

Adidas AG (ADDYY): Buy @ \$100.00

Buy Thesis: We view Adidas as the biggest turnaround story in the Athletic Sportswear Industry this year. The Adidas brand grew by an impressive 17% y/y in 2Q16, and 25% y/y on a currency-neutral basis. We believe this momentum can continue in the second half of 2016 driven by the strong retail environment in the company's key major markets – Western Europe, North America and Greater China. Moreover, secular trends in the athletic footwear and lifestyle shoe market will continue to drive strong growth in the company's line of Retro Classics and Performance Designed Street Footwear, particularly as we head into the 3Q Back-to-school and 4Q Holiday Shopping Season. The company also continues to execute well in securing key endorsements from some of the Biggest Names in the Fashion/Music industry (Kanye West) and Basketball (2016 NBA Draft Class). Expect Adidas to have a strong No. 2 Position in the Sneaker market this year and next, with Potential Share gains against UA and NKE.

A possible short-term risk is that current CEO Herbert Hainer is stepping down after the last quarter (2Q16) and new CEO Kasper Rorsted, who joined the Executive Board on August 1st, is taking over the reins during the current quarter (3Q16).

TABLE 1: Adidas Annual Guidance

FY2016 Guidance			FY2017 Estimate			FY2016 Guidance			FY2017 Estimate		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
€4.87-5.00	€4.18	beat	n/a	€4.58	n/a	€19.97B	€21.79B	miss	n/a	€23.22B	n/a

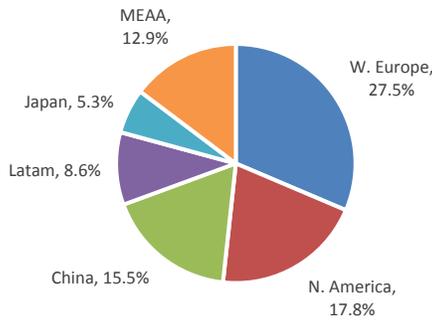
Source: Adidas AG

Adidas delivered outstanding 2Q16 results with Group sales of €4.42B (+13% y/y) driven by continued strong momentum at Adidas (+25%) and Reebok (+7%). Top-line growth accelerated in Western Europe (+29%), North America (+26%) and Greater China (+30%) driven by double-digit sales increases in key performance categories running, soccer and training as well as Adidas *Originals* and Adidas *Neo*. 2Q16 gross margin grew 0.5pp to 48.8% while operating margin climbed 3.4pp to 9.4%. Net income almost doubled to €291M.

Given the strong 1H16 performance, the company raised their outlook for FY2016 with Group sales expected to increase at a rate in the high teens (beating previous guidance of ~15%) and net income to increase between 35% and 39% (beating previous guidance of ~25%) reaching a level between €975M and €1.0B (from 2015 level of €720M).

I. Strong Retail Environment in Key Major Markets

FIGURE 1: 2Q16 Revenue Contribution by Geography

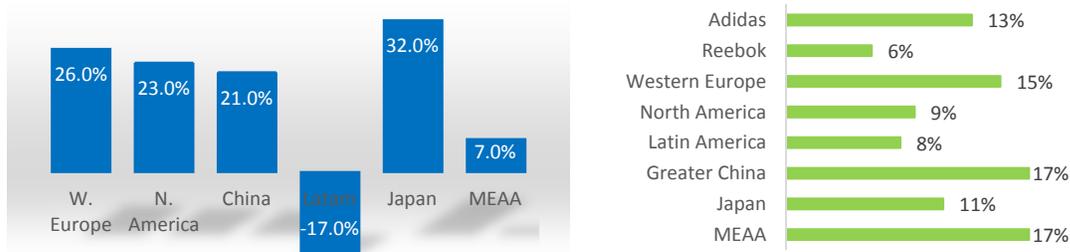


One major factor that differentiated Adidas from its peers in the 2Q16 earnings season was the strength of the retail environment in all of its key markets. Adidas’ major markets include Western Europe (27.5% of total sales), North America (17.8% of total sales) and Greater China, which contributed 15.5% of total revenue in 2Q16 (see Figure 1). In addition, MEAA (Middle East, Africa and other Asian markets) also contributed ~13% of total sales, although this category is more fragmented.

Source: Adidas

While Nike (NKE, Hold) and Under Armour (UA, Buy) both experienced a sales slowdown in North America (their biggest market), Adidas experienced a 23% y/y growth of 2Q sales in North America (see Figure 2 left). From a profit perspective, 2Q operating margin in North America was at 9.4% (up 6.8% y/y), the company’s highest ever. Another key market for Adidas is Western Europe, which also grew nicely at 26% y/y last quarter, with operating margin of 17.3% down slightly by 1.5%, from a year ago.

FIGURE 2: 2Q16 Sales Growth Y/Y (left) and Comp Store Sales (right)



Source: Adidas

Greater China, which contributed ~16% of total sales in 2Q, posted a 21% y/y growth. China is also very profitable for Adidas, with a 37.2% operating margin (up 0.7% y/y) in 2Q. Finally, Japan posted a 32% y/y sales growth with a 21.6% operating margin, up ~5% y/y. Latin America underperformed in 2Q, with sales falling by 17% y/y largely as a result of currency headwinds. Without the weak currency, sales would have actually grown by 8% y/y (on an FX-neutral basis). Operating margin in Latin America was at 10.5% for 2Q16, down 4.6% y/y from last year’s level of 15.1%.

From a brand perspective, Adidas performed much better than Reebok, with comparable store sales of 13% versus Reebok’s 6% (see Figure 2 right). Adidas’ all-in total comparable store sales came in at 12% for 2Q16. The retail environment in Western Europe was also strong with same store sales (SSS) of 15% versus North America, which had weaker SSS of 9%. Both Greater China’s and MEAA’s SSS were impressive at 17% while Japan’s SSS came in at 11%, slightly below the company’s SSS average of 12%.

II. Hitting the Right Trends – Retro Classics are a Big Hit for Back-to-school

Athletic shoes have become core lifestyle footwear, not only in street culture but also for fashionistas and corporate types. Sneakers are more commonly being paired with men’s suits. And it’s the retro styles that are currently popular with consumers. Reissued or “heritage” shoes were the fastest-growing footwear category in the U.S. in 2015, according to the *NPD Group*, which estimates sector sales rose more than 50% and accounted for about 20% of the \$17.2B U.S. athletic footwear market.

For Adidas, the classic retro sneakers are a range of leather tennis (the *Stan Smith* model) and basketball shoes (the *Superstar* model) that date back to the 1960s (see Figure 3). When Adidas relaunched *Stan Smith* in 2014, it wooed the fashion world. High-end designers Phoebe Philo, Raf Simons and Marc Jacobs all wore the white-and-green leather sneaker. U.S. designer Alexander Wang presented catwalk outfits inspired by the shoe.

FIGURE 3: *Stan Smith* Tennis Classic (left) and *Superstar* Basketball Classic (right)



Source: Google images

Retro sales, like the past resurgences of Adidas and other heritage brands, have largely focused on young and athletic buyers. Adidas plans on releasing around 5 to 10 heritage models each year. The next heritage model planned for release is the *Gazelle*. This was the sneaker that superstar pop singer Madonna performed in during her concerts in the 1980s.

Adidas Original Retro Classics Could be a Big Hit for Back-to-school (BTS) Shoppers

Some anecdotal evidence from a few merchandise managers indicates that Retro classic sneakers could be a big hit for this year’s back-to-school (BTS) shoppers.

- Jason Short, VP and Divisional Merchandise Manager (DMM) for Men’s and Women’s athletic shoes at Famous Footwear, said he expects the usual top-notch performance from Nike and Converse, but he is also adding Adidas to his list due to accelerating momentum. According to Jason Short: “Adidas is the new [standout] brand this back-to-school season. They’re trending strongly in the market place compared to a year ago this time.”
- Jeff Van Sinderen, analyst from *B. Riley & Co. LLC*, also noted that there has been a heightened interest in Adidas: “Adidas has made a substantial comeback, and I think that will translate into solid year-over-year gains for them during back-to-school this year.”
- Jill Oralevich, DMM at Lester’s in New York, said that she was also stocking up on fashion athletic picks from Madden as well as Puma and Adidas this season. She stated that “Fashion sneakers continue to drive the footwear business - that whole [Adidas] *Stan Smith*, tennis-inspired lace-up sneaker trend is big.”

III. Adidas' U.S. Comeback Strategy – Bet Big on Basketball and Kanye West

FIGURE 4: Adidas CMO Eric Liedtke and Kanye West



Source: Footwear News

Adidas announced on June 29th that it was expanding its partnership with hip-hop artist Kanye West to launch Adidas + Kanye West, a Yeezy-branded entity that would create footwear, apparel and accessories for all genders across street and sport, including sneakers for the basketball court and the football field. The new business unit will be run out of Adidas' U.S. headquarters in Portland, Oregon, and will be overseen by Kanye West along with a separate Adidas team.

Kanye West has already designed Yeezy products, like the Yeezy Boost 350, for Adidas Originals which have been selling out within hours (see Figure 5 right). The new partnership will extend beyond its current lifestyle focus to include performance gear, thus offering options for both sport and street. Adidas CMO, Eric Liedtke has called the new alliance unprecedented and referred to it as the most significant partnership ever created between a non-athlete and an athletic brand (see Figure 4 above).

It is not clear how well Kanye's fashion brand will translate to athletes looking for performance footwear. Until recently, offering a performance line to a non-athlete was almost unheard of in the sportswear industry, but the rise of the athleisure trend has changed everything. Dick's Sporting Goods Inc. launched a collection of activewear with singer Carrie Underwood, and actress Kate Hudson started her own Spandex collection, Fabletics.

Traditional sportswear makers have done limited collaborations with entertainers, including Nike with actor Kevin Hart and Puma with singer Rihanna. On its recent earnings call, Foot Locker pointed to the success of the Rihanna line and other casual gear, while sales of signature basketball shoes for star athletes like LeBron James have slumped.

Adidas Bets Big on 2016 NBA Draft Class

In the basketball footwear and sports apparel market, sales are mainly driven by endorsements. In 1984, Adidas had the opportunity to sign a 21-year old NBA rookie by the name of Michael Jordan. In what was perhaps the biggest missed opportunity ever, Adidas decided to pass and Michael Jordan signed on with Nike. After 32 years and several billion dollars later, Nike is still reaping the rewards from Adidas' colossal mistake.

Not willing to make that same mistake again this year, Adidas signed on five of the 2016 NBA Draft's biggest names: Brandon Ingram, Jaylen Brown, Dragan Bender, Kris Dunn, and Jamal Murray – the second, third, fourth, fifth and seventh overall draft picks respectively (see Figure 6). The 2016 NBA draft class is considered to be one of the most talented and deepest in recent memory, at least since the 2009 Draft which featured Steph Curry, Blake Griffin, and James Harden.

FIGURE 5: Yeezy Boost 350



Source: Google Images

FIGURE 6: Adidas 2016 NBA Draft Class

Source: Adidas News Stream

Just as the basketball market seemed to be consolidating to a two-horse race between Under Armour (UA) and Nike (NKE), Adidas stepped in and took over this Draft Class by storm. If Ingram or Dunn or any of Adidas' 2016 bets pay off, then we could probably see the early stage of Adidas' USA comeback strategy beginning to gain some traction.

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