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Fitbit Inc. (FIT): Hold @ $6.50

<u>Hold Thesis:</u> We are upgrading Fitbit to a Hold with a PT of $6.50. We believe our previous Short Thesis has been fully played out and the stock is currently trading at fair value (≈$6.00-6.50) with all the negative news and sentiment already priced into it. 4Q16 was a Brutal Quarter for FIT and management is looking to 2017 as a Transition Period where it hopes to stabilize top-line growth while it executes a turnaround plan. We believe Management has to overcome Two Major challenges if it wants to re-accelerate top-line growth in the short term: 1) how to grow User Retention and 2) how to Navigate a Saturated Market, especially in the U.S., where the market for basic tracker devices has already been fully penetrated. Fitbit is still the dominant player in the U.S. Device Tracker market with an 81% revenue share of the market. While still in the early innings of the turnaround plan, we remain optimistic that some positive results can be shown in 2H17.

TABLE 1: Fitbit 4Q16 Pre-Announcement (Jan. 30, 2017)

4Q16 Results (est.)			FY 2017 Guidance			4Q16 Results (est.)			FY 2017 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
(0.56)-(0.51)	0.17	miss	(0.44)-(0.22)	0.64	miss	572-580M	738.2M	miss	1.5-1.7B	2.39B	miss
Previous guidance: 0.14-0.18						Previous guidance: 725-750M					

Source: Fitbit Inc.

TABLE 2: Fitbit 4Q16 Results

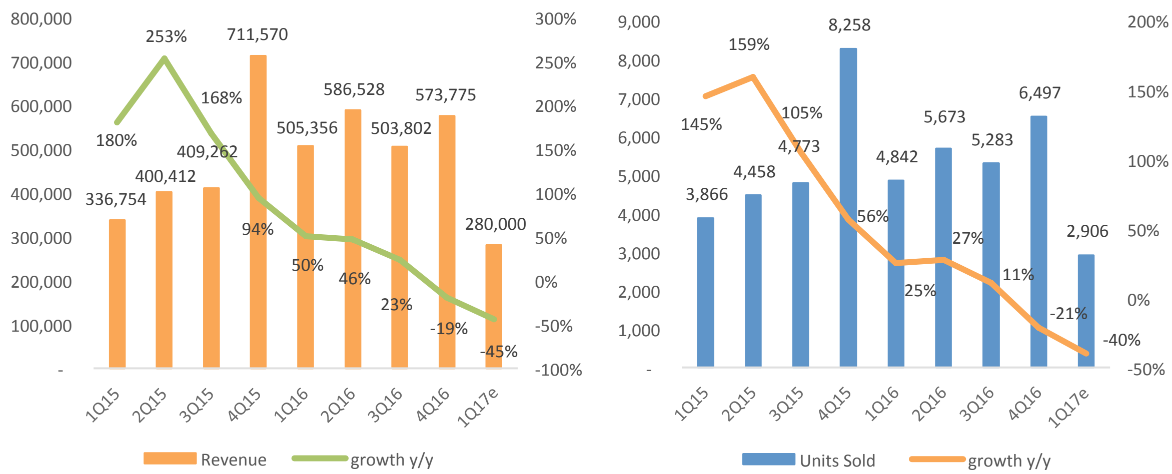
4Q16 Results			1Q17 Guidance			4Q16 Results			1Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
-0.56	-0.48	miss	(0.18)-(0.20)	-0.15	miss	573.78M	575.83M	miss	270-290M	303.14M	miss

Source: Fitbit Inc. and Estimize.com

I. <u>4Q16 Results were Terrible</u>

Revenue growth hit a peak inflection point in 2Q15 with a 253% y/y growth rate and descending quickly to a negative 19% y/y growth in 4Q16 (see Figure 1 left). After growing an average of 16.8% y/y in 2016, management guided 2017 revenue growth to a range of minus 31% y/y to minus 22% y/y. Fitbit also guided 1Q17 revenue to a mid-point of 280M or down 45% y/y from the same period last year.

FIGURE 1: Revenue ($ Thousand) Y/Y Growth (%) left chart and Units Sold (Thousand) Y/Y Growth (%) right chart



Source: Fitbit Inc. and Viola Advisory LLC estimates for 1Q17 Units sold

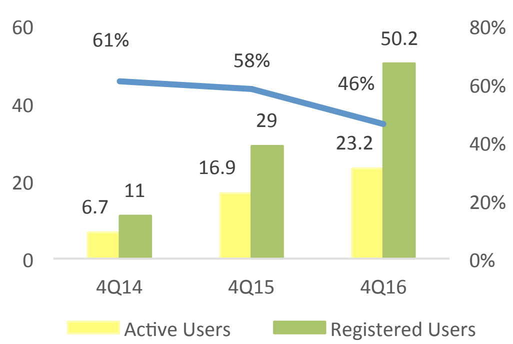
Units sold also took a big hit in 4Q16 with roughly 6.5M units shipped (down 21% y/y) from ~8.3M units (up 56% y/y) in 4Q15 (see Figure 1 right). Management pointed to a saturated U.S. market particularly among the early adopter market segment where Fitbit's market penetration of around 19% is probably the peak point. In addition, basic device trackers seemed to be out of favor this past holiday season as consumers increasingly preferred GPS-enabled smartwatches with fitness device features and apps.

Management considers the revenue slowdown as temporary and is looking to 2017 as a transition period where it hopes to implement a turnaround plan to revive top-line growth. We next identify the two major challenges facing Fitbit in the short term, which management has to overcome if it wants to meet its goal of re-accelerating top-line growth.

II. Two Challenges Facing Fitbit in the Short Term

A. Fitbit Needs to Grow User Retention

FIGURE 2: Active User Decline (% of Total Registered Users)



Source: Fitbit Inc.

Despite the increase in registered users (up 73% y/y) and active users (up 37% y/y) in 2016, the ratio of active users to registered users has been on a steady decline since 4Q14 (see Figure 2). In 4Q15, the ratio of active to registered users stood at 58%, down from 61% in 4Q14. By 4Q16, the ratio of active to registered users fell to 46%, indicating that only 46 out of 100 users who own a Fitbit device are currently using them. Presumably, the remaining 54 registered owners have lost interest and are no longer using the device.

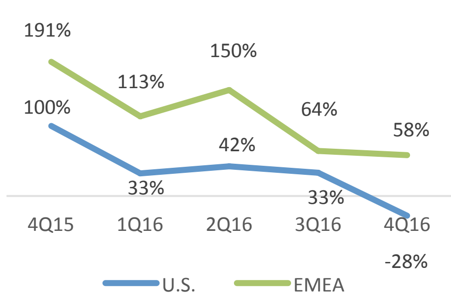
The downward trend in user engagement is problematic because it shows that Fitbit devices are not "must-have" devices, but rather just part of a short-term fad. To increase relevancy, management plans on investing more heavily in software and services – adding more coaching and guidance features in the app that will enable users to better regulate their training activities in order to meet their fitness goals.

To this end, Fitbit re-launched *Fitstar* at the Consumer Electronic Show last January. The app saw over 1.2M downloads, moving from No. 50 to No. 9 on the Top apps rankings by revenue. Management also indicated that it plans to streamline Fitbit's Tracker portfolio in order to make it simpler for users to understand which device to use for their specific fitness goals. By doing so, the company hopes that it can re-invigorate the tracker device market and grow user retention.

B. Market Saturation for Fitness Device Trackers

The slowdown in sales growth in the U.S. and EMEA, particularly in the U.S. for 4Q16, points to a saturated U.S. market. The U.S. comprises two-thirds (around 66%) of total sales while EMEA almost make up one-quarter (23%) of total sales. Together, they both make up almost 90% of Fitbit sales in 4Q16. The Americas (ex-U.S.) region make up about 6% of total sales while APAC (mostly Australia) make up around 4% of total sales. Figure 3 shows the sales growth of the U.S. and EMEA since 4Q15.

FIGURE 3: Sales Growth (Y/Y %): U.S. and EMEA



Source: Fitbit Inc.

While sales in the U.S. came down from triple-digit growth rate in 2015, it was stable for the most part during the first three quarters of 2016 where it grew by an average of 36% y/y. However, in 4Q16, sales were down by negative 28% y/y (see Figure 3). The EMEA market did comparably better than the U.S. During the first three quarters of 2016, EMEA grew by an average of 109% y/y dropping slightly to 58% y/y growth in 4Q16. We believe the EMEA market has not yet reached a saturation point, however, there is a risk that it could hit saturation maybe later in 2017.

Fitbit believes that the early adopter market in the U.S. has become fully saturated, but the latent majority adopter segment of the fitness device tracker market still remains untapped. The company estimates that this market segment in the U.S. is around 40M to 80M users. In order to reach that market, Fitbit is planning on installing a more sophisticated coaching and guidance app on their upcoming trackers and streamline their tracker portfolio to make it easier for users to decide which tracker best fits their fitness goals.

The company is also planning on increasing their new product release to a Spring-Fall cadence, in order to keep the product line refreshed. In addition, management is also planning on expanding their product portfolio to include GPS-enabled smartwatches. By doing so, the company hopes to double their addressable market in the U.S.

<u>There still remains a lot of uncertainty to Fitbit's turnaround strategy, in particular execution risk.</u> However, the acquisition of certain software IP assets last year from *Pebble*, *Vector Watch* and *Coin* gives Fitbit the software expertise to build a developer platform where it could eventually support a full ecosystem of products that would keep its growing user base engaged as well as induce them to upgrade to newer product releases.

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