

adidas Group Nine Months 2010 Results

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Q&A session

adidas Group participants:

Herbert Hainer, adidas Group CEO

Robin Stalker, adidas Group CFO

John-Paul O'Meara, Vice President Investor Relations

Matthias Eifert - MainFirst Bank

Can you give us a quick update on what is happening in China on a store basis? I've seen there were lots of store closures at the beginning of the year from some of your retail partners and I think that has improved a little over this summer. Can you give us an idea here about the store opening plans from your retail partners and where do we stand in terms of a store count at the moment?

Secondly, on Reebok, I would like to know the time lag in terms of the roll-out of the product, how quickly are you rolling out products in other markets? For example, if we say that in the US you are at 100% of your toning product launches, how far are you in Europe, Asia and also in Latin America, in terms of your product launches and how many months delay do you usually have with these launches?

And thirdly, in terms of your gross margin, there is still a very big difference between the Reebok and brand adidas gross margin. I would be interested to know how Reebok's gross margin in the US compares to the gross margin on a global basis? Considering that the US is now the furthest in terms of product roll-out at the higher price points.

Herbert Hainer

For China this is definitely correct, what you said in terms of store clean-up and also inventory clean-up. This is 100% in line with our strategy, which we told you already during the last 12 months: we will clean up inventory and we will clean up our store base. Non-profitable stores and stores that don't work well will be closed and we will also build new ones. So net we are up slightly in China, but also these are of a much better quality. You see this already in our results in the third quarter and this will continue in the fourth quarter and into 2011. And I am once again sure that from 2011 China will be a growth engine again.

At the moment, we have a store base of around 5,800. For Reebok roll-outs in general, we always start with our key concepts in the US, as Reebok is an American inspired brand and then six months later we roll out internationally. This was done with EasyTone™, so that you can expect that it is, more or less, everywhere in the world within the second half of 2010, with a further push in terms of marketing, stronger sell-in and store base enlargement, in a lot of markets. This is the same with ZigTech™, which we started this spring in the US and then rolled it out further across the country in the second half. We have started in a few other countries already in the second half of 2010 outside of the US, but the big push is coming in spring/summer 2011. And this is what we will continue to do with all of our other concepts which are coming up, such as Flex, Classics, etc.

Last but not least, gross margin outside of the US is higher by around 10 percentage points in Europe and in Asia compared to the US. This is true for adidas, this is true for Reebok and for almost all other brands. Therefore, it is our clear intention to build up our Reebok business internationally and this is what you will see us doing going forward. We are happy with the growth rate in the US, which was 25% in Q3 and over 20% for the first nine months. And this definitely has now to continue into the international markets as well. We have it in

Russia, we have it in Germany, we have it in Japan and Korea. But we definitely have to roll it out further internationally and this is what you will see in the next months and quarters to come.

Matthias Eifert

Looking at the gross margin, Reebok is in the low 30s and your adidas brand is in the high 40s. But in the US, where you have already the highest share of the new product at higher price points, is there the same big differential of the brand adidas gross margin and the Reebok gross margin compared to other markets or is it narrowing quite a bit?

Herbert Hainer

Obviously as we bring higher price points for Reebok into the market with \$99 or \$79 we are improving our margin. And I wouldn't say the gross margin is in the low 30s, it's around 35%-36% margin. But it is definitely increasing. At adidas in the US we have always been between 38% and 40% margin whereas we are around 48% to 50% in Europe and in Asia. So we are catching up in the US and we will also do that with the Reebok margin in Europe, but it will still take some time. Luckily we enjoy with the adidas brand around the world the highest price points which you can get for products. Look at the F50, the Predator, etc.

Matthias Eifert

And in terms of the product roll-out, you expect that by the end of the year 100% of all toning products will be available in all markets?

Herbert Hainer

I wouldn't say 100% because we are permanently launching new toning products. But we are now in all countries with EasyTone™, but we are also introducing in the US market new toning products like SimplyTone™. This will then be rolled out three to six months later internationally, in other countries in Europe, Asia and Latin America.

Jurgen Kolb - Cheuvreux

I think lead-time reduction has been a topic early this year and at the end of last year. Can you give us an update on where you stand? How much focus have you put on lead-time reduction? Maybe differentiate between adidas and Reebok?

Secondly, on China again, you've been part of the Taobao website since the beginning of the third quarter. What do you expect in terms of contribution from that angle and has it already contributed in the third quarter?

My third question is on ZigTech™. I think you said that for the full year 2010 you planned to have sold around 2 million pairs of ZigTech™. Is that still the number or can you provide any further details? Maybe you can also break this down into the US and the international markets.

Robin Stalker

I can't give any specifics on the lead-time reduction. It is a high priority for us. We've made good progress again this year, but I wouldn't expect it to differentiate really between the Reebok and adidas brands. It's being handled in the same way. There will be certain differences in certain countries, but basically reductions are planned for both.

Herbert Hainer

Regarding your second question, we have started cooperation with Taobao in the third quarter. The first initial success is encouraging. We have a big push on eCommerce worldwide with our own platform and also together with key retailers. So this is all in line with our strategy. Obviously it's still relatively small compared to the total sales in China, because we are starting to build it up now.

And to your third question, ZigTech™ 2010, we are exactly on plan. In some parts we see extremely good sales. For example, a few ZigTech™ products have been the best sell-through products in back-to-school at a few key retailers in the US. And all that we hear regarding ZigTech™ is very encouraging. We started on Monday with the ZigTech™ basketball shoe, the ZigTech™ with John Wall. But it is a little bit too early after three days to give you results. But all that we have seen so far on the website in the weeks before has been very good.

Erwan Rambourg - HSBC

You say that the inventory increase will match growth expectations for the future quarters. Should we understand you are basically looking at 9% growth for the next few quarters? And on inventories can you tell us what you think the situation is in the trade; i.e. would you qualify inventories as being healthy and are there differences by regions or brands?

Secondly, I just wanted to come back on the NFL sponsorship. I understand that not renewing the sponsorship is probably a good thing for margins. However, I was wondering if you could quantify what the size, in terms of sales, will be. Because obviously there have been a lot of figures flying around about how much business you are currently generating on this and I think it would be helpful if you could give us an indication of how much it represents for Reebok in the States for now.

Thirdly, just looking at the wholesale approach to the P&L, you have flat operating margin in that channel despite 8% top-line growth. My understanding is input costs were actually positive for the first nine months, which implies that the margin would have been down in wholesale. Can you comment on that? Am I looking at this in a correct way and what does it say about the cost of doing business in wholesale right now?

Robin Stalker

We'd certainly like to be growing at that level, but we will be seeing in our inventory build-up a certain amount of normalisation back to the levels that we need to have. We took a significant cut in inventories last year, but our expectations for future growth are also very positive. And the inventory is very current, the aging is very good and our sell-throughs, from what we're hearing through the trade, are also very positive. So we're not aware of any problems in inventory build-up in the trade.

Herbert Hainer

This is definitely correct. However, in a few countries it's the opposite. Especially in the US, we have an extremely clean inventory, also in China, which we have already mentioned. And as Robin said, our inventory is much younger and fresher than it has ever been.

Coming to the NFL question, the renewal didn't raise that much of a concern in terms of margin. First and foremost, the NFL didn't fit to the positioning of Reebok anymore. And the second point is that you always have to look what the costs are and what the outcome and the objective is. And therefore we think this didn't match, at least not for us, and therefore we didn't pursue it. So overall the total volume is around €200 million in revenues. This always depends a little on which team goes further in the Super Bowl. So it can be a big market, a small market, two small markets – so this is ballpark.

Robin Stalker

Regarding wholesale, what you have to be aware of is the country and product mix, which is always the big moving part here. And that plays a big role in terms of which countries are growing and which products are offered and when. We're very happy with the development of the margin.

Erwan Rambourg

Just a follow-up on inventories. There's no overhang in terms of World Cup product in Europe?

Herbert Hainer

No. What's difficult is to produce all the replica shirts, to be honest.

Louise Singlehurst - Morgan Stanley

Looking at your guidance for 2011, can you give us any colour on the implied kind of gross margin direction, reminding us of your hedging policy and how you're dealing with the magnitude of the sourcing costs? And then secondly, has there been any noticeable improvement in the pricing environment in Q3 and where we are with pricing and the discounting going on in China as well?

Robin Stalker

We're going to give you obviously much more detail about what our expectations are for 2011 when we see you in March. There's a lot of moving parts in the gross margin. Clearly we see some negatives in terms of the increased price for raw materials and wages. But we've been doing a considerable amount to mitigate those in terms of reengineering our products and more efficiencies in the supply chain and looking at strategically opportunistic price increases. We have a country mix and we also have the improvement in the Reebok business. So I think we've got a good chance of being able to hold margins to a certain extent, but I'll give you more detail on that in March.

Herbert Hainer

To your question on pricing and discounting in China in the third quarter, for our business pricing was up and discounting was down. Obviously this is a result of all the measures we have undertaken. We had more discounting in the first half because we still had to clean inventory and therefore the pricing was down. But now we are back with fresh products where we can hold our prices. We're achieving good margins again in China and we have less

discounting since on the one hand the new products are selling through very well and on the other hand we don't have old inventory anymore.

Michael Kuhn - Deutsche Bank

First of all, on your hedging rate, it would be interesting how much you've locked in for next year already and at which rate?

Second question is on your cost development. I think you had about a €100 million increase in sales and marketing working budget in the third quarter, but also quite considerable increases on other operating costs. Some details here would be interesting, what factors drove those costs and also what was the currency component in that because I think those also contributed positively in driving up the costs here.

And thirdly, your royalty income increased quite considerably in the third quarter. I would ask you to give some more details on what drove that development.

Robin Stalker

We are very well hedged for the next year. At the moment we're probably about 80% hedged for next year. Certainly it's a little bit less favourable than what we've been able to enjoy in 2010. But particularly considering the development of the last couple of months, I think we're holding it. We hope we have something around the 1.35, which will be \$0.02 or \$0.03 probably below what we had in 2010. In terms of the Q3 cost development, you've hit the nail on the head, because about 50% of the increase in Q3 was marketing related. And in addition to certain investments in retail systems and people, currency is the major part of that other balancing figure, because obviously the currency movements have been significant over the euro.

To your third point about royalty, that's also another indication of how strong our brands are at the moment. This is purely because of increased sales of licensed product with also some slight increases in royalty percentages. But it's basically sales based.

Michael Kuhn

Do you have a number of currency-neutral OpEx increases in Q3?

Robin Stalker

We could do some sort of calculations to be able to guesstimate it. But we definitely don't look at currency below the top line. So no, we don't do any currency-neutral calculations there.

Andreas Inderst - Exane BNP Paribas

I have also three questions. The first one is on North America: a very pleasing performance of plus 12% year-to-date. Outperforming Nike, which grew by around mid-single digit in the last three quarters. Beyond the low base, are there any other reasons for the outperformance?

My second question is on the toning segment: I hear what you are saying regarding your superior strategy and product offering versus your main competitor. However, Skechers seems to have over-distributed the market with toning shoes. Have you experienced some order cancellations? Have you also been impacted by that? And can you confirm your target in terms of volume for the EasyTone™ this year?

And related to that: you expect market leadership, taking over from Skechers. What's the target for that? Would that be in 2011, 2012?

Herbert Hainer

Let me start with the first question on North America. We are pleased as well with the results. And it is not because it's from a low base, it's definitely because of the better products which we are bringing to the market. We had a lot of compelling products, starting with football at the beginning of the year and also in the running category. In Originals we had the Mega launch and now we are bringing out the latest basketball boots for Dwight Howard and Derrick Rose. Apparel has also been doing very well. There are two things to consider. On the one hand we have better products and concepts and on the other hand we have better market and distribution segmentation. So we are bringing the right products to the right customers. This sometimes involves intensive discussions with retailers, but it's definitely better for the market and we can see the results. I can tell you this will continue, because in the meantime we have already sold into 2011 for the first and second quarters and the response is extremely good.

So let me come to toning. You have described the situation regarding promotions where our main competitor, Skechers, had too much product in the market. And what I hear is there's still too much in the market and in their own warehouses. There still might be some price pressure in the weeks to come. But we're clearly holding our line. We're holding our prices, we're holding our margin, we're supporting it with TV advertising and we are happy with the sell-through that we are getting. As I said before, we are five times bigger than a year ago and this will be rewarded by our retailers. We definitely have products which are compelling for the consumers, we are working closely with our retailers and we're helping one or the other retailer if they have too much inventory. Luckily, toning is selling very well around the world. For example in Japan, where we had tremendous success with ABC Mart and therefore we are able to channel some product into other markets, which of course helps.

So, in my opinion, all that I have just said shows two things. On the one hand it shows that we really know how to build up brands and product concepts, based on a disciplined approach. And second is that we are here with toning for the mid and for the long term. Therefore we are working closely with the retailers and trying not to put too much product into the market. And all this together will bring us market leadership and not only in 2012, we definitely want to have it earlier.

Andreas Inderst

And in Japan, you mentioned your success for the toning segment. In terms of the overall sporting goods market in Japan, how do you see the market at this stage?

Herbert Hainer

The market in Japan is in general still difficult, as you know. I think in the last 15 years the Japanese economy hasn't seen any growth. And this is definitely a challenge to the consumer. We also have an aging population. But nevertheless, as you have seen with our Q3 results, in a lot of countries in the world where the economy is not doing that well at the moment, we are still growing. Just take the US as an example, and the same thing is happening in Japan. So we are definitely back on track in Japan. And we have done more or less the same thing in other markets. We have cleaned the market of products which haven't sold through that well during the crisis. Now we are bringing more compelling products to the markets in a more disciplined way and this leads to us being back to growth in Japan as well.

Chris Svezia - Susquehanna

I guess the first is just on North America, specifically for the adidas brand. Can you talk about apparel versus footwear? I would assume you've seen nice apparel growth? We've heard some good commentary about the apparel side. Footwear is showing improvement but it seems like it's still, broadly speaking in this market, losing incremental share, though improving. I'm just curious when you believe or expect to start showing growth in terms of share trends on the technical side given the organisational changes I think you've made in your North American operation?

My second question is on EasyTone™, any highlights or thoughts about what you think about pre-book for spring 2011? I know you don't give futures, but just in terms of what you're seeing given the growth in the business and what you've seen so far in 2010. Have you seen any acceleration in pre-book trends for that product?

And lastly just on growth, you are talking about mid-single-digit currency-neutral in 2011. Just any thoughts from a geographic perspective or, if you want to, just in terms of retail versus wholesale? Obviously going into next year there's no major sporting event. I'm curious how you're thinking about getting to that mid-single-digit growth rate?

Herbert Hainer

Let me start with the first question on North America and the adidas brand. It is obvious that we have always had a good apparel business in the US and this is still continuing. This was also supported by football during the summer months. But don't underestimate footwear. We are growing in footwear and we had some compelling products on the footwear side. For example, in football the F50 was selling extremely well and is still selling extremely well in North America. We have a number of running shoes which are doing very well with running specialists, which you might not always find in the market share data. We also launched Mega with Finish Line and we have the Originals walls with Footlocker. Now we are bringing out the basketball boots: Beast and adiZero. We have a lot of product initiatives in footwear going on which helps us to grow footwear. But there is still potential in the future and this is definitely what we want to grab. Take EasyTone™ for example, I'm confident in EasyTone™. The market for this category will remain into the future, though with not so many players. You have experts in the US who are estimating that the toning market is valued at around \$1 billion at the moment. And we see positive signs for our bookings, at least for what visibility we have. In terms of volume, retailers are still a little bit careful because of all the discounting. But overall the retailers believe in it and they are buying into a broader assortment. We are permanently bringing new toning products into the market. But in terms of volumes they still are a little bit cautious, waiting to see how the Christmas business goes and how the discounting of one of our major competitors proceeds and how long it will take. But overall, I think there is a deep belief in the category and there is also a deep belief in Reebok's ability to really structure the market.

On your third question, regarding mid-single-digit growth and in which geographical areas. I believe that we will grow more or less everywhere in the world. Definitely China will continue, America will continue and Western Europe will continue. There might be one country which is better than another due to World Cup effects in the comparisons. The emerging markets will further grow. In my opinion, the really pleasing thing about the Q3 results is that, besides them being overall good results, the growth is broad-based over the entire world and we are growing everywhere. And we are also growing with all of our brands, be it adidas, Reebok, or TaylorMade.

Cedric Lecasble - Kepler Capital Markets

My first question is on the evolution of your gross margin in your retail business, which has been extremely strong over the last quarters. Given the sourcing input, gross margin headwinds that you are seeing kicking in, what kind of dynamic can we expect for the retail business going forward? Do you still expect nice margin growth for the retail business even if there's small pressure in the wholesale part of your business on the gross margin? And the second question is, before we get the details in March on your 2011 guidance, could you help us a little bit on the OpEx side and especially on marketing? How do you see marketing in a weaker year, in terms of sports events? How do you see marketing spend for the Reebok brand and overall how will this expense move as a percentage of sales?

Robin Stalker

What you're seeing in retail is also a factor of the focus that we now have on retail. And there's a tremendous amount of improvement coming and we'll obviously talk about that during Investor Day. Most of this has to do with mix and it's very difficult to project at the moment the specific development of that in terms of retail versus wholesale, but it is our intention to continue to grow a positive gross margin in the retail segment.

Herbert Hainer

In terms of the second question, when you asked about marketing and OpEx. Honestly, marketing for me is an investment because it is building the future of our brands and the health of our brands and I believe that the best example is Reebok. Two years ago people complained that we didn't put enough money behind Reebok and I always said as soon as we have the right products and concepts then we will support that with marketing spend. We have done so in 2010 and you see the success, and we will continue to spend in terms of marketing, because this is definitely an investment in the future. In comparison with 2010 our marketing working budget might be down slightly. But overall, as we have said already several times, we want to harmonise the spending more and more because in years where we don't have big events we put a lot of product concepts and innovative product launches into the market. And we'll see this as well in 2011.

I think you are on the right track that we are spending what is necessary to further drive the initiatives and the brands.

John-Paul O'Meara

Thank you very much for your attention today. Remember, we have our Investor Day here at Herzogenaurach on Monday. So we look forward to seeing those of you who are coming. And also for those of you who are not, you can follow parts of the Investor Day on our website. Our next results call will be on March 2nd for our full-year results. Thank you very much for your attention and enjoy the rest of the day.