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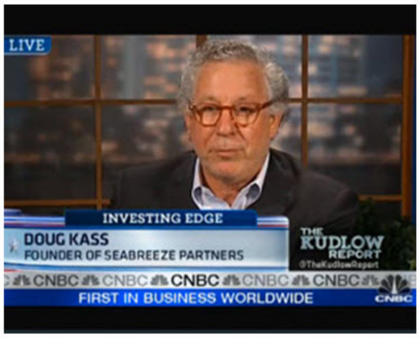

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THIS MONTH'S ISSUE

VIL EXCLUSIVE

Rocky Brands, Inc. (RCKY) appears to be undervalued

By Jeff L. Sutton

Rocky Brands, Inc. (RCKY) appears to be undervalued based on several criteria. First, at its recent price range between approximately $9.00 and $9.50 per share, RCKY trades at a trailing P/E multiple of approximately 6x, compared to peers Lacrosse Footwear (BOOT) and Wolverine World Wide (WWW) trading at approximately 17x and 14x, respectively. Second, RCKY trades well below recent acquisition multiples; in mid-2011 The Timberland Company (TBL) was acquired by VF Corporation (VFC) for $43.00 per share, which implies a trailing P/E multiple of approximately 24x. Third, RCKY has a net current asset value equal to approximately $9.21 per share, which may provide some downside protection to its stock price. (Net current assets is defined as current assets, less current liabilities, and less long-term debt, and is a classic measure used by Benjamin Graham to identify undervalued assets.) Finally, a free cash flow analysis implies a long-term intrinsic value of approximately $19.00 to $22.00 per share, suggesting that RCKY may have significant upside potential.

The Business:
RCKY manufactures high quality outdoor boots and shoes and related apparel. The company's products include hunting gear, western-styled boots, military boots, durable work boots (including steel-toe reinforced boots that comply with OSHA standards), and other specialty shoes (including slip-resistant footwear) that are often required to be worn as part of corporate uniforms.

RCKY operates in three segments. The Wholesale segment sells boots, shoes, and apparel to national retailers such as Bass Pro Shops, Cabela's, Dick's Sporting Goods, and Gander Mountain. The Retail segment primarily sells direct to corporations who require footwear to meet certain technical standards or to serve as part of a uniform. Major corporate customers include 3M, Abbott Labs, Alcoa, Carnival Cruise Lines, Federal Express, IBM, and Texas Instruments. Finally, the Military segment sells products designed for military and duty use, which are sold through contracts with the United States military.

Recent Trends:
RCKY's core operations are growing and profitability is improving in 2011.

For the first nine months of 2011, revenue was approximately $175.6 million, which is down about 5.6% from revenue of approximately $186.1 million during the first nine months of 2010. However, RCKY's results for the first nine months of 2010 included approximately $20.7 million in non-recurring revenue related to contracts that have now expired (about $5.5 million from sales under a license agreement to sell Dickies brand boots, and about $15.2 million in sales of boots under contracts with the United States military). On a normalized basis, excluding the impact of these expired contracts, according to my analysis RCKY's core revenue has actually increased by approximately 5.1% in the first nine months of 2011.

The third quarter of 2011 represents RCKY's 7th consecutive quarter of increased year-over-year earnings per share. Moreover, RCKY has streamlined its operations and is experiencing higher operating margins in 2011. For the first nine months of 2010 and 2011, RCKY's approximate margins were as follows:

First Nine Months:	2010	2011
Gross Margin	35.0%	37.3%
EBITDA Margin	8.5%	9.5%
Operating Margin	6.3%	7.0%
Net Income Margin	2.5%	4.6%

Expansion Opportunities:
RCKY recently began several new initiatives that have the potential to further increase the company's revenue and profitability.

First, RCKY is growing rapidly through international distribution agreements. The management team recently announced that it expects the company's revenue from international operations to grow to about $10 million in 2011, which is approximately 20% higher than it was in 2010, which in turn was about 40% higher than the company's revenue from international operations in 2009. RCKY currently operates in Canada, Europe, Russia, Central America, and South America, and the company continues to sign more agreements with distributors in new international markets.

Second, sales of commercial military boots have grown at astounding rates recently. These boots are not sold through government contracts, but are sold through the company's Wholesale segment to military supply stores. Year-to-date, RCKY's revenue from commercial military boots has grown to approximately $14 million, more than 230% higher than its revenue of approximately $6 million from commercial military boots in 2010. More importantly, the management team has announced that it believes this same growth rate may extend into 2012.

Finally, RCKY is extending its brand into new categories. A large portion of RCKY's boots are sold as work boots and hunting boots. The management team believes that the company's slip-resistant technology may have applications beyond the work boot category, and RCKY's boots may also have a broader appeal in the outdoor segment beyond hunting. In addition, RCKY is introducing new fashion oriented western-styled boots, and RCKY has licensed its brand to third parties to market belts, wallets, and other accessories.

Risks:
For the first nine months of 2011, RCKY's cash flow from operations has been reduced by about $20 million due to an investment in higher inventory levels. Based on the management team's recent comments, about 55% of the year-over-year increase in inventory is simply the result of higher raw materials costs, which can be passed on to customers, and about 45% of the higher inventory dollars are attributable to more units of finished products held in inventory. However, the management team also claims that it intends to bring inventory down to average historical levels by the end of the year 2011, without the impact of any unplanned promotional activity, primarily by producing fewer units during the fourth quarter. According to my analysis, RCKY held about $7.2 million of excess inventory at the end of the third quarter of 2011, which equates to about two weeks worth of revenue. Hence, it does not seem unfeasible for the company to be able to reduce its inventory balance by the end of the year, simply by cutting production during the fourth quarter.

Valuation:

RCKY deserves a higher P/E multiple.

On a trailing twelve months basis, RCKY has earned approximately $1.48 per share in EPS, compared to $1.14 per share in 2010. And analysts expect the growth to continue. Consensus EPS estimates for 2011 and 2012 are $1.55 per share and $1.82 per share, respectively. At its recent price range between approximately $9.00 and $9.50 per share, RCKY trades at a trailing P/E multiple of approximately 6x, and at a forward P/E multiple of approximately 5x 2012 EPS.

Any company growing its core revenue stream at 5% annually, and increasing its EPS at rates in excess of 15% annually, deserves a P/E multiple higher than 6x. RCKY should trade in line with its peers. BOOT has a P/E multiple of approximately 17x, and WWW has a P/E multiple of approximately 14x. Also, TBL was acquired in mid-2011 at a P/E multiple of approximately 24x. Applying a more appropriate P/E multiple of at least 12.5x to 15x would imply a valuation of at least $18.50 per share for RCKY, and possibly much higher.

In addition, RCKY's stock price is trading at a level that approximates the company's net current asset value of approximately $9.21 per share. (Net current assets is defined as current assets, less current liabilities, and less long-term debt, and is a classic measure used by Benjamin Graham to identify undervalued assets.) A company's net current asset value is an extremely conservative estimate of intrinsic value, as it does not attribute any value to a company's fixed assets, and it does not attribute any value to a company's ongoing cash flow generating capability. As such, a company's measure of net current assets per share may provide some downside protection to its stock price. Furthermore, by adjusting RCKY's inventory balance to reflect my estimate of its market value, my analysis suggests that RCKY's net current assets could be worth more than $15.00 per share.

Finally, according to my analysis, RCKY generates normalized free cash flow of approximately $11.6 million per year. Both BOOT and WWW trade at a free cash flow yield of approximately 5%. Assuming a more conservative free cash flow yield of 7% to 8%, would imply a valuation of approximately $19.00 to $22.00 per share for RCKY.

In Summary, RCKY appears to be undervalued, deserves a higher P/E multiple, and may provide significant upside potential.

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Jeff L. Sutton, CFA, is the founder of ValueTree Investments, LLC (ValueTreeInvestments.com), a Registered Investment Adviser in the state of North Carolina. ValueTree manages investment portfolios by selecting common stocks that we believe are trading at prices that represent significant discounts to our estimate of each company's long-term intrinsic value. Mr. Sutton graduated summa cum laude with two Bachelor of Arts degrees from Rhodes College, where he is a member of the Alumni Executive Board. He also earned an MBA degree from the Darden Graduate School of Business Administration at the University of Virginia.

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