

Herbalife LTD

HLF: NYSE

Analyst: Peter Ostrowski

Sector: Consumer Staples

Short

Price Target: \$33

Key Statistics as of 3/6/2016

Market Price:	\$55.39
Industry:	Health
Market Cap:	\$1.06B
52-Week Range:	\$33.02-\$60.77
Beta:	1.1

Thesis Points:

- Constant legal troubles leave future of uncertainty
- Back to back years of negative earnings leave company with capital structure of 103.4% debt
- Credit facility requires HLF to comply with strict contingencies; hindering key value drivers
- Business plan cannot sustain long-term growth

Company Description:

Herbalife Ltd. is a global nutrition company that sells weight management, healthy meals and snacks, sports and fitness, energy and targeted nutritional products as well as personal care products. The Company distributes and sells its products through a network of independent distributors, using the direct selling channel.



Thesis

HLF has been masking their highly sophisticated Ponzi scheme for over 30 years with the sale of health products. Recently, HLF has been receiving complaints and are now under multiple litigations based on a plethora of allegations. This has been destroying value to the company as each year more expenses are accrued because of constant legal trouble. This legal trouble will not disappear and HLF does very little to notify the public about potential losses as they believe that their business is entirely ethical. The financial trouble that they consistently get into has resulted in very strict contingencies with the credit facility.

Multilevel Marketing

It is important to note the recent legal troubles that companies who also practice multilevel marketing have received. Vemma verve was ruled a Ponzi Scheme in August 2015. This company used energy drinks as a cover for their pyramid scheme. The issue with this company is that they did not market their products. Vemma would target college kids with promises of large amounts of money as well as cars. The FTC was not a fan of this organization:

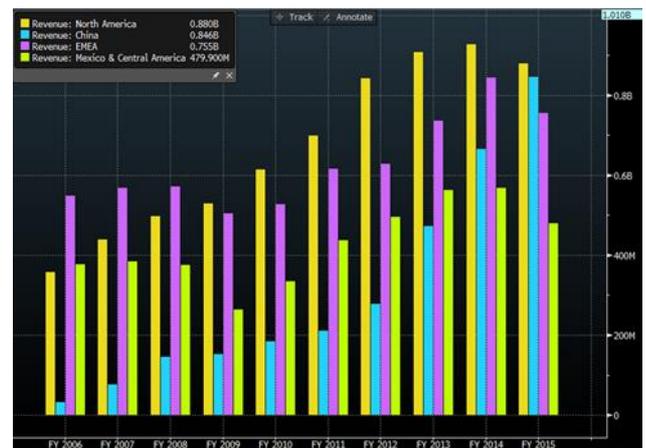
“Rather than focusing on selling products, Vemma uses false promises of high income potential to convince consumers to pay money to join their organization,” Jessica Rich, director of the FTC’s Bureau of Consumer Protection

This business was raided and forced to cease operations. Another company that used these practices was Burnlounge. Burnlounge had roughly 30,000 members and used online music as a cover for their pyramid scheme. Once the FTC can confirm that the business primarily receives their revenue from recruitment instead of sales of goods; operations will be stopped.

The main issue with multilevel marketing is that is cannot sustain the Earth’s population.

Unsustainable Growth

Ponzi Schemes work great when they are not being investigated. Most do not last long enough to understand the actual risks associated with long term growth opportunities. Since Herbalife went public they have been targeting low income/unemployed individuals and have been expanding into the world’s poorest countries as a result. Herbalife operates a “pop and drop” plan where they come into a new region and try to get as many individuals to become members as fast as possible. The main problem they are beginning to run into is the lack of new expansion opportunities.



This chart demonstrates the initial growth that Herbalife has in regions and then the decline and stagnation after the initial increase. EMEA represents this perfectly, it increased up until 2014 and is now beginning to descend. North America and Mexico represent the longer term effects as Herbalife has been operating in these areas for at least 10 years. This is why there is no growth. China is the newest player which is why the growth rates were so high in the past year. It is necessary to note that Herbalife lied about Asian growth rates between 2014 and 2015. This report came out on the third in the 8-k. Not only did they lie about Asian growth rates but they significantly inflated North American rates as well. They reported active members in North America was up 33% when they actually only increased 1.8%. Asian countries excluding China reported 21% increases YoY when they only increased 8.7%. This shows the little trust one can put in Herbalife’s reporting. This report will next show the other legal issues Herbalife has.

Legal Troubles

The abnormal losses section on Herbalife's Income Statement shows the danger and risks associated with this kind of business.

In Millions of USD except Per Share	FY 2013	FY 2014	FY 2015
12 Months Ending	12/31/2013	12/31/2014	12/31/2015
Herbalife Pretax Income (Loss), Adjusted	781.4	823.9	569.2
- Abnormal Losses (Gains)	64.7	402.6	82.8
+ Early Extinguishment of Debt	-	-	-
+ Asset Write-Down	-	236.9	-
+ Legal Settlement	29.1	40.1	22.0
+ Restructuring	-	-	-
+ Other Abnormal Items	35.5	125.6	60.8
Pretax Income (Loss), GAAP	716.7	421.3	486.4

The 3 key things to look at are the Asset Write-Down, Legal Settlements and Other Abnormal Items; because they include many of the same legal issues. They are simply written down as something else. The \$236.9M expense in 2014 is in relation to the exchange rate scheme Herbalife was running in Venezuela. Because Herbalife had 3 different exchange rates it was very easy for the business to capitalize on arbitrage. Distributors could simply buy the goods at black market prices (which have their own exchange rate in Venezuela) and sell them at the national rate. Distributors could essentially sell the products at a price 10X higher than the purchase price.



When this scheme was discovered Herbalife was crushed with expenses that continue to accrue. The expenses from this one also issue include the legal settlement from 2013 and the other abnormal items section from 2014 and 2015. The legal settlements are from the current investigation with the FTC. They have also had to make legal settlement fees in response to Bill Ackman's accusation that Herbalife is a Ponzi scheme. Ackman also has a \$1 billion dollar short on Herbalife as he firmly believes that their business is illegal.

Capital Structure and Contingencies

Herbalife is entirely financed by debt which increases the chances of bankruptcy substantially. They also have very strict contingencies with their credit facility which creates an overbearing restraint on potential value creation opportunities. Currently Herbalife must maintain a cash balance of at least \$200M and is only allotted \$233M for dividends and stock repurchases. They are also given a heavy incentive not to give dividends or repurchase shares as for every dollar repurchased or paid in dividends; the borrowing capacity is decreased by \$2. The credit facility also has restrictions and limitations on Herbalife's ability to incur liens, indebtedness, investments and every other area that includes financing. These contingencies restrict Herbalife substantially. It is also important to note that interest rates will be increasing on these loans between 2% and 5%. This is important to note as currently the increase in indebtedness is only included in the notes on the 10k and is listed as issuance costs.

Conclusion

I recommend a sell for HLF. This is based on the unsustainable growth that is not included in analysts' estimates. The risk of this kind of business is much higher than the benefits. With constant litigations and the recent discovery of inflated growth rates; HLF will have very high abnormal losses for the upcoming years. Multi-level marketing companies have also been targeted by the FTC and Herbalife is not the exception. The only thing that HLF guarantees is a future of uncertainty.

Herbalife Ltd. (hlf)

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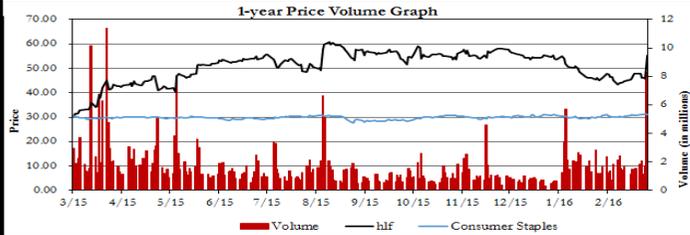
BEARISH

Analysis by Peter Ostrowski
3/6/2016

Current Price: \$56.40
Divident Yield: 0.6%

Intrinsic Value: \$33.90
Target Price: \$42.39

Target 1 year Return: -24.26%
Probability of Price Increase: 2%

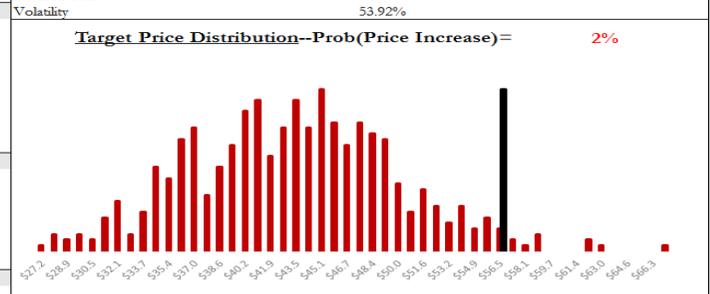


Description	
Herbalife Ltd., a nutrition company, develops and sells weight management, healthy meals and snacks, sports and fitness, energy and targeted nutritional products, and personal care products.	
General Information	
Sector	Consumer Staples
Industry	Personal Products
Last Guidance	November 3, 2015
Next earnings date	NM
Estimated Country Risk Premium	9.56%
Effective Tax rate	27%
Effective Operating Tax rate	29%

Market Data	
Market Capitalization	\$5,073.88
Daily volume (mil)	1.76
Shares outstanding (mil)	92.67
Diluted shares outstanding (mil)	85.30
% shares held by institutions	16%
% shares held by investments Managers	48%
% shares held by hedge funds	19%
% shares held by insiders	6.98%
Short interest	23.63%
Days to cover short interest	14.09
52 week high	\$61.95
52-week low	\$30.27
Levered Beta	0.80
Volatility	53.92%

Past Earning Surprises	
Quarter ending	Revenue
12/31/2014	-2.53%
3/31/2015	1.81%
6/30/2015	1.52%
9/30/2015	-3.67%
12/31/2015	3.27%
Mean	0.08%
Standard error	1.3%

EBITDA	
12/31/2014	-1.76%
3/31/2015	-0.08%
6/30/2015	-4.35%
9/30/2015	7.80%
12/31/2015	6.43%
Mean	1.61%
Standard error	2.4%



Management	
Johnson, Michael	Chairman and Chief Executive
Walsh, Desmond	President
DeSimone, John	Chief Financial Officer
Goudis, Richard	Chief Operating Officer
Hoffman, Alan	Executive Vice President of
Peterson, Susan	Founder

Profitability	
ROIC	12.3%
NOPAT Margin	12%
Revenue/Invested Capital	1.02
ROE	16.5%
Adjusted net margin	10%
Revenue/Adjusted Book Value	1.63

Invested Funds	
Total Cash/Total Capital	18.4%
Estimated Operating Cash/Total Capital	7.4%
Non-cash working Capital/Total Capital	-2.4%
Invested Capital/Total Capital	89.6%

Capital Structure	
Total Debt/Common Equity (LTM)	0.40
Cost of Existing Debt	5.62%
Estimated Cost of new Borrowing	1.19%
CGFS Risk Rating	5.62%
Unlevered Beta (LTM)	5.89%
WACC	5.62%

Peers	
Avon Products Inc.	
Nu Skin Enterprises Inc.	
Coty Inc.	
The Estée Lauder Companies Inc.	
Lifefantage Corporation	
Elizabeth Arden, Inc.	
USANA Health Sciences Inc.	
Mannatech, Incorporated	

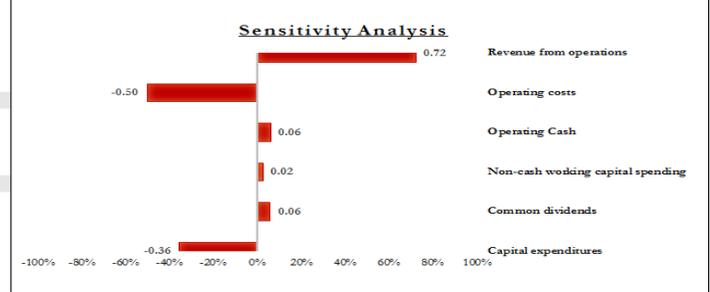
Total compensations growth	
1.1% per annum over 5y	
7.64% per annum over 5y	
-4.02% per annum over 4y	
9.23% per annum over 5y	
N/M	
N/M	

Total return to shareholders	
13.09% per annum over 5y	
13.09% per annum over 5y	
8.2% per annum over 4y	
13.09% per annum over 5y	
0% per annum over 0y	
N/M	

Industry (LTM)	
41.38%	22.50%
24.81%	11.4%
1.67	1.98
43.28%	23.65%
24.09%	10.9%
1.80	2.16

Industry (LTM)	
16.0%	25%
7.8%	N/A
-2.1%	17%
92.3%	61%

Industry (LTM)	
0.28	0.06
5.97%	3.82%
1.19%	3.82%
AAA	BBB
1.40	0.92
14.84%	11.60%



Porter's 5 forces (scores are out of 100)



Period	Revenue growth
Base Year	-9.9%
12/31/2016	1.4%
12/31/2017	4.6%
12/31/2018	0.2%
12/31/2019	1.1%
12/31/2020	1.2%
12/31/2021	1.5%
12/31/2022	1.8%
12/31/2023	2.1%
12/31/2024	2.4%
12/31/2025	2.7%
Continuing Period	3.0%

Period	Invested Capital
Base Year	\$1,789.64
1/0/1900	\$2,378.31
1/0/1900	\$3,183.60
1/0/1900	\$3,648.32

Valuation	
NOPAT margin	ROIC/WACC
12.1%	1.51
11.2%	1.37
12.0%	1.42
12.2%	1.35
11.8%	1.24
11.4%	1.15
11.4%	1.11
11.4%	1.07
11.4%	1.03
11.4%	0.99
11.4%	0.96
11.4%	0.93

Net Claims	
\$1,856.94	\$33.58
\$1,190.55	\$42.01
\$371.92	\$50.87
-\$482.66	\$60.11