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## Inside story

The collapse of the share prices of Valeant Pharmaceuticals International, Inc. and Endo International plc has drawn no line under the era of debt-funded roll-ups with accounting practices to make the head spin. Hanesbrands, Inc. (HBI on the Big Board), the underwear giant and topic of this unfolding analysis, is all the proof you need on that head. To anticipate, we're bearish.

Hanesbrands, which emerged from the cocoon of Sara Lee Corp. in 2006, was founded in Winston-Salem, N.C., in 1901 with the proceeds of the sale of a tobacco business. The company sells unmentionables and mentionables alike: bras and shapewear, "innerwear" (*not* "underwear"), socks and hosiery, fleeces, performance clothing, sweats, thermals. Brands include Hanes, Champion, Maidenform, Playtex, L'eggs and Just My Size. By the company's reckoning, four out of five Americans have a Hanesbrand something-or-other on their person, in the washer or in their bureau. Out of last year's \$5.73 billion in company-wide sales, innerwear contributed 46%, active-wear 27%, U.S. direct-to-consumer 7% and "sales to the rest of the world" 20%. Though 80% of receipts are logged in the 50 states, the international division is Hanesbrands' fastest-growing unit.

Innerwear bears little fashion risk, and it is an all-season, all-cycle essential, the bulls posit. From which it follows, they say, that Hanesbrands is a premium stock that deserves a premium multiple, something, say, on the order of Procter & Gamble's 21.3 times rather than Perry Ellis International's 10.4 times. It's a catchy and successful marketing story that's not entirely consonant with the historical re-

cord. In 2008–09, sales of Hanesbrands' fashion-proof essentials fell by 13%; operating profit tumbled by 24%.

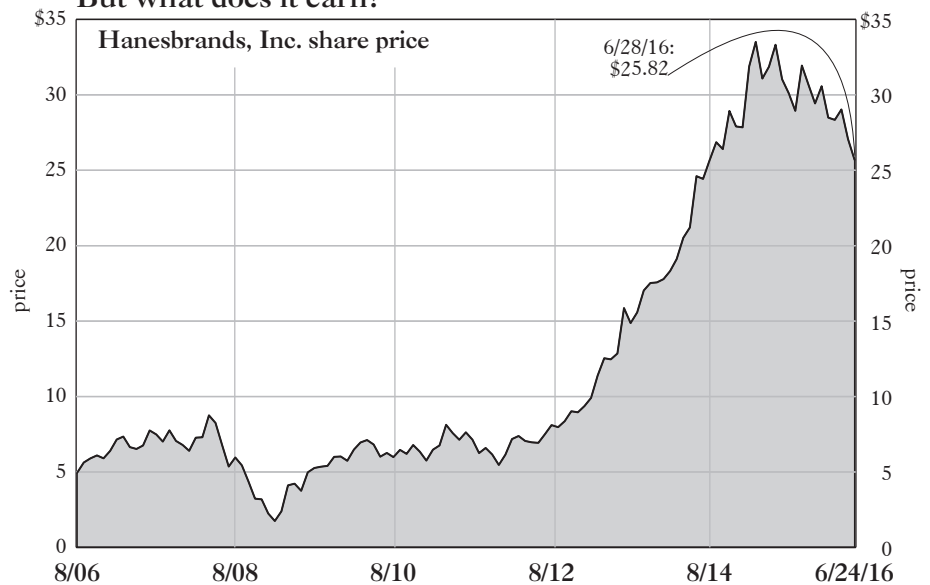
M&A is another mainstay Hanesbrands corporate business line, arguably its most remunerative. Since October 2013, when Maidenform Brands, Inc. entered the corporate fold for a consideration of \$580.5 million, through the first quarter of 2016, Hanesbrands has spent \$1.1 billion on new businesses. And after the first fiscal quarter closed on April 2, two more acquisitions closed for another \$1 billion consideration. They are Champion Europe, which owns the rights to the Champion brand in Europe, and Pacific Brands Ltd.

The Street expects the newcomers to pay major dividends in operating ef-

iciency. For now, for instance, Pacific Brands sources its product from third-party manufacturers. After the deal closes, Hanesbrands-owned factories will do that previously outsourced work. Today, company-wide, 90% of Hanesbrands production is attributable to company-controlled factories (either to the ones it owns outright or to the ones that contractors own but "dedicate" to Hanesbrands business).

"They can gain significant synergies through these acquisitions largely through bringing the product manufacturing in-house, which not only improves their margins with those acquisitions, but, through scale, they can help other recent acquisitions that they've closed," Michael Zuccaro, the Moody's Investor Service analyst who covers Hanesbrands,

### But what does it earn?



source: The Bloomberg

tells colleague Evan Lorenz. “They said some of the Australian products are similar to the European products. Combining the two, they get more synergies than what they were thinking out of each individual acquisition. They are gaining global scale and a global leadership position. They are improving margins on these acquisitions, so over the next several years you should see significant margin improvement on top of the sales growth expected from these businesses. From that sense they make strategic sense. They have a very strong global position now.”

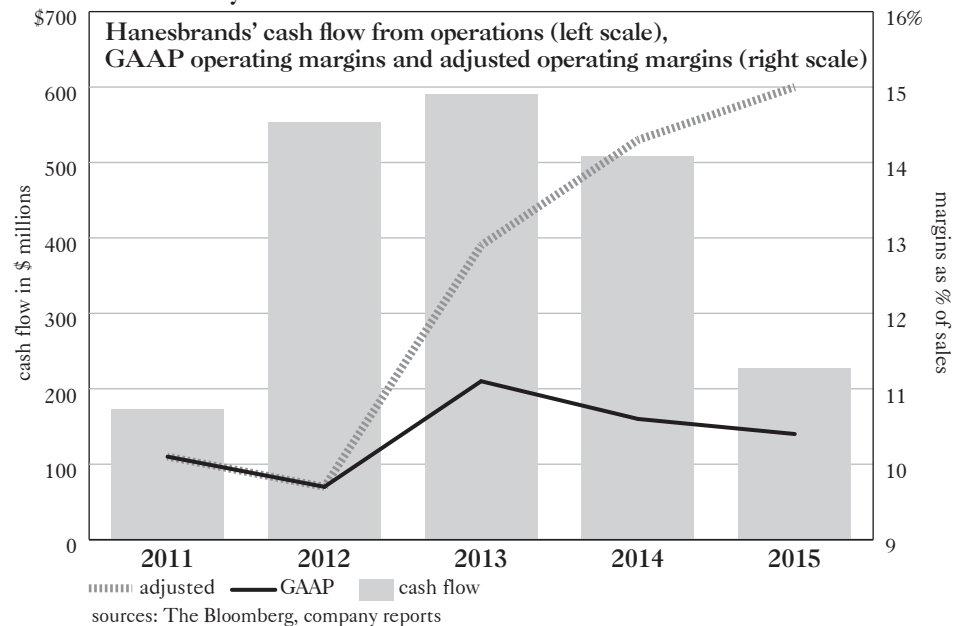
At first glance, the strategy appears to be paying off. Hanesbrands’ operating margin before acquisition-related expenses expanded to 15% in 2015 from 9.7% in 2012. Compare and contrast the 10.3% of Ralph Lauren Corp. or the 13.6% of Nike, Inc.

“Second glance tells another story,” Lorenz relates. “In tandem with the aforementioned \$1.1 billion in post-2013 acquisitions, Hanesbrands rang up \$570.5 million in ‘acquisition, integration and other action-related charges.’ It’s material not only in relation to M&A activity—it is, in fact, 51% of the cumulative purchase prices—but also to earnings. Include acquisition-related costs in operating results for the 12 months ended April 2, and the operating margin shrinks to 10.9% from the advertised, ‘adjusted’ 15.2%. Over the past 12 months, ‘adjusted’ earnings per share (i.e., scrubbed of acquisitions-related costs) come to \$1.71; GAAP accounting reduces that sum to just \$1.14 per share.”

What, exactly, are Hanesbrands’ underlying earnings? Lorenz put this poser to James Duffy, who covers Hanesbrands for Stifel Financial Corp. “I’d love to understand that as well,” Duffy replied. “We do think about it, but with all of the acquisitions and the one-time charges, that has been more difficult to determine with certainty. I guess I am not certain what to say beyond that. The disclosure around the one-time charges is broad-based and vague. It is difficult to kind of read through all of the different adjustments.”

Some things are easy to deconstruct. Thus, between year-end 2012 and the first quarter 2016, inventories grew at the rate of 14.9% per annum, almost double the 7.6% rate of growth in sales. The consequences are what you’d expect. Based on trailing-12-month sales, inventories today stand at 199.5 days, up from 146.9 days at year-end 2012.

### Whom do you trust?



Another observation: Cash flows from operations have been dwindling (they peaked in 2013) even as reported adjusted net income has been rising. Thus, by management’s reckoning, adjusted net income jumped by 15% to \$102.2 million in the first quarter, while cash flows from operations registered a decline of \$25.5 million, to minus \$284.8 million. The divergence is especially noteworthy because, over the same three months, pension contributions declined by \$60.6 million.

You may wonder, Is Hanesbrands encumbered, and, if so, by what margin do cash flows cover interest expense? The answers depend on how you define cash flows. Debt, net of cash, came to \$3 billion on April 2, which was 4.1 times trailing EBITDA. Alternatively, using management’s adjustments, net debt weighed in at just 3.1 times EBITDA. In the trailing 12 months, operating profit covered interest expense by 5.1 times with reference to the GAAP figure but by 7.1 times using management’s bespoke metric. (Leverage will increase with the Champion Europe and Pacific Brands acquisitions.)

“For all of its faults,” Lorenz points out, “Valeant was forthright about the costs it excluded from its non-GAAP figures. You could disagree with any line item [and Lorenz did, [in these very pages—ed.](#)], but former CEO J. Michael Pearson flagged inventory step-ups; step-ups and step-downs in property, plant and equipment; in-process R&D write-downs and a host of other adjustments in each and every quarterly earnings re-

lease. Hanesbrands, by contrast, is grudging in its quarterly press releases and not much more forthcoming in the 10-K and 10-Q documents it files with the SEC. And when it doesn’t withhold, it mystifies: What, for example, is ‘infrastructure (including information technology) and similar charges’? And how on earth does management know how much to apportion to expenses for infrastructure to support and integrate ‘future acquisitions,’ i.e., the ones that haven’t happened yet? Maybe underpants makers instinctively recoil from transparency.”

They do not draw back from incentive compensation, which the front office pays itself according to the following formula: 40%, growth in adjusted earnings per share; 40%, growth in cash flow from operations; and 20%, growth in top-line revenues.

It would take a C-suite of Boy Scouts not to notice how advantageous a strategy of growth-through-acquisition would be to their own personal betterment, quite apart from the benefits it provides to the company and the shareholders. For one thing, M&A boosts headline sales growth. For another, it furnishes a handy cover for earnings adjustments. As to the latter, though the Maidenform transaction closed in October 2013, management continued to expense Maidenform-related acquisition and integration costs through the fourth quarter 2015.

An American company, generating 80% of its top line in the United States, Hanesbrands has recently paid income

taxes at rates as low as 9.5% (in 2015) and as high as 31.5% (in 2007). As if to anticipate comparisons with a certain notorious pharmaceutical roll-up, the Hanesbrands FAQ webpage asserts, a little defensively: “We do not use inversions. We do not do earnings stripping. We do not engage in artificial tax management. Our accounting and tax strategies are sound. In fact, we were recently audited by the IRS (see our third-quarter 2015 Form 10-Q) and the audit was closed with no adjustments. Our tax rate is the by-product of our global business model, which we believe is sustainable for many years to come.”

Striking is the gap between vibrant sales growth—up by 8% per annum between 2012 and 2015—and weak organic sales growth. Organic growth, which excludes M&A as well as the effect of currency movements, grew by just 0.7% in 2014; it declined by 1.9% in 2015. U.S. mass merchants, like Wal-Mart Stores and Target Corp., delivered 49% of 2015 sales; department stores, e.g., Kohl’s Corp., chipped in 15%. Neither retail category is thriving. Nor will Hanesbrands’

dependence on American retail outlets be materially reduced by the recent accession of Champion Europe and Pacific Brands; the two generate revenues equal only to 14% of Hanesbrands’ trailing-12-month sales.

“Besides,” Lorenz points out, “competition in the U.S. underwear market may be heating up. Gildan Activewear, Inc., a Canadian apparel maker that is dominant in the North American printwear market (blank T-shirts and fleeces for sale to screenprinters and embroiders), has been gaining share in the U.S. underwear market. ‘Our underwear program started to ship in the second half of 2013,’ Sophie Argiriou, head of investor relations for Gildan, tells me. ‘Last year we ended with a market share in men’s underwear of about 7%. At the end of March we were at 8.5%. We feel we are well positioned and we feel we will probably get to a 10% market share. Initially [our share gain] was from private label but we are also gaining share from the existing national brands. We’ve got new distribution in food and drug that was occupied

by a national brand. Initially with our underwear we displaced some private label but we’ve gained shelf space and ultimately it is coming from the existing space of national brands.’”

On June 13, CEO Richard A. Noll, 58, who has led Hanesbrands since the company’s spinout from Sara Lee in 2006, announced his intention to step down as chief executive effective Oct. 1; he will remain as chairman. Around year end, in the space of two months, Noll liquidated 845,479 shares, or 54% of his Hanesbrands holdings. Others have taken his lead, or anticipated it; in the past 12 months, insiders have unloaded a net 1,270,530 shares for proceeds of \$39 million.

Hanesbrands changes hands at 22.6 times trailing GAAP earnings per share, or 15.1 times trailing adjusted earnings per share, if you trust management’s adjustments. Wall Street still does. Of the 16 analysts on the case, 13 rate the company a buy, while just three (including the afore-quoted Duffy) call a hold. We would call it a “sale.”

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