VOYANT ADVISORS

Voyant Global

Comprehensive Analysis

Adidas AG (ADGSn.DE - €88.63)

January 10, 2014

adidas AG (ADGSn.DE) is an international retailer of sports footwear, apparel, and accessories. The Company operates in three operating segments: Wholesale, Retail, and Other Businesses. The Wholesale segment comprises the adidas brand and Reebok brand activities with retailers. The Retail segment comprises its own retail stores and e-commerce channels of the adidas and Reebok Brands. The Other Businesses segment comprises the brands TaylorMade-adidas Golf, Rockport, Reebok-CCM Hockey, and other brands. The Company is headquartered in Herzogenaurach, Germany and its year-end is 12/31.

Thesis Summary

In spite of multiple revenue guidance reductions in FY 13, we believe the Company was able to report margin expansion (and prevent a significant FY 13 margin guidance reduction) by (1) delaying the sell-through of potentially obsolete or impaired inventories, (2) reducing its provisions for sales returns, allowances and warranties, and (3) assigning PP&E with longer useful lives to reduce near-term depreciation expense. Further, we believe revenue may remain pressured by potential market share losses in the adidas brand, weak trends in the TaylorMade brand, and a potential pull-forward of TaylorMade revenue. **As a result, we believe FY 14 consensus estimates and the Company's mid-term FY 15 financial guidance may be difficult to achieve.** Our concerns are heightened by a decline in cash from operations-to-net income and the existence of previous internal control weaknesses.

Catalysts and Timing

- The Company may revise its FY 14 guidance on its Q4 13 Conference Call.
- The Company may revise its "Route 15" revenue and operating margin targets.

Company Data

Country/Exchange	Germany/Frankfurt
Shares Outstanding (mil)	209.2
Float (mil)	204.9
Short Interest (mil)	--
% of Float Short	--
Avg. Volume	748,679
52 Week Range	€66.05 - €93.22
Dividend Yield	1.5%
Market Cap (bil)	€18.5
Net Debt (bil)	€0.4
TTM Rev (bil)/Rev Growth	€14.4/(2.5%)
TTM EBITDA (mil)	€1,434.0
TTM Gross Margin %/Change	49.3%/200 bps
TTM Op. Margin %/Change	8.2%/20 bps

Historical EPS

	Actual	Expected	Surprise
Q3 13	€1.51	€1.53	(1.3%)
Q2 13	€0.82	€0.86	(4.7%)
Q1 13	€1.47	€1.42	3.5%

Estimate Drift

	Est.	1M Ago	6M Ago	1Yr Ago
Q4 13 Rev	€3,450	€3,450	€3,595	€3,949
FY 13 Rev	€14,478	€14,477	€15,355	€15,841
FY 14 Rev	€15,527	€15,531	€16,378	€16,858
Q4 13 EPS	€0.20	€0.20	€0.25	--
FY 13 EPS	€4.01	€4.01	€4.48	€4.55
FY 14 EPS	€4.98	€4.96	€5.34	€5.37

Peers Mentioned In This Piece

- Nike, Inc. (NKE)
- Puma SE (PUMG.DE)

Please refer to the end of this report for an updated version of *The Short List*.

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Background and Bull Story

Company Background

Company description: adidas AG (ADGSn.DE) is an international retailer of sports footwear, apparel, and accessories. The Company operates in three operating segments: Wholesale, Retail, and Other Businesses. The Wholesale segment comprises the adidas brand and Reebok brand activities with retailers. The Retail segment comprises its own retail stores and e-commerce channels of the adidas and Reebok Brands. The Other Businesses segment comprises the brands TaylorMade-adidas Golf, Rockport, Reebok-CCM Hockey, and other brands. The Company is headquartered in Herzogenaurach, Germany and its year-end is 12/31.

Segment and geographic data: In FY 12, the Company's Wholesale segment accounted for 64.1% (70.1%) of revenue (operating income), the Retail segment accounted for 22.7% (17.1%), and the Other Business segment accounted for 13.3% (12.8%). In addition, the Company generated 27.4% of its revenue in Western Europe, 13.1% in European Emerging markets, 22.9% in North America, 10.5% in Greater China, 16.2% in Other Asia markets, and 10.0% in Latin America.

Results by Segment (% of total)	FY 12 Revenue	FY 12 Operating Income	Results by Geography (% of total)	FY 12 Revenue
Wholesale	64.1%	70.1%	Western Europe	27.4%
Retail	22.7%	17.1%	European Emerging markets	13.1%
Other Businesses	13.3%	12.8%	North America	22.9%
--	--	--	Greater China	10.5%
--	--	--	Other Asia markets	16.2%
--	--	--	Latin America	10.0%
Total	100.0%	100.0%	Total	100.0%

Product categories and brand data: In FY 12, the Company's footwear, apparel, and hardware products accounted for 46.5%, 42.3%, and 11.2% of revenue, respectively. In addition, the adidas brand accounted for 76.2% of revenue, Reebok accounted for 11.2%, TaylorMade-adidas Golf (TaylorMade hereinafter) accounted for 9.0%, Rockport accounted for 1.9%, and Reebok-CCM Hockey accounted for 1.6%.

Results by Product Category (% of total)	FY 12 Revenue	Results by Brand (% of total)	FY 12 Revenue
Footwear	46.5%	adidas	76.2%
Apparel	42.3%	Reebok	11.2%
Hardware	11.2%	TaylorMade	9.0%
--	--	Rockport	1.9%
--	--	Reebok-CCM Hockey	1.6%
Total	100.0%	Total	100.0%

The Bull Story: 2014 FIFA World Cup, Long Term Targets, Retail Store Expansion

2014 FIFA World Cup may drive sales of soccer apparel, shoes, and related accessories: In 2014, the FIFA World Cup will be hosted by Brazil. The FIFA World Cup soccer tournament is held every 4 years and involves 32 member teams of the *Fédération Internationale de Football Association.* The competition lasts one month and is one of the most widely viewed and followed sporting events in the world.[1] Since 1970, adidas has been the Official Sponsor of the FIFA World Cup, which provides adidas extensive licensing and marketing rights for the tournament. The official licensing rights allows adidas to sell official FIFA World Cup merchandise including the "Official Match Ball." During the previous three FIFA World Cups in FY 02, FY 06, and FY 10, adidas brand revenue increased by an average of 11.1% on a constant currency basis, respectively. In light of adidas' global soccer presence and official sponsorship of the FIFA World Cup, the 2014 FIFA World Cup in Brazil may drive sales of the Company's soccer apparel, shoes, and related accessories.

World Cup Year Results (growth in constant currency)	FY 10	FY 06	FY 02
adidas brand revenue	9.2%	14.0%	10.0%

Strong 2015 financial targets: In November 2010, the Company provided a five-year strategic plan called "Route 2015." As part of the plan, the Company guided for high-single-digit annual growth in constant currency revenue that would result in €17.7 billion in total revenue by 2015 (which represented a 47.5% increase from FY 10). In addition, the Company aimed to achieve operating margin expansion from 7.5% in FY 10 to 11.0% by 2015.

Retail store expansion may drive growth: The Company defines controlled spaces as retail stores, mono-branded franchise stores, shop-in-shops, eCommerce, joint ventures with retail partners, and co-branded stores with sports organizations. In its FY 12 Annual Report, the Company represented it planned to drive revenue contribution from controlled spaces from 45.0% in 2012 to over 50.0% over the next few years. In addition, the Company guided to open at least 550 adidas and Reebok stores between FY 13 and FY 18, which would represent a 21.1% increase in adidas and reebok branded stores (including outlet stores).

> We intend to increase the portion of sales that comes from controlled space initiatives to over 50% of Group sales in the coming years (2012: 45%). This includes new openings of adidas and reebok own-retail stores, the further extension of our mono-branded franchise store base in markets such as China, as well as new shop-in-shops initiatives with retail partners around the world. In terms of our own retail, we intend to open at least 550 adidas and Reebok stores over the five year period, as well as grow significantly our eCommerce business, which we project to increase to €500 million by 2015. (FY 12 Annual Report, 03/07/13)

Greater China expansion: In FY 11 and FY 12, the Company's Greater China revenue increased 23.4% and 15.0% on a constant currency basis, respectively. In addition, in FY 11 and FY 12, Greater China revenue increased 90 bps and 130 bps as a percentage of total revenue to 9.2% and 10.5%, respectively. In its Q4 12 Conference Call on 03/07/13, the Company represented its adidas' brand had significant momentum in the Chinese market and would continue to increase market share in FY 13. In the nine months ended Q3 13, Greater China revenue increased 7.0% year-over-year on a constant currency basis, faster than the Company's other geographic markets.

> In terms of highlights, without doubt, the standout performer was Greater China. Sales for the year increased 15%, to a new record level of over 1.5 billion euro, with double-digit growth in every quarter. ...Looking forward, from our market research, we can see that adidas' brand appeal has the most momentum in the Chinese market right now. As a result, I am confident we will continue to take more market share and grow faster than our major competitors also in 2013. (CEO Mr. Herbert Hainer, Q4 12 Conference Call, 03/07/13)

[1] In 2010, the FIFA World Cup hosted by South Africa was broadcasted in every country worldwide and in-home television coverage of the competition reached over 3.2 billion people, or approximately 46.0% of the global population.

Greater China Analysis (€ in millions)	9M 13	FY 12	FY 11
Greater China revenue	€1,244.0	€1,562.0	€1,229.0
Year-over-year change in constant currency	*7.0%*	*15.0%*	*23.4%*
Greater China revenue as a % of total	11.3%	10.5%	9.2%
Year-over-year change	*110 bps*	*130 bps*	*90 bps*

Valuation: As of 01/08/13, the Company's shares traded at 10.6 times forward enterprise value-to-EBITDA.

Valuation Analysis	Forward EV/EBITDA
adidas Group (ADSGn.DE)	10.6
Nike, Inc. (NKE)	14.2
Puma SE (PUMG.DE)	9.8
Peer average	12.0
% below the peer average	(11.6%)

Voyant's Earnings Risk Assessment

In spite of multiple revenue guidance reductions in FY 13, we believe the Company was able to report margin expansion (and prevent a significant FY 13 margin guidance reduction) by (1) delaying the sell-through of potentially obsolete or impaired inventories, (2) reducing its provisions for sales returns, allowances and warranties, and (3) assigning PP&E with longer useful lives to reduce near-term depreciation expense. Further, we believe revenue may remain pressured by potential market share losses in the adidas brand, weak trends in the TaylorMade brand, and a potential pull-forward of TaylorMade revenue. As a result, we believe FY 14 consensus estimates and the Company's mid-term FY 15 financial guidance may be difficult to achieve. Our concerns are heightened by a decline in cash from operations-to-net income and the existence of previous internal control weaknesses.

FY 13 Sales Below Forecast, Yet Margin Guidance Remains Strong

Q2 13 Earnings Report – Company lowered revenue guidance, while increasing gross margin guidance: On 08/08/13, the Company reported Q2 13 revenue (earnings) of €3,383.0 million (€0.82), 2.4% (5.7%) below the consensus estimate of €3,467.3 million (€0.86). In addition, the Company reduced its FY 13 revenue guidance from mid-single digit growth to low- to mid-single digit growth. While the Company lowered its FY 13 revenue guidance, it increased its gross margin guidance by 50 basis points (bps hereinafter) and reiterated its operating margin guidance.

09/19/13 – Company lowers revenue guidance for the second time in six weeks, maintains margin guidance: In a press release on 09/19/13, the Company lowered its FY 13 revenue guidance from low- to mid-single digit growth to low single-digit growth.[2] In the press release, the Company attributed the revised guidance to (1) further strengthening of the euro against certain major currencies, (2) a short-term distribution constraint at its new Chekhov, Russia distribution center, (3) continued global market softness, and (4) increased promotions in its TaylorMade business. **In spite of the second revenue guidance reduction in six weeks, the Company maintained its FY 13 gross margin and operating margin guidance.**[3]

FY 13 Guidance Analysis	Provided on 09/19/13	Provided in Q2 13 Earnings Report	Provided in Q4 12
Total revenue growth (CC)	Low-single-digit	Low-to mid-single digit	Mid-single-digit
Gross margin	48.5% - 49.0%	48.5% - 49.0%	48.0% - 48.5%
Operating margin	8.5%	Approaching 9.0%	Approaching 9.0%
Earnings	€3.92 – €4.06	€4.25 – €4.40	€4.25 – €4.40

Q3 13 results: On 11/07/13, the Company reported Q3 13 revenue (earnings) of €3,879.0 million (€1.51), 1.3% below the consensus estimate of €3,929.1 million (€1.53). In addition, gross margin (operating margin) increased 190 basis points (10 basis points) year-over-year to 49.3% (11.9%), 110 (10) bps above the consensus estimate. In its Q3 13 Earnings Release on 11/07/13, the Company attributed its results to (1) tougher prior year comparisons that included the sell-in of event-related products for the London 2012 Olympic Games, (2) ongoing macroeconomic softness in Europe, and (3) TaylorMade weakness due to a later seasonal start and lower rounds of golf played. In a press release on 12/03/13, the Company reaffirmed its FY 13 revenue, gross margin, operating margin, and earnings guidance.

[2] The Company reduced its Retail segment revenue guidance from high single-digit to low double-digit growth to high single-digit growth and its Other Businesses segment revenue guidance from mid- to high single-digit growth to low- to mid single-digit growth. Included in its Other Businesses segment, the Company reduced its TaylorMade revenue guidance from mid single-digit growth to low single-digit growth.

[3] The Company did not explicitly state gross margin guidance in its 09/19/13 release. However, we believe a reiteration of prior guidance was implied given the lack of new guidance in the release. In its Q3 13 Quarterly Report released on 11/07/13, the Company reiterated its FY 13 gross margin guidance of 48.5% - 49.0%.

During the third quarter of 2013, adidas Group sales were stable on a currency-neutral basis. From a regional perspective, currency-neutral revenues in Western Europe decreased 6%. This was mainly due to high prior year comparisons related to the sell-in of event-related products for the London 2012 Olympic Games as well as the ongoing macroeconomic challenges in the region. In European Emerging Markets, currency-neutral sales increased 2% with growth in most of the region's markets. Group sales in North America were down 5% on a currency-neutral basis. This development was mainly due to sales declines at TaylorMade-adidas Golf owing to a more challenging golf market as a consequence of the late seasonal start and lower rounds played. (Q3 13 Press Release, 11/07/13)

Results Analysis (€ in millions except earnings)	Q3 13	Consensus	*Above (below) the Consensus Estimate*
Revenue	€3,879.0	€3,929.1	*(1.3%)*
Gross margin	49.3%	48.2%	*110 bps*
Operating margin	11.9%	11.8%	*10 bps*
Earnings	€1.51	€1.53	*(1.3%)*

As discussed hereinafter, we believe revenue may remain pressured by potential market share losses in the adidas brand, weak trends in the TaylorMade brand, and a potential pull-forward of TaylorMade revenue. **Further, in spite of multiple revenue guidance reductions in FY 13, we believe the Company was able to report margin expansion (and prevent a significant FY 13 margin guidance reduction) by (1) delaying the sell-through of potentially obsolete or impaired inventories, (2) reducing its provisions for sales returns, allowances and warranties, and (3) assigning PP&E with longer useful lives to reduce near-term depreciation expense.**

Sales Decline in Largest End Markets, Significantly Trailing Nike's Performance

Background on primary end markets: Over the last three fiscal years, Western Europe and North America represented the Company's two largest geographic end markets, representing on average 28.8% and 23.2% of revenue, respectively. The Company's biggest competitor, Nike, Inc. (NKE), generated approximately 19.7% and 43.0% of revenue in Western Europe and North America over the same period, respectively.[4] In the most recent fiscal year, Nike's revenue in the North America market was $10.4 billion, compared to adidas' $4.4 billion in USD equivalent (calculated based on the average exchange rate). In contrast, adidas' total sales in the Western European market was $5.2 billion USD equivalent, compared to Nike's $4.1 billion.

Geographic Mix Analysis (% of total revenue)	adidas Prior 3-Yr Average	Nike Prior 3-Yr Average
Western Europe	28.8%	19.7%
North America	23.2%	43.0%
Rest of world	48.0%	37.3%
Total revenue	100.0%	100.0%

adidas' constant currency sales decline in largest end markets, while Nike's increased: In the most recent quarter, adidas' constant currency revenue declined 6.5% (4.7%) year-over-year in Western Europe (North America), while Nike's constant currency revenue increased 15.0% (9.0%) year-over-year. Accordingly, adidas' constant currency revenue growth in Western Europe (North America) trailed Nike's by 2,150 bps (1,370 bps). In adidas' Q3 13 Earnings Release on 11/07/13, the Company represented the decline was primarily due to tougher

[4] Nike's geographic mix data excludes its Converse business as it is not disclosed by geography. We believe our analysis is conservative given that Converse revenue has grown by a double-digit percentage on a constant currency basis in the past two years.

prior year comparisons, which benefited from the 2012 Olympic Games in London. On its Q2 14 Conference Call on 12/19/13, Nike attributed its revenue growth to double-digit growth in sportswear, running, basketball, and women's training categories. Over the past five periods, adidas' constant currency revenue growth in Western Europe (North America) has trailed Nike's constant currency revenue growth by 1,240 bps (1,610 bps). **In light of the trend in constant currency revenue performance between adidas and Nike in Western Europe and North America, we believe adidas may have lost share in its primary markets.**

Revenue Growth Analysis (% in constant currency)	Qt	Qt-1	Qt-2	Qt-3	Qt-4	Qt – Qt-4 Average
adidas Western Europe	(6.5%)	(11.2%)	(6.4%)	(4.1%)	1.1%	(5.4%)
Nike Western Europe	15.0%	8.0%	0.0%	8.0%	4.0%	70.0%
adidas' growth differential	*(2,150 bps)*	*(1,920 bps)*	*(640 bps)*	*(1,210 bps)*	*(290 bps)*	*(1,240 bps)*
adidas North America	(4.7%)	(2.0%)	3.2%	(7.5%)	(4.7%)	(3.7%)
Nike North America	9.0%	9.0%	12.0%	18.0%	17.0%	13.0%
adidas' growth differential	*(1,370 bps)*	*(1,100 bps)*	*(880 bps)*	*(2,550 bps)*	*(2,170 bps)*	*(1,610 bps)*
adidas total revenue	0.0%	0.0%	0.0%	1.0%	4.0%	1.0%
Nike total revenue growth	9.0%	8.0%	9.0%	10.0%	10.0%	9.2%
adidas' growth differential	*(900 bps)*	*(800 bps)*	*(900 bps)*	*(900 bps)*	*(600 bps)*	*(820 bps)*

TaylorMade-adidas Golf May Have Pulled Revenue Forward; FY 14/15 Estimates At Risk

Background on TaylorMade's recent growth despite declining golf market in the US: As mentioned, TaylorMade (contained within the Other Businesses segment) accounted for 9.0% of total FY 12 revenue. According to the National Golf Foundation, the rounds of golf played in the US have been in decline for at least a decade. Based on SRI International, an independent nonprofit research institute, the US golf market has declined 9.4% from $75.9 billion in 2005 to $68.8 billion in 2011. Based on our research, we believe the decline is primarily attributable to high unemployment rates, lower retiree wealth, and less replacement players from younger generations. In spite of a declining golf market, revenue from the TaylorMade brand has increased by an average of 12.1% on a constant currency basis between FY 10 and FY 12. We believe TaylorMade has achieved revenue growth in recent years through market share gains from competitors such as Nike Golf and Callaway Golf Company (ELY).

TaylorMade Golf Analysis (€ in millions)	FY 12	FY 11	FY 10
TaylorMade revenue	€1,344.0	€1,044.0	€909.0
Year-over-year change	*28.7%*	*14.9%*	*9.4%*
Year-over-year change in constant currency	*19.5%*	*15.9%*	*0.9%*

TaylorMade revenue declines in Q2 13 and Q3 13: In Q2 13 (Q3 13), TaylorMade revenue declined 8.4% (15.6%) year-over-year on a constant currency basis. On its Q3 13 Conference Call, the Company represented its results were impacted by continued weakness in the US golf market (which declined 9.0% during the first six months of FY 13) and its decision to rebalance inventories to "healthier levels" through markdowns and incentives. As previously mentioned, the Company represented that weaker-than-expected performance at TaylorMade contributed to its FY 13 guidance reductions.

> So to the first question – the golf market. Yes, we definitely believe that we will grow in the fourth quarter and going forward in the golf market. Even though there is no doubt it is a more challenging

market. **As I said before, the market is not growing, especially because of the first six months this year where the number of rounds played went down in the US by 9% and obviously this has an influence on consumption.** (CEO Mr. Herbert Hainer, Q3 13 Conference Call, 11/07/13) [emphasis added]

Thirdly, due to the continued softness in the global golf market, where TaylorMade-adidas Golf is the dominant leader, **we took the decision in the third quarter to be more consequent and accelerate the rebalancing of inventories to healthier levels in the marketplace. As a result, sales declined 16% in the segment in the third quarter and gross margins decreased over 10 percentage points due to additional markdowns and incentives**. This alone 3 had a 70 basis point negative impact on the Group's gross margin performance in the third quarter. (CEO Mr. Hainer, Q3 13 Conference Call, 11/07/13) [emphasis added]

TaylorMade Golf Analysis (€ in millions)	Q3 13	Q2 13	Q1 13	Q4 12	Q3 12
TaylorMade revenue	€210.0	€348.0	€423.0	€273.0	€283.0
Year-over-year change	*(25.8%)*	*(13.2%)*	*9.3%*	*18.2%*	*16.0%*
Year-over-year change in constant currency	*(15.6%)*	*(8.4%)*	*12.6%*	*14.6%*	*3.5%*
TaylorMade as a % of total revenue	5.4%	10.3%	11.3%	8.1%	6.8%
Year-over-year change	*(140 bps)*	*(110 bps)*	*120 bps*	*100 bps*	*30 bps*

We have the following observations:

1. **The Company may have lost market share to Callaway Golf, in our view:** On its Q3 13 Conference Call on 10/24/13, Callaway Golf represented that constant currency revenue increased 38.0% (13.0%) year-over-year in Q3 13 (9M ended Q3 13). We note this was 5,360 bps (1,530 bps) higher than TaylorMade's constant currency revenue decline of 15.6% (2.3%) and represented a significant reversal from Callaway's revenue performance in recent years. In addition, Callaway represented its growth significantly outpaced the industry and that its US market share increased 110 bps year-over-year to 15.1% as of August 2013. **We believe TaylorMade's recent revenue weakness may have resulted from (in-part) from potential market share losses to Calloway.**

   In Q3, we delivered an impressive revenue growth. **On a constant currency continuing business basis, our year-over-year revenues increased 38% for Q3 and are up 13% for the first nine months.** We're confident this growth significantly outpaced our industry, which has experienced soft market conditions for the year in whole, especially in North America and Europe. …In support of this position, **Datatech market share numbers show we continue to gain share in the U.S., finishing August with a 15.1% year-to-date hardgood dollar share, up 110 basis points year-over-year** and with a considerably better field inventory position in the last year. …Looking at Q4, our revised guidance shows constant currency continuing business revenue growth of 11% year-over-year. (Callaway Golf CEO Mr. Oliver G. Brewer, Q3 13 Conference Call, 10/24/13) [emphasis added]

2. **FY 13 TaylorMade revenue guidance is back-end weighted:** In order to achieve the Company's FY 13 constant currency revenue guidance of low single-digit growth for the TaylorMade business, revenue would have to increase 23.0% y/y in Q4 13.[5] **As discussed next, we believe the significantly back-end weighted guidance may have prompted the Company to accelerate a TaylorMade product launch into the Q4 13 period.**

[5] We are assuming a 2.5% constant currency growth rate for "low-single digit" growth.

TaylorMade Golf Analysis (€ in millions)	Q4 13 Implied	Q3 13	Q2 13	Q2 13
TaylorMade revenue in constant currency	23.0%	(15.6%)	(8.4%)	12.6%

3. **We believe TaylorMade accelerated the launch of its JetSpeed line of clubs in order to achieve its back-end weighted FY 13 guidance:** In December 2013, TaylorMade launched a new line of woods (drivers, fairway woods, and hybrids) called JetSpeed. We note in its Q3 13 Quarterly Report on 11/07/13, the Company represented it would only release (1) TaylorMade SLDR fairway woods and Rescue Clubs and (2) TaylorMade SpeedBlade irons during Q4 13. On its Q3 13 Conference Call, the Company confirmed it released its new SLDR fairway woods and SpeedBlade irons during Q4 13 and that it had an array of "**new innovative products coming through in 2014**." Further, based on our assessment of many professional golf club review websites, consumers have been surprised by the quick release of another set of TaylorMade woods just three quarters after the release of RBZ Stage 2 driver, fairway woods, and rescue hybrids in Q1 13. **Based upon these points of evidence, we believe the Company potentially accelerated the release date of its JetSpeed line in order to achieve its back-end weighted FY 13 TaylorMade revenue guidance.**

   > And we're making good traction with our latest product launches, which we just brought out, the SLDR driver, in the third quarter, and now the SLDR fairway woods and the new Speedblade irons. **And we have an array of new innovative products coming through in 2014.** So I believe that we will win further market shares in the golf market, but obviously it would be much easier if the golf market would grow. (CEO Mr. Hainer, Q3 13 Conference Call) [emphasis added]

4. **FY 14 consensus estimate and FY 15 TaylorMade revenue target may be difficult to achieve:** In FY 12, TaylorMade represented a large majority (approximately 68.0%) of Other Businesses segment revenue. Hence, we believe the Company's guidance and consensus estimates for the Other Businesses segment are a proxy of expected TaylorMade performance. While the Company expects TaylorMade revenue to increase by a low-single digit percentage in FY 13, the consensus estimate implies accelerated growth of 5.7% for the Other Businesses segment in FY 14. Further, in its FY 12 Annual Report, the Company provided Other Businesses segment revenue guidance of €2.2 billion for FY 15. Assuming TaylorMade's revenue mix remains constant, we believe the Company expects approximately €1,496.0 million of revenue contribution from TaylorMade in FY 15, which would represent a 15.7% increase from the anticipated level in FY 13. **Given (1) a year-to-date decline in TaylorMade revenue (down 8.4% y/y) in FY 13, (2) the expectation for accelerated growth in FY 14 and FY 15, and (3) evidence suggesting (in our view) that TaylorMade accelerated the launch of its JetSpeed line of clubs into Q4 13, we believe the FY 14 consensus estimate and FY 15 Other Businesses revenue guidance may be difficult to achieve.**

Elevated Inventory Levels May Result in Margin Pressure, In Our View

Background on inventory: The Company outsources nearly 100.0% of its production to independent third-party suppliers who are primarily located in Asia. The Company also operates a limited number of production and assembly sites in Germany, Sweden, Finland, the US, and Canada. Merchandise and finished goods are valued at the lower of cost or net realizable value and costs are determined using the average cost method.

Inventory surges in Q3 13: In Q3 13, inventory increased 6.2% year-over-year in absolute terms to €2,513.0 million, while revenue declined 7.0% y/y to €3,879.0 million. Accordingly, inventory-to-revenue increased 14.2% year-over-year to 0.648. We note that inventory-to-revenue was 11.8% higher than the prior five-year seasonal average of 0.579. On its Q3 13 Conference Call, the Company attributed half of the inventory build to goods in transit and the remainder to an unexpected short-term distribution constraint at its Russia distribution facility. In addition, the Company represented there was a slight increase in the aging of TaylorMade inventory.

> I'll take the first couple and yes, that's right, inventories are up 12% currency-neutral year-over-year. **But a good 50% of that is goods in transit.** And I don't know how much exactly of that is related to World Cup, but obviously that does play a role. The whole point about the goods in transit increase, however, is

that it's obviously fresh product and it plays into our expectations that obviously our fourth quarter is growing and also the start of the next year. So that's the majority of it. **Clearly Russia also played a role in the other 50%, with Russia being a very significant part of that.** But the rest of the markets are all very clean. **There's a slight increase in or deterioration in the ageing of the TaylorMade product**, but otherwise everything's looking very good from an inventory point of view. (CFO, Mr. Robin Stalker, Q3 13 Conference Call) [emphasis added]

Secondly, in one of our most important Route 2015 markets, Russia/CIS, we had an unexpected short-term distribution constraint in Q3 as a result of the transition to our Group's new distribution facility in Chekhov, close to Moscow. **This significantly impacted the quantity of new product deliveries to stores, which was a major contributor to the double-digit comp store sales decline we saw in that market during the third quarter.** (CEO Mr. Hainer, Q3 13 Conference Call) [emphasis added]

Inventory Analysis (€ in millions)	Q3 13	Q2 13	Q1 13	Q4 12	Q3 12	Prior 5 Year Q3 Average
Revenue	€3,879.0	€3,383.0	€3,751.0	€3,369.0	€4,173.0	€3,471.0
Inventory	€2,513.0	€2,611.0	€2,346.0	€2,486.0	€2,367.0	€2,012.0
Inventory-to-revenue	0.648	0.772	0.625	0.738	0.567	0.579
Year-over-year change	*14.2%*	*(0.2%)*	*(0.1%)*	*(4.4%)*	*(7.7%)*	--

<u>We have the following observations:</u>

1. **Russia distribution issue does not rationalize the inventory build, in our view:** As mentioned, the Company attributed 50.0% of the inventory build (approximately €156.4 million) to a distribution issue at its new facility in Chekhov, Russia. We note the Company only generated 13.1% (13.7%) of its revenue from the European Emerging Markets in FY 12 (Q3 13).[6] In light of the relatively low revenue contribution from the entire region, we do not believe inefficiencies at one distribution center in Russia would account for half of the Company's inventory build. If the Russia distribution inefficiencies did represent one-half of the inventory build, we would be concerned about potentially severe logistical problems that could result in inventory impairment charges.

2. **Healthy peer inventory levels:** In the most recent period, the Company's inventory-to-revenue increased 1,470 bps faster than its peer group average. In our view, the elevated level of inventory relative to peers suggests Company-specific demand challenges. We believe elevated inventory levels resulted from weaker-than-expected demand (as evidenced by multiple revenue guidance reductions within a short period of time).

Peer Inventory-to-Revenue Analysis (€ in millions)	Qt	Qt-4	*Change*
adidas AG (ADSGn.DE)	0.648	0.567	*14.2%*
Nike, Inc. (NKE)	0.575	0.557	*3.1%*
Puma SE (PUMG.DE)	0.701	0.724	*(3.2%)*
Peer average	0.638	0.641	*(0.5%)*
Above (below) the peer average	*1.5%*	*(11.5%)*	*1,470 bps*

3. **Overestimation of TaylorMade demand and/or market share losses resulted in excess inventory, in our view:** As previously mentioned, the Company represented that weaker performance at TaylorMade contributed to its FY 13 guidance reduction. Further, on its Q3 13 Conference Call, the Company represented it was more promotional to rebalance TaylorMade product and that inventories remained slightly aged at the end of Q3 13. In light of weaker-than-expected TaylorMade performance and the acknowledgment of aged inventories, we

[6] The Company's European Emerging Markets region includes Russia.

believe the Company potentially delayed sell-through of obsolete or impaired (older generation) inventories. **Hence, we believe margins may be pressured as the Company engages in promotional activities to sell excess inventory.**

> Thirdly, due to the continued softness in the global golf market, where TaylorMade-adidas Golf is the dominant leader, **we took the decision in the third quarter to be more consequent and accelerate the rebalancing of inventories to healthier levels in the marketplace. As a result, sales declined 16% in the segment in the third quarter and gross margins decreased over 10 percentage points due to additional markdowns and incentives**. This alone had a 70 basis point negative impact on the Group's gross margin performance in the third quarter. (CEO Mr. Hainer, Q3 13 Conference Call)

4. **Working capital guidance corroborates our view that the Company may be carrying excess inventories:** In its FY 12 Annual Report, the Company guided for FY 13 average operating working capital as a percentage of sales to "increase moderately" from the FY 12 level of 20.0%. In its Q3 13 Quarterly Report, the Company altered its guidance for FY 13 average operating working capital as a percentage of sales from a "moderate increase" to an "increase." While average working capital as a percentage of revenue increased 70 bps from 19.9% to 20.6% in Q3 13, we believe working capital would be higher without a potential temporary increase in accounts payable (up 8.5% y/y). **In our view, the Company's guidance for higher working capital levels concurrent with several revenue shortfalls suggests (1) the Company overestimated demand and (2) heightened gross margin risk related to excess inventory levels.**

5. **Ongoing SAP and IT systems implementation heightens our inventory concerns**: In its FY 12 Annual Report, the Company represented it was implementing five new supporting system solutions that used SAP as a basis to standardize, automate, bundle, and execute market processes and system functionalities. In addition, the Company represented the systems were critical to its "flexible make-to-stock service," which aimed to improve product availability and inventory utilization. As the systems integration costs were cited as a component of the significant increase in capital expenditures guidance (as discussed in more detail later), we believe the implementation was a material project. In light of the surge in inventory levels and the supply chain issues at the Company's new distribution facility in Russia, we believe the Company may have experienced inefficiencies related to the systems implementation. **In our view, inventory builds resulting from systems implementations often result in (1) missed sales opportunities and (2) high impairment risk given the potential for incorrect orders and/or inefficient internal distribution of inventory.**

Reserve Reductions Prevented Significant Margin Guidance Revision, In Our View

Background on other current provisions and sales returns, allowance, and warranty reserve: The Company's other current provisions account includes (1) marketing, (2) personnel, (3) provisions for returns, allowances and warranty, (3) tax liabilities and (4) Sundry provisions. Provisions for returns, allowances, and warranty primarily arise due to agreements with customers and the obligation of fulfilling customer claims with regard to product returns. The amount of the provision is estimated based upon a historical assessment of returns, allowances, and warranty utilization as well as current agreements. The Company only discloses the details of the other current provisions account on an annual basis. As of 12/31/12, the Company's returns, allowances, and warranty reserve accounted for 34.0% (€215.0 million) of the other current provisions balance (€632.0 million).[7]

Sales returns and allowance reserve declined in Q2 13: In Q2 13, other current provisions declined €51.0 million (€82.0 million) sequentially (year-over-year) in absolute terms and was flat (declined 180 bps) as a percentage of

[7] We assumed the provisions for sales returns, allowances, and warranty is a cost of sales expense (rather than an offset to revenue, i.e. contra-revenue) given that certain of the provisions are directly related to product costs (i.e. warranties). As of the date of the publication, we did not have an opportunity to speak to the Company's Investor Relations (IR) department. We will ask about following topics if provided the opportunity to discuss with the Company: (1) FY 15 revenue and margin targets, (2) TaylorMade's competitive and promotional environment, (3) the reduction of the provision for sales returns, allowances and warranty and its related accounting treatment, (4) the ongoing SAP and IT systems implementation, and (5) the movement of certain working capital accounts including inventory and accounts payable levels.

revenue. In its Q2 13 Quarterly Report on 08/08/13, the Company represented the decline was primarily related to a decrease in provisions for returns and allowances.

> Other current provisions were down 15% to €462 million at the end of June 2013 versus €544 million in 2012. This primarily relates to the decrease in provisions for returns and allowances. (Q2 13 Quarterly Report, 08/08/13)

Sales returns and allowance reserve declines further in Q3 13: In Q3 13, other current provisions declined by an additional €57.0 million (€182.0 million) sequentially (year-over-year) in absolute terms and declined 320 bps (360 bps) as a percentage of revenue to 10.4%, representing the lowest percentage of revenue in at least three years. In its Q3 13 Quarterly Report, the Company represented the decline was primarily driven by lower sales returns and allowance provisions and other operational provisions.

> Other current provisions were down 31% to €405 million at the end of September 2013 versus €587 million in 2012. This primarily relates to a decrease in provisions for returns and allowances as well as other operational provisions. (Q3 13 Quarterly Report, 11/07/13)

Reserves Analysis (€ in millions)	Q3 13	Q2 13	Q3 12	Q2 12	Q3 Prior 3 Yr. Avg.	Q2 Prior 3 Yr. Avg.
Other current provisions (OCP)	€405.0	€462.0	€587.0	€544.0	€516.3	€464.3
Revenue	€3,879.0	€3,383.0	€4,173.0	€3,517.0	€3,795.0	€3,166.0
OCP as a % of revenue	*10.4%*	*13.7%*	*14.1%*	*15.5%*	*13.6%*	*14.6%*
Sequential change	*(320 bps)*	*0.0 bps*	*(140 bps)*	*280 bps*	*(100 bps)*	*190 bps*
Year-over-year change	*(360 bps)*	*(180 bps)*	*60 bps*	*80 bps*	*80 bps*	*80 bps*

We have the following observations:

1. **Wholesale revenue trends cannot rationalize the reduction to the sales return reserve, in our view:** Since Q4 12, Wholesale segment revenue has declined in each period (y/y) on a reported and constant currency basis. Given our view that the Company reduced its full-year revenue guidance (in-part) due to weakness in the Wholesale channel, **we believe the reserve reduction may not be rational as Wholesale demand challenges (weak sell-through to end customers) may result in higher levels of product returns.**

Wholesale Revenue Analysis (€ in millions)	Q3 13	Q2 13	Q1 13	Q4 12	Q3 12
Wholesale revenue	€2,553.0	€2,014.0	€2,481.0	€2,063.0	€2,743.0
Year-over-year change	*(6.9%)*	*(4.7%)*	*(5.1%)*	*(0.9%)*	*6.4%*
Year-over-year change in constant currency	*(0.8%)*	*(1.0%)*	*(3.2%)*	*(3.6%)*	*0.4%*

2. **Nike's reserve increased in spite of healthier demand trends:** In its FY 13 ended 05/31/13, Nike's "post-invoice sales discounts, returns, and miscellaneous claims" reserve increased 16.7% y/y on an absolute basis and 10 basis points relative to revenue.[8] Given healthier demand trends at Nike, our concerns about the relative decline in the Company's sales return and allowance reserve is heightened.

3. **Reduction to reserve may have enabled stronger margins while sales underperformed:** We note the lower reserves coincided with two consecutive FY 13 revenue guidance reductions. Had the Company not reduced the reserves in Q2 13 (Q3 13), we believe consolidated gross margin would have potentially been 48.6% (47.8%),

[8] We believe Nike's post-invoice, sales discounts, returns, and miscellaneous claims reserve is comparable to adidas' returns, allowances, and warranty reserve.

150 bps below actual reported gross margin of 49.3% (50.1%) and 80 bps (30 bps) below the consensus estimate. In addition, we believe Q2 13 (Q3 13) operating income **would have been 20.2% (12.3%) below actual reported operating income of €252.0 million (€463.0 million) and 25.1% (12.1%) below the consensus estimate. Hence, we believe the Company would have (1) significantly missed its FY 13 operating margin guidance and (2) reported year-over-year operating margin contraction without the discretionary reserve adjustments.**

Baseline Gross Margin Analysis (€ in millions)	Q3 13	Q2 13
Reported gross profit	€1,913.0	€1,694.0
Add: sequential change in OCP	(€57.0)	(€51.0)
Baseline gross profit	€1,856.0	€1,643.0
Reported gross margin	49.3%	50.1%
Baseline gross margin	47.8%	48.6%
% Baseline gross margin below the reported results	*(150 bps)*	*(150 bps)*
Consensus estimate	48.2%	49.4%
% Baseline gross margin below the consensus estimate	*(30 bps)*	*(80 bps)*

Baseline Operating Income Analysis (€ in millions)	Q3 13	Q2 13
Reported operating income	€463.0	€252.0
Add: sequential change in OCP	(€57.0)	(€51.0)
Baseline operating income	€406.0	€201.0
% Baseline operating income below the reported results	*(12.3%)*	*(20.2%)*
Consensus estimate	€461.7	€268.5
% Baseline operating income below the consensus estimate	*(12.1%)*	*(25.1%)*

4. **Existence of prior internal control weaknesses surrounding sales returns and allowance reserve heightens our concerns:** In March 2012, the Company discovered irregularities at its Reebok business in India that included criminal activity and collusion between Company employees and external business partners. Key findings from the Company's internal investigation were (1) inappropriate revenue recognition, (2) failure to book sales returns, and (3) failure to correctly post credit notes to accounts receivable. In addition, the investigation discovered four undisclosed inventory warehouses that were not in the official accounting records. **The irregularities resulted in a significant overstatement of net sales, accounts receivable, inventories, and related provisions such as allowances for inventories and provisions for sales returns and allowances.**

> As we announced last April, we discovered commercial irregularities at our Reebok business in India, bringing to light a high level of criminal energy and collusion between former employees and external business partners. As promised, we have followed up vigorously and swiftly on the matter through a thorough internal and external investigation, also with police involvement. Key findings from our internal investigations include inappropriate recognition of sales, a failure to book sales returns and a failure to correctly post credit notes to accounts receivable. This resulted in a significant overstatement of net sales, accounts receivable, as well as materially incorrect accounting for inventories and provisions. During the investigation process, the new management also discovered four previously undisclosed warehouses not declared in the official accounting records. The findings of the investigations suggest that the practice of inflating sales and profits had been going on for several years. (FY 12 Annual Report)

As a result of the irregularities, the Company restated its FY 11 results by reducing net income by €58.0 million and shareholders' equity by €153.0 million. **In light of the existence of prior internal control weaknesses that resulted in a material misstatement, our concerns about the reserve reductions and elevated inventory levels are heightened.**

Elevated Capital Expenditures May Pressure Margins

Background on property, plant and equipment and intangible assets: The Company depreciates property, plant, and equipment (PP&E hereinafter) over an estimated useful life using the straight-line method (except when declining-balance method is more appropriate). The Company assigns buildings and leasehold improvements with useful lives between 5 – 50 years and technical equipment and machinery and furniture and fixtures between 2 – 10 years. In addition, the Company amortizes intangible assets on a straight-line basis. The Company assigns software useful lives between 3 – 5 years and patents, trademarks, and concessions between 5 – 15 years.

Capex-to-D&A increase: In the twelve months ended Q3 13, capital expenditures (capex) increased 11.9% year-over-year in absolute terms, while depreciation and amortization (D&A) remained flat. Accordingly, capex-to-D&A increased 11.9% year-over-year from an elevated base period. In its Q3 13 Quarterly Report, the Company reiterated its guidance for FY 13 capex growth of 21.0% (at midpoint) to support the Company's adidas and Reebok branded controlled space initiatives (retail stores and shop-in-shops), infrastructure build-out, and deployment of SAP and other IT systems. In addition, the Company increased its FY 13 store growth guidance by 25.0% from 200 to 250 net stores openings.

Capex-to-D&A Analysis (€ in millions)	12M Ended Q3 13	12M Ended Q2 13	12M Ended Q1 13	12M Ended Q4 12	12M Ended Q3 12
Capital expenditures	€461.0	€455.0	€420.0	€434.0	€412.0
Depreciation and amortization (D&A)	€271.0	€268.0	€265.0	€260.0	€271.0
Capex-to-D&A	1.701	1.698	1.585	1.669	1.520
Year-over-year change	*11.9%*	*11.1%*	*5.0%*	*12.3%*	*6.7%*

We have the following observations:

1. **Elevated capex increases risk of margin pressure, in our view:** While new store openings may rationalize the surge in capex, we believe margins may be pressured from higher D&A levels unless sales trends improve.

2. **Increase in useful life of PP&E may not be rational, in our view:** The Company discloses details of its PP&E on an annual basis. In FY 12, the estimated average useful life of PP&E increased 6.7% y/y to 9.5 years from an elevated base period (in FY 11, estimated average useful life increased 12.3% y/y). In addition, in FY 12, we note that technical equipment and furniture and fixtures drove the entire increase in PP&E (categories the Company assigns useful lives of 2 – 10 years), while PP&E with longer useful lives (such as buildings and improvements) slightly declined. Given the increase in a category with a lower average useful life, we would have expected (all else equal) the consolidated average useful would have declined. Hence, we do not believe the increase in useful life of PP&E is rational. **In our view, the Company may have assigned useful lives at the higher-end of its stated ranges in order to minimize near-term depreciation expense.**

Average Useful Life Analysis of PPE (€ in millions)	FY 12	FY 11
Average gross depreciable PPE	€2,029.0	€1,821.5
Depreciation expense	€214.0	€205.0
Estimated average useful life (in years)	9.5	8.9
Year-over-year change	*6.7%*	*12.3%*

Property, Plant, and Equipment (€ in millions)	FY 12	FY 11	*Change*
Land, buildings, and leasehold improvements	€670.0	€674.0	*(€4.0)*
Technical equipment	€199.0	€180.0	*€19.0*
Other equipment as well as furniture and fixtures	€1,204.0	€1,131.0	*€73.0*
Total gross PPE (excluding construction in progress)	€2,073.0	€1,985.0	*€15.0*

3. **Elevated useful lives for intangible assets:** In FY 12, average software, patents, and concessions increased 8.0% year-over-year to €685.5. The Company did not discuss the increase in its FY 12 Annual Report, in its Q4 12 Earnings Release, or on its Q4 12 Conference Call. However, we note the estimated average useful life of software, patents, and concessions increased 5.8% y/y to 14.0 years from an elevated base period (in FY 11, the estimated average useful life increased 27.8%). Given that the Company assigns software useful lives between 3 – 5 years and patents, trademarks, and concessions with useful lives between 5 – 15 years, we believe intangible assets were assigned useful lives at the high-end of the Company's stated ranges.

Average Useful Life Analysis of Intangibles (€ in millions)	FY 12	FY 11
Average gross amortizable software, patents, and concessions	€685.5	€634.5
Amortization expense	€49.0	€48.0
Estimated average useful life (in years)	14.0	13.2
Year-over-year change	*5.8%*	*27.8%*

Consensus Margin Estimates and FY 15 Margin Guidance At Risk, In Our View

Given our view that the Company would have (1) significantly missed its FY 13 operating margin guidance and (2) reported year-over-year operating margin contraction without the discretionary reserve adjustments, we believe recent margin expansion is unsustainable. Further, we believe the Company may be carrying excess merchandise that it may need to sell at lower margin (through higher promotional activities) in order to rationalize inventory levels. **Hence, we believe the consensus estimate for gross margin and operating margin expansion and the Company's FY 15 operating margin target (of 11.0%) may be difficult to achieve.**

Consensus Estimate Analysis (€ in millions)	FY 15E	FY 14E	FY 13E	FY 12
Gross margin	50.3%	49.7%	49.2%	47.7%
Year-over-year change	*60 bps*	*40 bps*	*150 bps*	*20 bps*
Operating margin	10.8%	9.7%	8.5%	8.0%
Year-over-year change	*110 bps*	*120 bps*	*50 bps*	*80 bps*

Cash Flow

In the twelve months ended Q3 13, cash from operations (CFO) declined €58.0 million year-over-year in absolute terms to €907.0 million, while adjusted net income increased €39.0 million to €791.0 million.[9] Accordingly, CFO-to-net income declined (by 10.6%) on a year-over-year basis for the third time in the last four periods. In the twelve months ended Q3 13, receivables (inventory) used €73.0 million (€271.0 million) of cash.

Cash From Operations Analysis (€ in millions)	12M Ended Q3 13	12M Ended Q2 13	12M Ended Q1 13	12M Ended Q4 12	12M Ended Q3 12
Cash from operations (CFO)	€907.0	€935.0	€1,071.0	€942.0	€965.0
Adjusted net income	€791.0	€816.0	€808.0	€789.0	€752.0
CFO-to-net income	1.147	1.146	1.325	1.194	1.283
Year-over-year change	*(10.6%)*	*(23.6%)*	*28.3%*	*(10.0%)*	*52.1%*
Cash (used) provided by receivables	(€73.0)	(€146.0)	(€140.0)	(€135.0)	(€14.0)
Cash (used) provided by inventories	(€271.0)	€30.0	€74.0	€23.0	€39.0

Risks to Our Thesis and Conclusion

Risks to our thesis: The following developments could present challenges to our thesis:

- The Company's new pricing initiatives more than offsets lower margin from promotional activities.
- The 2014 FIFA World Cup drives higher-than-expected revenue growth.
- The Company captures market share.

Conclusion: In spite of multiple revenue guidance reductions in FY 13, we believe the Company was able to report margin expansion (and prevent a significant FY 13 margin guidance reduction) by (1) delaying the sell-through of potentially obsolete or impaired inventories, (2) reducing its provisions for sales returns, allowances and warranties, and (3) assigning PP&E with longer useful lives to reduce near-term depreciation expense. Further, we believe revenue may remain pressured by potential market share losses in the adidas brand, weak trends in the TaylorMade brand, and a potential pull-forward of TaylorMade revenue. As a result, we believe FY 14 consensus estimates and the Company's mid-term FY 15 financial guidance may be difficult to achieve. Our concerns are heightened by a decline in cash from operations-to-net income and the existence of previous internal control weaknesses.

[9] In Q4 12, the Company recorded a €265.0 million goodwill impairment charge related to the re-evaluation of medium-term growth prospects of several geographic regions and segments. Hence, we adjusted Q4 12 net income (added the charge back) in order to maintain comparability.

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