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adidas First Half 2016 Results
August 4, 2016
Q&A session
adidas Group participants:
Herbert Hainer, adidas Group CEO
Robin J. Stalker, adidas Group CFO
Sebastian Steffen, Vice President Investor Relations

Antoine Belge - HSBC

First of all, I have one question regarding your outlook in terms of top line for the full year. You have increased your guidance, which implied sort of mid-teens growth in the second half. Could you maybe comment on Q3 and Q4 and which areas of growth you are expecting to provide the strong performance on a total basis? My second question is related to pricing. I think you expect to offset the significant FX headwinds, mostly by pricing. So could you maybe comment on pricing, making a distinction between the three buckets; the sort of pure pricing on a like-for-like basis, then trading up from consumers and then increasing your sales at full price? And finally regarding the EURO 2016, looking at your 17% growth in football, which was actually a bit below the overall average, could you maybe try to give a sense of how much EURO 2016 sales will be boosting your sales this year? According to my estimate, it could be less than 2%. Thank you.

Robin Stalker

Your estimate regarding the top-line growth is correct. Remember that for us Q3 is always the most significant quarter. So, in terms of the rates between Q3 and Q4 you'll see obviously the most significant development for our business in Q3. But you'll also see high rates in Q4, because obviously we had a slightly lower performance last year in Q4 compared to Q3. At the moment - we enjoy the momentum, it's good, it's coming from the same sort of areas that you have seen in the first half of the year also, there's no particular call-out for Q3, Q4 that I would suggest. In terms of pricing, the majority is definitely coming from our ability to increase our prices. This, in addition with the attractiveness of our product, helps us to avoid more clearance, and we're getting more full-price sell-through. I'd estimate that from the various items of pricing, product and country mix, almost 70% will be coming from pricing. In terms of your third question about the EURO 2016, we don't give specific figures for the EURO 2016. Obviously, it was a factor for this year and obviously overall for our ambition with football. You'll be aware we have the goal of achieving over EUR 2.5 billion in sales in football this year, which we will definitely achieve. In terms of the split between footwear and apparel: If you're looking at some of the footwear development in this period under review, please remember that last year we had significant footwear sales when we sold in the new three franchises for football.

Adrian Rott - Deutsche Bank

My first question refers to the gross margin development; it looks like the gross margin ex golf is down some 30 bps in H1. Is that reflective of what's been happening at brand adidas, or has Reebok been a drag gross margin wise? Regarding your increased gross margin guidance, what is roughly the contribution from golf that you're expecting in the second half?

Then secondly, can you share some details on the retail performance, Q2 retail like-for-like, as well as the retail gross and operating margin for the quarter would be very helpful.

Thirdly, on CapEx, you're still guiding for EUR 750 million in the full year, of which the majority into fixed assets I suppose. But PP&E CapEx was only EUR 180 million in the first half, so just wondering what the plan is for H2, and how that compares with your net store opening guidance, which is now for 50 versus the 100 plus you've been planning for previously. So how does that all fit together?

Robin Stalker

In reference to the gross margin, firstly, remember please that we were guiding last year and at the beginning of this year that our gross margin decline for this year could be as much as up to 1 percentage point. In our guidance, we were anticipating an improvement in the TaylorMade gross margin, because remember that last year we had a significant decline in the gross margin due to the discounting in the TaylorMade business. A lot of what we're seeing now is an improvement in the underlying profitability and gross margin profitability of the adidas and Reebok brands. But I think it's fair to say that we are experiencing some decline in the adidas and Reebok brand gross margin and, particularly, we expect that the hedging rates for the second half will obviously be a little bit worse than for the first half. But, fundamentally speaking, gross margins are positive for us, because it's underlying from adidas and Reebok and reflecting a better development than what we'd initially anticipated. In terms of the retail comps, our retail comp store development this second quarter was 12% and that's coming pretty much across the board, so good underlying growth in the retail business. In terms of CapEx, it's tracking a little bit below the run rate, that's correct, but bear in mind that a lot of this has to do with the retail locations and there is more heavy loading at the back end of this year. You should be aware of the fact that we are also opening the adidas Brand Center in New York later in the year, that's the main reason.

John Guy - MainFirst

Following up on the gross margin question, during the second quarter it looks like the aggregated gross margin for retail and wholesale fell 60 basis points. I just wanted to confirm that that's what you were seeing in the second quarter. I appreciate that you just flagged up the underlying performance of the adidas and Reebok gross margin, but just wanted to check that. With regard to the inventory position that was up 24% at constant currencies compared

to sales growth of 21%. And when we think about how confident you may be in terms of sustained sales growth in the third quarter, and the fact that you are going to have to invest more into the third quarter, one of your biggest competitors highlighted incremental cost growth going into the mid-teens from a high-single-digit rate from their fourth quarter. So, can you talk about how you are going to deal with the incremental investments, the sales and marketing into the back-to-school period please? And finally, just with regard to the plans, notably the retail store network in North America. There are some stores that are pretty dilapidated compared to other brands, and I was just wondering what your plans are particularly in North America with regard to the retail network. Thanks very much.

Robin Stalker
Taking the first two questions on the gross margin, no, that's definitely not a negative here. Your estimate for the second quarter, it might be 20 basis points or something like that. In terms of the inventory, the 24% increase, I said in my prepared comments that with regard to the ageing of inventory, it's all current. Hence this does reflect anticipated business in the near term, but obviously we don't hold inventories for the full six months. So just in the third quarter, as I mentioned in the earlier question, is the largest part of our business in the second half of the year. The MWB comment in terms of spend, that's right, we will be increasing our MWB year-over-year and about 60% of our marketing spend for the year is in any case planned to be in the second half of the year.

Herbert Hainer
Regarding the development of retail, let me tell you that we are extremely happy with our own-retail business in the US, and I obviously speak about the adidas brand, because I do believe this has been in the last 12 to 18 months a spearhead of recovery in the US, with a lot of other measures as well. As you have heard, we are opening a new flagship store on Fifth Avenue in New York later this year, and we will further expand our own-retail base in the US. But we are also heavily investing in shop-in-shop systems with our key retail partners and this is not just in Dick's Sporting Goods. Of course we put a lot of our performance products, into 700 displays now for football or soccer, but also with the likes of Foot Locker or Finish Line, and therefore when we talk about retail, we talk about controlled space, because it's our own retail and the retail, which we are running together with our wholesale partners. So we plan to extend our retail doors by up to 55 until 2017 and obviously this will give us an even better grip on the market and exposure for the future.

Robin Stalker
Just an addition to what Herbert said, we are accelerating our remodelling, if you think back to Adrian's question about CapEx, also that in the second half of the year.

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Omar Saad - Evercore
My first question is a follow-up on the gross margin. Could you give us a sense of how gross margins are developing excluding the currency effect? What's the underlying gross margin during the second quarter and the first half, just to give us a sense, what's going on outside of brand adidas?

Robin Stalker
Yes, very definitely. There is a very positive development here that is helping us compensate for those currency headwinds, both at the adidas brand, but also at the Reebok brand in certain parts of their product offering. Particularly at adidas, we're seeing the ability to sell higher-priced product and we are getting better sell-throughs around products and therefore less clearance, so underlying operational business is a positive for our gross margin.

Omar Saad
Robin, are you willing to put a kind of number around the first half, what gross margins would have been up year-over-year excluding the currency?

Robin Stalker
We did mention that the currency impact from the hedging or the appreciation of the US dollar was about 400 basis points in the first half of the year.

Omar Saad
My next question is on the Originals brand; obviously you experienced incredible momentum in that business. I think you said it was up 50%. Can you help us understand how you're managing the distribution with such explosive growth? Are you constraining supply with certain types of products within the Originals business? How do you think about segmenting the marketplace to ensure that business grows strong but also remains healthy?

Herbert Hainer
I think this is one of the key learnings from our previous strategic business plan Route 2015 as we are now focused on handling our Originals business in a much more sophisticated way. First and foremost, I think that our employees do an excellent job in refining and bringing new Originals models to the market. It's not just the Superstar or the Stan Smith. It is the NMD, it is the ZX FLUX, it is the Tubular, it is Equipment and now it is the Gazelle. We have quite an archive where we can permanently bring new products out. This is point number one. Point number two is that we have a clear segmentation in our distribution strategy — to which retailers we give our Originals products to. You might have heard the news a few months ago that we even took the adilette out of the traditional sports stores. We have defined it as an Originals product and therefore it is only accessible to a certain number of retail partners. Next point is that we are

controlling the quantities very strictly together with our key partners and within our own stores. We have a sophisticated system now to measure the demand and the amount of products which we should give to the market, to not overcrowd the market and secondly to guarantee full-price sell-through, which obviously helps the margin of the retail partners as well as ours. The next point is that in the future we will not only focus on the Originals side, but also on the performance side, when it comes to bringing more lifestyle products to the market. For instance, our ACE 16+ football boot is clearly an on-pitch model, which we now redesigned by putting a BOOST midsole at the product and re-launching it for off-pitch. And the last point which I want to make is that when you look to our Originals business and at the products that we include into Originals, our competitors tend to classify them in their running categories. It is the beauty of adidas that the entire Originals products have a clear history in sport and are seen by the consumer as former sports products. To conclude, don't worry about the growth at Originals. First and foremost, there is still huge potential, but it is a very controlled activity from our side in terms of what we're doing.

Omar Saad
And then maybe one last question, as we see the momentum in the business, the operating leverage and the underlying gross margin improvement, I think cash flows should really start to become significant in the coming years. How do you think about deploying cash flow, any changes versus previous history and how do you think about what to do with the cash flow, beyond investing in the business, of course?

Robin Stalker
There is no change in our view here. We've got a good and consistent policy on shareholder returns. We're not in the market for any particular M&A and our priority is to continue investing in the business.

Fred Speirs - UBS
My first question refers to North America. In early 2015 you laid out the five-year plan for the adidas brand in North America and you obviously made a lot of good progress to date. But I wonder if you could talk about what you think the next main executional challenges are to get the US right? The second question is on Russia. You've raised your organic sales growth guidance to mid-single digits from previously flat. I am just interested to hear what's behind the improved view? Are you seeing an underlying improvement in volume demand or is that mainly price-mix led? The last question refers to golf. Could you update us on how the disposal process is going? Could you comment on whether Nike's decision to dispose of its golf equipment will have any bearing on the Group's decision to sell and would you anticipate realising higher value for your golf business now? Thank you.

Herbert Hainer

At the beginning of 2015 we told you that for three years in a row — 2015, 2016 and 2017 — we will be investing more in the US market than ever before, which is what we are doing, not only in communication and advertising, but also in brand ambassadors, as we have started with James Harden and with Von Miller, just to name a few. But the investments are also directed towards a better retail presence at our wholesale partners as well as a further roll-out of our own stores. What I'm really pleased to see is that our growth in North America is not only coming from the lifestyle side, but it's also driven by the performance side. In running only we had growth of over 60% in the second quarter. And the UltraBOOST and the UltraBOOST Uncaged are two of the hottest products on the planet. But not only in terms of the premium products: we specifically designed the ALPHABOUNCE, which is a mid-price running shoe for the North American market. Within 48 hours we were completely sold out with this product. I think there is no doubt that the momentum exists in North America, the willingness on the part of the retailers to give us much more shelf space is there and the most important thing is that the consumer demand is also there. We have to execute and we have to execute in the most professional and best way, but I don't have any doubt that this momentum which we currently have will continue in the next years, because all the metrics and the measurements which we do, be it NPS, be it market research, is confirming that. Coming back to Russia: it's a mix of what you've said. It's obviously a price mix, yes. With the depreciation of the rouble we also raised prices in Russia several times in the last years. But there is no doubt that also our products are resonating very well with the Russian consumer. Even when times are tougher in Russia, we see that the demand is there when we bring new products to the market. Therefore we are quite optimistic for our business in Russia. Of course, five years ago, Russia was in better shape, but we continue to be, by far, the market leader in Russia. Russia is a big market for us and also very profitable. Last but not least on TaylorMade. Let me use the opportunity to say that I'm very pleased with the development of TaylorMade, because obviously we had two tough years in 2014 and 2015 and we did a lot of hard work. I said in the transformation projects which we launched on all the different fronts and this is obviously paying off, not only that we are bringing great innovative products to the market, which has made us again the undisputed leader in metalwoods, number one with 32% market share, but also on the cost side, you can see that there really is operating leverage. In terms of the process, there isn't anything new. We have a few very interested parties, which we have selected and with which we continue the dialogue. As soon as there is anything new, we will of course report accordingly. And that Nike has dropped out of the equipment business doesn't have any influence on our decisions.

Jürgen Kolb - Kepler Cheuvreux

Two questions from my side. In terms of the Capital Markets Day last year in March, the presentation was about the longer-term growth outlook with high-single-digit top-line

growth and I think 15% net profit growth. Now this year, you're starting off extremely strong, top line 17% to 19% and bottom line 35% to 39%. Should we maybe look at the longer-term outlook with a little bit more optimism as you're indicating that the momentum continues here? The second question refers to Reebok. With all the momentum that you're seeing, especially in the North American market, do you think you can move Reebok into positive growth territory already in 2016 within the North American market? Thank you.

Herbert Hainer

Concerning your first question: I understand that the guidance for 2020 which we gave in March 2015 may look conservative considering the momentum we are currently enjoying. You can be sure that we are looking into that and working on it already, but I definitely would leave this to Kasper and the executive team to draw their conclusions out of that. Second question on Reebok, we definitely do expect already positive growth in the second half of 2016 for Reebok in North America and, as I have already said during my speech, without North America we would have grown double-digit already with Reebok in all the quarters. We are definitely pleased with the positioning and with the development of the Reebok brand, and I think we have taken the right steps now in the US as well by cleaning up distribution to a certain extent and bringing new innovative products to the market with the support of our communication and advertising partners, such as J.J. Watt, Kendrick Lamar, CrossFit and the UFC. Definitely optimistic and, as I said, we will see growth in the second half already.

Chiara Battistini - JPMorgan

The first question refers to North America: I see that OpEx were up just 5% in quarter two, which is down quite a bit versus the run rate where we are coming from. Given the fact that this is an investment market, I was wondering whether it's just a timing impact or there are more savings coming through? And the second question is on TaylorMade. It was great to see growth in quarter two, but the guidance is still expecting a decline for the full year, which implies it will be down in H2. I was wondering why this slowdown is expected to come in the next few quarters? Thank you.

Robin Stalker

You're going to see continued investment in North America, and I don't think there's anything to be concerned about seeing the increase in OpEx there. This is a market we are investing in and we invested heavily last year, too. In terms of TaylorMade, I think you just need to be aware of the cycle and the business. I mean the bigger part of business in the first half of the year would be with the seasonality of the business. So, we stick to our guidance with TaylorMade and, as Herbert has already commented, we are very happy with the performance of TaylorMade this year.

Chiara Battistini

And just a clarification. My question on the OpEx, it was a slowdown of the OpEx growth in quarter two, so should we expect this now to be the new run rate or are we going to see a pick-up of OpEx growth in Q3 and Q4 for North America?

Robin Stalker

My point there is that we'll continue to invest. We are expecting to get leverage of this obviously, but it's still a small base. And last year we invested a lot heavier than this year, but this is too small a difference to extrapolate that out. And just bear in mind, as we've said many times, North America is an important strategic market, we're investing in it and we will continue to invest in it.

Zuzanna Pusz - Berenberg

The first question focuses on retail. You have achieved very strong 12% like-for-like growth at the Group level. But I was just wondering whether you could disclose like-for-likes by brand? I think it's something you used to give out in the past. Furthermore, I would appreciate it if you could give more disclosure on other regions, especially regarding North America. And then secondly on the Originals business, can you tell us what were the volumes of Stan Smith and Superstar held in H1? Besides, what is your expectation for the Gazelle franchise in this respect? How big do you think it could be? Thank you very much.

Robin Stalker

In terms of our comp stores, we have the adidas brand retail comped at 13%, the Reebok brand at 6%, and then we had a comp store development in Western Europe of 15%, North America 9%, Latin America 8%, Greater China 17%, Japan 11%, Russia/CIS 11% and MEAA 17%, all-in total 12%.

Herbert Hainer

I hope you will understand that we don't give out numbers for individual articles, such as Stan Smith and Superstar. With regard to Gazelle, we will do the same as we did with the other franchises. We'll build it up slowly but surely, giving it firstly into the right distribution channels, selective distribution so that the real influencers are getting it, but finally we want to build it up as a franchise just like the others. This would mean a double-digit million volume at its peak. And this is our clear strategy to have five to ten franchises within the Originals business and Gazelle definitely has the potential to be the next one.

Jamie Bajwa - Goldman Sachs

First of all, just in terms of the pricing environment. Given the momentum of the business, are you seeing any change in terms of your ability to pass through pricing to retailers and consumers in any particular region? And the second is just on your e-commerce business. I noticed that you had a pretty significant acceleration in Q2. I don't know if you could give us a bit more detail in terms of what's driving that, be it the sport performance or sport style product, and has there been any change to the seasonality of your discounting? And then on CapEx. I don't know if you could give us a little bit more detail in terms of how you're thinking about CapEx over the next three to four years. Thank you.

Robin Stalker

Regarding the CapEx question, we are not in a big CapEx intense industry, but our CapEx has increased over the last few years. As you heard from one of the earlier questions, our expectation for this year is between around EUR 700 million and EUR 750 million. Over a third of this is obviously in terms of our managed space, and we have about 2,700 shops at the moment and over time they clearly need to be refurbished, and that is something that, as our footprint grows, will become a bigger figure in the future. But actually, we are very confident that we would be able to keep our CapEx as a percent of sales in the corridor between 3.5% and 4.5% over the next few years.

Herbert Hainer

Concerning your first question on pricing, you are absolutely right, we are trying to push prices through to consumers based on our current momentum. I will give you a few examples. The Uncaged UltraBOOST in the US retails at $180. We never had a shoe before that we could sell for $180 in that quantity. So when you just look at the normal Stan Smith, we sell it now for EUR 90, or the ACE and X football boots for EUR 200 in Western Europe. Of course, I think in the last call we already mentioned that we have a sophisticated pricing system, which we have developed with an outside agency and of course we want to get the maximum out of it. This definitely helps us to mitigate the margin headwind which we experienced from currencies, or higher labour costs. The last question on e-commerce, the simple answer is this is reflecting the brand heat. We have so much positive momentum all over the world and obviously this pays off in our e-commerce business as well. The more detailed answer is that we have built out a lot of capabilities in our e-com business in the last several years and we have just announced with our brand leadership activation, which is part of our 'Creating the New' strategy, that we brought both the sales side and the marketing side of digital together into the digital brand commerce department, so that we not only bring attractive offers to the consumers on the product side, but also on the content side and excite the consumer for the brand and therefore for the sale of the product. And this, in combination with the professional skills which we have built up in the last several years in e-commerce, plus the brand heat is giving us the results which you have seen already.

Andreas Inderst - Macquarie

The first couple of questions are addressed to Mr. Hainer: what are you most proud of having achieved with the company over the last 16 years? Where have you made the biggest progress and in which areas have you been most disappointed. Furthermore, is it possible to get a sneak preview in terms of product launches for 2017? Can we expect a reiteration of existing strong BOOST platform products or are any new major technologies planned? The final question is for Mr. Stalker: are there any one-offs related to the hockey business, given this was loss-making in the second quarter, particularly I think about the insolvencies in the US? Thank you.

Herbert Hainer

I have so many positive memories in these 15 years and I think there is a lot to be proud of, just look at the market capitalisation. When I started it was EUR 3 billion, now we are close to EUR 30 billion. But something I am really proud of is the turnaround over the last 18 months that I managed together with my team. In 2014 a lot of people from the media, maybe also from the financial community, had lots of doubts. I sat together with my management team, and I think what we did was an incredible turnaround. Hardly anybody would have believed in it, I must say. I am really proud of that, and especially because it's a real team effort. In terms of the downturns, there are a lot of things which haven't gone the way I wanted to see and I think this is quite normal in business. In hindsight I would say we should have reacted earlier to Reebok and the repositioning of Reebok. This has taken too long. This in hindsight I would do much faster and much more radical than we have done. In terms of product innovation for 2017, I think you will be surprised, as it will exceed your expectations, what kind of innovative products we have in the pipeline, not only for 2017, but also the years to come. I already said so 18 months ago. We want to make BOOST the new EVA and we want to make EVA completely obsolete and we are well on the way to doing that. And I think this of course will be our main technological platform going forward on the mid- and outsole side. On the upper, Primeknit, we are bringing the first products with Primeknit and now running shoes with coloured midsoles and of course we will roll further out. You can also expect some spectacular new things on the football boot side. So I must say I'm quite excited and I'm sure Kasper and the team will present it to you guys when the time is right for 2017 and beyond. But we are definitely not short of new innovations which we will bring to the market.

Robin Stalker
Regarding CCM Hockey, yes, there is bad debt and also some loss of sales obviously, which we anticipate would have a mid- to high-single-digit million euro effect this year.

Herbert Hainer
Ladies and gentlemen, let me take the opportunity. As you all know, this will be my last call with you. Within the last 15 years I think we had a lot of good critical discussions and I enjoyed it a lot I have to say. Even if I wasn't always at the forefront in terms of roadshows in comparison to Robin, I had the chance to meet some of you in person and I have to say I always liked the critical, but always constructive and supportive approach that you took. I want to thank you all for accompanying me and our company for the last 15 years and I would like to ask you to give the same support to Kasper and the team, because the company and the brands are definitely worthwhile and I think the best is just ahead. So thank you very much and all the best for you.

Sebastian Steffen
Thank you very much Herbert. This actually completes our conference call for today. Our next reporting date for our Q3 results will be November 3. I'm sure we're going to catch up with many of you over the next couple of days, weeks and months during our roadshows in Europe and also the US. As always, if you have any questions please don't hesitate to reach out to any member of the IR team. Thanks for participating. Have a great day. Bye bye.