Fitbit: From Fad to Future

Short-term target: $15 (130% upside)

What was once a piñata for short-sellers (since IPO) has transformed itself to one of the most underappreciated med-tech stories in the market with a balance sheet and brand equity that gives investors a tremendous investing opportunity.

For years, Wall Street has mentioned Fitbit and GoPro in the same breath – for some crazy reason. While their stock charts are similar and they both started as consumer products companies, that is where the similarities end.

Citron has done the analysis that **NO ONE** on Wall Street has taken the time to fully analyze and appreciate. Based on our work and the information that follows, we will explain why **$FIT steps all the way up to $15/share in 2018 if not acquired first.**

Let's get the obvious out of the way. Yes, selling wristbands that count steps is a dead business (but not as stupid as walking around with a camera strapped to your head). While Wall Street normally applauds a company for losing money looking towards the future, Fitibit stock has been punished as investors cannot seem to look past their own wrist.

Read this story and remember when Netflix used to send DVDs in the mail. Fitbit feels no different as it has quietly established:

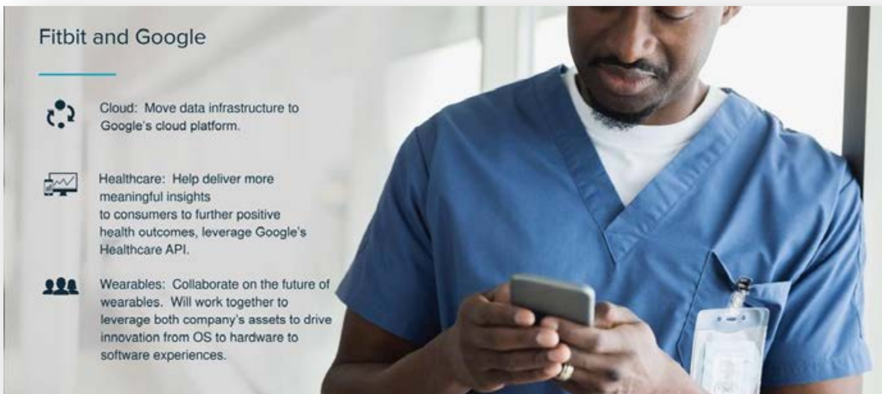
- Research Partnerships with Google (data sharing, machine learning & more)
- Partnerships with Dexcom for Glucose Monitoring
- Partnerships with the largest insurance companies in U.S.
- >$700 million spend on Research & Development since Jan 2016
- FDA acceptance, in a select premier group, to fast-track the process to help revolutionize digital health regulation
- Reclassification of company from consumer products to med-tech devices
- Establishment of a business model with recurring revenue
- Efforts on monitoring heart disease, diabetes, sleep apnea, Atrial fibrillation and more

And lastly FIT recently launched its first wearable device that sold 1 million units in the first month alone. Time Magazine referred to it as *"the biggest threat to the Apple Watch yet"*. Note: that all the aforementioned is in the bag and just the beginning.

Google Partnership establishes that Fitbit tech and approach are here to stay

This one quote is the future.

Gregory Moore, MD, PhD, vice president of health care at Google Cloud put it, *"At Google, our vision is to transform the way health information is organized and made useful … By enabling Fitbit to connect and manage key health and fitness data using our Google Cloud Healthcare API, we are getting 1 step closer to this goal. Together, we have the opportunity to deliver up-to-date information to providers, enhancing their ability to follow and manage the health of their patients and guide their treatment."* (Fitbit and Google Announce Collaboration, Apr 2018)



The leader in diabetes monitoring, is also on team Fitibit

Dexcom has partnered with Fitbit to integrate monitoring into future models. With more than 27 million people with Type 2 diabetes, imagine the size of the market. Just watch this interview to understand the importance of the partnership

Click on the link below to listen to the interview that discusses Dexcom and Fitbit, but here are a few excerpts.

"The partnership with Fitbit is all about Dexcom and how we look to innovate…Fitbit especially with their new watch allows an individual to get glucose readings in a place that is more convenient for them…the Fitbit watch is both iOS and Android…" Rick Doubleday, Dexcom Chief Commercial Officer Mar 2018

Just two days ago JP Morgan put out the headline.

"Diabetes 'technological wave' has too much upside to ignore"
https://www.cnbc.com/2018/06/08/diabetes-technological-wave-has-too-much-upside-to-ignore-jp-morgan.html

The opportunity in front of Fitbit is compelling and it is up to management to either "screw it up" or execute.

Investors: Fitbit is wooing the right customer → Insurance

While Wall Street is sometimes late to the party, insurance is participating in the pre-party. In a recent trial program, UNH is actually giving away Fitbits for real time compliance with glucose monitoring (UNH, Dexcom to launch CGM pilot – Jan 2018). From heart monitoring to tracking/analyzing sleep, insurance is seeing improved compliance from patients wearing Fitbits. These include heart, glucose, and sleep.

What gives Fitbit and advantage over the Apple Watch is that it is agnostic and can be used on all platforms, not to mention less expensive (Fitbit's Versa is its best Smartwatch Yet).

Humana is also working with Fitbit with nearly 4.5 million people in the program and providing incentives to those that use smartwatches or activity trackers (Humana's Wellness Program).

Not Snake Oil, But Rather New Clinical Research

The Journal of the American Medical Informatics Association studied the importance of the role of the Fitbit in remote patient monitoring programs for heart patients (mHealth Finds a Place for Fitbit in Remote Patient Monitoring Research, JAMIA-patient-based eHealth study using continuous-time heart rate and activity trackers).

"Researchers monitored participants' activity levels and sent alerts to those who were wearing their Fitbits less frequently, which yielded a 90% adherence rate at the conclusion of the 90-day study. Studies like this could go a long way toward encouraging providers and insurers to consider the clinical adoption of wearables to better inform clinical decisions and tracking the development of health condition."

What follows is the one most important line in this report

Fitbit has been classified by the FDA as one of the few companies selected to revolutionize digital health in the US.

"The U.S. Food and Drug Administration announced the names of the companies selected to participate in a first-of-its kind pilot program that will help revolutionize digital health regulation in the U.S. FDA Commissioner Scott Gottlieb, M.D. announced today the nine participants, who include leaders and innovators in the medical device and technology sectors, of the FDA's digital health software precertification pilot program (FDA Pre-cert)" (FDA Sep 2017).

Out of 110 names that applied, this is who was approved to revolutionize digital health. The complete list as follows:

- Apple, Cupertino, California
- Fitbit, San Francisco, California
- Johnson & Johnson, New Brunswick, New Jersey
- Pear Therapeutics, Boston, Massachusetts
- Phosphorus, New York, New York
- Roche, Basel, Switzerland
- Samsung, Seoul, South Korea
- Tidepool, Palo Alto, California
- Verily, Mountain View, California [owned by Alphabet, aka Google]

"Touching on the company's work with the FDA and its participation in the digital health pre-certification pilot program, Park said the company plans to submit digital health tools centered on Afibrillation and sleep apnea detection for clearance this year" (Fitbit plans to submit sleep apnea, Afib detect clearance – Feb 2018).

Yet another multi-billion-dollar market.

How did the "step counting" company get here? While Wall Street has been punishing FIT for not hitting profitability targets, they overlooked the corporate strategy behind FIT.

Investment in Research & Development has temporarily deferred profits while creating opportunity in the new med-tech business.

Let's compare them to Garmin, their only somewhat direct comp in the space.

Garmin and Fitbit R&D as % of Revenue	GRMN (Fitness)	Fitbit
2017 Revenue	$762	$1,616
2017 R&D	$81	$343
R&D as percent of Revenue	**10.6%**	**21.2%**

If Fitbit did the Same R&D as % of Revenue as GRMN	Fitbit Adjusted	
Fitbit 2018E Revenue	$1,469	
Fitbit 2018E R&D	$351	A
Fitbit Current R&D as percent of Revenue	**23.9%**	
Fitbit 2018E Revenue	$1,469	
GRMN R&D as % of Revenue (2017)	10.6%	
Implied Fitbit R&D for 2018 (at GRMN levels)	**$156**	B

If Fitbit did the Same Amount of R&D as Garmin	Fitbit Adjusted	
Consensus 2018 Adjusted EBITDA	($72)	
Reduction in R&D to get to GRMN levels	$195	A-B
Adjusted Cons. 2018 EBITDA	**$123**	

Simply reducing FIT's R&D to Garmin's level would result in it instantly generating over $100m in annual EBITDA (not to mention the cash flows that come with it).

Let's take a look at R&D. FIT has continued to invest an ever-increasing amount in R&D as is obvious in the following table.

Fitbit - R&D as Percent of Revenue			
Period	**Sales**	**R&D**	**% of Revenue**
Q1 2018	$248	$89	36%
2017	$1,616	$343	21%
2016	$2,169	$320	15%
2015	$1,858	$150	8%
2014	$745	$54	7%
2013	$271	$28	10%
2012	$76	$16	21%

THE CEO has said it all along and re-iterated it in the most recent quarter.

"Our mission and purpose is not about selling hardware devices to people but to make everyone in the world healthier. Our company strategy across devices, software and services, coupled with our integration into the health care ecosystem, is centered on this mission" ~James Park (CEO) Q1 2018 Earnings Call

And James followed up with:

"…transforming the business from an episodic-driven model centered around device sales and more recurring non-device revenue… *This evolution is less about providing near-term revenue in '18 and more about setting ourselves up to grow durable sources of revenue in '19 and beyond."* ~James Park (CEO) Q1 2018 Earnings Call

As identified by Wired Magazine, this is what makes Fitbit tick.

"FITBIT SPENT ITS first decade selling activity trackers. With its latest moves, the company is starting to look less like a gear maker selling pricey accessories to fitness buffs and ***more like a medical-device company****, catering to hospitals, patients, and health insurers."* ~Wired Dec 2017

It continues with the billion-dollar opportunity.

"Fitbit believes its position as a neutral player that works with any phone makes it desirable to insurance companies and hospitals. Apple Watches only work with iPhones;

if an employer, hospital or insurer wants its clients to use them, it won't be able to reach people who have Android phones." ~Wired Dec 2017

What Wall Street is labeling as a consumer products company is really a company with one of the best brand recognitions in med-tech and along with this transformation to med-tech comes:

1. Recurring revenue streams
2. Reimbursement from Big Insurance
3. Even more than their existing (and initial) 1,500 enterprise clients
4. Multiple Expansion from Wall Street
5. A potential higher margin business

And it is happening now.

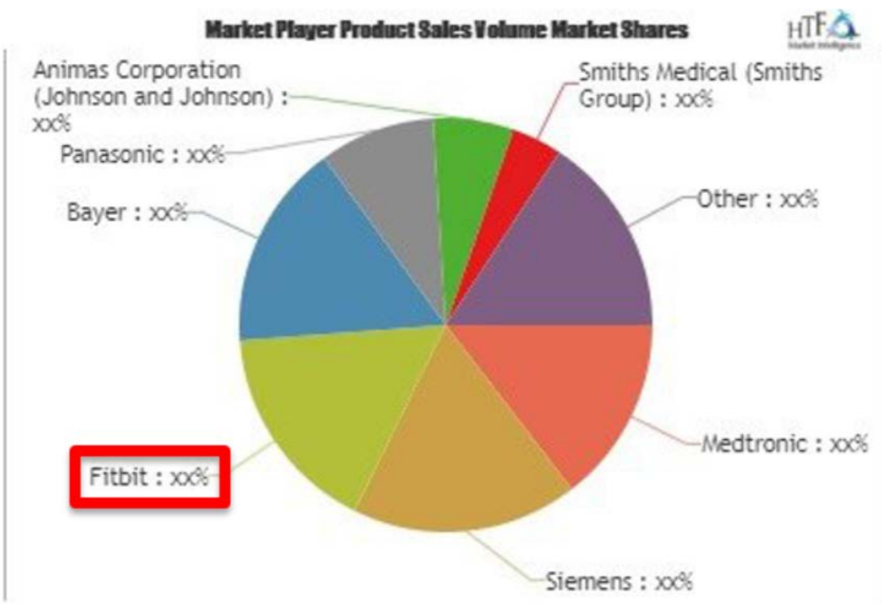
Statistica predicts sales for wearables will outpace PCs, laptops, and tablets by the end of the year.

The Versa Watch: This week Wall Street was excited that Fitbit sold 1 million units in its first month of the Versa Watch. And just like that, Fitbit currently has the top 3 spots on Amazon for smart watches.

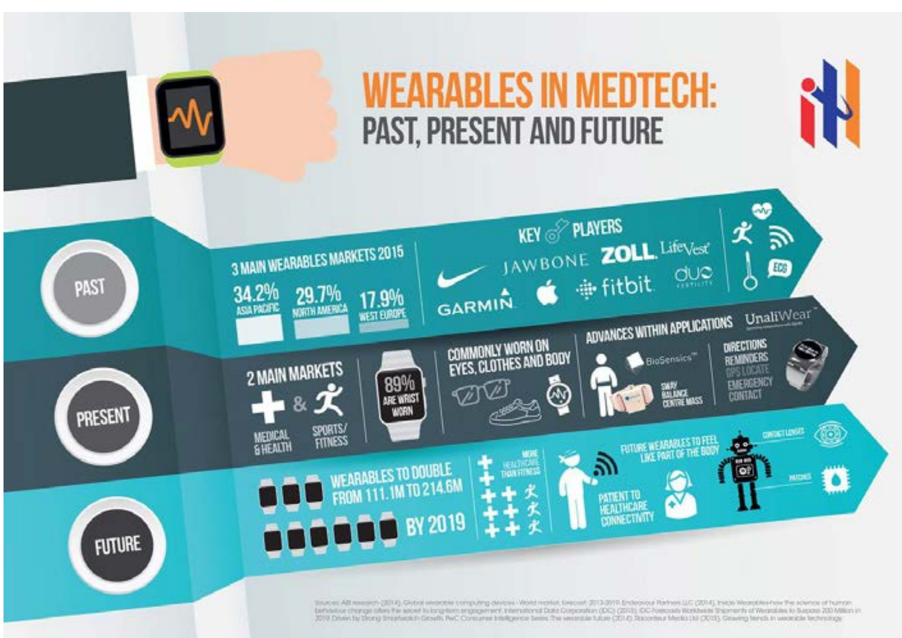
Citron views this as the beginning of a long-term plan that has finally started to take shape. While this might generate headline buzz and great reviews, this is the first step in a journey of a company to work with insurance companies to make a healthier population.

Med-Tech, Med-Tech, Med-Tech

As Fitbit re-calibrates on Wall Street to a med-tech company, we will see perception and valuation change (alongside a slow grind up of fundamentals of the business). Here is a chart this week from HTF about med-tech and look who is there, right beside Medtronic/Bayer/JNJ, none other than Fitbit – just further validation of the opportunity that Fitbit is well positioned to take advantage of.



And the industry future looks bright



Valuation: shareholders win in all outcomes

Fitbit has never been cheaper and is effectively pricing in its base fitness tracking business. Note in the chart below that compared to other wearables (including Garmin), Fitbit has gone from the most expensive to cheapest valuation in 3 years.

Here is an honest look at why FIT is worth $15 today. And recall that FIT has $3.13/share in cash, a business transforming to higher quality <u>recurring</u> revenue model and a base business that has stabilized (as evidenced by guidance recently re-affirmed).

What's Fitbit Worth | Using Garmin's Valuation (less a 30% discount)	
FIT 2018E Revenue	$1,469
Garmin EV / 2018E Revenue*	2.0x
Implied Enterprise Value of FIT	**$2,962**
Add: Cash	$658
Implied Market Cap of FIT	**$3,621**
FD Shares O/S	241
Implied Value per Share	$15.00
Current Share Price	$6.65
Upside to Stock	**126%**

**Citron is even applying a 30% haircut to Garmin's valuation for sake of being conservative*

Food for thought: FIT is often wrongfully associated with GPRO which was a fad, has net cash of ~$10m, and burning $100m annually (prior 2 years average) – it trades at 0.8x EV / 2018 Sales.

Using GOPRO's valuation, FIT is almost worth $8/share (20% upside) despite having more R&D spend, no cash burn and a compelling future.

All the valuation talk is nonsense because Citron firmly believes that Fitbit gets taken over in the next 12 months…our bet is Google (although there is easily a line up).

Why Google?

Beyond their partnership, Google will likely integrate the Fitbit data and become the default platform for every non-Apple Watch wearable. Think Android for watches.

"Fitbit claims to have 105 billion hours of heart rate data, 6 billion nights of sleep and 200 billion minutes of exercise tracked. "We do believe if there was a compelling value proposition people would be more willing to share data," Park said, although he emphasized that the company only uses de-identified data.

Also, Fitbit has more information on wearable studies than any other company https://www.fitabase.com/research-library/

The ability of Google to integrate this in their ability to analyze big data is a game changer.

BTW…CEO Park has not sold a share of stock under $40.

Conclusion

Fitbit has improved its core business offering with a slow, methodical and well telegraphed but unnoticed shift to Wall Street. The overhang of a poor legacy business with declining revenue, and a large R&D spend (that although quite positive) has weighed on short-term profits and effectively the short-term outlook of the investor on Wall Street.

With Fitbit's ongoing transformation (with proof to show for it), stabilization in its legacy business, and moat in the wearable technology business we expect FIT stock to either trade to $15 or more realistic Alphabet adds Fitbit to their collection of innovative companies.

Cautious Investing to All

For Giggles! If we compared Fitbit to Inogen, a medical device company we wrote on last month that dedicates no money to R&D and has a contract manufactured item, we could put $FIT at $71 a share. FIT spends more in R&D in a week than INGN does in a year.

What's Fitbit Worth | Using Inogen's Valuation (no discount)	
FIT 2018E Revenue	$1,469
Inogen EV / 2018E Revenue*	11.3x
Implied Enterprise Value of FIT	**$16,630**
Add: Cash	$658
Implied Market Cap of FIT	**$17,289**
FD Shares O/S	241
Implied Value per Share	$71.65
Current Share Price	$6.65
Upside to Stock	**978%**