adidas First Nine Months 2016 Results
November 3, 2016
Q&A session
adidas Group participants:
Kasper Rorsted, adidas Group CEO
Robin J. Stalker, adidas Group CFO
Sebastian Steffen, Vice President Investor Relations

Fred Speirs - UBS
Three questions from my side. The first one goes to Kasper. It sounds like you've been off to a quite busy start. I'd be very interested in having your early assessment of how well the reporting lines are optimized to speed and efficiency of decision making, and also whether you think the operating structure will need to evolve more to help you to execute on the vast transformation within digital. My second question relates to Reebok. You've talked about your plans of moving Reebok to a pure fitness brand that is more wholesale focused, but it does seem that perhaps the brand does not successfully appeal to a wide enough consumer base yet, especially in the U.S. So, where do you see the main opportunities for Reebok? Are those more focusing on brand, on product, or on distribution? Furthermore, how do you think about the target consumer? And the last question refers to BOOST. You've got a great product there, which is clearly performing very strongly. With your latest news on the potential of BOOST, could you talk about the levels of overall volumes for BOOST shoes in 2017 and compare them to 2016? I think the last disclosure I remember was 12 million volume in 2015. Thank you.

Kasper Rorsted
Regarding the first question I can say that of course I am looking upon the overall operating volume within our organization. And as our business evolves over time, including the digital transformation, I think it will be necessary to create a greater level of clarity, but when we get there we'll make the appropriate announcements. It is clear that any company in transformation will also have to evolve its organization over time, so we are not dogmatic about it. And at this stage, I don't want to go to a further level of detail. I'll be happy to outline any kind of changes that might occur in our organization during our Investor Day in March next year.

When it comes to the transformation of Reebok into a fitness brand, I think we've gone through an evolution over time where we tried to just illustrate what I mean. For a given period of time, the brand was probably stronger than the products. Right now, I would argue that our products are stronger than the brand, and we need to make sure that we reconnect our consumers with the brand that we have. And we have been able to do that outside the U.S.

quite successfully, which you have seen at least in terms of the growth rates. So, when you look upon what is really at the top of the agenda in the U.S., one is, of course, reigniting the brand through a number of initiatives, and Robin alluded to those, and get a better quality distribution than we've had in the past. This is accompanied with some of the changes we've announced by reducing the factory outlets. Getting the top line up to where it needs to be, particularly in the U.S., and clearly getting the consumer to pay more for the products as well, so we start getting an acceptable margin that we are not experiencing today. So, that would be my current assessment of Reebok's position. As I've said before, every member of a family or a team needs to contribute. And that is the assumption for being part of the team.

Robin Stalker

Regarding your third question about BOOST, you'll appreciate that we're not giving any guidance at the moment for 2017, and that includes any numbers for some of our franchises. But I can reconfirm the 12 million for 2015 that you've quoted and 13 million for expectations of BOOST sales in 2016.

Andreas Inderst - Macquarie

My first question relates to Reebok. You quantified the one-offs. Can you also quantify the benefits of these measures and where they are actually booked? Are they booked in the North American region? And in this respect, in case the turnaround cannot be achieved, what will happen then? Can you rule out a disposal of Reebok in the medium term, or what's the worst case scenario here? The second one refers to Kasper's motivation and interest in joining the company. Could you please provide some background here on your incentives? What is actually your first take on the sports industry? What do you find odd, interesting, and exciting in the sports industry and at adidas? And my third question is addressed to Robin. In terms of market shares, you reached now 10% in the North American market. It's a good achievement, but far away from the rest of the world. But you clearly highlighted this is just the beginning. Can you elaborate on that, please? What could be a reasonable mid-term target for the U.S. market? Thank you.

Kasper Rorsted

I will start with the first question, regarding Reebok, and Robin will allude to where it's booked. In any kind of company, everybody needs to contribute. If not, they can't be part of that company. Now, I think that is as clear as I can answer that question. So, there is no point in speculating, but it's clear that patience is not going to be around forever. And that goes for every country, every category and every brand. And I believe that we will be very consequent when it comes to that. That is not by any means saying that we're selling Reebok. We're saying we have put a plan in place. We'll execute that plan. And should something different come out, we'll deal with that scenario when we get there.

My motivation for joining adidas is multiple. First of all, I love sport. Secondly, adidas has been my sports brand since I grew up. Joining a company which is a sports company and the brand that I've used all my life was a purely emotional-driven decision, and after my first 90 days I can confirm that I am extremely happy to be here. You asked for my first observations, it's probably an industry that is much more growth driven than I'm used to, but it's also an industry that might be less structured than I'm used to. And I think these are two observations that I have. And I think the big challenge is going to be how do we maintain the growth and get structure, because that's where a lot of the upside will lie for the company. These were the primary drivers. I really wanted, very emotionally driven, to join this company, because I think it's a great company. And I see my responsibility as CEO, along with the rest of the management team, to make this company better. And I truly believe we can do that jointly, and that's why I joined the company.

Robin Stalker

Regarding Reebok I can say that we booked in the third quarter related to shop closures about EUR 10 million. That's in the North American region. And there's still coming, obviously, in the fourth quarter, which I've alluded to, about EUR 20 million for the restructuring that Kasper was talking about a few minutes ago. The second question about market share in America, I'm not going to, and I'm sure you're not expecting me to, quote a goal for market share. The more the better. I mean, I've always said that there wasn't really a market around the world where adidas has a market share of under 15%. And that's a personal view, but I still think something close to that has to be a pretty good, realistic first goal for us. But we'll give you more about our specific goals when we update the communication to you in March next year.

John Guy - MainFirst

My first question, with regard to gross margin by distribution channel, backing out the third quarter gross margin, Robin, it looks like retail/wholesale gross margin was down around 150 basis points, with other businesses off around 320 basis points. So, within that and your initial conversations around the pure FX impact, is it fair to say that the retail/wholesale deterioration quarter-on-quarter is again just driven by currency? You saw no incremental promotional activity in the North American market? I mean, a lot of competitors have been talking about a little bit more promotional pressure going into the third quarter. So, that's my first question. My second question is around working capital. We've seen the inventory increase by about 18% on a constant currency basis in the third quarter, your receivables up 9%, payables up 15%, great cash generation over the quarter. What can we expect in the fourth quarter? I appreciate it's a small quarter, but should we be looking at average working capital as a percentage of sales roughly in line with what we've seen so far over the nine months? And Kasper, just a question for you in terms of

sporting goods industry. You've been very busy over the last 90 days. How do you view the marketplace in 2017? I think with regard to some of the strategic positioning that we've seen around volume and value, certainly there have been a lot of price mix increases that have been pushed into the market to offset some of the FX and labour costs. As the FX impact dissipates going into 2017, do you think the market will be more of a volume-driven market over a value emphasis in 2017? And if you could, maybe give us any views around gross margin expectations for 2017, although I'm probably pushing that. Thank you.

Robin Stalker
John, let me take the first two questions. You're talking about hedging effects in our gross margin. And I can confirm very clearly that the only reason we have this significant negative element on the gross margin is simply because of the hedging. I mean, the purchasing of our products in US dollars, you know we said we had a hedge rate last year of something around about EUR 1.31 to EUR 1.32. For this season we're at EUR 1.12. So, that's a significant difference. And that was the reason why I was initially guiding beginning of this year that the gross margin for the full year could be down as much as 1 percentage point. That we've been able to mitigate a lot of that in the first half of the year, I think that's really positive. And we're still very positive. If you look at the graph we showed with the development of the product mix and price increases, around 400 basis points being able to compensate for this. And there's definitely nothing in here that relates to any sort of promotional activities or a heavy discount or anything like that. It is pure hedging. And I've just repeated the guidance for the full year for the gross margin, 48.0% to 48.3%. That should give you some confidence we're feeling reasonably good with the fourth quarter and what we're seeing on that. Your second question was about operating working capital. You know we've spoken about it a lot of times. We keep a very close eye on inventory. And I can confirm here that the inventory development is very current, so we're in line with sort of business expectations to a large extent here. Our operating working capital as a percentage of net sales is a good 20.3%. That's actually improved 40 basis points over the prior year. I expect, even though the fourth quarter is pretty small, nothing significant in the change in net operating working capital development. And that's all I could add about that at this stage.

Kasper Rorsted
And to your last question. I've been in the company for 90 days now, and CEO for 33 days, and I'd like to make sure I give good and content-rich answers when I get asked. And I'll be happy to answer the question when we meet in March, but I think that would be the appropriate time simply because I want to make certain the answer is well founded. Of course, I've spent quite a lot of time in the first 90 days really getting insight into the industry and, most of all, into our company, which I also think I am getting. But I would ask you for the patience, and then I'll be happy to give you an elaborate answer when we meet, either in person or virtual, in March.

Antoine Belge - HSBC

I have three questions, if I may. First of all, regarding Reebok that you identified as being one of your priorities, it's been a while since we haven't heard any idea of the operating margin at Reebok. So, is it a brand that is now loss making? Or at least what we know is that it's below the EBIT margin of adidas. So, what would be the main structural difference? Maybe in terms of gross margin and then in terms of operating cost and the initiatives that you've just announced, how do you think that they are going to solve part of that, or at least how you'll narrow the gap to adidas? And my second question is on the U.S., which is also a big priority for you. Under the 2020 plan, there is actually, I think in year one and year two, a big sort of step up in advertising. And then even in the U.S., there should be some leverage on advertising. Do you think that this has to be put under review? Do you think that there is more advertising needed to support the U.S. market? And finally, a sort of broader question about you - you are coming from a different industry, but still you are involved directly with the consumers. Have you identified some easy wins, or maybe an area where the sporting goods industry, and not to mention adidas would be a bit lagging behind other consumer type of companies? Thank you.

Kasper Rorsted

So, let me start on the commitment we made to the U.S. It was not a two-year commitment. It was a three-year commitment. So, we're entering into the third year, and I think you can see the progress we have made in the last particularly 18 months. It's important that we continue to make sustainable progress around the adidas brand in the U.S., because not only do we need a bigger market share position, which Robin alluded to, but then of course we need a greater contribution on the bottom line. And that will come through scale. So, you should expect to see the same kind of activities as in 2016 continuing in 2017, as we already indicated. What comes after 2017, we'll say at the appropriate moment of time. On the Reebok side, I'll hand over to Robin. But let me just answer the last question you asked, about what are some of the easy wins or not easy wins. I think if you were to look upon the two main differences between the consumer goods industry I come from and the sporting goods consumer industry, if you were to call it that, the sporting goods industry is a higher growth industry, where it's important that we continue to focus on maintaining sustainable high growth also in the future. The consumer goods industry I come from is a lower-growth industry, which has been run very disciplined. So, a lot of the earnings you've gotten, you have gotten out of getting through gearing of the organization and gearing through the entire business model also through leverage. And of course, then you can put one and one together and say a challenge. We have this. How are we going to make certain we maintain a very strong top line, which we've seen and we expect also for next year, while looking upon gearing in the model and for combining the two? And that would be my observation of it. I don't think in any business there is any easy wins. If there are easy wins and they wouldn't have been taken by management, they shouldn't have been there. And I think that that's why there are no easy wins, but it doesn't mean that there is no room for improvement. I will repeat what I have said in the last eight years at my previous job. I think there are improvements to be done in every single company. And it's identifying those improvements and then executing them very diligently, which is also going to be the case at adidas.

Robin Stalker

Besides, your first question was going in the direction of can we talk about profitability. Well, you know, since the joint operating model, we don't have anything to share on profitability of the Reebok or the adidas brand, other than comparing the gross margin. If you look at the gross margin, we're still very much in a situation where, although there were some quarters where Reebok improved its gross margin, we still have a deficit to the adidas brand of somewhere between 8 to 9 percentage points. And that's an area where I see the emphasis Kasper was talking about, and having them focus more on what they can do with Reebok and making it the best fitness brand in the world, that we should be able to see improving as we get a product with higher price points that can sell through better and generate better gross margins. And the rest will be also generating then further contribution to the Group.

Antoine Belge

And let me just follow up on Reebok. So, the EUR 30 million, that you are taking for 2016, how confident are you that it's going to be enough, or should we maybe expect some other restructuring charges that you could announce during the Investor Day in mid-March?

Robin Stalker

No, that is definitely not our expectation. These costs are related to exactly what our plan is now, to strengthen Reebok and its positioning, get them into a dedicated office in Boston, and doing the changes in personnel or headcount as Kasper mentioned in his opening remarks. Nothing else is expected.

Jürgen Kolb - Kepler Cheuvreux

Two questions on Reebok. First of all, you mentioned that you want to strengthen the wholesale business. If you could, just give us an indication of how the breakdown of the distribution of Reebok currently is in the U.S. in terms of mall-based retailing, full-line sporting goods, or other distribution areas, and where you plan to grow that business again. Secondly, the joint operating model seems to have been broken up now in the U.S. And I was trying to understand why that is. I mean, I know it's not growing in the U.S., but what can you do differently when you break up this joint operating model in the U.S. as compared to all other regions where this model is still working? And lastly, just as a teaser in terms of digital that you put the focus on, where do you think the company needs

some shot in the arm, or where do you think you have the biggest necessity to work on and to improve the digital side of the company? Thank you.

Kasper Rorsted

So, let me just start with the joint operating model. And as you rightly said, we have disbanded the joint operating model in the U.S. And I think going back and understanding our position in the U.S. and outside the U.S. is fundamental for this. And Robin spoke about it, actually, during his part, where he said that in almost every country in the world we have a 15% plus market share. So, that means outside the U.S. we have traditionally been extremely strong with adidas. And that has helped Reebok fundamentally in becoming successful, which is why you've seen 14 quarters of growth outside the U.S. In the U.S., as you know, we have traditionally had a challenging position, and only in the last 18 months have we really moved sustainably forward. So, that meant that we have had a challenged adidas business and, at the same time, a challenged Reebok business. And putting two challenged businesses together is normally not a good thing. Now we are in the position where adidas is really making great strides in the U.S. And we want to make certain on one side that the adidas management does not get distracted and gives full attention to continuing the journey we are right now on. And at the same time also for Reebok, that they get completely focused on only doing Reebok. And I am convinced that in the U.S. this is the right operating model, because we started from a very, very different origin in the U.S. than we did in the other regions. And you can then say maybe we should have done it before. I find that completely irrelevant. We've taken the position we now believe is the right one, and I can tell you we have a very, very well-articulated plan in place that we will execute upon. And the management team will review this plan on a regular, ongoing basis driven by Eric Liedtke, but of course also Robin and I, and ensure that everything that we have set ourselves out to do we will do. On the digital journey, I'll be more than happy to give you a lot of information in March. I think that would be the good way of answering that and maybe the teaser has to then last until March. But I think there is plenty of opportunity for us to expand here. Despite the fact that we are not doing it, we are doing a good job.

Robin Stalker

And Jürgen, you asked about the split between wholesale and direct-to-consumer for Reebok in the States. It's 60% wholesale, 40% DTC.

Jürgen Kolb

Okay, very good. And just maybe a follow-up for you, Robin. The hedge rate, the current hedge rate you have in your books for 2017 currently, roughly?

Robin Stalker

Around the EUR 1.11.

Adrian Rott - Deutsche Bank

I've got two quick follow-ups. Firstly, on gross margin trends in the quarter, can you please add a few comments on the full price share and category mix facts for adidas and Reebok? Because if I look at North America, for example, and we've touched upon that before, with the gross margin up 10 bps following very strong improvements in the first half, I was just wondering whether you can provide some more colour on what's been happening there. And then secondly, another one on Reebok, just curious to hear when that latest round of restructuring has been decided about and been initiated. And also, given that you have decided to reinvest some more Group profits into Reebok rather than elsewhere, I was wondering whether and what kind of targets and checkpoints you've defined along the way. So, what sort of improvements at Reebok would you want to see achieved by, say, mid 2017, subject to which you decide about any future steps? Thank you.

Robin Stalker

Okay, Adrian, thank you very much. So, yes, that's exactly what we're seeing in terms of improving full-price sell-through. You know it's one of our strategic goals. And I think that if you think of that chart we've just shown, it says 400 basis points or something of improvement coming from the mix and increases in prices. We're also seeing less clearance. So, we're getting better at full-price sell-through. And you talked about the 10 basis points improvement for the U.S. in the third quarter. But if you take the whole nine months, we got a 1.1 percentage point improvement there, and that is the quality of the product and the pricing that we're able to get for that.

Kasper Rorsted

On the Reebok side, without mentioning a date, the decision was taken very recently. And when it comes to the improvement plan, we have a plan in place, as I said, that we'll monitor with a number of milestones in. And we expect those milestones to be met. And as also I tried to indicate, we will be very disciplined in the way of following up on that to ensure that we can achieve what we need to achieve. And if not, then we'll deal with the matter when we get there. But right now we have put a plan in place that we will not disclose, but of course the plan expects significant progress in its contribution from Reebok. What I do want to say also on this call is that Reebok is around 10% of our overall business. So, while it's important that we fix Reebok, which we will fix, the more important part is we continue on the growth trajectory at adidas particularly in the U.S. And over time, as also indicated during our speech today, that will continue to have an expansion in our margin and our profitability.

Geoff Lowery - Redburn

Two questions, please. Firstly, can you help us out with the profit, or rather loss in the golf assets that you expect to be disposing of? And secondly, in terms of the non-FX

components of gross margin, which of those do you think can recur and in what sort of quantum next year and beyond?

Robin Stalker

Okay, Geoff. Firstly, TaylorMade. Well, all we're doing is flagging, obviously, that we're getting close to doing a deal, we believe. We would hope to have something clear by the end of this year, and we're just highlighting that there is a chance that there may be a loss on disposal. We cannot quantify that in any way at the moment, but we just wanted to flag it. That's all. And as Kasper said in his comments, this has no bearing on the underlying strength of the operations of the full business. Your second question, you were asking about what are the parts in the gross margin excluding hedging of FX?

Geoff Lowery

So, basically what I was trying to get at was, if your underlying gross margin is going to be up the best part of 400 basis points or so this year, could that number next year be 200 to 300 and then we take whatever view we want to on FX?

Robin Stalker

So, Geoff, I'm going to have to refer you to the guidance for 2017, which we're going to give at the beginning of next year. I can't give you anything other than that at the moment. I think if you refer back to the question that I answered from Jürgen a minute ago, you can see we have great confidence in the improvement of the product offering to the consumers, in our ability to price, our ability to sell more full price sell-through. So, I think you should have some confidence in the overall development of our margin.

Piral Dadhania - RBC Capital Markets

My first question refers to the U.S. apparel category. Some of your peers have been flagging the expected slowdown in that category in the U.S. market in particular. If we look at your apparel performance, it looks like there's about a four or five percentage point slowdown year-on-year on an underlying basis, notwithstanding the impact from the European football jersey sales in the base. So, I just wanted any comments that you might have on the U.S. apparel market and how you're seeing that evolving. Secondly, if I could just ask around your SKU offer, I think that your goal was to reduce SKU count by about 25%. Of course, it's very clear that the footwear silos that you have now are doing very well. And I just wanted to get an indication of whether the reduction in the assortment of the product has been helpful in driving your overall top line within the adidas Originals and lifestyle franchises. And finally, just on women's, I just wanted any indication you might be able to provide in relation to the contribution that women's has had to your organic

revenue growth of 17%. Are you seeing that part of the business growing faster or slower than the Group average? Thank you.

Robin Stalker

Allow me to take the first question. As Kasper mentioned earlier, we're still getting up to speed with some of this. But quite frankly, the point about the U.S. with apparel, you may be quoting some other brands' experiences. This is not our experience. We are very satisfied with the overall growth of everything in the U.S. at the moment, including apparel. And don't forget we said that this is not a sprint. It's a marathon. We want solid, sustainable growth, and that's exactly what we're getting. It's this quarter again up on the good growth that we've already had in the previous quarter. I don't see anything in the market that's causing us, because we are so small there in any case, to have any particular slowdown in the apparel area. SKUs, yes, definitely. That's exactly what's happening. We are on track to reduce our SKU offering by 25%. And it's the concentration also of the management of the franchises on our various products, not just in the leisure/lifestyle offering, but also in our performance offering and managing that, I think is indeed helping us be more impactful in the market. And that is definitely positive also for the leisure/lifestyle area. In women's, I'd love to be able to quote a figure for you here. At the moment, women's is still a smaller part of our business. I can't confirm we're growing faster in this area. And I'm sure that at some stage we can start sharing information with you in that area. But it's a very manual process for us to identify that at the moment, and we don't have anything else to share with you today on that.

Jamie Bajwa - Goldman Sachs

Just a couple of questions from me. First of all, just on your CapEx guidance for this year, I've seen this come down. I'm just curious to understand what the driver behind that was. And then secondly, just a slightly more strategic one related to digital. I know that it's going to be very limited what you can actually share at the moment, but I don't know if you could help us understand a little bit in terms of how this digital strategy will fit in in terms of your channel mix, particularly in terms of wholesale partners and what work you'll be doing there, because I know obviously you've got your partnership with Zalando, but how you expect that to evolve going forward. Thank you.

Robin Stalker

Regarding your question that is related to CapEx, over the last few years we've tended to come in a little bit lower than our guidance. Here at the end of the nine months, I think in CapEx we have only spent about EUR 360 million. The reason we've now reduced the guidance from EUR 750 million to EUR 650 million for the full year is just the practical one in terms of we are not finding the shops able to do all of the investment that had initially been planned. But as I said, this is often the case. We do an optimistic plan, optimistic in terms of what we wish to open, but we've still got to find the locations, and it's the timing of them. So, it's really just the timing, and definitely nothing from a strategic point of view or a different decision.

Kasper Rorsted

And related to your question about digital, without going into too much detail, but it's clear, at least to us, that digital is much more than just the dot com shop and will impact the entire organization, and of course have a fundamental impact on the overall speed projects that we have. Maybe on the dot com and how it relates to our go-to-market route, I think it's clear that there is not one unique go-to-market route. Whether it's wholesale, own retail, or pure play online providers like Zalando, what is equally clear is, as a branded manufacturer of sporting goods, being the second largest in the world, a strategic challenge for us to market is our dot com. And that will play a fundamental role in moving forward for us. And I don't see that it's in contradiction to any of our other partners. I think maybe five or ten years ago that question would have been asked, but I think it is completely accepted by the marketplace and, much more important, by the consumer. There is an expectation from the consumer that he or she can transact directly with us. And we need to ensure that we create the best possible transaction experience throughout our site and at the same time also ensure that we have very qualified wholesale partners and great retail stores. And one of them Robin has talked about, the opening of our store in New York coming in December. But clearly, as I said, dot com is the only global store that we have. I've said that we exploit this to the most, along with the other channels to market. As I said, there is no inherent conflict. That would have been the case five or ten years ago. That is not the case today because consumers expect multiple access routes to market. But more on that when we hopefully meet in March.

Sebastian Steffen

Thank you very much, Kasper. Thank you very much, Robin. Ladies and gentlemen, that completes our conference call today. As always, if there are any open questions, and I could imagine that there are a couple, please feel free to contact either Christian or myself, or any other member of the IR team. Kasper has already teased our next event in March. That will be on March 8th, the release of our full year results, followed by the Investor Day on March 14th, which will take place here in Herzo. And we of course hope that we will see many of you here in beautiful Franconia. We will also be on the road over the next couple of weeks on road shows and visiting some conferences, and I look forward to meeting you there and catching up with you then. And while we are on that topic, Kasper also mentioned that he's planning to go to New York, London and Frankfurt in December. And I just want to make sure that we're all on the same page here. This trip, and Kasper mentioned that, will be purely of an informal nature. So, that means that we're not going to discuss any business topics there. The purpose really is that Kasper wants to meet some of you guys and that you get the opportunity to meet him before we have the official Investor Day in March. So again, no business-related topics. And with that, I would like to thank you again for your participation today. I wish you a very good day, and look forward to talking with you.