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Hanesbrands (HBI) EQ Review

Current EQ Rating*	Previous EQ Rating
3-	NA

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We initiate EQ coverage of HBI with a rating of 3- (Minor Concern).

Our initial review of HBI turned up a few items of concern.

- HBI maintains an accounts receivables securitization facility under which it sells trade receivables to a wholly-owned subsidiary to fund a financing conduit. The receivables remain on the balance sheet and financing cash flows are reported in the financing section of the cash flow statement which avoids distortion of the trend in receivables origination and operating cash flows.

- However, HBI also sells receivables to third-party financing institutions which does result in the removal of receivables from the balance sheet as well as providing a boost to operating cash flow. Unfortunately, the company does not disclose the outstanding balance of sold receivables, making it impossible to get a clear picture of the trend in receivables origination and the impact on operating cash flow. A sudden, 5-day decline in receivable DSOs in the 12/18 quarter appears to have given a substantial boost to operating cash flow which may have been a result of the timing of such receivable sales.

- Inventory days (DSI) jumped by 8 days in the 12/18 quarter which the company blamed on preparation for growing sales of its *Champion* brand. However, we note that the sizeable increase has appeared very suddenly and is focused entirely on finished goods. In addition, cotton prices have been declining sharply since summer,

but the lower costs will not be fully reflected in the cost of sales until later this year due to FIFO accounting.

Accounts Receivable Securitization Program and Receivables Sales

HBI maintains an accounts receivable securitization program for short-term financing purposes as described in the company's 10-K:

> *"Under the terms of the Accounts Receivable Securitization Facility, the Company and certain of its subsidiaries sell, on a revolving basis, certain domestic trade receivables to HBI Receivables LLC ("Receivables LLC"), a wholly owned bankruptcy-remote subsidiary that in turn uses the trade receivables to secure the borrowings, which are funded through conduits and financial institutions that are not affiliated with the Company."*

Importantly, the receivables that have been sold to the financing subsidiary are reported with the rest of the company's trade receivables on the balance sheet. Therefore, reported trade receivables trends are not distorted by the program. Cash flows from borrowings and repayments of the securitization facility are reported in the financing section of the cash flow statement as follows:

12 mos ended:	**2018**	**2017**	**2016**
Borrowings on Securitization Facility	$213.336	$373.640	$238.065
Repayments on Securitization Facility	-$176.937	-$292.952	-$388.707

However, in addition to the securitization program, HBI also sells accounts receivable to third-party financial institutions. The company stated the following in its 2018 10-K with regard to its accounts receivable sales:

> *"The Company has entered into agreements to sell selected trade accounts receivable to financial institutions based on programs offered by certain of the Company's largest customers. As a result of the strong credit worthiness of these customers, the discount taken on these programs is less than the marginal borrowing rate on the Company's variable rate credit facilities. After the sale, the Company does not retain any interests in the receivables and the applicable financial institution services and collects these accounts receivable directly from the customer. Net proceeds of these accounts receivable sale programs are recognized in the Consolidated Statements of*

Cash Flows as part of operating cash flows. The Company recognized funding fees of $9,566 , $6,059 and $4,497 in 2018 , 2017 and 2016, respectively, for sales of accounts receivable to financial institutions in the "Other expenses" line in the Consolidated Statements of Income. The increase in funding fees in 2018 compared to 2017 was primarily due to the increase in LIBOR during 2018, which resulted in higher funding fees of $2,897."

Unlike the securitization program, the sale of accounts receivable would remove the sold receivable balances from the company's balance sheet and artificially distort the trend in receivables and consequently the calculation of days of sales (DSO). Unfortunately, the company does not disclose the outstanding amount of sold receivables which materially clouds the analysis of the company's revenue recognition as well as its growth in operating cash flows.

We know from the above disclosure that the discount the company paid to sell the receivables increased by more than 55% in 2018. However, the disclosure indicates that the bulk of this was due to an increase in LIBOR. The company does not give enough information to get a clear picture of how much the sales are impacting receivables and cash flows.

We do note that accounts receivables took an unusual decline in the fourth quarter as shown in the following table:

	12/29/2018	9/29/2018	6/30/2018	3/31/2018
Sales	$1,768	$1,849	$1,715	$1,472
Accounts Receivable	$871	$1,045	$974	$875
Sales YOY growth	7.5%	2.7%	4.2%	6.6%
Accounts Receivable YOY growth	-3.6%	3.5%	4.1%	9.3%
Accounts Receivable DSOs	44.9	51.6	51.8	54.2

	12/30/2017	9/30/2017	7/01/2017	4/01/2017
Sales	$1,645	$1,799	$1,647	$1,380
Accounts Receivable	$903	$1,009	$936	$800
Sales YOY growth	4.4%	2.2%	11.8%	13.2%
Accounts Receivable YOY growth	7.9%	4.9%	9.1%	10.9%
Accounts Receivable DSOs	50.1	51.2	51.8	52.9

After tracking very steadily, DSOs in the 12/18 quarter fell by 5 days from the year-ago period. In the conference call, management stated that its "focus on receivables and payables resulted in an eight-day improvement in our cash cycle versus last year." This was

the only mention we saw with regards to receivables movements in the quarter. (We do note that the company took a $14 million charge to bad debt in the 9/18 quarter related to the Sears bankruptcy.)

We do not see evidence that the company sold enough receivables to mask an alarming rise in receivables origination. However, the sudden drop in DSO does make us wonder if at least some of the decline could be due to a large receivables sale at the end of the quarter that could have artificially boosted reported operating cash flow. We note that accounts receivable generated $166.8 million in cash in the 12/18 quarter compared to just $116.3 million in the 12/17 quarter. Reported cash from operations for the full year 2018 was $643.4 million versus $655.7 million in 2017. Without the incremental boost from accounts receivables, cash from operations for 2018 would have fallen to $592 million.

Inventory DSI Jump

HBI's inventory days (DSI) have risen year-over-year in each of the last two quarters after a long string of declines:

	12/29/2018	9/29/2018	6/30/2018	3/31/2018
Raw Materials DSI	9.2	10.8	11.9	13.8
Work in Process DSI	15.7	15.7	18.6	21.8
Finished Goods DSI	151.4	145.3	152.2	173.4
Total DSI	176.3	171.8	182.6	209.0

	12/30/2017	9/30/2017	7/01/2017	4/01/2017
Raw Materials DSI	11.6	10.6	12.4	15.1
Work in Process DSI	20.3	16.4	18.1	22.3
Finished Goods DSI	136.1	132.0	151.9	179.5
Total DSI	168.0	159.1	182.4	216.9

	12/31/2016	10/01/2016	7/02/2016	4/02/2016
Raw Materials DSI	12.4	12.1	14.7	19.4
Work in Process DSI	17.5	16.4	20.4	26.3
Finished Goods DSI	144.4	136.1	165.0	190.2
Total DSI	174.4	164.6	200.0	235.9

Management has indicated that the buildup in inventory is a result of "increased investments to support the global demand of our *Champion* products." What is important

to note is that all of the increase in DSIs has come from finished goods. While total inventory DSI is over 8 days higher than last year's fourth quarter, it is only two days higher than the 12/16 level. However, the finished goods DSI is over 15 days higher than last year and 7 days higher than in 12/16. Meanwhile, raw materials and work in process DSIs have declined considerably.

To understand the increase in inventory, we need to look at trends in raw materials prices. Cotton is a key raw material for HBI and accounts for about 5% of the cost of sales. In addition, oil and other chemicals used in dyes are important. Interestingly, cotton prices have been in a freefall for the last few months:

Despite this, management has blamed higher costs for pressuring gross margins in 2018. Adjusted gross margin for the last eight quarters is shown below:

	12/29/2018	9/29/2018	6/30/2018	3/31/2018
Adjusted Gross Margin	40.1%	39.2%	39.1%	40.1%

	12/30/2017	9/30/2017	7/01/2017	4/01/2017
Adjusted Gross Margin	40.1%	37.8%	39.5%	40.2%

With regards to flat gross margin in the 12/18 quarter, the company stated in the conference call:

> *"Gross margin of 40.1% was consistent with prior year as the impacted input cost inflation, product mix and foreign exchange offset the benefits from acquisition contributions, synergies and price increases for certain Activewear products."*

Also, the company stated the following regarding the unusual improvement in adjusted gross margin in the 9/18 quarter:

> *"We increased gross margin by 140 basis points over last year. Favorable mix, driven principally by Champion, contributions from Bras N Things as well as the benefits from acquisition synergies and cost savings initiatives more than offset higher input costs."*

Management is forecasting a 50 bps improvement in gross margin in 2019 driven by price increases it is implementing in the first half of 1Q19 as well as a beneficial mix shift.

We know that the company does little in the way of raw materials hedging, but it can lock in cotton prices with suppliers to help shield itself from price moves. Also, keep in mind that FIFO inventory accounting ensures that raw materials prices do not impact the company's income statement for 6-9 months after purchase.

With all this in mind, we have the following observations about the recent inventory moves:

- The FIFO-related delay in realizing higher cotton costs in inventory means that the spike in prices experienced in the spring and summer of 2018 has still not run its course on the income statement. This points to continued pressure on gross margin in the next couple of quarters but could result in a tailwind in the second half of the year, depending on how well the 1Q19 price increases stick.

- The decline in raw materials DSIs may partly be from lower costs earlier this year, but also indicate that the company does not appear to be stocking up while raw materials prices are lower.

- The *Champion* brand has been growing as it rides the current sportswear fashion craze and the company's expansion of its own *Champion* retail stores. Therefore, the idea that inventory could be rising to prepare for future sales increases makes sense in principle. However, investors should keep in mind that innerwear (35% of sales, 22% of operating profit) was down over 3% in 2018. Therefore, the sudden increase in finished goods looks unusual. Further buildup should be viewed with caution.

Headcount reduction

HBI incurred acquisition and integration charges of $80.2 million in 2018, down from $190.9 million in 2018 related to several acquisitions taken over that time frame. Management indicated that it will take another $50 million in early 2019 which will wrap up the integration program. We will consider it a red flag if the company extends or announces new restructuring programs in 2019.

Explanation of EQ Rating Scale

Rating	Description
6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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