adidas GROUP

adidas Group Nine Months 2014 Results
November 6, 2014
Q&A session
adidas Group participants:
Herbert Hainer, adidas Group CEO
Robin J. Stalker, adidas Group CFO
John-Paul O'Meara, SVP Strategy/Investor Relations

Julian Easthope – Barclays Capital
Many thanks and good afternoon, everyone. Three questions if I may. First in terms of TaylorMade-adidas Golf: There's quite a big decline. I would assume it's just destocking with the sell-out. So I just wondered if you had the sort of take as to what the sell-out is like within the retailers relative to the destocking that took place. Just give some sort of guidance as to where the underlying market might be and what will happen once the destocking slows.
In terms of Russia, after the EUR 100 million cost to the EBIT this year, is it still profitable?
And I guess the last question comes back to Reebok and TaylorMade. I've seen all sorts of commentary about whether or not these may actually be sold in due course. I just wondered if you could give us your take as to whether that is a possibility. Thank you.

Herbert Hainer
Okay. Let me start with the first question and the third, and Robin will talk about the profitability of Russia. So TMaG, the sell-out situation: As I said in my speech, we are bringing fewer products into the market to help the retailers clean up inventory, which has piled up over the last 18 months. Obviously, this is the reason for the 36% decline in the third quarter as we aren't brining so many products to the market. But we start now in Q4 launching our new irons, which we just did last week. And we believe that from a TaylorMade-adidas Golf standpoint, we will get into 2015 with much cleaner inventory in metalwoods and irons. And we will come back with new product introductions, starting with drivers in January and then continue during 2015. The golf market in general will not have solved all the problems, as I said before. We have to deal with a declining participation rate in some areas, but from an inventory standpoint – and I also believe from a mind-set standpoint in the golf industry – the golf business will be healthier going forward than it is at the moment. But, as I said, structural problems will not be solved overnight.
Your third question concerning TMaG and Reebok, there was a lot of speculation, but you will understand that we do not comment on any rumours or speculations.

Robin Stalker
And Julian, in terms of Russia and the profitability, you know, although we don't talk about specific market profitability, we called out that Russia has been one of our most profitable markets. It's clearly down to what it has been, but I can confirm it's still profitable for us, and it's a market that we have long-term confidence in and good expectations.

Julian Easthope

Brilliant. Thank you. And just one final thing for clarification, when you talk about your Investor Day looking at your longer-term planning, will it actually be on the day of the full year results on the 5th of March?

Robin Stalker
No, Julian. We'll give you the date as soon as we can, but it's likely to be at the end of March.

Julian Easthope
Okay. Thank you very much.

Andreas Inderst – Exane BNP Paribas
Hello everyone. I have three questions. The first one on your cost structure. Given all the headwinds you are facing and accelerated decline in the Russian rouble, don't you think your operating cost basis is too high, and what are your measures to tackle these issues? That's my first question.
Then the second question, you indicated on Russia a decline on EBIT of roughly EUR 100 million. Is it for the first nine months or the full year? Based on current FX rates, what would the decline look like or the negative impact look like in 2015?
And my final question is on FOBs, on input costs. What's your expectations in terms of growth rate or decline year-on-year in 2015 given the decline in input costs in recent months? Thank you.

Robin Stalker
Thanks very much. And yes, you are absolutely right to call out costs, but you can be assured that this is exactly a key focus for us, but it's not new. We have been focused on this for some time, and a lot of the efforts that we undertook as part of Route 2015 were to get our whole organisation less complex and more streamlined, and we've been doing that. We've been consolidating warehouses. We've been consolidating services above market. We've been addressing the structure of marketing and sales. We just recently, at the beginning of this year, put the five key European markets together, and we continue to pursue concepts where we believe we will also in the future take costs out of the business. And this is definitely a focus for us.
In terms of Russia and the EUR 100 million that we mentioned in the prepared comments, that refers to the nine months. And obviously with the continued weakness of the rouble and the outlook for 2015, it's going to be more of a headwind for us. But we can't give specifics on that until we have a little bit more visibility, and we will try and do that as best we can in March.
And thirdly, in terms of FOBs, we still think there is continued pressure on FOBs or input pricing. It may not always be from the raw materials, but definitely labour continues, most likely, to be a negative for our industry. Don't forget when you are looking at the raw materials, even though oil has gone down, we are talking about oil derivatives obviously. So there's a timing lag sometimes in the change of the oil price for that. So I think you should expect or have a conservative view on FOBs, which are likely to still be some pressure in our industry next year as well.

Andreas Inderst
Okay. Thank you.

Chiara Battistini – JP Morgan
Good morning, hi. Thank you very much for taking my questions. Just a couple of questions from me, please.
First, on your gross margin on adidas wholesale specifically, which was actually the major drag to the Group gross margin, I was wondering whether you could provide more colour on what caused that pressure – if it was just one-off effects or more?
And then in terms of marketing spend, it was up 10% again in Q3. Should we assume this to be the new growth run rate for this cost line, please? Thank you very much.

Robin Stalker
Okay, Chiara. So the pressure on the Wholesale gross margin, obviously, we have the input price that has affected all of our channels in this quarter – that was about 80 basis points for the total Group deterioration. And then in Wholesale, we've been continuing to clear certain products, and the third point is that we have the devaluation impact in markets where the hedging is not done. And that is the Argentine peso and the Brazilian real.
And the second question was about the 10% increase in marketing working budget. You know, we called out as part of our second quarter announcement that we are investing more – particularly in the developed markets – and that we are expecting our marketing investment to increase by about a percentage point in 2014 and 2015. And so that run rate that you are seeing here is likely to be consistent for the total 2014 year.

Chiara Battistini
Perfect. Thank you very much. And just if I may, a follow-up on gross margin – following up also on the previous question on the input costs and what we should expect going into 2015. How should we think about your gross margin in 2015, weighing the fact that this year was penalised by FX, significantly, and hedges and into next year where the rouble will continue to be a headwind. But then I would assume you should also benefit from an easier base and lower drag from TaylorMade?

Robin Stalker
Yes. And I think that's a good summary. Obviously in the FOB increases, we try to mitigate this with the continuing improvements and efficiencies in our supply chain and our manufacturing processes and also obviously through price increases. That's not always possible. We are not too concerned about this for next year and, as you say, we are in a situation where it's not just the rouble. You've got a lot of markets, and we benefit from the channel and product mix as we have in the previous years also.

Chiara Battistini
Thank you very much.

Cedric Lecasble – Raymond James
Hello, gentlemen. I have two follow-ups, please. One follow-up on the marketing expenditure, when you decided to raise your marketing expenditure, especially in the developed markets, could you tell us why you decided to do that, what's your analysis, and what will be different from what you already did in the past? And just to double check, the 100 basis points is a split between 2014 and 2015, or should we assume a new significant increase in percentage of sales in 2015? So that would be my question on marketing expenditure.
And the second question is on your working capital, could you explain to us what happened on payables? You had a big decline in payables in the quarter year-on-year. Could you maybe tell us what has changed or if something has changed and how you see working capital going? Thank you.

Herbert Hainer
Cedric, let me start with question number one and why we increase our marketing spend. There are two main points: On the one hand, as we see momentum in several areas – be it Originals, be it adidas NEO, be it football, be it running where we think we have to make fast trains faster. And on the other hand, we also see in markets like North America that we are underspent and, as we have said, North America is a top priority for us going forward. We invest in people, we invest in designers, in design studios, as you may have read, we invest in ambassadors. We have signed four of the top six NBA drafts. We have collaborations with Kanye West, with Pharrell Williams. And we will definitely make more noise in this market. Therefore, these are the two main reasons why we spend more.

Robin Stalker
And we have quantified that: The increase in percentage of sales as being about a percentage point for each year, the 2014 and 2015 years. You know, we normally spend about 12% to 13% of sales on MWB, and we have said that it would be in the range of 13% to 14% in the future.
And then your last question about working capital. Yes, the working capital deteriorated a little bit this time because of the decrease in payables, but nothing special here, it is just related to the timing, obviously, the timing of World Cup products and when we pay; that year-over-year is different. But we still are very focused on further improving working capital, and I think the best call out that I can make here is look at what has happened with our inventory. Now that's the key mover in our working capital. It has been over the last few quarters. That's what we are focused on. We hope by the end of the year to have even a further improvement in the inventory growth.

Cedric Lecasble
Okay. Thank you.

Jürgen Kolb – Kepler Cheuvreux
Thanks very much. The first one on the online business, another very strong quarter. Could you please give us some indications what happened there? Why the online business continues to take off? Have you put additional money in there, or what drove the success there?

And then on NEO, also apparently a strong performer, how much further do you want to stretch NEO? Again, another category – winter more pronounced – you have no concerns that you might over-stretch the category a bit?
And then lastly on Reebok, the factory outlet consolidation, so remind me, how long will that take? When will we be finished with that? The general idea behind it is that just because Reebok has declined in the overall business you downsized it to the reality or what was the idea behind it? Thanks.

Herbert Hainer
Jürgen, this is Herbert. Let me start with question number three because you said Reebok's overall business has declined, which is not the case at all. The reason why we are consolidating our factory outlets in the US is twofold: On the one hand, we want to carve out more the positioning of Reebok as the training and fitness brand in the US, which we are doing around the world. We are growing with Reebok everywhere outside the US So we definitely have to be more focused in the US to bring the message across. And secondly, we simply have too many factory outlets. We want to have a real business, a connection with the consumer and not the majority of our business in factory outlets, so this is why we consolidate.
The second question on NEO: NEO is doing extremely well, and we get great feedback from the young consumer base, especially from the female consumer. And you might remember, when we launched NEO, this was one of the target consumer groups, as we anticipated we are not strong enough with the 13- to 19-year-old, especially female, consumer. So far, we only have a few countries where we sell NEO, mainly China and Russia. We have some test stores in Germany. We have a little bit of business in America. Believe me, we are quite careful how we roll-it out because we don't want to stretch the brand too far.
On the other hand, the positive feedback from the consumers – it's not just sales. It's also the qualitative feedback that we get. It's encouraging, and we will proceed carefully, but there is definitely more potential, as I said.
And last but not least, our online business – you might remember in the Route 2015 plan, this has been one of our strategic targets. We said we want to do at least EUR 500 million. Of course, we will over-achieve the EUR 500 million by the end of 2015. This is by consistent investment into people and into our systems. We now have one platform for all our businesses around the world. We have a lot of employees sitting in Amsterdam who are experts in the digital business in all the different functions – speed, conversion speed, how we drive traffic to the site, what articles we choose, etc. And we are absolutely convinced that this is just the starting point. But even if we do EUR 500 million, this is then around 2% of our total revenues for adidas and Reebok, and we definitely want to get to a higher percentage for our eCommerce business.

Jürgen Kolb
Alright, understood. Thanks very much.

Chris Svezia – Susquehanna Financial Group
Thank you, everyone, for taking my questions. A couple from me. First, on North America, I'm just curious: We continue to see some challenges just in terms of market share losses in some key categories – running, basketball and lifestyle. It seems like in our conversations with retailers, Boost doesn't translate or has not translated as well as in other markets

around the globe. So I'm just curious how you plan to address the product pipeline, marketing, point-of-sale in North America to have more consistent product sell-through in this region?
The second part to that question is the new hires that you made – the three gentlemen – I assume they have non-compete clauses. So I'm just curious if that's true and when they actually start and when they can actually have impact.
The other question I have here, on the golf business, I'm curious about your comments, Herbert, about seeing improving sales and margins next year. And given the fact that there's continued consolidation here in North America and the overall challenges with the market, I'm just curious: How do you prevent a similar play-out versus last year where you sold in a lot of product in Q4 last year only to have the challenges sort of unfold. So I'm just curious how you protect that.
And very lastly here, on FX: How do we think about FX as a percentage of the gross margin as we look forward and how are you hedged? Thank you.

Herbert Hainer
Okay. Let me start with the first question. When you say Boost is not resonating with the consumer in the US compared to the rest of the world, then it is true to a certain extent, but we also have some very positive signals. For example, in running, when you go to the running specialist stores, then our Boost shoes are selling very well. When you go to the normal sporting goods store, especially to the mall, we definitely have work to do. There is no doubt. We have just launched the new D Rose basketball boot, which is a Boost shoe for $140. I think it was 10 days ago, and we pushed 20% in the first two days. So we definitely are making inroads with Boost. There is no doubt. At the New York Marathon, as I said in my speech, the first two, Kipsang and Keitany, they were both wearing Boost and won the race. So we are making huge headways around the world with Boost, but there is definitely more work to do in America. But this is also what I said before why we are spending more marketing working budget: We want to bring our messages to the consumer, especially in America in a deeper and broader way.
When it comes to the new hires, yes, your speculation is also right. We will see them actively in the second half of next year.
Third question was on the golf business. When you look at the golf business in the last 10 years and the key success factors why we became the number one in the golf business, this was because we have been the most innovative golf company. We brought out innovations be it to metalwoods or to irons in a permanent and consistent way. And this is what we will do in 2015 as well.
Let me also say that at TaylorMade-adidas Golf we have a very clean inventory. So, much is still at retail, and this is decreasing step by step. But we definitely will energise the market with new product innovations, which we are bringing out in 2015. And, as I said, we started a week ago with irons and we will follow with new drivers in January, and it will continue during the course of the year. All our restructuring is done in 2014, which will not hit us in 2015. So the one makes us confident on the top line side, the other one makes us confident on the bottom line, because we will definitely have a better cost structure. And we are convinced that by having cleaned most of our inventory this year, the margin will go up next year again.

Robin Stalker
And in terms of the FX effect on the gross margin, Chris, the key here is obviously the dollar/euro, although we are subject to the other paying currencies that we hedge as well. Here the hedge rate for 2015 is slightly better than what it has been for 2014. So it should be a slight positive for us.

Chris Svezia
Okay. Thank you very much, gentlemen. Appreciate it.

Ingbert Faust – Equinet
Yes, good afternoon. I have two questions from my side. One follow-up on Boost. Can you confirm the 8 million pairs of shoes in 2014, and I think for 2015 it was 15 million, just a confirmation of that?
And the second thing, on your outlook for 2015, mid-single-digit sales growth and the pass-through portion of profit growth, why we have, if I am correct, around EUR 80 million restructuring costs in 2014? Is this above the proportionate profit growth indication? Is that adjusted for the EUR 80 million, or is it just in reported figures? Thank you.

Herbert Hainer
Well, point number one, yes, I can confirm the 8 million in 2014, and the plan for 2015 is 15 million pairs of Boost. Obviously we have not done it yet because the year is still ahead of us. But what we see is definitely confirming that we are achieving our targets.

Robin Stalker
And in terms of the profitability, I don't quite know where you get your EUR 80 million restructuring from. All we have talked about so far is the restructuring costs in the third quarter for TaylorMade, which is around EUR 10 million.

Ingbert Faust
Okay. I thought there were additional costs this year for TaylorMade and for the Russian operations, a one-off effect in the area of EUR 80 million, but I might have been mistaken.

Robin Stalker
What we communicated in the second quarter, I'm happy to repeat, was our expectations for the second half including obviously the poor trading of the business in terms of margin in both Russia and also in TaylorMade-adidas Golf, and we used that to explain why the total for 2014 would be down. But the restructuring is just in TaylorMade, and that's, as I said, about EUR 10 million and already booked in the third quarter.

Ingbert Faust
Okay. Thanks for the clarification.

Adrian Rott – Deutsche Bank
Hi, everyone. Thanks for taking my questions. Again on golf, please, I'm just curious to hear what the sort of "new normal" at TaylorMade would look like in your view. It's quite some time since we have seen an EBIT margin for the brand, and obviously that segment should be profitable again next year, but what's the sort of mid-term target corridor considering the structural changes in the industry and also your new set-up post the changes at Adams' workforce and so on.
And secondly, briefly on the US again, so obviously TaylorMade is heavy, but can you elaborate again on how you're seeing the adidas and Reebok brands selling? That would be it from my side. Thanks.

Herbert Hainer
So let me start with the second question, the US. Obviously, as I said before already, when we look at the adidas and the Reebok performance, especially in the third quarter, it was 12% and 7% up. We are quite satisfied, with the exception of North America. As I said, we are stagnating in America. I am positive for 2015 that we are growing again at adidas, Reebok will be more flat. Because, as I said, we are closing factory outlets, having cleared a lot of product and want to come back to more regular sales in Reebok. But for adidas, I definitely expect growth in 2015. But wonders will not happen overnight. So we have now changed the management. We are investing. We want to have high-quality distribution. We have to spend more on Boost. But we definitely want to build a sustainable growth business in the US
The first one was on TaylorMade. I think you were asking why we are confident about growing our profit in 2015 and going forward. First and foremost, we will have a lower revenue base in the future than we had in 2012 and 2013, but we definitely will have less clearance sales. As I said, we are bringing in new innovative products, and you will see already some new drivers coming in January next year, so not far away from today. This should mean less clearance sales. This should give us a better margin. And on the other hand, we will have an improved cost base and, therefore, our profitability will grow. We'll be there in 2015 again, and then we will be growing going forward.

Adrian Rott
Yes, but correct me if I'm wrong, I think 2006, 2008 TaylorMade was sort of delivering a 8% to 10% EBIT margin. And that's a big gap between turning golf profitable again. Are we ever getting back to those margins? What's your base case assumption in the mid-term for TaylorMade and golf?

Herbert Hainer
Yes, this is correct what you said with our margin EBIT. This is definitely our target, and we will get to that, as I said, on a lower revenue base. But all the measures which we are doing help the revenue business, which gives us higher margin and lower cost base, and this is definitely bringing us back to the margin which we had in the past.

Adrian Rott
Alright. Thanks. Great.

John-Paul O'Meara
So, ladies and gentlemen, that does complete our call for today, thank you very much for your attention. Our next communication will be on March 5, 2015 for our full year results. So enjoy the rest of the year and the holiday season.