

Nautilus Inc.

NYSE: NLS

Analyst: Senan Lonergan

Sector: Consumer Disc.

BUY

Price Target: \$28

Key Statistics as of 4/1/2016

| | |
|----------------|----------------|
| Market Price: | \$18.85 |
| Industry: | Consumer Goods |
| Market Cap: | 584.45M |
| 52-Week Range: | \$13.82-22.95 |
| Beta: | 1.32 |

Thesis Points:

- Impressive growth with margin improvements
- Closing gap between biggest competitors
- Undervalued, cheap stock

Company Description:

Nautilus, Inc., a consumer fitness products company, designs, develops, sources, and markets cardio and strength fitness products, and related accessories for consumer use in the United States, Canada, and internationally. The company operates in two segments, Direct and Retail. It offers specialized cardio, treadmills, ellipticals, and bike products under the Nautilus brand; fitness equipment comprising cardio and strength products, including TreadClimber and Max Trainer specialized cardio machines, PowerRod and Revolution home gyms, and SelectTech dumbbells under the Bowflex brand; cardio products, including elliptical machine under Octane Fitness brand; and recumbent elliptical under xRide and LateralX brand names. The company also provides exercise bikes, including the Airdyne, treadmills, and ellipticals under Schwinn brand; and various kettlebell weights and weight benches under Universal brand. In addition, it engages in licensing its brands and intellectual properties. The company offers its products directly to consumers through television advertising, catalogs, and the Internet; and through a network of retail companies consisting of sporting goods stores, Internet retailers, and large-format and warehouse stores, as well as specialty retailers and independent bike dealers. Nautilus, Inc. was founded in 1986 and is headquartered in Vancouver, Washington.



Thesis

Nautilus Inc. has been rapidly growing the last few years, and is continuing to improve margins as well. The recent acquisition of Octane has positioned NLS as a major influence in the fitness equipment segment. Typically dominated by companies such as Brunswick Corporation, ICON Health and Fitness Inc., and Amer Sports Corporation, Nautilus is gaining considerable market share. Moreover, NLS is outperforming these competitors in metrics such as EBITA Margin and Cost of Revenue. Although Nautilus's cost of capital is higher than these competitors, its return on invested capital is yielding a significantly higher ROIC/WACC.

Industry Outlook

While imported machinery and international players may increase competition, revenue for the Gym, Fitness and Health Clubs industry is expected to rise over the next five years at an annualized rate of 3.0%. Nearly 17% of young adults are considered obese, and there is a political movement in place, advocating for healthier life styles that involve fitness equipment. Furthermore, Sports participation rates are also expected to increase, especially among school aged participants. According to the NCAA's 2015 Sports Sponsorship and Participation Rates report, the number of student athletes and NCAA sponsored sports teams has steadily increased since 1988, and the trend is expected to continue. As gyms memberships and sports participation increases over the next five years, demand for new gym and exercise equipment is expected to increase. The life cycle for the fitness equipment industry has reached a period of larger companies buying smaller companies, in order to add value while diminishing competition. With fewer companies dominating the market share, there is greater demand for international business. Companies such as NLS are now expanding.

Growth

Nautilus has experienced rapid growth in the last 5 years. In 2014, revenue grew by 25.43% and in 2015, 22.34%. Since 2011, NLS has nearly doubled its revenue; reporting \$335.8M in 2015. As mentioned before, the company operates in two segments, Direct and Retail. Direct revenue, sales to places like gyms, accounts for about two thirds of total sales, while the remaining third comes from retail. Both segments have grown by double digits which can be accredited to the successful development and marketing of new products. Management mentioned in the latest quarter earnings that they expect to maintain the growth rate for both of the businesses, which is the high-single digit, low-double digit rates. Furthermore, in addition to revenue growth, NLS is consistently improving margins. Since 2011, both gross and EBITDA margins have improved by nearly 10%. The direct segment's operating margin has improved by nearly 7.5% over the last 4 years, while the retail segment has continued to fluctuate around 12-14%. With direct side revenues growing rapidly, alongside its margin improvement, NLS's total EBITA margin has surpassed its competitors and is just shy of 14%.

Market Share and Competition

The recent acquisition of Octane has generated greater sales, and as a result, NLS holds about 13% of the industry. More than half of the \$1.8 billion fitness equipment industry is dominated by two companies, Brunswick (BC) and ICON Health and Fitness. BC takes up about a third of the market share, and although the company continues to grow, its financials show that its operating income's growth rate has been steadily declining over the last 6 years. BC will prove to be Nautilus's greatest competitor for years to come. On the other hand, the second largest player in the industry, ICON Health is on the decline. IBIS World estimates that revenue has decreased at an annualized rate of 7.7% to \$405.0 million in the five years to 2016. This sharp decline is largely due to the scaling back of domestic manufacturing operations, numerous

lawsuits, as well as competition newer faces such as Nautilus. Profit has also suffered, as increasing legal fees and operational costs outpaced revenue. The third biggest competitor for NLS is Amer Sports corporation (HEL). HEL takes up approximately 3% of the market share, however, they specialize in commercial sales primarily. Nonetheless, Nautilus has taken over the third spot in this battle for market share, and soon enough, they will surpass ICON Health.

DuPont Analysis

When comparing the financials of NLS to two of its largest publicly traded competitors (BC and HEL), it is clear that Nautilus has many strengths as well as some weaknesses. Beginning with revenue to total employees, last fiscal year, NLS recorded 0.71 while the two competitors recorded 0.33. This plays a crucial role in the overall cost of revenue which for NLS, was just 47.2%, while for BC and HEL was 72.9%. Furthermore, these costs have been trending downward for NLS, while the industry remains relatively constant. LFY, NLS outpaced these competitors by 3.3% for EBITA margin, which for many analysts is surprising in various aspects. A smaller, growing, company is expected to be less profitable than well-established corporations, but at the same time, the significantly lower cost of goods should yield a higher margin. Where NLS is considered less efficient than its competitors is SG&A/revenue, which is primarily attributed to Selling and Marketing expenses. A major catalyst for the revenue growth that NLS is experiencing stems for the expenditure on advertisement and marketing. Management attributes their gain in market share to the successful response they see from these expenses, and as a result, do not plan on decreasing this percentage. Moreover, analysts are nervous of marketing and selling expenses to actual increase during the Olympics and presidential election time frame, but management assures that S&M has reached its maximum. With this in mind, when NLS become large enough to slow down S&M expenditure, their low COGS presents them with a serious competitive advantage over their

competitors. They continue to reach out to consumers through advertisement, spend 36.7% of their revenue on SG&A (compared to 13.9%), and still manage to yield a higher ROIC. Overall NLS's ROIC/WACC has improved from 0.91(history) to 1.54(LFY), while HEL and BC has worsened from 1.48(history) to 1.39(LFY).

Capital Structure and Ownership

Nautilus has typically operated without debt, but the recent acquisition of Octane has put \$80 million on their books. NLS does not have an official credit rating because of how recent this acquisition was, but management has reflected their confidence in being able to full the interest payments with the stability that they currently have.

Investment advisors ownership from March 2015 to now has increased 5%, now totaling 79.79% of all holdings. Hedge Fund Manager's hold 13.17% of shares, a decline of 2.64% from last year, and Pension Funds hold 3.15%, an increase of 1.42% from last year.

Conclusion

Nautilus Inc. is positioned to become the 2nd largest player in the fitness equipment industry. Their rapid revenue growth paired with superior margins is justifying the markets mispricing of the stock. Within the year, the price will increase to \$28 a share, as management continues to report record breaking quarters. The DuPont analysis comparing NLS to two of its largest competitors breaks down the company's strengths, as well as their large portion high selling and marketing expenses. While many analysts view these advertising costs to be way too high, management acknowledges these expenditures to be the catalyst for their revenue growth, and ultimately gain in market share.

Nautilus Inc. (NLS)

Senan Lonergan
4/2/2016

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BULLISH

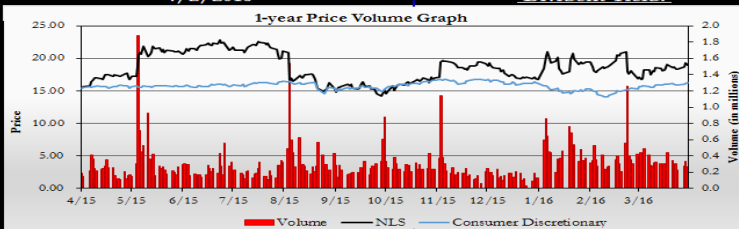
Current Price:
Divident Yield:

\$18.85
0.0%

Intrinsic Value
Target Price:

\$26.84
\$32.12

Target 1 year Return: 70.39%
Probability of Price Increase: 100%



Description
Nautilus, Inc., a consumer fitness products company, designs, develops, sources, and markets cardio and strength fitness products, and related accessories for consumer use in the United States, Canada, and internationally.

General Information
Sector: Consumer Discretionary
Industry: Leisure Products
Last Guidance: November 3, 2015
Next earnings date: N/A
Estimated Country Risk Premium: 9.15%
Effective Tax rate: 24%
Effective Operating Tax rate: -11%

Market Data
Market Capitalization: \$584.45
Daily volume (mil): 0.23
Shares outstanding (mil): 31.01
Diluted shares outstanding (mil): 31.59
% shares held by institutions: 55%
% shares held by investments Managers: 73%
% shares held by hedge funds: 13%
% shares held by insiders: 6.76%
Short interest: 3.54%
Days to cover short interest: 2.80
52 week high: \$22.95
52-week low: \$13.82
Levered Beta: 1.38
Volatility: 55.58%

| Quarter ending | Past Earning Surprises |
|----------------|------------------------|
| 12/31/2014 | -0.11% |
| 3/31/2015 | 15.21% |
| 6/30/2015 | 4.17% |
| 9/30/2015 | 4.79% |
| 12/31/2015 | 0.04% |
| Mean | 4.82% |
| Standard error | 2.8% |

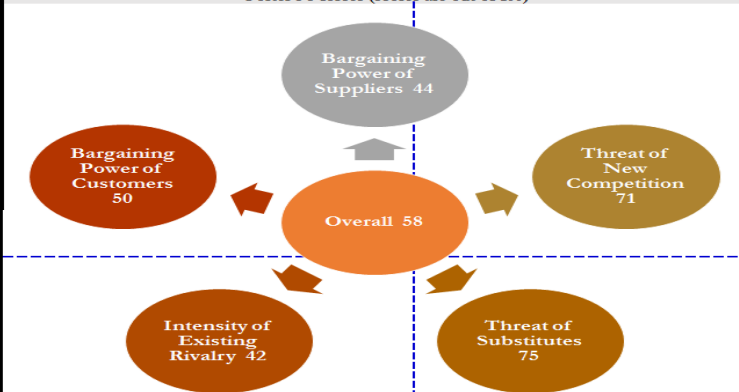
Management
Cazenave, Bruce
Nayar, Sidharth
McMahon, William
Bolio, Wayne
Murdoch, Robert
Brotherton, Aaron

Profitability
ROIC: 60.8%
NOPAT Margin: 23%
Revenue/Invested Capital: 2.67
ROE: 53.2%
Adjusted net margin: 23%
Revenue/Adjusted Book Value: 2.35

Invested Funds
Total Cash/Total Capital: 21.4%
Estimated Operating Cash/Total Capital: 10.8%
Non-cash working Capital/Total Capital: 8.7%
Invested Capital/Total Capital: 89.5%

Capital Structure
Total Debt/Common Equity (LTM): 0.22
Cost of Existing Debt: 1.45%
Estimated Cost of new Borrowing: 2.41%
CGFS Risk Rating: 1.45%
Unlevered Beta (LTM): 0.00%
WACC: 1.45%

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



| Revenue | EBITDA |
|----------------|---------|
| 12/31/2014 | -4.29% |
| 3/31/2015 | 48.77% |
| 6/30/2015 | 2.61% |
| 9/30/2015 | 22.62% |
| 12/31/2015 | -12.72% |
| Mean | 11.40% |
| Standard error | 11.0% |

Total compensations growth
2.09% per annum over 3y
N/M
22.6% per annum over 5y
13.63% per annum over 5y
25.7% per annum over 2y
N/M

NLS (5 years historical average)
8.99%
2.68%
3.36
10.08%
2.39%
4.22

NLS (5 years historical average)
30.2%
22.2%
6.2%
92.1%
NLS (5 years historical average)
0.23
3.23%
1.79%
AAA
1.08
12.36%

Period

| Period | Revenue growth |
|-------------------|----------------|
| Base Year | 22.3% |
| 12/31/2016 | 29.9% |
| 12/31/2017 | 27.2% |
| 12/31/2018 | 24.5% |
| 12/31/2019 | 21.8% |
| 12/31/2020 | 19.1% |
| 12/31/2021 | 16.4% |
| 12/31/2022 | 13.7% |
| 12/31/2023 | 11.1% |
| 12/31/2024 | 8.4% |
| 12/31/2025 | 5.7% |
| Continuing Period | 3.0% |

| Period | Invested Capital |
|-------------------|------------------|
| Base Year | \$73.59 |
| 12/31/2016 | \$78.72 |
| 12/31/2017 | \$85.02 |
| 12/31/2018 | \$110.64 |
| 12/31/2019 | \$125.63 |
| 12/31/2020 | \$254.01 |
| 12/31/2021 | \$345.66 |
| 12/31/2022 | \$420.35 |
| 12/31/2023 | \$512.73 |
| 12/31/2024 | \$624.69 |
| 12/31/2025 | \$768.02 |
| Continuing Period | |

Peers
Callaway Golf Co.
Malibu Boats, Inc.
Brunswick Corporation
Johnson Outdoors Inc.
MCBC Holdings Inc.
Escalade Inc.

Total return to shareholders
60.97% per annum over 3y
0% per annum over 0y
-0.33% per annum over 5y
-0.33% per annum over 5y
107.96% per annum over 2y
N/M

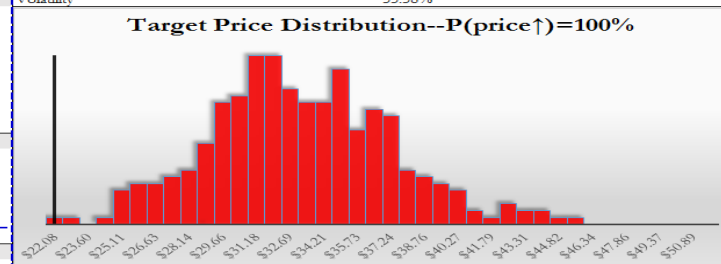
Industry (LTM)
13.37%
10.6%
1.26
15.10%
9.7%
1.56

Industry (LTM)
24%
N/A
24%
76%
Industry (LTM)
0.18
4.79%
4.79%
A
0.8
10.58%

Valuation

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| Continuing Period | |



Sensitivity Attribution Analysis

| | Revenue | Operating Expenses | Dividends | NWC | CAPEX | Operating Cash |
|--|---------|--------------------|-----------|------|-------|----------------|
| | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |

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| Continuing Period | |