THE FIXED INCOME CONTRARIAN

October 17, 2012

Iconix Brand Group, Inc.

2.5% Convertible Notes due 6/1/2016 (Ser. 144A)

(BUY)

Price (indicated):	100	**Outstanding:**	$300.0 million
Rating:	n/a	**Yield-to-Maturity:**	2.50%
Conv. Rate:	32.5169 shs.	**Current Yield:**	2.50%
Conv. Premium:	64.6%	**Cusip:**	451055AC1
Stock Price:	$18.75	**Callable:**	n/a
Market Capitalization:	$1.28 billion		
Ticker:	ICON		

Data As Of October 17, 2012

Exclusive Marketers of
The Fixed Income Contrarian Report

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Investment Thesis

As a company operating in the retailing industry, Iconix Brand is somewhat unique in the way it conducts business. Unlike other apparel retailers, Iconix does not manufacture products, nor does it have retail stores. Rather, it operates as a brand management company, in which it licenses its brands – such as Candie's, Danskin, Ed Hardy, London Fog, Peanuts (i.e. Charlie Brown and Snoopy) and Rocawear - to others. As such, Iconix is not burdened with the problems that retail companies typically face, such as rising raw material costs, complex supply chain logistics, or inventory obsolescence.

In effect, Iconix might be more appropriately viewed as an intellectual properties company. As such, the company is endowed with the advantage of generating substantial free cash flow. Over the past three fiscal years, free cash flow[1] has grown by 46.5% to $174.3 million, equating to a free cash flow margin of some 47%. On a more conservative basis, which would exclude items such as the benefits from stock-based compensation, deferred income tax provisions, and changes in working capital, among others, an adjusted free cash flow figure would closer to $130 million, for an adjusted free cash flow margin of roughly 35%. Readers should note that a free cash flow figure of this level would be sufficient to repay the company's debt outright in its entirety in less than four years. In other words, the Iconix business model is sufficiently profitable to suggest that the company's credit risk is low and therefore the convertible notes are essentially money good.

Nevertheless, given a yield of only 2.5%, the Iconix convertible notes are not being recommended strictly on a yield basis. Rather, the notes appear attractive on the basis of equity exposure. At present, the notes have a conversion premium of about 65%. At the same time, the Iconix shares are trading at the $18.80 level. As such, the shares are valued at about 12x 2012 estimated earnings, as compared to an average price-earnings multiple of 17.0x over the past seven years; over this period, the multiple has ranged from a low of 9.4x to a high of 28.3x earnings. Merely achieving a multiple in line with its average alone would propel the shares 26% higher to a price of $23.75 per share.

Viewed through the lens of free cash flow, the undervaluation of the Iconix shares appears even more pronounced. As mentioned above, free cash flow in 2011, conservatively calculated, was $130.2 million. Given an equity market capitalization of $1.2 billion, the price-free cash flow multiple is approximately 9.5x; its inverse, the free cash flow yield, is 10.5%. Given that its bond yield is only 2.5%, one must question whether a free cash flow yield of over 10% is appropriate?

In the past five years, Iconix's free cash flow grew at a compound annual rate of 17.7%, from $67.7 million in 2007 to $130.3 million in 2011. If the company were to increase free cash flow by even just half that rate going forward, then it might be expected to generate

[1] Defined as: Net Cash Provided by Operating Activities – Purchase of Property and Equipment

$180.5 million by fiscal year 2015. If it then were to still attract a multiple of 9.5x its free cash flow figure, its equity would be valued at about $1.71 billion, or $25.15 per share. If, instead, the multiple were to be 12.5x (free cash flow yield of 8%), the per-share price would instead be $33.00 per share, or 76% above the current price.

At a price level of $33.00, the convertible notes would be expected to increase markedly in value. For example, assuming that the conversion premium declines to, say 10%, which is the premium suggested by Iconix's equity options maturing in less than one year, the notes would then be priced at 118.0 per bond. On an annualized basis, and inclusive of interest income, if achieved over a three year period, the return on investment would be approximately 8.2% per annum.

Of course, were Iconix to continue to increase its earnings at the same rate that it has experienced lately, one's investment return might be even higher. At a compound annual growth rate of 17.5%, Iconix might expect free cash flow to reach $248 million by 2015. If valued at 9.5x, its shares would have a price of $34.50 per share; at a multiple of 12.5x free cash flow, its shares would be worth $45.50 per share, suggesting a compound return of approximately 20% per annum. Given the company's expansion into international markets, namely India, China and Latin America, as well as management's record of profitable acquisitions, its ability to continue such growth should not be considered incredulous.

Simplistically stated, the Iconix convertible notes offer the investor an asymmetrical risk/return profile that is very favorable. Considering its high free cash flow margins, one can be reasonably assured that the notes are money good, so that the chances of an outright loss on the investment are rather small. With that in mind, the lower bound of investment returns would simply be the yield to maturity. Although low in absolute levels, it nevertheless represents a spread of almost 200 basis points over Treasury rates. In success mode, one's realized returns could reach the double digits. In a scenario in which earnings grow at lower rates than achieved recently coupled with a modest bump in valuation, a return of 15% per annum could be envisaged. Consequently, the Iconix Brand Group 2.5% Convertible Notes due 2016 are recommended for purchase.

Company Description

History

Iconix traces its roots to the Candie's "slide", a high-heeled shoe marketed by Charles Cole, the father of clothing designer Kenneth Cole. Charles Cole registered the Candie's brand name in 1978, the same year the "slide" was made famous in the movie *Grease*.[2]

Sales of Candie's footwear grew to $130 million by 1984; however, by 1991, Cole saw sales decline to $29 million. Neil Cole, the younger brother of Kenneth Cole, saw an opportunity to revive the Candie's brand in the early 1990s as 1970s fashions regained popularity. Neil Cole's firm, New Retail Concepts, licensed the Candie's trademark to Millfeld Trading Company, which was to manufacture and market the brand. Candie's, Inc. came public with an IPO in February 1993.

The following year, the company extended the Candie's brand to other products for women as well as a line of footwear for children. It also began designing, manufacturing and marketing footwear under the Bongo brand name. In 1998, the company formed Unzipped Apparel for the purpose of marketing and distributing jeans and other clothing.

In 2003, Candie's completed the first of a series of strategic transactions designed to transform the company from a traditional apparel and footwear retailer to a brand management company. Neil Cole worked with brother Kenneth to license the Bongo footwear operations to Kenneth Cole Productions, granting it the exclusive right to design, manufacture, distribute and sell women's and children's footwear bearing the Bongo trademark. Soon thereafter, the company also entered into a license agreement with Steven Madden Ltd., granting it the exclusive right to design, manufacture, distribute and sell women's and children's footwear bearing the Candie's trademark.

With these two transactions, Candie's ceased manufacturing and shipping products under the Bongo and Candie's labels, while maintaining the rights to the trademarks. Candie's had transformed itself from a traditional apparel manufacturer to a brand management company and, to reflect this new business model, in 2005 the company changed its name to Iconix Brand Group.

Business Description

Following the Bongo and Candie's transactions, Iconix implemented the second stage of its transformation, which involved acquiring the rights to well-known (i.e., iconic) clothing brands. Since October 2004, the company has purchased 17 brands, and it now owns or partially owns 24 fashion brands in total, as summarized in the following table.

[2] In the final scene of *Grease*, actress Olivia Newton-John wears shoes very similar in appearance to the Candie's "slide." According to Charles Cole, within weeks of the movie's release, orders for the slide multiplied.

Exhibit 1: Iconix Brands

Brand Name	**Brand Type**	**Products**
Candie's	Junior lifestyle	Footwear, apparel, accessories
Bongo	California lifestyle	Women and children's casual apparel and accessories
Badgley Mischka	Premiere eveningwear	Women's apparel, footwear, handbags, accessories
Joe Boxer	Underwear, sleepwear	Underwear, loungewear
Rampage	Contemporary/junior women's sportswear	Sportswear, footwear, intimate apparel and swimwear
Mudd	Junior lifestyle	Denim, footwear, accessories
London Fog	Outerwear	Outwerwear, cold weather accessories, umbrellas, luggage, travel products
Mossimo	Contemporary, active and youthful lifestyle	Casual sportswear, denim, swimwear, bodywear, watches, handbags, accessories
Ocean Pacific/OP	Action-sports lifestyle	Footwear, sunglasses, children's apparel, fragrance
Danskin	Women's activewear	Legwear, dancewear, yoga apparel, fitness equipment
Rocawear	Urban lifestyle	Men's, women's and kids' apparel, outerwear, footwear, jewelry, handbags, fragrance
Cannon	Textiles	sheets, bedding, towels, rugs, bath accessories, kitchen textiles, window treatments
Royal Velvet	Luxury home textiles	Towels, sheets, rugs, shams
Fieldcrest	Bed & bath textile	Towels, bath rugs, quilts
Charisma	Home textiles	Bedding, sheets, towels
Starter	Sportswear, licensed team sports merchandise	Athletic apparel and footwear
Waverly	Home furnishings	Fabrics, wallpaper, window treatment, bedding
Zoo York	Action lifestyle	Men, women and kids' apparel and footwear
Sharper Image	Consumer electronics	audio/video electronics, travel gear, personal home products, kitchen & bath accessories, massage products, air purification products, giftables
Artful Dodger	Urban lifestyle	Apparel, outerwear
Material Girl (JV)	Consumer products	Products in joint venture with Madonna
Truth or Dare (JV)	Fragrance	Perfume in joint venture with Madonna
Ed Hardy (85% interest)	Tattoo-inspired lifestyle	Apparel, other lifestyle products
Ecko (51% interest)	Active athletic, streetwear	Outerwear, underwear, footwear

Peanuts Acquisition

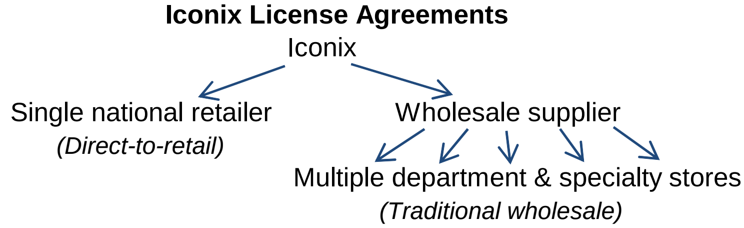
In April 2010, Iconix entered into an agreement with United Features Syndicate and E.W. Scripps to acquire the Peanuts comic strip brand in partnership with the family of Charles Schulz. As part of the transaction, Iconix also acquired the licensing and character representation business of United Media Licensing, which, in addition to Peanuts, represents a number of character brands including Dilbert and Fancy Nancy. These newly acquired assets are now held through a subsidiary that is 80 percent owned by Iconix and 20 percent owned by the Schulz family.

The addition of Peanuts essentially transforms Iconix from a pure apparel brand company to a diversified brand management entity. Peanuts has over 1,200 licensing agreements including relationships with MetLife, Hallmark, Universal Studios, Warner Bros., Cedar Fair, H&M, Benetton, Old Navy, CVS and Walgreens. The transaction also extends Iconix's international presence, as Peanuts includes licenses in over 40 countries, with approximately two-thirds of its revenue coming from outside the U.S.

Iconix enters into two types of license agreements: direct-to-retail and traditional wholesale. Typically, in a direct-to-retail license, it grants exclusive rights to one of its brands to a single national retailer for a broad range of product categories. For example, the Candie's brand is licensed exclusively to Kohl's in the U.S. across multiple product categories. Direct-to-retail licenses provide retailers with proprietary rights to national brands; in turn, these brands generally receive greater support from the retailers, including premium shelf space and premium in-store presentations.

In a traditional wholesale license agreement, the company grants rights to a single or small group of related product categories to a wholesale supplier that is permitted to sell these products to multiple stores. For example, Iconix licenses the Rocawear brand to numerous wholesale suppliers for products ranging from footwear and apparel to handbags and fragrances, for sale and distribution primarily to department and specialty stores.

Iconix License Agreements



In 2011, the company's largest direct-to-retail licenses were with Wal-Mart for the Starter, Ocean Pacific and Danskin brands (17% of revenues), Target for the Mossimo, Fieldcrest and Waverly brands (6% of revenues), Kohl's for the Candie's and Mudd brands (6% of revenues), and Sears/Kmart for the Joe Boxer, Cannon and Bongo brands (5% of revenues). Its largest wholesale licenses were derived from Li & Fung, a world leading consumer goods company, for Rocawear, Ecko, Zoo York, Peanuts children sportwear, Royal Velvet and Cannon home furnishings. Iconix typically maintains the right in its licenses to preview and approve all product, packaging and other presentations of the licensed brand. In many of its licenses, prior to each season, representatives of the company supply licensees with trend guidance as to the "look and feel" of the current trends for the season, including colors, fabrics, and an overall style sensibility.

Licenses typically require the licensee to pay royalties based upon net sales with guaranteed minimum royalties in the event that sales do not reach certain specified targets. The licenses also typically require licensees to pay Iconix certain minimum amounts for the advertising and marketing of the respective licensed brands. As of January 2012, Iconix and its joint ventures had a contractual right to receive over $700 million of aggregate royalty revenue through the balance of all of their licenses.

Iconix plans to continue to expand its portfolio by acquiring brands. Management also aims to continue monetizing its brands through new international licenses and partnerships. Since September 2008, Iconix has established four 50/50 international joint ventures: Iconix China, Iconix Latin America, Iconix Europe and OP Japan.

In September 2008, Iconix joined with Novel Fashions Holdings Limited to form Iconix China, to develop and market the company's brands in China, Hong Kong, Macau and Taiwan. Iconix China receives a minority equity stake in local operating companies in exchange for the rights to one or more of the Iconix brands in the aforementioned countries.

In December 2008, the company formed Iconix Latin America, which is 50% owned by New Brands America LLC, which is an affiliate of the Falic Group (a privately held retailing company whose parent is Duty Free Americas, the largest duty free store operator in North America). This joint-venture controls the rights to virtually all of its brands in Mexico, Central America, South America, and the Caribbean.

In December 2009, the company formed Iconix Europe to own the rights to virtually all of its brands in the European Union. An investment group led by the Licensing Company and Albion Equity Partners LLC, purchased a 50% interest in Iconix Europe to assist in developing, exploiting, marketing and licensing the Iconix brands in Europe.

In November 2011, the company formed a subsidiary in Japan, in which it contributed substantially all rights to the Ocean Pacific and OP brand in Japan, Singapore, Malaysia, Indonesia and certain other countries in Asia. Its partner, Itochu Corp., purchased a 45% interest in OP Japan to assist the company in developing and marketing the brands in the OP Japan territory.

Lastly, in January 2011, Iconix signed its first license agreement in India—a direct-to-retail license with Arvind Limited for its Mossimo brand. Under the agreement, Arvind holds an exclusive multi-year license to distribute Mossimo apparel and accessories throughout its 170 stores in India. Mossimo is a junior lifestyle brand founded in 1986 by designer Mossimo Giannulli. Retail chain Target is the exclusive distributor of Mossimo in the U.S. Moreover, in May 2012, the company formed a joint venture company with Reliance Brands (a subsidiary of Reliance Industries, India's largest private sector company) in India, called Iconix India. Iconix India will pursue a business model similar to that of Iconix in North America, focusing on producing royalty revenue through licensing agreements with manufacturers and retailers.

Financial Review

The notable feature of the Iconix business model involves the very high-margin nature of its operations. As previously mentioned, Iconix underwent a transformation in 2003 and 2004 from a traditional clothing manufacturer to a brand management company. In the process, manufacturing costs and other sales costs were shifted to third-party licensees, and Iconix went from a company that could not produce operating earnings (during the 2000 through 2003 time frame) to a profitable company beginning in 2004. Since 2006, its operating margin ranged from 62% to 76%; over the same six-year period, the net profit margin ranged from 29% to 40%, which is remarkably high for any type of business.

Exhibit 2: Iconix Revenue and Operating Income Progression (2000-2011)

		Revenue	Operating Income	*Operating Margin*
	2000	$ 95.2	$ (7.2)	*n/m*
	2001	101.4	(1.6)	*n/m*
	2002	156.8	(1.0)	*n/m*
Iconix (then Candie's) transforms business model	2003	131.4	(8.1)	*n/m*
	2004	69.0	2.7	*3.9%*
	2005	30.2	15.4	*51.1%*
	2006	80.7	53.7	*66.5%*
	2007	160.0	121.8	*76.1%*
	2008	216.8	142.0	*65.5%*
	2009	232.1	152.6	*65.8%*
	2010	332.6	209.7	*63.1%*
	2011	369.8	228.8	*61.9%*

($ in millions)

Source: Company reports

Further, the combination of high profit margins and minimal capital expenditure requirements leads to the ability to produce copious amounts of free cash flow. In 2011, it produced $174.3 million of free cash, resulting in a free cash flow margin of 47.1%.

It should be noted that the figure is calculated as net cash provided by operating activities minus purchases of property and equipment (i.e. capital expenditures). As such, the figure includes such items as stock-based compensation and deferred income tax provision, which boosts the cash flow figure, but might be inappropriate for our purposes.

A more conservative calculation would involve the addition of amortization expenses to net income and from that, deduct capital expenditures (as well as non-cash gains). On this basis, free cash flow is markedly lower, at $130.2 million, but still represents a margin of 35.2%, which is still impressive (discussion of free cash flow henceforth will be based on this more conservative calculation.

Exhibit 3: Iconix Income Statement Items and Free Cash Flow (2010-2011)

($ in millions)	2011	2010	*% change*
Licensing and other revenue	$ 369.8	$ 332.6	*11%*
Selling, general and administrative expenses	141.0	138.5	
Operating income	228.8	209.7	*9%*
Interest expense	50.8	43.2	
Net income	141.2	110.5	*28%*
+ Depreciation & amortization	13.7	12.4	
−Non cash gain on re-measurment of equity invest.	(21.5)	-	
− Capital expenditures	(3.2)	(3.2)	
= Free cash flow	130.3	119.7	*9%*
Free cash flow margin	*31.0%*	*33.4%*	

Source: Company reports

In terms of the balance sheet, Iconix is fairly conservatively financed, with total debt of $490.9 million and shareholders' equity of $1.2 billion, which equates to a debt-to-equity ratio of just 0.38x. However, it must be noted that shareholders' equity is comprised primarily of intangible assets, stemming from the company's history of acquiring brands. Goodwill plus trademarks and other intangible assets total approximately $1.7 billion, while total assets amount to $2.0 billion, meaning tangible assets comprise only 12% of total assets. Consequently, the company has tangible equity of negative $494 million, as shown in the following table:

Exhibit 4: Iconix Abridged Balance Sheet

($ in millions)	At June 30, 2012
Cash	$ 46
Goodwill	223
Trademarks & other intangibles	1,544
Total Assets	2,003
Long-term debt	491
Shareholders' equity	1,273
Tangible Equity *	(494)

* Calculated as total assets minus goodwill, trademarks & other intangibles, and total liabilities.

Source: Company reports

Nevertheless, other measures attest to the financial strength of the company. For example, presently the company carries $137.2 million of current assets against only $75.3 million of current liabilities, for a current ratio of 1.85x. Additionally, the interest coverage afforded by Iconix's capital-lite model is very high. In 2011, operating income exceeded interest expense by a ratio of 4.5-to-1.

As to the company's debt, one would find that the company can well handle the existing amount that is outstanding as well as the timing of the maturities. Presently, the company carries $542.2 million (face value) of debt, of which the convertible notes account for over one-half the total. As can be seen in the following table, $190 million of debt will come due in 2013, consisting primarily of the revolving credit facility. Although the amount appears to be somewhat large, exceeding Iconix's current cash on hand, such borrowings are typically rolled over into a new credit facility.

Exhibit 5: Iconix Maturity Schedule

($ in millions)	2012	2013	2014	2015	2016	Total
2.5%Convertible Notes	-	-	-	-	300.0	300.0
Revolver	-	150.0	-	-	-	150.0
Ecko Note	5.0	10.0	47.0	-	-	62.0
Asset-Backed Notes	-	30.2	-	-	-	30.2
Total	$ 5.0	$ 190.2	$ 47.0	$ -	$ 300.0	542.2

Source: Company reports

Nevertheless, if the company were desirous to repay the debt outright, it could be achieved by utilizing its free cash flow. Assuming its free cash flow does not increase by any appreciable degree, the company would be on track to produce roughly $190 million of free cash flow in the period up to the end of 2013. Indeed, if free cash flow were indeed frozen at the 2011 level (i.e. $130 milli0n per annum), Iconix would still produce sufficient free cash to be able to repay *all* of its debt by 2016.

Given all of the above, one could reasonably argue that the Iconix convertible notes (as well as the other borrowings) are essentially money-good paper, and the likelihood of default, therefore, low.

Valuation

Since the investment thesis hinges upon the ultimate level of the Iconix share price, the analysis provided below pertains to the common stock.

Historical Method

Despite its remarkable record of revenue and earnings expansion since 2005, Iconix appears to trade at a price-to-earnings ratio that is well below its historical level and the level of the broad equity market. As shown in the following table, since becoming profitable in 2005, Iconix has traded at an average P/E multiple of 17.0x. The current average EPS estimate of sell-side analysts for 2012 is $1.54, meaning the forward P/E is now just 12.2x.

Exhibit 6: Iconix Historical Price-Earnings Ratio (2005-2011)

2000-2004	n/m
2005	28.3x
2006	25.5x
2007	19.5x
2008	9.4x
2009	11.8x
2010	14.9x
2011	9.6x
Historical average:	17.0x
Current P/E:	*12.2x*

Source: Bloomberg

This low P/E multiple warrants further remark. The average company in the S&P 500 now trades at approximately 13.9x estimated 2012 earnings. Yet the average company in the index surely has not increased revenue and earnings at nearly the same rate achieved by Iconix over the last several years. Recall that from 2010 to 2011, the company increased revenue by 11% and net income by 28%. Since 2005, revenue has increased at a compound annual growth rate of 52%, while net income has grown at 41%; even if 2005 and 2006 are deemed high growth years and are excluded, revenue has increased at an average rate of 23% and net income has increased at 20% per annum, as illustrated below:

Exhibit 7: Iconix Revenue and Earnings Growth (2005-2011)

(in millions)	2005	2006	2007	2008	2009	2010	2011	***CAGR***	***CAGR 2007-2011***
Licensing and other revenue	$ 30.2	$ 80.7	$ 160.0	$ 216.8	$ 232.1	$ 332.6	$ 369.8	***52%***	***23%***
Net income	15.9	32.5	60.3	62.9	76.0	110.5	141.2	***44%***	***24%***
EPS	$ 0.51	$ 0.81	$ 1.12	$ 1.09	$ 1.14	$ 1.37	$ 1.72	***22%***	***11%***

Source: Company reports, Bloomberg

Perhaps the market is discounting an extended and sharp slowdown in its future growth. However, it is still unusual for a company that has increased earnings at such an exemplarily rate to be priced at a discount to the market; on the contrary, it is more reasonable for a company exhibiting such high rates of growth to be priced at a substantial premium.

To illustrate the appreciation potential in the short term, if Iconix were to simply attain its 7-year average multiple of 17x 2012 estimated earnings of $1.54, the shares would approach $26.25, for an increase of 40%. Assuming a conversion premium of, say 32%, which was the premium at issuance, the convertible notes would be valued at 112.6, which would imply a return on investment of 15.1%, inclusive of one year’s interest income.

On a longer-term perspective, let us assume that Iconix can continue to increase earnings at a 20% annual rate, as it has exceeded since 2007 (as opposed to the 44% rate since 2005). By 2015, earnings might then reach $3.83 per share. At a multiple of 12x, the share price would be $45.95; at 17x, it would reach $65.10 per share.

At the $45.95 level, assuming a conversion premium of, say, 10%, which is the general premium level of Iconix’s options expiring in less than one year, the convertible notes would be valued at 164.3 (parity alone would be 149.4). This would imply a return of 64%; over a 3-year holding period and inclusive of interest income, the implied return would be almost 21% per annum, compounded.

HORIZON KINETICS

The superlative returns described above can only occur if the share price rises sharply. What then, if it doesn't?

Should the shares fail to appreciate or appreciate sufficiently to have an impact on the convertible notes, one would simply earn the yield to maturity, currently 2.5%. This is, admittedly, an uninspiring yield in the context of historical distressed bond yields. However, it still represents a spread of some 200 basis points above Treasuries, which is not an inconsequential sum.

Free Cash Flow Approach

Before the discussion about free cash flow can begin, one would be well served to note that there are a number of ways by which to calculate free cash flow. One is to simply deduct the amount paid for the purchase of property and equipment from the net cash provided by operating activities – items found in the cash flow statement provided by the company. While technically correct, the cash flow from operations figure might include items that are not truly indicative of the cash flow characteristics of the underlying operating business (see "Free Cash Flow 1" below). For example, Iconix's cash flow statement includes line items such as "amortization of convertible note discount," "amortization of restricted stock grants," and deferred income tax provision, all of which serve to increase the free cash flow figure.

Therefore, for our purposes, free cash flow will be computed as net income plus certain depreciation and amortization expense, less any unusual gains. The net effect is a more conservative free cash flow figure (i.e., "Free Cash Flow 2" in the table below).

The following table illustrates the difference between the two methods:

Exhibit 7: Iconix Free Cash Flow (2007-2011)

($ in millions)	2007	2008	2009	2010	2011
Net cash provided by operating activities	$ 83.69	$ 89.24	$ 122.86	$ 165.72	$ 177.61
- Purchases of property & equipment	(0.13)	(6.28)	(3.87)	(3.19)	(3.24)
Free Cash Flow 1	$ 83.55	$ 82.96	$ 118.99	$ 162.53	$ 174.37

(cont'd)

($ in millions)	2007	2008	2009	2010	2011
Net income	$ 63.76	$ 62.91	$ 76.03	$ 110.48	$ 141.24
+Depreciation of property & equipment	0.23	0.86	0.69	1.80	2.45
+Amortization of trademarks & other intangibles	5.57	7.26	7.33	8.31	6.99
+Amortization of deferred financing costs	1.29	1.75	2.31	2.28	4.31
- Gain on sale of trademarks	-	(2.63)	(6.60)	-	-
-Non-cash gain on re-measurement of equity investment	-		-	-	(21.47)
-Gain on sale of 50% interest in subsidiary	-	(4.74)	-	-	-
-Net cash settlement of a dispute	(3.01)	-	-	-	-
- Purchases of property & equipment	(0.13)	(6.28)	(3.87)	(3.19)	(3.24)
Free Cash Flow 2	$ 67.70	$ 59.13	$ 75.885	$ 119.67	$ 130.28
Licensing and other revenue	*$ 160.0*	*$ 216.8*	*$ 232.1*	*$ 332.6*	*$ 369.8*
Free cash flow 2	*67.7*	*59.1*	*75.9*	*119.7*	*130.3*
FCF margin	*42%*	*27%*	*33%*	*36%*	*35%*

Source: Company reports

Over the past five years, Iconix has recorded free cash flow margins above 25%, a feat very rarely achieved in any type of business. Nevertheless, just as in the earnings valuation discussed above, Iconix appears to command an unduly low valuation based on free cash flow.

At the present market capitalization, Iconix is valued at approximately 9.5x 2011 "adjusted" free cash flow (i.e. Free Cash Flow 2). The free cash flow yield (the inverse of the price/free cash flow multiple) is about 10.5%. It should be noted that the free cash flow yield for the S&P 500 is roughly 8%, so that Iconix is priced at a discount (i.e., higher yield) to the market on a cash flow basis as well.

In the past five years, Iconix's free cash flow grew at a compound annual rate of 17.5%, from $67.7 million in 2007 to $130.3 million in 2011. If the company were to increase free cash flow by even just half that rate going forward (i.e. 8.5% per annum), then it might be expected to generate $180.5 million by fiscal year 2015. If it then were to still attract a multiple of 9.5x its free cash flow figure, its equity would be valued at about $1.718 billion, or $25.15 per share. If, instead, the multiple were to be 12.5x (free cash flow yield of 8%), the per-share price would instead be $33.00 per share, or 76% above the current price.

Translating this into a bond price, the latter scenario suggesting a share price of $33.00 would be equivalent to a parity price of 107.3. Attaching a 10% conversion premium would suggest a price of 118.0. The return strictly from capital appreciation, if achieved in three years, would be 5.6%. Inclusive of interest income, the annual returns would be 8.2%.

Naturally, if Iconix were to continue to grow its cash flow at historical rates, one could expect a much higher share price over time. At a compound annual growth rate of 17.5%, Iconix's free cash flow would approach $248 million by 2015. Capitalized at 12.5x, the market capitalization would be $3.1 billion, or $45.50 per share. The compound annual return to the convertible note investor might approach 20% per year. Considering the company's record of growth free cash flow, one might wonder whether this valuation would *still* be exceptionally low, in part because the free cash flow figures used in this exercise are more conservatively calculated than the usual method (i.e. cash from operations – capital expenditures).

Investment Summary

Iconix Brand Group owns a portfolio of valuable clothing brands, which has enabled it to grow at a remarkable rate over the past seven years: revenue and net income have increased at compound annual rates of 52% and 44%, respectively, since 2005. Furthermore, as an owner of brands—not a clothing manufacturer or retailer—the Iconix business model has very low capital expenditure requirements. Consequently, the company generates a tremendous amount of free cash, with free cash flow margins exceeding 30%. Despite these attributes, the Iconix shares are priced at a multiple of 12.2x, which is significantly below its own historical average and the current average of the broad equity market. One could easily assert that Iconix is deserving of a significant premium multiple to the average company.

One way to capture this valuation discrepancy is via the Iconix convertible notes. While one would not capture the same rates of return as that of an equity investor, the owner of the notes would not be exposed to any decline in the shares, were that to occur. Rather, one could reasonably expect the range of returns to be 2.5% at the low end, with a reasonable upper range of, perhaps, 8% to 15% per annum, whereas a compound annual return of some 20% could be envisaged, provided that certain conditions are met. As to credit risk, the Iconix convertible notes do not appear to be highly risky for the same reason the shares appear undervalued: the company is a prolific generator of free cash flow. Consequently, the risk/return tradeoff appears to be highly favorable, and therefore purchase of the Iconix 2.5% Convertible Notes due 2016 is recommended.

Iconix Brand Group, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(in thousands, except par value)

	June 30, 2012 (unaudited)	December 31, 2011
Assets		
Current Assets:		
Cash (including restricted cash of $23,574 in 2012 and $14,071 in 2011)	$ 46,133	$ 181,788
Accounts receivable	73,845	79,669
Deferred income tax assets	2,114	2,114
Other assets – current	15,136	20,934
Total Current Assets	137,228	284,505
Property and equipment:		
Furniture, fixtures and equipment	18,926	18,136
Less: Accumulated depreciation	(8,391)	(6,860)
	10,535	11,276
Other Assets:		
Restricted cash	-	7,220
Other assets	28,424	34,186
Trademarks and other intangibles, net	1,543,636	1,550,996
Deferred financing costs, net	2,573	3,573
Investments and joint ventures	57,587	46,278
Goodwill	223,387	223,269
	1,855,607	1,865,522
Total Assets	$2,003,370	$2,161,303
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 19,036	$ 22,940
Deferred revenue	9,821	11,801
Current portion of long-term debt	40,209	322,423
Other liabilities – current	6,300	5,619
Total current liabilities	75,366	362,783
Deferred income tax liability	188,998	174,238
Long-term debt, less current maturities	450,713	310,966
Deferred revenue	5,067	5,897
Other liabilities	9,898	13,843
Total Liabilities	730,042	867,727
Commitments and contingencies		
Stockholders' Equity		
Common stock, $.001 par value shares authorized 150,000; shares issued 75,660 and 75,393, respectively	76	75
Additional paid-in capital	809,730	802,194
Retained earnings	476,605	420,421
Accumulated other comprehensive loss	-	(483)
Less: Treasury stock – 7,976 and 2,708 shares at cost, respectively	(119,207)	(33,154)
Total Iconix Brand Group, Inc. Stockholders' Equity	1,167,204	1,189,053
Non-controlling interest	106,124	104,523
Total Stockholders' Equity	1,273,328	1,293,576
Total Liabilities and Stockholders' Equity	$2,003,370	$2,161,303

Iconix Brand Group, Inc. and Subsidiaries

Unaudited Condensed Consolidated Income Statements
(in thousands, except earnings per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Licensing and other revenue	$93,646	$ 89,293	$182,097	$181,649
Selling, general and administrative expenses	34,641	31,662	65,540	63,667
Expenses related to specific litigation	-	45	-	92
Operating income	59,005	57,586	116,557	117,890
Other (income) expenses:				
Interest expense	12,882	13,825	26,602	23,761
Interest and other income	(568)	(22,208)	(1,160)	(22,809)
Equity earnings on joint ventures	(1,460)	(2,517)	(2,758)	(3,138)
Other expenses - net	10,854	(10,900)	22,684	(2,186)
Income before income taxes	48,151	68,486	93,873	120,076
Provision for income taxes	16,178	23,640	31,021	40,104
Net income	$31,973	$ 44,846	$ 62,852	$ 79,972
Less: Net income attributable to non-controlling interest	$ 3,388	$ 3,303	$ 6,668	$ 6,997
Net income attributable to Iconix Brand Group, Inc.	$28,585	$ 41,543	$ 56,184	$ 72,975
Earnings per share:				
Basic	$ 0.41	$ 0.57	$ 0.79	$ 1.00
Diluted	$ 0.40	$ 0.55	$ 0.76	$ 0.97
Weighted average number of common shares outstanding:				
Basic	70,085	72,962	71,317	72,865
Diluted	72,216	75,423	73,534	75,396

Iconix Brand Group, Inc. and Subsidiaries

Unaudited Condensed Consolidated Statements of Cash Flows
(in thousands)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Cash flows from operating activities:		
Net income	$ 62,852	$ 79,972
Adjustments to reconcile income from continuing operations to net cash provided by operating activities:		
Depreciation of property and equipment	1,531	1,203
Amortization of trademarks and other intangibles	2,765	3,639
Amortization of deferred financing costs	1,057	3,769
Amortization of convertible notes discount	14,094	8,868
Stock-based compensation expense	5,206	4,946
Gain on re-measurement of equity investment	-	(21,465)
Provision for doubtful accounts	1,400	883
Equity earnings on joint ventures	(2,758)	(3,138)
Deferred income tax provision	14,760	16,679
Changes in operating assets and liabilities, net of business acquisitions:		
Accounts receivable	4,424	(1,214)
Other assets—current	6,503	12,997
Other assets	7,547	14,075
Deferred revenue	(2,810)	4,216
Accounts payable and accrued expenses	(2,814)	(11,126)
Net cash provided by operating activities	113,757	114,304
Cash flows used in investing activities:		
Purchases of property and equipment	(791)	(2,441)
Acquisition of interest in Hardy Way	-	(62,000)
Net distributions to equity partners	(4,865)	(3,855)
Additional investments in joint ventures	(3,771)	-
Earn-out payments on acquisitions	(6,854)	-
Sale of trademarks	4,490	-
Additions to trademarks	(504)	(76)
Net cash used in investing activities	(12,295)	(68,372)
Cash flows (used in) provided by financing activities:		
Proceeds from long-term debt	150,000	292,500
Proceeds from sale of warrants	-	28,800
Purchase of convertible note hedges	-	(58,740)
Proceeds from exercise of stock options and warrants	757	1,519
Payment of long-term debt	(306,561)	(190,312)
Acquisition of interest in MG Icon	(4,000)	(4,000)
Excess tax benefit from share-based payment arrangements	1,574	910
Shares repurchased on open market	(85,062)	-
Deferred financing costs	(54)	(740)
Shares repurchased on vesting of restricted stock and stock option exercises	(991)	(2,447)
Restricted cash - current	(9,503)	(427)
Restricted cash – non-current	7,220	-
Net cash (used in) provided by financing activities	(246,620)	67,063
Net decrease in cash and cash equivalents	(145,158)	112,995
Cash and cash equivalents, beginning of period	167,717	118,635
Cash and cash equivalents, end of period	$ 22,559	$ 231,630
Balance of restricted cash - current	23,574	3,727
Total cash and cash equivalents including current restricted cash, end of period	$ 46,133	$ 235,357

Iconix Brand Group, Inc. and Subsidiaries
Consolidated Balance Sheets
(in thousands, except par value)

	December 31, 2011	December 31, 2010
Assets		
Current Assets:		
Cash (including restricted cash of $14,071 in 2011 and $3,300 in 2010)	$ 181,788	$ 121,935
Accounts receivable	79,669	65,507
Deferred income tax assets	2,114	1,743
Other assets - current	20,934	36,681
Total Current Assets	284,505	225,866
Property and equipment:		
Furniture, fixtures and equipment	18,136	14,894
Less: Accumulated depreciation	(6,860)	(4,410)
	11,276	10,484
Other Assets:		
Restricted cash	7,220	15,866
Other assets	34,186	43,128
Trademarks and other intangibles, net	1,550,996	1,400,550
Deferred financing costs, net	3,573	3,119
Investments and joint ventures	46,278	59,677
Goodwill	223,269	192,780
	1,865,522	1,715,120
Total Assets	$ 2,161,303	$ 1,951,470
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 22,940	$ 43,275
Deferred revenue	11,801	16,305
Current portion of long-term debt	322,423	36,380
Other liabilities - current	5,619	4,000
Total current liabilities	362,783	99,960
Deferred income tax liability	174,238	138,577
Long-term debt, less current maturities	310,966	548,007
Deferred revenue	5,897	11,561
Other liabilities	13,843	14,451
Total Liabilities	867,727	812,556
Commitments and contingencies		
Stockholders' Equity		
Common stock, $.001 par value shares authorized 150,000; shares issued 75,393 and 73,930, respectively	75	74
Additional paid-in capital	802,194	752,803
Retained earnings	420,421	294,316
Accumulated other comprehensive loss	(483)	-
Less: Treasury stock – 2,708 and 1,409 shares at cost, respectively	(33,154)	(10,831)
Total Iconix Brand Group, Inc. Stockholders' Equity	1,189,053	1,036,362
Non-controlling interest	104,523	102,552
Total Stockholders' Equity	1,293,576	1,138,914
Total Liabilities and Stockholders' Equity	$ 2,161,303	$ 1,951,470

Iconix Brand Group, Inc. and Subsidiaries
Consolidated Income Statements
(in thousands, except earnings per share data)

	Year Ended December 31, 2011	Year Ended December 31, 2010	Year Ended December 31 2009
Licensing and other revenue	$ 369,845	$ 332,559	$ 232,058
Selling, general and administrative expenses	140,985	138,532	79,356
Expenses (benefit) related to specific litigation, net	94	(15,688)	137
Operating income	228,766	209,715	152,565
Other expenses (income):			
Interest expense	50,754	43,155	41,214
Interest and other income	(24,162)	(3,837)	(2,481)
Equity earnings on joint ventures	(10,353)	(5,492)	(3,424)
Loss on marketable securities	-	13,000	-
Other expenses - net	16,239	46,826	35,309
Income before income taxes	212,527	162,889	117,256
Provision for income taxes	71,286	52,409	41,225
Net income	$ 141,241	$ 110,480	$ 76,031
Less: Net income attributable to non-controlling interest	$ 15,136	$ 11,633	$ 920
Net income attributable to Iconix Brand Group, Inc.	$ 126,105	$ 98,847	$ 75,111
Earnings per share:			
Basic	$ 1.72	$ 1.37	$ 1.14
Diluted	$ 1.67	$ 1.32	$ 1.10
Weighted average number of common shares outstanding:			
Basic	73,111	72,151	65,763
Diluted	75,495	74,713	68,325

Iconix Brand Group, Inc. and Subsidiaries
Consolidated Statements of Cash Flows (in thousands)

	Year Ended December 31, 2011	Year Ended December 31, 2010	Year Ended December 31, 2009
Cash flows from operating activities:			
Net income	$ 141,241	$ 110,480	$ 76,031
Adjustments to reconcile income from continuing operations to net cash provided by operating activities:			
Depreciation of property and equipment	2,450	1,800	690
Amortization of trademarks and other intangibles	6,988	8,307	7,325
Amortization of deferred financing costs	4,309	2,276	2,313
Amortization of convertible note discount	23,057	15,021	14,101
Stock-based compensation expense	11,742	11,444	8,925
Loss on marketable securities	-	13,000	-
Non-cash gain on sale of trademarks and joint venture interests	-	-	(6,601)
Non-cash gain on re-measurement of equity investment	(21,465)	-	-
Realization of cash flow hedge		87	201
Allowance for doubtful accounts	1,948	2,253	4,312
Earnings on equity investments in joint ventures	(10,353)	(5,492)	(3,424)
Deferred income tax provision	27,737	13,448	17,137
Changes in operating assets and liabilities, net of business acquisitions:			
Accounts receivable	(17,252)	3,638	(19,925)
Other assets - current	16,868	(16,002)	4,094
Other assets	12,298	(14,872)	(3,196)
Deferred revenue	(10,168)	(13,515)	11,791
Accounts payable and accrued expenses	(11,791)	33,850	9,084
Net cash provided by operating activities	177,609	165,723	122,858
Cash flows used in investing activities:			
Purchases of property and equipment	(3,242)	(3,190)	(3,873)
Acquisition of interest in Peanuts Worldwide	-	(172,054)	-
Acquisition of interest in MG Icon	-	(4,000)	-
Acquisition of Sharper Image	(65,600)	-	-
Acquisition of interest in Hardy Way	(62,000)	-	(9,000)
Investment in IP Holdings Unltd	-	-	(63,500)
Payment of accrued expenses related to acquisitions	-	(1,177)	(223)
Acquisition of Zoo York - net	(18,000)		
Net distributions (to) from equity partners	(8,116)	2,154	2,469
Earn-out payment on acquisition	-	(799)	(12,900)
Addition to trademarks	(568)	(88)	(145)
Net cash used in investing activities	(157,526)	(179,154)	(87,172)
Cash flows (used in) provided by financing activities:			
Proceeds from exercise of stock options and warrants	3,312	2,083	3,230
Payment of long-term debt	(211,784)	(81,418)	(60,937)
Proceeds from long-term debt	292,500	-	-
Proceeds from sale of warrants	28,800	-	-
Payment for purchase of convertible note hedge	(58,740)	-	-
Acquisition of interest in MG Icon	(4,000)	-	-
Proceeds from common stock issuance, net	-	-	152,798
Deferred financing costs	(3,381)	-	-
Excess tax benefit from share-based payment arrangements	4,940	1,301	3,600
Shares repurchased on vesting of restricted stock and exercise of stock options	(3,185)	(2,970)	(724)
Non-controlling interest contribution	1,800	14,826	2,066
Shares repurchased on open market	(19,138)	-	(1,455)
Restricted cash - current	(10,771)	2,863	(5,286)
Restricted cash - non-current	8,646	-	-
Net cash provided by (used in) financing activities	28,999	(63,315)	93,292
Net increase (decrease) in cash and cash equivalents	49,082	(76,746)	128,978
Cash and cash equivalents, beginning of year	118,635	195,381	66,403
Cash and cash equivalents, end of year	$ 167,717	118,635	195,381
Balance of restricted cash - current	14,071	3,300	6,163
Total cash and cash equivalents including current restricted cash, end of year	$ 181,788	$ 121,935	201,544