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# Fitbit Inc. (FIT): Short @ $6.00

**Short Thesis: Fitbit needs to innovate with device features not already found in smartphones. Step counters and heart rate monitors – two of Fitbit's basic features – are already in most Android and Apple smartphones. The lack of compelling features stops consumers from purchasing Fitbit devices. Moreover, the commoditization of mobile devices limits Fitbit's ability to maintain premium pricing and exposes them to lower-cost competitors in Asia. We believe this is the reason for the current headwinds in APAC. Fitbit expects to have a cash balance of ~$900M-950M by the end of 1Q17 giving them a $3.70-3.90 cash per share value. We believe this forms a solid support for the stock price. We believe consumer demand for wearable devices will continue to be weak over the holiday season. There is also a lack of visibility as to when demand will recover. Ultimately, we view Fitbit's Long-term Value as an Attractive Take-out for a Large-cap Sportswear Apparel/Shoe Company like Adidas (ADDYY) or Under Armour (UA).**

**TABLE 1: Fitbit 3Q16 Results**

| 3Q16 Results | | | 4Q16 Guidance | | | 3Q16 Results | | | 4Q16 Guidance | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| EPS | Cons. | Result | EPS | Cons. | Result | Total Rev. | Cons. | Result | Total Rev. | Cons. | Result |
| 0.19 | 0.19 | in-line | 0.14-0.18 | 0.22 | miss | 503.8M | 504.34M | miss | 725-750M | 738.7M | miss |

Source: Fitbit Inc. and Estimize.com

Fitbit disappointed investors with its 3Q16 earnings report with revenue of $503.8M missing consensus forecast of $504.3M and EPS of 19 cents in-line with estimates. Both 4Q16 revenue (at the mid-point) and EPS guidance also came in below expectations (see Table 1). Fitbit shares were down 31% after the company gave 4Q16 guidance and several analysts downgraded the stock.

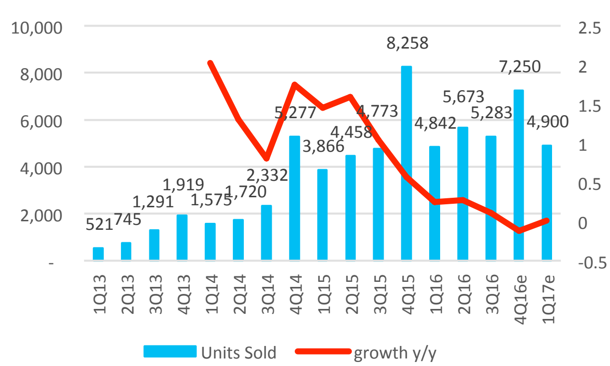
**3Q16 Highlights**

- Revenue increased 23% y/y to $504M
- U.S. comprised 72% of Q316 revenue; EMEA 16%, APAC 7%, and Other Americas 5%
- U.S. revenue grew 33% y/y; EMEA 64%, APAC (45)%, and Other Americas 7%
- GAAP net income of $26M, non-GAAP net income of $46M
- GAAP diluted net EPS of 11 cents, non-GAAP EPS of 19 cents
- Adjusted EBITDA of $81M
- New products – *Blaze TM, Alta TM, Charge 2 TM, Flex 2 TM* and related accessories – comprised 79% of 3Q16 revenue, compared to 54% in 2Q16
- GAAP and non-GAAP gross margin flat y/y at 48% and up 600 basis points sequentially; higher estimated warranty claims for legacy products offset by lower costs on certain replacement units
- GAAP operating expenses increased by 52% and non-GAAP operating expenses increased by 46% primarily driven by 93% increase in GAAP and 91% increase in non-GAAP R&D spend

- Sales & Marketing costs remain the largest expense line item up 23%
- Expense in R&D and Sales & Marketing was to bolster innovation and growth: The bulk of the expense came from headcount, R&D headcount up 105% y/y, represented ~60% of the workforce
- 11% growth in unit sales, 11% rise in average selling price
- 60% of the activations in the quarter came from new customers buying new products, 40% from customers who made repeat purchases of new products; of the repeat customers, ~20% were reactivations (customers who were inactive for 90 days or greater)
- Corporate wellness: Expanded reach by signing partnership with Virgin Pulse, one of the leading corporate wellness technology companies; added new customers including Pitney Bowes and Dr. Pepper/Snapple Group
- Substantially completed the global installation of new display materials in many retail locations
- Introduced two new products, *Charge 2* and *Flex 2,* and associated accessories; introduced a new accessories partnership with Simply Vera Wang for Kohl's
- Introduced *Blaze* and *Alta* gold series and new accessories for each device
- Launched new software feature *Adventures,* giving a virtual, personal challenge experience to users
- FY16: Expects revenue between $2.320-2.345B, representing growth of 25-26%, with non-GAAP diluted EPS in the range of 55 to 59 cents, and a non-GAAP tax rate of ~34%
- 4Q16: Expects revenue between $725-750M, representing growth of 2-5%, with non-GAAP diluted EPS in the range of 14 to 18 cents, and a non-GAAP tax rate of ~33%

## *I. Consumer Demand for Fitness Devices Peaked in 2Q15*

**FIGURE 1: Units Sold (in Thousands) and Y/Y Growth (%)**




Consumer demand for fitness tracker devices may have peaked as early as 2Q15 when Fitbit sold 4.45M units and units sold grew at a 159% y/y (see Figure 1).

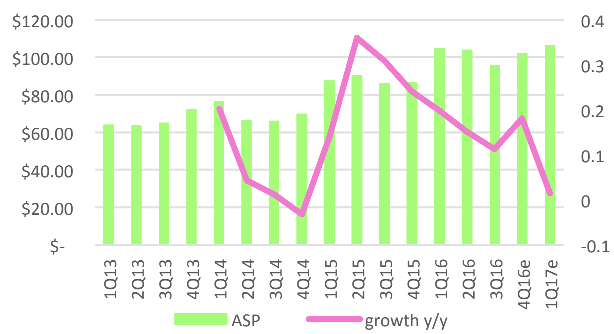
While Fitbit still had its best quarter in 4Q15, selling over 8.2M wearable device units for a growth rate of 56% y/y, the U.S. market was already saturated at that time and in 3Q16, units sold reached 5.28M units for a mere 11% y/y growth.

Source: Fitbit, Inc.

For 4Q16, we are projecting Fitbit to sell ~7.25M units (for a growth rate of minus 12% y/y) based on management's 4Q revenue guidance. The negative growth rate for units sold marks the first negative growth quarter for the company. At the peak 2Q15 quarter, average selling price of $89.82 reached the peak growth rate of 36% y/y (see Figure 2).

Despite the saturated market, Fitbit was able to raise their ASP in 1Q16 to $104.37 for a 20% y/y growth rate. This was because the company cleared the inventory channel of most of their legacy products. In 1Q16, the *Alta* and *Blaze* accounted for 47% of revenue while in 3Q16, Fitbit's flagship products – *Alta, Flex 2, Charge 2* and *Blaze* – accounted for more than 79% of total revenue.

**FIGURE 2: Average Selling Price and Y/Y Growth (%)**

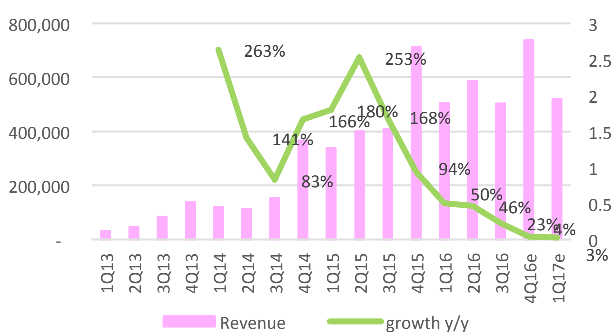



Source: Fitbit, Inc.

Due to the clean inventory channel, we are projecting 4Q16 ASP of $101.72 for an 18% y/y growth rate (see Figure 2). However, due to weak consumer demand in APAC and competition from lower priced competitors, we are not sure if Fitbit can maintain their premium pricing heading into 2017.

## *II. Still No Signs of a Bottom but Inventory Channel Remains Healthy*

**FIGURE 3: Revenue ($ Thousand) and Y/Y Growth (%)**

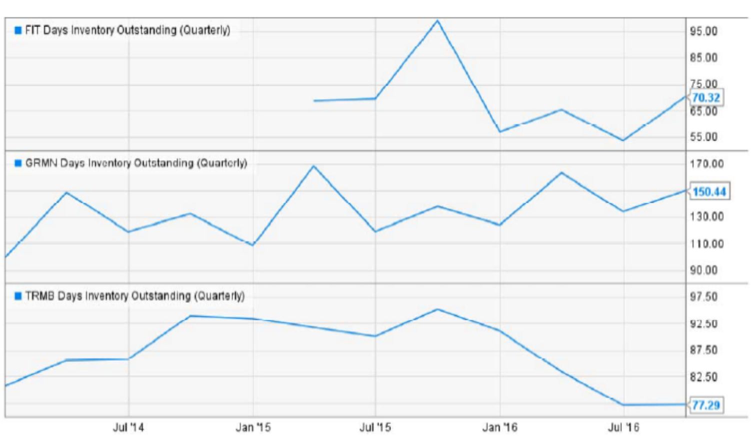



Source: Fitbit, Inc.

We believe consumer demand for wearable devices will continue to be weak over the holiday season. Management remains cautious for the near term, indicating that Western Europe may be the next growth area since it remained underpenetrated in Germany, France, UK, Italy and Spain, where less than 15% of Fitbit's total devices are sold. Management guided 4Q16 revenue to a mid-point of $737.5M (up 4% y/y) down from last year's 4Q15 growth rate of 94% y/y (Figure 3).

Our biggest concern going forward is excess inventory. Inventory channel needs to be clean in order to maintain higher ASPs and to keep margins stable. Comparing days inventory outstanding between Fitbit and its closest peers Garmin and Trimble shows that in 3Q16, Fitbit needed roughly 70 days to turn inventory to sales while Garmin took about 150 days and Trimble around 77 days (see Figure 4).

**FIGURE 4: Days Inventory Outstanding: Fitbit (FIT), Garmin (GRMN) and Trimble (TRMB)**




Source: YCharts

Moreover, in 2Q16, FIT was even more efficient compared to its peers – needing 54 days to turn inventory to sales, while GRMN took 134 days and TRMB ~77 days. The efficiency by which FIT manages its inventory gives us some confidence that average selling price can be maintained, although a weak demand environment may pressure Fitbit to lower prices in order to sell more units.

## Disclosure Information

**Analyst Certification**

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