VIOLA ADVISORY

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Under Armour, Inc. (UAA): Hold @ $22.00

Hold Thesis: We are downgrading Under Armour from a Buy to Hold and reducing our Price Target from $40 to $22. We believe the Shift in Consumer Preference in North America (~80% of Total Sales) from Performance to Casual Athletic caught UA by surprise taking down trailing 4-quarter average top-line growth of ~28% y/y to ~12% y/y in 4Q16. Management attributed the decline in top-line growth to supply chain disruption coming from the bankruptcies of *The Sports Authority* and *Sports Chalet* in 4Q16. We believe the negative effects of supply chain dislocation will be mitigated by the end of 1Q17. More uncertain however, is how long management will take to transition from Performance-centric to a more Lifestyle/Fashion-oriented Apparel/Footwear company. We believe the biggest near-term risk will be in Apparel (roughly 70% of total revenue) as the Apparel category suffered the biggest sequential decline (down almost 60% y/y) in 4Q16. Furthermore, the trends in Apparel are fluid and the space is subject to intense competition among well-known athleisure brands like Lululemon and Nike, which are constantly innovating and refreshing their product pipeline.

TABLE 1: Under Armour 4Q16 Results

4Q16 Results			1Q17 Guidance			4Q16 Results			1Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
0.23	0.25	miss	n/a	0.04	n/a	1.31B	1.41B	miss	n/a	1.29B	n/a

Source: Under Armour, Inc. and Estimize.com

4Q16 Highlights

- 4Q16 revenue up 12% to $1.3B, driven by a 5% increase in Wholesale revenue to $742M and a 23% increase in Direct-to-consumer revenue to $518M
- North American revenue grew 6%
- International revenue, which represented 16% of total revenue in the quarter, was up 55% (up 60% currency neutral) driven by significant growth in the U.K., Germany, China and Australia
- Apparel revenue increased 7% to $929M including strength in golf and basketball
- Footwear revenue increased 36% to $228M driven by accelerated growth in running and basketball
- Accessories revenue increased 7% to $104M with strength in bags and headwear
- Gross margin at 44.8% vs. 48% in the prior year's period, as benefits from more favorable product costs were offset by aggressive efforts to manage inventory, changes in foreign currency and the outperformance of footwear and International businesses in the overall mix, which carry lower margins than the apparel and North American businesses
- SG&A expense grew 9% to $420M, or 32.1% of sales (down 70 bps), due to continued investments in the company's highest growth businesses: Footwear, International and Direct-to-consumer

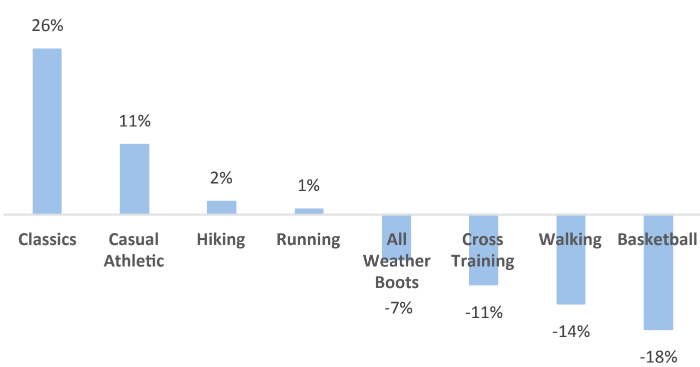
- Operating income declined 6% to $167M
- Net income decreased 1% to $105M and diluted EPS of 23 cents vs. 24 cents a year ago
- Cash and cash equivalents increased 93% to $250M
- Inventory increased 17% to $917M
- Total debt increased 22% to $817M
- CFO, Chip Molloy, decided to leave the company due to personal reasons; effective February 3, David Bergman, Senior Vice President, Corporate Finance, will serve as acting CFO; Mr. Molloy will remain with the company in an advisory capacity to assist with the transition

I. U.S. Consumer Preference Shifts from Performance to Casual Athletic

The NPD Group reported that the U.S. athletic footwear industry grew by 3% in 2016, generating $17.5B. Unit sales also grew by 3% and average selling price remained flat at $60.81. The industry grew in each of the first three quarters of 2016, slowing down slightly in 4Q16. Moreover, during the 4Q holiday season, slower traffic caused significant promotional activities earlier, deeper and broader than expected by the retail sector.

Furthermore, the bankruptcies of *The Sports Authority* and *Sport Chalet* caused disruptions in the supply chain with the greatest impact occurring during 4Q16 when both retailers were shutting down. *The NPD Group* projects that the supply chain dislocation will likely continue through 1Q17, but after that the drag should be over and the trend should return to normal.

FIGURE 1: U.S. Athletic Footwear Growth by Category



Source: NPD Group Retail Tracking Service

In terms of category performance, the Classics category drove the industry, with sales increasing by 26% in 2016 (see Figure 1). *NPD* data shows the category growing sales by $1.7B over the past three years as trends shifted away from performance-driven categories to more retro styles. For example, the *Inspired by Running* class within Classics experienced a 36% increase in 2016, while sales of performance running footwear remained flat for the year.

Also, *Inspired by Basketball* sales grew by 27% as performance basketball footwear sales were down 18%, for the first time in recent years. The Casual Athletic category also benefited from the strong Classics trend, as sales were up 11% in 2016 after two years of decline.

NPD believes that the Retro category will remain the dominant fashion trend in the near-term, but success will not be easy as competition will intensify and brands must constantly update their styles. Moreover, to further distinguish themselves and stay ahead of the competition, brands should focus their innovation on the manufacturing side, emphasizing speed and sustainability, as this impact will be long-lasting, regardless of where the fashion trends move the market.

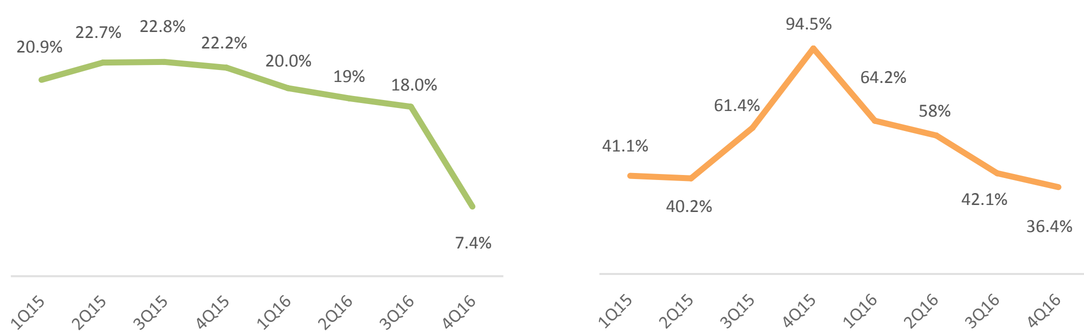
II. UA Strength in Performance Category; Hurt by Shift to Casual Athletic

1. Apparel and Footwear Growth Surprises to the Downside

We consider Apparel the biggest risk to UA since it comprises roughly 70% of total revenue. Slight changes in Apparel performance can have a major effect on UA's top-line growth. Moreover, the Athleisure space is extremely competitive in North America. Therefore, management must be aware of the constant shifts in consumer fashion trends in the space.

We believe the 4Q16 shift from performance athletic to casual athletic may have caught UA management by surprise. Apparel revenue growth in 4Q16 surprised to the downside, dropping from a trailing 4-quarter average (4Q15 to 3Q16) of ~20% y/y to 7.4% y/y growth in 4Q16 (see Figure 2 left). During the 4Q16 call, management admitted that they needed to become "more fashionable" and that higher demand for more lifestyle silhouettes caused the company to be out of balance with their product assortment.

FIGURE 2: UA Revenue Growth: Apparel (left) and Footwear (right)



Source: Under Armour, Inc.

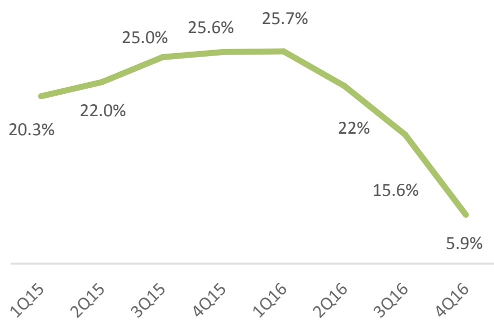
Footwear comprises about 20% of UA's total revenue. At this point, we do not believe that UA has any differentiable advantage in athletic footwear. Furthermore, the company was overly reliant on just one model, the *Curry 3* to drive the basketball performance category. The *Curry 3* launch last quarter underperforming expectations along with the shift to casual athletic, hurt footwear revenue growth.

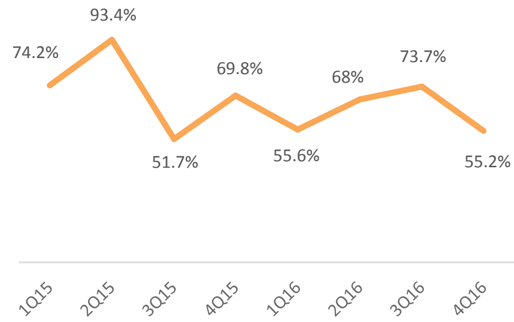
Prior to 4Q16, footwear sales grew at a trailing 4-quarter average of roughly 65% y/y before dropping to around 36.4 y/y last quarter (see Figure 2 right). It is currently difficult to predict how UA will transition their footwear category to casual athletic. Retro is the biggest growth category right now in footwear and unlike Adidas and Puma, UA has no pedigree in the Retro category.

2. North America Growth at a Standstill, but International Still has a Lot of Runway Left

Under Armour's growth in North America came to a standstill in 4Q16. After seeing growth at a 4-quarter trailing average of ~22% y/y, N.A. growth came to ~6% y/y last quarter (see Figure 3 left). However, there is still plenty of runway left for sales growth in international markets. Sales in international markets grew at a trailing 4-quarter average of approximately 67% y/y, falling to ~55.2% y/y in 4Q16 (see Figure 3 right).

FIGURE 3: Revenue Growth: North America (left) and International (right)

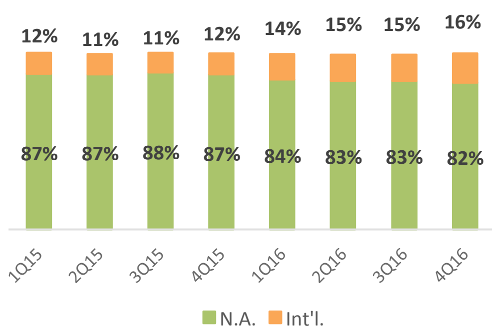




Source: Under Armour, Inc.

While sales in North America comprises ~80% of total revenue, the share of international revenue is ~15% and remains significantly under represented (see Figure 4). Management hopes to grow international revenue to ~20% of total revenue in 5 years. UA's entry in the international markets started last year when it successfully introduced the *Curry 2* basketball sneaker in China.

FIGURE 4: North America vs. International Share of Total Revenue



Source: Under Armour, Inc.

We believe there is still plenty of room left for UA to grow revenue abroad as market penetration in China and APAC still remains significantly below that of Nike, which entered the Asian markets several years before Under Armour. Furthermore, in the recent earnings call, management also called out Brazil as one of their target market in Latin America.

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