K2 Inc.

Short investment

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Business Description

- K2 is a diversified consumer products company with a focus on sporting goods
  - Skis-K2
  - Snowboards- K2, Ride
  - Inline skates- K2
  - Mountain Bikes- K2
  - Fishing- Shakespeare, Pflueger
  - Baseball equipment- Rawlings, Worth
  - Various lines of apparel- Adio, Hawk, Planet Earth

Industry Analysis

- Highly fragmented, highly competitive
- Lots of other brands- substitutes
- Low margins with low competitive advantages other than brands matched to size economies
- Lots of buyer strength, consolidation increasing on retail side
  - Sports Authority merger with Gart
  - Wal-Mart
  - Dicks Sporting Goods

How They Make Money

- Manufacture sporting goods in house and distribute the merchandise to retailers who sell it to consumers (75% of sales from sporting goods, 19% from industrial goods, 6% recreational)
  - Sales highly influenced by demand- hard to predict
    - 15.6 million write down of small wheels for skates in 2001
  - Seasonal lines create free cash flow gaps and strained working capital requirements

K2's New Strategy

- New Strategy is to grow K2 into the one stop sporting source for retailers through acquisition
  - Centralize distribution system
  - Create leverage with suppliers
  - Secure more retailers as customers
- Recent events
  - Richard Rodstein was ousted as CEO and replaced by Richard Heckman
  - Richard Heckman was CEO of USFilter, where he acquired over 150 companies before selling to Vivendi in 99'

Stock Misperception

- Richard Heckman's history of acquisition has helped pump the stock from a 52 week low of 6.40 to a high of 18.35
- Markets high enthusiasm for Heckman's transformation of K2 will not be met
- Misperception proved through
  - Value added research
  - Matched to financial evaluation

Investment Points

- K2 is a company masking low organic growth and does not make returns over their cost of capital
- The companies being acquired are not top ranked businesses and do not add real value to the firm
- Supply issues will develop as production from acquired companies is moved to China.

Point 1

- K2 has not shown organic growth in the past few years and won't in the future
- Using acquisitions to mask these concerns
- Acquisitions provide opportunities to cover low organic growth or create sales growth illusions
- Conversations with stores claimed new products from acquired companies did not make a splash in market
- Possible future write downs. Opinionated research from message boards claimed warehouses were overflowing

Point 2

- K2 is acquiring businesses that are not top ranked and don't add real value
  - Rawlings- March 26th, 2003
  - Worth- Sept 19th, 2003
- Rawlings wanted to sell themselves for three years. Allowed competitors like Mizuno and Nike to take top market position
- Worth is a leader in softball equipment, but doesn't add real value to K2
- Strong brands in skis and other products could be hurt by less specialization (mostly in hardcore enthusiasts)

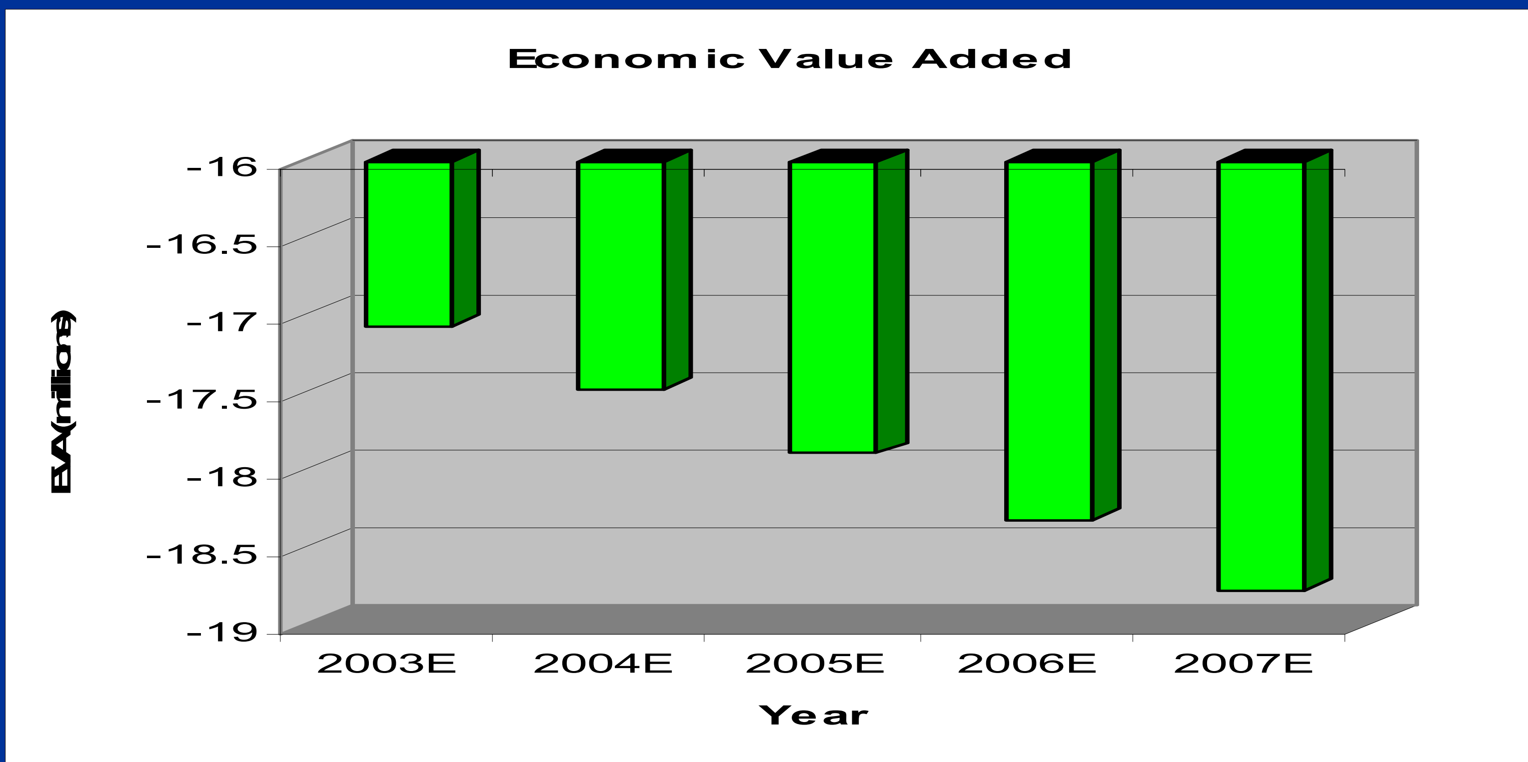
Point 2 Continued

- K2 does not make returns over their cost of capital
  - Cost of Capital (aka WACC) = 8.5%
  - Also using equity to acquire businesses, increase cost of equity and dilutes shareholder value
  - 5 year projected ROIC:

2003E	2004E	2005E	2006E	2007E
4.99%	5.02%	5.06%	5.09%	5.12%

Point 2 Continued

- Negative economic value added shows they are destroying value



Point 3

- Moving production to China could create supply problems
  - Should occur as acquired companies' production is moved to China (75% of K2 production already in China)
  - When K2 moved ski production to China a few years ago, Freestyle said they experienced customer service problems
  - Performance Bike recently quit carrying K2 bikes, managers nor employees knew why. Corporate would not discuss
  - CFO of Hibbet Sports, Gary Smith, said he would not hesitate to switch suppliers if K2 developed supply issues

Discounted Cash Flow

- 4% Sales growth
- WACC 8.5%
- 5 yr. averages for pro forma assumptions
- DCF yielded price per share of $9.50
- Current market valuation is $16

Other Metrics

- Market Cap 400M
- PEG 2.18
- Price/Sales 0.63
- Price/Book 1.25
- Price/Earnings 30
- Beta 0.79
- Profit Margin 1.62%
- Short Interest 5.8%

Investment Risks

- Heckman has proven himself a visionary leader
- Strong brands and Triple AAA credit rating
  - Only 154m in LTD
- Ability to improve performance through more acquisitions

Additional Research

- Call manufacturing and ask about internal practices (anyone speak mandarin?)
- Survey and monitor more retailers to find any other supply issues
- Get in touch with warehouses to check on inventory levels
- Examine progress at merged companies
- Further examine financial concerns

Questions ?

- The End

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