adidas Group Nine Months 2015 Results
November 5, 2015
Q&A session
adidas Group participants:
Herbert Hainer, adidas Group CEO
Robin Stalker, adidas Group CFO
Sebastian Steffen, Vice President Investor Relations

Antoine Belge, HSBC
Three questions from my side. First of all, in regard to the gross margin, could you be a little bit more specific about the different levers in Q3? I imagine there was also some negative impact from input costs and FX in Q3. What were the offsetting factors?

And when you look at 2016, I understand that you didn't give a precise guidance for gross margin, so I'm not expecting one. But in terms of at least just the FX impact that you've mentioned, is it possible to have some information on your hedging rates for 2016?

My second question is related to the women's business. I think recently, during their Investor Day, Nike mentioned that they wanted to double their women's business in five years to $11 billion. So what are the key initiatives that you have for this fast-growing segment?

And finally, there is one region that you did not really mention too much, which is MEAA, which is characterised by very high profitability. Could you maybe mention which are the main markets in this region? I think Korea is a big one. And why is the margin so high? Is it sustainable? Is it because of less competition in those markets? Thank you.

Robin Stalker
Okay, Antoine, let me start with your first question and Herbert will take number two and three. Itis the normal moving pieces in our gross margin. During the third quarter we saw again the rouble devaluation year over year, and a significant amount from FOB increases, almost a percentage point. But our pricing increases and product mix also has obviously given us more than enough to compensate for that.

In terms of looking out into 2016, yes you're right; I'm not going to give you any specifics today. We will continue to do what we do in terms of leaving the specifics until the beginning of next year, where we can summarize exactly what our situation is with the hedging rate.

But quite obviously, the hedging rate that we've been enjoying for 2015, which is around the 1.33, is clearly not going to be able to be repeated. The one we are looking at for 2016 is significantly more negative and, therefore, we are saying yes, our gross margin is going to be under pressure in 2016. The price increases that we're doing, the reengineering of products and the working with the factories, all those things that we're doing, probably will not be enough to be able to hold the gross margin for us.

But we are very confident that, because of the significant progress we've been making on the cost base, and the leverage we can get out of our operating overheads, we will be able to compensate for the negatives on the gross margin. And, therefore, we've been able to call out today that we're very confident that we'll be able to at least maintain our operating margin at the level of 2015.

Herbert Hainer
So, Antoine, coming now to your second question in regard to the women's business. Yes, the women's business is definitely a focus for us as well, but not just recently. You might remember, already 10 years ago, we started to work together with Stella McCartney to give us better insights into the women's business and to help us create a collection that will resonate more with the female consumer.

And then we continued with our NEO collection, where we especially address a younger consumer group which is definitely also much more female driven. And you know all the successes that we celebrate with NEO. And just recently, we partnered with Christine Day, the former CEO of Lululemon; she is consulting us in our overall women's business. So a lot of initiatives are going on, on our side, and not just recently.

To your second question, MEAA, you are right, it is Korea but there is also the whole Middle East part. And there, we have the biggest part of our business with our own stores and this, obviously, gives us a better margin. In addition we enjoy very good sell-through in the market. We have an extremely high, rewarding image from the consumer base and this, together with a very efficient organisation, helps us to achieve these margins which we enjoy.

Robin Stalker
And, Antoine, while you are still there, let me remind you also what Herbert said before about the workshop. If you want to know more about the gross margin development, we have a tutorial workshop here in Herzo on December 9.

Antoine Belge

Yes, maybe just a follow-up actually on pricing, which will be one of the levers, I can imagine. Is your confidence based on the fact that other competitors are also planning to increase prices, or have you seen a weakness from the consumer to trade up when the product is right?

Robin Stalker

Both, absolutely. And you've seen it also in the third quarter. We covered price increases as well.

Antoine Belge

Thank you very much.

Zuzanna Pusz, Berenberg

Just a couple of questions from my side. First of all, I was wondering whether you would be able to comment on the price unit growth for the adidas brand.

Secondly, on NEO, I understand it was another quarter of strong growth for NEO with 32% FX neutral growth, but I was just wondering, whether you would be able to provide the split of like for like and space growth for the brand, because I understand that you're probably also expanding your store network.

And maybe just a final question on the 2016 guidance. I appreciate it's just a kind of preliminary outlook, but is the leverage you are expecting just coming from the strong top-line growth, or are you also expecting maybe some initiatives on the costs side? It would be interesting to hear a bit more detail on that. Thank you.

Robin Stalker

Well, I'm not sure, Zuzanna that you're going to be very happy with my first two answers because basically no, we don't break down the price and unit as we don't publish it. And secondly with NEO, I don't have those figures in front of me. The fact is, as Herbert said in his speech, NEO has been going extremely well and this is also what we're seeing in the comp store growth.

In terms of your third question regarding our outlook and the various initiatives we plan on taking on the cost side. We've been doing a lot of things over the last few years. You will recall back some years ago when we were talking about all the investment we're doing through Route 2015, to consolidate warehousing, bring services above market and also consolidating our operating units.

Think of the significant amount of work we've done over the last 18 months here in Europe, putting our five major markets together under one area, and we're starting now to get all this leverage. We have a lot of initiatives which make us very confident that they are going to give us operating overhead leverage. And I'm talking about operating overhead leverage, I am not talking about any sort of marketing leverage.

We will continue to spend and invest in our brands through marketing. We are not expecting to reduce the level of marketing as a percentage. You'll see absolute numbers of marketing, obviously, also going up in 2016.

And if you're looking for evidence of our confidence in our operating EBIT, if you think of where we are at the end of the year in 2015, we have increased our marketing spend as a percentage of sales, about 20 basis points, and yet the operating expenses are down 40 basis points. So there's obviously been leverage of about 60 basis points on the operating overheads there.

Zuzanna Pusz
Thank you very much.

Adrian Rott, Deutsche Bank
Three questions from my side, please. Firstly, on gross margins and the measures you have taken. So we understand that you've pulled all levers available, and I was just wondering whether there's a chance that you've maybe even overshot in some respect when it comes to talking to suppliers and de-specking product choice there.
Do you see any risk that there might be quality issues in certain categories next year, seeing that you're trying to really fight off the currency pressures?

And then secondly on retail, and just looking at the new guidance for net store closures of around 50 stores this year, which implies that you are opening some 30 stores in Q4 net, so I was just wondering where those openings will happen.

And the last one also in retail, rather than the economics of retail, so this has been the second quarter now with really strong profitability increases. Can you just split up a little bit to what extent those improvements in margins in retail are due to closing unprofitable stores in Russia, or elsewhere? And to what extent that is due to better like-for-likes and ecommerce outperforming within retail? Thanks a lot.

Robin Stalker
Firstly let me be very clear, we are a collection of brands and obviously we're very, very cautious to make sure we support the brands in the eyes of the consumer. And there is nothing that we

have undertaken in managing our margin exposure that I believe would compromise our high levels of quality, and the desire to satisfy our consumers with the products.
I don't believe there's any risk in that. We are passing on as much of the price increases as we can, but I'm acknowledging that we're not able to pass it all on and, therefore, we have to get it through the operating overheads.

In terms of retail, yes that's right, it'll be a net growth of shops in the fourth quarter of 2015. They're coming from China, North America, and MEAA.

And your third question was about the profitability of retail and, you may recall, over a year ago, we were talking about the initiatives we are taking to now really improve profitability in our own retail shops. And this is something you should expect to be a natural process of the learnings that we've had out of running now so many shops ourselves.

And certainly, there will be, in the profitability improvements, some impacts from the closure of the less profitable shops. That is a normal part of retail; we'll presumably be doing some of that also in future periods.

But basically, we are getting better also at execution in retail, and with the increase in economies of scale, and getting the right sort of product in the market now, and improving that with our supply chain, that's bringing us these better margins, better sell-through and, therefore, better profitability.

Adrian Rott
That's clear. Thank you.

Chiara Battistini, J.P. Morgan
Three questions from me, please. The first one on golf; you are continuing to put investments into TaylorMade, so what are your latest thoughts about the disposal process? Are you still considering that for TaylorMade and what's the update there also for the smaller brands, please?

Then on Originals up 33%, so another great quarter with exceptional growth. Could you please tell us the drivers of this growth in terms of new doors and increasing penetration in new markets and new retailers, and what's the replenishment in existing doors? And what do you think about the sustainable Originals growth going into next year and the year after?

And finally, the EBIT margin for China was down 370 basis points, despite gross margin being roughly flat. So I was wondering if you could tell us what's behind that decline in the margin, please. Thank you.

Herbert Hainer

So let me start with the first question and Robin will answer your third one. On golf, as we have said, we definitely will divest our Adams and our Ashworth brands. On the TaylorMade side, we have not decided yet what we will do in the future. As I said, we will keep all options open and have the help of Guggenheim, the investment bank, where we finally will decide, in the first quarter of 2016, what to do.

But anyway, we will have to restructure the business and bring it back to growth. And this is, on the one hand, making our processes more efficient, bringing our costs down, to bring it in line with the revenue development. And on the other hand, bringing money up to invest in innovative products, going forward, and this is exactly what we are doing.

On the one hand, as you have heard, we are restructuring and laying off people, thus making processes more effective. On the other hand, we are bringing new innovative products to the market, as we have done with M1 just in October. And as I said in my speech, it's already the number one selling driver out in the market. And we're also continuing with the M family going into 2016. But we will keep you updated in the first quarter, as soon as we have decided what we will do.

Secondly on Originals, the growth is not coming just by expanding into new doors. This is coming because there is high demand for our products in the market, and this has a lot to do with franchise management.

You might remember that, for a certain period of time, we have taken Stan Smith off the market, we have taken out Superstar off the market, to make sure that we don't overshoot the market and to create the hype for the product in the market when they are not available.

And the same we will do with our upcoming new franchise in December, which we just alluded to. We also will slow down our volumes which we bring to the market in the fourth quarter, just to make sure that the desire from the consumer will stay.

And you ask how we are continuing, going forward, to make sure that this brand, or these Originals products are cool? As I just said, part is, of course, the lifecycle management of the franchise product. But also bringing new innovative concepts to the market. Kanye West is just one which helps us; the new franchise model which we are going to release in December is another one. And believe me, we are full of such innovations and ideas for the coming months and years.

Robin Stalker

And for the third question about the third quarter margin in China, you're right, it's down, and this is primarily due to timing of marketing expenditure. There was quite a lot of increase in marketing in the third quarter related also to football.

But, overall, don't forget China continues to have an extremely strong margin, and that strength we believe will continue in the future period as well.

Chiara Battistini

Perfect. Thank you very much, very clear.

Jürgen Kolb, Kepler Cheuvreux

Some questions here from my side. First, on the innovations, the new products, Herbert, that you mentioned, the leather manufacturing, Futurecraft. When can we expect more commercial impact of those shoes and when do you launch those, probably with a bigger marketing campaign, first of all?

Secondly, just a brief one on 2016. First indications out, thanks very much for that; just a quick one on the tax rate for 2016. Shall we expect that the blip, the uptick we've seen in 2015 is not going to last, and so we go back to, say, around 29% to 30% for 2016?

And lastly on Reebok and here the US situation. Given that the consolidation of the factory outlets is still ongoing and the effects we're still seeing, when do you expect to see Reebok coming back into positive territory on currency-adjusted sales growth in the US specifically? Thanks.

Herbert Hainer

Let me start with the first question on innovation in Futurecraft. As you might imagine, there are some products which are still in the science level, where we don't know yet what the outcome will be and how fast it will go. For example, Sport Infinity, which is supported by the European Commission, this still might take a longer time.

In terms of 3D printing, we are already able to make the first shoes and soles in 3D printing, but it's still too expensive. So we have to work further to bring the cost down, so that it is efficient to produce it in big quantities.

On the other hand, when you look at our Laceless football boot, which we just announced the other week, this is already one of the parts which is coming out of one of these Futurecraft things.

And the last point on that one is Speedfactory, where we will already produce the first pairs here, close to Herzogenaurach in Ansbach, next year, where we have installed a prototype factory. And definitely, for 2017, you will see already production from there.

So a lot of things going on, different stages and, of course, we will update you. Some are coming within the next 12 to 18 months, but some might take longer.

And let me jump directly to the third question, then Robin will answer the tax rate question.

With regards to Reebok in the US, I think it's fair to say, first and foremost, that the US is definitely the toughest market, not only for our adidas brand, but also for Reebok. And therefore, with all the competition which is going on in this market, it is more difficult for Reebok to resonate with the consumer, as it does already in all the other parts of the world.

In addition to that, we're still closing factory outlets of Reebok, because I think they had too many in the US and obviously this costs us also sales. But we definitely do believe that in 2016 we will stabilise our business for Reebok in the US and from there on, then further grow it, as we see the growth all over the globe.

Robin Stalker
And to the tax rate, as you know we give detailed guidance on 2016 in March, but let me give you some confidence. We've clearly explained why we're at the 32% level for 2015. And if we look over the years what our tax rate's been around, I would hope that we do not disappoint with the guidance that we do give you in March. But I'm not going to give it to you at the moment.

Jürgen Kolb
Very good. Fully understand, thanks very much.

Cedric Lecasble, Raymond James Euro Equities
I have a question on the allocation of your marketing expenditure. Could you elaborate a little bit on how you see things between sportswear, which is booming, and performance, which has been underperforming sportswear for some time with some strong results and some weaker results in some segments.
How do you see things and what will be your focus in terms of geographies, probably the US, but between performance and sportswear? That would be the first question.

And the second one is a follow-up on the previous ones regarding your ability to stabilize your EBIT margin and to get this cost leverage, despite the gross margin pressure. If you try to go on the big cost savings where would the biggest leverage come from? Would it come from

golf, with this workforce reduction, or any other component; could you help us a little bit with that? Thank you.

Herbert Hainer

Cedric, let me start with the first question on Sports Performance and Originals. Yes, at the moment, we are definitely enjoying a stronger sales growth on the Originals side but, as I told you, we are also looking carefully into it, how we can guide it and how we can make sure that it stays cool.

But this does not mean that we are not doing well on the performance side. As you have seen, double-digit growth in football and not only in football apparel, as a result of Manchester United or Juventus Turin, also in football footwear we are growing double-digits. We have a 9% increase in running, which is also quite good.

But there is no doubt that, going forward, and especially in 2016 around the European Football Championship and the Olympic Games, our focus will be clearly on performance. We want to be the best sports brand for the athletes and, therefore, it is quite important that we will be successful on the performance side by bringing new innovative products to the market which help the athletes to perform better.

But on the other hand, we also want to push further on the lifestyle side as consumers are heavily gearing for our products, but the focus is on performance.

Robin Stalker

And Cedric, with regards to our operating overheads, we're getting more centralised, more global, more efficient and we're executing better. And it's a range of areas, but it's definitely not golf people. The combination of the five units in Europe into one European organisation, as I called out in the answer to one of the previous questions, that's obviously significant for us.

But we've been doing this over the last couple of years. We've been investing, however, to get us into this situation, that's why we're so confident about being able to get the benefits now. They're starting in 2015 and they will accelerate obviously into 2016. Just to repeat what I've already said, it's the consolidation of warehousing, it's services above market and all those sort of things.

Cedric Lecasble

Thank you.

Andreas Inderst, Macquarie Research

My first question is on the marketing budget. You continue to increase that; it seems to work on the top line. In which areas do you intend to accelerate the marketing spend, by category and maybe also by region? And when can we expect actually a normalization in marketing spend? Would that be more in 2018/2019, maybe an indication on this one?

Then my second question is on the golf segment. You already significantly reduced your headcount last year and in summer; what was the trigger for additional rounds of workforce reductions, and when can we expect actually a break-even for TaylorMade?

And my third question on automation; what's the vision for the Group? You come out with 3D printing, Futurecraft, local manufacturing. What can we expect, let's say, in five to ten years' time, in terms of automation? Thank you.

Herbert Hainer

Let me start with the marketing budget, and I think the best example is the fourth quarter. In the fourth quarter, the basketball season has started and in the NBA we have, with James Harden, a new ambassador on our roster, and also Derrick Rose back in the game. Hence you will see a big basketball campaign in the US market in the fourth quarter because the US is clearly a focus market for us.

Approximately 1% which we spent more on marketing and working budget goes mainly to the US and this is just one of the examples. Then we will introduce this new Originals franchise in December, where we will give you more information in the coming weeks. This will also be backed by a big campaign also starting in the US and then going around the world.

And last, but not least, next week we will start our European Football Championship campaign by showing the new jerseys for all the participating adidas teams and releasing the new official match ball for the European Championship.

So these are just a few examples where we spend our money but, definitely, the US is a focus of this additional budget which we have told you a year ago. And in addition to that, you can expect that we still spend more in 2016, as we have already said, but we want to go back to a normalised level in 2017.

Golf, this is correct, we already released and restructured some parts in 2014 bringing the Adams, or closing the Adams facility in Texas and bringing it over to Carlsbad.

But unfortunately, our sales have further gone down in 2015, as you have seen, and we definitely do believe we have to align our cost structure and our workforce to the revenue level. But we also think we can take out costs by bringing new processes to life and concentrating on key countries, as I have said America, Japan, Korea and England which generate 90% of the revenues.

We have therefore done a further reduction and a further restructuring, without going into all the details as I said this morning, we are working over 40 initiatives, and you can expect a break-even in 2016 already for the golf business.

Last but not least, automation. Our vision, going forward is that we can bring back production to the market where the consumption is. This finally would mean that we could produce in Germany for the European markets, or in England for the English market, or in America for the American market which would give us a lot of advantages, and especially in light of one of our strategic choices for 'Creating the New', which is speed.

This definitely will be one of the key factors. And while this is still a vision, be it in three, four or five years, you can already see with Speedfactory, we are making the first attempts and we are working intensively on the topic that makes us faster.

Andreas Inderst
Okay. Thank you.

Volker Bosse, Baader Bank
A lot of questions are answered already. Thank you very much for this. Two questions are left from my side. Could you please provide us some figures on your online sales trend? So how much online sales did you generate here in the third quarter, or how was the momentum?

And second, on NEO, what's your current view on the NEO store expansions throughout Western Europe? What are your plans in terms of opening stores here? Thank you.

Robin Stalker
Ecom sales are up 25% in the quarter; they're up 44% for the first nine months, representing about € 450 million.

Herbert Hainer
The second question was on NEO in Western Europe. So in general, Volker, we are creating the revenue growth with our franchise partners, for example, in China. We have started to operate some of the NEO stores here in Europe. But this is not our primary target, because we definitely do believe that we have so many wholesale partners which we can work with, with our NEO collection, and this is what the main part will be, going forward.

So don't expect a big expansion here in Europe and around the world with our own NEO stores.

Volker Bosse
Thank you, perfect.

Graham Renwick, Exane BNP Paribas
I just have a couple of quick questions. The first one, just coming back to the golf business, how far are we away from seeing supply and demand rebalance in the golf industry?
And after we see the restructuring and self-help initiatives come through, what margin should the TaylorMade business achieve in a normalised demand environment?

And then, just on the US. Just looking at the US strategy, there's clearly a lot of positive commentary around the work you're doing there and a good performance this quarter. Just over what timeframe and from which key metrics do you think your US success should be judged? And what competitive response do you expect to see from peers such as Nike and Under Armour as you push a lot deeper into certain sports in the US? Thank you.

Herbert Hainer
Let me start with the golf business. In my opinion there is definitely a much better situation in the golf market in terms of inventory levels on the supplier side and on the retail side, going forward, because I do believe that everybody from the supplier side, including us, has learned that there was too much product in the market, especially in 2013 and 2014, when the weather conditions were so bad that less rounds have been played and oversupply was there.

And while I believe that, going forward, there will be a much healthier situation, we will not push all the product into Q4, because we want to build these franchises for the long term.

In golf, on the margin side, and I think you talk about gross margin, mid-40% gross margin is definitely doable, and this we always have had in the past.

When it comes to the US in general, we don't want to talk that much about the horizon and when will we achieve certain things, because we clearly said that we want to establish a sustainable healthy-growing business in the US.

I think you have seen already that our growth in the US is not only coming from one or two categories. It is coming from football, from running, from American football and also from Originals. So it's broad-based.

As you can imagine, one of the next points will be basketball now with the roster we have, and with the activities we do. Our target is quite clear. We want to grow double-digits again in 2016 with the adidas brand, and all the indications which we have, because as you know we sell six months in advance, give us all the confidence that we will achieve that, besides gaining better shelf presence in the stores, and I mentioned two examples with Foot Locker and with DICK'S.

Sebastian Steffen
Okay, thanks very much. This concludes our conference call today. Our next results will be released on March 3 next year.

However, as Robin and Herbert have already mentioned, we will be hosting our second IR tutorial workshop on December 9 here in Herzogenaurach, and we'll explain to you in more detail the drivers of our margin development in general and, of course, for 2016 in particular. You will receive a formal invitation within the next couple of days and we, of course, hope to see as many of you as possible here in Herzogenaurach in a month's time.

But as Robin mentioned, even if you are not able to make it to Herzogenaurach, we will, of course, make sure that all the content is also available through our website.

If you have any questions, be it on the tutorial or on the quarter results, please don't hesitate to reach out to the IR team. And with that being said, I would like to thank you for your participation and would like to wish you a great day and talk to you soon. Bye-bye.