KIPPINGTON
CAPITAL MANAGEMENT

P: +1 (847) 648-2667
F: +1 (847) 920-6703

1060 W Balmoral Ave
Ste G
Chicago, IL 60640

April 21, 2020

Summary

- Boot Barn operates an almost monopolistic business with strong returns on incremental capital deployed.
- Shares have been oversold due to fears of the decline in oil prices and the economic downturn associated with COVID-19.
- At current levels, the share price offers a substantial margin of safety.

Boot Barn (BOOT) is an advantageously positioned retailer insulated from many of the corrosive forces that other retailers face. BOOT operates a growing number of brick and mortar retail stores and e-commerce properties that sell western wear and boots (70% of sales) as well as work attire for the oil and gas, agriculture, and construction industries (30% of sales). And where most retail clothing stores are based solely in extremely competitive population centers, a large portion of Boot Barn stores are located in smaller cities and more rural areas.

The stores are generally around 10,000 square feet and feature substantial inventory on display. BOOT ensures the shopping experience is a pleasant one with trained associates to actively help customers and even iPads that allow customers to order from the e-commerce site if they'd like an item that isn't in stock. This great experience is reflected in positive customer reviews of the stores and an 8% average same store sales growth over the past 36 quarters. From my conversation with investor relations, this is likely due both to expansion of the company's TAM as well as taking of market share.

The company's primary advantage is its size; both in overall scale and relative to its competition. In fact, BOOT has triple the number of stores of its next largest competitor, Cavender's, who primarily focuses on Texas markets. The remaining competitors in the fragmented industry are small, regional groups or family owned one or two-location stores leaving plenty of room for consolidation.

Combined with Boot Barn's dominant physical store footprint, its e-commerce properties encompass most of the top results for relevant internet searches. All this leads to an almost monopolistic position in its industry, providing it both pricing power with branded suppliers as well as the opportunity to introduce in-house higher-margin products. BOOT has jumped at this chance, and in fiscal 2019, it saw 15% of its sales derived from exclusive brand partnerships as well as roughly a full 1% jump in merchandise margin due to increasing penetration of its private brands.

Generally, long-term investors have been quite wary of retail clothing businesses. After all, fashion trends are notoriously difficult to predict, change very quickly, and decimate those who do not adapt fast enough. But, this is not your typical retail clothing business. Boot Barn's focus on western wear and workwear largely eliminates the typical risks of changing tastes as both of those categories change very slowly if at all. Think how similar work jeans and cowboy boots look today compared to several decades ago.

Boot Barn has used its dominant position and its steady cash flow to compound its physical store count at an average annual rate of about 16% since 2012 compared to roughly 7% for Cavender's. Its new stores have excellent unit economics with an average cost of $800k and a targeted payback period of 3 years. Management believes there's an opportunity to almost double the store count to 500 indicating a lengthy runway for incremental capital to be deployed with strong returns.

Excellent Management Team

At the helm is Jim Conroy, Boot Barn's CEO, President, and a director since 2012. Over the past 5 years, he has overseen the company's compounding of its book value at almost 27% per annum. Though he is not a significant shareholder in the company, with holdings worth only about $1.5mm, his long tenure shows commitment and should be considered a strong positive. What's more, he has a background in retail management, serving as EVP, President, COO, and interim CEO at Claire's, Inc. while it was owned by Apollo. During his tenure, the company increased sales as well as operating margin substantially.

Greg Hackman, Boot Barn's CFO since 2015, worked with Jim at Claire's and brings a strong finance background from Macy's and other department stores. The Chairman of the Board, Peter Starrett, also has an astounding retail resume having served as President of Warner Bros. Studio Stores as well as Chairman and CEO of clothing retailer, The Children's Place.

Management's compensation plan is sound but has room for improvement. The board's compensation committee retains discretion over the percentage breakdown for executives' salary and short-term and long-term incentive compensation, something I believe would be more efficient if it were formulaic. However, fully 70% of Mr. Conroy's pay last year and 52% of other officers' pay was determined by performance. Performance pay is largely determined by adjusted EBIT. Though it's difficult to determine if the adjusted EBIT targets are ambitious enough, the percentage of compensation tied to the company's profitability is encouraging.

Though management has overseen significant growth in most metrics, their track record is not without its flaws. Several years ago, BOOT bought its largest e-commerce competitor, Shepler's, further solidifying the company's dominant position. Unfortunately, the acquisition has not performed as well as hoped with Shepler's seeing declines in sales while BOOT continues to grow. Management responded by taking steps to reduce Shepler's pay-for-click advertising costs when results showed the returns were inadequate. Importantly this indicates that they are not looking to grow for growth's sake, a costly mistake many management teams make.

What It's Worth & Risks

Boot Barn is a member of the small group of companies that neither pay a dividend nor repurchase their own shares. It has continued to deploy its retained capital into growing its business. To a long-term investor, this is preferable. Not only is it tax-efficient as opposed to paying dividends, but ideally, the company can earn higher returns on the capital it deploys than investors can. This seems to have been the case with BOOT as the company's average return on incremental capital deployed for the past 5 years has been about 27%. This has led the company to compound its free cash flow (adjusted for new store openings) at just over 17% per year over the past 5 years on a two-year rolling average basis. It's important to note that, even absent the current macro-economic conditions, this level of growth is not likely to be repeated as the trend in recent years shows same store sales growth slowing to low to mid-single digits.

The company has seen little volatility in earnings since 2013 (the company's earliest public history), but there's no question that the current economic downturn will take a large toll on BOOT's business just like any other retailer. Inconveniently, the oil market is also seeing a dramatic shift take place at the same time with holders of the front-month WTI crude futures contract actually being paid to settle in spot oil. In 2015 and 2016, the last time there was an oil shock that sent prices lower, same store sales decreased to roughly flat across the entire store base. Management disclosed that there were about 15 stores at the time that were particularly affected in Wyoming, Colorado, Texas, and North Dakota with smaller spillover effects felt at other stores. A greater shock should be expected this time, though it's impossible to know how long the oil rout will last given it's to a large extent tied to the reopening of the world economy.

BOOT is carrying a long-term debt load of $108.8mm and has $45mm drawn on their line of credit as of the end of Q3 (Dec 28, 2019). In fiscal 2019, the company covered its interest expense about 4x with operating income, and the average debt load was just short of $190mm including its credit line. In the first three quarters of this fiscal year, that interest coverage has expanded to about 6x due to the lower debt load and steady sales. With the strong interest coverage, BOOT runs very little risk of default even during this economic downturn.

It's a difficult time to attempt to forecast what any particular company will be earning in the next several years as the effects of COVID-19 are unprecedented. And it is, after all, the job of the equity analyst to distill information and project the future earning power of a business such that it can be compared against returns on other assets. In the current environment, I believe it's best to establish conservative cases as parameters for finding a fair valuation range.
In a quick recovery case where BOOT sees a 35% decrease in FCF in F2021 (assuming F2020 is roughly no change from the prior year), it takes two years to return to F2019 cash flow levels, and the company grows at 2% per year from there, a fair valuation is about $18.38 per share. In a worst-case scenario where the company instead faces just over a 50% decline in FCF in F2021, it takes four years to return to F2019 levels, and then grows at an annual 2%, a fair valuation is roughly $16.73 per share. This shows the extreme magnitude of a downturn the market is already pricing in with shares recently trading hands at $11.

There are risks to Boot Barn's long-term performance. First, a permanent contraction of the oil and gas market in the US would lead to both a lower normalized level of workwear sales for the company as well as diminished sales of recreational western wear in stores based near oil producing areas. Though we are seeing multi-decade lows in oil prices because of disagreements between oil-producing nations, it is also due to the historic (and quite temporary) drop in demand from stay-at-home orders across the developed world. There is little reason to expect a long-term, permanent impairment of the oil and gas industries. Second, Amazon or other e-commerce companies could move western wear sourcing in-house and steal sales away from Boot Barn. BOOT is well-defended with its brand name, exclusive products, and the fact that people generally prefer to buy cowboy boots and other fashion in-person to ensure the proper fit as it can vary substantially.

All in all, demand for western and work wear will continue and grow, and it's quite difficult for purchasers not to buy from Boot Barn. The company is many times the size and scope of its largest competitor which has allowed it to sell both private and exclusive brands, and it is frequently its suppliers' largest customer giving it pricing power on the input side. The company will likely never be unseated from this position.

Boot Barn is operated by capable retail veterans and reinvests the entirety of its spare cash flow back into its business. A runway for growing stores paired with strong unit economics means that incremental returns on capital will likely remain satisfactory. There's no question that the current economic downturn and the shock to the oil industry will significantly impact Boot Barn in the short-term. But on the other side of the coin, the company may also be able to consolidate smaller, struggling competitors at more attractive valuations, providing value in the long-term. And with shares pricing in a beyond-worst-case scenario, there's an opportunity to own a great business with a substantial margin of safety to a fair valuation of $17 - $20 per share.

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Disclosures

I am/we are long BOOT.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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