

Nike, Inc. (NKE): Sell @ \$46.00

Sell Thesis: We suggest investors stay on the sideline for the near term as we believe market conditions in North America and Western Europe will make it difficult for Nike to re-accelerate top-line growth. We believe the Retro trend in athletic footwear is a disadvantage for Nike allowing its competitors to gain market share. Our informal survey of Foot Locker’s Top-selling Footwear shows that Nike’s signature Brand in Men’s Basketball (ex-Jordan Brand) has not gained any traction while Under Armour has gained significant share in Women’s Basketball. Furthermore, the challenging operating environment in North America could make it difficult for Nike to bring a “pull-market” condition by the second half of Fiscal 2017.

TABLE 1: Nike F2Q17 Results

F2Q17 Results			F3Q17 Guidance			F2Q17 Results			F3Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
0.50	0.43	beat	n/a	0.60	n/a	8.18B	8.08B	beat	n/a	8.67B	n/a

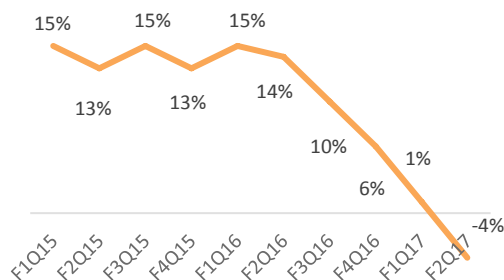
Source: Nike, Inc. and Estimize.com

I. Challenges Continue for North America in 2017

A. Return of Performance Basketball – Nike’s Strong Suit – Not Likely in Near Term

The Retro trend in athletic footwear continues to be popular in North America – much to Nike’s disadvantage. Nike takes pride in being the leader in innovation for performance footwear and apparel – focusing mainly on the athlete’s needs. The shift in consumer preference from high-performance footwear to a more casual, fashion-oriented style has caught the company off-guard.

FIGURE 1: North America Future Orders Growth



Source: Nike, Inc.

Nike’s inability to pivot quickly to the new trend has been costly. North America Future Orders growth, which comprise 6-month advance orders from North American wholesalers, has been dropping steadily since F2Q16 – about the time the Retro trend started (see Figure 1).

An informal survey by *Viola Advisory* of Foot Locker’s (FL: rated Buy) top-selling sneakers in Men’s Basketball category showed Michael Jordan’s Retro basketball sneakers to be the most popular.

TABLE 2: Footlocker Top 15 Selling Sneakers – Men’s Basketball

Men's Basketball	
1 Nike Air Force 1 Low	9 Jordan Retro 3
2 Adidas Harden Volume 1	10 Jordan Retro 7
3 Jordan True Flight	11 Under Armour Curry 3 (Black)
4 Adidas Originals Superstar (White)	12 Nike Air Presto
5 Nike Air Force 1 High	13 Nike Air Force 1 High
6 Jordan Retro 1 High OG	14 Jordan AJ XXXI (Black)
7 Under Armour Curry 3 (Blue)	15 Jordan Dub Zero
8 Jordan Son of Mars	

Source: Footlocker.com 12/19/16

Jordan Retro footwear took 7 slots of the Top 15 category as of 12/19/16, confirming our belief that the Retro trend is still strong (see Table 2). This is good news-bad news for Nike since it owns the Jordan brand but its main competitive advantage is in its own Nike signature brand. Table 2 shows that Nike Basketball sneakers only took 4 slots, including the No. 1 spot, while both Adidas and Under Armour each occupied two spots respectively.

B. Nike Losing Share to Under Armour in Women’s Basketball

Our survey also covered Footlocker’s Top 15 Best Sellers in Women’s Basketball footwear as of 12/19/16. The survey results showed that Nike has lost considerable ground to Under Armour in Women’s Basketball category. Of the Top 15, Under Armour had 8 models while Nike had 6 models. Surprisingly, no Adidas basketball sneaker made it in the Top 15 (see Table 3).

TABLE 3: Footlocker Top 15 Selling Sneakers – Women’s Basketball

Women's Basketball	
1 Nike Air Versatile (Black)	9 Nfinity IL 12T
2 UA Clutchfit Drive 3 (Red)	10 Nike Prime Hype DF 2016
3 Nike Air Versatile (Red)	11 Nike Prime Hype II
4 UA Clutchfit Drive 3 (White)	12 UA Jet Mid (White)
5 UA Torch Fade	13 Nike Prime Hype II
6 Nike Air Versatile	14 UA Torch Fade
7 UA Clutchfit Drive 3	15 UA Torch Fade
8 UA Jet Mid	

Source: Footlocker.com 12/19/16

While Table 3 shows how far Under Armour has come in transitioning from sportswear apparel to high-end performance footwear, it also indicates that Nike may no longer be the sole leader in manufacturing innovative high-end athletic footwear. Nike now has to compete with two other brands in the global sporting goods market – Adidas and Under Armour. Furthermore, market conditions have also changed drastically for Nike – from being a performance-driven market to a more fashion-conscious, style-driven market where average consumer preferences are what matters, instead of the peak-performance athlete.

II. Near-term Headwinds in Key Markets

A. Sequential Sales Declines in Key Markets

Nike competes with Adidas and Under Armour in the top 3 global markets – North America, Western Europe and Greater China. Sales in North America comprise 45% of Nike’s total revenue while Western Europe and Greater China account for 17% and 13% of total revenue respectively. For the current F2Q17 quarter, Nike’s sales momentum slowed down in North America and Western Europe, while Greater China had a slight positive growth (see Table 4). Sales in North America grew 3% y/y in F2Q17 down from 6% y/y growth in F1Q17. On a sequential basis, North America sales fell by 9.5%.

TABLE 4: Division Revenues (by Geography, \$ Million)

	F2Q17 11/30/2016	Y/Y Change	Q/Q Change	% of Rev.	F1Q17 8/31/2016	Y/Y Change
North America:						
- Footwear	2,219	3%		27%	2,518	6%
- Apparel	1,273	4%		16%	1,317	6%
- Equipment	158	-4%			196	5%
Total	3,650	3%	-9.5%	45%	4,031	6%
W. Europe:						
- Footwear	865	2%		11%	1,147	2%
- Apparel	454	16%		6%	531	22%
- Equipment	66	5%			85	8%
Total	1,385	7%	-21.4%	17%	1,763	7%
Greater China:						
- Footwear	669	12%		8%	710	19%
- Apparel	355	16%		4%	269	9%
- Equipment	31	-3%			41	0%
Total	1,055	12%	3.4%	13%	1,020	15%
Total Nike Brand:						
- Footwear	4,822	5%	-11.9%	59%	5,472	7%
- Apparel	2,535	7%	-0.5%	31%	2,549	9%
- Equipment	346	0%		4%	423	4%

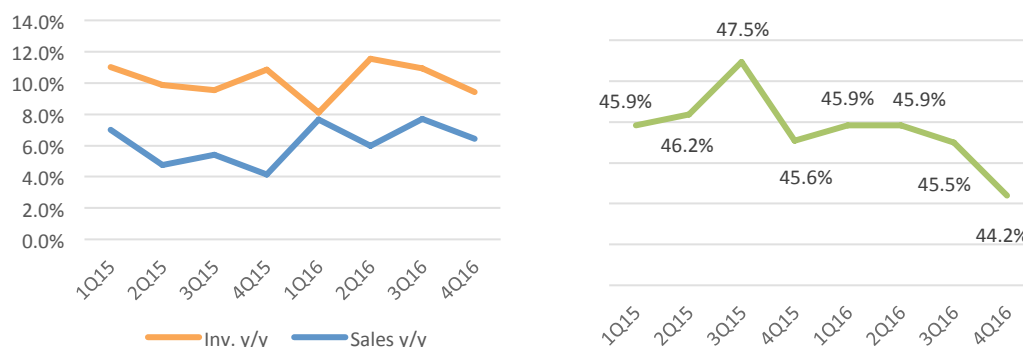
*Highlighted area = Revenue Drivers; Source: Nike, Inc.

In Western Europe, y/y sales was flat at 7% from last quarter to the current quarter, but sequentially, sales slowed down by 21.4% q/q. In Greater China, y/y sales slowed from 15% to 12% from last quarter. Sequentially, sales in Greater China grew 3.4% q/q, maintaining a slight positive momentum. Overall, momentum in Nike brand footwear sales (59% of total revenue) dropped by ~12% sequentially while apparel sales (31% of total revenue) remained flat at minus 0.5% q/q (see Table 4).

B. Demand-pull Conditions in North America Not Likely in Near Term

During the call, management indicated it wanted to bring its key North American market back to “demand-pull” market conditions in the back half of fiscal 2017. Setting up the right conditions for a “pull market” means constraining inventory growth while consumer demand continues to expand. By supplying just enough product to meet growing demand, the company can maintain higher average selling prices and grow its gross margin. We believe the period between 2Q15 to 3Q15 was the last time demand-pull conditions existed for Nike (see Figure 2 and the corresponding data on Table 5).

FIGURE 2: Quarterly Inventory to Sales Growth, Y/Y (Left Chart) and Gross Margin (Right Chart)



Source: Nike, Inc.

TABLE 5: Factors Leading to a Demand-pull Condition in North America

Inventory Y/Y	Sales Y/Y	Period	Gross Margin	GM Change	Event Description
11.0%	7.0%	1Q15	45.9%		
9.9%	4.8%	2Q15	46.2%		Demand-pull condition occurred 2Q15 – 3Q15
9.5%	5.4%	3Q15	47.5%	+130 bps	
10.8%	4.1%	4Q15	45.6%	-190 bps	
8.1%	7.7%	1Q16	45.9%	+30 bps	Heavy promotional Pricing 4Q15 – 1Q16
11.6%	6.0%	2Q16	45.9%		
10.9%	7.7%	3Q16	45.5%		
9.4%	6.4%	4Q16	44.2%		

Source: Nike, Inc.

Table 5 shows that between 2Q15 to 3Q15, Nike managed to constrain y/y inventory growth by ~40 bps (from 9.9% down to 9.5%) while y/y sales grew by ~60 bps (from 4.8% to 5.4%). By keeping inventory levels tight, gross margin for 3Q15 grew by an impressive 130 bps, from 46.2% to 47.5%.

The demand-pull market of 3Q15 was short-lived, only lasting for one quarter and was followed by a period of heavy promotional pricing (from 3Q15 to 4Q15) as inventory growth swelled to 10.8% y/y and sales slowed down dramatically to 4.1% y/y, causing gross margin to fall by 190 bps. The following period of 1Q16 also saw heavy promotional pricing as Nike cleared excess inventory – inventory only grew by 8.1 y/y (down 270 bps) while sales grew to 7.7% y/y (up 360 bps), causing gross margin to only grow slightly by 30 bps to 45.9% (see Figure 2 and Table 5).

The key takeaway for a successful demand-pull market is healthy quarterly sales growth combined with constrained inventory growth. This allows average sales price to remain elevated and gross margin to grow. As soon as sales growth begins to slow, inventory levels begins to build and average sales price starts to drop causing downward pressure on gross margin.

At this time, we do not believe it is possible for Nike to bring pull-market conditions to North America by F2H17. This is because the Retro trend is likely to continue in 2017 and Nike's competitors continue to gain market share. For Nike to constrain inventory growth by limiting product supply, consumers will simply go to Adidas and Under Armour to meet their demand. The athletic footwear market will always be competitive and promotional pricing will always be a given market condition for some time.

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