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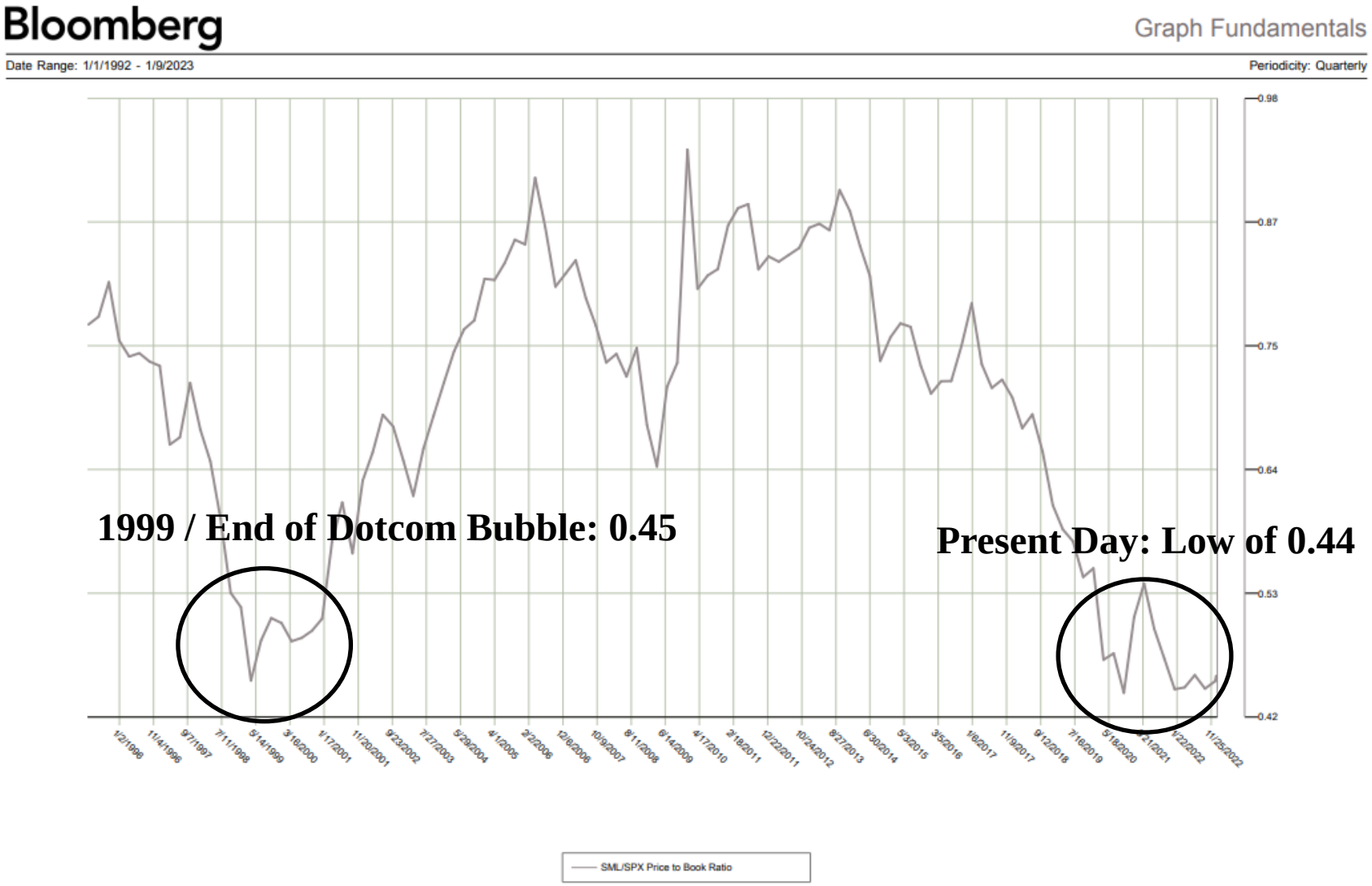
Small Caps Versus Large Caps: The Largest Discount +20 Years



Founded in 1853, Leading Category Brand in Denim

Small Cap Profile with Growth & Margin Opportunities

Undemanding Valuation: P/E 11.3x, P/CF 8.5x

Shareholder Friendly Capital Allocation

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Levi Strauss and Co.

Company Description: Founded in 1853, Levi Strauss is credited with the original invention of the riveted blue jean (technically, Levi Strauss went into business with a customer of his dry goods store that was making them but couldn't keep up with demand). The company has $6.3 billion in revenue with 92% in the Levi's brand the other 8% brands include: Dockers and Beyond Yoga. Approximately 56% of revenue is in the U.S., with the remainder split between Europe at 27% and Asia at 17%. The Levi's brand in blue jeans has the #1 market share at 6.1% almost twice its nearest competitor, Kontoor Brands at 3.7%.

Fundamentals: The company's annualized sales growth since 2016 has been 5.2%, over time it is a mid-to-high single digit grower, with some cyclicality. 2023 sales growth expectations are low at 1.8%. The Levi's brand supports relatively premium pricing in the mass market channel, as evidenced by its gross margin at 57.6% compared with its near competitor Kontoor Brands (Wrangler and Lee) at an average of 41.4%. The current operating margin is 11.6% and management's goal is to increase it to 15% by 2027. Net debt to EBITDA is 1.36x with operating leases included, and ex-leases it is 0.6x.

Growth Strategy: Management has a combined strategy of investing in growth through Direct to Consumer (DTC), International, Women's, Tops, and other brands (Dockers, Beyond Yoga). On the Direct to Consumer business, it is currently 28% in branded stores and 8% E-commerce. The company has 3,100 brand dedicated stores and shop-in-shops. In jeans, the company still has a large addressable market. Levi's is the largest brand at $6 billion, but global jeans is a $100 billion market. The company plans to increase DTC from 36% to 55% by 2027. Currently the company has 1,000 company owned stores and 19M loyalty members. The company expects to open 80 stores annually, an additional 400 by 2027. The company plans to increase its E-commerce from $500M to $1.5 billion in 2027 (from 8% of sales to 15%). Then outside of DTC, they want to 2x the women's business ($2.2 billion and 33% of sales currently to 42%--11-13% CAGR), 2x in sales from tops ($1.3 billion and 21% of sales currently to 25% in 2027—11-13% CAGR), continue expanding international and other brands. The company targets international to increase from 53% of sales to 57% in 2027, 8-10% CAGR. Other brands, Dockers and Beyond Yoga from 7% to 11% in 2027, 15-17% CAGR.

Valuation: The shares currently trade at a P/E of 11.3x, Price to Cash Flow of 8.8x, EV/EBITDA of 7.8x, and Dividend Yield of 2.9%, Free Cash Flow Yield 7.1%. For context we bought the shares in October at P/E of 7.9x and Price to Cash Flow of 7.8x. The bottom line on the valuation is that expectations today are relatively low (but not rock bottom as in October), and the market is not giving the company any credit for future growth including a cyclical rebound in the international markets, i.e., Europe and Asia or its ability to hit its five-year goals and targets. The international piece seems to be significant in valuation terms since the European the business today is $1,597M in revenue vs. $1,708M in 2019, and in Asia, pretty much the same $952M versus $926M in 2019 (+2.8%--basically flat). These markets are still down 3 years and counting, with the U.S. driving all of the growth during the past 3 years. Today's share price nearly approximates the historical average results of the company 5-6% topline and 11-11.5% EBIT Margin. If you include a rebound in Asia over the next year (i.e., one year of 25% growth…as seen in the U.S.) and management eventually reaching its 15% EBIT Margin, then shares have 42% upside to intrinsic value.

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