

Nike, Inc. (NKE): Sell @ \$48.00

Sell Thesis: We Believe Nike has lost the ability to pivot fast enough to satisfy the changing consumer preferences in casual athletic footwear. While Nike continues to innovate, it mostly does so in Athletic Performance – missing the Big Trend which is in Lifestyle/Fashion Performance. This enabled Adidas to move quickly on the Growing Fashion Performance Trend and slice into segments of Nike’s share in Running, Athletic casual, Basketball and Sportswear Apparel in Nike’s largest Markets – North America, Western Europe and Greater China – representing 44%, 19% and 11% of Nike’s Total Revenues respectively. We believe this trend of continued share gains by both Adidas and Under Armour could continue for the next 4 to 5 Quarters.

TABLE 1: Nike F1Q17 Results

F1Q17 Results			F2Q17 Guidance			F1Q17 Results			F2Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
0.73	0.56	beat	n/a	0.52	n/a	9.06B	8.83B	beat	9.51B	8.28B	beat

Source: Nike, Inc. and Estimize.com

Nike reported F1Q17 earnings beating both top- and bottom-line estimates. The company reported revenues of \$9.06B (+8% y/y) vs. consensus \$8.83B and EPS of 73 cents (+9% y/y) vs. consensus 56 cents (see Table 1). Revenue guidance for next quarter also came in strong with \$9.51B (+5% y/y) vs. consensus of \$8.28B. Despite the solid print, the stock headed lower in after-hours trading as analysts were concerned about the weak North America Future Orders of 1% vs. analyst expectations of 5%. Moreover, 1Q gross margins fell by 200 basis points to 45.5% as higher ASPs were offset by a higher off-price mix, a shift of expenses from operating overhead to cost of goods sold and the negative impact of exiting the Golf equipment business. Other investor concerns include the increasing competition from Adidas and Under Armour which may weigh on the stock’s performance in the next several quarters.

I. Nike Misses the Mark – too Slow (or too Stubborn?) to Pivot to Changing Consumer Trends in the Sneaker Market

According to *The NPD Group*, less than a third of consumer spending on activewear was intended for athletic activities, the lowest percentage in four years. Consumers buy sportswear shoes and apparel with the intent towards work use or recreational/social weekend activities. Furthermore, *NPD’s* monthly tracking analysis also showed that activewear purchases for aerobic and fitness based activities have accelerated (through August) over the past two years, while purchases for running use has decelerated. According to *NPD*, the results indicate that activewear spend has become more closely tied to lifestyle (i.e., fashion) than to technical purposes.

We believe that one of the main reasons why Adidas was able to stage a major comeback was because it was able to successfully meld fashion with the sports shoe business. Management at Adidas changed the way they viewed the sneaker business – from just strictly sports performance to mixing it with the latest fashion trend that was hip and cool – which in today’s market is retro.

Management at Nike, on the other hand, continues to emphasize the importance of performance when they think of the sneaker business. Manufacturing sneakers with the highest technical innovation has always been what Nike is all about – it’s in their DNA. During the latest F1Q17 earnings call, Jim Duffy from *Stifel Nicolaus* asked Nike management the following question:

Question from Jim Duffy (Stifel Nicolaus): *My next question is just on general trends. At the moment, lifestyle fashion trends appear to be gaining in popularity while on a relative basis performance appeal seemingly is softer. Can we speak to any historical precedents for this and how those trends played out in past cycles?*

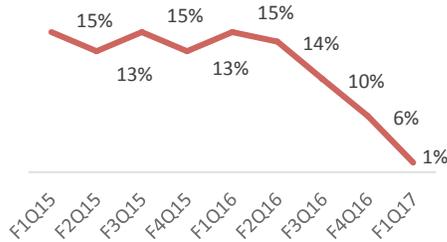
Answer from Mark Parker (CEO/President): *There’s always been a shift back and forth from a consumer standpoint. I’ll just back up and say though that sport in general and innovation have always been and I think always will be two of the most powerful drivers of culture and style. NIKE always – we’ve always started with the athlete. That’s how we create the insight to drive innovative product and then we amplify that across the portfolio... We see tremendous growth in all areas, specifically in both dimensions of performance and sportswear. So performance is really an element of sportswear for NIKE and that’s what helps to separate and distinguish NIKE in the marketplace.*

Answer from Trevor Edwards (President, NIKE Brand): *I’ll maybe just add and say been there, done that certainly around as you approach the idea around sportswear and certainly the lifecycle that we go through. We continue to believe that our performance business is actually what is at the root of what drives continued innovation in the marketplace. We then leverage that point of view to create sport style innovation. We can serve the consumer who want a performance product to wear as a lifestyle product but also something that he can wear to compete – he or she to wear to compete in. And again, this current environment is great for us. This is when we are at our best and that’s why I said been there, done that and we’ll do it again.*

While we respectfully disagree with Trevor Edwards’ view that the current environment is great for Nike, we do agree with Mark Parker’s assessment that the current consumer trend between lifestyle and performance could shift back and forth. The only question is how long will the current trend in lifestyle sports footwear last? We believe that the casual athletic lifestyle could last for some time. If this were the case, then how soon can Nike change their current strategy? The answer may depend on how quickly the competition begins to catch up and possibly overtake them.

II. Continued Headwinds in North American Athletic Footwear

FIGURE 1: North America Future Orders Continues to Trend Down



Source: Nike, Inc.

North America Future Orders have continued to trend down for 4 consecutive quarters since F1Q16 (see Figure 1). Nike’s Future Orders in North America rose by a mere 1% in F1Q17, missing analysts’ forecasts for a 5% increase.

We attribute the weakness in N.A. Future Orders to a) greater mix shift in off-price channel, b) weakness in Nike Brand Basketball, and c) greater competition from both Adidas and Under Armour.

While North America Future Orders growth could bounce back to the low- to mid-single digit range for the next 4 to 5 quarters, a re-acceleration towards the high-single digits is not likely due to continued softness in basketball (due to increased competition from UA) and greater competition from Adidas in running and casual athletic (retro) sneakers.

- A. *Greater Mix Shift in Off-price Channel:*** Nike is selling more in the off-price channel. Despite indications from management that this is a temporary one-quarter event, inventories continue to remain out of balance in the U.S. and gross margins have dropped ~200 basis points y/y in the quarter. Nike has also reduced its full-year gross profit margin outlook following the weaker-than-expected results. By selling more in the off-price channel, Nike could run the risk of tarnishing its once-premium brand.
- B. *Weakness in Nike Brand Basketball:*** Nike's signature basketball business is ~5% of total wholesale revenue and declined by 1% y/y in FY16 (see Table 2). At the recent F1Q17 earnings call, management did not spend any time discussing the Basketball business, preferring instead the Sportswear (+14% y/y), Jordan (+18% y/y) and Running (+3% y/y) categories.

TABLE 2: Nike Brand Revenue (FY2016 vs. FY2015, \$ Million)

By Category (wholesale only)	FY2016	Reported Y/Y Change	FX-neutral Y/Y Change	% of Wholesale Revenue
Running	5,017	3%	10%	18%
NIKE Basketball	1,378	-1%	2%	5%
Jordan Brand	2,753	18%	21%	10%
Football (Soccer)	2,143	-5%	7%	8%
Men's Training	2,611	3%	6%	10%
Women's Training	1,344	5%	11%	5%
Action Sports	711	-4%	3%	3%
Sportswear	7,513	14%	22%	28%
Golf	706	-8%	-6%	3%
Others	3,073	0%	6%	11%

Source: Nike, Inc.

Looking forward, Nike may have to drop prices on more high-profile basketball sneaker launches in order to take back share from Under Armour's Stephen Curry brand which is cheaper than Nike's. A prime example of the intensified competition weighing on Nike was explained by Finish Line's (FINL) CEO Sam Sato during the Sept. 23 earnings call: "Nike's signature basketball [sales] were down in the [second] quarter," he told analysts. Adding that Adidas' business "remains on fire" and that Under Armour saw "explosive" demand for the latest Curry basketball sneaker.

III. Slowdown in Greater China Momentum

China is a key growth market for sportswear makers, as more middle-class Chinese consumers head for the gym, take up sports or travel for outdoor adventures. The sportswear market in China, including everything from swimsuits to soccer shorts, grew to 165B yuan, or \$25.3B, last year, up 11% from a year earlier, according to market research firm *Euromonitor International*. Nike is currently the No. 1 sports brand in China by market share, leading with 17.5% share of sales, while Adidas is right behind with 16%.

As part of diversifying the economy, China's leaders are also championing the development of sports, building up athletic events as well as arenas and television stations to support them. A big priority is soccer. Chinese president Xi Jinping, a huge soccer fan, has said his dream is that China will qualify for, host and win a future World Cup. Chinese companies have invested in overseas soccer teams and Chinese

teams have paid large transfer fees to bring in star players from Europe. As an example, conglomerate Dalian Wanda Group bought a 20% stake in Spanish soccer club Atlético Madrid last year.

Table 3 below shows Nike's revenue performance over the last two quarters in its three largest markets: North America (44% of total revenue), Western Europe (19% of total revenue) and Greater China (11% of total revenue).

TABLE 3: Nike Revenues (by Geography, \$ Million)

	F1Q17 8/31/2016	Reported Y/Y Change	FX-neutral Y/Y Change	% of Total Rev.	F4Q16 5/31/2016	Reported Y/Y Change	FX-neutral Y/Y Change
North America:							
- Footwear	2,518	6%	7%	28%	2,367	2%	2%
- Apparel	1,317	6%	6%	15%	1,163	-2%	-2%
- Equipment	196	5%	5%		205	-10%	-10%
Total	4,031	6%	6%	44%	3,735	0%	0%
W. Europe:							
- Footwear	1,147	2%	4%	13%	1,027	14%	15%
- Apparel	531	22%	26%	6%	411	33%	34%
- Equipment	85	8%	10%		64	12%	13%
Total	1,763	7%	10%	19%	1,502	19%	19%
Greater China:							
- Footwear	710	19%	25%	8%	681	24%	28%
- Apparel	269	9%	15%	3%	268	9%	14%
- Equipment	41	0%	4%		30	-9%	1%
Total	1,020	15%	21%	11%	979	18%	23%

Source: Nike, Inc.

Some key observations from Table 3 include:

- Nike was able to improve its performance in North America this quarter as sales grew 6% y/y on a constant currency basis from 0% last quarter. North America footwear sales, which comprise 28% of total revenue grew from 2% to 6% and apparel sales increased from minus 2% to plus 6%.
- Western Europe slowed markedly from 19% to 7% caused by a drop in footwear sales from 14% y/y last quarter to 2% this quarter. Apparel sales also fell from 33% to 22% in the latest quarter.
- Some softening in Greater China as footwear sales slowed from 24% to 19% causing overall China growth to decelerate from 18% y/y to 15% y/y for the quarter.

We believe that momentum in Greater China has slowed as Under Armour continues to penetrate the Chinese basketball market with the growing popularity of Steph Curry basketball sneakers. Moreover, as soccer continues to gain favor among Chinese sport fans, Adidas has already made plans to grow its soccer business in China in the same way that Nike grew its basketball business.

Adidas plans on opening 3,000 new stores in China by 2020, expanding its store count from 9,000 to 12,000 stores. Moreover, the company wants to more than double the cities where it sells its running gear and tennis shoes to more than 2,200 Chinese cities. With such ambitious growth plans from its main competitor, it may be difficult for Nike to sustain its growth momentum in that market in the coming years.

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