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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Hanesbrands (HBI) 4Q'19 Update
Maintain NEUTRAL
Maintain EQ Rating of 3+ (Minor Concern)

We maintain our NEUTRAL rating and our EQ Rating of 3+ (Minor Concern) indicating the situation is. Investors could be attracted to the 6% dividend and a free cash flow yield of 11% based on current prices. Some adjustments in working capital have likely inflated that free cash flow yield by 200-300bp in our opinion. Also, many of our working capital concerns appear to have corrected and debt levels have been reduced to 2.9x adjusted EBITDA. Margins have also rebounded and while innerwear continues to suffer from retail stores closing – that part of the story is not surprising anyone in our view.

In general, there are likely some better growth stories out there given current prices. Several of the negative issues have corrected in our view and the dividend appears well covered. We would not argue with anyone who does see this as a buy. The catalyst to follow there is the FIFO inventory that has been penalizing HBI due to slow inventory turn and commodity costs falling – may become more benign and allow the company to see some margin expansion:

- Securitization of receivables has gone to zero. We see that as a positive. Securitized A/R were always on the balance sheet and did not impact cash from operations or DSOs. They may still use this mechanism going forward, which could boost cash flow in the financing section of the cash flow statement.

- Adjusting for the inflows and outflows of securitization in free cash flow, HBI's adjusted free cash flow is lower by $162 million than it first appears. But starting 2020 at zero, it could only rise going forward.

- HBI also sells receivables and does not disclose the amounts. There are signs that this happened in a large way in 2019 and positively boosted cash from operations and free cash flow. Discounts on receivables sold are linked to LIBOR which fell throughout 2019 – yet the level of fees paid rose y/y. Also, from 3Q to 4Q, HBI saw a $195.5 million positive cash flow swing from receivables.

- DSOs look lower than normal both y/y and sequentially. We think selling receivables could be the issue here and it is difficult to completely assess DSOs. Based on the swing in A/R in the quarter, DSO of 42.5 could be 10 days higher.

- Inventories have improved, which reflects some new product roll-outs being completed and lower commodity costs coming into raw materials. The inherent problem of simply having a slow turning total inventory balance remains with DSIs at 166 days.

- FIFO accounting is likely masking some potential margin gain at HBI. The company is touting that price hikes for innerwear in early 2019 are now showing up as higher margins and total gross margin rose 130bp in 4Q19 and operating margin up 30bp. The raw material prices have been declining for over a year now.

- FIFO has HBI selling the oldest raw materials and the company is reporting that higher raw material costs have remained a headwind throughout 2019. If the innerwear is starting to work past this as it did in 4Q19, this could be an area for upside surprise for HBI. 50bp of margin is worth 8-cents in EPS.

- Other positives – the company finally started to boost advertising again last year, Activewear adjusted for the loss of Target is still growing, the bulk of intangibles are on the growth parts of the company of Activewear and International.

- Other negatives – Innerwear sales continue to lag and that is expected to continue and we still wonder how much of the International sales growth is due to opening new stores and initial stocking. As the base grows, HBI will rely more on replacing sold merchandise for growth.

Receivable Concerns Have Mitigated on Securitization – On A/R Sales We are Less Certain

The company still has its securitization program we discussed in the February 14, 2019 EQ report. However, at the end of 2019, it had no balance on it. Under this program, the receivables stay on the balance sheet and the cash impacts run through the financing section of the cash flow statement:

Securitization	2019	2018	2017	2016
Borrowings	$246.4	$213.3	$373.6	$238.1
Repayments	-$408.0	-$176.9	-$293.0	-$388.7
Net Cash Flow	-$161.6	$36.4	$80.7	-$150.6

These securitized receivables do not distort DSOs and do not impact cash from operations. This source or use of cash flow only flows through the financing section. The current balance is zero. This is another area of debt that was paid down in 2019. One could argue that because the receivables are being used to generate cash flow – it should also be viewed as a source or use of operating cash flow too. Under that scenario, we would question if cash flow and free cash flow are as strong as they appear on the surface:

Securitization	2019	2018	2017	2016
Cash from Ops	$803.4	$643.4	$655.7	$227.0
Capital Spending	$101.1	$86.3	$87.0	$99.4
Free Cash Flow	$702.3	$557.1	$568.7	$127.6
Net Securitization	-161.6	36.4	80.7	-150.6
Adj. FCF	$540.7	$593.5	$649.4	-$23.0

Looked at this way, the free cash flow drops from $702 million to $541 million and the free cash flow yield on a $6.3 billion enterprise value falls from 11% to 9%.

The other issue that remains is HBI does sell receivables also. When that happens, it does remove the receivables from the balance sheet and that helps operating cash flow and it would influence DSOs. While HBI does not disclose the amount sold, there are two clues that there was a large sale of receivables in 4Q and during the year:

- In 2018, the company noted that it saw funding fees related to these sales rise from $6.1 million in 2017 to $9.6 million. It reported that $2.9 million of the increase was due to an increase of LIBOR in 2018 – and LIBOR did rise through the year and gained about 100bp. In 2019, the funding fees related to sales of receivables rose to $9.9 million. However, we know LIBOR fell over 100bp during the year and yet the fees were higher. That leads us to believe HBI sold more receivables than the year before.

- At the end of the 3Q19 – A/R was a consumer of cash flow for the first nine months of $170.3 million. By the end of 4Q19 – A/R was generating $45.2 million in operating cash flow for the year – a $195.5 million positive swing in 4Q. From 3Q18 to 4Q18, the swing was $166.8 million. There is a seasonal impact too, where receivables normally decline, but that 4Q19 was a very large move.

When we first wrote HBI as an EQ report in early 2019 – we thought a large sale may have happened in 4Q18 and resulted in a drop in DSOs of 5-days. It happened again in 2019 and the drop was larger:

	4Q19	3Q19	2Q19	1Q19
Sales	$1,751	$1,867	$1,761	$1,588
A/R	$815	$1,034	$1,012	$933
Sales y/y Growth	-0.8%	1.0%	2.7%	7.9%
A/R y/y Growth	-6.4%	-1.1%	3.9%	6.6%
A/R DSOs	42.5	50.5	52.4	53.6

	4Q18	3Q18	2Q18	1Q18
Sales	$1,768	$1,849	$1,715	$1,472
A/R	$871	$1,045	$974	$875
Sales y/y Growth	7.5%	2.7%	4.2%	6.6%
A/R y/y Growth	-3.6%	3.5%	4.1%	9.3%
A/R DSOs	44.9	51.6	51.8	54.2

	4Q17	3Q17	2Q17	1Q17
Sales	$1,645	$1,799	$1,647	$1,380
A/R	$903	$1,009	$936	$800
Sales y/y Growth	4.4%	2.2%	11.8%	13.2%
A/R y/y Growth	7.9%	4.9%	9.1%	10.9%
A/R DSOs	50.1	51.2	51.8	52.9

Just Using the 4Q Swing in A/R as a Proxy for Sold Receivables, the 4Q19 DSO May Be 10 Days Higher and 4Q18 About 8.6 Days Higher

There is nothing evil about selling receivables. But investors need to be aware that the company is producing cash flow from this source and DSOs are impacted. Also, the risk is that it becomes tougher to keep selling a larger total of receivables each year. That may be especially true with much of the growth here coming from foreign markets. Investors also face a risk if the receivable sales come in less in a given year as that would swiftly reduce cash flow. If we add a line to the table adjusting free cash flow for securitizations to include cash flow generated from receivables, the free cash declines further:

Securitization	2019	2018	2017
Cash from Ops	$803.4	$643.4	$655.7
Capital Spending	$101.1	$86.3	$87.0
Free Cash Flow	$702.3	$557.1	$568.7
Net Securitization	-$161.6	$36.4	$80.7
A/R change	$45.2	$10.3	-$31.7
Adj. FCF	$495.5	$583.2	$681.1

Now the adjusted FCF yield would fall under 8% without the receivable funding mechanisms. HBI would be starting 2020 with one positive in that the securitization trust is at a zero balance and would not consume cash this year. That alone could help the adjusted figure. What may have happened though is that the cash from selling receivables simply repaid the securitization line and both programs could be smaller in 2020.

These events within receivables are the difference between HBI having a payout ratio on the dividend of 31% of normally calculated Free Cash Flow and 44% adjusted for the receivable movements.

Inventories Have Improved – FIFO Margin Drag May Slow in 2020

HBI came into 2019 claiming that future sales releases for Champion in 2019 would result in higher inventory build-up. That happened and the levels have dropped back again, which we regard as a positive:

Inventory DSI	4Q19	3Q19	2Q19	1Q19
Raw Materials	7.3	7.8	9.0	11.2
Work in Prog.	11.9	10.8	14.2	16.1
Fin. Goods	147.3	148.0	164.4	183.6
Total DSI	166.5	166.6	187.6	210.9

Inventory DSI	4Q18	3Q18	2Q18	1Q18
Raw Materials	9.2	10.8	11.9	13.8
Work in Prog.	15.7	15.7	18.6	21.8
Fin. Goods	151.4	145.3	152.2	173.4
Total DSI	176.3	171.8	182.7	209.0

Inventory DSI	4Q17	3Q17	2Q17	1Q17
Raw Materials	11.6	10.6	12.4	15.1
Work in Prog.	20.3	16.4	18.1	22.3
Fin. Goods	136.1	132.0	151.9	179.5
Total DSI	168.0	159.0	182.4	216.9

Raw materials like cotton, natural gas, and liquids have been falling since mid-2018. The raw materials and work in progress show that they have been declining except during the ramp-up of early 2019 for Champion. The problem we see is HBI still turns inventory only about 2x per year and uses FIFO accounting. It should be seeing higher-priced goods rolling through cost of goods sold. The company complained that margins were restrained in 2018 and 2019 by higher raw material costs so that is still working through the inventory supply.

In the 4Q19 – the margins did pop a bit. This was due largely to price increases at Innerwear, more favorable price/mix at other units, and realizing some benefits of distribution restructuring. The company is giving guidance that it could see margins expand during 2020 and the inventory trends do support that forecast.

Adj Gross Margin	4Q	3Q	2Q	1Q
2019	41.4%	38.8%	39.0%	40.2%
2018	40.1%	39.2%	39.1%	40.1%
2017	40.1%	37.8%	39.5%	40.2%
2016	39.6%	37.6%		

Adj Op. Margin	4Q	3Q	2Q	1Q
2019	15.0%	14.9%	14.0%	10.7%
2018	14.7%	15.0%	14.3%	11.3%
2017	14.3%	15.0%	15.8%	11.6%
2016	15.9%	15.4%		

If investors want to look for reasons to be more bullish on HBI – look here. A 50bp gain in margin if the raw material headwind declines is almost $30 million in earnings and cash flow plus 8-cents in EPS.

Extra Positives

- Advertising rose last year. We noted that much of HBI's cost-cutting in recent years came from cuts to advertising, R&D, and 401-k contributions as well as moving pension cost below the operating income line adding 30bp to margins too. The cost-cutting in R&D continued, but we were pleased to see HBI boost advertising in 2019:

$ spent	2019	2018	2017	2016	2015	2014	2013
R&D Exp.	$51.5	$59.3	$65.5	$70.1	$62.3	$63.3	$51.3
Advertising	$163.8	$152.7	$157.4	$168.7	$182.0	$183.3	$161.5
401-k	$28.9	$25.8	$21.3	$26.4	$22.0	$22.9	$23.5

Basis Pts	2019	2018	2017	2016	2015	2014	2013
R&D Exp.	74	87	101	116	109	119	111
Advertising	235	224	243	280	318	344	349
401-k	41	38	33	44	38	43	51
total	350	350	377	440	465	506	511

- Active Wear adjusted for the loss of some Target business in 2019 is growing. The company reported that Champion sales adjusted for the loss of C9 in the mass market grew 14%. This loss was well-known, and the y/y comps will continue to show this in early 2020 – but the negative figures should mitigate through the year:

Sales Growth	4Q19	3Q19	2Q19	1Q19	4Q18
Activewear	-6.7%	-1.2%	10.5%	17.1%	13.5%

The loss in 4Q19 was below forecast and the remaining business may be doing better. We still think some of this is the result of initial stocking of new product which doesn't require sell-through to become sales at HBI, but it could top forecasts in this area in 2020.

- The bulk of the intangible assets here are related to the International and Activewear segments, which are growing sales – but have some FX and raw material pressures.

Extra Negatives

- Innerwear sales continue to fall. This is due to lost market share and retailer locations closing. That has been a long and well-known trend. But this is still 33% of sales and 43% of segment income:

Sales Growth	4Q19	3Q19	2Q19	1Q19	4Q18
Innerwear	-4.1%	-3.5%	-2.3%	-3.1%	-0.1%

The -0.1% in 4Q18 was likely helped by the -6.9% in 3Q18. Guidance is for an ugly 1Q20 of -5.5% to -7.5% based on more store closings and tougher comps from higher shipping levels in early 2019. The company expecting it to improve after that and is noting that margins have improved at this point.

- While International sales are still growing by opening new stores, we expect the law of big numbers to start impacting results as the existing base of stores become repeat business beyond initial stocking. Another sign of some maturity is HBI had an unexpected $3 million bad debt loss from an Australian retailer last quarter.

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 recently 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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