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Concerning the 3¼s of '26

Near the climax of the 2016 frenzy for fixed-income securities of any and every type, Under Armour, Inc. issued $600 million of marginally investment-grade 10-year debt. The coupon was 3¼%, the price was near par and the timing—the company's timing—was impeccable.

Now in progress is a triple status update: on the bonds, on their issuer and on the risks attached to the burgeoning triple-B portion of the corporate credit market. In preview, we remain bearish on Under Armour equity (UAA for the Big Board-listed Class A shares), guarded on the bonds and more than ever persuaded that the cost of "financial repression," as the adepts call the officially sanctioned downside manipulation of interest rates, will be greater than the central bankers can admit or allow themselves to imagine.

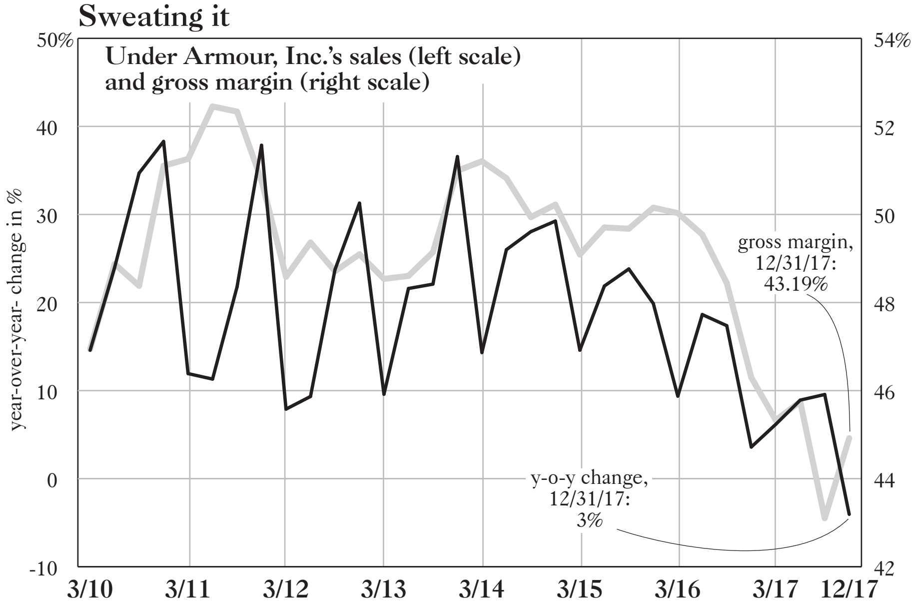
The UA 3¼s debuted within weeks of the July 2016 culmination of the buying panic that sent 10-year U.S. Treasury yields plunging to 1.36% and $14 trillion of foreign bonds reeling into the netherworld of negative nominal yields. In these circumstances, 325 whole basis points might have seemed a godsend. Buyers of the UA 3¼s surely thought so, as they settled for a yield pickup to the Treasury curve of 160 basis points, 40 fewer than the underwriters had banked on or that LQD, the iShares iBoxx Investment Grade Corporate Bond ETF (more than half of whose assets are rated single-A or better), was actually priced to deliver.

Bullishness comes easily and habitually to investors in Under Armour, which was logging its 25th consecutive quarter of revenue growth in excess of 20% when its bonds flew out the window. Indeed, first-quarter 2016 sales had spurted by 30%, which fact, on April 21, inspired Kevin A. Plank, founder, CEO and chief visionary of UA, to fling a handful of stardust into Wall Street's unblinking eyes: "When Stephen Curry [MVP point guard of the Golden State Warriors] decided to average 30 points this season to take the scoring title while wearing the number 30," said Plank, "we thought that putting up 30% growth on our end was the best way to demonstrate our pride and support of Stephen and the Warriors."

Curry averaged his 30 points in 2015–16 (30.1, in fact), but UA fell short of its revenue goal in 2016 and shorter still in '17, when top-line growth decelerated to 3% from 22%. No longer invoking Curry, the UA legal draftsmen began to warn readers of the annual 10-K reports that the sales of its Heatgear, Coldgear, Allseasongear, etc. "may not continue to grow" (February 2017) and even, a year later, "may decline" (February 2018).

The collapse in demand, or, as Plank has preferred to style it, the "rapid [supply] expansion," brought not only dismal top-line growth, but also inventory discounting, layoffs, lease terminations, asset write-downs and other such operational and financial eyesores, which may cost the company a combined $260 million in 2017 and 2018. Gross profit margin has dwindled to 45.1% in 2017 from 46.4% in 2016 and 48.1% in 2015. It registered 44.2% in the first quarter of 2018. "Good luck," remarks colleague Fabiano Santin, "keeping gross margins intact

Sweating it



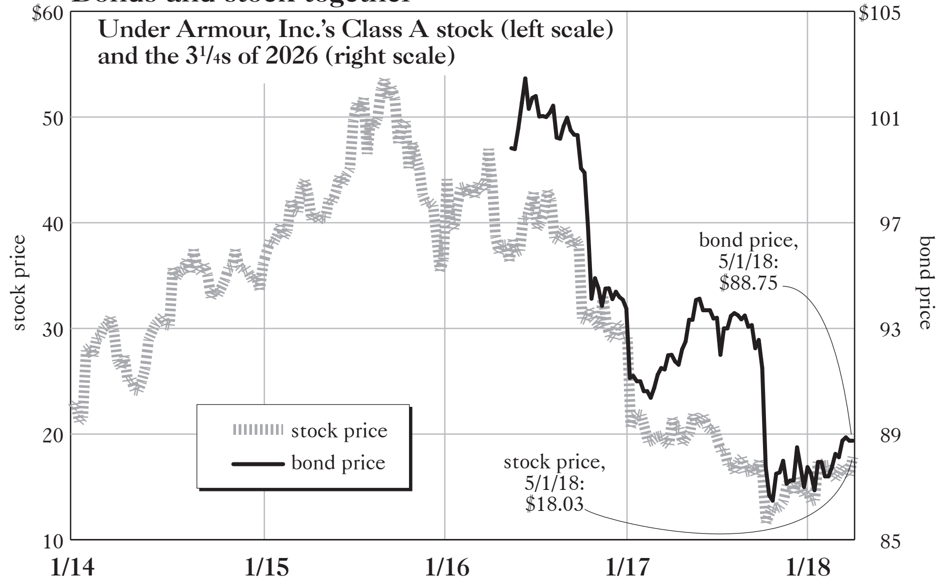
source: The Bloomberg

during periods of heightened oil prices (UA's fabrics are mainly petroleum-derived synthetics) and rising shipping costs. It's no surprise, then, that operating income before restructuring and impairment expense fell to $152 million in 2017 from $417 million in 2016."

Whether the slump is something more than a pause in a story of stupendous growth remains to be seen—first-quarter results, featuring better-than-expected adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) and slightly worse-than-expected operating income, held few surprises. Whatever happens in the future, the now-split-rated 3¼s (Baa3/double-B) have fallen to a price of 88¾ to yield 4.95% to maturity, a loss of more than three years of coupon income, quite apart from the 3½% of purchasing power that inflation has burglarized. The bonds today are quoted at 200 basis points over Treasurys, while shares in LQD have tightened to a spread of 120 basis points over the curve—an inversion of the comparative spreads quoted at the UA offering. With no margin of safety, the 3¼s rather delivered loss and disappointment. It will be the story of many such securities that arrived in the days of stunted interest rates and spandex-tight credit spreads. On form, an extreme of overvaluation (today's state of play) will give way to a mirror-image excess of undervaluation (tomorrow's). Such was the narrative of 2007–09, and a lucrative, if not always pleasant, episode it ultimately proved to be (see, for instance, *Grant's*, Dec. 12, 2008).

In August 2017, the public pension funds of Aberdeen, Scotland and Bucks County, Pa. sued UA for allegedly covering up bad news. If the truth about the cooling of UA's brand heat had come to light when Plank et al. first knew about it, the oddly matched plaintiffs allege, UA would have received the junk rating it deserved and the 3¼s would have come to market at a lower price and higher yield than the ones they mistakenly were assigned. To these allegations, an arbiter named Grant might observe that not everyone was blinded by Plank's non sequitur concerning Stephen Curry's ambitions for the 2015–16 NBA season (see the issue of *Grant's* dated May 6, 2016) and that, besides, the fast-growing segment of triple-B-rated corporate debt constitutes a holding pen of future trouble. Risky enough now, such bonds will likely deliver outsize losses in the next recession as wholesale demotions of borderline credits swell the supply of junk in relation to the cyclically reduced demand for junk (*Grant's*, Oct. 20, 2017). As a well-informed fiduciary should have been aware of these facts and conjectures, Justice Grant of the Journalistic Supreme Court would toss the plaintiffs' case on the grounds of whining.

Bonds and stock together



source: The Bloomberg

What about the investment case for UA stock and bonds? To answer, we survey liquidity, asset coverage, valuation, sentiment, business prospects—and the pregnant, if obscure, language in some tightly drawn Under Armour bank-loan covenants.

Liquidity first: At the end of March, UA showed $284 million in cash, $1.12 billion of undrawn capacity in a bank revolving-credit line and $1.1 billion in inventory. Incidentally, inventory ballooned by 26% last year, overwhelming the aforementioned 3% growth in revenue; it was little changed at the close of the first quarter.

Asset coverage: Say that 2019 sales come in 10% lower than the $5 billion rung up in 2017, for a total of $4.5 billion. Assume that the brand is worth a multiple of between 1 and 1½ times those sales; call that value $5.6 billion. Now, add net current assets of $907 million (i.e., current assets minus current liabilities, knocking 20% off the face value of the inventory just to be on the safe side). These steps yield corporate value of $6.5 billion, from which we subtract $920 million in debt (bonds and bank credit), $1.5 billion in lease liabilities and $1.2 billion in sponsorship commitments, for back-of-the envelope net corporate value of $2.9 billion—60% lower than the $7.5 billion current market cap.

"Thus, holders of the 3¼s of 2026 would seem, for now, to enjoy more than ample asset protection," Santin observes, "though in the long run the fortunes of the bondholders, like those of the stockholders, will depend on the company's business results. On that score, Under Armour burned cash in each of the past three years: $287 million in 2015, $23 million in 2016, $49 million in 2017."

UA's stock-market capitalization has shrunk by $10.2 billion, or 58%, since we said our piece nearly three years ago (*Grant's*, June 12, 2015); 36% of the float is sold short and only seven of the 35 analysts who cover Under Armour call its stock a buy.

Then, again, the shares change hands at 102 times the 2018 earnings estimate and at 23 times forecast 2018 EBITDA. As to the latter metric, it's higher than industry leaders Nike, Inc. and Adidas AG (some of the variation among the three may stem from off-balance-sheet operating leases and other commitments).

Taking one thing with another, we suspect that Mr. Market is of a mind that the company's destiny is under Plank's firm control, that the 2016–17 crisis is ended, that a short squeeze is possible and that adjusted EBITDA will rally to $425 million in 2019, following a small projected dip this year from the $365 million booked in 2017.

It's a defensible reading of the tea leaves, though it tempers the bullish case to consider that, since the beginning of 2017, six C-level managers have resigned, not including co-founder and chief product officer Kip Fulks, who left "on sabbatical" in November. In the past year, insiders have dumped $1.2 million of stock; none has bought a share. Plank sold nothing, which is not necessarily a vote of confidence; the founder and CEO must hold a 15% stake of the combined A and B share classes to retain his super-voting power—his ownership of 15.7% confers 65% of the votes.

Under Armour has catered to the young since it started in 1996, when Plank himself, at 23, was a mere slip of a lad. Twenty-odd years later, is the founder still in touch? Another question: Will UA succeed in adding new retail outlets, such as Kohl's, without alienating or, evidently, in the case of Dick's Sporting Goods, Inc., further alienating its important existing retail partners?

The most telling marks against the equity, in our opinion, have to do not with the usual equity-like subjects of operating margins and revenue growth. They rather concern some February amendments to the fine print that bear on the senior bank debt. Perhaps management negotiated the changes only out of an abundance of caution. If so, it was a superabundance. Or maybe Plank et al. have reason to be worried about 2018.

Thus, Santin relates, "the leverage-ratio covenant, defined as debt to EBITDA, had fixed maximum indebtedness at 3.25:1. The lenders agreed to boost that limit to 3.75:1 and 4:1 for the 12 months ending on June 30 and Sept. 30, 2018, respectively (with reversion to 3.25:1 at year-end).

"There were liberalizing changes, too, in some definitional language—for instance, amendment of the definition of adjusted EBITDA to allow for the elimination of restructuring cash costs. And permission to subtract up to $100 million of excess cash from total debt outstanding in computing the ratio of debt to EBITDA.

"You would have supposed," Santin goes on, "that management could raise the cash it needs by liquidating inventory—certainly, there's enough of it. And the redefinition of EBITDA would seem to be sufficient to deal with any revenue-related one-offs, without having to resort to temporary boosts in allowable leverage.

"You can get a better sense of management's concern by reviewing a few numbers," our analyst proceeds. "Thus, at year-end 2017, $917 million of debt and $365 million in adjusted EBITDA delivered a leverage ratio of 2.5:1. Assume no change in debt. In that case, adjusted EBITDA could fall to $204 million without breaching the new 4:1 covenant. Or assume a $200 million increase in debt until the end of the third quarter. In that case, the leverage would rise to only 3.2:1, based on analysts' estimates of adjusted EBITDA. Given the sizable margin for error, I wonder if Plank isn't planning for adjusted EBITDA much worse than the $319 million that Wall Street is expecting for the 12 months ending Sept. 30, 2018, given his first-quarter result and second-quarter guidance."

Perhaps we are overthinking these inside-baseball minutiae and Under Armour is poised to mount a simple cyclical comeback. The analysts at Moody's seem to think so, or they would not have persisted in assigning UA the (barely) investment-grade rating of Baa3. More likely, we conclude, the Street is under-thinking, or under-analyzing, the situation, as we see no mention of all covenant adjustments in the sell-side research which we have been able to read.

The devil's in the details.

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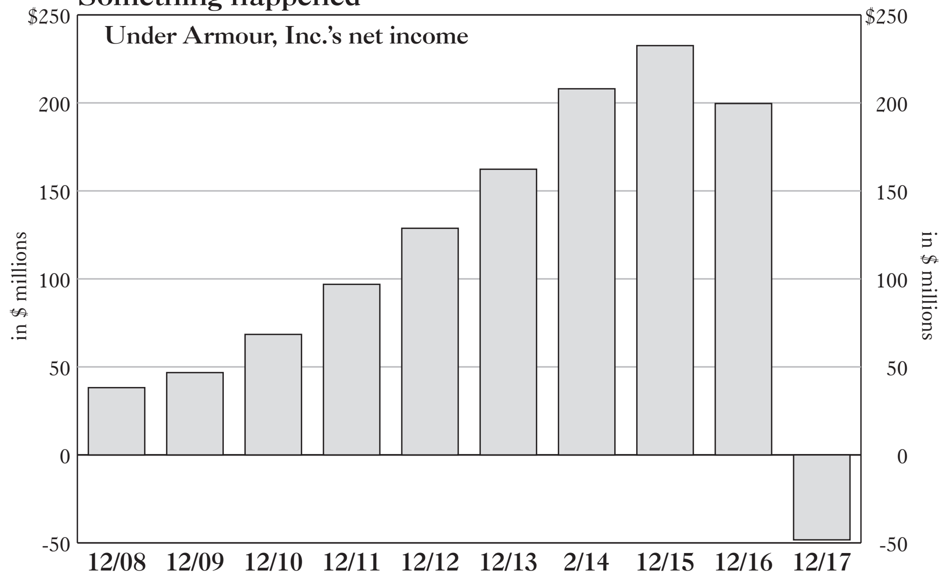
Something happened



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