adidas GROUP

FINANCIAL RESULTS PRESENTATION

First Quarter 2014 Speech

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Herbert Hainer, Robin Stalker, John-Paul O'Meara

John-Paul O'Meara

Good afternoon ladies and gentlemen and welcome to our first quarter 2014 financial results conference call. I'm JP O'Meara and I head up the IR activities here at the adidas Group. Our presenters today are Herbert Hainer, adidas Group CEO, and Robin Stalker, Group CFO.

To allow for ease of comparison, all sales and revenues related growth rates will be discussed on a currency-neutral basis, unless otherwise specified.

So, let's get started and over to you, Herbert.

Herbert Hainer

Thanks JP and good afternoon ladies and gentlemen.

Our financial results for the first quarter reflect the challenging start to 2014 that we had expected. However, looking in depth through our results, there are many positive underlying trends. Therefore, we can look forward to an accelerated period of growth and momentum for our Group for the remainder of 2014.

The key financial results of the first quarter were as follows:

- Sales were stable but declined 6% in euros to 3.5 billion euro.

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- Gross margin decreased 1.0 percentage points to 49.1%.
- Operating margin declined 3.2 percentage points to 8.6%.
- Net income attributable to shareholders was 204 million euro.

Two factors in particular had significant financial impacts in the first quarter. The first is related to strategic changes we are implementing at TaylorMade-adidas Golf. We are in the process of realigning key shipment and product launch cycles to more appropriately mirror market demand patterns. The goal of these changes is clear: to extend and drive higher margins throughout the product cycle and to reduce inventory risk by shipping closer to key retail selling periods. This change, as well as the continuing challenges in the underlying golf market, where rounds played were down a further 5% in the US in the first quarter, resulted in a sales decline of 34% at TaylorMade-adidas Golf. In total, this impacted Group operating profit by around 80 million euro.

Secondly, we continued to suffer from sharp and unfavourable movements in several currencies versus the euro and the US dollar, such as the Argentine peso, Russian rouble, Brazilian real, Turkish lira and Australian dollar. This again put a significant strain on our reported sales and achieved margins.

Our sales were reduced by 235 million euro from adverse currency translation, or the equivalent of 6 percentage points of growth. Gross margin was negatively affected by the devaluation of the Russian rouble as well as by less favourable hedging rates. Taking the translational and transactional effects of currency together, we estimate that these impacts reduced our operating profit by around 50 million euro.

While these two issues dictated the Group's financial results in the first quarter, they mask some very encouraging underlying developments we are seeing from our business units around the globe.

Let me give you a few examples.

From a geographic perspective, we continue to dominate in the emerging markets, where sales in European Emerging Markets, Latin America and Greater China grew 28%, 19% and 5%, respectively.

In own retail, we saw a significant acceleration in growth, with comparable store sales increasing 8%. In addition the first roll-out of our new store formats HomeCourt (Beijing and BlueWater/UK) and Neighbourhood (Berlin) was a key highlight in the quarter, ushering in a new era of retail experiences for the consumer.

At adidas, sales increased 5%, with growth in every region except for North America, which I will come back to.

This is a year of football, a key competitive battleground where we are clearly back on the attack. Our football category sales were up 27%, demonstrating once more our leadership position and innovative strength in the category, with impressive double-digit growth rates in Western Europe, Latin America, Russia/CIS and North America.

Key to it all has been a firework of product launches.

- We brought the beauty of the Brazilian rain forest and the tradition of carnival to the pitch with both our Earth and Carnival footwear packs.
- We introduced the world's first knitted football boot, the Samba Primeknit, featuring an upper that is knitted from heel to toe, providing a bespoke second-skin fit that retains the strength of a conventional boot.
- And just a few weeks later, at the beginning of March, we unveiled another ground-breaking innovation, the Primeknit FS, the world's very first all-in-one knitted football boot and sock hybrid, giving players a glimpse of the football boots of the future.
- We celebrated Lionel Messi's new all-time club record of 371 goals for FC Barcelona with a limited edition of the adizero f50 Messi 371 boot which thrilled Messi's highly engaged fan community in the social media world.
- We introduced our adizero f50 crazylight concept with Gareth Bale, resulting in a huge media pick-up especially in the world of social media. Weighing just 135g, this game-changing shoe is the lightest football boot ever.

Our running business also remains strong. We had a good start to the year, with sales in the category up 7% driven by strong double-digit growth in Western Europe, Emerging Markets and Japan. We shipped one million pairs featuring our Boost technology in the quarter, which continues to set the pace in major marathons and thrill running consumers around the world. As our volumes build throughout the year, this growth rate will accelerate in the coming quarters.

We also enjoyed great momentum in training, where sales increased 8%. Apparel is a big focus area for us this year as we look to build a new period of sustained growth in the category and reassert our leadership in the space. A great example is the ClimaChill concept, which is already resonating extremely well with consumers and retailers. Endorsed and supported by a digital marketing campaign with David Beckham, we have already had 4.6 million views on YouTube, making ClimaChill our most successful apparel technology launch through digital marketing ever.

In lifestyle, while we are still trading through some softer trends for Originals in North America and Western Europe, our Originals & Sport Style business grew 3%. Double-digit growth in all of our emerging markets offset softer trends in Western Europe and North America due to weakness in Originals. However, I believe we are approaching the tipping point in these regions.

Product launches such as the Originals ZX Flux are enjoying encouraging early signs from Western Europe with sell-throughs clearly outpacing our major competitor at Foot Locker Europe. We also have had strong response to our new collaborations with TopShop and Farm as well as record conversion from the Stan Smith re-launch. And as you know, we have an array of hotly anticipated initiatives in the pipeline, be it Kanye West or Pharrell Williams, amongst others, to bring momentum back to the category.

Speaking of momentum, another area of outstanding growth in the quarter was at the adidas NEO label, where sales increased 24%, with double-digit growth in all regions. Our Selena Gomez collaboration took on a whole new dynamic in its second year, with over five hundred thousand conversations on Twitter in the first two days after the collection launch. We also continued to roll out our store test phase, opening two stores in Poland and one in Germany, right here close to our headquarters in Erlangen.

And finally, at Reebok, we recorded our fourth consecutive quarter of growth for the brand, with sales increasing 3%. More importantly, we also achieved a further solid gross margin increase of 50 basis points to 39.6%, despite the currency headwinds we faced throughout the Group.

Reebok continues to build strong consumer loyalty with the evolving fit generation. No other brand in our industry has embraced this rapidly growing consumer demographic. As we drive a high level of grassroots brand engagement through our strategic collaborations with CrossFit, Spartan Race and Les Mills, our commitment to fitness as a sport is clearly resonating. To broaden our offering, we launched promising new footwear concepts such as ZQuick for running and training, the All Terrain series for obstacle racing and the Skyscape shoe, an extremely comfortable walking shoe for women. Our visually striking and activity-specific apparel offering for a growing number of fitness activities is also going from strength to strength, with growth of 14% during the quarter.

And we also continue to see nice momentum in Classics, where sales increased 19% in the quarter, with strong demand for retro basketball products as well as the GL 6000 series.

All of these successes that we are seeing from adidas and Reebok underpin our confidence in the direction of our business. Over the last weeks, as more of our new concepts are hitting the market, we are hearing and seeing first-hand from retailers that we are not only maintaining momentum where we are strong, but also turning the corner in our most challenging markets and categories.

In Western Europe, where we have been under competitive attack in the last twelve months, we have stabilised our position, with adidas and Reebok growing at a low-single-digit rate in the first quarter. With Germany and Poland up at strong double-digit rates, good comps in our own retail and visible improvements in orders for our latest innovations, you will see a good acceleration in the region in the coming quarters. And don't forget that this year we will be completing our ONE Europe project, where I definitely expect benefits and synergies as we plan and build for 2015.

On that note, let me also come back to North America, where Group sales were down 20% in the first quarter. While TaylorMade-adidas Golf accounted for more than half of the sales decline in the region, adidas and Reebok also had a slow start to the year, declining 13% and 8%, respectively. For adidas, the decline in the quarter was mainly due to Originals and basketball. In Originals, we acknowledge that we missed some fashion trends in the market over the past twelve months, while, in basketball, footwear sales declined in the first quarter due to the comparison with the ramp-up for the Derrick Rose return in the prior year. At Reebok, sales mainly declined due to running footwear in the wholesale channel. Importantly though, all of our other fitness-related products as well as Classics are doing extremely well.

My Board colleagues and I definitely are not happy with our performance in North America, but let me assure you of one thing – we are fully committed to driving long-term success for the Group in this market. When it comes to our brand positioning, we are convinced that we are focusing on the right areas.

Nonetheless, our biggest obstacle has been and still is the quality of our execution, particularly in the wholesale channel. When I look at own retail, sales were up 13% in the quarter, clearly showing the strong consumer desire and conversion of our brands when they are presented in the right way.

Therefore, in North America, we are accelerating change internally, with the completion of the joint operating model for adidas and Reebok and the appointment of Mark King, who has been responsible for taking TaylorMade-adidas Golf to the top of the golf industry. Under the guidance of my Board colleague Roland Auschel, who will take over responsibility for the market at the Board level from me, as well as strong support from Eric Liedtke and his brand management team, we are putting our top minds and talents fully behind this market as we build towards our next strategic plan.
While this team will focus their attention on building a more robust Group executional strategy for the market in the long term, in the short term, we already see improving trends for both brands in North America, and I expect adidas and Reebok to reverse the negative trend from the first quarter and to grow in North America for the full year.

Our new Originals initiatives which I have already mentioned, higher volumes of Boost running shoes and the introduction of our award-winning Boost technology into basketball are all driving increasing demand and orders for adidas for the second half of the year. At Reebok, as we increase the depth and scale of our fitness offering and introduce more volumes of our latest running products during the summer months, we also see growing momentum in the region.

And not just in North America. At a global retailer event we held for Reebok in Canton at the end of April for our most important retail partners and key accounts, we have also received unprecedented feedback on our ranges, collections and concepts for spring/summer 2015. While up to now Reebok's successes have been driven mainly from controlled space related markets and channels, I firmly believe this will be a turning point to unlocking the wholesale potential of the brand.

Therefore, as I stated earlier, I am looking forward to increasing momentum for our Group in the coming months. As a result, I can confirm our full year guidance as given in March with only some minor changes. The weak start to the golf market in 2014 is likely to mean that TaylorMade-adidas Golf sales will be moderately below the prior year level on a currency-neutral basis. This, however, will be offset by own retail, which we now expect to be at the upper end of the currency-neutral range of high-single-digit to low-double-digit growth initially expected for the year.

While we still have to be wary of currencies and their effects on our financials, the first quarter will be the low point of our performance. I expect a strong second quarter to point the way forward.

After all, with the 2014 FIFA World Cup taking centre-stage, it will definitely be an adidas quarter.

Later this month, we will unleash our largest football offensive ever ahead of the 2014 FIFA World Cup. The energy and intensity of our campaign and product concepts will be a clear statement and sign of things to come from our Group as we drive towards the realisation of our strategic goals and our 2014 financial guidance.

Also watch out for even more Boost, as we unleash more volume of the most innovative technology, driving to more than nine million pairs across all categories for the full year.

And watch out for a host of great new products and collaborations from Originals as we reclaim growth and stamp our authority as the most desired and authentic streetwear label in the world of sport.

With that, let me now hand you over to Robin to take you through the financials in more detail.

Robin J. Stalker

Thank you, Herbert, and good afternoon ladies and gentlemen.

As you have heard from Herbert, our financials in the first quarter were significantly impacted by the changes we are implementing to the business model at TaylorMade-adidas Golf as well as by negative currency impacts. Throughout my comments today, I will therefore focus on these topics and how they impacted our financial results throughout the various P&L items.

Let's start with the gross margin development. The Group's gross margin decreased 1.0 percentage points to 49.1%. This development was mainly due to the following negative effects:

- Firstly, while our euro/US dollar hedging rate is at similar levels to 2013, hedging for most other currency pairs were at less favourable rates – amongst others the Japanese yen. Altogether, less favourable hedging rates accounted for 70 basis points of the Group's gross margin decline.
- Secondly, on top of this, due to the rapid currency devaluation seen since the beginning of the year, we endured significant transactional negatives in the gross margin. This was mainly related to the sharp decline in the Russian rouble, which on its own had a negative impact on the Group gross margin of 30 basis points.
- Thirdly, lower gross margins at TaylorMade-adidas Golf impacted the Group margin by 40 basis points.
- And finally, higher input costs impacted gross margin by 20 basis points.

These negatives were partly offset by positive mix effects from strong growth in own retail, a solid improvement in the Reebok margin of 50 basis points and a better overall product and pricing mix.

Turning to operating expenses, other operating income and expenses were flat in euros or increased 5% currency-neutral. This was mainly as a result of the higher number of stores compared to a year ago as well as an increase in sales and marketing working budget expenditure, which increased 6% currency-neutral. This was primarily due to higher expenditures at Reebok. As a percentage of sales, the Group's sales and marketing working budget grew 90 basis points to 12.6%.

Group operating profit declined 31% or 139 million euro to 303 million euro. This translates into an operating margin of 8.6%, down 3.2 percentage points compared to a year ago. The majority of this decline, or 80 million euro, relates to TaylorMade-adidas Golf. And roughly 50 million euro relates to currency translation and hedging impacts.

Turning briefly to the non-operating items of the P&L: Net financial expenses decreased 9%. While net interest expenses were down 14%, this good progress was partly offset by negative exchange rate variances.

The first quarter tax rate increased 140 basis points to 28.9%, mainly due to a less favourable earnings mix. This, however, is in line with our guidance for a full year tax rate at a level of around 28.5%.

As a result, net income attributable to shareholders decreased to 204 million euro in the first quarter of 2014 from 308 million euro in the prior year. This translates into basic earnings per share of 98 cents and diluted earnings per share of 96 cents. The dilutive effect results from additional potential shares that could be created in relation to the Group's outstanding convertible bond, with all details on the interest effect and number of shares available in the notes to the accounts.

Let me now spend a few minutes on our segments. Wholesale revenues increased 1%, mainly due to growth at adidas Sport Performance, led by the football, training and running categories. Revenues at adidas Originals & Sport Style were below the prior year level, as growth at adidas NEO was more than offset by sales declines at adidas Originals. Sales at Reebok declined, as growth in fitness training and Classics was more than offset by sales declines in other categories.

Gross margin for the segment was down 50 basis points to 43.8%, as the positive effect from a more favourable pricing mix was more than offset by negative currency effects following the devaluation of currencies such as the Argentine peso and Brazilian real.

Segmental operating margin for Wholesale declined 40 basis points to 35.6%, as a result of the gross margin decrease, which more than offset the positive effect of lower segmental operating expenses as a percentage of sales.

Looking at Retail, revenues increased 22% as a result of double-digit growth at both adidas and Reebok. Comparable store sales accelerated significantly during the first quarter to 8%, with growth across all regions and all store types. By brand, adidas comp store sales grew 9% and Reebok comp store sales increased 4%. Our eCommerce business continued to grow at strong double-digit rates, with sales up 72%.

Retail gross margin decreased 80 basis points to 59.9%. The positive effect from a more favourable product mix was more than offset by a less favourable pricing and regional sales mix. In particular, the devaluation of the Russian rouble versus the euro and the US dollar was a major headwind and negatively impacted the segmental gross margin by 90 basis points.

Segmental operating margin for Retail was down 80 basis points to 13.2%, as a result of the lower gross margin in the first quarter of 2014. Segmental operating expenses as a percentage of sales remained stable at 46.8%, which shows good leverage considering we have opened 283 stores net since the first quarter of 2013.

Coming back to the 8% comparable store sales growth, Retail trading was particularly robust in emerging markets, where our brands enjoyed strong traffic and consumer sentiment. This resulted in double-digit comp store sales increases in European Emerging Markets, Greater China and Latin America.

In terms of our store development, at the end of the first quarter, we operated 2,741 stores, a net increase of 1 store versus the end of 2013. Of the total number of stores, 1,558 were adidas and 411 were Reebok branded. In addition, the adidas Group Retail segment operated 772 factory outlets. During the first quarter, we opened 70 new stores and closed 69 stores, while 41 stores were remodelled.

As in the prior year, the number of store openings is expected to accelerate throughout the year. As a result, we continue to forecast the number of store openings in 2014 to increase by 250 stores net compared to the end of 2013.

Let me now spend a minute on Other Businesses, where revenues decreased 27%, driven by a 34% decline at TaylorMade-adidas Golf. The pronounced decrease at TaylorMade-adidas Golf is mainly due to a change in the timing of product launches as we have strategically pulled forward product launches into the fourth quarter of 2013 to quickly re-establish key price points in the market after a heavy clearance period in Q3. This, as well as continued weakness in the golf market resulted in double-digit sales declines in metalwoods and irons in the first quarter of 2014.

The segmental gross margin decreased 5.5 percentage points to 39.0%, as a result of lower product margins at TaylorMade-adidas Golf due to a lower volume of new product, which more than offset higher product margins at Rockport and Reebok-CCM Hockey.

Segmental operating margin was down 11.8 percentage points to 19.5%. This was a result of the gross margin decrease as well as the negative impact from higher segmental operating expenses as a percentage of sales.

Finally, looking at the balance sheet, operating working capital as a percentage of sales grew 80 basis points to 21.1%. This was mainly caused by an increase in inventories, up 18% on a currency-neutral basis, as a result of our expectations for growth in the coming quarters as well as higher inventories in Russia/CIS compared to a year ago.

In terms of capital structure, we ended the quarter with net borrowings of 254 million euro, compared to 180 million euro last year. This development is mainly a result of higher capital expenditure during the first quarter of 2014. In addition, currency translation had a negative effect of 12 million euro. Our equity ratio remains at a strong level of 48.8% at the end of the first quarter compared to 49.7% in the prior year.

So, ladies and gentlemen, to sum up our comments from today: Yes, the first quarter has been a challenging start to the year with currency effects being a major drag on our Group results. Nevertheless, the solid underlying trends we are seeing in the business give us every confidence in achieving our full year 2014 guidance.

With that ladies and gentlemen, let me thank you for your attention, and Herbert and I are now happy to take your questions.