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Recommendation: SELL

Quantitative Highlights:

- ◆ Overvalued according to the DCF analysis with assumptions by 11.15%
- ◆ Margin compression going forward due to increase growth in SG&A and related expenses
- ◆ Low inventory turnover which is key to the consumer industry
- ◆ The price of this stock is substantially underperforming relative to its industry and P/E is expensive compared to industry
- ◆ Low ROE and ROA compared to industry averages
- ◆ Net Income has decreased the past 4 years due to increasing COGS and SG&A

Qualitative Highlights:

- ◆ Heavy confidence in new product launch of Oakley Thump to achieve full year sales and earning goals.
- ◆ Core sunglass business down 10.7% due to weak retail environment in Europe and South Pacific as well as high competitive pressures.
- ◆ Institutional investors have sold more shares of Oakley than they have purchased – showing lack of confidence in Oakley.
- ◆ Operating Expenses up 8.7% due to rise in foreign operating expenses and design expenses for Oakley Thump.

Financial Highlights

Price as of 11/29/2004	\$12.43
Symbol	OO
Exchange	NYSE
52 - Week Range	\$9.68 - \$16.23
Shares Outstanding	69 M
Market Cap	\$821 M
Beta	0.95
5 yr Projected EPS Growth	11.51%
CFY P/E	19.36
PEG Ratio	1.46
ROA	8.44%
ROE	10.37%
Current Ratio	2.93
Debt/Equity	0.10
Fiscal Year Ends	12/31/2004

■ OO.N Price Chart



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Investment Thesis

At this time we feel that we should sell Oakley Inc. Their price has decreased over the past three years, and this is significant since we bought Oakley at \$19. Our DCF analysis has also concluded that this stock is overvalued. In addition, Net Income for Oakley has also decreased in the past 4 years. This past summer, Oakley has missed its EPS estimates causing its stock to drop. Their low efficiency ratio, especially ROE, and low inventory turnover are of concern. Oakley has put its hopes on its newest product line, Thump. They are depending on Thump to achieve this year's estimates of sales and earnings. They also expect that they will have a sales growth of 10%-15% as well as a 10%-15% EPS growth. We do not believe that this is achievable especially in their current state. Institutional investors have sold more shares of this company than they have purchased. This may indicate Institutional buyers are losing confidence in this stock. On October 1, Oakley increased their cash dividends from 14 cents per share to 15 cents per share. This is an effort to please investors but may not be a beneficial move for the company's growth. Oakley's price performance momentum is in decline. The stock's 4 week price performance relative to its industry decreased by 5.3% and its Adjusted 13 week price performance went down only 1.0% relative to its industry. In the third quarter, Oakley core sunglasses business declined 10.7% as a result of weak retail environment in Europe and South Pacific. A wet summer in Europe and high competitive pressures from competing brands also had a impact. This inconsistent retail environment also complicated management's attempts to predict sales trends affecting inventory turnover. Operating Expenses also increased 8.7%

due to increase in foreign operating expenses and an increases in design expenses for Oakley Thump.

Company Profile

Oakley, Inc., incorporated in 1994, is a consumer products company engaged in the design and development of sunglasses, prescription eyewear, apparel, footwear, watches, goggles and accessories. The Company's products are sold in the United States through a carefully selected account base that fluctuates between 8,400 and 9,200 accounts, with approximately 14,500 to 15,600 locations depending on seasonality of summer and winter products. The store base is comprised of optical stores, sunglass retailers and specialty sports stores, including bike, surf, snow and golf shops, as well as motorcycle, athletic footwear and sporting goods stores and limited department store distribution. It also operates 27 Oakley retail stores in the United States that offer a full range of Oakley products. In addition, the Company owns Iacon, Inc., a sunglass retailing chain with 76 sunglass specialty retail stores as of December 31, 2003. Internationally, the Company sells its products in over 100 countries outside the United States, with direct offices in France, Germany, United Kingdom, Italy, Japan, Mexico, South Africa, Canada, Australia, New Zealand and Brazil. In those parts of the world not serviced by the Company or its subsidiaries, its products are sold through distributors who sell the Company's products either exclusively or with complementary products.

In December 2003, the Company opened a licensed O Store in Santiago, Chile, making it the sixth international Oakley retail location. In addition to

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this store, the Company operates an O Store in Torquay, Australia, two Oakley Vaults in Portsmouth and York, United Kingdom, an Oakley Vault in Calais, France, and an Oakley Vault in Port Elizabeth, South Africa.

Eyewear Products

In 1999 the Company introduced a polarized lens choice for consumers. Unlike most polarized lenses, which stack multiple layers together using adhesive that compromises optical clarity, durability and lens integrity, the Company uses a patented lens technology to maintain precision optics by molecular fusing of the polarized filter between thin Plutonite surfaces. Oakley then injection molds liquid Plutonite onto the filter to create a true polarized lens with patented XYZ Optics and optical clarity. The Company's O Matter frames are composed of a lightweight synthetic that retains durability while allowing critical flex. As the only 3-D sculptured, hypoallergenic, all-metal frames on earth, X Metal is a family of eyewear named for a proprietary metal blend that exhibits an extraordinary strength-to-weight ratio.

In March 2001, the Company released a line of ophthalmic-specific frames and has a prescription program encompassing both ophthalmic frames and corrective lenses. There are several shapes and sizes for the consumer to choose from and a variety of materials used, including Magnesium, C-5, X Metal and Rx O Matter. As part of the Plutonite prescription lens offering, the Company sells a single lens product that is suited for the sports enthusiast. To complement the single lens product, the Company also offers a dual lens program for the consumer who is interested in a more traditional eyewear frame or one of Oakley's many high-wrap



sunglass frames.

The Company's sunglass and clear prescription lenses are offered for any prescription ready or sunglass frame that eye care professionals have on display in their stores. The lenses are not limited to use with Oakley prescription ready and Oakley sunglass frames. The Company offers 19 colors from which the consumer may choose, including polarized, Iridium and clear options. Single vision and progressive lens designs are also offered.

In the sports segment of the nonprescription eyewear market, Oakley competes with Luxottica, Marchon and Safilo. The Company-owned Iacon chain of specialty sunglass stores competes primarily with mall-based sunglass specialty retailers, including Sunglass Hut, which is owned by Luxottica.

Apparel Products

The Company released 535 apparel styles and accessories during 2003. Spring apparel releases for 2003, totaling 223 styles, included an introduction of Oakley denim for men and the launch of board shorts for women. Fall 2003 apparel releases, totaling 312 styles, included an increased focus in technical outerwear with 46 new designs. The Company's key styles incorporate AirVantage technology, a self regulating insulation system invented by Gore. During 2003, the Company expanded its lifestyle product line and its women's product line. The women's line totaled 116 pieces and men's totaled 196 pieces. Categories include golf, mountain bike, surf, lifestyle, lifestyle athletic, fleece and tees.

The Company's technical apparel outerwear competes with Burton, North Face, Columbia Sportswear and Patagonia. Its sports and lifestyle

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apparel competes primarily with Nike, Quiksilver, Billabong and Ashworth.

Footwear Products

With continued advancement in the design and manufacturing of footwear, the Company is utilizing proprietary Net Shape technology to create shoes with superior fit throughout the full range of motion. Instead of creating parts separately and forcing their consolidation, true unibody construction is achieved with computer-aided design/computer-aided manufacturing engineering, allowing components to form an integrated system. During 2003, 21 footwear styles were released, including the Elite Special Forces Standard Issue Assault Boot/Shoe, part of the Company's military/industrial product line; three sandal lines, four golf shoes and 12 lifestyle shoes.

Within the athletic footwear market, the Company competes with Nike, FootJoy, Reebok, Adidas and Timberland.

Wristwatch Products

The Company offers a line of wristwatches. The range of performance accuracy extends to the level of six-jewel high precision Swiss movement. The Company produces self-powering wristwatches, true analog quartz systems and a precision analog chronograph. In 2003, it terminated further development of digital watch models to focus on analog watch products allowing for more sculpture and styling to be designed into the watches.

The Company's luxury timepiece products compete with established Swiss brands, including Rolex,



Breitling, Omega, TAG-Heuer, Movado, Rado and Hamilton. In addition, Oakley's performance watches compete with other fashion brands from the Swatch Group, Swiss Army and Fossil.

Goggle Products

Available in a number of styles, the Company's goggles include features such as scratch-resistant Lexan lenses, conical frames and multi-layered face foams. Updated in 2000, the MX O Frame continues to be used in motocross events. The A Frame is an optically correct dual-lens snow goggle and is engineered to optimize protection, as well as the clarity and range of peripheral and downward vision. A triple layer of face foam insulates and cushions the contact surface for thermal shielding and comfort. In 2002, the Company introduced the Wisdom goggle, featuring increased lens sizing for greater visual range and interchangeable strap connections to accommodate helmets.

Accessories

In June 1997, Oakley acquired One Xcel, Inc., a company that designed an optically correct protective face shield available for use with hockey and football helmets. In 2001, the Company discontinued the One Xcel brand name for football shields and began marketing those products under the Oakley name. The Company transitioned its hockey shield products to the Oakley name in 2002 and also began marketing hockey gloves featuring the Oakley logo. The Company continues to maintain a licensing relationship with the National Hockey League for both of these product lines.



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Discounted Cash Flow Analysis

The DCF analysis revealed an average value across the models of \$11.04 which is 11.15% lower than its market price of \$12.43. We predicted a 9.5% revenue growth for 2004 based upon their first three quarters and a close estimate of their fourth quarter.

We are confident in our revenue estimates since they closely match those of the industry analysts. Instead of growing their SG&A at the same rate as their revenue we are predicting a higher growth due to their new product launch. They have substantially bumped up their spending on advertising and campaign efforts for their new product 'Thump' and this will cause the margins to compress going forward between SG&A and revenue. We think that this is a quite conservative viewpoint since in the past 4 years they have had a negative net income growth and we are assuming that going forward they will have a positive net income growth. Even with this generous assumption their stock price is much overvalued. Oakley's valuation is very sensitive to their revenue and expense growth rates as well as their beta. We used value line's beta of .95 which is also conservative compared to some analyst's calculation of 1.95. If 1.95 were used as the beta the stock price would plummet to \$3.94 from \$11.04.

Valuation model used	Summary	
	Equity \$M	\$ Per Share
Unlevered value	\$733	\$10.66
Adjusted Present Value	\$760	\$11.05
Flow to Equity	\$769	\$11.19
WACC with FCF	\$755	\$10.99
AT-WACC with UFCF	\$752	\$10.94
Average across models	\$759	\$11.04
Price deviation across models	\$2	2.3%
Key Assumptions for the models:		
Date of valuation	12/6/2004	
Risk Free Rate:	3.60%	
Equity Market Risk Premium:	7.00%	
Long term inflation:	2.50%	
Terminal Growth:	5.00%	
Equity beta based on VL:	0.95	
No. of shares (diluted):	69	
Current Market Price per share:	\$12.43	

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Oakley Inc.
NYSE: OO
Consumer Sector
Leisure, Equipment & Products
12/7/2004

Comparable Analysis

We compared Oakley with Luxottica, Reebok and Nike. Seeing that Oakley has expanded its sunglasses business to include apparel, shoes, and sports equipment, it is difficult to find a more fitting comparable company. Oakley's ROA and especially ROE are low in comparison to the industry. Their P/E ratio are also trading expensive compared to the industry. This is supporting our belief that this stock is overvalued. All in all Oakley is underperforming compared to the industry.



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Comparable analysis

Company Name	Footnote	Oakley Inc. <u>OO</u>	for Comps	Luxottica Group <u>LUX</u>	Nike Inc. <u>NKE</u>	Reebok Intl. <u>RBK</u>
<i>(LFY Income Statement):</i>						
Latest Fiscal Year End Date (as if we are at Dec. 2003)	1	12/31/2003		12/31/2003	5/31/2004	12/31/2003
Revenue	2	\$521.55	\$19,296.61	\$3,558.19	\$12,253.10	\$3,485
Gross Profit	3	\$294.70		\$2,451.75	\$5,251.70	\$1,338
EBITDA	4	\$90.83	\$2,861.88	\$713.78	\$1,860.10	\$288
<i>(Per Share Income Statement Data)</i>						
LTM EPS Date	5					
LTM EPS*	6	\$0.54		\$0.80	\$3.74	\$2
CFY EPS Estimate	7	\$0.59		\$0.84	\$4.22	\$2
NFY EPS Estimate	8	\$0.68		\$0.92	\$4.72	\$3
*Excl. extra. Items, writeoffs, & one time charges						
<i>(Balance Sheet Data - Most Recent Quarter):</i>						
Cash and Cash Equivalents	9	\$59.17	\$2,176.71	\$377.83	\$1,297.50	\$501
Total Debt (incl. ST Debt and leases)	10	\$35.18	\$2,899.00	\$1,578.94	\$698.50	\$621
Total Common Equity (Book Value)	11	\$350.33	\$7,851.08	\$1,731.50	\$5,022.10	\$1,097
<i>(Stock Data):</i>						
		10/22/2004		10/24/2004	10/24/2004	10/25/2004
Stock Price	12	\$11.42		\$18.71	\$79.11	\$35
Common Shares Outstanding	13	68.34		448.16	262.48	59
Market Capitalization (MV of Equity)	14	\$780.44	\$31,261.52	\$8,385.07	\$20,764.79	\$2,111
Total Mkt. Capitalization (Tot. Net Debt+MV of Equity)	15	\$815.62	\$34,160.52	\$9,964.02	\$21,463.29	\$2,733
<i>(Financial Ratios excl. debt ratios-see Risk Section)</i>						
LFY Gross Margin	16	56.51%		68.90%	42.86%	38.4%
LFY EBITDA Margin	17	17.41%		20.06%	15.18%	8.2%
ROE	18	10.37	21.06	20.29	22.03	16
ROA	19	8.44	26.62	7.51	13.33	8
Receivable Turnover	20	5.94		7.01	6.15	5
Inventory Turnover	21	2.30		2.36	4.52	4
Current Ratio	22	2.93		0.63	2.95	2
<i>(Growth/Return):</i>						
Historical 3 Year Revenue Growth Rate	23					
Historical 3 Year EPS Growth Rate	24	4.90%		1.50%	13.00%	23.8%
Projected ROE (CFY)	25	11.51%		21.74%	22.06%	15.4%
CFY - NFY EPS Growth Rate	26	15.25%	11.65%	9.52%	11.85%	15.0%



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Proj. Growth in EPS 5 Years	27	13.00%	12.69%	10.00%	13.50%	13.4
Dividend Yield	28	1.29%		0.99%	1.01%	0.8
VL Timeliness	29					
<i>(Risk):</i>						
Beta	30	1.9	0.60	0.33	0.73	0
VL Safety	31					
LT Debt / MV of Equity	32	0.05	0.09	0.19	0.03	0
LT Debt / BV of Equity	33	0.10	0.23	0.91	0.14	0
<i>(Valuation):</i>						
MV of Equity / Book Value	34	2.23	3.98	4.84	4.13	1
ltnPrice / EPS (03)	35	21.27	20.79	23.45	21.15	12
cfyPrice / EPS (04)	36	19.36	18.91	22.27	18.75	12
nfyPrice / EPS (05)	37	16.79	16.94	20.34	16.76	10
Total Market Capitalization / EBITDA	38	8.98	11.94	13.96	11.54	9
Relative P/E (CFY)	39					
PEG 04 to near term growth	40	1.27		2.34	1.58	0
PEG 04 to 3-5 yr growth	41	1.49		2.23	1.39	0