adidas Group Full Year 2013 Results
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Q&A session
adidas Group participants:
Herbert Hainer, adidas Group CEO
Robin Stalker, adidas Group CFO
John Paul O'Meara, Vice President Investor Relations

Cedric Lecasble – Raymond James & Associates
I have a question on how we reconcile your gross margin trends and your EBIT guidance when we understand that foreign exchange currencies are real headwinds today but, at the same time, your gross margin guidance is not that negative. So, it is more reflected in the EBIT guidance? Could you explain a little more why OpEx will play against the company more than expected in 2014? That is my first question.
And the second question, could you please give an update on your sales in running and also give us the percentage this is of the adidas brand's sales? That would be very useful. Thank you.

Robin Stalker
Thank you very much for those two questions. The currencies are obviously playing a role throughout the whole P&L. For this particular guidance that we have given, we are pointing out that we lose a lot of leverage. If we lose so much on the top line, it's not just so much that the gross margin suffers. It really is the operating margin that suffers because we don't get the full benefit of decreases in costs because so much of our headquarter costs and indeed some of our long-term contracts are, obviously, denominated in euros or dollars. So that is part of the reason.
And in terms of the currency exchange movements within the gross margin, it has a lot to do with the hedging. We hedge basically for all of our markets 12 months in advance. But for those markets where it has not been economic to hedge in the past or it hasn't been really possible to hedge – I am calling out here particularly Argentina and Russia – there we are exposed when there has not been hedging because they have to buy in the market, the dollars, whatever it is, and that has an impact on the margin.
But I think our net margin guidance, 49.5% to 49.8%, gives us a good indication that we're still expecting the trend in our margin to really be positive.

Herbert Hainer
Let me answer the second question on running. Please understand that we don't give out absolute numbers for our running category, but let me tell you that in the fourth quarter our running business was up 34%. I am definitely more than convinced that going forward for the next years we will see double-digit growth in the running category. Why? Because first and foremost I think with Boost we have a unique technology which nobody else has. And this is so exceptionally better than what is out in the market. We get so many positive comments either from the specialty running stores, from the running core group, that as I said in my speech already, we will ramp up to 8 million pairs in running in 2014 and do even more going forward.

But Boost is just one part. It is also Springblade, it is miCoach smart watch, and so on, which gives us absolutely credibility. And I can tell you that we have never been better and never had higher market shares in the running category of above EUR100 than we have today. And this will continue.
This also follows our strategy that we start from the top, convince the real runners with the best product and then we will trickle it down.

Jürgen Kolb – Kepler Cheuvreux
Thanks very much. Three questions from my side. First, in your annual report you talk about the North American market again and that you see substantial potential to increase your market share there. And you are talking about improved distribution and higher share of specifically developed products for that market.
Now, the growth in market share in 2013 as we know didn't work out. So what is changing for 2014 and also for 2015 that makes you confident that you can now finally use that potential and show developing market share there?
Secondly, on TaylorMade, you indicated that you lost some market share because of some cleaning of inventories. Do you think you can recover that lost margin entirely in 2014 or is that a process that will probably also last into 2015?
And lastly on the currency exchange impact in your mid-term strategies – Robin, I hear you say you will probably change the business model. What does that exactly mean? And selective price increases – what countries do you specifically look at? So maybe some elaboration on these individual strategies. Thank you.

Herbert Hainer
Let me start with the first question on North America. As you remember in the first two years of our Route 2015 planning, 2011 and 2012, we grew double-digit in North America, and we were pleased with the results. Unfortunately this didn't continue in 2013, as you rightly pointed out. The main reasons have been that there is a certain shift in the fashion part of the business towards more performance-related lifestyle silhouettes, going a little bit away from Originals.
And the second point is that unfortunately for the entire year, one of our key assets, Derrick Rose, more or less didn't play at all. He didn't play the back season, 2012/2013 and he came back in October and then got injured again. Obviously, this is not helping our basketball business.
There is no doubt that the potential for us in North America is much bigger. We are making good inroads into the market. We are increasing our margin; we are increasing our profitability; we are growing. But yes, it definitely could be more for us.
I don't see a fast change in this fashion shift, as I said, but going forward we will bring an array of new products, be it the Stan Smith or the ZX Flux, and so on. I definitely see, starting in the second half of 2014 and then going into 2015, much more potential.
Running will help us, no doubt. I'm sure football and soccer will help us in the US. And then hopefully we will have all of our guys are back in October when the new basketball season will start.
On your second question on TaylorMade-adidas Golf; there is no doubt that with our leading position, which we have with TaylorMade-adidas Golf, being the clear market leader in metalwoods and in irons, and I have no doubt that this will continue and we will keep our leading market share.
Of course, we all – not just TaylorMade – had hoped for a better 2013 but when it started that badly in the first half, especially in North America, products had been already shipped to the markets. I think we were the first ones who realised that there's too much product in the market and we started, especially in Q3, to clean up the market. And this obviously has hurt our margin to a certain extent as well. Going forward, we will try to be

closer to the market demand in terms of the sell-through numbers with our shipping patterns. And therefore you can expect for the first quarter lower net sales in 2014 for TaylorMade and then from the second through the fourth quarter we will ramp it up again because we want to make sure that the products are selling through in the first quarter which were shipped in the last quarter of 2014. But from all that we are hearing about our SLDR driver and our JetSpeed we are definitely expecting to be very successful.

Robin Stalker
And in terms of the business model, obviously, this is an ongoing thing. We look at each of our operating units and consider what we should be doing here, but it will involve questioning investment – what we invest in, do we invest in roll-out of our own-retail in certain markets? It will involve looking at the mix of product that we want to sell in these markets. Maybe there are opportunities for local sourcing. Or where do we actually buy the product from? And the types of distribution that might include more e-commerce or whatever.
And of course, we continue to look at what we can do to become even more efficient with our cost base. And you have seen us do this across our markets. You have seen our "Europe ONE" initiatives that we announced last year. You have seen us also look at our "Joint Operating Model" in America. And these are the sort of things that we will continue to do to improve our business model and to improve the profitability in the individual markets.
In terms of price increases, yes, this is a sensitive issue obviously because clearly, as I said, the consumer needs to be in a situation to be able to pay for or to be able to afford some of this. And therefore, obviously, you are in markets where there is higher inflation. But we do have opportunities. If you think of some of our own-retail areas where we have more flexibility perhaps on the pricing. And you have heard from Herbert's comments about the very attractive and somewhat higher margin or at least higher-priced product offerings that we now have in the market that we believe we can further see opportunities with price increases there.
But this will be something taken on a case-by-case basis depending on the individual country situation.

Jürgen Kolb
Understood. Just one quick follow-up. Have you already terminated the opening of one or more stores specifically in Russia because of these rouble issues?

Robin Stalker
Yes, I think that is fair to say. We have reviewed opening strategies in those sorts of markets, yes.

Matthias Eifert - MainFirst Bank
My first question is on the guidance again. Robin, you mentioned up to EUR 250 million negative EBIT impact from currencies this year. Do we understand it correctly that you have factored that into the lower end of your guidance range for EPS, which you have given? And you come up with those current spot rates? Or would that lower end allow even a small deterioration from a currency standpoint from today's levels? That would be my first question.
Secondly, can you go a bit more into detail on Russia? Were you fully back up in the fourth quarter in terms of your delivery from the new distribution centre? Or were there still some issues at the beginning of the quarter? I.e., can we assume that maybe in Q1 you are back to 100% and have a stronger growth rate?
And on the same page, how was the retail performance there in terms of a like-for-like basis? And can you explain also a bit more about the adidas 3% like-for-like in the fourth quarter, which was quite nice? Was it

all driven by World Cup product already, or was there an underlying improvement in the fourth quarter? Thank you.

Robin Stalker

Okay, Matthias, I'll start – and yes, you're absolutely right I can confirm that the range that I gave you of what we estimate could be the impact – EUR 150 million to EUR 250 million on the EBIT line is what we have taken into consideration. And given the net income guidance of the EUR 830 million to EUR 930 million – yes, we do certainly hope that this also covers some further deterioration that may be possible. But at the moment it is the best estimate we can give. Obviously, we don't know exactly where we will land, but that is why we have such a large or wide range, which we have presented.

Herbert Hainer

And in terms of Russia, Matthias, I happily can confirm that the warehouse is now fully functional and is distributing flawlessly products to our over 1000 stores across Russia. How the first quarter will compare to last quarter, I can't provide you with exactly, because even in the third quarter we still had some difficulties, however we were still delivering close to 1 million pieces per week. But at that time it was not to the extent order, we still had some difficulties. But this is now over. We are happy that it is fully functional now, and I can tell you that 2014 is starting well in Russia. So far we don't see any negative impact from the political situation. Obviously, it would be better if this can be solved quickly and peacefully because the longer it goes the more nervous consumers get, and a nervous consumer is never good for business. But so far, as I said, we haven't seen any negative impact.

Sales in the fourth quarter in adidas sports performance increased by about 3%, or 11% currency-neutral. This came from a broad basis, be it football, be it running and so on. And it would have been even higher if we didn't have a slight setback in the outdoor category where warm weather in many parts of the world held us back a little bit. But the main drivers were mainly running and football.

Julian Easthope – Barclay Capital

I would like to ask two or three questions, if I may. Maybe I'll start with your letter to the shareholders which is always quite interesting. There were a couple of statements in there I'd like you to comment on. You say at one point: "We have also made a few executional mistakes towards the Route 2015". So I would be interested to see if you could expand on those. And then, you say at the end, that it will take a little longer to achieve every goal outlined in the strategic plan. I just wondered whether this is a one-year or two-year delay you would expect in achieving Route 2015.

And the second question I have is on Japan. Last year, you had hedged rates from the previous year. But also Japan has seen such a huge currency hit. I just wondered what you have done to offset that.

And the last question, coming back to currency as well, back in 2009 you had a massive hit on the rouble. Now, you obviously managed that incredibly well afterwards. So I just wondered whether you could take the lessons learned from that, what you actually did to offset that – whether this could be applied to the currency movements we have today. Thank you.

Herbert Hainer

Yes, let me start with the first question on the executional mistakes. There is no doubt that the Russian warehouse interaction was something which was not managed well internally. We had not been alerted early

enough about problems in the shift from a very old manual warehouse to a much more automated warehouse. And then, in Russia, we have a particular retail model which we don't have in any other country, where so many stores are shipping back products at the end of the season into the warehouse. This was definitely underestimated and not managed well as we indicated already in our call in November.
I also think for TaylorMade, when we shipped products to the markets in the first half of 2013, we should have been more careful that we don't overload the market. These are the two main things when we talk about executional excellence or mistakes in that case.

Robin Stalker
The hedging in Japan, yes, we have been continuing this. And it is a simple fact that they have had to increase prices as well in the country, where basically, presumably, it was economically desirable on the part of the government to do that sort of thing in any case. But we have over time been increasing prices in Japan. And that is the only thing we can really do to compensate for that currency decline.
Similar to what happened in 2009 in Russia. We still suffer, obviously, from this because we do not really hedge or we do very limited hedging because of the cost of it. We have to buy the rouble in the market at the time they require the product. That was only, however, one of the reasons why we had the significant hit in 2009.
The other reason was because so much of our cost base was at that stage also denominated in dollars. And the biggest lesson we learned from that was to ensure that the vast majority of our costs, and here I'm talking also about rental agreements, that we have them denominated in roubles rather than dollars. And that will help us in this period as well. And barter does not help, however, in terms of the cost of the product that they are buying in an unhedged form in dollars.

Herbert Hainer
And concerning your question on the 2015 targets, I think it is fair to differentiate between the operational achievements and then the absolute financial numbers. In operational terms, I think that we will achieve most of our goals, if not all, at the end of 2015. Unfortunately, as Robin has already outlined, through the currency devaluation, it is much more difficult on the absolute numbers. This might delay the achievement of our goals in euro terms by one or two years.
But we are doing, in my opinion, the right things operationally as we will drive sales in 2014 at a high-single digit rate and are looking forward and positive about the ongoing year with all the products we have in our pipeline.

Andreas Inderst – Exane BNP Paribas
I have three questions, the first one on your risk profile. What kind of measures can you take to further de-risk your business model overall? That is my first question.
The second question is in case the situation in the Ukraine and Russia escalates, what kind of measures can you take in the very short term? Maybe you can give us a few examples.
And my third question is related to TaylorMade. I estimate your EBIT margin must have declined by over 300 basis points with TaylorMade. You answered an earlier question only on the top line, but what kind of margin and recovery can we expect in 2014 for TaylorMade? Thank you.

Robin Stalker
I actually think, although we are always trying to improve our risk management, we have got a pretty good risk model – being a truly global and multi-national organisation, with a very broad portfolio of brands. That is probably the best way to mitigate and manage risk. At least we are spreading it.
We have a very good risk modelling and risk reporting within our Group. We hedge as much as we can. I've mentioned there's a couple of areas where it has not been economic to do so. And we have a very solid management of our balance sheet, and so, we are not exposed to considerable risk in that area.
At the moment we are probably doing all the things we can to identify and to manage risk. And I think that is what you're seeing also coming through in our operationally extremely good performance over the last few years.

Herbert Hainer
Concerning the Ukraine and Russia, obviously we are monitoring the situation quite carefully. And we are in daily contact with our management in Russia. And we would look at our store base if the conflict gets bigger.
But we have less than 10% of our Russian business in the Ukraine. And obviously, we're monitoring especially the Island of Krim, where we have around 10 stores. All the stores are open and operating. But, as I said, we are in daily contact and we could re-route product, inventory, etc. relatively fast in preparing for that.
On the other hand, we obviously want to do business there because as I said before, we haven't seen any negative impact yet.
The last question was on TaylorMade and the margin improvement. I thought I had already given the indication in my first answer that, because of the clean-up activities in the third quarter of 2013, we had a bigger margin hit, which I would not expect in 2014. We will ship less volume in the first quarter and then build it up when the seasons all around the world have started so that we have less inventory and better sell-through. And obviously, this should result in an increase in the margin.

Andreas Riemann – Commerzbank
Three questions from my side. First one on retail, like-for-like, it was plus 3% for the Group. Probably like-for-like was negative in Russia, I assume. So was like-for-like positive in all other regions? And with regard to Reebok and retail, Reebok is doing quite well but Reebok retail was only flat like-for-like in Q4. Why is Reebok only flat on a like-for-like level?
Western Europe, question number two, the business recovered nicely in Q4. Maybe you can go through the regions – any countries that stick out here? Or any countries you are not happy with within Western Europe?
And the third one, to Herbert, I'm trying again on your 2015 targets. You already said some growth might be achieved, yes. So my question is: Is it fair to assume the 11% operating margin growth assumption for 2017, also bearing in mind that your new contract is running into 2017? That would be my three questions.

Robin Stalker
So I will answer the first one. We are up 3% like-for-like in retail. Reebok's less positive performance is largely due to the factory outlet performance. Actually, at the end, a very good sign because the quality of their products is getting better and better and we sell more products through concept stores.

Herbert Hainer
So let me come to Western Europe. Obviously, we had two stand-out countries in Western Europe which was Germany and Spain. For sure helped by the football World Cup because – as you know – we have the German

national team and the Spanish national team under contract; but also supported by our Brazuca ball sales and the running category, as I already mentioned before.
Coming to the last question, the extension of my contract: This definitely hasn't anything to do with our 11% target. Please don't forget: We didn't only have the two targets for 2015, the € 17 billion in sales and the 11% for the operating margin. We have a lot more targets. We want to move the Reebok margin to over 40%. We want to move the dividend payout to the upper end of the 40% range. And a lot of these targets are happening and we are close to achieving them already. The dividend payout ratio is at 37%; the Reebok margin is at 39.7%. And we still have 18 months to go to achieve it.
For achieving the 11% operating margin – this definitely depends on currency movements. And it is hard to predict what this will look like in 18 months. As I said before, what we have to do as a management team is to drive our operational business, drive growth on the one hand and be very cost conscious on the other hand by improving processes and systems. And also as you know, we are consolidating our warehouses. We are bringing Europe together, structurally consolidating countries, etc. And we look at our cost base.

Andreas Riemann
And just to follow up in regard to your answer to my third question, which was on whether all other regions except for Russia were positive on a like-for-like basis, is that right?

Robin Stalker
Yes, that is correct.

Philipp Frey – M.M. Warburg & Co.
My question is also on Western Europe – in the last two quarters, your key competitor reported low double-digit growth rates in this market and has recently shown an over 20% backlog growth rate. Can you elaborate on what you see as the key reasons for your underperformance and what gives you such a level of confidence that you can turn this situation around?
And secondly, can you elaborate on the 2015 margin targets, which you mentioned, would you see this margin upside mainly as a function of operating leverage, or are there certain projects of which you can share some details with us, such as the timeframe of execution and saving volumes or anything like that, which will contribute to your margin improvement?
And lastly, on marketing, you have shown modest increases in the marketing working budget and as a percent of sales, which are more than what we were expecting. Is this a function of the currency exposure in your marketing budget? Or is there a corresponding absolute increase in percentage of sales spending in the advertising portion of your marketing budget?

Herbert Hainer
Let me start with the first question on, as you called it, our underperformance in the European market. This has mainly to do with the comparison with 2012. Remember, we were the official sponsors of the European football championship in 2012. We had a big push for that, which resulted in a strong performance. We were also the partner and sponsor of the London Organising Committee of the Olympic and Paralympic Games (LOCOG) and therefore we outfitted their entire team of volunteers, technical staff and officials. And with all the merchandising licence rights this brought us a big boost in sales. This was worth in total approximately EUR 100 million just for the Olympic merchandising program and 80% to 90% of that was in 2012. So this is

definitely a key factor to consider. Obviously, in football we have a fierce competition going on, but I believe it was these two major 2012 comparison items which I have just outlined that were the major considerations.

Robin Stalker

In terms of your margin question, Philipp, about our gross margin and our operating leverage – let's put it firstly within the context that it's one of the key goals of our 2015 strategy – to fundamentally improve the long-term sustainable profitability of the Group. And I think over the last few years you have seen us make considerable progress on this point. And indeed, even with all the pressures we have had in 2013, we were able to increase the margin by 70 basis points. So we're not quite where we wanted to be by the end of 2013, but we have achieved a considerable amount. And we're very close to our objectives. And I think it will be similarly the case for our efforts in 2014. We will continue to work on all of our initiatives that we believe will make us more efficient and take costs out of the organisation to further sustainably improve our operating margin.

And a lot of these initiatives have already commenced and I have discussed some of these over recent years. Moreover, some of the investments in the first few years will be coming to fruition in the last couple of years of the 2015 plan, so there is that leverage to look forward to. But there are obviously also other items which we will continue to look at and become even better. For example, we have recently announced our "Europe ONE" and "Joint Operating Model" initiatives for Europe and North America, respectively. And we will continue to look at such programmes and not just our existing programmes but other ones too and therefore achieve even more operating leverage.

Your last question was on marketing spend and the slight increase in that item for 2014. The main impact there is the World Cup, which is basically the reason for the slight increase in 2014 over 2013 in terms of marketing costs.

Philipp Frey

But also on the advertising point, is it really that the media volume that you are buying is also increasing?

Robin Stalker

Yes, it is also the communication activities for that event.

Michael Kuhn – Deutsche Bank

Also three questions from my side. First of all, on Russia and on store openings, there seems to be ongoing pressure there to open new stores, due to the number of new mall openings. Once again, the guidance looks like 250 net store openings. My question is, what does that mean for your profitability in Russia and also for operating expenses in the retail channel as a whole?

Secondly on China, as of late there hasn't been much comment around that market. It seems to grow quite steadily at a high-single-digit rate. Is this development set? In that should we expect this performance into 2014 and beyond?

And then lastly, more from a housekeeping perspective, what is your current euro/dollar hedge rate into this year and for the parts that you have hedged into next year? And what could be an operating working capital ratio at year-end in 2014? Thank you.

Herbert Hainer

So on the first question regarding the opening of malls, yes, this is definitely correct. And therefore, we are addressing our store base there. This means we are closing stores which were in the right location five years ago but are no longer in the best locations. And we are definitely going into the new malls; provided they are premium malls and that they are in the right location with better retail equipment and are more attractive to consumers. This is a permanent situation, which our management in Russia constantly monitors and reacts to on an ongoing basis. And this definitely doesn't have any significant impact on our profitability going forward. This is because with over 1,000 stores you can imagine that this is a continuous process where you always have to refurbish, close, or open stores in new areas, wherever consumer trends are.
China, yes, we're happy with our development in 2013. And we definitely can assume that this development will continue in 2014, and definitely we do not intend to stop there.

Robin Stalker
And in terms of dollar hedging, this year, 2014 was just over the 1.33, and looking out into 2015, although we are not extensively hedged yet for 2015, but the indication at the moment is now 1.37.
And in terms of operating working capital, it is our goal, obviously, to further improve it. I think we are around 20.9, which I think you'll agree is not bad. And the increase this year, as I said, was mainly because of the increase in the inventories and part of that was due to the impact of Russia. So we would expect to get that back. And so, we would look to have a slight improvement at the end of this year in terms of our operating working capital as a percentage of sales.

Antoine Belge – HSBC
Three questions from my side. First of all, on Route 2015, specifically on the margin evolution, even though the basis for 2014 would be lower than expected, can we still expect a 160 basis points improvement year-on-year?
My second question is regarding the currency impact on your 2014 guidance, are there also some negative currency impacts on the financial income results?
And finally, I believe in the press release you mentioned some input cost pressures – I would like some details on this, specifically on how you are compared to three months ago, when you gave the initial guidance? Have you seen any worsening elements in terms of input costs?

Robin Stalker
In terms of margin, as I was saying in one of our previous answers, it is our goal to continue to work on things that improve our operating margin. In naming a number, and precisely around the 1%, I can't tell you at the moment exactly what it will be in 2015, that is still too early. We will have a lower cost base, and there are a lot of things which we are doing to fundamentally improve our operating margin. And so our goals are still in place, and they are still what we are aiming for.
In terms of the financial exchange rate impact and the financial results, yes we had an EUR 18 million effect in 2013 versus last year when it was EUR 7 million so that was a deterioration of EUR 11 million.
And in terms of the input costs, we haven't seen anything significant, no substantial deterioration over the last three months. Our guidance is still approximately the same as that which we gave last year, but there is still input pressure that is largely coming from labour costs. But that is obviously reflected in the guidance that we are giving to you today.

Antoine Belge
Can you give a little more detail in terms of what kind of inflation year-on-year you are expecting for these labour costs?

Robin Stalker
Our expenses in our manufacturing base countries are going up at a low percentage point rate and this is mainly because of rising labour costs. The labour increases in some of these markets are significant, however, as part of our overall FOB expenses it is a smaller part, obviously, because the majority of our costs in this case are raw materials.