Payless ShoeSource: A Financial Analysis of the Company
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Abstract
Payless ShoeSource was created in 1956 and is currently the largest discount shoe retailer in America. In 2003 the Company experienced its first loss in five years. After that year, the Company worked hard to increase sales and correct the inventory problems. From 2004 through 2006 sales were increasing as cost of goods sold was decreasing. By the end of 2006, the stock price had reached an all time high and Payless was standing out among competitors and in the industry. In 2005 the mission statement, vision statement, and company strategy were revised. These changes strengthened the Company and it is expected that Payless will continue to improve.

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In completing the analysis of Payless ShoeSource, many of the financial numbers used are from 2005. The Company has a fiscal year end of January 31 and so the 2006 Annual Report was not released until April 13, 2007. For this reason, I have tried to include as much of the 2006 information as possible.

For publication purposes, all supplemental information has been removed from the paper. The twenty graphs and tables that were originally included have been omitted. In addition, financial statements, analysis spreadsheets, and PowerPoint slides originally presented in appendixes are not included in this version.

History
In 1956 the company was founded as Volume Distribution. It began with two cousins named Louis and Shaol Pozez. Payless Shoes became the pioneer for the self service shoe store format. Many other companies would later mimic Payless’ store format. In 1962 the Company entered into the public market as Volume Shoe. (http://premium.hoovers.com)

Seventeen years later, Mays, the department store giant, acquired Volume Shoe. It quickly brought in 10% of the corporation’s earnings that year. In 1991, May changed its shoe unit name to Payless Shoes. The next year a kids section of the store was created. This would either be within or adjacent to the existing store and would feature kid’s brands and sizes. (http://premium.hoovers.com)

Then in 1996, May department stores decided to refocus its efforts on the department store. Therefore, May spun-off Payless. In the same year, Payless ShoeSource opened four stores in Alaska, rounding out the fifty states. It also opened its first international stores that same year. Four years later, a joint venture was formed and stores were opened in Central America and the Caribbean. In 2005, Payless ShoeSource experienced increasing sales and popularity. (http://premium.hoovers.com)

Strategy
A revamped company strategy was created in 2005. One of the main focuses of it is to offer “on-trend, differentiated products”(Payless 2005 Annual Report). This would be accomplished by expanding the women’s business, increasing the accessories portion of the
business, and offering more athletic footwear. The Company also wants to “reposition and strengthen brands” (Payless 2005 Annual Report). By doing this the Company would create a “House of Brands” available to the consumer at a discounted price.

The third strategy is to enhance the customer experience by hiring friendly, helpful employees and work to improve customer service. Finally, the Company looks to invest in business efficiency. It will complete this task by improving technology and introducing the POS system. This system shortens the checkout time and keeps better track of sales for the Company. It would also invest in a logistics network. This would improve inventory flow and flexibility. The Company is going to double capital expenditures as well. (Payless 2005 Annual Report)

For the full analysis of a company, a competitor is often found to compare. In this instance I have chosen Brown Shoe as the closest competitor to Payless. This is because they both have the same fiscal year end and are shoe companies. They also have domestic and international business, as well as, are comparable in size.

Distribution of Stores

Both Payless ShoeSource and Brown Shoe have stores that are located outside of the United States. As of the end of 2005, Payless operates 3,986 stores in the U.S., while Brown has 1,117. Payless also operates in Canada, Puerto Rico, and Central and South America. Brown operates 12% of its stores in Canada as its only international sector. All of the Payless stores are operated as Payless ShoeSource. Brown Shoe stores include Famous Footwear, Factory Brand Shoes, Supermarket of Shoes, Naturalizer, F.X. LaSalle, Franco Sarto, and Brown Shoe Closet, depending on the region and type of shoe. (Payless 2005 Annual Report, Brown Shoe 2005 Annual Report)

Company Strengths

Payless has a great geographic location. It also shows positive cash inflows and has a high and increasing cash flow liquidity ratio. Payless is currently operating in all of the fifty states, as well as, foreign countries. It is testing a store located in Japan to see how the products fare there. (Payless 2005 Annual Report)

The Company has been using cash efficiently. The largest portion of inflows for 2003 and 2004 was operations. This inflow represents the cash made from the sale of products which is the main business. In 2005, the largest inflow, followed very closely by operations, was proceeds from senior notes. This inflow occurred when the Company replaced the current credit line with one of $150 million dollars. Payless plans to use this extra money towards a capital expenditure for expansion of the business. (Payless 2005 Annual Report)

The Cash Flow Liquidity ratio is strong. It has increased each year for the past four years. This ratio shows the ability to pay off liabilities with available cash. For each year, Payless’s ratio is well above Brown Shoe’s ratio. This ratio has improved each year because of the amount of cash that Payless keeps on hand. By financing more with equity than debt, and by holding onto cash each year, the Company has a rising cash flow liquidity ratio.

Strong Ratios

There are other ratios that are considered strengths for Payless. The Current Ratio measures the short term ability of a company to repay debt. The recommended average for a company is around two. Payless saw an increase from 2004 to 2005 while Brown and the industry average experienced decreases. Even with a decrease in Payless’s ratio from 2003 to 2004, the Company has maintained above a two for all three years.

The reason for the decrease in 2004 was a greater amount of accrued expenses for the Company. Payless had an increased amount of liabilities that it has since tried to repay. Moving
into 2005, the Company held approximately the same amount of current liabilities but increased its current assets by 17%. (Payless 2003 Annual Report, Payless 2005 Annual Report)

The Quick Ratio computes the same ratio as the Current Ratio, except that inventory is removed from current assets. This allows for a better representation of the ability to pay off debt, especially for a merchandiser. Inventory is considered a current asset, but is not highly liquid like most other current assets. Often inventory can become obsolete or lose value, making it a less liquid asset.

For Payless, the quick ratio has increased each year from 2003 to 2005. Payless also exceeded the industry number in 2005 by three times as much. Even though this ratio does not calculate inventory in it, it is affected by the levels of inventory. For Payless, the inventory on hand has decreased each year making it less of a portion of the total assets. In addition to this, the cash that the Company held increased by 39% from 2004 to 2005. By 2005, the cash account made up about half of the total value of current assets. (Payless 2005 Annual Report)

### Inventory Ratios

Payless has improved its inventory ratios from 2003 to 2005. The Days Inventory Held ratio tells the average amount of days it takes for a company to sell its inventory to the consumer. This number could be slightly distorted because of the fact that Payless is a seasonal company. However, since sales are consistent, the Company is showing a strength by decreasing the number each year. (Payless 2005 Annual Report)

The other inventory ratio, Inventory Turnover, is also a strength. It shows the liquidity of the inventory that the Company has on hand. It is essentially the amount of times that inventory is sold during the course of a year. In the case of retail, a higher turnover is good for a company. Payless experienced an increase each year because of new inventory efficiency methods that it put into place. (Payless 2005 Annual Report)

For Payless, the number increases each year, beginning with 5.12 in 2003 and ending with 5.34 in 2005. Brown also increased its number from 2.75 to 3.36 from 2004 to 2005. Even with this increase, Payless’ number is still higher than Brown’s by almost two times. Payless is also above the industry number of 5.1, while Brown falls below. The reason the changes occurred in the inventory ratios for Payless each year is again because of increased efficiency in inventory handling. (Payless 2005 Annual Report, Brown Shoe 2005 Annual Report)

The debt ratio measures the amount of the Company that is financed by debt. In this case, Payless holds slightly more equity financing than debt and the ratio is below Brown. The Company took on slightly more debt in 2004 because of the loss it incurred in 2003, but regained its former debt percentage by 2005. It is not necessarily a bad thing to finance more with debt, however the lower the debt ratio, the more willing a bank is to loan more money. (Payless 2003 Annual Report, Payless 2005 Annual Report)

### Other Strengths

Payless has other strengths within the company. In a common sized income statement from 2003 to 2004 and 2004 to 2005, Payless’s Cost of Goods Sold (CGS) decreased as a percentage of total sales. Each year CGS decreased by nearly 3%. This was because of more favorable mark-ups and less mark-downs relative to the prior year. Even though Selling, General, and Administrative (SG+A) expense did increase each year from 2003 to 2005, it was only about 1% each year. The decrease percentage of Cost of Goods Sold more than covers the increase percentage of SG+A. (Payless 2005 Annual Report)

Sales have increased by 0.4% from 2004 to 2005. This is mostly attributable to positive sales growth in the women’s shoe and accessory department. During the same year, Cost of
Goods Sold decreased by 3.2%. This resulted in a 8.39% increase in the Company’s Gross Margin. (Payless 2005 Annual Report)

The ratio Days Payable Outstanding represents a strength of the company. With each year being below Brown, it shows Payless’ ability to repay suppliers quickly. However it has increased each year from 2002 to 2005. This may seem like a weakness, however, it represents a strength. This shows that the Company is able to hold its cash longer before needing to pay suppliers. This is typically a reflection of a strong relationship with the suppliers. (Payless 2004 Annual Report, Payless 2005 Annual Report)

Changes since 2005 Annual Report

There have been several changes in the Company since the 2005 Annual Report was released. From 2005 to 2006, Sales continued to increase, rising 4.9%. In relation, Cost of Goods Sold continued to decrease, moving down 2.5%. This created an even greater Gross Margin for the Company. This was also caused by positive sales performance in the women and children’s shoe departments. These changes may be explained partially by the fact that 2006 included an extra week, and was actually a 53 week year. (Payless 2006 Annual Report)

Since the CGS decreased faster than sales increased, Gross Margin increased. The SG+A expense did rise, but not by as much as the CGS percentage declined. The Company also experienced a decrease in the tax rate of nearly 4% due to differing tax rates across the United States. In total, the Net Earnings for the Company in 2006 increased 83.7% over the previous year. With this additional Net Earnings, the Company was able to repurchase $52.3 million dollars of Common Stock. (Payless 2006 Annual Report)

Stock Analysis

The stock for Payless has been on an upward trend. An anonymous analyst from Zacks Investment Research is calling it a “strong buy” and two others are naming it a “moderate buy”. This comes at a time when the retail industry as a whole is stagnant. (http://moneycentral.msn.com)

Over the past five years Payless stock has seen some major changes. It started at about $20 per share in late 2002 and during 2004 experienced an all time low. This had to do in part because of the former management of the Company, and decreased performance in 2003. However a new CEO was introduced in July of 2005, and the stock price has continued to increase since the beginning of that year. At the end of March 2007 the stock price is at an all time high of about $33 per share. (http://finance.yahoo.com)

On Money Central online, provided by MSN, the stock received a stock rating of 6 out of 10. This is a good rating for a company. It was above Brown’s rating and the industry rating, both scoring a five. The analysts are saying this is a good time to buy Payless stock because the Company is continually posting increasing sales and performance numbers. They expect the risk to be relatively low with a high return.

The reason for this rating and expected risk/return is that the Company produced higher fourth quarter earnings. It also relates to the analysts increasing the earnings estimate for Payless. It did not receive a higher rating because of shares being sold by financial institutions and a difference in price to earnings averages. The return is predicted to be double the risk for investors. (http://moneycentral.msn.com)

Over the course of the past year, Payless and Brown have both experienced mixed results. They both moved in a similar pattern, but did not equally match each other. As of April 13, 2007, Payless sold for $33.54 per share and Brown sold for $28.66 per share.
Recent Good News

According to the *Kansas City Star*, Payless recently completed a $91 million dollar acquisition of Collective Licensing. This company owns the brand *Airwalk*, which has been exclusively sold in Payless stores since 2003. Collective Licensing also owns other skating and skateboarding brands. The company will become a wholly owned subsidiary of Payless ShoeSource. Even though the transaction was complete in early 2007, the added earnings are not expected to appear on the financial statements until 2008. (“Payless ShoeSource…”).

Also reported in the *Kansas City Star*, Payless’ stock soars. In comparison with most retail establishments, Payless has seen much better performance in the stock market. This is mostly due to a strong fourth quarter in 2006. J.P. Morgan analyst Robert Samuels states that Payless is “executing on all cylinders”. The increase in Payless stock makes the Company appear even better in a sluggish economy. (“Stocks slip…”).

Reported in *Business Week Online*, Payless has been improving sales. In 2006, same store sales increased by 3.5%. The results of the stock have exceeded the Wall Street estimates. The best divisions of the Company are the women’s and children’s. The Company has even been able to increase prices without losing same store sales. This has given Payless the ability to produce higher profit margins. Many of these improvements can be attributed to the change in CEO. (“A Shoe-Biz Success Story…”).

The new CEO began work in July 2005. His name is Matthew E. Rubel and he is 48 years old. That makes him the second youngest of the top five in charge of the Company. His youth and former experience has given him a better understanding of how a shoe business is run. He is the former CEO of Cole Haan, a highly respected shoe and handbag retailer. (Payless 2005 Annual Report).

Since his commencement, the Company has been doing well. Sales have been increasing and the stock price has risen. Even though the Company seems to be doing exceptionally well, it does have some areas of weakness.

Income Statement Weaknesses

The Gross Profit Margin measures the amount of profit made from the sale of merchandise. A company should always have a positive amount for Gross Profit. In 2003, Payless saw its lowest Gross Profit Margin in four years because of a high level of leftover inventory and unseasonable weather conditions. Even with increasing by 2% from 2004 to 2005 and 2005 to 2006, Payless still falls below Brown and the industry average. However, after seeing the problems that arose in 2003, the managers have learned when to increase inventory and when not to. (Payless 2003 Annual Report, Payless 2006 Annual Report)

The Operating Profit Margin for Payless is considered a weakness because it has fluctuated over the past four years. It was down to 1% in 2003 for the same reasons the Gross Profit Margin dipped then. The problems in 2003 affected the Operating Profit Margin more than the Gross because of high SG+A costs for that year. However, in 2005 Payless was able to increase its Operating Profit Margin by 4%. (Payless 2005 Annual Report)

Net Profit Margin measures the amount of income dollars that are generated from sales in the Company. Since this is directly correlated to Gross and Operating Profit Margins, it follows the same pattern and for the same reasons. However, in 2005 Payless was able to increase the Net Profit Margin to 3%. Still, the instability of the ratio causes it to be a weakness for the Company. (Payless 2005 Annual Report)
Sales

The weakness in sales occurs over the last five years. In 2003 there was a dramatic drop in sales due to poorly performing women’s sandals, canvas shoes, and children’s athletic shoes. Payless also had large inventory levels in the second half of the year during a weakened retail environment. In retrospect, it was also thought that unusually low levels of inventory in the beginning of the year hurt sales as well. In 2004 and 2005, sales were flat. However, by 2006, the Company saw a 4.9% increase in sales because of the additional week in the fiscal year and because of increased same store sales. It is also attributable to positive sales performance overall in women’s and children’s shoes. (Payless 2003 Annual Report, Payless 2005 Annual Report)

Financial Statement Weaknesses

The Total Asset Turnover ratio is considered a weakness for the Company because it has declined by about .15 each year from 2002 to 2005. This ratio measures the Company’s ability to generate sales using its assets. The ratio has been declining each year because Payless has been increasing its total assets faster than its net sales. This is mostly due to the Company’s rapid increase in cash each year. Even with the decline in ratio, Payless is still above the industry average of 1.8, but falls nearly .20 below Brown each year. (Payless 2004 Annual Report, Payless 2005 Annual Report)

Restatements

In 2004, Payless restated some of its previous financial statements. This happened because of a comprehensive review completed in 2004 pertaining to lease accounting. The procedure for lease accounting was determined to be “inappropriate”. The rent expense and amortization of leasehold improvements was improperly recorded. The 2001 through 2003 financial statements were restated to better reflect the proper accounting. (Payless 2004 Annual Report)

The other item that was changed was Deferred Income Tax Asset. A $4.5 million dollar error was discovered and corrected. The total amount of the restatement was not material according to the Company. The overall effect of the restatement was a reduction to Retained Earnings of $3.2 million in 2002 and a reduction of $0.1 million in 2001. No change was made to Retained Earnings for 2003. (Payless 2004 Annual Report)

The restatements did not have any affect on past or future cash flows, the timing of lease payments, nor the compliance with debt covenants. The change that was made to the cash flow statement was just a reclassification. In 2003 and 2004 there was a portion of cash flows that was removed from the cash flow from investing activities section and added to the cash flow from operations section. The amount of those cash flows did not change. (Payless 2004 Annual Report)

Other Weaknesses

The Company operates using a large amount of fixed costs, such as: leasing costs of stores, interest expense, and labor costs. This is a weakness for Payless because these expenses cannot be changed based on sales. If sales were to greatly decline, the Company could experience a loss due to a large amount of cash going to fixed costs. Payless also sells seasonal merchandise. Weather conditions for the year must be on target to avoid overstocking inventory. If consumers are not buying the expected amount of inventory at the right time, it could cause the inventory to build up and mark-downs become necessary. (Payless 2005 Annual Reports)

Payless relies completely on third party manufacturers for its products. The fact that the Company needs another company to survive is risky. If the supplier lacks the raw materials necessary, it could have an adverse effect on Payless. The Company also does not currently have any long term agreements with its suppliers. These relationships with key suppliers could be
terminated at anytime, causing the Company to have an inventory shortage. Both of these weaknesses could cause major problems for the Company. (Payless 2005 Annual Reports)

The other two main weaknesses that Payless faces are the use of outside trademarks and heavy reliance on one main distribution center. The sale of shoes with outside trademarks or brands accounts for 22% of total sales. These brands are not owned by Payless, meaning their products are not guaranteed. If one of these other companies decided to withdraw its merchandise, it would cause a substantial decrease in sales. The main distribution center for Payless is in Topeka, Kansas and handles a majority of the entire company’s inventory. If something were to happen to that distribution center, it would adversely affect 44% of any store’s needs. All of these weaknesses affect the Company and somewhat detract from the strengths of the business. (Payless 2005 Annual Report)

Industry Opportunities

There are quite a few opportunities available for Payless to take advantage of. The first one being market share in relation to sales. Payless is the largest discount shoe retailer in America, but not the largest shoe retailer in general. Footlocker is a direct competitor and its sales are twice as much as Payless. Fortunately, this is an opportunity for the Company since there is room to grow and expand within the industry. (http://premium.hoovers.com)

Since Payless already has experience with operating stores outside of the United States, it has created another opportunity for itself. There are many more countries in the world that do not have Payless stores. There is actually one trial store open now in Japan. The Company is looking to see what the demand and sales are from that store. This could create another large opportunity since Asia is highly populous. (Payless 2005 Annual Report)

The Company is currently working on another opportunity. That is, to focus more attention on domestic sales. Since international sales have a higher profit margin, they naturally produce higher profit numbers than domestic. So if the Company puts more effort into domestic sales, it could produce more income. (Payless 2005 Annual Report)

In a time of unstable economic patterns, the amount of disposable income that a family has is uncertain. In the past few years, there has been less disposable income for people to spend on shoes. This is actually an opportunity for the Company since the demand for discounted items has increased greatly. Since Payless is the largest discount shoe retailer in America, it has the opportunity to attract customers who are looking to save money when buying shoes. The most stable of all the customer groups is the teenage age customers. Despite what the economy is doing, the teenagers are willing to spend the same amount of disposable income, which translates into sales for Payless, despite times of economic decline. (Payless 2005 Annual Report)

Other Opportunities

The distribution of Current Assets creates an opportunity for the Company. Payless holds nearly 30% of its total assets in Cash. This money could be used to pay dividends, repurchase stock, pay off debt, or invest. The Company has also decreased inventory while sales has increased, proving better inventory efficiency. As a result, the portion of cash as a current asset has grown to about 50% of Current Assets. (Payless 2005 Annual Report)

2005 Current Assets

The Cash Outflows for Payless also represent an opportunity for growth. The largest outflow for 2003 and 2004 was Capital Expenditures, which signals company growth. In 2005, Capital Expenditures were the second largest outflow behind Acquisition Costs. Payless is purchasing more outside brands, like Collective Licensing, to create a “House of Brands”. This opportunity would be important for the company to build a better reputation among consumers.
This is because most people want to wear footwear with a recognizable brand name. (Payless 2003 Annual Report, Payless 2005 Annual Report)

**Threats**

There are certain external forces that affect the Company. Competition and the economy are generally powerful threats for any company.

**Competition**

With the stagnant nature of the market in terms of the retail sector, the competition is rivaling for market share. Payless experiences direct competition from three different types of retailers. There are large department store types like Macy’s or Dilliards. The second type is the specialty shoe store, like Brown Shoe and Nine West. Finally, the third type is the large mass merchandiser like Wal-Mart and Target. Each of these types of stores are competition of Payless and threaten the Company’s market share.

**Economy**

Over the past five years, the retail, and particularly shoe industry has seen decreases due to the economy. People have less disposable income to spend on retail items. If this continues, Payless could see reduced sales as a result. Also, to offset potential losses, some companies, including Payless, have been laying off employees.

It is also a problem for public companies when the market is volatile, people are hesitant to invest their money. If people were to stop investing in the stock market, the companies could suffer. (Payless 2005 Annual Reports)

**Other Threats**

In a company such as Payless, there are other potential threats to the business. The first one would be the inability to accurately predict future trends. When people depend on a company to deliver the latest styles and the company falls behind, sales are lost. That is why Payless must try to stay ahead of the trends.

The Company is a part of a mature industry. The shoe industry has been around so long that it is hard at this point to raise profit margins. This could negatively affect the Companies earnings. (Payless 2005 Annual Report)

Even though Payless has room to grow in the overall shoe industry, it currently holds the largest market share in the discount industry. This becomes a threat to the Company since it does not have much room to expand. Payless is also greatly affected by unstable weather patterns. If there is any unseasonable weather, it can have a negative affect on sales and cause large mark-downs on merchandise. Overall, the threats to the Company are not unexpected, but they do need to be analyzed to improve preparation. (Payless 2005 Annual Report)

**Conclusion**

Payless ShoeSource has updated its overall image throughout 2005 and 2006. With the revised mission and vision statement, along with a new strategy, the Company is looking to increase market share. It is more on point with trends and styles to bring customers in, rather than relying on discounted prices only. In 2006, sales increased 4.9% over the previous year and Net Earnings doubled. Retained Earnings for the Company also increased in 2006 by 11%. While employing these new strategies, the Company looks to continue growing and improving.
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