Quiksilver's Margin Problem, Covenant Breach Risk, Increasing Cash Burn: Why The Common Stock Is Likely To Get Wiped Out

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Summary

- Despite mammoth underperformance this year, the scale of deterioration in ZQK's business and balance sheet suggests full equity impairment could be as little as two quarters away.
- Worsening performance in recent years has been driven mostly by sales declines, not margin declines. With margins still largely higher than peers, discounting remains a key risk this holiday season.
- Cash conversion has been favorably pushed out in the recent 3Q, suggesting payback in coming quarters; ZQK likely breaches debt covenants on its senior credit facilities in 1-2 quarters.
- Recent non-core asset divestitures provided a significant cash buffer that has now been exhausted, meaning senior creditors will have to fund any future cash burn.
- Tangible book equity is negative, suggesting shareholder value in any restructuring (not just bankruptcy) should be de minimis; and even assuming a massive recovery, the stock is not cheap.

Regular readers will recall I much prefer shorting a structurally-broken business (often with an irredeemable capital structure) at a low price than a decent business at an expensive price; of course, when you can short a broken business at a relatively rich price, that's when you've found yourself a real dandy. I believe Quicksilver (NYSE:ZQK), the Huntington Beach-based collection of surfing + skate brands, is one such candidate. Hadrian Capital wrote an excellent writeup on the name recently, so I won't rehash too much covered ground. Here is the 30-second summary of ZQK's current predicament:

- wholesale channel revenues (~70% of total last fiscal year) have collapsed this year as ZQK's main consumers (i.e., teens) flock to cheaper, trendier, off-mall fast fashion offerings;

- chronic over-leverage has limited marketing/sponsorship spend, leading to loss of core surf/skate customers (the very few who are willing to pay a brand premium);

- global restructuring (including non-core brand sales + a move to licensing-out a number of SKUs) has caused execution issues that have compounded the above problems;

- financial performance has been beyond miserable (sales -14% YoY 1Q-3Q FY14, adjusted EBITDA -77% YoY ($90mm ->$21mm) and leverage has exploded (20x LTM EV/Adj EBITDA as of 3Q).

As horrible as recent performance has been, I am quite concerned that performance in 4Q14 through 2015 won't meaningfully improve, and that this spells the end for the listed ZQK's equity 'stub' value.

Here's why (I will address each point in turn):
- **the margin problem:** sales declines in recent quarters have mostly been a function of lost traffic (lost share, lower demand), not declining margins. While margins have come off, the overall margin level has - up until now - been pretty healthy (when you compare against other teen retailers). Going forward, this is a huge problem for company with damaged brand equity, and even something management has potentially telegraphed in recent conference calls;

- **working capital payback:** while ZQK has been burning cash due to high cash interest payments and the collapse in EBITDA, this has been mitigated by a favorable move in working capital (especially in the recent quarter). As business continues to deteriorate, this former benefit will likely boomerang back on ZQK in coming quarters, causing a painful cash drain;

- **limited liquidity and covenant breach risk**: ZQK's balance sheet is so highly levered, with limited available liquidity, that any potential covenant breach could bring the whole cap structure tumbling down. Unfortunately, given the likely accelerating cash burn in coming quarters, a covenant breach appears highly likely (which, given the massive quarterly cash interest burden payable on subordinated notes, may not be easy to waive and could cause an acceleration);

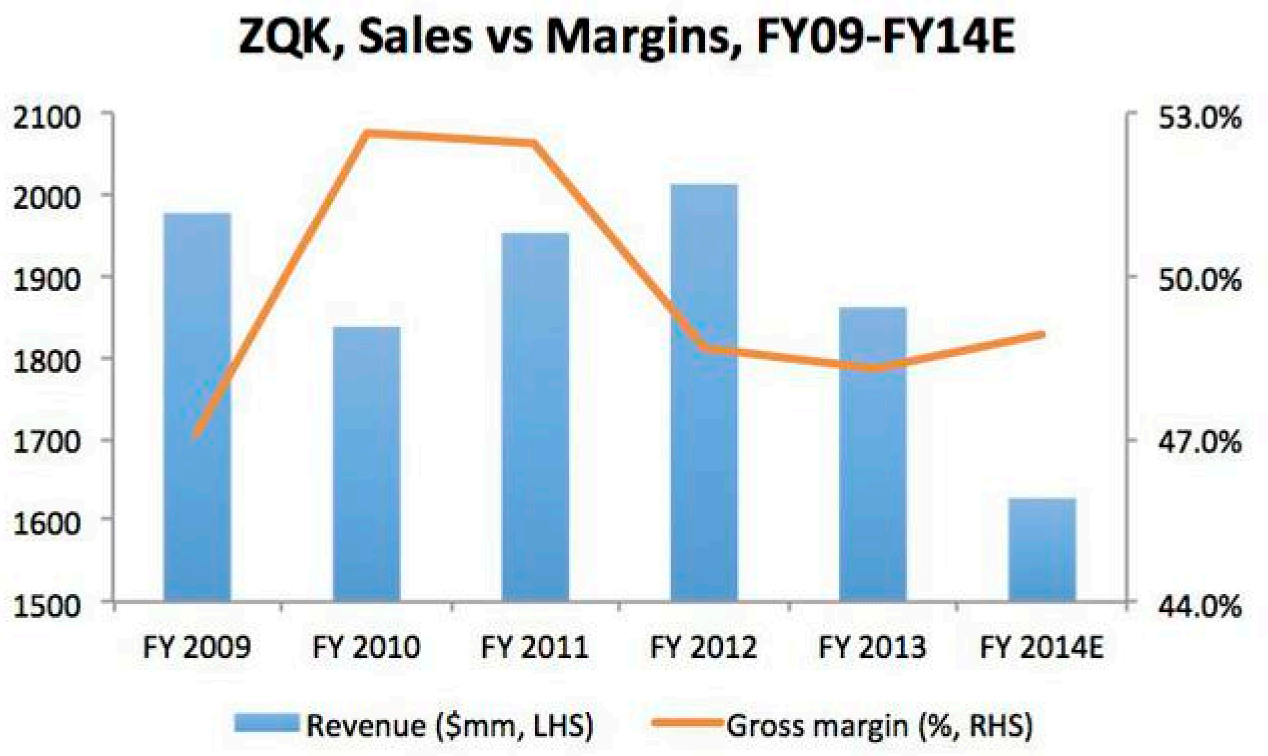
- **non-core asset sales are over**: ZQK has completed its sale of non-core assets, with the recently announced sale of its minority stake in Surfdome. There is no more cash cushion to come from selling non-core assets (and covenants will not let ZQK sell any of the main 3 brands);

- **the 'even if' upside turnaround case is not that scary**: leverage weighs so heavily on top of the common equity here that even assuming a successful turnaround in FY15, the stock still looks far too rich at current levels ($2/share).

1. The margin problem

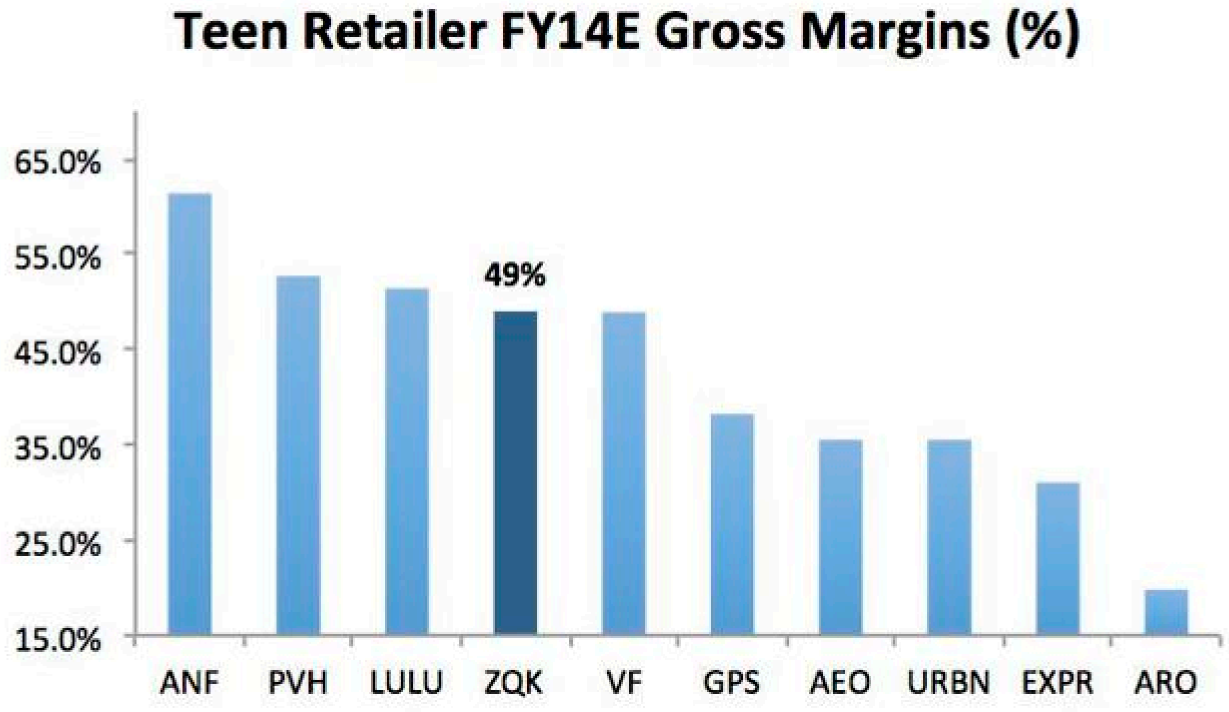
Looking at ZQK's recent performance, the most interesting thing that jumps out to me (other than the scale of the top-line declines at some of ZQK's individual brands) is how gross margins have remained stable at relatively healthy levels. The below chart shows ZQK GMs vs sales performance in the FY09-14E period:

(source: company filings, my estimates)



Clearly, margins have contracted a few points from recent peaks. But despite the overall promotional environment that has gripped retailers (and particularly teen retail) in recent years, ZQK group margins have remained near 50% and above 2009 levels (even as sales have cratered). This is especially intriguing when we look at what other teen-focused retailers are grossing these days:

(source: GS research + my estimates)



While some may argue we shouldn't lump in a surf brand with pure teen retailers like Abercrombie (ANF) or American Eagle (AEO), I would suggest that, as largely mall-based specialty retailers focusing on teens, they make the most sense as comps (besides, there are no relevant 'surf' comps listed in the US, as Tilly's (TLYS) is a pure third-party retailer).

Looking at the peer landscape, the main takeaway is simply that **teen-focused retailers sporting gross margins near 50% are more than a rarity; they are a dying breed**. Other than ANF - which is going through its own painful transition, another name I feel will see significant margin pressure going forward - the margin profile for teen-focused retailers is squarely in the 30s range, while ZQK, even now, still enjoys the margins of non-teen retailers like PVH (PVH) or VF Corp (VF); or of a much more niche, unique specialty property like Lululemon (LULU). Even fast fashion players like Fast Retailing (Uniqlo, listed in Tokyo) - a far superior operator with a massive scale and sourcing advantage - sported GMs of 'just' ~49.5% last fiscal year.

It's clear, then, that ZQK has sacrificed sales in recent years to try to maintain a pricing premium in a heavily discounted environment. Going forward, competing as they do for teen dollars and with brands impaired by years of underinvestment, is it really likely ZQK will be able to extract meaningful margin expansion? To me, it seems unlikely; rather, I expect the margin glide path to be significantly more challenged.

On this point, there was an interesting moment on the most recent earnings call where the CFO may have surreptitiously telegraphed Quicksilver's need to mark down to stay competitive. The following is an excerpt where he is discussing the pricing of a new footwear product, the Trace, on the 2Q14 conference call (my **emphasis**):

> **Taposh Bari** - Goldman Sachs
>
> Can you maybe provide some more color on how the Trace is different from the bulk? Is it the price point, is it the style and the optimism that you have for the spring '15 collection. What is that rooted in? I am assuming that your sharper price points and better product if you can just elaborating...
>
> **Richard Shields** - Chief Financial Officer
> Well, let me answer the various components. As it relates to DC, the 200 million payers that I talk about in the canvas market, **the retail price parameters for that payer is just between $45 retail and $50 retail. The market is really compressed and there has only really been one significant breakout product from Nike** that has produced any type of Volume above that.
>
> We were optimistic that with the Nyjah Vulc [an earlier DC product launch this year], **which is outside of that price range** that we could do some volume with that product. The product is selling okay, but we don't believe at this point it is going to be a breakout model.
>
> **However the Trace is priced to $45**. It's completely in the sweet spot of volume potential, so that's really why we are much more optimistic about the Trace than Nyjah Vulc.

While this is just the discussion of one new product, this brief exchanged encapsulates the commodization of ZQK's brands that has occurred - and hence the need to compete on price going forward, which can hardly be positive for gross margin trends.

2. Working capital 'payback' to come

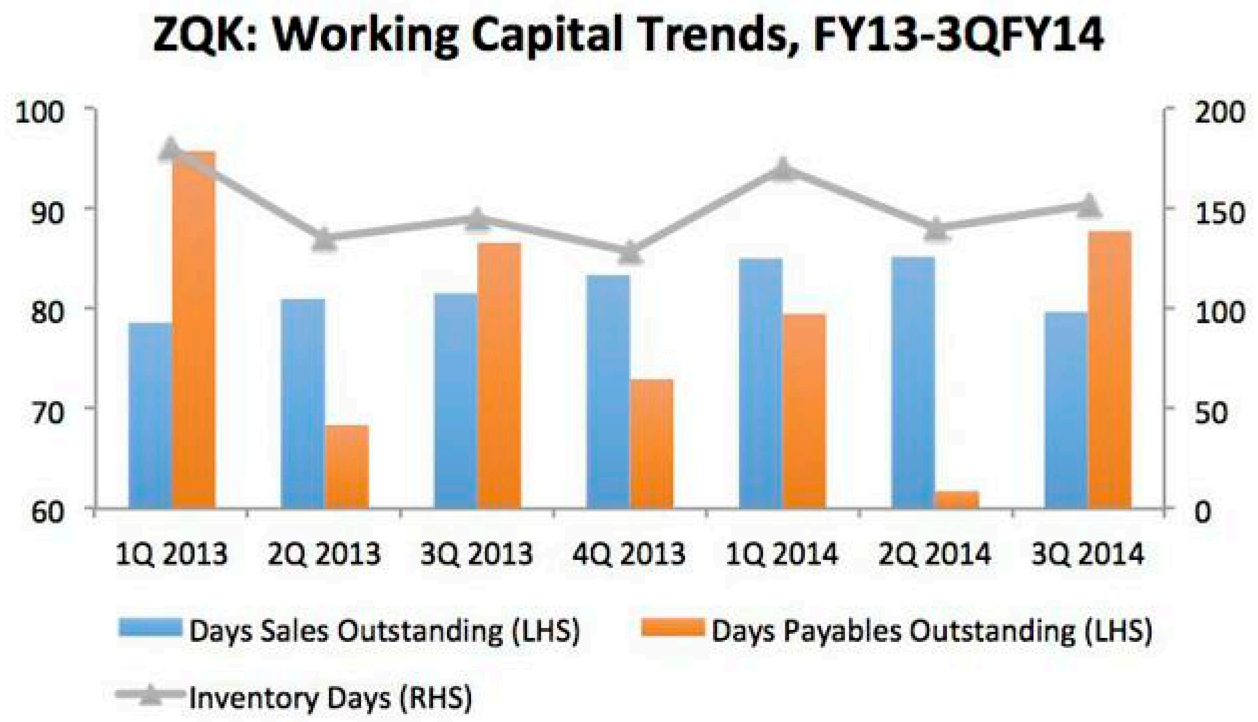
Despite deteriorating performance, ZQK's working capital cycle has remained surprisingly resilient: in FY13, ZQK actually generated a small amount of cash from working capital, even as financial performance rapidly faltered. See abbreviated cash flow statement below:

(source: company filings)

	2009	2010	2011	2012	1Q 2013	2Q 2013	3Q 2013	4Q 2013	FY 2013	1Q 2014	2Q 2014	3Q 2014
Net income	-191.9	-9.8	-18	-9.7	-30.7	-32.2	1.8	-176.2	-237.3	14.9	-60.7	-222.2
Gain/ loss from discontinued ops	118.8	-1.8	0	0	0	0	0	-5.9	-5.9	-37.6	7.2	0.0
Asset impairments (incl intang)	10.7	11.7	86.4	7.2	3.2	5.3	2.2	1.7	12.4	0.9	20.0	182.6
D&A	55	53.9	55.3	53.2	12.2	12.8	13	12	50	10.5	15.1	15.6
Loss on PPE, provisions on a/cs	20.4	14.8	2.9	-1.8	4.1	-0.6	1	1.4	5.9	1.4	13.3	0.2
Others	49.4	64.5	-9.2	-4.8	2	0.8	3.7	162	168.5	4.4	2.5	-4.1
Stock-based comp	8.4	12.8	14.4	22.6	7.3	3.9	5	5.4	21.6	5.1	6.5	4.2
Changes in working cap	121.4	53.5	-77.7	-80.3	25.1	-31.8	-20.7	37	9.6	-3.7	-23.6	62.8
Cash from continuing ops	192.2	199.6	54.1	-13.6	23.2	-41.8	6	37.4	24.8	-4.1	-19.7	39.1
Cash from discontinued ops	13.8	3.8	0	0	0	0	0	2.3	2.3	-7.2	-9.1	1.0
Net cash from operating activities	206	203	54	-14	23	-42	6	40	27	-11.3	-28.8	40.1
Capex, net	54.6	43.1	77.1	57.9	12.8	15.8	10.8	11.9	51.3	10.6	12.4	15.5
Free cash flow	151	160	-23	-72	10	-58	-5	28	-24	-22	-41	25

Even more surprising was the massive move in working capital in the most recent 3Q: in what is seasonally a cash-out quarter (see 3Q the previous year, highlighted in orange above), ZQK managed to generate $63mm from working cap, versus -$21mm last year - **a mammoth $84mm swing year over year**. In the face of the horrid reported numbers, ongoing difficult business conditions, and stretching of working capital ratios (see below), it appears unlikely this cash benefit can be sustained in coming quarters, and will likely 'boomerang' back in the form of a large cash outflow in the soon-to-be-reported 4Q.

(source: company filings, my estimates)



	1Q 2013	2Q 2013	3Q 2013	4Q 2013	1Q 2014	2Q 2014	3Q 2014
Days Sales Outstanding	79	81	82	83	85	85	**80**
Days Payables Outstanding	96	68	87	73	80	62	**88**
Inventory Days	181	135	145	128	170	140	**153**

As per the above, DSO as of 3Q14 is lower than 3Q13, and basically at 2-yr lows; while DPO has been pushed out to levels higher than a year ago. Meanwhile, due to slow sell-through, inventory days are +6% YoY (versus sales -20% YoY in 3Q), suggesting somewhat of a bloated inventory position.

Net net, I estimate working capital will be a **~$30mm use of cash in 4Q** (model to follow later). This is important because...

3. ZQK's liquidity problem + covenant breach risk

...ZQK's liquidity position is precarious. Let's refresh, for a moment, ZQK's cap structure, along with what the company tells us about their available liquidity (note: my adjusted EBITDA numbers may be slightly different to reported company figures, as I try to model a purer adjusted number). Here is the current cap structure:

(source: company filings, my estimates)

	Maturity	$mm Out (as of 3Q14)	Leverage thru	Notes
EMEA Credit Facilities	Oct'16	26.8		Secured by EMEA receivables
ABL Credit Facility	May'18	38.2		Secured by first lien on most all non-EMEA inventories + receivables
First lien debt		**65**	**1.2x**	
7.875% Dec'18 USD Notes	Dec'18	278.8		Second lien on ABL security; first lien on most everything else
Second lien debt		**343.8**	**6.4x**	
8.875% Dec'17 EUR Notes	Dec'17	268		Senior unsecured
10% Dec'20 USD Notes	Dec'20	222.5		
Total debt		**834.3**	**15.4x**	
Capital leases		6.5		
Adjusted total debt (excl operating leases, pensions)		**840.8**	**15.5x**	
Cash (excl restricted cash)		84	**14.0x**	$23.9mm restricted cash mostly capex-dedicated
Market cap (at $2/share)		341.6		
Enterprise Value		1098.4	**20.3x**	
LTM Adj EBITDA	54.1			

It doesn't take a genius to figure out that ZQK's cap structure is wickedly overlevered (even in the context of a bad EBITDA year). Frankly, 6x levered just through the second lien bonds is scary enough. But then there is another ~$500mm of unsecured debt below that - and that is before you get to the implied ~$340mm equity capitalization!

Neutral observers may note that there is no upcoming maturity cliff and take heart that ZQK has at least some breathing room to see the business rebound. The real issue, however, is not upcoming maturities but **the lopsidedness of the cap structure**: there is a mountain of subordinated debt (second lien + unsecured = $769mm) with relatively little senior secured ($65mm). As a result, of the annual ~$80mm cash interest tab, **~$75mm relates to subordinated debt**.

This is a problem because **if/when ZQK breaches covenants on its senior facilities, the senior lenders have little incentive to waive/renegotiate** (as it just means more cash being paid out to sub lenders, and less security for senior lenders as the collateral - receivables + inventories - diminishes). This begs the question - will ZQK violate any covenants?

Here is what the company has to say about its available liquidity and maintenance covenants (from the latest 10-Q):

> As of July 31, 2014, the Company's credit facilities allowed for total cash borrowings and letters of credit of $216 million. The total maximum borrowings and actual availability fluctuate with the amount of assets comprising the borrowing base under certain of the credit facilities. At July 31, 2014, the Company had a total of $65 million of direct borrowings and $57 million in letters of credit outstanding. As of July 31, 2014, the effective availability for borrowings remaining under the Company's credit facilities was $85 million, $66 million of which could also be used for letters of credit in the United States and APAC. In addition to the $85 million of effective availability for borrowings, the Company also had $9 million in additional capacity for letters of credit in EMEA as of July 31, 2014. Many of the Company's debt agreements contain customary default provisions and restrictive covenants. The Company is not subject to financial covenant restrictions unless remaining borrowing availability under the ABL Credit Facility was to fall below the greater of $15 million or 10.0% of total borrowing base availability.

The first point to note: available liquidity of **$94mm** ($85mm in borrowings, $9mm in EMEA letters of credit) is **down from $235m at the end of last fiscal year**, so liquidity is rapidly disappearing. But more importantly: ZQK is only subject to financial covenants (just one, a fixed charge coverage ratio covenant that they would certainly fail given how much EBITDA has fallen) if availability under the

While the $ value of the borrowing base is not disclosed, we know (from the credit agreement) that it likely comprises North American, Australian + Japanese subsidiaries' eligible inventories + eligible receivables, multiplied by some discount factor. For argument's sake, let's just assume the borrowing base is ALL inventories + receivables, multiplied by 70%: this yields **a borrowing base of ~$485mm** (working from the 3Q14 balance sheet), 10% of which is clearly **~$49mm**.

Thus, I feel if availability falls below ~$50mm (highly likely in the next few quarters, discussed below), ZQK could be forced to ask their senior lenders for a waiver, which while not an automatic death sentence, could be very problematic given the haemorraging in the business and over-levered cap structure. Certainly, it would not shock me to see senior lenders either push for a restructuring or extract draconian terms to waive the covenant if this breach occurred.

4. Non-core asset sales

Over the last 1.5 years, ZQK has implemented a 'Profit Improvement Plan' that, amongst other things, involved the divestiture of non-core brand assets such as Hawk Designs, Mervin Manufacturing, Surfdome, etc. The below table summarizes these transactions:

(source: company filings)

	Date	Sales price
Mervin Manufacturing	23-Oct-13	58
Hawk Designs	13-Jan-14	19
Surdome (51% interest)	11-Nov-14	16
		93

While perhaps not a huge nominal amount, we should keep in mind that ZQK burned $24mm in cash in FY13, and **will likely burn ~$84mm in FY14** (incorporating my estimated ~$45mm cash burn in 4Q). In this context, the **~$93mm cash inflow from asset sales effectively financed this year's negative cashflow without adding to ZQK's leverage**; but with the sale of Surfdome, the divestitures are now completed and **this lever for the company is now gone** (admittedly, the $16mm from the Surfdome transaction will hit in 1Q15). If I were a lender, this would really scare me, looking towards FY15.

5. Equity valuation and why the upside case is not (TOO) scary

The benefits (to the short case) of such a large amount of leverage and so little flexibility for the company are that **the equity's very existence at this point is already implying a significant turnaround for the business** - as such, anything less than flawless execution from here and the equity is in real, real trouble. To think about it another way: adjusted EBITDA (on my numbers) was $123mm in FY13, and will be ~$35mm this fiscal; this is down from ~$195mm two years ago. Given diminution in the business (via asset sales, out-licensing of revenues, lost share, etc) and chronic underinvestment in brand-building, a $200mm EBITDA target is out of the realm of possibility in the near future.

But even the beyond-lofty target of achieving FY13's EBITDA number ($123mm) would imply - at current stock price of $2/share - an EV/EBITDA of 9.1x, **still a sizeable premium to where the stock traded for most of FY09-FY12** (see model below). To be fair, valuations did expand in FY13 on the appointment of the new CEO and the optimism of the potential turnaround plan, but those have now fizzled. I will not bother with a full comp table but even those teen retailers NOT burdened by excessive leverage trade in the 4-7x EV/EBITDA multiple range; while a 10-12x EV/EBITDA multiple is reserved for much better businesses like LULU, PVH, or VF. Let's keep this in mind while we model out 4Q14 and FY15...

Model

I made the following key assumptions in modelling out the next 5 quarters (which I feel are all pretty generous):

- sales -10% YoY in 4Q (despite -21% in 3Q), then rebounding in 2H FY15 to end the year +~4.5% YoY

- GMs improve 130bps YoY in 4Q and 80bps in FY15 (better execution, fewer SKUs, fewer returns)

- SG&A % of sales improves ~240bps YoY in FY15 (lower overhead, lower marketing spend)

- $20mm interest expense per Q in FY15 (despite further cash burn and therefore increased leverage)

- capex aggressively cut from ~$48mm in FY14 to $34mm in FY15

- FY15 net change in working cap -$15mm (vs estimated +$6mm in FY14)

- no tax offset/benefit (as has been the case in recent quarters, despite accumulated NOLs, ZQK has not been able to realize tax savings)

With these assumptions, **ZQK generates ~$73mm in adjusted EBITDA in FY15 (vs $35mm in FY14) - still not enough to cover cash interest of $80mm - burns $56mm more cash (despite cutting capex by a third), ends FY15 at 11.3x net levered and an implied EV/EBITDA of 16x (at $2/share)...** and as bad as this looks, ZQK would likely also have to negotiate a covenant breach (as discussed earlier) due to ~$65mm cash burnt in 4Q14 and 1Q15 (by my estimates enough to reduce availability on their ABL facility below the minimum required).

Earnings model (source: company filings, my estimates):

(fiscal yr end Oct)	FY 2009	FY 2010	FY 2011	FY 2012	1Q 2013	2Q 2013	3Q 2013	4Q 2013	FY 2013	1Q 2014	2Q 2014	3Q 2014	4Q 2014E	FY 2014E	1Q 2015E	2Q 2015E	3Q 2015E	4Q 2015E	FY 2015E
Income statement	Oct'09	Oct'10	Oct'11	Oct'12					Oct'13					Oct'14					Oct'15
Revenue	1977.5	1837.6	1953.1	2013.2	431	458.7	495.8	475.9	1861.4	392.6	408.2	395.7	430.2	1626.7	380.8	408.2	427.4	481.9	1698.2
COGS	1046.5	870.4	929.2	1032.9	211.3	247.6	251	252.2	962.1	192.8	209.3	206.7	222.4	831.2	190.4	206.1	213.7	243.3	853.6
Gross Profit	931	967.2	1023.9	980.3	219.7	211.1	244.8	223.7	899.3	199.8	198.9	189	207.8	795.5	190.4	202.1	213.7	238.5	844.7
SG&A (incl R&D, D&A)	851.7	832.1	895.9	916.1	225.3	218.2	216.6	220.4	880.5	203.8	213.6	212.7	211.0	841.1	196.0	209.0	215.0	217.0	837.0
Asset impairments	10.7	11.7	86.4	7.2	3.2	5.3	2.2	1.7	12.4	0.9	20.0	182.6	5.0	208.5	0.0	0.0	0.0	0.0	0.0
Operating Profit	68.6	123.4	41.6	57	-8.8	-12.4	26	1.6	6.4	-4.9	-34.7	-206.3	-8.2	-254.1	-5.6	-6.9	-1.3	21.5	7.7
D&A	55	53.9	55.3	53.2	12.2	12.8	13	12	50	10.5	15.1	15.6	13.0	54.2	10.0	14.0	15.0	12.0	51.0
Stock comp	8.4	12.8	14.4	22.6	7.3	3.9	5	5.4	21.6	5.1	6.5	4.2	4.0	19.8	4.0	4.0	3.0	3.0	14.0
Others (impairments, rest'ing, etc)	39.5	21.6	84.4	19.3	3.2	12.1	15.5	14.2	45	0.9	26.4	182.5	5.0	214.8	0.0	0.0	0.0	0.0	0.0
Adjusted EBITDA	171.5	211.7	195.7	152.1	13.9	16.4	59.5	33.2	123	11.6	13.3	-4	13.8	34.7	8.4	11.1	16.7	36.5	72.7
Other income/expense	11.1	-5.9	0.1	-1.7	3.2	-2.6	4.1	0.3	5	2.8	0.9	-2.3	1.2	2.6	0.0	0.0	0.0	0.0	0.0
Interest expense	63.9	114.1	73.8	60.8	15.5	15.3	20.2	20	71	19.4	19.2	18.8	19.0	76.4	20.0	20.0	20.0	20.0	80.0
Income taxes	66.7	23.4	-14.3	7.6	3.2	7.1	-0.1	157.5	167.7	-4.4	-1.2	-0.6	0.0	-6.2	0.0	0.0	0.0	0.0	0.0
Net income from cont ops	-73.1	-8.2	-18	-9.7	-30.7	-32.2	1.8	-176.2	-237.3	-22.7	-53.6	-222.2	-28.4	-326.9	-25.6	-26.9	-21.3	1.5	-72.3
Loss from discontinued ops	118.8	-1.8						-3.6	-3.6	-37.6	7.1	0	0.0	-30.5					
Income/loss for NCI	0	3.4	3.4	1	0.5	0.2	-0.2	-1.5	-1	-0.5	-7.7	-2.1	0.0	-10.3					
Net income (unadjusted)	-191.9	-9.8	-21.4	-10.7	-31.2	-32.4	2	-171.1	-232.7	15.4	-53	-220.1	-28.4	-286.1	-25.6	-26.9	-21.3	1.5	-72.3
Adjusted net income	6.7	46.6	32.4	20.8	-25.5	-13.1	31.3	3.6	-3.7	-16.5	-27.2	-39.7	-23.4	-112.1	-25.6	-26.9	-21.3	1.5	-72.3
Avg shs outstanding (diluted)	128.089	151.954	182.049	178.907	165.767	166.815	190.568	168.796	167.255	169.747	170.5	170.8	170.8	170.8	170.8	170.8	170.8	170.8	170.8
Diluted EPS	-1.50	-0.06	-0.12	-0.06	-0.19	-0.19	0.01	-1.01	-1.39	0.09	-0.31	-1.29	-0.17	-1.67	-0.15	-0.16	-0.12	0.01	-0.42
Adj diluted EPS	0.05	0.31	0.18	0.12	-0.15	-0.08	0.16	0.02	-0.02	-0.10	-0.16	-0.23	-0.14	-0.66	-0.15	-0.16	-0.12	0.01	-0.42
Sales growth (%)		-7.1%	6.3%	3.1%					-7.5%	-8.9%	-11.0%	-20.2%	-9.6%	-12.6%	-3.0%	0.0%	8.0%	12.0%	4.4%
Gross margin (%)	47.1%	52.6%	52.4%	48.7%	51.0%	46.0%	49.4%	47.0%	48.3%	50.9%	48.7%	47.8%	48.3%	48.9%	50.0%	49.5%	50.0%	49.5%	49.7%
SG&A % of revs	43.1%	45.3%	45.9%	45.5%	52.3%	47.6%	43.7%	46.3%	47.3%	51.9%	52.3%	53.8%	49.0%	51.7%	51.5%	51.2%	50.3%	45.0%	49.3%
Effective tax rate	97.2%	19.0%	-34.4%	13.3%	-36.4%	-57.3%	-0.4%	9843.8%	2620.3%	89.8%	3.5%	0.3%	0.0%	2.4%	0.0%	0.0%	0.0%	0.0%	0.0%
Operating margin (%)	3.5%	6.7%	2.1%	2.8%	-2.0%	-2.7%	5.2%	0.3%	0.3%	-1.2%	-8.5%	-52.1%	-1.9%	-15.6%	-1.5%	-1.7%	-0.3%	4.5%	0.5%
Adj EBITDA margin (%)	8.7%	11.5%	10.0%	7.6%	3.2%	3.6%	12.0%	7.0%	6.6%	3.0%	3.3%	-1.0%	3.2%	2.1%	2.2%	2.7%	3.9%	7.6%	4.3%
Stock price	3	5.5	4.1	5.1	6	7	6	8	8	7	3.5	2	2	2	2	2	2	2	2
Market cap	384.3	835.7	746.4	912.4	994.6	1167.7	1143.4	1350.4	1338.0	1188.2	596.7	341.6	341.6	341.6	341.6	341.6	341.6	341.6	341.6
Net Debt	887.0	608.2	637.9	716.2	720.1	766.0	787.9	774.0	774.0	794.6	773.7	732.8	778.2	778.2	781.8	814.7	843.0	818.5	818.5
Enterprise Value	1271.3	1443.9	1384.3	1628.6	1714.7	1933.7	1931.3	2124.4	2112.0	1982.8	1370.4	1074.4	1119.8	1119.8	1123.4	1156.3	1184.6	1160.1	1160.1
EV/Revenue (TTM) (x)	0.6x	0.8x	0.7x	0.8x	0.9x	1.0x	1.0x	1.1x	1.1x	1.1x	0.8x	0.6x	0.7x	0.7x	0.7x	0.7x	0.7x	0.7x	0.7x
EV/Adj EBITDA (TTM)	7.4x	6.8x	7.1x	10.7x	13.4x	18.2x	15.1x	17.3x	17.2x	16.4x	11.7x	19.9x	32.2x	32.2x	35.6x	39.5x	23.7x	16.0x	16.0x
Net debt/Adj EBITDA (x)	5.2x	2.9x	3.3x	4.7x	5.6x	7.2x	6.2x	6.3x	6.3x	6.6x	6.6x	13.5x	22.4x	22.4x	24.8x	27.8x	16.5x	11.3x	11.3x

Abbreviated cash flow (source: company filings, my estimates):

	2009	2010	2011	2012	1Q 2013	2Q 2013	3Q 2013	4Q 2013	FY 2013	1Q 2014	2Q 2014	3Q 2014	4Q 2014E	FY 2014E	1Q 2015E	2Q 2015E	3Q 2015E	4Q 2015E	FY 2015E
Net income	-191.9	-9.8	-18.0	-9.7	-30.7	-32.2	1.8	-176.2	-237.3	14.9	-60.7	-222.2	-28.4	-326.9	-25.6	-26.9	-21.3	1.5	-72.3
Gain/ loss from discontinued ops	118.8	-1.8	0.0	0.0	0.0	0.0	0.0	-5.9	-5.9	-37.6	7.2	0.0	0.0	-30.4	0.0	0.0	0.0	0.0	0.0
Asset impairments (incl intang)	10.7	11.7	86.4	7.2	3.2	5.3	2.2	1.7	12.4	0.9	20.0	182.6	5.0	208.5	0.0	0.0	0.0	0.0	0.0
D&A	55.0	53.9	55.3	53.2	12.2	12.8	13.0	12.0	50.0	10.5	15.1	15.6	13.0	54.2	10.0	14.0	15.0	12.0	51.0
Loss on PPE, provisions on a/cs	20.4	14.8	2.9	-1.8	4.1	-0.6	1.0	1.4	5.9	1.4	13.3	0.2	0.0	14.9	0.0	0.0	0.0	0.0	0.0
Others	49.4	64.5	-9.2	-4.8	2.0	0.8	3.7	162.0	168.5	4.4	2.5	-4.1	0.0	2.8	0.0	0.0	0.0	0.0	0.0
Stock-based comp	8.4	12.8	14.4	22.6	7.3	3.9	5.0	5.4	21.6	5.1	6.5	4.2	4.0	19.8	4.0	4.0	3.0	3.0	14.0
Changes in working cap	121.4	53.5	-77.7	-80.3	25.1	-31.8	-20.7	37.0	9.6	-3.7	-23.6	62.8	-30.0	5.5	0.0	-15.0	-15.0	15.0	-15.0
Cash from continuing ops	192.2	199.6	54.1	-13.6	23.2	-41.8	6.0	37.4	24.8	-4.1	-19.7	39.1	-36.4	-21.1	-11.6	-23.9	-18.3	31.5	-22.3
Cash from discontinued ops	13.8	3.8	0.0	0.0	0.0	0.0	0.0	2.3	2.3	-7.2	-9.1	1.0	0.0	-15.3	0.0	0.0	0.0	0.0	0.0
Net cash from operating activities	206.0	203.4	54.1	-13.6	23.2	-41.8	6.0	39.7	27.1	-11.3	-28.8	40.1	-36.4	-36.4	-11.6	-23.9	-18.3	31.5	-22.3
Capex, net	54.6	43.1	77.1	57.9	12.8	15.8	10.8	11.9	51.3	10.6	12.4	15.5	9.0	47.5	8.0	9.0	10.0	7.0	34.0
Free cash flow	151.4	160.3	-23.0	-71.5	10.4	-57.6	-4.8	27.8	-24.2	-21.9	-41.2	24.6	-45.4	-83.9	-19.6	-32.9	-28.3	24.5	-56.3

Equity Value: wiped out no matter how you slice it

As mentioned above, on my numbers ZQK at $2/share is trading at 16x FY15E EV/EBITDA (and 0.7x EV/Sales), with 11x net leverage through the cap structure. Frankly, I don't think this business should trade north of 7-8x EV/EBITDA, and certainly not at a multiple above 10x - clearly with 11x net leverage, this **implies an equity value of zero**. The 'low' EV/Sales multiple does not bother me, either, as there are similarly distressed retailers (though with much less or no leverage) trading far, far cheaper (ARO trades at 0.15x EV/Sales, for example). Additionally, the most recent divestiture conducted by ZQK, of Surfdome - an online surf gear retailer that is likely in much better shape than the ZQK core business - only garnered a 0.53x P/Sales multiple. Again: put a 0.5x EV/Sales multiple on ZQK parent, and **the equity is worthless** (~$820mm net debt as of end FY15E, $1.7bn FY15E sales).

I won't conduct a full liquidation/recovery analysis; Hadrian Capital did so with more competence than I could in his piece. Suffice to say that with near-zero tangible book equity and sub debt trading at 60c on the dollar, there shouldn't be anything left for shareholders in a restructuring.

Conclusion

ZQK's 4Q earnings - to be released on Dec. 11 - should provide an immediate catalyst for fresh downside, but even if the numbers are a little better than I expect, the capital structure is so broken, and the structural trends in the teen business so overwhelmingly tough, that I really feel a full restructuring of some kind is simply a matter of time, likely wiping out current shareholder value in its entirety. **SHORT ZQK**.

This article was written by

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