in the business than to the distribution of capital to shareholders.

This clarifies how the top performers managed to create so much value for shareholders. They developed or merchandised sought-after products that were effectively marketed to attract consumer purchases at prices that generated more sales and gross cash earnings per dollar of capital invested.

The more efficient the capital is, whether manufacturing facilities or retail stores, the higher the cash-on-cash returns become, enabling more profitable growth with less investment. For the bottom performers, capital is less efficient and growth becomes significantly more expensive — which makes reinvestment much less value-creating for shareholders.

Gregory V. Milano, a regular CFO *columnist, is the co-founder and chief executive officer and Steven C. Treadwell is a partner and heads the Chicago office of Fortuna Advisors LLC, a value-based strategic advisory firm.*