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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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February 21, 2019 | www.btnresearch.com

Hanesbrands Inc. (HBI)- SELL

We looked at Hanesbrands (HBI) last week as an EQ report based on several areas regarding working capital. Looking deeper at the business model, we are going to rate the stock a SELL. At 11x 2019's EPS and 10.7x trailing EBITDA, the company does not look that expensive. The 3.2% dividend also does not appear in jeopardy at a 35% payout ratio of EPS and 30% of free cash flow. However, our conclusion is that this company grows almost solely from acquisitions, its customer base has problems, its cost-cutting efforts are largely complete and only helped marginally. Its forecasts require growth and margin expansion, which it has not seen much of lately. Pulling cash out of working capital was the focus of the EQ report and at least half of that appears to have occurred. Even HBI notes that while it expects to complete pulling $200 million from working capital by the end of 2019 – that should only be a one-time event.

The innerwear – underwear, socks, bras unit is the largest and most profitable. It also has several of the #1 and #2 brands in that industry, but the industry is far from consolidated with $165 billion in sales and HBI has 1.4% of that. Sales and margins remain weak and new sales channels add expense in our view. The company's goal to jumpstart the business is to cut costs by eliminating colors, different materials, reducing inventory and mass producing fewer SKUs and boosting prices. That seems to run counter to most retailers who are looking for ways to offer more choices at better values and work with suppliers to hold more inventory.

The activewear – essentially workout clothes, sports apparel, sweatshirts is keyed by the *Champion* brand and has seen some growth in recent years as it was rolled out to new channels. It wants to do less private label and extend the *Champion* brand name. It is competing with Nike, Adidas, among others and is the #4 or #5 brand in the industry. HBI is losing Target as a *Champion* retailer in January 2020, which is 20% of activewear sales.

Our basic concerns are we see several areas where HBI could disappoint on earnings even though the forecast looks modest at first glance. Producing actual growth is rare here and the cost-cutting programs may actually reverse. We believe the stock may have 20%-25% downside:

- **HBI grows via acquisition. Since its spin-off from Sara Lee, sales were essentially flat for seven years before a buying spree began. The company highlights growth in sales from acquired companies of $2.7 billion since 2013, but total sales are only up $2.2 billion showing some negative organic growth.**

- **Margin gains are also touted as the acquired businesses get installed into the HBI model and purchasing/distribution systems. We only see that margins have grown by 100bp from 2013-2018 and even that includes a positive accounting change of 30bp where pension expense was part of SG&A until recently and now moved below the operating income line.**

- **In another sign of disappointment from growth through acquisition, HBI has spent over $1 billion to digest and streamline $2.5 billion in purchases and achieve about 70bp of margin gains.**

- **Forecasts call for only 1.2%-2.7% sales growth. However, from 2013-2017, HBI posted negative growth in every year without acquisitions. In 2018, the company benefited from initial stocking of product in Activewear in the US and products in Australia.** How many more untapped stores remain in Australia? Also, Target is going to cancel 20% of the sales at Activewear in January 2020 – how much will Target stock in 2H 2019?

- **Margin gains were driven by cuts in areas of investment in the company. Of the 70bp of margin gain seen at HBI over several years – 161bp came from cutting R&D, Advertising, and 401-k contributions.** Now even HBI plans to ramp up R&D and advertising. If those cost areas reverse and sales are essentially flat, how will the company boost margin?

- **Margin forecasts call for 10bp of operating margin improvement along with 50bp of gross margin gains. HBI has to also overcome that royalties and license fees have long been growing faster than sales.** Also, as it competes more in Direct to Consumer and helping big retailers like Amazon, Macy's Kohl's with their inventory and direct shipping – shipping costs are also rising faster than sales. HBI will then have to

cover higher marketing costs on flat sales and the gross margin gain is expected to come from boosting prices in innerwear despite commodity prices having dropped considerably.

- **Innerwear has been losing market share and margins at a steady rate. The cost savings of rationalizing the supply chain have long ceased to help the situation.** Their goal is to cuts SKUs, colors, and materials in women's intimate apparel to help on margins – which we think my drive more retailers away and certainly give retailers more power to push back on price hikes. We believe retailers are also put off by HBI's drive to sell on its own direct to consumer channels. It has highlighted how strong bra sales are there, but sales overall for bras are down 10% as retailers reduce purchases. **Price hikes are also tough when the market only grows at 0.5% per year and the market has numerous competitors.**

- **Activewear benefitted from initial stocking of product in 2018, just like 2015 before it didn't recur the next year to produce negative growth. Margins have also been under pressure as the synergies from rationalizing the supply chain have not been helping for several years.** The loss of Target in early 2020 may well have negative impacts on sales for the 2H of 2019. Why would Target highlight a discontinued product line during Christmas 2019?

- **International has been growing largely with acquisition, positive FX, and recently with product stocking in new retailers in Australia and Europe.** We question how many new stores there are in those areas to maintain initial stocking growth. **We also noticed that margin has been helped by rationalizing the supply chain situation**. It's been three years now for that in this division – the rationalizing gains ended after 2-3 years for the other two units.

- **Working Capital goals and debt goals appear doable. We urge clients to read the EQ report that discusses this in more detail**. The company wants to pull $200 million out of working capital and appears to have already achieved half of that in 2018. The goal of reaching 2.9x EBITDA in net debt along with the dividend should require nearly all of FCF in 2019 but it appears doable. It would likely require sales and margin disappointment to miss this target. We're forecasting both and that should be enough to weigh on the stock price more than if debt is 2.9x or 3.0x EBITDA.

Big Picture for HBI- Growth Through Acquisition

The company was spun-off from Sara Lee in 2006. In 2007, sales were $4.3 billion. It didn't top that figure until 2011 when the cost of cotton rose, and the company boosted prices and hit a sales figure of $4.4 billion. Sales were only $4.6 billion in 2013 and helped with the acquisition of Maidenform.

At the Investor Day in 2018, HBI noted that since 2013, it had acquired $2.7 billion in sales. The first problem is sales are only up $2.2 billion. It also reported that the $2.7 billion in purchased sales had an operating profit of $225 million when acquired or 8.3% margin. HBI was able to grow profits on the acquired sales to $465 million or 17.2%. Yet, margin for the full company is only 13.9% adjusted for numerous restructuring charges designed to streamline operations and boost margin:

	2018	2017	2016	2015	2014	2013
Sales	$6,804.0	$6,471.4	$6,028.2	$5,731.5	$5,324.7	$4,627.8
Adj. Gross Profit	$2,694.9	$2,545.6	$2,315.4	$2,199.2	$1,977.5	$1,627.9
Adj. SG&A	$1,746.8	$1,608.4	$1,386.9	$1,338.0	$1,214.7	$1,031.9
Adj. Oper Profit	$948.1	$937.2	$928.5	$861.2	$762.8	$596.0
Adj. Gross Margin	39.6%	39.3%	38.4%	38.4%	37.1%	35.2%
Adj. SG&A %	25.7%	24.9%	23.0%	23.3%	22.8%	22.3%
Adj. Op. Margin	13.9%	14.5%	15.4%	15.0%	14.3%	12.9%

The company and we added back the various restructuring and acquisition-related charges to Gross Profit and SG&A in the table above. Here are the charges, which total $929 million over six-years:

Restructuring	2018	2017	2016	2015	2014	2013
COGS	$38.4	$55.0	$39.4	$62.9	$73.1	$16.2
SGA	$41.8	$109.9	$99.1	$203.2	$125.8	$64.6

There was another $80 million in charges that were not recorded under Cost of Goods Sold or SG&A expenses – bringing the grand total of charges to over $1 billion. The cost of these acquisitions was $2.5 billion so the level of restructuring has been significant at 40% of purchase price. **At the end of this, we see that gross profit is up 440bp but SG&A is up 340bp. As a result, operating margins without the one-time charges improved only 100bp and have been declining since 2016.**

Also, the accounting for pension expense changed in 2018 and was moved out of SG&A into Other expenses below the operating income line. In 2013, pension expense was a 31bp hit to operating margin and in 2018, it's not in operating margin. We would conclude that margins have only improved by about 70bp.

For 2018 margins, HBI noted that gross margins rose due to synergies in the International division of 50bp, but higher input costs lowered margins. SG&A was helped by 30bp of cost-cutting but hurt by higher bad debt expense.

For 2017 margins, HBI noted 70bp of improved synergies and efficiencies for gross margin. SG&A suffered from 190bp from higher distribution costs related to higher volume, higher labor costs, increased marketing, product mix.

For 2016 margins, HBI was helped in gross margin by acquisitions from foreign operations and synergies and offset by inventory cuts and unfavorable product mix. SG&A was helped by synergies and cost-cutting actions.

We will discuss this in more detail below examining the key segments. On the surface, it still sounds like there is no sales growth without acquisitions and synergies cannot offset weaker sales volumes:

	2018	2017	2016	2015	2014	2013
Sales Growth	$332.5	$443.2	$296.7	$406.8	$696.9	$102.1
Acquisitions	$177.0	$470.0	$456.0	$605.0	$672.0	$98.0
For. Ex.	$13.0	$25.0	$0.0	$0.0	$34.0*	$0.0

*In 2014, the $34 million was a 53rd week not FX.

For 2019, the company is not expecting much sales growth only 1.2%-2.7%. As low as that sounds, it just doesn't happen very often that HBI posts any sales growth except via acquisition and FX.

The Margin Forecast May Have Problems Too

We noted above that from 2013-2018 $1 billion in restructuring and integration activities have added about 70bp to operating margin after the pension expense was moved out of

operating income. When we look more closely at where some cost savings have come from, we believe there are headwinds coming:

$ spent	2018	2017	2016	2015	2014	2013
R&D Exp.	$59.3	$65.5	$70.1	$62.3	$63.3	$51.3
Advertising	$152.7	$157.4	$168.7	$182.0	$183.3	$161.5
401-k	$25.8	$21.3	$26.4	$22.0	$22.9	$23.5

basis points	2018	2017	2016	2015	2014	2013
R&D Exp.	87	101	116	109	119	111
Advertising	224	243	280	318	344	349
401-k	38	33	44	38	43	51
total	350	377	440	465	506	511

The company may have only picked up 70bp in margin expansion, but it pulled 161bp from reducing R&D, advertising, and 401-k contributions as a percentage of sales. Frequent mentions on the 4Q call pointed to this spending going up:

> *"In 2019, we're increasing our marketing investment behind our key brands and innovations."*

> *"We are stepping up the investment as I noted in my prior comment. One of the first things we've done is, is launch our first global campaign. As you know, we've used digital very effectively to connect with the younger consumer, we're stepping up our efforts that way as well as driving this global campaign. Our online presence does have opportunity for further development and its one of our key focuses is to develop our own website as well as working with others on their sites as well."*

> *"I would estimate that our increase in investment to support growth is probably in the $25 million range year-on-year with the vast majority of that supporting brands and a slight expansion to our distribution network to support all the growth we're experiencing."*

If they add $25 million to marketing – that's 36bp of headwind for 2019. They talked about more websites, more innovation to move development of products faster and more distribution improvements. That sounds like R&D to us. HBI has been cutting in that area for years. Another $25 million could be further 36-basis point headwind.

The company is forecasting only 10bp of operating margin expansion. The rationale behind that is 50bp of gross margin improvement from boosting prices for the Innerwear unit, a drop in bad debt expense from $29 million in 2018, and $10 million in savings from Project Booster during 2019. Adding that all up, it sounds conservative on the surface:

50bp of Gross Margin	$34.5
Lower Bad debt Expense	$14.0
Restructuring savings	$10.0
New Investment Adv/R&D	-$51.6
Label	$6.9

The New Investment is a plug figure (which comes out ahead of the $50 million that appears likely) and the $14 million in lower bad debt expense is our estimate of what HBI is thinking. In reality, they are still worried about store closings, which should hold up bad debt expense. Also, the $29 million of bad debt expense reflects $14 million from Sears bankruptcy in 2018, but it was hardly out of line with recent years:

	2018	2017	2016	2015	2014	2013
Bad debt Expense	$29.3	$22.8	$23.5	$13.3	$25.4	$6.7

That figure could come in higher than forecast and we already believe the new investment may come in above $52 million. But, let's also look at some other fairly large expenses that are growing:

$ spent	2018	2017	2016	2015	2014	2013
Royalties	$109.9	$100.9	$95.7	$84.7	$57.1	$42.1
Shipping	$409.1	$376.4	$324.8	$332.7	$295.3	$241.0

basis points	2018	2017	2016	2015	2014	2013
Royalties	162	156	159	148	107	91
Shipping	601	582	539	580	555	521

Royalties and license fees are paid to other designers and companies and are located as part of cost of goods sold. Those have become a bigger part of the business and product line. Even with acquisitions pushing the sales total up, these fees are growing even faster than sales. Shipping fees are a necessary part of selling more product direct to consumer and being on platforms such as Amazon and even working with other retailers like Wal-Mart and Macy's

on their website platforms. That is an area where HBI expects to see more growth at the expense of traditional bricks and mortar retailing. In our view, if sales are expected to be essentially flat and those areas are bigger parts of the business – those costs should become headwinds to margin. It is possible for HBI to lose 25-30bp just in those areas in our view.

Also, while other retailers are closing stores, HBI has been opening its own. It now operates 243 outlet stores in the US and 690 retail and outlet stores internationally. That is up from 245 and 475 at the end of 2017. The company leases more than just these stores and does not break out its operating leases by property. We'll just say that having another 215 retail stores with leases and employees – that will add to costs and margin pressure if the company is assuming minimal sales growth of 1% to less than 3%.

Now look at what may happen on margin forecasts:

	bps	$
Gross Margin	50	$34.5
Bad debt cut	14	$10.0
savings	14	$10.0
Royalties/Shipping	-30	-$21.0
Leases	-5	-$3.5
New Adv/R&D	-72	-$50.0
Total	-29	-$20.0

Even giving the company full credit for its 50% of higher gross margin due to price increases, and $10 million in expected cost savings from Project Booster in 2019, we think the only way to reach forecasts for a 10bp gain in operating margins is to have R&D come less than last year AND have growth in shipping costs slow.

Innerwear – Losing Market Share and Margin

The Innerwear division for HBI is its largest at 35% of sales. It is also the most profitable and generates 45% of segment profit. It is number 1 in many of its categories for various brands. The problem is that is supposed to grow at essentially the rate of population growth – yet has been posting negative sales and margin trends for years:

Innerwear	2018	2017	2016
Sales Growth	-3.4%	-3.2%	-2.5%
Margin change	-1.5%	-0.6%	-0.7%

This unit has not seen sales growth since it enjoyed a 53rd week in 2014. That was also the last time it saw some margin growth from synergies after the Maidenform acquisition and the last time they mentioned margin gains from streamlining the supply efficiencies. Since then, the annual explanation has been sales are lower due to poor product mix with weakness focused on woman's intimate apparel and retailers buying less inventory as stores were closed. For margin, the company has benefited from cost-cutting and reducing headcount. However, it has seen operating leverage unwind as lower volumes were produced over fixed costs. In 2018, it blamed higher raw material costs as well.

Several things we would like to point out here. First, if this industry is growing at population growth rates as the company pointed out on Investor Day – HBI is losing market share as it is posting negative growth of 2.5%-3.4% while world population is growing at 0.5% and the US at 0.6%. Second, HBI said it sees this as a $165 billion market at retail prices globally. If HBI only has sales of $2.4 billion in this area or 1.4% of the global market and yet has several #1 brands – then this market still looks incredibly competitive and there is little dominance by HBI. In addition, if margins can fall from lack of economies of scale for volume production – this may be tough to fix if the market is only growing at 0.5%.

Also, as noted in the February 14, 2019 EQ report – while HBI is blaming higher raw material costs for pressuring margins in 2018. Cotton prices were high in 2Q18 but have been falling rapidly since then. In fact, cotton prices at 70-cents are well within the 20-year normal range of the mid-60s to 70 cents. Oil has fallen too, which makes some of the synthetic fibers. **The goal the company laid out for margin expansion in 2019 relies heavily on boosting prices in innerwear by about $40 million.** Given that retailers are still pushing back on carrying inventory and this is not the most concentrated market for HBI to wield power – **they could see some disappointment simply by retailers pushing back on price increases.**

Giving retailers more ammunition to push back on HBI are some of the other plans to fix the growth and margins in this unit. First, HBI wants to boost its own online direct-to-consumer sales platform and compete with the retailers. That alone may cause retailers to buy less from HBI as retailers don't want to be the 27th outlet to sell the same product. This may be happening already. At Investor Day, HBI touted how 23% of its bra sales are now online and grew at 20%. Yet, in 2018, the company said it is suffering from loss of retail stores and intimate apparel sales fell 10% led by bras:

"Innerwear net sales decreased 3% compared to 2017 driven by a 1% decline in our basics business and a 10% decline in our intimate apparel business. Within our basics business, strength in our men's underwear business was more than offset by declines in our women's panties, children's underwear and sock businesses. Net sales in our intimate apparel business decreased primarily driven by declines in our bras product category, which continues to be impacted by door closings and the challenging retail landscape within the mid-tier and department store channel."

Second, one of HBI's plans to rebuild the profitability of this division is to cut the number of SKUs and colors offered in women's intimate apparel. The Investor Day presentation on p.43 laid out some of this: Simply Product Line and design, reduce SKUs, reduce colors, reduce number of materials. The goal is to speed-up the time it takes to get a product to market (which sounds like R&D again to us – which is what HBI has been cutting for years). We are going to tread lightly on this as we don't have much experience in shopping for women's underwear. However, we have seen many retailers over the years crow about having wider selections of clothing and more colors and more styles. Victoria's Secret stores and advertising seem to highlight many colors and new styles as corporate policy. Scaling down selection at HBI may well help margins a bit, but it could cost HBI more sales.

Activewear Shows Stronger Sales – but Margins Still Eroding

At 26% of segment sales, Activewear is smaller than both Innerwear and International. It seems to be posting growth only via acquisition or initial stocking of product at stores:

Activewear	2018	2017	2016
Sales Growth	8.3%	3.3%	-0.3%
Margin change	-1.1%	-0.5%	-1.3%

Sales in 2018 were driven by acquisition for 3.3% of sales growth and by stocking inventory in more retailers. In 2016, the -0.3% sales growth was actually helped by a 2.1% growth rate from acquisitions and while initial stocking to retailers in 2015 was not repeated and produced negative sales.

Margins continue to fall via higher raw material costs in 2018, more SG&A support required at acquisitions. Margins were hurt in 2016 by poor product mix and overall lower volumes.

The bigger issue here though is $380 million in *Champion* Activewear sales are to Target – that's 21%. Target is not renewing the contract and will stop selling product in January 2020. We would also ask; how much is Target likely to stock of a product it has discontinued in the 3Q and 4Q of 2018? It makes more sense that they would be using Christmas sales to highlight new product roll-out. Conceivably, this could be a $200 million sales headwind. At the current 14.9% margin, that's $30 million in lower operating income. Compare that to the $6.9 million growth that HBI has forecast for the whole company on operating income.

Much like Innerwear, there has not been much discussion at Activewear about cost savings from streamlining acquisitions into HBI's lower cost supply chain since 2014 and 2015.

International Still Driving Forward – But Is It Maturing?

The International Division focuses largely on Europe and Australia and was built largely with acquisitions. Recent sales growth has been stellar but organic growth is much lower than reported figures:

International	2018	2017	2016
Sales Growth	14.1%	34.1%	35.3%
Margin change	1.9%	0.8%	3.0%
Acq/FX Sales	6.6%	28.8%	37.3%

The bulk of sales growth has come via acquisition and also the latest deal for Bras N Things was already higher margin when it entered the mix. Bras N Things helped margin in 2018 along with scale efficiencies. Cost synergies and streamlining are touted for 2017 and 2016 margin improvement. It also appears there has been some initial stocking by increasing the number of retail stores the products are carried.

We are simply going to point out that even at 34% of segment sales, the margin growth and sales gains at International have not been able to offset the decay at the other two units. Moreover, Australia is a small country in term of population, it's about 25 million people. How many more retail units can there be to initially stock the channel left? The other big part of this is Europe where GNP growth remains very low relative to other parts of the developed world. The underlying growth in these areas adjusting for acquisitions and initial stocking is likely in the low single digit range too. The activewear has already seen those

types of boom and bust of putting new inventory in the channel in 2015 and 2016 and again in 2018.

We have also already seen how long it takes for HBI to right-size distribution and manufacturing items for the supply chain of acquired companies. It was acknowledged for driving margin gains for two years at Innerwear and Activewear and then stalled. It's now been three years for International.

HBI is a Heavy Working Capital Business – and Debt Ratio Guidance

As we noted many times in the EQ Report from February 14, 2019 – HBI has seasonality to inventory and receivable and heavy commitments to both. Inventory generally runs about 160-200 days and receivables about 50 days. We are not going to repeat all of the EQ Report here – but the company expects to pull about $200 million of working capital out of the business between late 2017 and the end of 2019. That cash is expected to be used to retire debt.

As we noted, HBI is selling receivables and using a securitization facility to boost cash against receivables. After running at 51-52 days of sales, DSOs for receivables dropped to 45 days in the 4Q18, which the company says is part of its work in achieving this $200 million goal. The simple math is Receivables are $871 million or 44.9 days of $1.77 billion in 4Q sales. If they had remained at 50 days, receivables would have been $982 million or $111 higher. We would estimate that HBI has already achieved about half its $200 million goal.

In terms of inventory, the company wants to bring this down. It finished 4Q18 at 176 days of inventory and it has been running higher than 2017 much of the year. However, all the growth in finished goods. The DSIs for raw materials and work in progress are already at multi-year lows. HBI said that expanding demand for the *Champion* products in the International division is part of the reason inventories were higher in 2018 along with rising raw materials costs. However, the raw material increase was not seen at any point in 2018 vs. 2017 or 2016. Pulling the extra $100 million out of working capital should require that HBI cut DSIs by about 9-10 days. That does not look like an outlandish target – but remember it was International expansion that pushed this up and is the only unit showing meaningful growth.

Also, as even HBI admits, this will be a one-time release of cash. It already pulled out $100 million from receivables in 2018. So perhaps another $100 million can be released from inventory in 2019. The company has also given guidance that it will see net debt to EBITDA fall from 3.3x to 2.9x in 2019. Net debt is $3.57 billion (financed debt + A/R securitization – cash) and EBITDA was just under $1.1 billion. To hit the forecast, net debt needs to fall by about $360 million in 2019.

Operating cash flow is expected to be $700-$800 million. Capital spending is about $100 million so free cash flow will be $600-$700 million. The dividend is $220 million. The company should be able to reach its debt target even if the working capital drawdown does not fully materialize. The pension plan consumed $17 million in cash payments in 2018 and is expected to receive a $26 million contribution in 2019. That does not appear likely to derail the cash flow forecasts on debt either.

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