

Mossberg's Investor Digest

Best Idea Profile

Heelys (Nasdaq: HLYS)

DESCRIPTION:

Headquartered in the Dallas/ Fort Worth Metroplex, Heelys makes footwear targeted at children 5 to 14 years old. It is most well known for its primary product which is a sneaker with a removable wheel(s) (98% of sales). The wearer can run, walk, or, by shifting weight to the heel, roll. The technology is protected by over 90 patents and trademarks. Heelys are sold worldwide with approximately 65% sales generated outside the United States.

KEY INVESTMENT CONSIDERATIONS:

Litigation issues and costs are behind them – The company was experiencing significant growth when it came public in 2006. When economic difficulties, inventory corrections, and negative publicity surrounding injury rates caused significant declines in revenue and the stock price, several shareholder litigation suits were filed. At the end of last year, those suits were settled. Litigation costs associated with shareholder litigation lawsuits were over \$4 million during 2009.

Asset-light model gives potential for significant returns – The bulk of the company's 51 employees and resources are focused on design and marketing... manufacturing is outsourced. As costs are rationalized to current sales levels, the company should be capable of generating net margin in the range of 5% to 10% and returns of 15% to 20%. During 2006 and 2007, at the height of the brands popularity, net margin was 15% and 12%, respectively, and ROE exceeded 20%.

Costs are closer to being in line with revenue levels - The company has reduced the number of SKUs and inventory levels at retail are in better position, allowing the company to sell more product at full margin. As a result, 4Q09 gross margin increased to 40% from 24% in the prior year. The \$4 million in legal fees associated with shareholder litigation shouldn't be repeated during 2010. Combined with even a modest recovery in consumer discretionary spending and continued improvement in gross margin, the company could produce profitability this year.

New management team – The company recruited 30-year advertising and marketing veteran, Tom Hansen to serve as CEO in August last year. Mr. Hansen has a track record of developing and re-developing brands.

The tide of consumer discretionary spending appears to be coming in – Consumer discretionary stocks are up over 10% year-to-date and 65% over the past year...one of the best performing sectors. Recent reports from retailers (Foot Locker, DSW) suggested that recent trends in shoe sales are improving.

Are they really that unsafe? – As a parent of children who have, and use Heelys, I was obviously concerned with the safety issue of the product. There have been many hatchet jobs in the media declaring Heelys as unsafe. However, a 2007 study by the Heiden Associates found that Heelys was the safest activity among popular wheeled sports. The study stated that on a per participant basis, Heelys are 39x safer than bicycles, 24x safer than skateboards, and 9x safer than scooters.

VALUATION:

The company is currently trading at an enterprise value near zero. On the surface, the stock has the potential to be a value trap and investors may have to wait to realize return from this stock. However, there seems to be a good chance that the company could turn a profit this year. The Heelys brand must have more value than zero, and a return to profitability could be the catalyst that brings some attention from investors.

(Nasdaq: HLYS)

Investment Data (as of 3/24/10)

Recent Price	\$2.40
52-Week Range	1.12 - 2.91
Fiscal Year End	December
Dividend	N/A
Yield	N/A
Shares Outstanding	27.6 MM
Average Trading Volume (3 mos)	45,000
Market Capitalization	\$67 MM
Cash	\$67 MM
Debt	N/A
Enterprise Value (EV)	\$0
Debt/ Equity	N/A
Tangible BV/ Share	\$2.84
TTM Revenue	\$44 MM
P/ Revenue	1.5x
TTM EPS	-0.19
P/ EPS	NA
TTM EBITDA	-2 MM
EV/ EBITDA	NA

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