adidas Group First Quarter 2013 Results
May 3, 2013
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
The first question I have is about Latin America – amazing growth rate there. Is it already due to a build-up for next year's World Cup, with the whole region getting excited about it, or is it just a better underlying development of those markets, which have been a bit difficult in some quarters in the last two to three years?
And my second question is on Reebok apparel. Could you elaborate on that a little more? The 13% increase in the training category that you mention on page 18 of your presentation, is that all apparel-related? And do you plan to grow this apparel initiative out into other categories?
And then my last question is on China. When will you be the market leader, given that you keep growing there and everyone else is struggling? It must be just a question of months until you have the number-one position?

Herbert Hainer
So, let me start with Latin America. As you have been following us for quite some time, you have seen that in the last few years, maybe the last eight or nine years, we have more or less permanently been growing at a double-digit rate in Latin America, and increasing our market share there. So, we can really speak about it from an underlying good business in Latin America. It's not just one country, like Brazil, where we have the World Cup in front of us – it's really growing on a broad basis. You will see in the second half of this year that we will start to build up our football business, when we start to introduce our new jerseys, the official match ball, new football boots, et cetera. But overall we have a very, very solid and very positive business in Latin America.
Regarding Reebok apparel; that plus 13% is mainly CrossFit, from our Delta range, which we recently introduced. It's still on a small basis, of course, but we are trying, within our House of Fitness initiatives, to further expand our apparel offering from the Reebok brand.
And your third question on China – yes, we are definitely getting closer and closer to market leadership. I can't give you an exact date, but you can see that we are growing faster than our main competitors and, if this continues, then we will see it sooner rather than later.

Matthias Eifert
And that 6% in the first quarter, is that a good indication of how you see the year? Or can we even expect a small improvement in the coming quarters?

Herbert Hainer
In China, I think this is a good indication of how we are growing, going forward. We have always told you that we want to have qualitative growth instead of just quantitative growth, and this is underlying what we are doing.

Jurgen Kolb – CAI Cheuvreux
Two questions from my side, all about Reebok. First of all, what's the situation in Latin America, which seems to continue in relation to Vulcabras, I assume? Maybe an update there – what is the state of affairs and can that be resolved quicker than you might think? And, secondly, on new locations for your fitness retail hubs in North America and also in Europe, have you taken any further steps? Maybe signed first leases and what's the current status on the expansion with this successful format that you already have in New York?

Herbert Hainer
So, for the first question, as we might have said already, we have a contract with our joint venture partner, Vulcabras, in Brazil and Argentina, which is going to end in 2015. And at the moment, we don't have any further information on that.
On the new Reebok Fit Hub locations, yes, we are actively searching. And I believe that we will get close to 10 test stores in North America. In the UK, it might be between six and eight, as there it is a little more difficult to find the right locations. We have signed the first locations and for the others we are progressing well through our conversations with the landlords. But this is the best outlook we can give you today.

Jurgen Kolb
Very good. Okay, that's enough from my side. Looking forward to the launch of the new football boot.

Herbert Hainer
Of course, Nitrocharge.

Michael Kuhn – Deutsche Bank
Yes, good afternoon, a few questions from my side. Firstly, again on Reebok, I understood that ex-NFL, the phase performance was about flattish in the first quarter. I'd be interested whether you could make some comments about what you expect for the recovery growth plan and what growth rates are realistic for the upcoming quarters.
Secondly, in your retail business, I understood from your comments that you expect a return to like-for-like sales growth in the retail channel. I would also be interested in what your expectation is in terms of operating profit and operating margin in the retail segment. And, finally, also in connection with retail, you mentioned your positive experience lately with your adidas NEO stores in Germany. How far are you, in terms of the development plans, particularly in terms of further rollout in Western countries? Thank you.

Herbert Hainer
Michael, let me start with your first question. And then, Robin, will talk on the retail part, in terms of gross margin.
On Reebok, we were minus 2%, if we exclude the NFL and the Reebok India comparisons. And we are, as I said in my opening speech, expecting to get back to growth in the following quarters and for the full year 2013. Of course, it will be building up through the year, because in the third quarter we will bring most of our new introductions for the back-to-school season, especially on the footwear side. And we definitely believe we will see acceleration in the third quarter.

Robin Stalker
And as far as the profitability of the retail gross margin is concerned, yes, we obviously do expect to see continued improvement here. There's two factors you need to consider. The first is in terms of the comp store sales developments, which we expect to turn positive. And secondly, in terms of profitability, when you look at the first quarter, this performance is not representative. Meaning we will have a better season going forward. This quarter is a clearance quarter, obviously, and so, therefore, the gross margin would be better than that. The improvement will also come through as we leverage the expenses of the new shops over the coming few quarters. So that will improve things too.

Herbert Hainer
And the last part of your question was on the adidas NEO label. Yes, the 10 NEO stores in Germany are running well and they're getting better and better. We are learning a lot and, as we have said in previous calls, we will take a decision in the summer, this year, when we have a 12-month comparison period for all the stores, and decide on any further rollout. But from what I can see today, everything is very positive, so it should not come as a surprise if we decide that we will further roll out the NEO stores in Europe, when we take this decision in the summer months.

Richard Edwards – Citigroup
My question relates to the wholesale division. Looking at the OpEx development, it looks like it fell somewhere around 14% in the quarter. I want to understand if there are any one-off elements to that, or whether we should assume OpEx declines in the coming quarters?

Robin Stalker
Richard, I think you've got to realise that we have some comparisons directly year-over-year which impact this, such as India, and they play a role. But generally you'll see through our performance that we are leveraging our operating expenses better and better. And it's that leverage that you should expect to see in the future, but there are a couple of small items relating to India for last year.

Richard Edwards
If you stripped out those small items, do you have any sense what the underlying OpEx trend was in Q1?

Robin Stalker
No, I haven't got that figure in front of me, but it won't be a major difference. It's a small percentage.

Omar Saad – ISI Group
I wanted to see if I could get you to elaborate a little more on the exciting new Boost platform. What kind of technologies do you think this technology is replacing in the marketplace? And do you think the technology has the opportunity to be levered into some of the other categories, such as basketball, football and maybe even some of the equipment categories? I'd be curious to hear your thoughts on that. And I have one follow-up, as well. Thanks.

Herbert Hainer
Thanks very much, Omar, for your positive comments. Boost is, as we have said already, a revolutionary new technology. I don't know exactly which technologies it will replace. But what I can tell you is that this is definitely the best technology which is out in the market, by far, for the

running category. And you have seen the successes which our retail partners enjoyed after we launched the first Energy Boost collection. Unfortunately, we do not have enough supply at the moment. The technology is between BASF and ourselves, and BASF is currently ramping up production. So, during the course of the year, we will bring more volume into the market. And then we will also spread it to other categories. Basketball, as you mentioned, will be the next category where we will introduce it.

Omar Saad
Great. And that's a good lead-in to my follow-up question on the supply chain. How are you thinking about your supply chain, especially as more and more of these proprietary technologies become an important part of the adidas Group's differentiation in the marketplace? I know with Boost you are keeping proprietary ownership, but are you thinking, given the macroeconomic environment, about approaching the supply chain a little bit differently than what was the status quo over the last 10 to 20 years?

Herbert Hainer
Overall, I must say that we have a very stable and very close relationship with our supply base. When you look at our suppliers, we hardly ever change any of our key suppliers. We just add new suppliers, and this is because of the growth which we have been enjoying for more than 10 years, more or less. We are working very closely with our suppliers in developing new and innovative products and also planning how we can produce them later. Therefore you can be sure that whenever we bring to market a new and innovative product it will be extensively tested in the pre-production environment within our supply base. So, I'm absolutely convinced, especially when you look into our recent years, that we have hardly any quality issues and we're producing around 240 million pairs of footwear, just to give you an example. Our delivery-on-time performance is excellent, so we are quite satisfied with the supply base we have.

Omar Saad
Thank you. One further quick question, on pricing. I know pricing and product mix have been an important driver. How are you thinking about pricing long-term here? Are you using it as a tool to drive the business as innovation becomes a key driver as well?

Herbert Hainer
There is no doubt that with new and innovative products you can charge better prices. And this is one of the reasons why I said already 10 years ago that this industry is driven by product and by product innovation. And we have to make sure that we are the leader in innovation. And I think so far we have proved that is true, with ample innovations which we have brought to market. For example, when you look at this year, with Boost, there is another revolutionary innovation. And, of course, you can charge higher prices and therefore hopefully achieve better margins.

Omar Saad
Herbert, do you feel like innovation is translating into price, more now than it ever has before, for the industry and for adidas?

Herbert Hainer
When you look at the FOB increases that we have seen over the last few years, of course pricing plays a key role more and more. But we are working on different initiatives to improve how we make and engineer our products and this, of course, helps on the pricing side as we re-engineer our supply chain. Therefore with all of these components coming together, we can enjoy a nice

margin, which is what we did in the first quarter. But pricing definitely is becoming more sensitive as well and we will continue to watch this very closely.

Louise Singlehurst – Morgan Stanley

Good afternoon, gentlemen. A couple of questions from me please. Firstly, a question on the very strong balance sheet that we're now seen coming through, particularly in terms of the use of cash. Herbert, you've spoken in the past about some of the smaller brands, but do you think there is any scope, now such that you might actually reignite some of the talks to dispose of any of the smaller brands in the Group?

And then, secondly, just on the US – obviously a tough market to take market share, and a very strong performance in Q1. How are the negotiations working out with Foot Locker and Finish Line, in terms of taking more space? Obviously, you are doing very well in basketball. But is there something fundamental you think that's changing for the Group that gives you a lot more confidence in the ability to take market share, along with the new product launches? Thank you.

Robin Stalker

Louise, no, there is no change to what we've been consistently saying about our use of cash. Yes, we want to continue to be very disciplined on the control of our balance sheet and how we generate this cash. Our first priority is investing in the business and our second priority is obviously increasing our dividend. And you can see we've recommended an increase in the dividend of 35% for this year. But there is nothing in terms of acquisitions on the horizon and there's nothing anticipated.

Herbert Hainer

In terms of the US market, of course the US market is very competitive, as we know. However, I think when you look at our footwear business and our market share developments, we are definitely enjoying a nice run there. This is supported by our broad range of different products which we have brought to market. This is especially the case when you look at the two customers to which you referred – Foot Locker and Finish Line. With Finish Line, you can see a strong presence of our Originals business with the white walls space. And in Foot Locker stores, with our basketball product, starting with the adizero Crazy Light, and now with the Crazy Quick, we are definitely enjoying good retail presentation, and this will continue. But also with lots of other customers for example, in Dick's Sporting Goods, we are building our big shop-in-shop concept, together with the Dick's team, in a lot of their stores. So, overall, I'm quite happy with these developments. Of course, as they say, "Rome was not built in a day". But we are making improvements day by day, month by month and quarter by quarter, in the US.

Chris Svezia – Susquehanna Financial Group

Nice performance on the margin. I have three questions. First, I want to focus on the gross margin performance. Being up 240 basis points here in the first quarter, I think you've achieved half of your expected gross margin improvement for the year. I'm curious, how much do you anticipate currency to be a pressure point as you go through 2013? And do you anticipate less favourability or benefit from input costs? And how do we think about Reebok on the gross margins? It was up 150 basis points. Does that continue to show improvement and progress for the year? That's my first question on gross margin.

My second question is on China. I'm curious, Herbert, given inventory levels in that channel, what's really working with that consumer? What's resonating? And I'm curious, if it gets 6% currency-neutral revenue growth but with an 8% comp growth, how the unit growth looks.
And lastly, on the Sport Style business, which was up 4% – that's a good number; I think maybe slower than what you've seen in the past. Just what are your thoughts about that business for the balance of the year? Thanks.

Robin Stalker
Okay, Chris, thanks. I'll take the first question on margins. It is a very good development in the first quarter. But as we said, the negative currency hedging impact in the first quarter was pretty minimal. But as I've been telling you the last few quarters, our hedge rate for 2013 is worse than what we enjoyed for 2012. I think we were looking at around the 1.38 for the hedge rate in 2012; we're at about 1.32 for 2013. And that comes through during the next few quarters, so you will see more of a negative impact from the hedging over the next quarters. Nevertheless, I'm expecting that we will show quarter-over-quarter improvements of our gross margin. And as I just said in my prepared comments, we are now guiding to be at the upper end of our range for the gross margin, which is 48.5% for the year.
So for Reebok, we made it clear last year, also, that not only do we expect a 2013 top-line improvement for Reebok, but we definitely want to see the margin improvement. And that's our guidance, also, for the complete year – that you will see an improvement in Reebok's gross margin this year.

Herbert Hainer
Your second question, Chris, on China inventory levels; I have said it several times, that we have worked very hard getting a closer collaboration with our retail partners and their stores, such that we know exactly what's going on in the store; and, therefore, we can manage our inventory much better. This is by exchanging sell-through data on a much faster and more detailed level. And the 8% comp stores are only in our own retail stores. So this is not on the 7,000 stores which we have with our retail partners.
And your third question was on Sport Style, 4% growth, whether there are any issues. No, definitely not. But we also have to make sure that we don't overheat Sport Style, and especially Originals. This is what makes a brand cool with especially the young consumer base. And we have enjoyed such a nice performance in the last four years with Originals that we have to be careful that we don't overheat it, and rather further build the momentum with our Originals business on a quality basis.

Chris Svezia
Okay, that's helpful. Just two quick follow-ups. Do you anticipate the sports lifestyle business to grow for the year? And on Reebok, up 150 bps on gross margin, do you anticipate that to accelerate, as new product begins to hit the marketplace in the third quarter?

Herbert Hainer
On your first question on Sport Style; yes, we definitely anticipate further growth. And on Reebok's gross margin, this is a good level for this year. Of course we have to build it further in the years to come. But I think if it stays like that in 2013, we are satisfied with that.

Rogerio Fujimori - Credit Suisse
Two questions for me. First, I was wondering if you could give us a bit more colour on the trading conditions in Russia as the quarter evolved, and your thoughts for the balance of the year?

Herbert Hainer
Russia was a more challenging environment in the first quarter, especially because of the weather conditions. You might have seen, it was cold even until Easter. Normally, we expect that the new spring/summer products are arriving into our stores in the middle of February and unfortunately, with the cold weather, this did not go as well as we had anticipated. Since the weather has improved here in Europe, the same improvement is happening more or less in Russia. So therefore our trading conditions are also going better. So, Russia will still grow in 2013. And as you know, we are market leader by far with our two brands, so this is doing very well. And don't forget that Reebok was up 10% in the first three months in Russia. This also shows that our Reebok product and concept is getting more and more attractive for the consumer.

Rogerio Fujimori
Thank you, Herbert. And you also flagged that you are increasing your promotional spending in certain markets – I presume in mostly Western Europe? Do you expect this to be a headwind to gross margins in the coming quarter? Or is this situation already stabilising? Any colour on this would be appreciated. Thank you.

Herbert Hainer
No, we don't expect that. As you know, we are always spending at a certain level, which you always hear set at around 12.5%. And it depends on the events, with the years of big events, or in non-event years relating more to product innovation promotion, as we have had this quarter with Boost. But we are quite disciplined in our spending on both the marketing sides and in relation to the marketing working budgets.

Antoine Belge - HSBC Global Research
Actually, I have three questions. First of all, on your EBIT margin evolution, obviously a very positive evolution on the gross margin. But I think, in 2013, you are also expecting some SG&A improvement, so maybe could you comment on that?
And my second question is regarding the performance of the adidas brand in the US. How has your market share moved in the US for the adidas brand with regard to footwear on the one side, and then also for apparel?
And, finally, regarding the World Cup, is there any development that you could already share with us today?

Robin Stalker
Okay, so I'll take the first two, and then Herbert will close on the World Cup. I can just repeat the comment I made about operating expenses. Yes, we definitely expect to get further leverage out of our operating expenses, not only as we grow in the quality of our sales, but also because of the initiatives that we are implementing. We started our Route 2015 to become more efficient in various areas – be it the consolidation of our warehousing or the consolidation of certain services above markets. And although there are costs involved in setting these up, 2013 is probably the first year where we should start to see some of the net benefits of that investment. So that is a fact which will help us get to an operating margin approaching 9%.
On our market share in the US – firstly, we only get the footwear market share. And as you know, our apparel is a little bit bigger than some of our competitors, as a percentage in the US. But we're

still at a very low level of market share in the States. We're growing slightly, but I think we're only around about 12%.
But as Herbert said earlier, in one of his answers, Rome wasn't built in a day. We're doing everything to make sure that we're building the basis to provide good, long-term, sustainable, and profitable growth in this very important market. And you'll see further improvements in market share, I'm sure, as we go through the next periods.

Herbert Hainer
And on the last question concerning the World Cup – no, we don't yet have World Cup product in the market. This is because we start in the third quarter, when we'll sell in the new jerseys of the participating teams and also the new football silos, as I have mentioned. And then in December we start to sell the official match ball for the World Cup. But, obviously, we have already shown all our World Cup-related concepts and products to our retail partners. And this was very well received by all of them. So, we are quite excited about the upcoming World Cup, and also about the qualification status of our teams. So we expect that we have between eight and 10 teams for the World Cup. And this is definitely quite exciting.

John Paul O'Meara
So, ladies and gentlemen, that completes our call for today. Our next call will be on the August 8 for our Q2 2013 results. And we wish you a very happy and joyful summer.