VIOLA ADVISORY

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Under Armour, Inc. (UAA): Sell @ $18.00

<u>Sell Thesis:</u> We are downgrading Under Armour from Hold to a Sell and reducing our Price Target from $22 to $18. We believe FY2017 will be the Year of Diminished Expectations for UAA as the company tries to navigate the athleisure terrain which runs counter to their core brand image as a peak performance/athletic sport company. We also foresee challenges in implementing an effective product segmentation strategy (premium brand offerings in DTC vs. generic brand offerings in mid-tier retailers) which could likely hurt gross margins in the near term. This is because UAA's product portfolio (apparel and footwear) is not as diverse as Nike or Adidas, for example. <u>Lastly, we believe Adidas and Nike could gradually take both mind share and wallet share from UAA in North America as the popularity of the *Curry* Basketball franchise continues to fade with no replacement in sight for the near term.</u>

TABLE 1: Under Armour 1Q17 Results

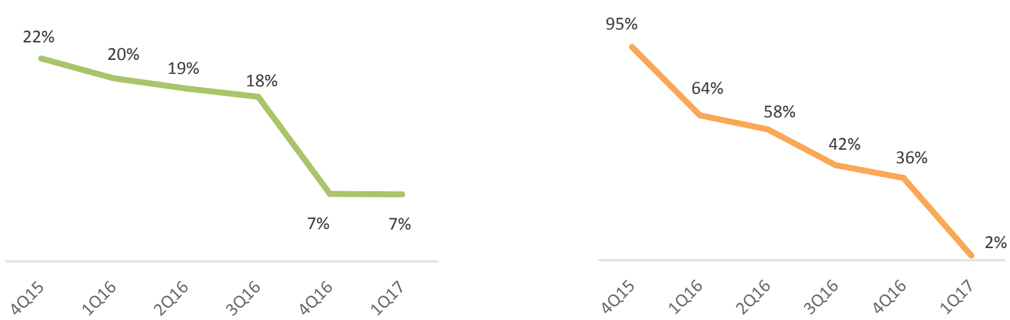
1Q17 Results			2Q17 Guidance			1Q17 Results			2Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
-0.01	-0.04	beat	n/a	-0.04	n/a	1.12B	1.11B	beat	n/a	1.10B	n/a

Source: Under Armour, Inc. and Estimize.com

I. *<u>Apparel Sales Flat and Footwear Sales Sinking</u>*

Product category sales remained tepid in 1Q17 pointing to the difficulty Under Armour has in adjusting to the new athleisure terrain. UAA footwear (24% of total revenue) is narrowly focused on the *Curry* basketball franchise, which has the highest profit margins, while its running footwear closely resembles Skechers' high-performance athletic footwear both in looks and colorways. Moreover, there also seem to be some similarities between UAA's casual lifestyle footwear and Adidas' athleisure footwear.

FIGURE 1: UAA Revenue Growth: Apparel (left) and Footwear (right)



Source: Under Armour, Inc.

We believe the lack of product differentiation in UA's casual lifestyle footwear offerings has caused overall footwear sales to sink abruptly to 2% y/y growth in 1Q17 from a robust 36% y/y growth in 4Q16 (see Figure 1, right).

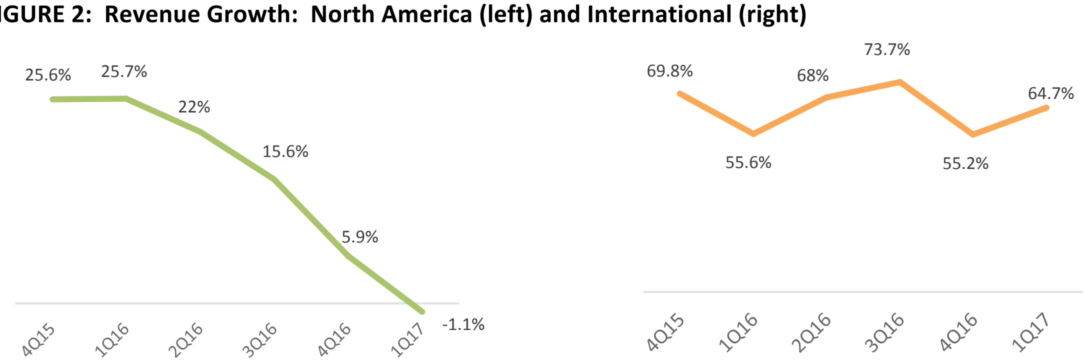
Apparel sales (64% of total revenue) were also tepid at mid-single digit growth in 1Q17, down significantly from a healthy 20% y/y growth in the same period last year (see Figure 1, left). While management blames it on the bankruptcy of The Sports Authority, the launch of generic apparel products at Kohl's Department Stores was supposed to generate the same amount of shelf space as The Sports Authority. Furthermore, the primary customer base at Kohl's is the middle-class suburban housewife – ideal for Under Armour which remains underrepresented in the women's athletic apparel space.

However, Kohl's is also known for heavy promotional activity and anecdotal evidence showed a price war brewing between Nike and Under Armour as soon as Kohl's started offering UAA apparel and footwear. Moreover, some data checks by *Piper Jaffray* showed that Nike continued to outsell Under Armour in Kohl's and that both brands have become heavily promotional. This could explain why apparel sales growth failed to gain traction in 1Q17.

II. North America Sales – UA's Largest Market – in Negative Territory

North America sales (78% of total revenue) is in negative territory, down by 1.1% y/y in 1Q17, after growing 25.7% y/y in the same period last year (see Figure 2, left). The North American market has become heavily saturated with Nike, Adidas and many other sportswear manufacturers entering the athleisure space. As the competition heats up, product differentiation and brand image becomes key to maintaining premium pricing and profit margins.

FIGURE 2: Revenue Growth: North America (left) and International (right)



Source: Under Armour, Inc.

However, while UAA management talked about investing heavily in supply chain systems and infrastructure in order to bring their product quickly to market, the company clearly has not invested enough from a fashion or style perspective in order to differentiate their footwear and apparel from their competitors. Clearly, UAA footwear is heavily dependent on the *Curry* Basketball franchise to drive footwear sales. While this strategy was effective two years ago, consumer preference has changed much since then.

Product endorsements are also heavily skewed towards sports celebrities and sport teams. UAA can gain a much higher ROI by soliciting endorsements and style/fashion ideas from cultural icons in the fashion and music industry, just like Adidas did, when its retro sneaker “Stan Smith” was endorsed by multiple fashion designers and Hollywood actors, leading to wide adoption by millennial consumers.

While North America growth has deteriorated, growth in international markets (22% of total revenue) continues to remain robust. In particular, Asia-Pacific (7.7% of total sales) grew at 60% y/y in 1Q17 and EMEA (9.2% of total sales) and Latin America (3.4% of total sales) also grew at 55.2% y/y and 30.5% y/y respectively. We believe Under Armour still has significant runway for additional growth abroad.

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