Under Armour Company Analysis

Investment Thesis

We view Under Armour as a beneficial addition to the CIB portfolio based on the belief that UA is underpriced by the market. In spite of a dip in stock price over the last few months we believe that UA will be able to rebound and exceed original price levels. The company has strong financials and most of the downward pressure on the stock has come from noise as opposed to credible analysis. The athletic apparel industry has room for a third player and will continue to grow in size as time progresses, Under Armour can cement itself as an integral player in the industry. For these reasons we initiate a BUY rating for Under Armour at a price target of $56.

Brief Business Description

Under Armour Inc. (UA) is an international athletic apparel, footwear, and accessories distributor. The company was founded in 1996 by Kevin Plank and is headquartered in Baltimore, Maryland. UA currently holds the fourth largest market share in the athletic apparel market at 3%, only behind Nike, Adidas, and VF Corp. UA's apparel division generates the majority of its revenue at 71%, while the footwear and accessories divisions attribute 17% and 9% respectively. While 67% of sales are driven by wholesale channels (sporting good chains, department store chains, collegiate athletic departments, etc.), the firm boasts a growing direct-to-consumer network that accounts for 30% of revenues. The company is rapidly expanding into international markets, including the Middle East, Africa, Latin America, and Asia. UA aims to provide athletic apparel for athletes of all ages and skill levels. However, in terms of segmentation, UA has taken an active approach in targeting the mid-tier and family footwear markets by launching its lines into 1000+ Kohl's in early 2017 and Famous Footwear stores in the latter half of next year. UA has also broken into the digital fitness and application market in the past three years, acquiring a number of smaller platforms which now form the Connected Fitness segment. In of April 2016, UA announced its Class C non-voting common stock by issuing a dividend on a one-for-one basis to the existing holders of Class A and Class B stock, which generated the same effect as a two-for-one stock split.

Recent Key Events

Sports Authority Closing

Under Armour took a major hit in Q2 of 2016 as Sports Authority closed stores nationwide in the wake of their bankruptcy. Like many conventional retailers such as American Apparel and RadioShack, Sports Authority faced tough competition, in this case from Dick's Sporting Goods, for the in person market. If a consumer is going into the store to buy a good, as opposed to simply ordering it online, they want a better customer service experience than Sports Authority could give. Sports Authority was UA's largest retailer and they expect to take a sizeable loss in 2016 with UA only predicted to realize $43M of the projected $163M from the partnership.

Uniform Deal with MLB

On October 17th UA signed a deal with the MLB for the rights to manufacture jerseys for Major League Baseball. Monetary terms were undisclosed, however, the timeline will be from 2020-2025. This is an important win for UA as the MLB is a tremendous source of both revenue and branding with more than 2.2M views on average for each game and more than 14M viewers for games during the World Series.

Kohl's Partnership

Under Armour's recent partnership with Kohl's puts UA products in more than 1100 stores across the US. This creates greater access for a demographic with which the product is already tremendously popular. This partnership helps to close the gap between UA and Nike in stores in North America with UA found in 11,000 stores and Nike found in 24,000.

Industry Analysis

The major barriers to entry into the athletic apparel and footwear industry are large capital costs for branding, and costs to manufacturing/distribution channels. Due to these, Nike and adidas still remain as the main players in the athletic footwear division, holding about 43% market share combined. However, the athletic apparel industry is extremely fragmented, with no players holding more than 11% market share (Nike and Adidas). This fragmentation signifies opportunity for expansion as Under Armour holds the fourth largest market share at 3%.

The industry as a whole can expect to see a rapid upward trend due to global demographic. The Millennial and Gen Z generations now make up 59% of our world's population, and are the most physically active demographic. 76% of Millennials and 82% of Gen Z participate in physical activity, compared to 74% of Gen Z and 66% of Boomers. There is an increasing "athleisure" trend which is described as consumers purchasing and wearing athletic wear for everyday comfort wear. Millennial women are more likely to wear their athletic apparel all weekend than Gen X and Boomers. The rising gym/health/fitness club membership among Millennials and Gen Z also adds to the active lifestyle movement as 27% of young people ages 21-30 own a gym membership.

Major Players in the Athletic Apparel Industry

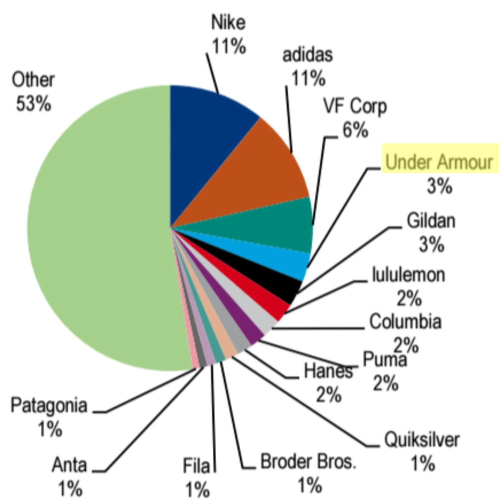
Nike Inc.(NYSE: NKE)

Nike is the largest player in the athletic apparel industry, holding 11% of global market share. Founded in 1964, Nike has always grown into its role as industry leader and has held that role for the better part of three decades. The brand name and unavoidable Nike "Swoosh" are two of the company's greatest assets. Nike's brand power is truly what sets the company apart, through its products the company has the ability to set what is considered fashionable/useful. Nike has a market cap of $86.5M and an EPS of $.73. Nike is an obvious obstacle for UA given their size and ability to set the market. That being said, the athletic apparel industry is shared by enough players that UA doesn't have to directly compete with Nike for every consumer.

Adidas (EUR: ADS)

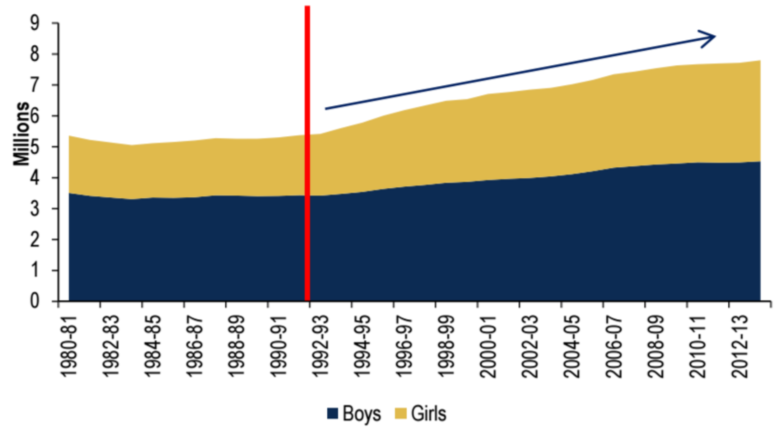
Adidas is the old incumbent, founded in 1924 as Gebrüder Dassler Schuhfabrik, the company has been a consistent player in the sports apparel industry for the last century. Adidas is a German company that holds a close second place in terms of largest athletic apparel to Nike with 11% global market share. Subsidiaries include Reebok and TaylorMade along with many other stakes in various markets. Adidas has a market cap of $31.32M and an EPS of $3.20 so far in 2016. In a similar way to the way UA competes with Nike, the competition between Adidas and UA isn't necessarily as fierce as you would expect. Only 22% of the industry is held by Adidas and Nike and while this is a high share in comparison to every other company in the industry, this means that UA has the opportunity to gather market share by dominating smaller more niche markets through either M&A or in house efficiencies of scale that smaller firms cannot utilize. Both M&A and efficiencies of scale provide paths towards growth without having to directly fight incumbents like Nike and Adidas.

Chart 230: Key athletic apparel vendors



Source: BofA Merrill Lynch Global Research, Company Data

Chart 225: Athletics participation has been rising since Millennials entered high school & Gen Z entered grade in the US



Source: NFSHA

Competitive Advantages Assessment

People in the U.S. and around the world have become more health-conscious in recent years, and companies that make the products that help people be more active have done extremely well. Nike is a pioneer in the athletic apparel business, with more than half a century of history behind its world-renowned brand. Yet a greater amount of competition has popped up recently, especially Under Armour, which stands out as the most successful in challenging Nike's dominance. Other competitors for Under Armour include Adidas and Lululemon Athletica.

Nike Stock Performance and Valuation

Nike and Under Armour have produced strong long-term performance for shareholders, but recently, both stocks have been weak. Nike has fallen 2% over the past 12 months, but that's far better than the 66% drop Under Armour has suffered since October 2015. This can be mainly attributed to the Sports Authority bankruptcy, which removed one of Under Armour’s main retailers from business.

From a valuation perspective, it's easy to see the different ways in which market participants perceive Under Armour and Nike. When you look at trailing earnings, Nike's status as a more mature player in the industry stands out. The stock trades at 20-25 times earnings, which reflects the past growth in the overall industry and Nike's success in capturing it. Yet Under Armour trades much more like a high-growth stock, with a trailing earnings multiple approaching 100 before the Sports Authority Bankruptcy. After this incident, the earnings multiple dropped significantly. However, this drop is due to an external incident outside of UA and does not reflect UA’s intrinsic qualities.

Dividends

Dividend investors typically look to the more mature companies in an industry for potential income, and that practice holds true in athletic footwear and apparel. Nike pays a dividend, while Under Armour doesn't, so the only choice for those looking for immediate income is Nike.

Yet even Nike isn't all that dedicated to shareholders when it comes to its dividends. The stock's current yield is just 1.1%, and past increases to its quarterly payout have been relatively modest compared to its earnings growth. Nike has doubled its quarterly dividend since 2011, but even it has to invest sizable amounts toward promoting its brand and developing new growth opportunities. Nike is the better pick for those needing portfolio income, but dividends aren't a huge priority for the older company as long as internal investments can pay off.

Growth and Fundamentals

Nike and Under Armour have both done a good job of capitalizing on the potential of the athletic apparel industry, but they've also had to deal with the challenges that come with lightning-fast growth. Nike recently posted results for its fiscal fourth quarter, and the company kept its top line moving in the right direction, rising 6% for the quarter and for the full 2016 fiscal year. Yet even though Nike managed to boost its net income for the year by 15% compared to 2015, its fourth-quarter results weren't as strong, with the bottom line actually falling 2% from year-earlier levels. Although currency impacts put some downward pressure on Nike, overall sales in its key North American market were flat, which stands in stark contrast to gains in the 20% range for Western Europe, China, and Japan. International growth remains the biggest driver of expansion for Nike, but some are worried about sluggishness closer to home as a potential signal for a longer-term slowdown.

Interestingly, Under Armour saw some of the same trends, although its growth trajectory is somewhat higher. In its most recent quarter, the company posted a 28% rise in revenue, but net income slid by more than half. From a sales standpoint, Under Armour has done a good job in several growth categories, including a nearly 60% jump in footwear sales and a gain of more than two-thirds in its international revenue. Increases in overhead expenses held back bottom-line growth, but one big concern for Under Armour comes from the bankruptcy of longtime distribution partner Sports Authority. Under Armour is making big moves to compensate, including building a relationship with retailer Kohl's and its plans to enter the sportswear business. Near-term reductions in guidance made some shareholders unhappy, but Under Armour remains focused on the long haul and expects worldwide growth to help it keep climbing. Due to the strong growth metrics over the past few quarters and the expected jump in revenue due to the agreement with Kohl's, Under Armour's low stock price at the moment is undervalued due to the Sports Authority closing. This makes it the perfect time to buy UA before the market changes to reflect UA's future expected growth.

In terms of marketing, UA has been able to secure a partnership with NBA MVP Steph Curry, who has brought much needed attention to the UA brand.

Management Assessment

Overview

The Under Armour(UA) executive team sets a culture of hard work and passion in the ranks of UA employees. Beginning at the top with Kevin Plank we see a clear devotion to the company as well as candid communication of the roadmap the executive team has crafted. Having founded the company, Plank has a clear vision for where he wants to take UA. This passion to make UA a success is one of the company's greatest assets because of Plank's capabilities as an executive and leader.

Kevin A. Plank - CEO/Chairman/Founder

Kevin Plank has served various roles for UA since it's inception in 1995. As founder, more than two decades ago, he created the concept of *performance apparel*. Plank's corporate experience is almost exclusively with UA and is clearly passionate about his company in a way only a founder can be. This passion shows through in his hard work and clear devotion to the company. Plank employs three statements as a leader, "This is what I heard." "This is what I think." And, "This is what we're going to do." These three statements guide his own thought and he encourages a similar line of thinking at all levels of the company.

Paul Fipps - CIO/EVP

Paul Fipps has been with UA for a little over a year in his current capacity as Chief Information Officer. Prior to UA Fipps was CIO (2009-2013) at The Charmer Sunbelt Group, a leading distributor of wines, spirits, beer, bottled water, as well as other beverages. Although Fipps is relatively new to UA, he has a fair amount of executive experience.

Matthew C. Mirchin - President North America

Matthew Mirchin has served various management and executive roles at UA since 2005. Mirchin is truly a company man, he has risen through the ranks of the company to find himself as President of North America since December 2014. An experienced executive with insight into the inner workings of the company is a great pairing. Mirchin has found success in his various roles within the company bringing value at all levels.

Lawrence (Chip) Molloy - CFO

Lawrence Molloy has served as UA's CFO since January 2016, prior to joining UA he was a Senior Advisor at Roark Capital Group, a private equity firm, from October 2014- December 2015. Molloy has served in a variety of roles at many different firms throughout his career, the best way to describe Malloy is as a journeyman Advisor/CFO. A tremendous amount of experience over the past few decades serves as a positive for Molloy's capability as CFO.

Conclusion

The Under Armour management team has an optimal balance between people who have a clear direction for the company and people who can facilitate their end goals. CEO Kevin Plank has a clear direction for the company and he has helped to facilitate the growth UA has experienced over the last two decades. Plank is clearly passionate about the fate of UA. Commenting on Plank's passion for the company helps to illustrate the culture which pervades UA. Resulting from his leadership, his executives and employees will run through walls for the company. The rest of the executive team is well experienced with a good amount of experienced UA employees, who know the ins and outs of the company, as well as a group of executives who bring experience from other industries and perspectives. This combination of passion for the company and broad experience creates a potent combination which leads to success.

Relevancy Assessment

The Sporting Goods Stores industry has benefited from growth in the sports participation rate, as it led to greater demand for athletic apparel, footwear and sporting goods. As the sports participation rate is expected to grow over the next five years, there will be an increased demand for sporting activity products, thus increasing UA’s revenue. The primary consumers are adolescents between the ages of 10 and 19.

Analysts expect revenue to grow at an annualized rate of 2.1% as a rise in health-consciousness leads to a greater demand of athletic apparel and footwear for daily fitness. Due to this overall trend in health consciousness, more consumers are expected to purchase Under Armour products over the next several years, making UA a promising investment.

Per capita disposable income is also expected to rise. This is expected to cause an increased demand in sporting goods with more households being able to allocate income toward such products. As with an increase in health-consciousness, a growth in disposable income will also boost UA’s revenue as demand for their products rises.

Risk Analysis

Under Armour faces competition from rising competition with mass merchandisers, department stores, as well as online retailers. These companies have an advantage because they are able to offer comparable products at lower costs with their high leverage. As these companies continue to also integrate sporting goods into their sales portfolios, players in the sporting goods industry face a decrease in revenue.

Furthermore, Under Armour faces increasing competition from rivals including Nike and Adidas, as well as from emerging companies. In regard to distribution intensity, some chains are lowering their UA assortment or exiting the market. Taking into consideration these risks, UA may require further investment in marketing and websites.

In 2014, it was reported (by the National Sporting Goods Association) that adolescents aged 7 to 17 have been participating in fewer team sports. If this trend persists, companies in this industry will experience a decrease in sales. Video games such as sport simulators compete with traditional sports and consequently, compete with this industry as some adolescents forfeit their participation in sports in favor of these video games.

Under Armour has benefited from a solid brand reputation. However, because fashion trends tend to change quickly, Under Armour may struggle to uphold these returns over extended periods of time.

In order to maintain a competitive edge, Under Armour may need to differentiate its service offerings. For example, hiring fitness trainers or building interactive components to their stores may cause Under Armour to appeal more to common consumers, and thus distinguish itself from competing companies.

Trends

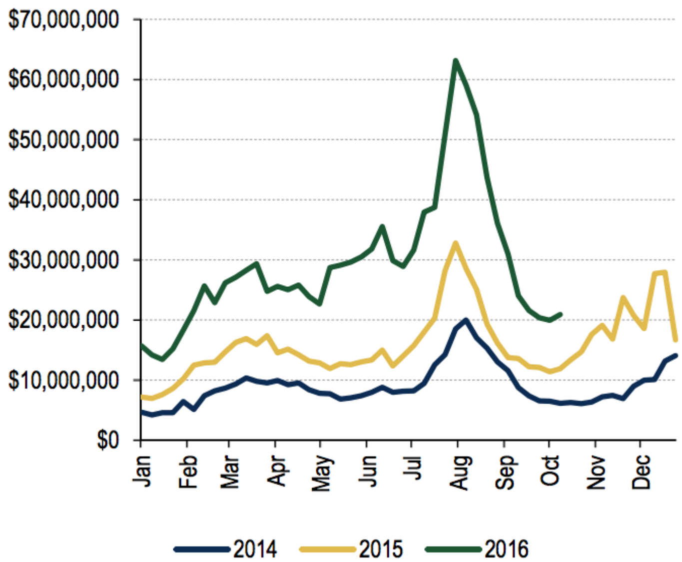
In the past five years, Under Armour has rapidly expanded in terms of growth and brand awareness. At the beginning of 2012, UA's stock price traded at $9.50. Since then, the stock has reached a high of nearly $55 during September of 2015, and is now trading at $30.94.

UA has expanded its reach into several high growth athletic markets, including women's sports, basketball, golf (fastest growing golf brand), and NCAA athletics. It currently holds more than 10% market share in only one of its nine key categories, signifying viable long term potential for growth. Earlier this year, UA secured a 15-year, $280 million apparel and footwear sponsorship deal with UCLA, the largest in collegiate sports history. By breaking into the ever growing NCAA and women's sports markets, UA puts itself in a prime position to differentiate itself from competitors.

In addition, UA now sponsors several blue-chip athletes across many key sports: Stephen Curry (basketball), Cam Newton (football), Jordan Spieth (golf), and Michael Phelps (swimming). Steph Curry's sneaker line has acted as a major catalyst to UA's footwear revenue growth, and with the newest Curry 3 launching on October 27th, we can expect to see its success reflected in 4Q earnings report. Additionally, Curry's Golden State Warriors are expected to be under the microscope this season coming off two consecutive Finals appearances and with the offseason addition of former MVP Kevin Durant. Under Armour can only gain more exposure and brand awareness during this highly anticipated season.

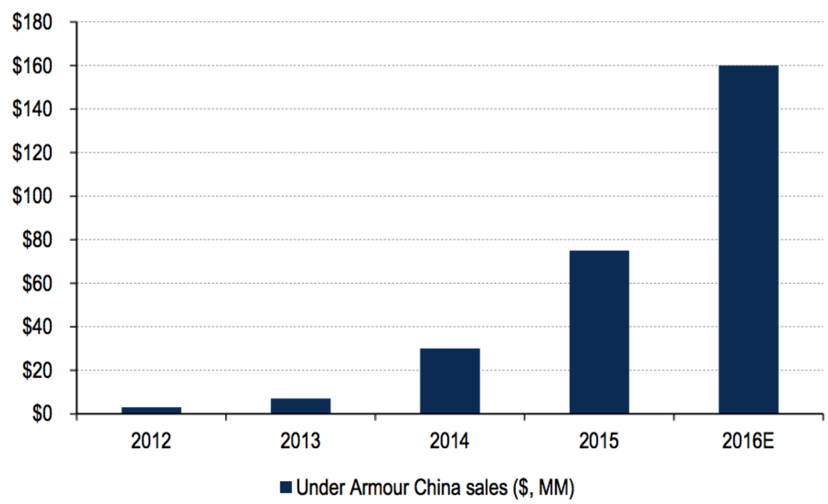
Under Armour has taken an active approach in expanding into international markets, and in particular, China. Stephen Curry and Jordan Spieth are now easily recognizable names to Chinese consumers and brand awareness is expected to ramp up. UA will launch in more than 200 doors in China by the end of 2016 with expected revenues of over $160 million. Utilizing its strong e-commerce presence, we expect rapid expansion and revenue growth into the Chinese market.

Chart 1: Under Armour footwear sales



Source: BofA Merrill Lynch Global Research, SportScanINFO

Chart 3: Under Armour China revenue growth is poised to accelerate



Source: BofA Merrill Lynch Global Research, Company Data

Controversies and Potential Misunderstandings

A major source of worry for most investors looking into Under Armour is the effect of the Sports Authority bankruptcy on future Under Armour cash flows. Under Armour predicts that it will only be able to collect $43 million from the $163 million it expected from Sports Authority in 2016. While this looks worrying, the bankruptcy was external to UA and does not reflect an intrinsic decline in the company's operations. Also, UA has been signing new contracts with sports figures and collegiate partners, which has been quickly increasing its brand recognition.

While the bankruptcy may lead to short term declines in UA cash flows and stock prices, long term growth is to be predicted for UA.

Catalysts

At the 2016 Consumer Electronics Showcase, UA revealed its line of Connected Fitness products, which include a heart rate monitor, sport watch, and weight scale. These products, if bought together in one package, are cheaper than buying the trio from any other competitor, such as Garmin or FitBit. The Connected Fitness platform differentiates UA from other sportswear companies such as Nike or Adidas, who offer no similar products together. The platform has gained 190 million users so far, and is consistently growing. Continuous growth of this platform would serve as a catalyst for UA stock price increases because it would allow UA to effectively expand into the fitness-related electronics industries that haven't been captured by either of its main two competitors: Nike and Adidas.

Also, UA's expansion into Kohl's, its MLB contracts, and potential expansion into soccer would all serve as catalysts for future stock price growth.

Valuation

We based our analysis off our DCF using the past three years' financial data. In order to paint a more accurate picture of UA's 2016 YTD performance, we projected the 2016 4Q using assumptions drawn from the last 5 quarters. Using this last quarter to feed more accurate 2016 figures, we projected out unlevered free cash flows 5 years into the future. We calculated our discount rate using a number of assumptions: the risk-free rate (10-Year Treasury Bill), market-risk premium, and a recalculated levered beta based on Comparable Company analysis. Using this WACC, we also lowered the expected revenue growth rate YoY from the high 20%'s to 10%, influenced by Nike's revenue growth rate, in order to generate a more reasonable and achievable share price valuation.

In addition to Comparable Company analysis, we also followed the P/E method by projecting net income into the next three years using a growth rate. Using these figures and our current number of shares outstanding, we determined EPS until 2019. We then multiplied these projections by a P/E of comparable companies and calculated a projected share price of $50 by 2019. Thus, using our current share price of $30 and the 3-year projected price of $56, we calculated an IRR of 6.6%.

We utilized two other methods to calculate a share price: Gordon Growth Method and the Multiples Method. Under our Gordon Growth method, we assumed a modest perpetuity growth rate of 1.5%, and generated an price of $50 per share. Our Multiples method determined a share price we believe can be our price objective in the coming years. Using a comparable company average EBITDA multiple of 14.78, we were able to calculate a fair value share price of $59. We believe that with the explosive international growth UA is expected to undergo, as well as rising popularity among younger generations, $59 per share is an adequate price.

Sources:

Bank of America Merrill Lynch

Morningstar