FINANCIAL RESULTS PRESENTATION

First Quarter 2011 Speech

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John-Paul O'Meara

Good afternoon ladies and gentlemen and welcome to our first quarter 2011 financial results conference call. I'm JP O'Meara and I head up the IR activities here at the adidas Group.

Our presenters today are Herbert Hainer, adidas Group CEO, and Robin Stalker, Group CFO. They will be covering our very impressive first quarter financial performance, and updating you on our prospects for the remainder of the year in light of recent developments. So, let's get started and over to you, Herbert.

Herbert Hainer

Thanks JP and good afternoon ladies and gentlemen.

As you will have seen from our communication this morning, the first quarter of 2011 is the fastest start the Group has had in more than a decade.

- We achieved record first quarter sales of 3.3 billion euro, up 18% currency-neutral, which is our highest organic quarterly growth rate in almost five years.
- Group gross margin was virtually unchanged at 48.5%, a very strong result given what many of our peers in the footwear and apparel industry delivered.
- And despite a significant increase in marketing spend and the non-recurrence of prior year one-off gains, operating expense leverage in the quarter, helped drive net income and earnings per share up 25%.

This powerful performance shows a marked acceleration for our Group across the board, and a major highlight worth noting is how clearly the global desirability of our brands shines through in these results.

Every region grew at double-digit rates, the only exception being Other Asian Markets – which was nonetheless up a healthy 7%, including growth in Japan.

Particularly important was the strong momentum in our three key "attack markets" which, as we outlined last year, are central to our Route 2015 strategic plan.

In North America, sales were up 26% currency-neutral, with 30% growth at adidas and 22% growth at Reebok. The performance of adidas in America demonstrates the merits of the strategies we are now executing to close the gap to our major competitor. In running, basketball and Originals, adidas in the US is on fire. For example, in running, sales were up 65% in the quarter.

And with large-scale launches, like the ClimaCool Ride running shoe, we have shown our retail partners we have the marketing muscle to successfully sell through major new concepts.

In Greater China, we are back in full swing, with sales up 36% currency-neutral. Fresher inventory in the market as well as strong demand and the expansion of adidas Sport Style presence, where sales grew 51% in the quarter, contributed to the improvements. And the great news is, all the feedback we have had from our partners suggests that momentum is definitely with the adidas brand, with comp store sales for our customers continuing to get stronger.

In Russia/CIS, we extended our market share lead with sales climbing 44% in the quarter. Our own-retail stores, which represent the majority of our business in this market, saw comparable store sales up a very impressive 37%.

Elsewhere, the start to the year has also been strong. In Western Europe, revenues increased 14% on a currency-neutral basis. This was driven by double-digit growth in all major markets, in particular Germany and France, as well as double-digit growth at adidas and Reebok.

Finally, in Latin America, sales for the first quarter were up 15% on a currency-neutral basis, mainly due to double-digit growth at adidas.

From a brand perspective, without doubt, adidas – the engine of the Group – has never come out of the blocks faster. Revenues grew 18% currency-neutral in the quarter and gross margin expanded 10 basis points to 47.8%.

adidas Sport Performance sales were up 15% currency-neutral, with all major categories growing at double-digit rates. adidas Sport Style also continued its remarkable run with sales growth of 27% currency-neutral.

Our leadership in innovation is clearly evident in the growth drivers for the quarter. In running, products such as the adiZero F50 Runner and ClimaCool Ride, drove sales up over 30%.

In basketball, the adiZero Rose and the Crazy 8 have given the brand much needed momentum in basketball footwear. With Derrick Rose just crowned the youngest ever NBA Most Valuable Player, the success of our individual athletes and the brand over the last six months is creating significant interest in our next innovation instalment – the adiZero Crazy Light. This is the lightest shoe ever in the category at 9.8 ounces, and comes to market this June, retailing at $130.

We also had great successes in other categories such as training and outdoor. In outdoor, sales grew 25%, as we continue to gain market share in key markets as well as expand our offering into the emerging markets.

Last but not least, one area that cannot go without mention is football, where sales were unchanged despite being up against a World Cup powered Q1

2010. This was driven by an incredible 34% increase in footwear sales due to our domination on and off the field with the adiZero F50 football boot.

And ladies and gentlemen, on that front I have a world exclusive for you today. We are now getting ready to take the game of football to the next level. Later this year, we will revolutionise the game by introducing an interactive boot to global elite football. The interactive boot will feature adidas miCoach technology and will capture in-game data through a smart pod embedded into the sole of the shoe. The new adidas miCoach football boot will change the way players train and ultimately perform on the field of play, and is a product of many years development. You'll be hearing more about this in the coming days from the brand.

Another milestone of the quarter for adidas was the launch of the "all adidas" campaign in March. A crucial part of our Group's strategy is ensuring we nurture our brands and create demand for our products through investment and excellence in marketing.

Historically for adidas, we have predominantly promoted a specific event, athlete or product. However, we've never really stepped back and celebrated everything that makes adidas and its sub-brands so extraordinary.

With "all adidas", we have taken the opportunity to do just that – highlighting and celebrating every aspect of the adidas brand – from the court to the catwalk, and from the stadium to the street. The raw and authentic emotion of the "all adidas" campaign comes across loud and clear, connecting and resonating in particular with our young target consumer.

With the campaign, adidas will be seen by 1.25 billion digital users and we will reach almost three quarters of all next generation youths worldwide.

The response has already been very exciting. From its launch on March 16 to the end of April, adidas has gained 3.2 million new fans on Facebook and now has a total of over 16 million fans across all categories. Our various video spots have been viewed 7.5 million times on YouTube. In addition, we have seen an increase of 26% in traffic to our adidas.com website.

Our retailers have also noted our efforts to drive consumer demand, which is partly reflected in the strong sell-in we have seen in the first quarter. In the coming months, I am convinced the impact of this campaign will only get stronger, which is very important at a time when driving brand desirability is so crucial given the backdrop of increasing prices.

Moving over to Reebok, we had another great quarter with growth of 24% currency-neutral, and gross margin increasing almost a percentage point to 37.2%. Don't forget, it was only this time last year that Reebok's sales development turned positive, with 1% currency-neutral sales growth. So the result shows we have successfully translated the potential from new product introductions over a 12-month period. While North America was up 22%, as I already mentioned, we also saw strong growth in other regions with growth rates of over 25% in Western Europe, European Emerging Markets and Other Asian Markets.

While toning continued to be a growth driver globally year-over-year due to international expansion, ZigTech was the key driver of the performance in North America. That being said, the good news for Reebok is that sell-through of our toning collections continues to be very good, and we are liquidating product faster than our main competitor in stores where we are competing.

Coming back to Zig, demand is extremely strong, as the concept creates a new dimension of brand experience for the consumers. Here, a great example is Your Reebok, where individuals can create their own recipes for Zig, customising their shoe online. Of the 1.2 million original recipes created on Your Reebok for our various iconic styles, almost three quarters are Zig related.

In terms of the phasing of growth over the coming months, given that we will start to anniversary our big global push on toning in the second quarter, the pace of growth will moderate briefly until we ramp up our new product concepts and collections for this year.

And again, I am sure these new initiatives will provide plenty of new impetus to growth as we get into the second half of 2011. One of these is RealFlex, which just launched in the United States in mid-April. The product, just like toning and ZigTech, again symbolises Reebok's attitude of making fitness and training fun and aspirational.

RealFlex features 76 independent sensors on the bottom of the shoe, each strategically positioned to twist, bend, expand and support, to help athletes' feet move more naturally. The sensors work together throughout the athlete's stride to help provide all the benefits and ground feel of barefoot running, a movement which runners around the world are embracing, while at the same time helping to eliminate all the negatives that come with running on hard surfaces.

Our marketing concept for RealFlex is also very striking as we bring the 76 flex-friendly sensors to life as individual characters, working together as a team. Although it is early days yet, the initial sell-through from retail in its first two weeks has been very encouraging. And I am convinced that RealFlex has all the potential to become another hit for Reebok.

Finally on the brands, let me spend a moment on TaylorMade-adidas Golf. Sales grew 20% currency-neutral in the first quarter, due in particular to the very successful launch of the R11 driver. For the coming quarters, I believe it is prudent to be more cautious on growth, particularly given TaylorMade-adidas Golf's relatively high exposure to Japan, which accounts for about 20% of the segment's sales.

While on that topic, let me remind you that Japan is a very important market for our Group, and we were deeply saddened by the events that happened in March. We have a long history in this market with all of our brands, and we have a very close connection to the Japanese consumer whose passion for innovation and design is unrivalled around the world.

Today, we are the market leader in the sporting goods industry in Japan, and have more than 1,500 employees working there. In total, Japan makes up a high-single-digit percentage of Group sales and is highly profitable.

Since the events, we have been in constant contact with our team who thankfully are all safe and well, although sadly some lost family members. The reaction of the Japanese people, our staff and our customers and the camaraderie shown by Group employees around the globe has been inspiring. One of our Group values is integrity and we have seen many great examples over recent weeks of how this can be lived. Therefore, I have no doubts that Japan will overcome this disaster very quickly.

In the short term, there will be some setbacks for our Group. This is mainly due to store closures which have affected several of our retail partners and our own retail. Also, the possibility of rolling power cuts through the summer months may affect business. Currently, we have scenarios that imply we may suffer sales declines of 15% to 25% over the nine-month period from April to December. This will obviously in turn have an over-proportional impact on profits in Japan, leading to a significant double-digit million euro negative, which we will have to compensate.

The good news is that our business around the globe has started the year strongly. All of our other markets are rising to the challenge to find opportunities to make up the difference. As a result, I remain confident that, despite the short-term headwinds, we can meet our Group's guidance for 2011.

With the strong performance in markets like Greater China, North America and Germany, we can even increase our Group's sales guidance to the top end of our March target range and now expect high-single-digit currency-neutral growth for the year.

This is driven in particular by the Wholesale segment, where we have increased our guidance to mid- to high-single-digit. Obviously, this growth rate might have been even higher except for the weakness we now see in Japan. As a result of the latter, the rest of our guidance on margins and the bottom line remains unchanged. While we expect to see a significant profit hit in Japan, strength in our other markets will help to offset the negative effects. This is why I am very confident in our profitability guidance for the full year where we expect earnings per share to improve at a rate of 10% to 15%.

In summary, I believe that 2011 is a fitting start to our journey on Route 2015. The diversity of our business proves that, even when new challenges emerge, we can count on the tremendous strength and reach of our brands to deliver on our promises.

Let me now hand you over to Robin to take you through the financials in more detail. Robin.

Robin Stalker

Thank you, Herbert. And good afternoon ladies and gentlemen.

As Herbert has already outlined, we have enjoyed an extremely dynamic start to 2011. The Group's top-line momentum accelerated compared to the fourth quarter of 2010, with Group sales increasing at the highest organic growth rate since the second quarter of 2006.

Group sales were up 18% currency-neutral in the first quarter. Similar to the prior quarters, but to a much lower extent, the year-over-year appreciation of various currencies such as the Japanese Yen, the Chinese Renminbi, the British Pound as well as various Latin American currencies, against the euro, had a positive impact on the Group's reported sales. In euro terms, Group sales increased 22% to 3.3 billion euro.

By segment, currency-neutral Wholesale revenues increased 18% in the first quarter, driven by strong growth in all regions. North America and Greater China were exceptionally strong, growing at 31% and 39% respectively.

By brand, Q1 adidas wholesale sales increased 17% on a currency-neutral basis with adidas Sport Performance expanding 16% and adidas Sport Style increasing 21%. Reebok wholesale sales climbed an impressive 26% on a currency-neutral basis, driven by the running and training categories.

Gross margin for the segment was stable at 43.1% in the quarter. A more favourable product mix as well as fewer clearance sales helped mitigate the headwinds from rising input costs. In addition, shifts within the regional sales mix positively impacted the wholesale gross margin development.

More importantly, however, due to the strong growth, we were able to enjoy economies of scale during the quarter, which, despite the flat gross margin, drove segmental operating margin up 1.5 percentage points to 34.6%.

In the Retail segment, comparable store sales increased an impressive 17% during the first quarter. Including new store openings, revenues grew 22% on a currency-neutral basis. All geographies contributed to this development, with growth of 39% in European Emerging Markets and 33% in Latin America being the outstanding highlights.

By concept, all formats increased at double-digit rates, with concept stores and factory outlets growing 25% and 16% respectively. Retail gross margin improved an impressive 300 basis points to 61.2%, supported by improvements at all store formats as well as at both brands. Reebok in particular saw a strong 7 percentage point improvement in retail gross margins, due of course to the big improvements in product assortment over the last 12 months.

At the end of the first quarter, we operated 2,297 stores, a net increase of 27 stores versus December last year. During the period, we opened 83 new stores and closed 56 stores, while 45 stores were remodelled. In addition, 110 concept stores were reclassified as other retail formats during the quarter.

Coming to the segmental operating margin for Retail, we were also able to achieve significant operating leverage during the quarter. Segmental operating margin improved 4.2 percentage points to 15.4%, as segmental operating expenses declined 1.1 percentage points as a percentage of sales.

Finally, in Other Businesses, sales grew 14% currency-neutral in the first quarter, which was mainly a result of the tremendous 20% sales increase at TaylorMade-adidas Golf. Sales at Reebok-CCM Hockey were flat compared to the prior year period, while Rockport sales were down 6% on a currency-neutral basis.

The gross margin of Other Businesses increased 0.6 percentage points to 45.6% in the first quarter. This development was driven by better product margins in all segments.

The segmental operating margin declined 0.9 percentage points to 28.1% as the higher gross margin was more than offset by increased segmental operating expenses as a percentage of sales. This was mainly related to our efforts to further roll out Rockport's own-retail activities in the US and Russia.

Moving below the top line, Group gross margin was virtually flat, declining a slight 10 basis points versus the first quarter of 2010. While higher sourcing costs (which hurt gross margins by a little over one percentage point) and, to a minor extent, hedging exerted pressures on the gross margin development. We also had several factors on the positive side which helped to offset these negatives.

- Firstly, the most important positive catalyst was the over-proportionate growth of sales in our Retail segment, which carries higher margins.
- Secondly, due to more current inventory levels, we had less clearance activities compared to the prior year.
- And, finally, we benefited from positive regional mix effects, which was mainly a result of the over-proportionate growth in higher-margin markets such as Greater China and Russia.

In terms of operating margin, which on a reported basis declined slightly to 9.6%, here we actually have seen very good leverage during the first quarter on a comparable basis. As a reminder, this time last year, we benefited from two one-off effects related to the settlement of a lawsuit and the sale of a trademark, each of which represented low-double-digit million euro amounts. If we exclude these effects, operating margin is up around a percentage point on a comparable basis.

This was achieved despite significant increases in marketing investments to support the global launch of our new "all adidas" campaign, as we were able to leverage our impressive top-line momentum to bring other operating expenses as a percentage of sales down 1.5 percentage points to 40.0%.

Within this, marketing increased 0.3 percentage points as a percentage of sales to 12.7%, or grew 25% in absolute terms to 417 million euro. For the full year, marketing as a percentage of sales will be slightly lower than the 13.3% of sales we invested last year.

Turning to the items below operating profit, net financial expenses increased 70% compared to a year ago. This was due to the non-recurrence of prior year positive exchange rate variances and negative exchange rate variances in this quarter (a swing of 15 million euro), which more than offset lower interest expenses which declined 16% due to the reduction of gross borrowings.

The first quarter tax rate came down 400 basis points to 26.5%, which predominantly is due to a more favourable regional earnings mix. As a result, first quarter 2011 net income attributable to shareholders increased 25% to 209 million euro from 168 million euro. This translates into basic and diluted EPS of 1.00 euro, up from 80 cents a year ago.

Moving to the balance sheet and cash flow, I can report continuous improvements as we maintain the discipline we demonstrated throughout the last quarters.

At the end of March, Group inventories were up 23% currency-neutral to 2.0 billion euro. I am not concerned about our inventory position, neither for our brands nor on a market level. The majority of the increase currently stems from two points.

- First, we dramatically cut inventories on hand this time last year, in view of the uncertainty in the economic environment.
- Secondly, we have now rebuilt our inventory reserves to match our sales base, given our strong growth over the past 12 months and also bearing in mind our growth expectations for this year.

As we outlined in March, the rate of inventory increase has already started to moderate to 23% from the 34% growth reported in the fourth quarter.

As we go through the rest of the year, you will see the rate of growth narrow further, and by the end of the year it will more closely represent future sales growth expectations.

Broadening the discussion to operating working capital, the current level of 20.5% represents a decrease of 2.4 percentage points over last year as well as a new record level for our Group. While we may lose some basis points due to the planned growth of our business, I am very confident that our tight management of working capital will ensure we continue to maximise cash flow generation as we go through 2011 and beyond.

Finally, ladies and gentlemen, the strong operating cash flow generation over the last twelve months contributed to the meaningful reduction of net borrowings. At the end of March, our net debt stood at 914 million euro, equating to a decrease of 444 million euro versus the prior year. This represents a ratio of net borrowings over 12-month rolling EBITDA of 0.8, which means we are comfortably within our target corridor of a ratio of below two times. At the end of the prior year period, the ratio stood at 1.4.

So ladies and gentlemen, the strong start to the year, together with the solid trends we see for our brands affirm the confidence we have in our potential for 2011. We are executing well, and our positions in key growth markets are strong and getting stronger.

Despite the tragic events in Japan, which will have a significant negative impact on profitability development, we can confirm all of our targets for the year.

Now, Herbert and I will be happy to take your questions.