adidas GROUP

adidas Group Nine Months 2013 Results
November 7, 2013
Q&A session
adidas Group participants:
Herbert Hainer, adidas Group CEO
Robin J. Stalker, adidas Group CFO
John Paul O'Meara, Vice President Investor Relations

Antoine Belge – HSBC
Three questions. First of all, regarding Russia, I think you had commented in the past that there was a lot of new space being added, new malls and so on, which was putting pressure on traffic. Do you think that this phenomenon will continue for a couple of quarters? Can you elaborate on that?
And a second question on pricing. Obviously this is having a very strong impact on your gross margin. It seems, especially in the US, that maybe this aggressive pricing strategy may have led to a bit of pressure on your volumes? How has this been accepted by the consumer? And how have distributors like Foot Locker reacted to some of your more recent innovations and the price increases associated with those products?
And finally, I think you pointed to the evolution of the cash flow generation and the cash position. So what is the outlook for share buybacks? Also, in this year, where there won't be much earnings growth, what will be the dividend payout?

Robin Stalker
I'll take the first and last questions. Yes, indeed, our traffic issue in Russia is likely to continue for a bit. We have recently also highlighted in our communications that in Moscow alone there's going to be further openings of new malls and new square footage added in terms of retail space over the next year. But we're working on that, as we've said previously, closing the older shops, for example, and we will get that a little bit better during the year of 2014. But it does remain as a pressure at the moment.
On your third point, in terms of the generation of cash; yes it's one of the great talents of this group to be able to continue to generate cash. At the moment our emphasis is still to continue to pay down debt and to put the emphasis on our dividend payout. We do not have any plans to have a share buyback at this stage. We've got a very good and clearly communicated dividend payout ratio. We said we're going from 20% to 40%. We're up at over 35% at the moment in the last year and I think you can expect us to continue to show growth in our dividend payout ratio.

Herbert Hainer
Your second question was regarding pricing and if I understand it correctly, you were asking whether we have priced our new innovative products in the US market too high and therefore we aren't getting high-volume sales? No, definitely not, because when you look to the sell-through rates which we have, especially when you look to Springblade, we have never had such high sell-through rates as we are having with Springblade and Boost. And they are doing very well all over the world. So we definitely think we have the right price for the value which these products provide. And as you might have heard, people are asking everywhere around the world for more volumes, be it Boost or Springblade.
We already explained in the last conference call that we have some limitation on the supply of Boost material because this is exclusive material from BASF for us, but we continue to grow our supply and I'm absolutely sure we have found the right pricing strategy.

Antoine Belge
Maybe just a follow-up on this and a little more on the US market specifically. Is it fair to say that some of your different retail channels in the US are more active or have reacted more positively than others to those innovations and this pricing, just maybe explain a bit more about the rationale behind the price increases in the US.

Herbert Hainer
First and foremost, Antoine, you always have it with our distribution strategy that we have retailers across the US, but also everywhere around the world, who are very specific for certain categories from our footwear offering. Obviously, in running you have specialty running stores, you have some sporting goods stores, et cetera. And these are the stores where you can expect to put running shoes such as Springblade. Definitely, Foot Locker is one of our key customers because this is a very attractive running shoe, which is not only for running but also for lifestyle wear. And it is very popular particularly with young people. Therefore we segment the market very clearly. We carefully decide where we want to bring our product and I can tell you that wherever we have introduced Boost or our other innovative running products, the sales have been great.

Jurgen Kolb – Capital Cheuvreux
Three quick questions. On the cost side first of all, could you give us some additional details as to how much the three reasons given, which led to the profit warning in September, affected your third quarter – i.e. the Russian DC issue, the golf situation and currencies – such that we can get an idea of how much of the additional costs you have already put into the Q3 numbers?
Then on the gross margin side; obviously a great performance. You indicated two factors, currencies, but also obviously the TaylorMade issues. Can you provide any additional breakdown details as to what it was on the positive side, broken down into individual factors?
And just a housekeeping question on the hedging side. I think you should largely be done for 2014. At what rate have you now hedged for 2014?

Robin Stalker
Yes, we obviously had this negative impact largely in the third quarter specifically for Russia. I think we've already quantified that as being a contribution impact or an operating result impact of negative around 30 million euro. The TaylorMade point; here we estimated a double-digit negative impact in the third quarter. We still have a bit of development left in this year. The currency effect is difficult to quantify unfortunately. You have to do that sort of calculation yourself. We've obviously been able to quantify the impact to the top line. However, it's difficult to quantify it right down to the operating margin. I think you can see from the significant negatives on the top line that these have obviously had a significant impact on what we would have been able to generate as an operating result as well.
In terms of the gross margin, the regional and channel mix is the biggest impact there and that's also obviously been the factor over the last few quarters. The rest is pretty much evenly spread.
And in terms of the hedging rate, for 2013 we're around the EUR/USD 1.32. And regarding our hedging for 2014, don't forget the euro was not as strong as it is at the moment, so we may get to EUR/USD 1.32 again in 2014, which is what we're looking at at the moment. We're not fully hedged for 2014 yet, but we're significantly hedged and I think we'll be doing pretty good if we're around EUR/USD 1.32 or so for 2014.

Jurgen Kolb
And just on the Russian DC point, have all those costs been allocated in Q3 or is there anything else coming in the fourth quarter?

Robin Stalker
The costs are obviously in terms of the additional work we had to do to get the DC working fully. And don't forget that one of our issues here is that we didn't have the right product at the right time in the market. And while we're working well to get this sorted out, there's still a bit of clean-up necessary.

Herbert Hainer
Let me add to what Robin has just said. As I said in my opening speech, we are happy that we see progress in the DC and that we are getting back to the shipment levels that the market demands. But you should also not forget that there is an effect in the third quarter because we didn't have full size ranges and we didn't have the right quantities in the stores, so it will still affect our fourth quarter. So we are working on this and getting back to having the consumer excited by all of our product lines, as it was for us before in Russia. So there is still some work to be done in the fourth quarter, but I'm happy to say that we're really making progress on our DC.

Matthias Eifert – MainFirst Bank
My first question is about the US wholesale business, which was down 5% in the quarter in your wholesale division. Can you go into a bit more detail? What were the negative drivers there?
And maybe a related question to that, in terms of basketball; can you give us an idea of the Q3 trends in the US for the adidas brand? And how big could the impact be in the fourth quarter of D Rose coming back playing basketball again?
And a question on your retail business; would it be right to assume retail like-for-likes would have been positive if you exclude Russia? These are my questions.

Herbert Hainer
The second question is an easy one to answer – yes, our like-for-like retail sales would have been positive, if you exclude Russia. The first question is, as you indicated already, that the US wholesale business is down because of basketball. But we definitely see improvement, as I said in my prepared comments, with the D Rose 4, which has had excellent sell-through rates. And obviously, now that Derrick Rose is back playing it is helping us a lot. We have also been building up the number of our key players, as you might know. With players such as Dwight Howard, Damien Lillard, John Wall, Ricky Rubio and Iman Shumpert, just to name a few. So we are building it up and we can see there positive effects already, so yes, we definitely expect better sales in the fourth quarter.

Matthias Eifert
In terms of direction, was there maybe a double-digit decline in the third quarter and can we maybe expect a double-digit increase in the fourth quarter? Just a rough direction would be helpful.

Herbert Hainer
Well, let's be surprised. We will grow our business in the fourth quarter.

Andreas Inderst – Exane BNP Paribas
I have three questions. The first one is on your 2015 target. You say a target of 17 billion euro, this implies high-single-digit growth in the next two years. Do you expect this to be evenly spread across 2014 and 2015? And what will be the key sales drivers? That's my first question.
The second question is, Robin, you mentioned earlier you didn't have the right products at the right time in Russia. This also seems to be the case in the US with the Springblade and with Boost. What are you doing right now, in terms of operational processes, to get the products quicker and on time to the market? That's my second question.
And the third question relates to the other segment which was down 15% in the third quarter or almost 60 million euro in EBIT. Was this purely related to TaylorMade-adidas Golf or is it also because of the other segments? And what do you expect in Q4 and in 2014?

Robin Stalker
First on the sales guidance that we give. As with all the guidance we're giving for 2015 it is a reconfirmation of the 17 billion euro and the 11% operating margin targets. I think we've obviously seen with the performance in 2013 that it's clearly not going to be linear and that we'll be expecting growth to be significant in 2014, but also obviously in 2015. 2015 is the year where we're clearly focused on getting that delivered.
In terms of the third question – on the performance of the Other Businesses segment. That is just TaylorMade-adidas Golf. The other businesses, such as Rockport and Reebok-CCM Hockey, were slightly up in that period. So the significant negative is because of TaylorMade-adidas Golf.

Herbert Hainer
So coming to your second question, Andreas, I think there must be a misunderstanding because we never said for Springblade or Boost that we didn't have the right quantity at the right time in the stores. It's the other way around, with product selling through so fast that we couldn't replenish it. But this was the strategy, as we said from the very beginning, with Boost we would only have a certain amount of pairs which we would bring to the market in 2013. Obviously, we will bring much more to the market in 2014, but this never had anything to do with the DC issue, neither for Boost or Springblade. It was just limited by the raw material for goods and so on and for Springblade we have already said the quantities which we want to have in the market to really spark demand and this is selling through very well. So this definitely doesn't have anything to do with the DC.

John Guy – Berenberg
Several questions for me please. First of all, with regard to the inventory, the 12% currency-neutral increase, could you maybe talk about the splits there between the stock build ahead of the World Cup and what the split was there for to have a little bit more stock than you would like within the Russian market?
My second question is about the dividend payout rate. You said that you're moving north of the 35% level last year, moving up towards 40%. Why can't you take it up to 50% or even higher because even at 50% your dividend will be covered at around 2 times?
My third question is around the Boost status in terms of rolling out across the USA. Can you maybe just talk about how fully rolled out Boost is across all of the US states in all of your stores and whether or not Boost is now fully integrated in all the malls and all the channels? Or is there still more to do? I appreciate that you are limited by the raw materials.

And maybe just one more final question on distribution. Could you give an update as to how many CDCs you have now compared to 2010 and what do you think the headline cost savings might look like from the second half of 2014 and into 2015?

Robin Stalker
I'll take the first couple and yes, that's right, inventories are up 12% currency-neutral year-over-year. But a good 50% of that is goods in transit. And I don't know how much exactly of that is related to World Cup, but obviously that does play a role. The whole point about the goods in transit increase, however, is that it's obviously fresh product and it plays into our expectations that obviously our fourth quarter is growing and also the start of the next year. So that's the majority of it.
Clearly Russia also played a role in the other 50%, with Russia being a very significant part of that. But the rest of the markets are all very clean. There's a slight increase in or deterioration in the ageing of the TaylorMade product, but otherwise everything's looking very good from an inventory point of view.
And in terms of the dividend, we articulated this policy some time ago and at the time we were very happy to get into the 20% range. We're now obviously over 35% and it'll be great if we can move that up over the next few years. But we have no intention at the moment of changing that policy. We still think it's a very fair distribution of the earnings.

Herbert Hainer
Coming to your third question: regarding the Boost rollout and especially in the US. As you have seen, we did a homogeneous Boost launch around the whole world. And obviously we have selected to certain distribution channels, as I said before, such as the running specialists and the sporting goods stores, and then some other distribution channels where we think the consumer is buying key running shoes. Overall we are happy with our distribution in the US, we have reached these stores and the consumers. Obviously what we are lacking is the volume in each store, but this was clear from the very beginning. But with this strategy we have created a lot of interest in the different distribution channels. So it's not just at sporting goods in the US, it's also at specialty, where we have great success with the Boost running shoes. And this is what we will continue to do. We will bring Boost first in large numbers to more products within the running category and with bigger volumes going into the future and further build-out in the distribution channels which we have defined with higher volumes through 2014.
So as I said, I'm very happy about the Boost success, also for Springblade as well and you can see it in our running numbers. But it's not only that we are selling the products in, they are also performing very well at the competition level. As I have said, Geoffrey Mutai won the New York Marathon last week wearing Boost. The Chicago Marathon just two weeks before had the number 1, the number 3 and the number 4 running in Boost. And the Berlin Marathon was also won by a Kenyan runner wearing Boost. So the last three key marathons have all been won by runners wearing our new Boost shoe, which we have never seen before.
And your last question on the distribution centres. In 2006 we had around 90 distribution centres and we are now down to around 50. And obviously we will consolidate that going forward.

John Guy – Berenberg
Just to go back to your homogeneous and biggest rollout throughout the world. I mean when we were around in China back in June, it seemed that certainly in Shanghai and Hong Kong they got Boost a little bit earlier than some other markets. I mean is there a slight phasing in terms of delivery as to when and which market receives their product? Or do you try very much to keep it on a consistent rollout basis?

Herbert Hainer
Yes, this was not our intention, John, when we started with Boost because, as I said, we had the rollout for Boost globally around the world all on the same day. It could be the case that because of the distribution strategy, as I just said, a few customers got it to the shelf a week or two weeks later, but in general, it was at the same time. It was a little bit different for Springblade. For Springblade we started its introduction in the US, and then rolled it out to Brazil and to Russia and we will have a full global rollout in spring 2014.

Chiara Battistini – JPMorgan
A couple of questions for me please. The first one is on the golf market and how you're seeing it starting going into quarter four and how we should think about it into next year for TaylorMade. And then the second question, on the gross margin improvement to follow up on the previous questions. The gross margin expansion continues to be very impressive. How sustainable is this and how shall we think about that going into next year please?

Herbert Hainer
So to the first question – the golf market. Yes, we definitely believe that we will grow in the fourth quarter and going forward in the golf market. Even though there is no doubt it is a more challenging market. As I said before, the market is not growing, especially because of the first six months this year where the number of rounds played went down in the US by 9% and obviously this has an influence on consumption.
But we are quite pleased with our market shares. We enjoy close to 40% on the metal-wood side, clearly over 20% on the iron side. And we're making good traction with our latest product launches, which we just brought out, the SLDR driver, in the third quarter, and now the SLDR fairway woods and the new Speedblade irons. And we have an array of new innovative products coming through in 2014. So I believe that we will win further market shares in the golf market, but obviously it would be much easier if the golf market would grow.

Robin Stalker
And Chiara, talking about gross margin and its sustainability, we have to be very cautious. Obviously, I'm not giving any guidance at the moment on 2014. But fundamentally, the factors that are improving our gross margin have been very inconsistent over the last few quarters, such as the fact that we are growing our retail business faster than wholesale. We are growing faster in some of the emerging markets. And these factors are all having a positive impact on the gross margin. I think the key thing that really impacts gross margin outside of those things is what happens with FOBs. And for this year 2013, we haven't had much negative development in our FOBs, and that's good. But I can't say anything about 2014 at the moment. Other than just from the short-term perspective, be aware obviously that, and I'm talking here about the fourth quarter 2013, our hedging is at least something that's got a little bit more negative for us in the 2013 period compared to 2014. That's the only real negative we've had in the development of this at the moment. Otherwise, fundamentally we're seeing good underlying gross margin improvements, which talks to our emphasis on the quality of the growth. The right sort of sales and the quality of this growth, and we would hope for that to continue.

Andreas Riemann – Commerzbank

Three topics. Firstly, I'm focusing on the gross margin again. You were speaking about Springblade and Boost being sold at high price points. This does imply that in 2014 this favourable pricing should support the gross margin. That's question number one.

Number two is on retail. You accelerated retail expansion this year. Is it about attractive rental conditions or what is behind this? And the second question – is it is fair to assume that we will obviously run to about 500 store openings in the coming years? That is what you guide for in 2013?

And the third question is on Reebok wholesale. Reebok revenues were growing strongly in Q3, but like-for-like sales were actually down 7%. So it seems like sell-in is better than sell-out at Reebok. Can you shed some light on this divergence please?

Robin Stalker

Well, I'm sure it's good to talk about pricing and the positives of the Springblade, but I'm still not going to give you any guidance for gross margin development in 2014. Obviously it's great that we've got some good product that is able to speak to our strategy here to have good quality growth.

Your second question was about retail and the growth of retail. Yes, it's a bit higher than we had expected, but that's because of the fact that we mentioned earlier about Russia. We have been re-basing our retail base there. We've had to open stores in various new locations, since whenever new malls open we have to be there. And that's part of the growth for this particular period.

In terms of your third question, where you also asked about whether there would be 500 openings next year. I think we're looking at 100 to 150 net store openings. We're a bit higher than that in the nine-month period for 2013, but our guidance was around the 100 to 150 for each year and that should be it for 2014 – without giving any guidance again for 2014. That should be the sort of number you should be looking at.

And the last question was about Reebok and whether there's a retail issue there. Clearly Reebok suffered particularly heavily – also in Russia. And because we have a very strong Reebok business in Russia and there's been some clearance in the factory outlet business in the US. Otherwise, as Herbert said in his prepared comments, we're very happy with the development of Reebok. It's going to grow this year and especially when you look at the gross margin and the positive development of that as well.

Cedric Lecasble – Raymond James

Actually I also have three questions. So my first one is on China where you seem to continue to outperform the market. Can you tell us what is driving your good growth in China?

The second question is on Western Europe. Did you see any country turning positive which was negative and any negatives turning positive? What kind of change in momentum did you see in the quarter?

And the last question is a follow-up on inventories. Could you again go through the inventory situation in the golf business? I understood there was heavy de-stocking. What makes you so confident that you would have a rebound as soon as Q4? Are your inventories in golf now extremely clean? Just to be sure I got the answer.

Herbert Hainer

Let me start with China. And I have to go back to 2009. You might remember after the Beijing Olympics when we ran into some charges with high inventories, et cetera. And I told you already at that time that we will carefully build up the business in China for the benefit of long-term growth.

We installed IT systems with our retail partners to get better information from the stores. To find out what we need to replenish, what is selling, what isn't selling and so on. We are working very closely with the markets on the re-sale side to really understand what the Chinese consumer wants. And this has helped us to outperform our competitors in the Chinese market over the last two to three years.
We have clean inventories in the franchise stores around China and we are creating the best profitability for them and obviously, as the sell-through rates are good, this is continuing. And I must also say here that I'm extremely happy with our management in China, especially how they have built up the business and how carefully they read the market and work together with our key franchise partners over there.
In Western Europe in the third quarter, Germany has also been positive. Obviously football is helping here with Bayern Munich and the whole enthusiasm that is coming due to the build-up for the World Cup. But also running is doing very well. Once again, it's Boost and a lot of other concepts which we are building up around running and driving this momentum. Springblade hasn't been introduced into Germany yet. But I think these are the two main drivers here in Germany. And we definitely believe that going into the fourth quarter we see momentum in many more markets, because we have Germany, we have Spain and we have Russia, all qualified for the World Cup. Football is coming alive, and we will launch the official match ball. So we will definitely look positively into the fourth quarter, despite a more challenged Western Europe environment.

Robin Stalker
And the situation with golf inventories, we did a significant amount in the third quarter to rebound the inventories there. We cleared a lot and that's why we have a negative development in the gross margin in our Other Businesses in the third quarter also. But at the end of the third quarter we're still a little bit higher than we were the same time last year, so the ageing is a little bit worse. However, our confidence about the fourth quarter is related a lot to the timing of the product launches and we're very confident that we're back into good growth in this fourth quarter independent of a little bit of ageing in the inventories.

John Paul O'Meara
So, ladies and gentlemen, that completes our conference call for today. As Herbert mentioned, we are very much looking forward to having you all here in Herzogenaurach on December 2nd and 3rd for our Investor Field Trip. As places are running out fast, please register as soon as you can in the next couple of weeks by contacting any of us here in the Investor Relations team. Other than that, thank you very much and have a very good day.