WESTPEAK RESEARCH

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Cherokee Inc. (CHKE: NASDAQ)

Licensing – Retail Licensing

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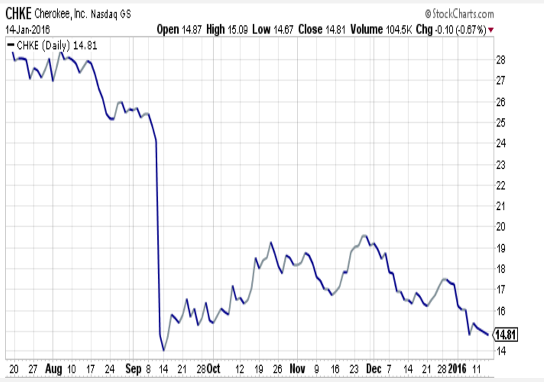
Bachelor of Commerce 2017

Equity Research	Canada
Price Target	**CAD$ 17.94**
Rating	Hold
Current Share Price, close	USD$ 14.84
Total Return	20.89%

Key Statistics	
52 week H/L	$29.72/$13.64
Market Capitalization	$129.5M
Net Debt	$25.6M
Enterprise Value	$149.4M
Net Debt/Enterprise Value	17.1%
Diluted Shares Outstanding	$8.72M
Free Float %	90%
Dividend Yield	0.33%
LTM P/E	14.85x
LTM EV/EBITDA	9.98x

WestPeak's Forecast

	2016E	2017E	2018E
Revenue	$34.3M	$37.7M	$30M
EBITDA	$14.9M	$14.3M	$11M
EBIT	$14.1M	13.8$M	$11M
Net Income	$8.7M	$9.2M	$7.3M



Source: Bloomberg, StockCharts, WestPeak Research

Executive Summary

Company Profile

Cherokee is a global brand marketer and manager based in Sherman Oaks, California. They currently license a portfolio consisting of more than twelve fashion and lifestyle brands, focusing on domestic and international direct to retail licensing.

Healthy Profit Margins create Growth Opportunities

With above average profit margins Cherokee has been able to experience a continuous flow of cash generation, which Management believes will allow for the further acquisition of new brands. This is further reinforced by the decision to stop paying dividends in order to reinvest cash for future growth. The addition of new brands with potential of international expansion should provide higher short term returns for the shareholders of the firm. Recent licensing agreement with the European retail sport giant; Sport direct should benefit Cherokee with a broader international reach as a leading retail licensing company.

Valuation & Recommendation

Cherokee is a leading firm in the retail licensing industry. Historically, it has been experiencing above average net margins when compared to its peers. However, due to the discontinuance of a contract accounting for 43% of its revenues in 2017 we feel it will be a challenge for Cherokee to recover.

With a 6.98% revenue slippage, and a 32% loss in value Cherokee's management will be challenged to find new licensing partners to fulfill the impending loss in revenue and cash flow. As such, we edge on the conservative side and rate Cherokee as a **hold** with a target price of **$17.94**.

Business Overview/Fundamentals

Company Description

Cherokee is a global marketer and brand manager. Currently, Cherokee licenses a portfolio consisting of more than twelve fashion and lifestyle brands in more than 50 countries and 7,000 retail locations. Notable trademarks include: Hawk, Tony Hawk, Liz Lange, Carole Little, and Saint Tropez-West. Cherokee's common shares are traded on the NASDAQ stock exchange under the ticker CHKE and it is currently headquartered in Sherman Oaks, California. In addition to licensing their own brands Cherokee also acts as an advisor by assisting other brand owners in identifying attractive licensing opportunities. Partnership deals have also been realized in the past as seen with Alessandra Ambrosio's *ale by alessandra* brand.

Strategic Initiatives

Cherokee employs Product Design and Development teams in Los Angeles and Minneapolis. These teams work with Cherokee's brand licensees in order to develop innovative seasonal product design concepts. This involves introducing new product categories and expanding brands into new regions. Cherokee also focuses on organic growth drivers such as: enhanced in-store experiences, a larger online presence, partner expansion with more stores, and category expansion into home, footwear, and essentials.

Direct to Retail Licensing Model (DTR)

Cherokee employs a direct to retail licensing model. This model is based on the premise that for many retailers, business activities such as product development, design, merchandising, sourcing and distribution, can be executed more effectively by the retailers themselves who not only command economies of scale, but also interact with their customers on a daily basis. This model provides retailers the ability to obtain a higher gross margin on sales, and increase consumer traffic due to the flexibility of being able to design, source, stock, and sell the licensed products rather than having a fixed set of strictly labeled branded goods obtained through a third party vendor.

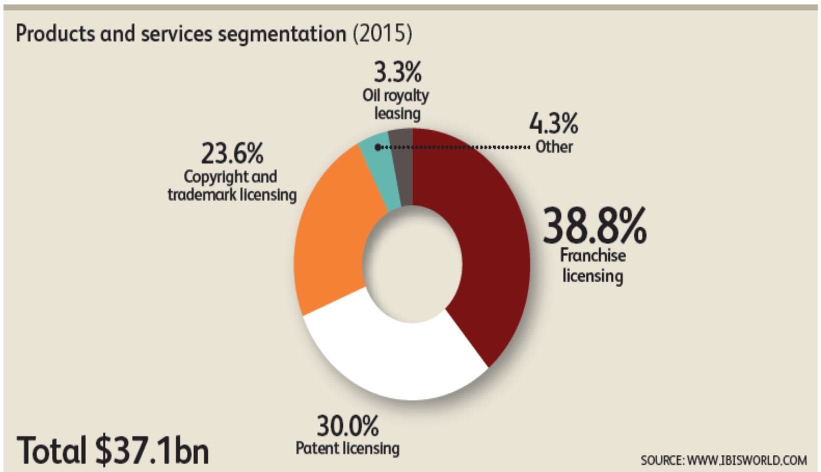
DTR has been gaining acceptance among retailers as it offers the licensee or retailer exclusivity in its right to market several categories of products; allowing the use of a recognized brand within their territory. This offers the retailers the ability to gain competitive advantage through the development of enhanced marketing strategies; providing the opportunity of charging a premium over private label price points. Notable retailers who use the DTR model include Target, Wal-Mart, Kohl, and Carrefour.

Royalties

Royalty payments received through DTR licenses vary depending on the agreement with the retailers. These methods include charging a percentage of the retailer's net sales, charging a fixed percentage of product sales, and offering a decreased royalty rate after a certain level of annual sales. Generally, Cherokee requires retailers to guarantee a minimum dollar amount of sales, and therefore guaranteeing a minimum amount of royalty payments each year. In the case of Target, they are required to pay a minimum royalty rate of $10.5 million per Fiscal year.

Macro Environment/Industry Overview

Licensing Business



Firms in this industry assign rights to intangible assets such as patents, trademarks, brand names and franchise agreements for a royalty payment or licensing fee. Although the ascribing firm owns the rights of the original asset it does not mean they are the creators of such assets. Primary activities in this sector include assigning rights to intangible assets, brand purchasing, and licensing.

Profit and industry size

Industry profit margins are generally high as the sale of licenses are intangible and have no incremental costs. Profitability around the industry has increased since its lowest base in 2010. The increase in business investment and consumer demand has provided consumers with the capital necessary to license intellectual property, allowing an increase in licensing rates. Firm restructuring and the shedding of excess costs during the recession has allowed firms in the sector to further increase its profit margins. IBIS estimates that number of firms in the industry are expected to grow by an average annual rate of 1.4% over 5 years.

Business investment

Investment in the industry has been on the rise over the past 5 years. The licensing sector has experienced an 11.4% increase in corporate profits since 2012; recovering off the effects of the financial crisis. As previously noted, an increase in consumer demand as well as lower costs due to restructuring has driven demand for licensing.

Outlook

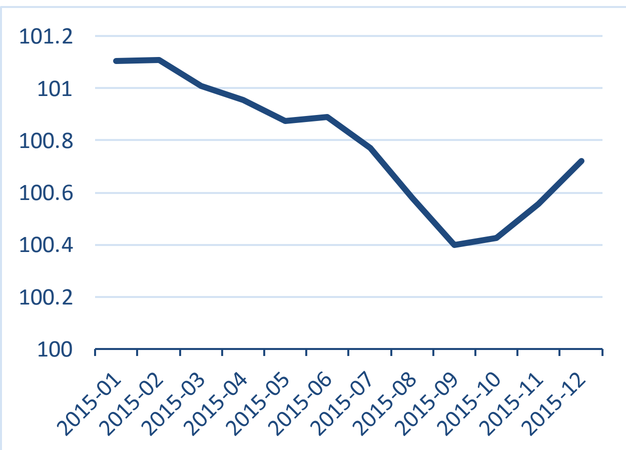
Over the next 5 years, the economy will experience stronger macroeconomic conditions. Consumer spending will surge due to improving consumer conditions as well as falling unemployment rates. This in exchange, will cause an increase in advertising expenditures, which will drive consumers towards branded products. Over the next 5 years consumer spending is also forecasted to grow at an annualized rate of 2.6%. This is driven by lower unemployment rates boosting disposable income per capita. Consumer confidence is also on the rise, although interest rates are being raised, the Federal Reserve is being extremely cautious of raising the cost of capital too high. The recent hike in interest rates might create a downward push on consumer spending due to the increase in saving opportunities.

Catalysts

Per capita disposable income

Disposable income measures the dollar amount individuals have at their availability to purchase goods and services. An increase in the per capita disposable income allows individuals to spend and purchase a greater amount of products, including branded products that the sector holds.

Consumer Confidence Index



The Consumer Confidence Index is calculated on a monthly basis, measuring consumer sentiment over a variety of issues such as unemployment, household finances, inflation, income, business conditions, and government economic policy. The CCI also asks consumers whether it is a good time to purchase or sell an automobile, house, or a major household item. As consumer sentiment rises, consumer spending follows through, especially on branded items; thereby increasing industry revenue.

Acquisitions of Brands

M&A | EQUITY | BONDS | LOANS

	Rank Date	Target Name	Acquiror Name	Ranking Value inc. Net Debt(mil)
	10/19/15	Flip Flop Shops	Cherokee Inc	-
	01/13/14	Hawk Designs Inc	Cherokee Inc	19.00
	09/06/12	LLM Management Co LLC-Product	Cherokee Inc	14.00

Cherokee's strategic platform for future growth involves the acquisition and representation of new brands. Targeting style-focused lifestyle brands such as Tony Hawk, Liz Lange, and recent acquisition Flip Flop Shops. In the past, the acquisition of brands that fit the company's long term goals has allowed Cherokee to expand and sustain its revenue trend. In FY 2014, through the acquisition of the Tony Hawk brand, Cherokee was able to increase revenue levels by 18%.

Management Team

Name/Title	2011	2012	2013	2014	2015
Key Executive Compensation	2,149,000	1,693,000	1,743,500	2,102,000	2,489,000
Henry Stupp/Chief Executive Officer	1,322,000	777,000	1,062,000	999,000	1,271,000
Jason Boling/Chief Financial Officer	-	-	-	511,000	509,000
Howard Siegel/President Chief Operating Officer & Secretary	827,000	916,000	681,500	592,000	709,000

Key Executive Compensation

Henry Stupp

Title: CEO & Director **Basic Compensation**: $1,271,000 **Since**: 2010

Mr. Stupp became Chief Executive Officer in August 2010. Prior to joining Cherokee, Mr. Stupp was the co-founder of Montreal based Novel Teez Designs, later known as NTD Apparel USA LLC, a licensee of entertainment, sport, and branded apparel. Mr. Stupp served as President of NTD Apparel USA LLC from 2005 until 2010. Mr. Stupp is currently serving a two year term as a Director of International Licensing Industry Merchandiser's Association. Mr. Stupp has a bachelor's degree in Economics, through Concordia University.

Howard Siegel

Title: President & COO **Basic Compensation**: $709,000 **Since**: 2010

Mr. Siegel has been working for Cherokee since January 1996 as VP of Operations and Administration and became President on June 1, 1998. As of January 2010, Mr. Siegel was appointed as the Chief Operating Officer. Prior to January 1996, Mr. Siegel worked as a senior executive for Federated Department stores and Carter Hawley Hale Broadway stores. Mr. Siegel attended University of Florida where he received his Bachelors of Science degree.

Jason Boiling

Title: CFO **Basic Compensation**: $509,000 **Since**: 2013

Mr. Boling became Chief Financial Officer in March 2013. Prior to joining Cherokee, Mr. Boling was VP of Finance and Accounting at DTS Inc., a high-definition audio technologies and audio enhancement solution company. Mr. Boling has domestic and international experience in M&A, acquisition integration, strategic planning, budgeting, compliance and controls, investor relations, and tax planning. Mr. Boiling is a Californian CPA, and earned his bachelor's degree in Business administration from California State University Northridge.

Risks

Brand & Trademark vulnerabilities

The main risk for licensing companies is a revenue slip due to unprotected copyrights, as well as vulnerabilities in their brands and trademarks. This includes, pirating, copycat products, selling of products without permission or selling rights.

Retail Industry

Because Cherokee is in the retail licensing industry, it is exposed to the risks associated with the retail sector. These risks can impact the sale of products that bear their brands, adversely affecting revenues. Such risks include consumer preferences regarding trends and styles, consumer preferences regarding where to shop, shifts in the seasonality of shopping patterns, declining retail prices, and changes in cost of capital.

Reliance on Target

Royalty revenues from Cherokee's brands at Target accounted for 43% of consolidated revenues in fiscal 2015. This leaves Cherokee vulnerable to a substantial decrease in both its revenues and cash flow if Target were to reduce or discontinue its sales of Cherokee's brands. Target recently announced that it will not renew its contract pertaining the sale of Cherokee's branded products. The contract which expires in January 31 of 2017 will severely reduce the sales and royalty payments of Cherokee. Currently, the reliance in Target means Cherokee's success is dependent on several factors affecting Target's business.

Dependency on Kohl

In January 2014, after the acquisition of the Hawk and Tony Hawk brands, Cherokee entered a retail licensing agreement with Kohl's, granting Kohl's the exclusive right to sell Tony Hawk, and Hawk branded apparel in the United States. Therefore, revenues from Kohl's that surpass the $4.8 million minimum annual royalty are subject to the growth of the aforementioned brands in future periods.

Geopolitical Risk

Geopolitical risk showcases the possibility of investment returns suffering as a result of political changes or instability in a region or country. This could arise from a change in government, legislative bodies, other foreign policy makers, or military control. Cherokee licenses its brands in more than 50 countries, as such it is subject to geopolitical risk in several regions.

Shareholder Base

Investor Type				
Investor Type	Investors	% O/S	Pos	Val ($MM)
Investment Managers	125	72.23	6,298,862	98.20
Brokerage Firms	13	1.16	101,273	1.57
Strategic Entities	9	9.68	843,684	16.75
Holding Companies	0	0.00	0	0.00
Corporations	1	3.81	332,531	5.16
Individuals	8	5.86	511,153	11.59
Government Agency	0	0.00	0	0.00
Total - All Holders	147	83.07	7,243,819	116.52

Ownership Summary

Investor Name	% O/S	Pos	Pos Chg	% Pos Chg
Cove Street Capital, LLC	9.14	796,652	211,792	36.21
Headlands Capital Management, LLC	7.82	681,626	-60,000	-8.09
Renaissance Technologies LLC	7.70	671,075	-43,559	-6.10
Pembroke Management Ltd.	7.35	640,747	378,447	144.28
BlackRock Institutional Trust Company, N.A.	6.16	536,860	-27,470	-4.87
The Vanguard Group, Inc.	3.89	339,560	7,997	2.41

Valuation

Comparable Company Analysis (CCA)

Our selection criteria is based on similar business and financial profiles as well as susceptibility to similar risks and opportunities. Growth profiles tend to be similar, driven by inorganic growth opportunities such as the acquisition of brands, as well as organic growth stemming from the development of new brand products through retailers. Currently, Cherokee is trading below its peers on a 2015E EV/EBITDA basis of 9.98x compared to the comparable universe average of 16.88x.

Discounted Cash Flow Analysis (DCF)

Cherokee's unlevered free cash flow was projected over a 5 year period based on historical data as well as qualitative analysis. Due to the discontinuance of Target's contract pertaining the sale of Cherokee branded products in 2017, and due to the lack of an appropriate comparable multiple range, we decided that the Gordons Growth Model in order to calculate the terminal value was the most appropriate in this scenario. The Weighted Average Cost of Capital (WACC) was calculated at 6.30%. Enterprise Value is calculated as $176,393 giving an Equity value of $156,464. Equity value was then divided by total number of shares outstanding giving a target price per share of $17.94.

Appendix

Comparable Company Analysis (CCA)

TRADING COMPARABLES ANALYSIS — **Cherokee inc.**

Company	Price	Mkt-Cap	Cash	T. Debt	EV	EV/Sales	EV/EBITDA	EV/EBIT	P/E
Iconix Brand Group	6.41	262800.00	136400.00	1471600.00	1748600.00	4.35	9.39	8.74	2.88
PVH Corp.	72.38	5636000.00	369900.00	3367200.00	8633300.00	1.14	8.78	14.61	11.51
Perry Ellis International	17.35	273660.00	39161.00	371990.00	606489.00	0.70	14.19	20.65	N/A
Kate Spade & Company	16.73	2095500.00	219740.00	401600.00	2277360.00	1.88	16.55	57.49	25.51
XCEL Brands	6.99	128900.00	19203.00	65513.00	175210.00	6.75	35.47	46.76	102.79
Cherokee inc.	**16.02**	**129500.00**	5709.00	25570.00	**149361.00**	**4.35**	**9.98**	**10.59**	**14.85**
High						6.75x	35.47x	57.49x	102.79x
Average						2.96x	16.88x	29.65x	35.67x
Median						1.88x	14.19x	20.65x	18.51x
Low						0.70x	8.78x	8.74x	2.88x

	EV/Sales	EV/EBITDA	EV/EBIT	P/E
Implied Market Capitalization - High	$989,026.81	$5,277,616.90	$8,566,285.18	$896,646.49
Implied Market Capitalization - Average	$422,830.51	$2,500,699.67	$4,408,769.96	$311,165.40
Implied Market Capitalization - Median	$260,712.02	$2,099,650.54	$3,064,856.14	$161,444.79
Implied Market Capitalization - Low	$84,454.14	$1,291,528.58	$1,285,701.94	$25,125.54

DISCOUNTED CASH FLOW ANALYSIS

Cherokee inc.

	2014A	2015A	2016A	2017E	2018E	2019E	2020E	2021E
Current Debt to Total Capitalization			36%					
Current Tax Rate			35%					
Current Weighted Average Debt Yield-to-Maturity			7%					
Current LTM Equity Market Return			7%					
Current Risk Free Rate			2%					
Current LTM Equity Beta			1.06x					
Current Weighted Average Cost of Capital (WACC)			**6.30%**					
Long-term Perpetuity Growth Rate			2.00%					
EBIT				13846	11014	11475	11937	12404
Tax Rate				*33%*	*33%*	*33%*	*33%*	*33%*
Depreciation, Depletion and Amortization				1425	1383	1341	1301	1262
Capital Expenditure				-392	-431	-474	-521	-573
Change in Net Working Capital				-497	-823	-879	-939	-1003
Unlevered Free Cash Flow				**9767**	**7471**	**7638**	**7798**	**7955**
Discounted Unlevered Free Cash Flow				9188	7442	7637	7798	7955

Present Value of Projected Cash Flows	$	40,019
Present Value of Perpetuity Cash Flows	$	136,374
Total Enterprise Value	**$**	**176,393**
Total Debt	$	25,638
Cash	$	5,709
Total Equity Value	**$**	**156,464**
Shares Outstanding (Thousand)		8,720
Price/Share	**$**	**17.94**

Discount Rate (WACC)

Long-term Growth Rate	4.30%	5.30%	6.30%	7.30%	8.30%	9.30%	10.30%	11.30%
0.00%	$19.51	$15.61	$12.97	$11.08	$9.66	$8.56	$7.68	$6.97
0.50%	$21.78	$17.00	$13.89	$11.72	$10.13	$8.92	$7.96	$7.19
1.00%	$24.72	$18.70	$14.99	$12.47	$10.67	$9.32	$8.27	$7.43
1.50%	$28.72	$20.86	$16.31	$13.35	$11.29	$9.77	$8.61	$7.70
2.00%	$34.46	$23.67	$17.93	$14.39	$12.00	$10.28	$8.99	$7.99
2.50%	$43.39	$27.48	$19.99	$15.65	$12.84	$10.87	$9.42	$8.32
3.00%	$59.18	$32.95	$22.67	$17.21	$13.83	$11.55	$9.91	$8.68
3.50%	$94.71	$41.46	$26.31	$19.17	$15.04	$12.35	$10.48	$9.10

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