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## The Long/Short Investor



### Kenneth Cold

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### Summary

I am short Kenneth Cole (KCP) because the firm has declining sales and poor prospects. KCP now trades at about \$22.70 and I think the stock could decline to about \$16 to \$19. I would cover the short if the stock rose 10% from current levels, which would be about \$25.

### Investing and Demographics

One of my favorite things to do is to invest around demographic themes. And one of my favorite demographic themes operates on the premise that Baby Boomers are living younger for much longer, and that younger generations are reaching financial maturity much sooner. In addition to controlling more capital than what their parents' generation did at the same time in their lives, these two cohorts similarly consume in very different ways as compared to prior generations. I call this the "Demographic Convergence Thesis". There is almost no other industry that has experienced this phenomenon as much as the fashion industry.

### The Evolution of Fashion

The fashion game has always been a hypercompetitive pursuit. Back issues of fashion magazines and catalogues are littered with fly-by-night brands and the newest lines. In addition, brands with once core followings sometimes fade into the ether. This competition has become extremely intensified by a more discerning and educated consumer coupled with the sheer proliferation in brand choices (especially with regards to denim, but that's another article altogether). As the school of fashion portends, there are winners and losers, and **Kenneth Cole** (KCP) is having a tough time on the playground.

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### TV as a New Force in Fashion

How did consumers get so smart about fashion? Television, for one. Shows such as *Sex and the City*, *Desperate Housewives*, and *What Not to Wear* have helped to educate consumers as to the do's and don'ts and also to brands, prices, and quality. *Sex and the City* was a main force in introducing the era of mix-and-matching designers, and helped eradicate the idea of wearing the same name from head to toe. This proved to be a major competition adjustment for the industry.

### False Sense of Importance

Houses such as Club Monaco, owned by **Ralph Lauren** (RL), **H&M**, Banana Republic, owned by **Gap** (GPS), and **Zara** with their fast fashion turnaround times, are providing consumers with looks that imitate fashions from the chief luxury fashion houses of **Gucci**, **LVMH**, **Chanel** and the like. Some of the more sensibly priced houses have even enlisted the help of the designers from the high-end shops. H&M had Karl Lagerfeld of Chanel, among others, design a special one-time line. **J. Crew** (IPO to price this week) is now included in this class of new popular kids. J. Crew has even taken it a step further and is now offering a wedding line.

A typical shopper, for instance, will go to H&M for basics pieces and then "splurge" on accessorizing with shoes, bag or jewelry. KCP is left out of this whole equation as they have priced themselves out of the basics category, and are no longer perceived as a luxury item to splurge on.

### Kenneth Cole Doesn't Get It

KCP has recently continued to try to position the company as a higher-end luxury goods fashion house, which just doesn't work in the back drop of the aforementioned. Its strategy to position its Reaction brand as the default brand for department stores in the **Federated Department Stores** (FD) chain, and its Kenneth Cole New York brand as a higher-tier brand in its own stores and high-end department stores such as **Nordstrom** (JWN), has not worked well, to say the least. KCP has seen signs of declining demand for its products for some time now, and in the fashion industry, that usually isn't an easy fix.

### When Cole Isn't Cool

A *Motley Fool* article stated that they "liked the company's strategy of positioning the Kenneth Cole New York brand as something to aspire to, as **Coach** (COH) and **Tiffany** (TIF) have done." The big problem with this argument is that TIF and COH are premised as accessory brands, so they fit nicely to the new consumer model of mixing and matching that I described above. These two brands, along with the others mentioned, have also done a good job of staying current. KCP just isn't cool anymore. Its stores are approaching empty in some places, and they have lost all of their fashion buzz.

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Further, KCP has to reckon with competitors such as Nine West, owned by **Jones New York** (JNY), and **Steven Madden** (SHOO) who have won over loyal customers with their consistent high-fashion look-alike pieces.

### **The Goods**

For 2006, first-quarter wholesale revenues were down 5.1% vs. the prior year's level. Consumer direct revenues for the quarter decreased 10.0% vs. the same quarter last year, with a comparable store sales decline of 13.5% vs. the year-ago quarter. Licensing revenue for the first quarter increased by 8.0%. It usually indicates in this scenario that a brand is on its last leg. In contrast, Ralph Lauren has been buying back its licensing in an effort to gain more control and to strengthen its brand. In addition, KCP's consolidated inventories on March 31, 2006 were up 7.2% vs. the year-ago level.

### **Turnover of Personnel**

There also appears to be a degree of management issues as key people have left and new people try to orchestrate a very difficult turnaround. On the company's last conference call they explained miss-hits and disappointments in raising "price points too far too fast", as the new prices and the value added by the products did not line up.

### **Valuation**

This is also a great trade if you are concerned by a slowing economy and declining consumer confidence. The company is currently trading at a PE of 16 (it has already contracted some since I initiated the position) with JNY at 17.21, RL at 18.78, and **Dillard's** (DDS) at 17.41, all of which are companies that have better prospects than KCP. A good stop loss for this position is 10 percent.

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*At the time of writing, James Perkins was short KCP.*

James Perkins is the founding partner and portfolio manager of [Thrasher Funds](#), a long/short equities hedge fund that focuses on demographic and lifestyle themes and opportunistic situations. Prior to his current position, James was an analyst for ZBI Equities, a private firm that manages money for a wealthy family, covering the Industrial, Transportation, Aerospace and Defense sectors. He also worked for the CEO and CFO of Alliance Capital (now Alliance Bernstein), where he conducted competitor, equity market, and mutual fund performance analyses, in addition to examining investor sentiment and investor communications.

He co-founded Prism Investment Equity Partnership (PIEP), an investment partnership aimed at motivating Manhattan young professionals to participate in the

equity markets via the Gendex 100™ (the 100 stocks most important to Generations X, Y, and beyond). Early in his professional financial career, he worked for Morgan Stanley's Equity Research Group.

James received his B.A. in chemistry from Yale University.

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