UA – Trading Call – Short

UA presents an even more attractive risk-adjusted short opportunity at $20 than it did one year ago at $50, offering 30-40% reward with 15-20% risk.

- This runs contrary what one would think from the fact pattern. The stock is 60% off highs, short interest is nearly 1/3rd of the float and sentiment is fairly washed out.
- However, peeling back the onion, the stock has actually become more expensive on a forward basis in the face of this decline (now at 42x NTM EPS/17x EBITDA) and the story is completely broken.
- The brand's equity has become structurally impaired over the past 12-18 months and the firm continues to ruin their relationships with legacy partners (particularly DKS at 10% of revenue).
- UA is struggling with both product segmentation and new product innovation and vendor de-stocking has ensued as a result given that UA's product fails to resonate with the consumer.
- Worst, management has exposed themselves as poor stewards of shareholder capital, wasting nearly $700m on unprofitable "Connected Fitness" acquisitions over the past three years. The firm's corporate governance is questionable (multiple share classes) and has been marked by a raft of staff departures, including UA's CFO who left earlier this year "for personal reasons" after just a year with the company.
- CEO Kevin Plank appears focused on empire-building and has become distracted with expensive side projects like whiskey distilleries and horse farms.

It is still early innings for the decline of UA. Top-line growth has masked a lot of ills over the years and UA's long-term growth algorithm has now been sliced in half, leaving the firm with a bloated cost structure that is unequipped for an industry in the midst of accelerating price wars.

There is substantial downside to both UA's earnings and multiple and the stock likely trades to $13 over the next 6-12 months, or 35% downside; this triangulates to ~30x model est EPS (.45 vs cons .54) or ~25x FY2 EPS estimate of .52 (cons: .60) which is appropriate for a mature brand. A multiple of 25x FY2 is more than generous given that LULU trades at 23x with 50%+ gross and 18% EBIT margins, a 1000+ bp operating margin premium to UA. Mature comps like NKE and Adidas both trade at 21x FY2.

Near-term setup: Short into the print. It is puzzling that bulls have conviction in a 2020 (at earliest) inflection for an apparel business with an iffy management team, questionable long-term strategic vision and no ability to forecast the direction of the business three months out - much less three years. UA management doesn't expect margin leverage until they surpass $10B in annual sales which is a 2021 event assuming everything goes right. Short interest, understandably, has crept up in the past 45 days or so and stands at ~30% of the float.

UA shares remain extremely volatile given short interest and utilization. Long-only growth managers have had trouble letting go of the stock, where apparently it screens cheap on an EV/Sales basis - a largely irrelevant metric for a company with slowing growth and deteriorating profitability that isn't earning its cost of capital. This is a poorly-positioned player in one of the most competitive sub-sectors within Consumer (apparel retail).

UA's 2H guidance was formed with the view that 2H17 will be less promotional than 2H16 and that gross margins will be up y/y in 4Q. The opposite has happened this year, with competitive pressure accelerating throughout the entire retail space. UA once again needs to rebase investor expectations lower.

Below: UA customer DKS (~10% of UA revenue) has an updated front page this week, featuring a new "Best Price Guarantee" along with prominent 50-60% discounts.

Developments and newsflow during the quarter:

Management's guidance implies y/y gross margin improvement in 4Q and a less promotional environment than last year. All data and newsflow indicates the opposite is taking place and that UA management is having continued problems with their vendor relationships and product segmentation.

ROST/TJX read-through: Freight costs have become a meaningful headwind to industry-wide operating margins, with off-price calling this out as a multi-year problem (tight labor market in freight has led to higher wages, which are summarily passed through to the customer). It is unlikely this was contemplated in UA's guidance.

In the face of these headwinds, UA needs to cut numbers again. Consensus gross margin forecasts - based off UA's guide - stand in stark contrast with both the realities of apparel retail today and with UA's recent trends in GM% + gross profit return on investment (GP$ / avg ending inventory).

Returns on capital have rolled over and hit single-digits for the first time in 1Q17 on a TTM basis. ROIC likely troughs in FY17 at 6-7% (well below UA's cost of capital) and settles in the high single digits as int'l becomes less of a drag on EBIT.

Below: North America revenue growth (constant-currency) since 1Q13. This comprises 80%+ of UA's revenue (declining as % of sales) and over 100% of operating income.

Given these trends and the fact that "turnarounds rarely turn" in apparel, it makes sense to press the short here. From a process vs. outcome perspective the failure rate in apparel is abnormally high and over time you should get paid shorting this combination of severe industry headwinds and ongoing management miscues. Note that UA is not in the "hyper-growth" phase anymore where it was beating and raising; re-accelerating revenue growth is extraordinarily difficult in this space, especially when competing against efficient and experienced operators like Nike and Adidas.

Variant View: Why is the $20 dollar bill on the ground, what are the structural inefficiencies, why does the opportunity exist?

Inefficiency #1: Price Anchoring / Loss Aversion:

- Too many bulls are anchored to the past, on multiple fronts. First, this was a $50 stock one year ago. Second, this was a stock that was doing 25% revenue growth a few years ago. It is a near certainty that neither of these characteristics will ever apply to UA again, yet the stock's valuation fails to discount this new reality.
- Thesis creep in terms of how bulls are now choosing to justify owning the stock. Some chosen methods include TAM via making assumptions on top-down international sales, relative market share vs NKE, or assuming some sort of "normalized market share" figure 5-10 years out. These are flimsy valuation methodologies for unprofitable internet startups, much less faddish apparel manufacturers.
- As of today, International still only comprises 7% of revenue and contributes negligible EBIT - this is not enough to offset severe headwinds domestically and so consolidated margins are likely to be pressured from mix-shift going forward. UA may have success internationally at some point – but the current enterprise is valued 30%+ too high relative to the discounted value of UA’s international cash flow generation.

Barclays (buy-rated) throws out a hypothetical 15% EBIT margin at maturity.

It is unclear when bulls expect UA to get to these margins. Even on consensus Bloomberg estimates - which imply a nearly 400 bp ramp from 2020 into 2021 - UA is only at 10.8%.

Below: a recent Baird note lays out the assumptions a bull must make in order for the stock to have 30% upside.

This implies UA will be able to grow revenue at a ~15% CAGR off a $10B+ revenue base. Mauboussin/Credit Suisse offers a "Book of Base Rates" which has tracked sales growth for the constituents of the S&P 1500 for the past 65 years and is a helpful "gut check" on these types of growth assumptions. Based on this data set and definition of "mid-teens growth" during the 2020-2025 period, UA has somewhere between a 4% and 9.5% chance of success:

Next, a look at Jefferies’ valuation methodology given that they are the street high with a $28 price target. This is supported by a DCF with some equally wonky assumptions, including a

WACC of 8% (BBG est for NKE is 9.4%) and that UA is able to expand globally with minimal incremental working capital needs (legitimately zero working capital required beyond 2025):

These FCFs thru 2026 sum up to $2.6B, or about $1.3B when discounted back at their chosen WACC of 8%. A $30 target implies about $14B of enterprise value - so that leaves 90%+ of UA's value tied up in terminal.

Not surprisingly, to triangulate the price target they want means putting 12.5x on UA's terminal EBITDA. This implies UA can grow FCF at a mid-single digit clip in perpetuity (well in excess of global GDP growth) along with generating 125-150% returns on incremental invested capital. For the record, no company on earth has ever been able to do this.

No matter how much the model's DCF is adjusted, it is hard to triangulate any reasonable timeframe where UA hits 15% EBIT margins "at maturity" that discount back to a $20 stock.

Inefficiency #2: Confirmation bias driven by "cult" mentality

Tying into the previous "Pocket of Inefficiency," this is a stock which has made people a lot of money this cycle and is led by a charismatic CEO with a cult following. This leads to confirmation bias as bulls ignore bad news and refuse to accept that their thesis has broken, or accept that fundamentals may never reach prior peak. This is why UA is offered to us at this elevated valuation rather than at fair value 30%+ lower.

Inefficiency #3: Operating Leverage / De-Leverage:

Over time, it has been shown that the street - and many buyside investors - have no idea how incremental or decremental margins affect retail businesses, which inherently have heavy fixed costs.

Often the street hardcodes in gross or EBIT margins rather than performing thoughtful analysis on unit economics or how UA's operating profit will be disproportionately affected by a 50% deceleration in revenue growth. UA's cost structure was designed for a business growing revenue at 25%, not at 11-12% (FY17 guide).

The street is mismodeling UA's decrementals and that margins compress faster than expected.

Longer-term headwinds facing the business + strategic management missteps:

UA management has continued to "shoot itself in the foot" in the face of severe industry headwinds and the ongoing collapse of their relationship with DKS marks a pivotal negative inflection point for the story.

• The loss of Sports Authority, Sports Chalet and other bankrupt dealers has affected UA's business; lower selling square footage is a headwind in general and liquidations en masse have pressured gross margins and brand perception.

• Great management teams are not determined by their initial plans, but how they react in the face of adversity. To say UA has reacted poorly is an understatement.

• In order to make up the lost sales from sporting goods retailers, UA hastily began opening up distribution to Famous Footwear, DSW, Shoe Carnival, Rack Room and other family retail channels. This is a short-term fix to "plug the revenue gap" and may help current year results but as the expense of long-term brand health.

• It is hard to see how selling into the family channel enhances this "lifestyle" brand and is a high-risk, low-reward move by management. It appears UA has completely given up on cultivating the "coolness" that made Under Armour great in the first place.

• Reports indicate that Foot Locker and Finish Line have begun to give UA less shelf space - not only to avoid being associated with low-end and highly promotional distribution channels including KSS, but also because UA has been unable to launch any new innovative product that truly resonates with the consumer. Other existing wholesale partners such as Hibbett (a top 10 account) and Modell's will likely follow suit and reduce the size of their UAA business after sharply discounting their current product offering to levels seen at Kohl's and elsewhere. Over the years these firms have conducted their sales at full price for the most part and this balance has been ruined.

• Multiple reports suggest Nike has relaxed its policy on MAP (Minimum Advertised Price) throughout apparel. Previously, retailers were only allowed to offer 25% at certain times throughout the year. This rule has been eliminated and now this discounting can be practiced year-round. Nike is clearly willing to sacrifice points of gross margin to regain market share; likely at UA's expense and the timing of this may be because NKE recognizes UA is in a weakened state.

UA's lack of product segmentation has made itself apparent in the face of declining revenue and is straining their distribution relationships:

• The sudden revenue deceleration has indirectly exposed UA's lack of product segmentation, which feeds upon itself in the way they've treated their legacy distribution partners.

• UA's brand and pricing power suffer when UA offers the same high-end product everywhere, whether it be their own website (underarmour.com), through DKS/FL, or through new channels like Famous Footwear.

• This is a misstep that is nearly impossible to undo unless UA is willing to pull back on distribution and attempt to restore the exclusivity of the brand; this is the opposite of the path UA is heading down.

• This lack of segmentation not only hurts UA, but their legacy partners. Canaccord ran a store check on KSS vs. DKS and discovered that ~50% of the product available at Kohl's was also available at DKS, and that KSS product was available at discounted prices (as much as 25% on identical items!):

DKS and other legacy accounts will not tolerate this level of overlap with retailers like Kohl's, and unsurprisingly, DKS is finally taking action.

Below: UA's lack of differentiation on premium offering has eroded the brand's pricing power, potentially for good. Product segmentation is extremely difficult in general, which is understandable - NKE tends to lead by example here and would not offer a premium Foot Locker exclusive at any other retailer. UA has been unable to quickly construct a comparable offering that attacks all price points.

Model vs Street: The variant view is tied more to margins than revenue. Between aggressive promotional activity, slight revenue downside vs consensus, and the need for accelerated investment in the international segment, numbers for UA need to come down substantially for FY1 and FY2. I believe these negative revisions take place over the next two quarters, leading to UA trading to the low-teens.