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BTN Research

May 16, 2019 | www.btnresearch.com

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Hanesbrands 1Q update

We are maintaining our SELL recommendation on HBI after 1Q results, which beat forecasts by 2-cents. Despite several areas of stronger sales, HBI did not boost guidance and in fact, reduced it slightly for 2019 in our view. Many of our concerns were evident such as margin pressure despite heavy restructuring. Past cuts in advertising are proving unsustainable. Sales growth also appears to be coming largely from initial stocking at new stores and forecasts of 2% sales growth are not calling for that to continue.

- **Guidance may be at the lower end for forecasts now.** The company kept the same EPS range of $1.72-$1.80 for 2019 but noted that operating profit would be hit by an extra $10 million in FX headwinds. That is worth 2.3-cents in EPS.

- **HBI is seeing areas of margin gain reverse as it has to support brands more.** We noted in our original report that the company's 70bp of margin gains since 2013 were driven by 161bp by cutting advertising, R&D and 401-k payments. Also, shipping and royalty costs are rising.

- **After a strong 1Q, HBI did not raise sales forecasts. Much of the growth seems to come from initial stocking. How many more stores are there to roll-out Champion?**

Guidance Is Unchanged Despite Ramping up Forecasts of FX Headwinds

EPS guidance for 2019 calls for HBI to earn $1.72-$1.80. That is the forecast based on 2% sales growth, 50bp gain in gross margin and 10bp gain in operating margin. After 4Q18, the company built in a headwind of $60 million on sales and $7 million headwind on operating profit from FX that was expected to heavily impact 1Q19. After 1Q19, the only part of guidance that changed was the FX headwind which is now expected to be $115 million for sales and $17 million for operating profit.

The $10 million in lost operating profit would be 2.3 cents in EPS using the expected 14% tax rate. With an 8-cent range on EPS guidance, a 2 cent change could happen and HBI remain in the same 8-cent range. However, it should move the forecast toward the lower end.

The company's view of this is outperformance in the 1Q offsets the bulk of the incremental $10 million in FX headwind. Barry Hytinen the CFO said, "In effect, this incremental FX headwind has been fully offset by the $9 million of outperformance in our first quarter operating profit."

We are not so certain this is the case. First, sales came in above guidance, but the operating profit margin fell from 11.3% to 10.7% (10.9% if you exclude the $4 million bad debt charge). The higher sales at the lower margin produced $4.1 million in higher operating profit. The company came in at $169.4 million in adjusted operating income which beat forecasts of $157-$167 million. So, the outperformance looks like 2.4 million, not $9 million.

Second, the company also talks about $4 million of bad debt expense in the quarter and adjusts for that, but that was an actual expense and given the credit quality of many retailers – we don't view that as a one-time event. It doesn't sound like HBI does either with this comment from the 10-Q, *"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."* We don't think investors should forget that bad debt expense was $29 million in 2018 and is normally over $20 million. Part of the margin improvement being forecasted by HBI involves that figure declining by 50%.

Third, HBI expected $7 million of FX headwind for 2019 with the bulk impacting 1Q19 – which came in at $5.9 million. It then raised this headwind to $17 million so they are not ahead of the game here already.

Fourth, 2019 guidance is calling for gross margin gains of 50bp. The first quarter came in +10bp. It is calling for 10bp of operating margin improvement for the year. After the first quarter and even adjusting for the $4 million bad debt charge, operating margin fell 40bp. So, they are in the hole on margins after 1Q.

Margins were actually helped by taking price increases against higher raw material costs. However, HBI uses FIFO accounting and routinely has 160-200 days of inventories. Cotton prices have been falling for much of 2018 and only rose for a month during 1Q19. They have since fallen rapidly in 2Q. We doubt they will have much success retaining pricing against falling cotton prices as they also battle with the strong dollar. Since inventory turns more slowly here – the brief rise in cotton prices could work their way through cost of goods sold against lower selling prices. We are actually concerned about the 50bp gross margin improvement prediction if 1Q only rose by 10bp.

Oil would be another key raw material for nylon. Prices for oil have been rising in 2019 and would justify some price hikes for HBI. The problem here is the slow inventory turns would have meant price hikes helping revenue and low-cost merchandise going through the income statement first and holding down cost of goods sold. As the year progresses, cost of goods sold for oil-derived raw materials should rise as revenues are flat. That could mean margin pressure going forward.

The fifth reason we aren't so certain guidance should be looked at as 1Q offset the higher FX headwind is the company didn't raise sales guidance. That was the whole reason 1Q looked better than forecast as it certainly didn't shine on margins. After the quarter, HBI held forecasts for sales flat at $6.885-$6.985 billion. Given that FX is expected to jump from a $60 million to a $115 million headwind now for sales, one could argue, they did boost sales guidance by $55 million. Let's grant that. $38 million was already realized in 1Q, so only half of that amount is now expected in the next three quarters. That still doesn't sound like much of an earnings driver to offset the increased headwinds.

HBI Is Seeing Higher Spending on Advertising and Brand Support

In our initial report on HBI, we noted that despite years of restructuring and digesting acquisitions, the company only improved margins by 100bp. That was overstated because 30bp came from moving pension expense out of the mix to a line item below operating income. So 70bp of margin was the gain after years of work.

Looking further, we saw that the company's biggest source of margin gains came from cutting Advertising, R&D, and 401-k contributions. These three items from 2013 to 2018 produced 161bp of higher margins with advertising being 125bp.

Our concern was that HBI would need to invest more in these areas and that would create headwinds on margin. That is already happening according the company:

From the 10-Q, *Activewear operating margin was 10.8%, representing a decrease from 11.1% in the prior year as a result of higher selling, general and administrative expenses, reflecting an increase in investments to support our brands and investments in distribution to maintain service levels and fulfill accelerating demand for Champion products.*

Guidance calls for $25 million in brand support for 2019 also – that's 36bp of margin headwind. We would not be surprised to see the company spend more than this. The company will argue the $25 million is built into their forecasts. But with the company assuming only 10bp of margin gain on a 2% increase in sales – those two items are only looking at a $35 million increase in operating profit. If the advertising needs to rise more, or R&D rises – it doesn't take much to chip away at the $35 million in expected growth.

Also, we noted in the first report, HBI is paying more in royalties to designers on products and more shipping for online sales. Those two areas have been rising as a percentage of sales and may be another 30bp ($21 million) of headwind this year:

$ 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

We Still Believe Much of Sales Growth is From Initial Stocking in the Channel

Initial stockings are real sales. But, the next year sales to the consumer need to grow or the shipments to retailers will be flat or down and HBI would report negative growth. It's more of an issue with how sustainable growth trends are. In the case of HBI, we're not seeing much evidence that 1Q sales growth was much more than one-time in nature:

Sales Growth	2Q19e	1Q19	4Q18	3Q18	2Q18
Innerwear	-2.0%	-3.1%	-0.1%	-6.9%	-3.4%
Activewear	11.0%	17.1%	13.5%	6.8%	6.9%
International	1.0%	13.4%	11.7%	11.3%	14.9%

The Innerwear division has been seeing retailers vanish and has been posting negative sales for some time. Activewear benefited from stocking products in new sporting goods stores and more directly to consumer channels. The Champion brand is expected to show strong results again in 2Q19 to offset mid-single digit declines in the rest of the portfolio. The International unit has talked about selling into new stores in Asia and Australia with Europe being negative. Guidance is now for a 1% quarter coming – much lower than recent periods.

This goes back to the basic issue we have with HBI, there just isn't much growth and much of it has come from inorganic ways such as acquisitions. We noted in the original report that since 2013, HBI has bought companies with $2.7 billion in sales. Yet, total sales are only up $2.2 billion since 2013.

Moreover, while Innerwear has been showing negative growth for years, Activewear was not seeing stellar growth until 2018 as more retail stores took their products. Forecasts already show the growth there is going down again. International was growing at over 30% in 2016 and 2017. The 13% growth of 1Q is going to be followed up with 1% in 2Q? How much have things really changed in a few months other than there may not be as many stores to stock?

The fact that the company didn't raise sales guidance after beating in 1Q was curious to us. When the company expects International to drop off in growth rate and is forecasting a decline in non-Champion activewear is another bad sign.

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