GREENBERG MERITZ
RESEARCH & ANALYTICS

June 18, 2008 **Hanesbrands (HBI-NYSE)**

Herb Greenberg: herb@greenbergmeritz.com PO Box 59426 Potomac, MD 20859
Debbie Meritz: debbie@greenbergmeritz.com 240.482.4849

Pulling the 'Levers' at Hanesbrands

Our Takeaways.....

- **Uninspiring sales growth**
- **Dubious earnings quality**
- **Strained balance sheet**
- **Puffed up cash flow**
- **Stiff headwinds**

The GMRA Hook

Investors cheered Hanesbrands' rising first quarter operating profits and impressive beat of earnings per share in the face of falling sales. The company's explanation for the strong bottom line: "Globalization and consolidation initiatives."

Sounds impressive, especially for a company being portrayed by some pundits as having pulled off a "remarkable" turnaround. Indeed, if you view the company the way Hanesbrands skillfully presents the numbers in its first quarter earnings release and post-earnings conference call, it looks and sounds like a turnaround – until, that is, you get to the 10-Q, which was filed 16 days later.

To us, the reality: Less than two years after being spun off from Sara Lee, the company remains in the middle of trying to turn itself around and appears to be relying heavily on nonrecurring, nonoperational "levers" and artificial income boosts as the core of its current growth story.

For obvious reasons, we're not fans of companies that use nonrecurring, nonoperational levers and artificial income boosts to give the impression that the underlying business is on a solid growth trajectory. We're even less enthusiastic when the company leaves the good stuff for investors to find on their own in regulatory filings.

At Hanesbrands, nothing was more compelling last quarter than an $11.9 million reduction in the allowance for doubtful accounts. This wasn't mentioned in the earnings release or *conference call. <u>Yet we estimate that without that single boost, non-GAAP operating income, which the company guides Wall Street to watch, would've skidded by 5.7% rather than grow by 4.9%.</u>*

We believe the balance sheet and operating cash flow were equally unimpressive in the quarter: Both deteriorated faster than normal and, in our opinion, are inferior to peers in a mature, competitive and rapidly consolidating industry at a company that is maneuvering itself through a major restructuring.

We realize that one quarter does not make a trend, but we believe the risk for investors is that as the economy continues to struggle, costs rise and competition intensifies, Hanesbrands had better hope it can find more nonoperational levers to pull to help make things look better than they really might be.

Ticker:	NYSE: HBI	**Daily Trading Volume:**	1.4 M shares
Market Capitalization:	$3.1 B	**Long-Term Debt:**	$2.3 B
Enterprise Value:	$5.3 B	**Long-Term Debt / Equity:**	7.4
Shares Outstanding:	94.07 M	**2008 EBITDA Estimate:**	$584.8 M
Price:	$32.96	**Reuters 2008 EPS:**	$2.55
52 week high:	$37.73	**2008 Revenue Estimate:**	$4.4 B
52 week low:	$21.47	**Price/Earnings 2008 Est.:**	12.9
Float:	93.7 M shares	**Price/Earnings 2007:**	20.0
Short Interest, 5-28-08:	11.8 M shares	**Est. Expected Rev Growth:**	1.0%
Short Interest / Float:	12.7%	**Est. Expected EPS Growth:**	54.5%

The story: Since its spinoff from Sara Lee almost two years ago, the mantra at Hanesbrands has been to "sell more, spend less and generate cash."

The company embarked on an ambitious restructuring, with a goal of generating operating profit growth of 6% to 8% and impressive double-digit earnings per share growth – all on mere sales growth of 1% to 3%.

To emphasize that point, speaking at the company's investor day last February, CEO Rich Noll said: "While a year from now we may narrow our annual EPS growth goal to be in the range of, say, 15% to 25%, for now we will maintain the double digit goal because 2008 has the potential to be above this range. Yes, 2008 could be greater than that."

Tempted by the lure of squeezing *so* much in the way of operating earnings out of a top-line flat-liner that is top-heavy with debt (albeit debt that is being shaved), investors have been willing to jump on the company's brand-wagon.

Are They Really Selling More?

Let's start with the company's stated goal to "sell more" at a pace of 1% to 3% annually. The company hit that target with a sleepy 1.6% growth rate in 2007. However, with March 2008 quarterly sales sliding 5% from the prior year, Hanesbrands fell short of its goal on a trailing four- quarter basis. Sales for the trailing four quarters rose just 0.27% over the same period a year earlier.

As the chart below shows, March's dismal quarterly sales were the lowest ever reported publicly by the company. To make matters even worse, the $987.8 million reported in the March quarter includes a currency benefit of $11 million, which translates into $2 million in operating income. Without the currency boost, rather than falling by 5.0%, we estimate sales would have been roughly $976.8 million, a drop of 6.1%.

	MAR 2008	**DEC 2007**	**SEPT 2007**	**JUNE 2007**	**MAR 2007**	**DEC 2006**	**SEPT 2006**	**JUNE 2006**	**MAR 2006**
Net Sales ($millions)	**987.8**	1,159.1	1,153.6	1,121.9	1,039.9	1,131.5	1,119.0	1,120.1	1,032.9

Dubious Quality of Earnings

While sales fell, reported non-GAAP operating income, net income and earnings per share rose. But we believe the quality of earnings leaves something to be desired, especially in light of

Noll's comments at the investor day that operating profit would be "magnified by our cost reduction opportunities." He added that EPS would be "further magnified by the judicious use of cash flows."

Further magnifying profits was the $11.9 million reduction in the allowance for doubtful accounts. The size of an allowance is subjective, and can vary for a variety of reasons, including improved receivables quality or a change in the dollar amount of receivables. We find the magnitude of the drop curious if not downright propitious.

As we show in the chart below, while gross receivables in the March quarter fell by 7.4%, the allowance plunged by 37.5%. Put another way, in its first six quarters as an independent company, Hanesbrands recorded an allowance on average of roughly 5.5% of its gross receivable. <u>In the December 2007 quarter, the allowance was 5.2%. But by the March 2008 quarter the allowance had been slashed to 3.5% of gross receivables – the lowest ever.</u>

	MAR 2008	**DEC 2007**	**SEPT 2007**	**JUNE 2007**	**MAR 2007**	**DEC 2006**	**SEPT 2006**	**JULY 2006**	**JULY 2005**	**JULY 2004**
Gross Receivables ($millions)	561.7	606.7	606.5	581.8	542.9	516.3	561.2	565.0	622.9	585.6
Change over prior quarter	**(7.4%)**	0.0%	4.2%	7.2%	5.1%	(8.0%)				
Allowance for Doubtful Accounts ($millions)	**19.8**	31.6	28.7	25.9	29.1	27.7	44.4	41.6	47.8	59.9
Change over prior quarter	**(37.5%)**	10.3%	10.8%	(10.9%)	4.9%	(37.6%)				
Allowance as % of Gross Receivables	**3.5%**	5.2%	4.7%	4.5%	5.4%	5.4%	7.9%	7.4%	7.7%	10.2%

Had the company kept the allowance level unchanged in the March quarter from the quarter before, as it did in the same span a year earlier, we believe non-GAAP operating income would have been reduced by 10%, or $9.4 million.

More to the point, as the chart below shows, we estimate that the drop in allowance let the company report a healthy 4.9% growth rate in non-GAAP operating income versus a drop of 5.7%, which would most likely not have gone over well with Wall Street.

	MAR 08
Non-GAAP Operating Income – As reported	$93.6 mill
Y/Y Growth - As reported	4.9%
Less: **Estimated boost to Income from Drop in Allowance for Doubtful Accounts *(using the 5.2% allowance from Dec '07)***	($9.4 mill)
GMRA Adjusted Non-GAAP Operating Income	$84.1 mill
GMRA Adjusted Y/Y Growth	**(5.7%)**

.

But, wait, there's more. Other nonoperational or one-time artificial boosts to March 2008 non-GAAP operating income included:

- $2 million, or 2 cents a share, from lower cotton costs (which, currently, are an anomaly as cotton prices continue to confound.)
- $2 million, or 2 cents a share, from the previously mentioned currency benefit.
- $2.7 million, or 2 cents a share, from a drop in stock-based compensation expenses.

Added to the drop in the allowance for doubtful accounts, as seen in the chart below, we estimate that non-GAAP operating income got a total boost of $16.1 million from these one-time nonoperational levers.

Stripping away these benefits, we calculate non-GAAP operating income tumbling 13.2% to $77.4 million from $89.2 million in the year ago quarter. That translates, at best, into 29 cents per share compared with 27 cents, an increase of 9% -- after getting additional aid from a lower share count, lower tax rate and lower interest expense. That's a far cry from the highly publicized 56.5% growth.

	Non-GAAP Operating Income	Non-GAAP EPS
As Reported	**93.6** vs. 89.2 in 2007	**0.42** vs. 27c in 2007
Less: GMRA Adjustment for Drop in Allowance	(9.4)	(0.07)
Less: Benefit from Lower Cotton Costs	(2.0)	(0.02)
Less: Foreign Currency benefit	(2.0)	(0.02)
Less: Drop in Stock-based Comp Expense	(2.7)	(0.02)
Total Estimated Benefits	**16.1**	**0.13**
GMRA Adjusted Operating Income and EPS	**77.4** vs. 89.2 in 2007	**0.29** vs. 27c in 2007
Estimated Benefits as a % of Reported Non-GAAP Operating Income / Earnings Per Share	**17.2%**	**30.3%**
GMRA Adjusted Y/Y Growth	**(13.2%)**	**9.0%**

In what appears to be yet another attempt to put a positive spin on its low-quality earnings -- further steering investors to Hanesbrands' preferred view of itself -- Noll pointed out at the top of his opening remarks on last April's earnings call that $12 million of the $14 million increase in net income came from debt pay-down, "lower spreads" and lower LIBOR rates on its debt. To be sure, interest expense dropped to $40.4 million last quarter from $47 million the quarter before -- and $51.7 million a year earlier. That's the equivalent of 9 cents of the reported 15-cent increase in non-GAAP earnings per share over March 2007.

Another earnings-boosting lever has been the tax rate, particularly in the March 2008 quarter. While the company in its press release says that improvements in non-GAAP income were "partially offset by slightly higher income tax expense," we note that the company actually received a 3-cent per share benefit from a meaningful drop in tax rates from the prior year. The tax rate, benefiting from supply chain investments in "low tax geographies," as the company puts it, dropped to a post-spinoff low of 24% versus 30% a year ago.

	MAR 2008	DEC 2007	SEPT 2007	JUNE 2007	MAR 2007	DEC 2006
Tax Rate %	**24.0**	33.7	30.0	30.0	30.0	33.2

Almost another penny per share came from buying back stock.

	MAR 2008	DEC 2007	SEPT 2007	JUNE 2007	MAR 2007	DEC 2006
Diluted Shares Outstanding	**95.6**	96.6	96.6	97.2	97.1	96.6

The Bottom Line on the Bottom Line

What would the March 2008 non-GAAP operating income, net income and earnings per share look like without all of the nonoperational levers and one-time benefits? The chart below takes into account our estimate of all items that we believe helped boost the quarter and lift the stock, which has since given up some of the gains. After removing what we believe to be one-time non-recurring benefits and non-operating levers, we estimate that the underlying fundamentals of the business produced only a rounded up 19 cents in earnings per share compared with the reported 42 cents.

(Non-GAAP)	MARCH 2008 REPORTED	*MARCH 2008 GMRA ADJUSTED	MARCH 2007 REPORTED
Operating Income $ millions	93.6 4.9% growth	**77.4** **(13.2%) growth**	89.2
Net Income $ millions	40.4 54.1% growth	**18.0** **(31.4%) growth**	26.2
Earnings Per Share	0.42 56.5% growth	**0.19** **(31.4%) growth**	0.27

*Operating income is adjusted by GMRA for lower allowance for doubtful accounts, currency benefits, deflated cotton costs and lower stock-based compensation. Net Income and EPS are adjusted for all of the operating adjustments plus the lower tax rate, decreased share count and lower interest expense.

As for Spending Less…

While we believe paying down debt is a strong positive for Hanesbrands, whose long-term debt to equity ratio last quarter was roughly 7.4, we would prefer not to see something as discretionary as debt pay-down and the resulting lower interest expense interest expense viewed as a "lever" when, in our opinion, the underlying business fundamentals are weakening.

Yet that's just what Hanesbrands appears to do.

From CFO Lee Wyatt's comments via the First Call transcript of the April earnings call:

> In summary, in the first quarter of 2008 we saw sales decrease broadly as a result of a difficult consumer environment. Yet, as we pointed out in our February investor meeting there are many independent levers that will drive our earnings growth. <u>Operating profit excluding actions benefited from cost reduction initiatives and lower interest expense and contributed to strong EPS growth</u>. We have the flexibility in our strategy and capital structure to react to changes in the business environment to create maximum value.

Balance Sheet Once-Over

The story isn't much different on the balance sheet. Even as the company has started to pay down debt, key line items remain strained, especially those targeted for improvement.

Among the "major strategies" spelled out by Hanesbrands at its investors' day, the No. 1 goal was to "continually improve asset turns – especially fixed assets, inventory, receivables and payables."

Flying in the face of these goals, inventory days in March 2008 shot up – and not by a small amount, especially when compared with the prior year *and* the competition. <u>The chart below shows that inventory days grew to a disturbing 171.4 days in March 2008 – up from 161.1 days a year earlier and the highest ever since the company went public.</u> (We look at year-over-year figures because Hanesbrands' business can be seasonal.)

However, sequential growth in inventory days paints an even uglier picture, with a 45.6 day pop from December 2007 to March 2008; that compares with a 20.2 day rise in the same period a year earlier.

And to drive the point even further, Hanesbrands' inventory days far exceed those of its biggest competitors as seen in the chart below.

In our opinion, that's not a desirable position for a company saddled with debt and facing competition with much stronger balance sheets.

Inventory Days	MAR 2008	DEC 2007	SEPT 2007	JUNE 2007	MAR 2007	DEC 2006	SEPT 2006
Hanesbrands (HBI)	**171.4**	125.8	135.8	149.7	161.1	140.9	150.9
Gildan (GIL)	139.1	154.5	125.0	105.7	142.3	159.3	110.7
Maidenform (MFB)	94.2	109.3	86.7	69.7	73.4	79.34	63.5

This unusual rise in inventory didn't escape Brian McGough, an analyst at Morgan Stanley. According to the Street Events conference call transcript, he said:

> I think your days of inventory on hand is something like 140 days. I mean it's just huge. I think it could outfit like every person in the country with a couple of pairs of tidey-whities. There is no reason why that shouldn't be a lot lower, particularly as you take down your number of factories.

Gerald Evans, president of Global Supply Chain for Hanesbrands, responded by dancing around the issue:

> Brian, I can certainly tell you what we are doing to simplify and I have actually reduced inventory and I mentioned it earlier. We … are working very closely through the marketing group and simplifying our product lines which will have a tremendous effect on reducing our inventories. We got a fewer products and we sell more of those products in more places. We actually simplify the inventory, we get high returns. It is not typically your high turning out that creates your inventory problems; it is typically your fringe type of SKUs, the backup and so forth.

He later added that the company expects to reduce inventory "over time" because of fewer facilities.

Our stab at translating his comments: Inventory is out of control.

That's not all: Days Sales Outstanding (using the company's stated accounts receivable) in the March 2008 quarter also hit a high at 49.4 days.

That's up 4.7 days, or 10.5% from a year earlier and up almost five days sequentially. That is the highest level since the company became public, and flies in the face of the stated goal to improve asset turns.

	MAR 2008	DEC 2007	SEPT 2007	JUNE 2007	MAR 2007	DEC 2006	SEPT 2006
Days Sales Outstanding	**49.4**	44.7	45.1	44.6	44.5	38.9	41.6

And one note on long-term debt: According to Wyatt on April's call:

> Long-term debt at March 29 was $2.3 billion, approximately 67% of our debt remains at a fixed or capped rate. We have structured the debt so that $1.7 billion is benefiting from lower interest rates."

That's something to think about if interest rates reverse themselves or in the very least don't fall any further. An upward move in rates could really dampen this lever.

<u>And About that Cash They're Generating …</u>

The rise in payables also suggests the very operating cash flow generation that is central to the Hanesbrands turnaround is increasingly aided by stretching out the amount of time it takes to pay its bills. This couldn't be more evident than in the March 2008 quarter when Days Accounts Payable grew to 43.4 days – well above the December 2007 quarter at 32.6 days and the year ago quarter at 29.9 days.

	MAR 2008	**DEC 2007**	**SEPT 2007**	**JUNE 2007**	**MAR 2007**	**DEC 2006**	**SEPT 2006**
Days Accounts Payable	**43.4**	32.6	33.0	30.8	29.9	25.7	24.4

We understand that rising payables can be considered part of good cash management. However, had days payables remained constant at the same level at the December quarter's 32.6 days -- already higher than the average of the prior six quarters since going public -- we estimate that operating cash flow would've been lower by approximately $77.3 million.

<u>Making these adjustments, we estimate that cash flow from operations would have been a negative $96.8 million in the March 2008 versus the reported negative $19.5 million.</u>

Furthermore, if true underlying cash flow doesn't meet expectations, we believe debt pay-down could be stunted and share repurchases could be hampered. Debt pay-down is the company's most important long-term "value creation" lever.

As noted earlier, the company received a 9-cent per share benefit in March quarter compared with 2007 for lower interest payments.

Additionally, over the past five quarters, the company has bought back stock worth $52 million, which in part has driven earnings per share growth through the declining share count. Again, as noted earlier, in the last quarter the company received almost 1-cent a share benefit from the share repurchase versus last year.

Stiff Headwinds

With brands like Hanes, Champion, Playtex and Bali, Hanesbrands is certainly well-positioned as it tries to navigate through a rocky economy.

But as the economy is cooling, inflation is rising and competition is heating up. In the past year Hanesbrands, to make itself more cost-competitive, has closed 15 plants, with an eye to saving more $200 million over time. They're being replaced by plants in China and Southeast Asia, <u>but the timing of the shift is occurring as costs in China are rising</u>, especially for "innerwear," as underwear is known in the trade.

According to a recent story in *Women's Wear Daily*, some companies are even starting to move production away from China.

"It's like a sea change," Jeff Mirvis, CEO of MGT Industries, which makes private label innerwear, told WWD. "The inflation in China and the weakening of U.S. currency is definitely having an effect. <u>China is no longer a cheap place to manufacture and the U.S. currency has devalued 10 percent against the Chinese currency</u>."

He added that wages in China have been inflated and that "there are not as many workers in southern China."

As production costs prove challenging, so do the costs of cotton, which is 6% of costs of goods and which has been trading at the high end of its historic range. Hanesbrands says it's bracing for prices in the mid 80-cent range in 2009. Noll said that other "input prices" are rising as well.

Noll's take, on the April call:

> …It is clear that sustained price deflation is over for much of the apparel industry since most of the industry supply chains have already moved to lower-cost geographies. And second, over time price increases will need to become a tactical tool in this new environment. The question is, how much and how soon. <u>We are in an industry where most buyers and sellers entire careers have been spent in a deflationary environment and mindsets can shift slowly.</u> However, we are starting to see price increases in some select areas. How much, how fast and how broad the price changes become remains to be seen.

As the tug-of-war over pricing intensifies, Hanesbrands still believes it can increase operating margins by a half to one full percentage point a year.

<u>That depends, we believe, on whether retailers themselves are willing to accept lower margins or pass along higher costs to increasingly price-conscious consumers. Or whether Hanesbrands can cut its manufacturing costs fast enough to outpace the cost pressures.</u> One hint on which way this may tilt came Tuesday, when Wal-Mart said it has cut its capital spending estimates for next year while reiterating its focus on value.

Competition

Even Hanesbrands warns that its debt, which still tops $2.3 billion, could hamper its competitive position.

As of last quarter	LONG-TERM DEBT *($MILL)*	NET DEBT / EBITDA (LTM)
Hanesbrands (HBI)	**2,315.3**	**3.86**
Gildan (GIL)	142.2	0.51
Maidenform (MFB)	88.4	1.23

From the company's 10-K:

> Our leverage also could put us at a competitive disadvantage compared to our competitors that are less leveraged. These competitors could have greater financial flexibility to pursue strategic acquisitions, secure additional financing for their operations by incurring additional debt, expend capital to expand their manufacturing and production operations to lower-cost areas and apply pricing pressure on us.

Hanesbrands has several prominent competitors, including Berkshire Hathaway-owned Fruit of the Loom and Maidenform Brands. If we didn't know better, however, we would think they're talking about Gildan Activewear. Gildan, whose plants are largely in Central America rather than Asia, where logistics are better for serving mass marketers in the U.S., is guiding investors to expect $100 million in free cash flow this year *after* $155 on capital spending.

Gildan historically has focused on wholesale. But with two recent acquisitions, it's veering aggressively into retail, with an eye on stealing share from existing players much as it did a number of years ago when it climbed from nowhere to become No. 1 in the business of selling t-shirts to screen printers.

<u>Gildan's foray into retail has put it head-to-head with Hanesbrands in the sock market, which Gildan private labels for Wal-Mart, among others.</u> Gildan is also starting to private label underwear, which in mass retailers is sold more on price than brand.

Gildan has said that last month it started shipping underwear to a major retailer. <u>According to press reports, that retailer is Wal-Mart, which is Hanesbrands' biggest customer.</u>

Here's where it gets interesting: At its investors' day last in February, Hanesbrands reiterated what it has said in every 10-Q and 10-K since going public: That it is No. 1 or No. 2 in most of its markets As recently as its 10-K, it had disclosed:

> Our brands have a strong heritage in the apparel essentials industry. According to The NPD Group/Consumer Tracking Service, or "NPD," our brands hold either the number one or number two U.S. market position by sales in most product categories in which we compete, on a rolling year-end basis as of December 31, 2007.

<u>That disclosure, or anything remotely like it, disappeared from the most recent quarterly filing.</u> During that period, in a segment-by-segment breakdown, the company said sales of socks were off by 10% from a year earlier; underwear -- pre-Gildan's push into Wal-Mart – down by 5%; innerwear as a whole, down 8%; outerwear, down 4% and hosiery, down 9%. The bright spot was international, which accounts for 10.6% of sales: up 15.3%. But that while international sales were the bright spot, this sales category was inflated by an $11 million currency benefit. Without it, international sales were only up 3.1%.

Does that mean Hanesbrands' is feeling vulnerable? It's unclear, but as Noll said in April, "Much has changed since our February investor day."

Duly noted.

<u>Going Forward</u>

Hanesbrands does not offer earnings guidance. However, it does offer clues. Here's all you really need to know: With Wall Street expecting 31.5% growth in earnings per share (per Reuters estimates) for the June 2008 quarter on a 1% sales gain -- and an average target price of $39.75 – investors appear to be expecting another blockbuster report. For the year, analyst expectations are for 54.5% earnings per share growth on a 1% sales gain.

That leads us to wonder: If Hanesbrands relied to so many levers and one-time, artificial boosts to get to last quarter's low-quality number on a sales *decline*, what will it do for an encore?

<u>Management's Take</u>

A Hanesbrands spokesman declined comment, citing the company's pre-earnings quiet period.

About GMRA's Reports

GMRA is a publisher of research and analysis about public companies. Its Reports are prepared for informational purposes only. GMRA is not an investment adviser and does not provide investment advice to the subscribers or readers of its Reports. Nothing in its Reports is intended to be or should be understood as recommending or soliciting the purchase or sale of any security or recommending any trading strategy.

The information contained in GMRA's Reports is believed to be reliable and current when published. However, GMRA does not independently verify such information and does not represent that such information is accurate, complete or current.

GMRA collects information from numerous sources including from subscribers. GMRA solely reserves the right to select information for inclusion in its Reports.

Copyright 2008 by Greenberg Meritz Research & Analytics, Inc. All Rights Reserved. The works of authorship contained in the accompanying material, including but not limited to all data, design, text, images, charts and other data compilations or collective works are owned by Greenberg Meritz Research & Analytics, Inc. or one of its affiliates and may not be copied, reproduced, transmitted, displayed, performed, distributed, rented, sublicensed, altered, or stored for subsequent use, in whole or in part in any manner, without the prior written consent of Greenberg Meritz Research & Analytics, Inc.