FINANCIAL RESULTS PRESENTATION

First Half 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 half 2014 financial results conference call. 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.

It is with disappointment that, after such a great summer of sport, we had to announce last week that our Group has not been able to meet your and our high expectations as laid out in our Route 2015 agenda.

While there is no doubt that our Group has endured external pressures over the past 18 months, missing our goals is something we take very seriously as a management team and we definitely reflect critically on. We clearly recognise that part of this underperformance is due to our executional mistakes, and we take full responsibility to rectify our shortfalls swiftly and to return the Group to stronger earnings growth.

On this note, I am convinced the fundamentals of our business model remain fully intact and, as I take you through our second quarter results and the strategic measures we are taking, this will become more apparent.

Overall, we had a good second quarter, with increasing momentum across most of our business units and markets as expected. Sales increased 10% in Q2.

Of particular note, sales increased in all regions during the period. The emerging markets continued to be a strong source of market share gains, with sales in Latin America, European Emerging Markets and Greater China increasing 33%, 14% and 11%, respectively.

In Latin America, we saw significant sales growth across the brands, with adidas up 35% and Reebok up 26% during the quarter. Our investments in controlled space also yielded strong results, with comp store sales up 42% in the second quarter.

In Greater China, our business continues to go from strength to strength, driven by strong growth in key performance and lifestyle categories. Our Retail expertise is also paying dividends in the market with comp store sales in China up 18% in the second quarter.

In European Emerging Markets, sales growth was broad-based across the various countries, with strong double-digit increases in the Middle East and Africa. In Russia/CIS, sales in the quarter were up 13%, with comp store sales almost on par with the prior year, down only 1%.

In addition, we also saw further improvements in our business in the developed markets.

Western Europe is back to winning ways, with sales growing 13% in the quarter, driven by double-digit increases in several key categories, with running, football and basketball all growing at rates above 20%, and Originals and Style up 12%. By country, Germany, the UK, Spain and Italy all grew at double-digit rates during the quarter.

In North America, Group sales also increased, as solid growth of 8% at adidas offset modest declines at Reebok and a 10% decline at TaylorMade-adidas Golf. Football and running were stand-out categories, growing 52% and 13%, respectively. Originals however remained challenged, declining at a high-single-digit rate. Nonetheless, I am optimistic this trend will improve as new products hit the market later this year and into spring 2015.

Finally, from a regional perspective, in Other Asian Markets, our trends are also improving. Sales for adidas increased 7% during the quarter and Reebok continued its strong momentum in the region, growing 20%. Our biggest challenge in Asia was, and still is, TaylorMade-adidas Golf, where sales were down 37% in the quarter.

By brand, adidas delivered a powerful performance, with sales increasing 14%. It goes without saying that adidas dominated the summer of football on and off the field.

Sales in the football category climbed 41%, confirming we will reach our aspiration of 2 billion euro, extending our lead over our major competitor. There is no doubt that the 2014 FIFA World Cup™ will go down as one of the most captivating and memorable sporting events in history. The visibility of adidas and the commercial success we captured for the brand is a timely reminder of just how effective we can be when we are focused and committed.

We sold more than 8 million World Cup jerseys, celebrating record sales for the jerseys of the winning German national team with fans buying more than 2 million units. Further bestsellers were runner-up Argentina, Mexico and Colombia, with more than one million units sold each. With Brazuca, we delivered one of the most successful and best-selling Official World Cup Match Balls ever, with more than 14 million balls sold. Having its own twitter account with over 2.4 million followers, Brazuca was one of the most engaging twitter accounts of the World Cup, bringing amazing attention to the brand and showing just how innovative and effective we are in new forms of digital marketing. And to round off our success, our counter-attack in football footwear shows just how agile we can be when we go all in. Our “Battle Pack” World Cup footwear collection, which was part of many of the finest moments in the competition, inspired the next generation of footballers back to the original football boot brand. The eye-catching designs made sure our shoes were the most recognisable on the playing field. Our adizero f50 boot ranked as the number one top-scoring boot of the tournament, with Lionel Messi, James Rodriguez and Thomas Müller, three of the top scorers, all wearing it.

While football was clearly a highlight, we also had several other notable successes which provide plenty of reasons to be optimistic about our future potential.

Momentum in adidas Running continued thanks to the further roll-out and evolution of our breakthrough innovation Boost to new silhouettes and price points. Sales in the category increased 16% in the quarter, with all regions growing at double-digit rates. Our sell-in in the US and our performance in own retail were particularly strong, with product launches such as our Pureboost running shoe resonating extremely well with the American consumer.

Our adidas Originals & Sport Style business, which missed some trends over the past year, also markedly improved, with Originals returning to growth, up 8% globally in the quarter. The Originals ZX Flux is taking the market by storm, currently being the number one selling shoe at Foot Locker Europe, and I am fully convinced this will evolve into a big commercial opportunity for us.

Sport Style maintained its strong growth trajectory, increasing 21% in the quarter, driven again by the adidas NEO label.

At Reebok, we recorded our fifth consecutive quarter of growth, with currency-neutral sales increasing 9%, driven by double-digit growth in most regions. The quarter was again all about strengthening Reebok's credibility in fitness. The brand continued to roll out its new brand mark, the Reebok Delta, and deepen its connection to the fitness community, hosting spectacular fitness events and grassroots activities around the globe. This drove Reebok's training business up 26%, propelled by the ZSeries and CrossFit Nano, where sell-through rates across all channels exceeded our internal expectations.

Reebok Classics also continued to build on last year's solid momentum, with strong growth of 24% in the quarter.

Finally, our Retail business enjoyed another outstanding quarter of growth, increasing 22% currency-neutral. This was driven by a strong 10% comparable store sales growth rate in Q2. Also, eCommerce grew robustly, with an increase of 59% in the second quarter.

While all of this all highlights our solid and improving competitive position, we nonetheless faced some material challenges in the first six months, which had a particular impact on our profitability levels.

The first is currency, which negatively impacted our top-line result by around 250 million euro in Q2 and by over 450 million euro year-to-date. Our gross margin was negatively affected by 60 basis points, due to less favourable hedging rates. In addition, our gross margin suffered a further 50 basis point negative in Q2 and 30 basis points in the first six months from the devaluation of the Russian rouble. In total, currency impacted our operating profit by over 100 million euro in the first six months.

Secondly, the golf industry is weathering an extremely difficult year and, as market leader, this hurts us severely. TaylorMade-adidas Golf sales were down 18% in Q2 and 27% year-to-date. This amounts to a 236 million euro sales decline in the first six months compared to a year ago. The significant sales decline and lower gross margins resulted in a 120 million euro negative operating profit swing compared to a year ago.

Thirdly, our Retail segmental profitability, particularly in the second quarter, was heavily influenced by our performance in Russia/CIS. Gross margins in the Retail segment declined 4.9 percentage points, almost 4 percentage points of which relate to that market. This was mainly related to an extended period of promotional activity through the summer months as well as the impact from the year-over-year devaluation of the Russian rouble.

Taking these challenges into consideration, and the improving momentum that we are seeing from adidas and Reebok, we undertook a review of the various scenarios and strategic choices for the remainder of 2014 and for 2015.

We know driving higher levels of profitability is absolutely critical to our long-term success, and we will get there. But we will not get there if we are not constantly winning in the marketplace.

With this in mind, my Board colleagues and I were unanimous in our view that:

- we need to be more decisive and faster in dealing with our challenges,
- we must act to strengthen brand leadership to be more impactful in the marketplace,
- and bring more diversity to our earnings streams.

This starts with completing our initiative to strengthen brand leadership. Since taking over their new responsibilities, our new Board members Eric Liedtke and Roland Auschel have been looking to the future and the organisational requirements needed to take our brands and consumer experience to the next level. With this initiative, we are transforming our current marketing organisation to be more consumer-focused, brand-driven and agile, with clear empowerment and accountability. The new set-up empowers our category business units to take responsibility for all marketing processes, end-to-end. In addition, we have added key expertise in areas such as concept-to-consumer, innovation and strategy, to ensure we drive our brand agenda more professionally in the marketplace and stay ahead of the game. All organisational changes are effective from August onwards. We believe the new set-up will help us bring our concepts to the consumer in a more efficient and effective way.

Secondly, we have made a new commitment to invest in our brands, to drive more balanced growth across our entire portfolio of categories and markets. On this front, this has been one of the shortcomings of our Route 2015 agenda. We won many of our key battles where we had a well-resourced offensive focus. Greater China and NEO are good examples. However, we left our brands exposed to attack in some markets, which has cost us market share, Western Europe being an example.

Given the rebound in brand momentum for the adidas and Reebok brands that we saw in the first half of 2014, now is the right time to increase investment. You saw the first indication of this with the World Cup, where we clearly won by all indicators. We know consumers love our brands when they hear our stories. Therefore, we will be bringing even more of these to life on the streets, screens and stores in the future, to ensure consumers constantly hear what we have to say. Our recent partnership announcement with Manchester United, our active participation in signing the best from this year's NBA draft as well as the new collaborations we will start in the next months in Originals confirm our intent. In 2015, we will launch our most ambitious brand campaign yet, which will once and for all tell the world why adidas is the best sports brand in the world. In total, we will increase our marketing spend target range by 1 percentage point to between 13% and 14% of sales from our Route 2015 corridor of 12% to 13% of sales. And I expect, within our next strategic planning period, we will compensate for this through more consistent global growth and tighter overhead leverage. We will share much more on this and our five-year strategic plan to 2020 in the first quarter of 2015.

However, we will already begin now in the rest of this year, to ensure we sustain the momentum we have in key categories and markets. And here, there are several initiatives to look forward to.

In football, while the World Cup may be over, we certainly are not done yet for 2014. With the new Predator Instinct, we are following up fast on the Battle Pack, to keep the heat on our competitor as the new club football and back-to-school season kicks off.

In basketball, we expect to accelerate growth as we build into the 2014/2015 season. Together with our expanded portfolio of high-calibre partnership assets, we are also bringing our game-changing Boost technology to the category with the Crazylight Boost and the D Rose 5 Boost.

We will also further push the cross-category roll-out of Boost, bringing the technology to the baseball, training, snowboarding and kids business. With our new editions and colourways in key running franchises, we will also further propel the great momentum we have in adidas Running during the second half of the year.

For adidas Training, the introduction of ClimaHeat, a ground-breaking warming technology, will continue to reinvigorate the Clima franchise following the success of ClimaChill this spring. The concept will launch in the fourth quarter and will contribute growth to our business in several categories.

adidas Originals will launch new colourways and models for ZX Flux in Q3, supported by a back-to-school campaign, especially in the US. The introduction of a photo-based product customisation app, which allows consumers to print their own photos on their ZX Flux, will ensure this franchise remains the talk of the town.

Furthermore, our collaboration with Rita Ora, which already created great hype amongst consumers globally, will hit the market in September, followed by our highly anticipated adidas Originals Pharrell Williams and Kanye West collections.

And finally, we are confident that the progress we have seen at Reebok in the past months is set to continue. Our key CrossFit and Spartan Race partnerships are showing tremendous long-term growth potential. This is confirmed by all the positive media attention we received around the Reebok CrossFit Games that took place at the end of July and the strong demand we are seeing for the latest CrossFit Nano 4.0 training shoe.

While this will ensure we again deliver good growth from adidas and Reebok in the second half, we also have decided to take strategic measures to tackle our profitability challenges at TaylorMade-adidas Golf and in Russia/CIS.

At TaylorMade-adidas Golf, given the inventory that is still in the market, we will carefully look at new launch and introduction timings. In addition, we will begin a restructuring programme at TaylorMade-adidas Golf to align the organisation's overhead to match lower expectations for the golf industry's development. Combined, I expect these measures will impact second half operating profit by 50 million euro to 60 million euro. As the dominant market leader, we take this initiative now to secure our lead, and to be the first mover in reinvigorating the market. Our innovation pipeline is full and we are set to go, whenever we feel the market is ready.

In Russia/CIS, given the downward pressure visible in retail trends in the market over recent months, as well as the increasing risks to consumer sentiment and consumer spending in the region, we have decided to reduce our net store opening plan in the market for 2014 and 2015. In total, we will now add only 80 stores in the market this year, compared to our original plan of 150, and are planning with a similar figure for 2015. These steps, which are short-term in nature, are aimed to reduce risk and protect profit as well as to drive a faster implementation of new inventory management principles for that market. This, as well as the current more promotional environment, means that we will have an operating profit shortfall of around 50 million euro compared to our plan in the second half. While uncertainty in the market is high right now, we believe this is the right decision for the short term. Nevertheless, we remain fully committed to the market. Right now, we are very encouraged by increasing brand momentum for both adidas and Reebok as a result of local marketing investments as well as improving store operations.

In summary, while we have delivered notable achievements with our Route 2015 plan, we also accept that we need to lift our game to drive more consistency and dependability in our financial performance. With momentum returning in key markets, we are taking consequent and necessary decisions now to put the Group on a firmer footing to build for the future. By cleaning up markets, investing with more conviction in our growth opportunities and driving more agility through our new organisational set-up, we will return the Group to a higher and more consistent level of earnings growth in the mid to long term.

That's it from me; let me hand over to Robin to give you some more detail on our Q2 and half year results and our updated outlook for the remainder of the year.

Robin Stalker, CFO

So let's start with our gross margin development. Our Group gross margin decreased 1 percentage point in the first six months or 90 basis points in the second quarter to 49.2%.

Similar to the first quarter, gross margin development in the first six months was primarily driven by the following negative effects:

- Firstly, less favourable hedging rates – amongst others, the Japanese yen, British pound and Canadian dollar accounted for around 60 basis points of the Group's gross margin decline.
- Secondly, the rapid currency devaluation year-over-year led to transactional negatives on the unhedged portion of our US dollar exposure. The significant decline in the Russian rouble on its own had a negative impact on the Group gross margin of around 30 basis points.
- Thirdly, lower gross margins at TaylorMade-adidas Golf as a result of a highly promotional environment in golf negatively impacted the Group margin by 40 basis points.
- And finally, higher input costs impacted the gross margin by 20 basis points.

In the second quarter, these four factors compressed the Group's gross margin by 60, 50, 30 and 20 basis points, respectively.

Moving over to operating expenses, other operating income and expenses increased 1% in euros or 7% currency-neutral in the first six months. 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 17% currency-neutral and 12% currency-neutral for the second quarter and the first half, respectively. This was primarily due to higher marketing expenditure at adidas related to the 2014 FIFA World Cup™ as well as initiatives to support Reebok's expansion in the fitness market.

The decline in gross margin and the increase in operating expenses resulted in Group operating profit declining 25% or 170 million euro to 523 million euro. This translates into an operating margin of 7.5%, down 2.2 percentage points compared to a year ago.

Turning now to the non-operating items of the P&L: Net financial expenses decreased 6% in the first half compared to a year ago, driven by a 12% increase in interest income.

The first half tax rate increased 150 basis points to 29.0%, as a result of a less favourable earnings mix.

As a result, net income attributable to shareholders for the first six months decreased 27% to 348 million euro. Second quarter net income attributable to shareholders declined 16% to 144 million euro.

Looking into our segments, Wholesale revenues increased 10% in the second quarter and 5% for the first half, mainly due to sales growth at adidas Sport Performance, led by the football, running and training categories. Sales at Reebok were slightly above the prior year level, driven by sales increases at Fitness Training, Walking and Classics.

Gross margin for the segment was up 20 basis points for the quarter and down 20 basis points for the first half, as the positive effect from a more favourable product and pricing mix was more than offset by negative currency effects following the devaluation of currencies such as the Argentine peso and Brazilian real.

In the Retail segment, revenues continued to grow at a strong double-digit rate, up 22% in the second quarter and for the first half. Comparable store sales accelerated during the second quarter, up 10% for the quarter and 9% for the first half, with growth across all regions and store types.

By brand, adidas comp store sales were up 12% for the quarter and 10% in the first six months. Reebok comp store sales remained stable during the second quarter and grew 2% for the first half.
Our eCommerce business continues to grow strongly, with sales up 59% in the second quarter. For the first half, our eCommerce business was up 65%.

Retail gross margin decreased 4.9 percentage points to 60.5% for the second quarter and 3 percentage points to 60.2% in the first six months. Our performance in Russia/CIS heavily impacted these results, with the impact of promotional activity and product mix as well as currency devaluation in that market accounting for almost 4 percentage points of the decline in Q2 and 2.3 percentage points of the decline in H1.

Segmental operating expenses as a percentage of sales increased 1.2 percentage points to 41.7% in Q2 and 70 basis points to 44.0% in the first six months. The increase is almost entirely related to higher marketing spend to drive strong point-of-sale execution for the World Cup and new product concepts. Excluding this, overhead as a percentage of sales in Retail remained stable.

At the end of the second quarter, we operated 2,825 stores, a net increase of 283 stores versus June 2013. Of the total number of stores, 1,590 were adidas and 427 were Reebok branded. In addition, the adidas Group Retail segment operated 808 factory outlets. During the first six months, we opened 199 new stores and closed 114 stores. 64 stores were remodelled.

In our Other Businesses, revenues in the second quarter decreased 11%, driven by an 18% decline at TaylorMade-adidas Golf, as Herbert already discussed. For the first six months, revenues of Other Businesses were down 19%.

The segmental gross margin decreased 4.8 percentage points to 38.5% in the second quarter. For the first six months, gross margin was down 5.2 percentage points to 38.8%, due mainly to lower product margins at TaylorMade-adidas Golf, as a result of the highly promotional environment in golf, resulting in ongoing clearance activities.

Finally, let me refer to our balance sheet and cash flow development. At quarter-end, operating working capital as a percentage of sales increased 1.2 percentage points to 21.6%, due to a 16% currency-neutral increase in inventories. As stated in our previous calls, we expect inventory growth rates to come down to a level more in line with projected sales growth as we approach year-end.

In terms of cash flow development, we ended the quarter with net borrowings of 454 million euro, compared to 94 million euro a year ago. Higher capital expenditure, which amounted to 265 million euro, as well as the dividend paid to shareholders of 314 million euro were the main drivers of this development.

Finally, ladies and gentlemen, let me give you some more detail on the changes to our outlook which we announced on July 31. We now expect mid- to high-single-digit sales growth on a currency-neutral basis for the year. While our top-line growth expectations for adidas and Reebok remain virtually unchanged, given the challenges at TaylorMade-adidas Golf, we now expect a double-digit decline in Other Businesses compared to our previous projection of a stable performance.

In terms of our gross margin, we now expect a decline to a level between 48.5% and 49.0%, compared to our original expectation of 49.5% to 49.8%. This is mainly due to TaylorMade-adidas Golf as well as lower margins in Russia/CIS from more extensive promotional activity as well as rouble and other currency devaluation impacts.

The Group's other operating expenses as a percentage of sales are now expected to increase (previous guidance: around the prior year level) compared to the prior year level of 42.3%. Sales and marketing working budget expenses as a percentage of sales are projected to increase to a level of around 13% (previous guidance: to increase modestly) compared to the prior year level of 12.4%.

As a result, the Group's operating margin is expected to be at a level between 6.5% and 7.0% (previous guidance: between 8.5% and 9.0%). The Group's tax rate is expected to be between 29.5% and 30.0% (previous guidance: around 28.5%) and thus less favourable compared to the 2013 tax rate excluding goodwill impairment losses of 29.0%.

Finally, net income attributable to shareholders is expected to be at a level of around 650 million euro as already communicated.

With that ladies and gentlemen, let me echo Herbert's comments that we are disappointed we are not in a position to bring more to the bottom line this year. However, we are steadfast in our view of the fundamental strength of our brands, and the opportunities we have to drive long-term growth and value for the Group.

Thank you for your attention, and Herbert and I are now happy to take your questions.