

Nike, Inc. (NKE): Hold @ \$52.00

Hold Thesis: Nike’s F4Q16 results show the company Still Struggling to Grow Sales in its biggest market, North America, where U.S. consumer purchases of Sports Footwear and Apparel have slowed down considerably and competition remains fierce. Despite Impressive Growth Rates in Western Europe and Greater China as well as Early Traction in Nike’s DTC (direct-to-consumer) Strategy, we remain cautious in the short term until we see demand conditions in North America starting to improve.

TABLE 1: Nike F4Q16 Results

F4Q16 Results			F1Q17 Guidance			F4Q16 Results			F1Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
0.49	0.48	beat	n/a	0.56	n/a	8.24B	8.28B	miss	8.85B	9.16B	miss

Source: Nike, Inc. and Estimize.com

Nike reported F4Q16 results with earnings of 49 cents (0% y/y) beating expectations of 48 cents but revenue of \$8.24B (+6% y/y) just fell short of analysts’ estimate of \$8.28B and top-line guidance for the current quarter also missed (see Table 1). Geographically, North America, which represents 45% of total revenue, continues to exhibit weakness while sales in both Western Europe (18% of total revenue) and China (12% of total revenue) continue to show strength.

TABLE 2: Sales (\$ Million) by Region

	F4Q16	% of Total	Y/Y Change
N. America	3,735	45%	0%
W. Europe	1,502	18%	19%
China	979	12%	18%

North America revenue of \$3.74B was flat y/y, missing estimates of \$4.01B. Sales in Western Europe and Greater China grew 19% and 18% respectively, from a year earlier. Western Europe and China are Nike’s second- and third-largest regions by sales (see Table 2).

Source: Nike, Inc.

FIGURE 1: Growth of Future Orders



Source: Nike, Inc.

Another telling sign of Nike’s business slowdown is the deceleration of Future orders. These are orders placed 5 to 6 months in advance by Nike’s wholesale partners. After seven straight quarters of double-digit growth, Nike projected aggregate Future orders to grow at just 6% in F4Q (see Figure 1).

Regionally, Future orders for North America excluding currency changes rose 11%, slightly short of the 12% projected by the Street. Futures orders in Western Europe and China grew 11% and 24% respectively, from the previous year's quarter.

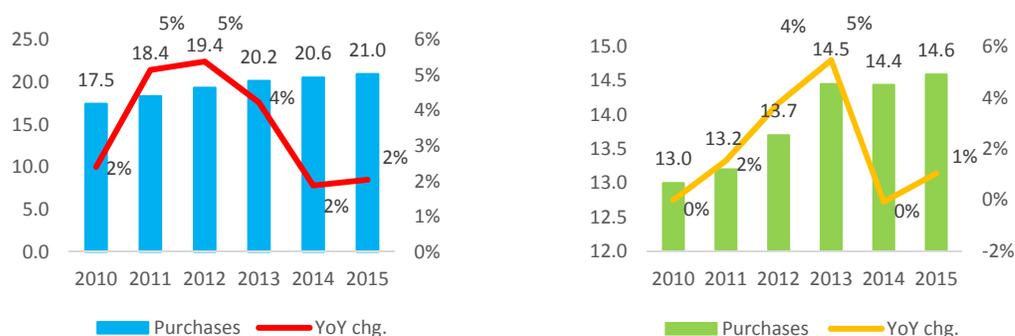
F4Q16 Highlights

- **Gross margin** declined 30 bps. to 45.9% as higher ASPs were more than offset by higher product costs, the negative impact of clearing excess inventory in North America and unfavorable changes in foreign currency exchange rates
- **SG&A expense** grew 7% to \$2.8B; demand creation expense was \$873M, up 7%, reflecting investments in digital demand creation, sports marketing and brand events which were partially offset by lower advertising expense; overhead expense increased 7% to \$1.9B, reflecting continued growth in the Direct-to-Consumer (DTC) business and targeted investments in operational infrastructure and consumer-focused digital capabilities
- **Net income** decreased 2% to \$846M as revenue growth was offset by lower gross margin, higher SG&A expense and a higher tax rate
- **Cash and short-term investments** were \$5.5B or \$467M lower than last year as growth in net income and proceeds from the issuance of debt in the second quarter were more than offset by share repurchases, investments in infrastructure and working capital as well as higher dividends

I. North American Market Headwinds: Weak Demand and Stiff Competition

We believe the weakness in U.S. consumer purchases of both sports footwear and clothing in 2015 has had an adverse impact on Nike's top-line growth (see Figure 2). Growth in U.S. footwear purchases slowed down markedly from 4% in 2013 to half the growth rate of ~2% in both 2014 and 2015 (see Figure 2 left). Footwear is Nike's core product making up 63% of total sales in North America. These sales totaled ~\$2.37B up 2% y/y in F4Q.

FIGURE 2: U.S. Consumer Purchases (\$ Billion) of Sports Footwear (left) and Sports Clothing (right)



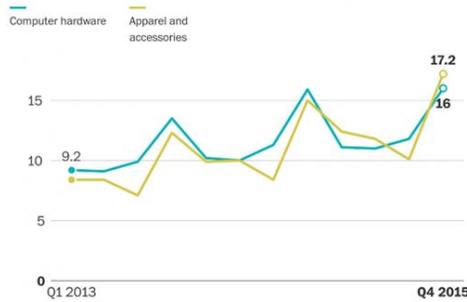
Source: Statista, 2016

U.S. consumer purchases of sports clothing have also been weak. After growing 5% y/y in 2013, sports clothing growth was flat in 2014 and only 1% y/y in 2015. Nike's apparel sales make up about 31% of total revenue in North America and amounted to ~\$1.16B, down 2% y/y in F4Q.

II. Online Sportswear Apparel/Shoes Outperforming E-commerce

Nike's maturing business may also partly explain the slowdown in sales growth. However, there is a broader secular growth trend in apparel and e-commerce sales that might help bring back some momentum to Nike's top-line growth.

FIGURE 3: Digital Commerce Sales by Category (Quarterly, \$ Billion)

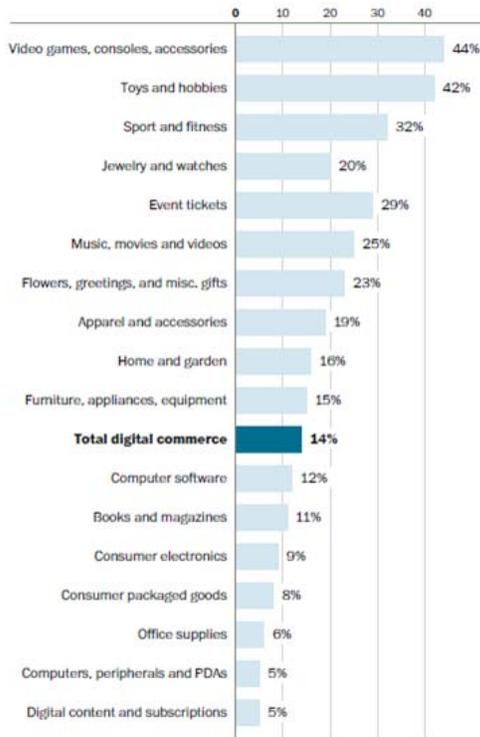


Source: ComScore

ComScore analyzed which shopping categories drew the biggest online sales in 2015. Computer hardware, i.e., personal computers and tablets, has been the leader for at least a decade. But last year, for the first time, spending on apparel and accessories took first place in e-commerce sales. In three out of four quarters in 2015, apparel and accessories brought in the most dollars. For the year, clothing generated \$51.5B in online sales, slightly edging out \$51.1B spent on personal computers and tablets (see Figure 3).

This trend is mostly driven by companies such as Amazon (AMZN) and the proliferation of delivery services that facilitate the movement of goods from the warehouse to consumers' doorsteps as well as the convenience of return, refund and exchange of items. These factors encourage consumers to rely on e-commerce rather than making trips to the shopping malls.

FIGURE 4: Growth in 2015 Online Retail Sales (Y/Y % Change in Dollars Spent Online, by Category)



Source: ComScore

According to ComScore, apparel is also among the categories that is benefiting from the explosive growth in smartphone shopping. ComScore stated that many of the categories that registered strong increases in online spending last year were those where the purchases were not "highly considered", meaning that customers did not spend much time researching before buying.

Furthermore, these purchases were especially conducive to being made on a small screen. Therefore, as the majority of online shopping is being done on mobile devices, these "non-highly considered" categories are getting a tailwind from the change in consumers' shopping habits.

Figure 4 shows the categories that grew the fastest and the slowest in online retail sales for 2015. Note the sport and fitness category grew at 32% y/y and apparel and accessories grew at 19% y/y. Both categories outperformed the digital commerce average growth rate of 14% in 2015.

Nike has been one of the early movers into the online brand space that enabled it to reap some benefits, such as: 1) a lower cost of capital, 2) controlled merchandising and messaging, 3) direct consumer feedback and 4) a more personalized experience that embedded the consumer deeper into its ecosystem.

III. Nike E-commerce/Digital Strategy: A Long-term Game Changer

There are only a few apparel companies in 2015 that have built a successful online platform that integrates both product messaging and sales channels into a consumer first digital platform. Nike is the segment leader in the shoes category of the online apparel market. The company is ranked #47 in the *Internet Retailer* Top 1000 with a market share of 17% (see Table 3). Moreover, Nike was able to grow its web sales of \$1.0B at a rate of 30.4% in 2015, achieving one of the highest growth rates in the online apparel market.

TABLE 3: Online Apparel Market: Segment Market Leaders (Ranked by 2015 Web Sales)

Market Segment	Segment Leader	Top 1000 Rank	2015 Web Sales	2015 Growth	Segment Share
Dept. Stores	Macy's Inc.	6	\$6,210,000,000	15.0%	40%
General Apparel	Gap Inc.	20	2,530,000,000	1.1%	19%
Shoes	Nike Inc.	47	1,000,000,000	30.4%	17%
Women's Apparel	Yoox Net-a-Porter	72	558,000,000	19.7%	14%
Sportswear	Fanatics Inc.	38	1,265,000,000	15.0%	32%

Source: *Internet Retailer, Behind the Online Apparel Boom, 2016*

Management has set an aggressive target for its e-commerce business that is projected to reach \$7B by FY20 from \$1.2B in FY15. The company is looking to leverage online as the point of introduction for many of its products which could result in a powerful marketplace when combined with retail and wholesale management.

Nike has seen an acceleration in its e-commerce business over the past few years growing at 26% in 2013 followed by 42% in 2014 and 30% in 2015. The company hopes to generate \$9.5B in additional revenue from its DTC (direct-to-consumer) business in the next 5 years with 60% coming from online. Given its early entry into the digital commerce space along with the current traction achieved so far in the online apparel market, we are positive on the company's long-term growth driven by its e-commerce and digital strategy.

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