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Hanesbrands (HBI) – 2Q19 Update
Upgrade to NEUTRAL

We are boosting our EQ rating from 3- (Minor Concern) to 3+ (Minor Concern) but indicating some of our concerns have improved. We are also raising our recommendation on the stock from SELL to NEUTRAL with the stock down 30% from our initial SELL warning in February. We still have concerns that HBI has posted weak to negative sales growth adjusting for acquisitions and initial stocking. The weakness for Activewear should become more evident as the Target deal ends later this year too.

However, there is still very little expected of HBI. Sales growth before FX is expected to only be 3% in 2019 after posting 7.6% sales growth in the 1H19. FX is expected to be less of a headwind in 2H19 – only $35 million vs. $80 million in 1H. Adjusted operating profit growth and adjusted EPS growth are only supposed to come in at 2% and 3% higher y/y. In the 1H19, adjusted operating profit grew at 7.2% and EPS at 8.2%. These targets should not be tough to beat. Inventory trends may actually become a tailwind along with FX and the stock is only trading for just over 8x forecasted EPS. We recommend readers refer back to our EQ report from February 14, 2019 and fundamental report from February 21, 2019 for background information.

- We questioned the company's 4Q18 sudden 5-day drop in DSOs for receivables for its sustainability. The last two quarters have seen DSOs bounce back to normal and in fact, working capital was a sizeable consumer of cash in 1Q19.

- Inventories may be set up to help margins more going forward although a case can be made that inventory units are higher than the dollar terms truly reflect. Finished Goods inventory DSIs are rising over 10 days in 2019 so far.

- The company uses FIFO and is reporting that it is both taking price increases in recent quarters and suffering from higher raw material costs. We see no evidence of

the latter as cotton prices have been falling all year and actually since summer of 2018. Natural gas has been falling all of 2019 and is less than half the level of 2018 – which is a key input to chemicals and plastics. Oil rose from December to April but falling ever since.

- We are seeing declining raw material and work-in-process DSIs to reflect falling input costs. Finished goods DSIs are over 6-months but they are being replaced with ever lower-cost merchandise. If HBI is taking price hikes on the basis of increasing costs, we think they are likely to see some gross margin increases in 2H19. Eventually, we expect customers to push back on HBI pricing as they can see cotton prices too – but this may be an area where HBI outperforms forecasts in the near-term.

- The FX headwind also sets up as something that will have minimal impact on margins in the 2H19. In the 1H19, HBI had comps where FX was a positive for results in 2018 and negative on results in 2019. For the 2H, FX may actually be a slight positive on y/y comps based on guidance. Negative FX swings have offset the impacts of higher pricing against lower raw materials in 1H19. If FX becomes neutral – the price hikes may become more pronounced and surprise on the upside.

- The International Division is Slowing. Much of the growth had come from stocking more stores overseas, which we did not see as sustainable. Growth has dropped to low single-digits rapidly from double-digit rates. Guidance calls for slowing down.

- Activewear growth of new products going to retailers and online sales has been strong too. This division is expected to come in flat for 3Q and only 4% growth for 2019 after strong double-digit rates of late.

- We still think marketing and R&D will continue to rise and HBI has reported that it continues to invest more than guidance in these areas. Investors should remember that against poor sales growth, this is likely a headwind on margins. Moreover, as we noted before, about 150bp of margin gain at HBI has come from this area in recent years.

Receivables Back to Normal Levels

As noted in the February 14 EQ report, HBI enjoyed a surprise drop in DSOs for receivables in 4Q18. We could not find any rationale behind this except perhaps a bad-debt charge in the prior quarter helping about 0.7 days. Management attributed this drop in DSOs due to its increased focus on working capital to improve cash flow – but it certainly didn't last:

	2Q19	1Q19	4Q18	3Q18
Sales	$1,761	$1,588	$1,766	$1,849
A/R	$1,012	$933	$871	$1,045
y/y Sales G	2.7%	7.9%	7.5%	2.7%
y/y A/R G	3.9%	6.6%	-3.6%	3.5%
A/R DSOs	52.4	53.6	44.9	51.6

	2Q18	1Q18	4Q17	3Q17
Sales	$1,715	$1,472	$1,645	$1,799
A/R	$974	$875	$903	$1,009
y/y Sales G	4.2%	6.6%	4.4%	2.2%
y/y A/R G	4.1%	9.3%	7.9%	4.9%
A/R DSOs	51.8	54.2	50.1	51.2

The company has picked up cash flow from the securitization facility until it became a slight headwind in 2Q19:

	2Q18	**1Q18**	**2018**	**2017**	**2016**
Borrowed on Securitization	$16.9	$106.9	$213.3	$373.6	$238.1
Repaid on Securitization	-$26.5	-$68.6	-$176.9	-$293.0	-$388.7

The securitized A/R remain on the balance sheet, but HBI has been raising cash by taking advances on the receivables. We also know that the company does sell receivables in factoring deals, which do remove them from the balance sheet. However, there is minimal information given on outstanding balances and essentially none in the 10-Qs.

We also want to point out that there is some seasonality to working capital changes on cash flow – with early quarters being negative and later quarters being positive. However, HBI does not have much of a recent track record of pulling cash out of working capital like it hinted at for 4Q18. Please note that the positive figure for 2017 was due to the tax changes

and revaluing accounts. GAAP earnings in 2017 were $62 million rather than a normal $550 million. There were non-cash impacts added back to cash flow of $239 million for deferred income taxes and $179 million for accrued taxes. We would argue without the tax changes, working capital would have been a negative drag on cash flow in 2017 too:

	2Q19	2Q18	1Q19	1Q18	2018	2017	2016
W/C Impact	-$56.2	-$107.1	-$321.1	-$243.8	-$93.2	$165.0	-$103.6

Inventories DSIs are still Rising – Focused in Finished Goods

	2Q19	1Q19	4Q18	3Q18
Raw Materials DSI	9.0	11.2	9.2	10.8
Work in Process DSI	14.2	16.1	15.7	15.7
Finished Goods DSI	164.4	183.6	151.4	145.3
Total DSI	187.6	210.9	176.3	171.8

	2Q18	1Q18	4Q17	3Q17
Raw Materials DSI	11.9	13.8	11.6	10.6
Work in Process DSI	18.6	21.8	20.3	16.4
Finished Goods DSI	152.2	173.4	136.1	132.0
Total DSI	182.7	209.0	168.0	159.0

HBI uses FIFO accounting. Obviously, inventory does not turn that quickly – about 2x per year. At the same time, raw materials and work in-process have only been about 30 -31 days historically – yet it's now falling rapidly to 22-23 days. We do not think this is due to more efficiency and cash management. We think it is due to rapidly falling raw material costs:

These are cotton prices from Macrotrends.net. Cotton has been in a near freefall since the summer of 2018. During that time, inventory has likely turned over twice. With minor spikes of a couple of weeks during in the last year, Hanesbrands should be seeing ever-cheaper inventory entering raw materials, then work-in-process and finally finished goods. We are definitely seeing inventory levels drop in both the early forms of inventory. Raw materials are down y/y by 3 days, which is huge for what was an 11-12 day account. Work in process is down 4-6 days y/y, again that is huge for a 20-21 day account.

This is not just cotton going down, natural gas was $3 in the summer of 2018, spiked to $4.70 by November 2018 before falling continuously for 9 months to $2.00. Natural gas and NGLs make chemicals and plastics that HBI uses. All the expensive gas-related inventory is now gone and would have fallen throughout the 2Q19. Oil prices were $70 for the summer of 2018, fell to $46 in late 2018, rallied to $64 by April, and now are $55 – they are essentially lower for all of 2019 vs. 2018. These other commodities are down too. With rising DSIs on falling raw material costs, it could mean unit inventory is actually growing much faster.

Falling Raw Material Costs and FX Could Help Gross Margin in 3Q and 4Q

One of the reasons we are moving the rating on the stock from SELL to NEUTRAL is we expect a great deal of cheaper y/y inventory to be moving through the income statement for the rest of 2019. On top of that, the company has been touting that it has been taking price increases for several quarters as the future inventory costs were falling rapidly:

2Q19 commentary in 10-Q:

> *"Operating profit as a percentage of sales was 13.3%, an increase from prior year of approximately 50 basis points.* ***Increased operating profit from price increases taken in the first quarter of 2019 and higher margin product sales mix*** ***were partially offset by increased materials costs****, planned investments to support our brands and future growth initiatives as well as an unfavorable impact from foreign exchange rates. Included in operating profit in the second quarter of 2019 and 2018 were charges of $13 million and $25 million, respectively, related to acquisition, integration and other action-related costs."*

1Q19 commentary in the 10-Q:

> *"Operating profit as a percentage of sales was 9.3%, a decrease from prior year of approximately 60 basis points.* ***Improved sales mix and pricing taken in the first quarter of 2019 were offset by increased materials costs,*** *planned investments to support future growth initiatives, unfavorable impact from foreign exchange rates, higher variable compensation accruals and higher bad debt expense. Included in operating profit in the first quarter of 2019 and 2018 are charges of $21 million and $20 million, respectively, related to acquisition, integration and other action-related costs."*

Looking at the margins for the last three years we see the following:

Adj Gross Margin	4Q	3Q	2Q	1Q
2019	n/a	n/a	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	n/a	n/a	14.0%	10.7%
2018	14.7%	15.8%	14.3%	11.3%
2017	14.3%	15.0%	15.8%	11.6%
2016	15.9%	15.4%		

These margins are adjusted to add back acquisition/integration/restructuring charges. FX is not added back. They are already taking price hikes based on prior raw material prices. By this time, all the higher cotton prices of 2018 and early 2019 have been expensed. All the higher natural gas prices have been expensed. There should be some considerable gross margin built in if HBI can hold pricing for a while longer. So far offsetting the gross margin gains have been FX losses and higher marketing/support investments. We'll talk about FX next, but the company is giving guidance for $7 million in higher marketing for the 2H of 2019, which is roughly 20bp – we will call it 10bp each quarter. If the raw material prices are as low as we think, HBI may be able to pick up 50bp of gross margin. Take away the 10bp for marketing – and that still adds up to 1.7 cents of EPS per quarter.

The company is giving guidance that FX will be less of a drag in the 2H19 than the 1H19. Guidance for the year is $115 million negative hit for the year on sales. $45.5 million hit in 1Q19 and $34.1 million in 2Q19. However, those were very tough comps on FX – look at what is coming for sales based on forecast vs. last year:

FX on Sales	4Q	3Q	2Q	1Q
2019	-$15.0	-$20.0	-$34.1	-$45.5
2018	-$25.8	-$22.0	$15.5	$44.9

So, in 1Q19 – the negative swing from FX was $90 million, it was $50 million in 2Q19. For 3Q19, the impact is expected to be the same or a small improvement and for 4Q19, it is forecast as an improvement of $11 million. That should be a positive change for margins if forecasts are correct. HBI gave a constant currency adjustment for Gross Profit and Operating Profit in 2Q19 results too. In the 1Q19, gross profit margin was hurt by 35bp by FX and operating profit margin by 11bp. For 2Q19, gross profit margin was hurt 29bp by

FX and operating profit margin was impacted by 1bp. It appears that HBI should have some tailwind here on margin simply by not having FX be the same type of y/y penalty to overcome in the 2H19.

Just looking at this from the big picture – FX was hurting on gross margin by about 30bp in 1H19 and gross margin was flat. Going forward, FX should be flat the next two quarters and the higher prices vs. lower raw material prices should be a more pronounced positive. 10bp is worth 0.4 cents in EPS per quarter. So, if FX and pricing combine for 50-70bp of gain – HBI could pick up 2-2.8 cents per quarter the market isn't expecting. And expectations are very low already.

Why Not Make this a BUY? Basically – There Are Still Other Problems We Have Highlighted

We are going to again point out that HBI has not been very successful in generating organic sales growth. In fact, more than 100% of sales growth over the last several years has been acquired. Given the guidance for 3Q19 and full year 2019 for the key divisions, we believe that our concerns that HBI was enjoying some initial stocking for some new customers and that would play out shortly – is becoming evident:

Sales Growth/Unit	2019e	3Q19e	2Q19	1Q19	4Q18	3Q18	2Q18
Innerwear	-2.0%	-2.0%	-2.3%	-3.1%	-0.1%	-6.9%	-3.4%
Activewear	4.0%	0.0%	10.5%	17.1%	13.5%	6.8%	6.9%
International	6.0%	3.5%	4.2%	13.4%	11.7%	11.3%	14.9%
International pre-FX	10.0%	7.0%	10.5%	18.3%	8.5%	9.5%	5.0%

We can infer the 4Q forecast looking at quarters 1, 2, and HBI's guidance for 3Q. Innerwear has had easy comps and continues to be a laggard. That is still the largest part of HBI at 35% of sales. Activewear has hit the wall and is losing Target sales in the 2H. And the easy comps are over. After strong double-digit gains for three quarters, forecasts are for 0% in 3Q? Only up 4% for the year? It's 25% of sales. International was opening new stores and getting growth, but FX has been taking a toll. We also doubt that a strong dollar makes it possible to push through and hold price hikes overseas. It's also about 35% of sales.

Second, remember that DSIs for finished goods are increasing by 10 days y/y despite lower raw material prices. That is a sign that inventory in unit terms are rising at the same time HBI is guiding to slower sales. On top of that, the guidance for sales has price hikes in

place, meaning they need fewer units sold to hit targets. That could add-up to inventory overhang and lead to discounting.

Third, people buying from HBI can see what the raw materials prices are doing too. And they have their own customers to deal with on pricing. It may be possible for HBI to hold higher pricing for another quarter or two, but its buyers are likely to begin pushing for lower prices sooner than later in our view. Tariff issues may pull that issue forward too as retailers look to offset some import tariffs.

We have also highlighted several times that much of the past margin gains came from cutting marketing and R&D. Now, HBI is having to rebuild those investments and every call seems to indicate that it will be spending more. The 2Q19 was no exception. Those continue to be headwinds for margins too.

Plus, HBI is trying to sell more online direct to the consumer as well as focus on higher brand awareness items. That's all good news, but its shipping and royalty expenses are rising faster than sales in many cases. The company only provides this information in the 10-K so we will refer investors back to the February 21, 2019 report.

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