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Fitbit Inc. (FIT): Short @ $12.00

<u>Short Thesis:</u> We are Maintaining our Short Thesis on Fitbit amid growing signs that Consumer Fatigue with Mobile Devices may also Translate to Fitness Trackers and Wearable Devices. Moreover, leaked images of Fitbit's new products only show Modest upgrades to Current Models. Besides the Issues with Product Quality, we also believe Fitbit has very limited upside, due to negative perception of being a one product hardware company swimming in a sea of competition. At any time, a competitor could come out with the latest and greatest gadget. Fitbit must always innovate in order to stay ahead, and even that will Not Guarantee future success in such a highly competitive and constantly evolving market. <u>We believe Fitbit's Long-term Potential lies in being an Attractive Take-over Candidate for a Large-cap Sportswear Apparel/Shoe Company like Nike (NKE) or Under Armour (UA).</u>

TABLE 1: Fitbit 2Q16 Results

2Q16 Results			3Q16 Guidance			2Q16 Results			3Q16 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
0.12	0.11	beat	0.17-0.19	0.19	miss	586.5M	580.2M	beat	490-510M	499.7M	in-line

Source: Fitbit Inc. and Estimize.com

Fitbit reported 2Q16 earnings with sales of $586.5M handily beating consensus estimate of $580.2M and EPS of 12 cents came in slightly ahead of the consensus estimate of 11 cents. The company guided 3Q revenue at $490-510M with a midpoint of $500M projecting y/y revenue growth of 22% but a sequential decline of ~15%. Next-quarter EPS guidance of 18 cents (midpoint) also missed analysts' estimate by 1 cent (see Table 1).

Besides the new product announcement, the interesting part of the call came when CEO James Park made a pledge that he along with Eric Friedman (Co-Founder/CTO) and Bill Zerella (CFO) would not sell any of their stock holdings from now until the rest of the year. We believe management was sensing some investor wariness heading into 2H16 and made the pledge in order to shore up some confidence ("We're all in this together"). Management left open the possibility of not selling any of its stock holdings heading into the next year.

<u>2Q16 Highlights</u>

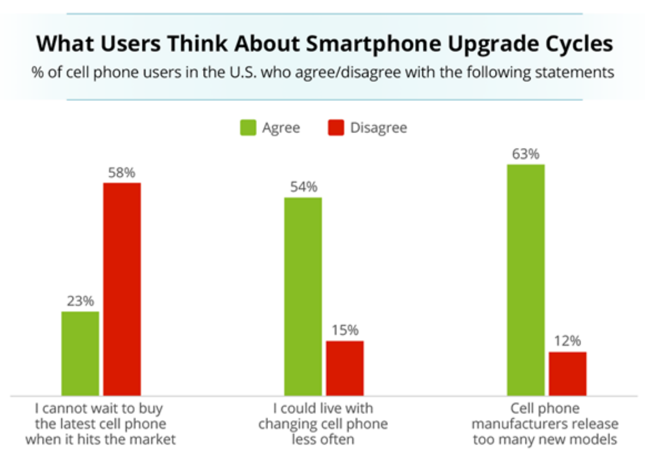
- Sold 5.7M devices
- 2Q16 revenue increased 46% y/y
- U.S. comprised 76% of 2Q revenue; EMEA 17%, APAC 2% and Other Americas 5%
- U.S. revenue grew 42% y/y; EMEA 150%, APAC (-54%) and Other Americas 63%

- APAC impacted by factors including the progressive shut down of retailer Dick Smith in Australia and a reduction of channel inventory; excluding the Australia impact, APAC revenue increased 98% y/y
- New products *Blaze* and *Alta,* including related accessories, comprised 54% of 2Q16 revenue compared to 50% in 1Q16
- Gross margin was affected by an increase in warranty reserves for legacy products, with an expectation the additional reserves taken will adequately cover future warranty liability, allowing gross margin to return to more normalized levels beginning in 3Q16
- 120% GAAP and 90% non-GAAP y/y increase in operating expense reflects increased investments in R&D and marketing to drive innovation and growth
- 2Q16 activations of *Alta* and *Blaze* – around two thirds were by new customers and the other third were by people who own, or previously owned another Fitbit device; similar to last quarter, about one fifth of repeat purchasers were reactivations, having been inactive for 90 days or more
- Launched Chinese, Japanese and Korean language versions of products into their respective markets; also launched a relationship with Alibaba's TMall platform, generating 100M consumer impressions and ~1.3M unique visitors to TMall
- R&D headcount grew to 863 in 2Q16, comprising 59% of total headcount

I. Consumer Fatigue with Mobile Devices May Translate to Fitness Trackers/Wearable Devices

A survey conducted by *Greenpeace* suggests that most phone users in the U.S. are a bit fatigued with how frequently manufacturers upgrade their handsets. For instance, more than half of survey respondents say they could live with changing phones less often (see Figure 1).

FIGURE 1: Consumers are Not So Excited About New Mobile Device Product Releases



Source: Greenpeace and Statista

We are concerned that growing signs of consumer fatigue with electronic devices could translate to a lukewarm reception for Fitbit's upcoming product cycle refresh sometime in 2H16 (both in the Fall and in the Holiday season).

For instance, 58% of survey respondents are not eager to buy the latest smartphone when it hits the market. Moreover, 63% of those surveyed responded that device manufacturers tend to release too many new models.

This supports the growing belief that product refresh cycles will lengthen from two years to three years. This is not good news for device makers like Fitbit, who rely on new product releases to drive consistent growth to their top-line.

II. Simple Upgrades Lacking Innovation

Two images of Fitbit's upcoming new products, the *Charge 2* and the *Flex 2* were leaked on a website published by *TechnoBuffalo.* According to the leak, *Charge 2* is an upgrade to *Charge.* It will feature the new "PurePulse" heart-rate tracking technology and support all-day sleep and activity tracking, multi-sport tracking, and interchangeable bands. It will also have a screen larger than that of the current model (see Figure 2, left). *Flex 2,* the successor to the original *Flex,* will be "swim proof" and will also support all-day sleep and activity tracking. However, unlike the *Charge 2,* it will not have a large screen (see Figure 2, right).

FIGURE 2: *Charge 2* (left) and *Flex 2* (right)

Source: TechnoBuffalo, 8/16/16

The leaked images did not seem to create any excitement among investors. To some market watchers, the new products lacked innovation and appear to be moderate upgrades of current models.

Given that the new product design is more evolutionary, and not revolutionary, there is a risk going into 2H16 that existing Fitbit users may be less inclined to upgrade.

III. Issues with Product Quality

Fitbit has had issues with product quality in the past that have materially impacted its results. In 2Q16, warranty claims caused Fitbit to add $50M to its warranty reserves ending the quarter with around $77M in warranty reserves. In addition, users have also reported skin irritation and have even sued the company on such grounds. Fitbit told the Consumer Product Safety Commission that it had heard of 9,900 cases of irritation caused by allergic contact dermatitis.

Fitbit acknowledged that users have reported skin irritation from its *Charge, Charge HR* and *Surge* devices. While the company has so far survived these instances, the risk of product defects and warranty claims keep investors wary and presents an overhang on Fitbit's share price.

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Analyst Certification

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