

adidas Group First Quarter 2011 Results

May 5, 2011

Q&A session

adidas Group participants:

Herbert Hainer, adidas Group CEO

Robin Stalker, adidas Group CFO

John-Paul O'Meara, Vice President Investor Relations

Matthias Eifert – MainFirst

My first question would be what is your best guess in terms of overall market growth, in the first quarter? To help us judge your own performance, which is very impressive.

And the second question relates to the Reebok gross margin, which was more or less flat in the wholesale business, but up very strong in the own-retail business. Can you give a bit more detail into what was the driver here? Was it all Russia? Because otherwise, you just have the outlet stores. And also, can you explain your performance in the wholesale business. I would have expected it to be up.

And my third question is what was the big driver in China? How many stores were opened there in the first quarter from your third party retail partners?

Herbert Hainer

Let me start with the first question. Market growth, I don't have a precise number, but we expect the market to grow at a single-digit rate. So this is definitely far below what we have seen as the growth rates for our company in the first quarter.

Robin Stalker

The gross margin in wholesale is purely a mix effect here, particularly with influences from the UK and Latin America. But overall, don't forget, the gross margin for Reebok has improved 90 basis points over the year.

Herbert Hainer

And your third question on the store openings in China, it's around 150 stores, net. We have opened a few more, but we also have closed some, or more specifically our franchise partners have closed a few, so it's around 150 net. So we are close to 6,000 stores at the moment.

Juergen Kolb – CAI Cheuvreux

A question on the input cost issue, obviously this is the big driving topic right now. You had some first impacts, in the first quarter. Can you quantify as to how high this impact was in the first quarter?

Secondly, I have a question on the new products, especially at Reebok. The product margin that you are achieving with these products, are they higher, more attractive than what we had initially with Toning?

And lastly, on the topic, the reduction in clearance sales, which obviously was a driver of the gross profit margin in the last quarters. How would you see this element developing in the next quarters? Because I think we are also anniversarying here some quite good developments from last year, so is that going to be a drag in the coming quarters?

Herbert Hainer

There were two main reasons for less clearance. On the one hand, it is distribution policies, such that we try to bring the right products into the right distribution channels. So the consumer demand is matched with the supply for this kind of product.

And secondly, it is the good sell-through rates which we are generating within the retail stores, and therefore we have less clearance. And I don't see any slowdown on these sell-through rates, because we are strongly supporting our concepts, with either the *all adidas* campaign, or individual measures for the individual products, such as with basketball shoes through Derrick Rose, etc. So therefore, I don't think that we will see any increase in clearance sales.

On the product margin for Reebok, you can expect that ZigTech or RealFlex have more or less the same margin range as Toning, because they are more or less at the same price level. Where we will create a further increase in our margins is through the expansion of our products from the US market into the European or the Asian markets, because here, we enjoy higher margins. But this is what we have said from the very beginning, and we will be doing this consistently quarter by quarter.

Robin Stalker

As far as the impact of rising input prices goes, we estimate that that cost us about 1% of gross margin in the first quarter.

Juergen Kolb

Okay, very good. And maybe a quick follow-up on the new football boot. Obviously, that sounds interesting. Any additional comments that you can make here?

Herbert Hainer

Juergen, I know how passionate you are about football. We will introduce it in the fourth quarter of 2011, and it is based on the miCoach system, which now allows the individual player to measure his mileage, so how many kilometres or miles he ran during a game, how fast he is, what his acceleration is, etc. This is, to a certain extent, what you can do today on the Bundesliga level, but now this can be done with every individual, at every level of football.

Joerg-Philipp Frey – M.M. Warburg & Co

Congratulations on your figures and I have some questions on the reasons behind them. Actually, when I'm looking at the strong performance in Sport Style, I have the impression that the *all adidas* campaign is substantially higher in terms of marketing efficiency than usual. Could you perhaps elaborate a little on that and how you expect that to continue? And then I have two follow-up questions.

Herbert Hainer

Joerg, thanks very much that you think our advertising is good and that it is immediately making an impact. But I think it's too early, because we only launched it on the 16th of March. So it's too early to really see in the first quarter the impact already on sales. The impact in terms of interest is certainly true, with people going onto YouTube, Facebook, etc. But in terms of mapping the growth rates, such as the very impressive growth rates of Sport Style, these are coming more because of us really bringing collections and products to the market which are highly anticipated, respected and in demand by the consumer. There is also the effect of other individual measures, such as improving our distribution channels. As you might know, twelve months ago, we cleaned up the market in the US and now we are seeing the impact of that distribution policy. In China, we have had good inventory control, where we don't sell Originals products to every franchisee, etc. and we are building up our own stores, etc. And I think these factors explain the success we enjoy at our Sport Style division. And at the end of the day, I think the adidas brand has never been so strongly in demand as it is today.

Joerg-Philipp Frey

I guess that's where you're taking your confidence from, for the continued progress of Sport Style.

Herbert Hainer

This is definitely correct and, as you can imagine, I also know a few order numbers for the next few months.

Joerg-Philipp Frey

If I look at retail on a like-for-like basis, and if you would have to allocate the proportion of your like-for-like sales in retail that is driven by the strength of the product, and what you had in terms of concept changes at a retail level, what would you see currently as the main drivers? And how far are you in the implementation of the retail changes that Michael Stanier outlined at the Investor Day in Herzogenaurach last year?

Herbert Hainer

I guess you hit the nail on the head, Joerg. First and foremost, we definitely have better collections, better products and higher demand from the consumer. This you can see in our retail sales numbers. But the second point is the impact Michael Stanier and his team are making. We are definitely getting more professional in how we are dealing with our retail business, what we are stocking in our stores, how we replenish, how we read the data, how fast we can get them analysed. And also in terms of bringing products into the stores, which products are being demanded by the consumer, etc. And this, all together, well you can see the results in the numbers.

Joerg-Philipp Frey

Sounds good. And one last question on the use of cash. As you are continuing to generate cash at a very high rate, could you imagine, based on the fact that you were virtually debt-free at year-end, that you might consider stepping up your payout ratio guidance above the 40% range that you have or would you rather prefer to “build a war chest”?

Herbert Hainer

We have always said that we want to let the shareholders participate, but I think it's definitely too early. We will be happy if we will be debt-free at the end of the year, as you said, and then we have to see what we are doing. But I think we still have room to play within our dividend range of 20% to 40%.

Joerg-Philipp Frey

Well, I hope you can surprise us with that one as well. And thanks for your answers.

Michael Kuhn - Deutsche Bank

Good afternoon, gentlemen. I also have a few questions from my side. First of all, coming back to Matthias' question, on the gross margin of Reebok and wholesale; we have seen a trend of closing the gap of the margin difference in retail over the last quarters, and the trend was not so pronounced in wholesale. So do you see a chance of closing that gap in the foreseeable future, or will the margin difference remain?

And then secondly, on a few cost positions; marketing costs obviously went up, due to the *all adidas* campaign, but the other operating expenses in the non-operating segments were also up quite significantly, by almost a third. And is that also a relatively flexible position from quarter to quarter, or is this a sustainable cost increase trend, so maybe some more details on that? So what are the cost increases which are behind that trend?

And two more questions; one on the tax rate, which was obviously lower due to the better regional mix. Is that a sustainable trend, or more a quarter-driven thing?

And finally, the US dollar has obviously lost ground against the euro recently, which should be positive for you. So what are your current hedge amounts and hedge rates, and have you hedged bigger portions than usual in the current marketplace?

Robin Stalker

We definitely confirmed that our expectations are for further improvement in the Reebok gross margin. As we have often said, we see opportunities for the Reebok gross margin to continue to improve towards the adidas gross margin, and you should expect to see that also in the future. So that gap will definitely not remain as it is.

On the second question about the operating overheads increase. Our growth at retail also has some influence on that. In fact, I think the development of the operating overheads, excluding the marketing working budget, has been very positive. You've seen us leverage this here, and this has resulted in the percentages coming down. Also, if you think of the currency effects, which has obviously had a negative impact on the euro, I think that's a positive development for our operating expenses. The third point, on tax rate; no, we're not expecting to enjoy as much of a benefit in the future quarters as you've seen in the first quarter, but we're also reasonably confident that our total year tax rate definitely will not be higher than it was at the end of last year. So there may be some opportunity for it to be a little bit lower than last year's rate.

Your fourth point was about currencies and our hedge position. And as you know, the hedge positions for 2011, by this time of the year, we've closed those. And these hedge rates for 2011 don't really benefit from anything that's happening in the market at the moment. These are things we did last year. And so the hedge rate this year is slightly worse than what we enjoyed in 2010. However, the trends in the market clearly give us some opportunity, perhaps, to enjoy a better hedge rate next year when we're hedging for 2012.

Michael Kuhn

So are you looking, in terms of hedging portions for 2012, to be maybe hedging in bigger dimensions than usual?

Robin Stalker

We have a very strict policy on how much we want to be hedged at the time that we set our pricing, that's in a 50% to 80% range. And in a period where the dollar is weakening, which is advantageous for us, yes, we tend to hedge or close the hedging a little bit more. That's correct.

Michael Kuhn

And back to costs; at the HQ level, or in the non-operating segments, the operating expenses went up from € 320 million to € 407 million. So even in percentage of sales, that's an increase. So that is what the question was about, as I cannot imagine this is driven only by retail expansion.

Robin Stalker

Michael, I think you have to look at all of our costs together, because we have continued to go through reorganisations between the various operating units at our headquarters, and you should be looking at the total development of operating expenses. We've given you also the total development of marketing. There, I think, you're looking at a good picture.

Louise Singlehurst - Morgan Stanley

A couple of questions from me please. Just firstly, on the US, obviously you're making very good inroads, when we look at some of the market data coming out for both the adidas brand and Reebok. Can you give us any of the feedback from the new launches that you've had so far this quarter, from the wholesalers, and your ability to take market share, or increase floor space.

And then secondly, on China, there's a bit of a mixed view with domestic brands, concern regarding them slightly slowing down and their order books decelerating. Can you just give us a picture of how the market is developing now, and your expectations for adidas this year?

Herbert Hainer

So, first on the US, I can tell you, as you have seen from the numbers for the adidas brand in the US, more or less all of our new concepts which we brought into this market, whether it's on the Originals side or on the Basketball side, with our Derrick Rose shoe and which we supported by advertising, are all doing very well with good sell-through rates. And it's the same to a large extent for our Running brands. And I definitely do expect to see this continuing going forward.

The same is true for Reebok. RealFlex, which we launched just two weeks ago, has had some very encouraging first results. I think it's still too early after two weeks, but all I hear from the US market, and what I see, and when talking to the key retailers, it looks very promising for both brands, also going forward.

In China, over the past four or five quarters we have clearly outlined in our plan to clean up the market for adidas in China, and then to restart. This we had done and I think you now see the fruits of our strategy. Yes, from what I am hearing, there is a mixed performance from some of the local brands and the market is definitely not growing as fast as we are growing, which was 36% in this quarter. And not everybody is winning in the market. And I definitely think that we have the strongest momentum at the moment.

Louise Singlehurst

Just as a follow-up, can you let us know when the Reebok Classics will be launched in the US?

Herbert Hainer

We still have the Reebok Classics business in the US, but, for example, we will be bringing out some Reebok Classics Lite and other new Classics products to market in the summer months.

Erwan Rambourg - HSBC

Congratulations on the results. Three quick follow-ups.

You have actually maintained the range in terms of EPS despite the Japanese catastrophe. You're indicating that you're expecting Japan to be down 15% to 25% in the months to come. What would have been your outlook on Japan without the catastrophe and what is the sort of underlying upgrade in the figures?

Secondly, meeting with a few lower tier local Chinese players, they seem to say that the volumes are slowing, that the ASP trends are actually going up, and ASPs are in the high-single-digit to low-double-digit range. Where do you see ASPs going for your brands?

And thirdly, a follow-up on Reebok. You were mentioning higher gross margins coming from ex-US growth, and I remember you were saying a few years back that the gross margin expansion would also come from the expansion into apparel. Can you give us an update on how the apparel push is going for Reebok, and what the next steps are?

Herbert Hainer

So, let me start with the first one, on Japan. As you know, we don't give any individual numbers for countries, only for our six regions which we have designated. Second question, on China, our ASPs definitely are going up because, as I said, on the one hand, the momentum we have has accelerated. We are bringing new, fresh products into the marketplace, which are highly innovative, for example on the Basketball side and on the Football side. And these, in general, have slightly higher retail prices, so we are also seeing our ASPs going up.

And the higher gross margin for Reebok; as I always have said, this will be supported by the further expansion into the international markets, as well as growth in retail and apparel. Also in apparel, I think you have seen already the first new concepts for EasyTone apparel, which are bringing further acceleration to the women's category during the course of 2011. And this will continue. So yes, we definitely will do what we have said during the last few quarters, bringing new

concepts on the footwear side, and then bringing new, innovative products on the apparel side as well.

Erwan Rambourg

Just going back to Japan. Had you seen growth up until the catastrophe, and basically, had you planned growth for the full year?

Herbert Hainer

Of course, as you can see we have grown in Japan already in the first quarter, which I mentioned during my speech, so yes, we were up. So you can imagine that we would have planned for growth in Japan.

Bernd Muell - Landesbank Baden-Wuerttemberg

A couple of questions from my side.

I wanted to come back to the Reebok gross margin and the timing of the rollout, for example, of RealFlex and other new innovative Reebok products. Could you perhaps give us a little bit more detail about the phasing, as to when you plan to launch which product categories in the international marketplace, such that we can get a feel for the phasing and therefore understand the development of Reebok's gross margin?

And the second one is more of a housekeeping question. I saw that the write-offs in the first quarter came down by roughly a quarter, to € 15 million. Did you have any extraordinary effects in last year's first quarter? Or perhaps you can give a little bit more detail on that one.

And the last question is, talking about selective price increases. Perhaps you can elaborate a little bit more on that, as to when, in terms of timing, you plan to raise, selectively, prices. If that's still the case going forward from Q4 or have any changes occurred on this one?

Herbert Hainer

So let me start with the first question on Reebok. In general, we have a delay of six months after we introduce a product into the US market and then bring it to the international markets. The same will happen with RealFlex. We have just started in April, where we introduced the product two weeks ago in the US. And then at the end of the third quarter, beginning of the fourth quarter, we will introduce RealFlex into the European and Asian markets, as we have done with Toning and ZigTech as well.

The selective price increases is your question number three. We have started on a very small basis, but we will continue to go forward with selective price increases through the various categories. We're looking very closely into where the sensitive price levels are, what the competition is doing, where we have leverage, etc. And this will continue over the next six to twelve months. There is not one starting point and there is not one across-the-board price increase. We are looking very carefully into it, where and by how much we can increase our prices.

Robin Stalker

So if I understood your second question, you're talking about one-offs, where last year, in terms of the positives, we had two. Those were the settlement of some litigation and the sale of a small trademark. Each of these were double-digit millions in value and therefore, obviously, the Other Income went down significantly this year. Does that answer your question?

Bernd Muell

Robin if I haven't miscalculated, I found that the depreciation and amortisation in the quarter has come down quite considerably. Have any one-off impacts occurred last year at the same time, or has anything changed this year?

Robin Stalker

There's nothing in there that's anything special, definitely not from last year. Certain things have been moved between assets held for sale, and back, but no significant differences in the depreciation.

Cedric Lecasble - Kepler Capital Markets

I have some follow-ups on Reebok. Last time, you gave some figures. You told us that Basics had come down to about 20% of total sales, from a very high number before the introduction of new, innovative products such as Toning. Could you maybe help us a little bit to understand the dynamics within Reebok, to give us some kind of colour on the weight of Toning and ZigTech at this stage and what your expectations are going forward on RealFlex? That's the first question. The second question is linked to sourcing. You're mentioning these traditional headwinds that the industry is facing. Given the hedging evolution and given your expectations or your assumptions for the year, could you tell us, in terms of phasing, when you could imagine or hope that sourcing, everything being equal, would turn positive? When should we expect that to happen, if raw materials and wages stay as they are?

Herbert Hainer

Let me start with the first question on Reebok Basics. I guess you are talking about Classics. Here we are doing the same things as we have done with adidas. We cleaned up the market, taking out a lot of older models, and we are now bringing new products into the market. And as we said just a few minutes ago, we will start in the summer with the Classic Lite, which is the first innovative concept on the Classics side, and then follow up in the future with newer concepts. You might have seen or heard that we have a relationship with Swizz Beatz now in the US, who is helping us to bring new products into the market and to get new consumer groups, etc. We will give you more colour on this as we go forward in the future quarters.

On Toning, ZigTech and RealFlex - Toning, I must say, we are still very happy, as I said during my speech, that the sell-through rates are still holding up, of course not as high as they have been in the peak period last year. But considering the situation, that there is definitely high over-inventory from one of our competitors in the market, our toning products are still retailing very well.

Zig is definitely a home run in the US, especially kids' Zig, which has surprised us positively with a retail price of \$ 75 and is selling very well. RealFlex, which was introduced two weeks ago, has started very well, but I think it's too early to call it a home run already. But from everything we have seen so far it is very encouraging.

Robin Stalker

As far as sourcing goes, our view on sourcing is that as far as we can see at the moment, it remains a negative for us. We have already described the situation for 2011, and the hedging situation we have here. These are negatives for us in this period, but obviously we're finding ways to compensate for that, and we're presuming that our sales price increases that we're introducing in the second half of this year will also help compensate for this. If we look out further, yes, it's encouraging that some of the sourcing cost increases seem to be coming back down again, and we also see some positive trends in the weakness of the dollar, which may help us in terms of hedging

in the future. But at the moment, I think it's far too early to speculate on anything in terms of a net positive for sourcing. In our simulations, we continue to see this as a net negative.

Cedric Lecasble

Maybe just on capacity or additional capacity, given future capacity concerns from strong demand worldwide and good performance from most of the players, yours being particularly impressive, how do you see capacity moving, and is there any pressure today?

Herbert Hainer

We have a very long-standing relationship with most of our suppliers. So we have built up capacity within the last 12 months for the growth rates which we anticipated. We shared our Route 2015 plan with all our suppliers at our supplier summit in November last year, in Vietnam, and got commitment from all our suppliers that they will invest to help us to achieve our growth rate targets. So I don't see any major constraints. We definitely didn't have any in the first three months and from visibility I have for the remainder of the year I don't see any major issues.

Tony Shiret - Credit Suisse

First off, a word on your really good figures – well done.

My first question is on Reebok. Looking at the product pipeline, I know you've only just launched RealFlex, it seems your product launches follow a sort of sequential process. Do you have any shoes following RealFlex you can tell us about?

My second question is on the retail side of the business, your retail comps in adidas are up 17%, and on the gross margin, that's up 210 basis points. Can you tell us what the split of the adidas comp between price and volume was, and what you ascribe the 210 basis point improvement in the retail gross margin to in adidas? And last question, looking longer term and talking about Route 2015, you didn't really say anything about the US high school market in your presentation and how you're progressing with driving your penetration into that market. Is there anything you can say at the moment?

Herbert Hainer

Let me take question number one and number three and Robin will talk about the retail comps. We are happy that we now have a third pillar at Reebok, adding to the Toning and the ZigTech platforms. We are now introducing RealFlex and plan to exploit it. Of course we are working on further concepts as well, but it's too early to talk about those already. But be assured that we have the right people in place at Reebok, as we have told you over the last several quarters, who are permanently bringing fresh innovative products to the market. But we also have to make sure that we exploit and execute the concepts which we have in the market right now in the most successful way and there is still work to do with all our existing concepts, rolling them out to the international markets.

We told you a year ago that our strategy for the US, within Route 2015, is to win back the high school kid and this is what we are doing and what we are targeting. When you look at our product assortment or at our advertising, for example with Dwight Howard and Derrick Rose in Basketball, this is clearly targeted at the high school kid, and we can see the success already in the malls through the sales of our two main customers. This is where the high school kids are shopping. So we are definitely going in the right direction and we are executing our plan and are winning back the high school kid in the US.

Robin Stalker

So turning to the retail gross margin, we believe it is volume and mix, more so than price increases, with the vast majority definitely coming from the volume.

John-Paul O'Meara

Okay, thank you very much for your attention today. That concludes our first quarter conference call. As you know, our AGM is next week, which is our next event. And I wish you all a very nice afternoon.