European Sportswear

Assessing risks from the Red Sea

Industry Overview

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Equity
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Sporting Goods

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Unresolved Red Sea scenario could impact EBIT up to c.10%

We think the Red Sea situation is a bigger risk than understood. European Sportswear companies generate around 40-50% of revenues in Europe, with most of this supply transiting the Suez Canal. Disruptions have led to transit times increasing 2-3 weeks and global container spot freight rates >100% since December. We see a twofold impact: 1) product availability issues and surcharges on existing contracts, 2) freight contracts renewing at much higher rates. We think the market is not anticipating point (2). We see up to a c.10% potential impact to cons EBIT (annualised) in a bear case scenario for the Red Sea. Brands more immediately impacted, but eventually retailers too over time.

Immediate effect: availability issues and surcharges

Shipments from Asia around the Cape of Good Hope to Europe add 2-3 weeks to a trip that usually takes 35 days via the Red Sea. We see some risk of seasonal product shortages ahead of Easter, but overall think this delay is manageable given the seasonality for sportswear is lower than general "fast" fashion. We think JD Sports and Frasers (Sports Direct) are most exposed to product delays given greater revenue share from Europe. We see modest margin impact to brands from surcharges on existing freight contracts as product is re-routed. Overall, the immediate effect should not be material. Of the brands, adidas and PUMA have similar revenue exposure to Europe, while On Holding has the lowest.

Delayed impact: freight contracts resetting +65% higher

Freight costs are c.1.5% of revenue for sportswear brands. While retailers have no direct freight costs, sell-in prices adjust over time. Brands typically negotiate extended fixed price contracts with shipping partners around mid-year. Assuming a mix of routes, if spot levels hold, we think this could reset contracts +c.65% higher, and drive 1ppt gross margin pressure. This could hit sector EBIT by up to c.10% assuming no incremental price is achieved. Typically, sportswear companies offset sharp input cost pressures with product pricing (on top of existing increases), however JD Sports' recent profit warning points to a price sensitive consumer (see our report) which may limit this.

Feeds into cautious sector view for 2024

Whilst sportswear is a structurally attractive sector, it has faced many challenges over the past two years, and 2024 is a mixed picture (see our 2024 sector outlook, Fumbling the Rebound). Tailwinds include fewer promotions and a potential wholesale restock, partially offset by a slowdown in Europe. On average we are already 9% below consensus 2024 EBIT (pre adidas profit warning), but see this largely reflected in valuation with the sector having de-rated c.20% in the past 8 weeks (to 20x 2024 P/E). Our below-consensus estimates in 2024E factor in a -50bps net margin headwind from freight, though a bear case outcome would see downside risk to our 2025E estimates.

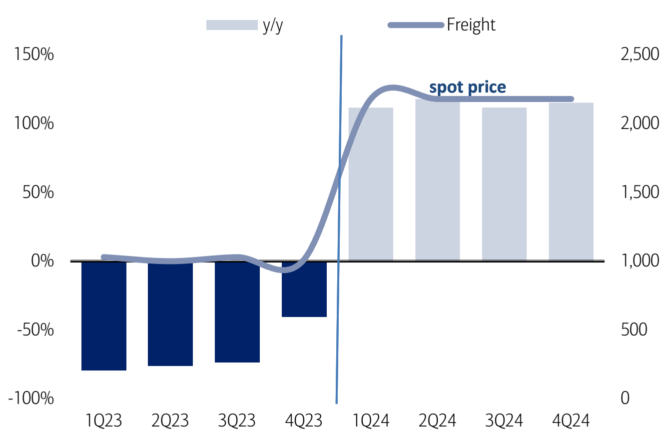
Timestamp: 02 February 2024 12:31AM EST

Background to Red Sea issue

The global composite Shanghai Containerized Freight Index (SCFI) is up >100% y/y and since early-December 2023 following Red Sea disruptions. This is a global composite index however and freight contracts are based on regional routes and typically at a discount to spot. Our underlying data (non-SCFI) by route shows China-Europe rates are currently around +50% y/y, while China-US and the Global composite are +15%.

European sportswear brands typically negotiate freight contracts around mid-year from our understanding, locking in prices for 12 months. This provides cost visibility.

Exhibit 1: Holding the spot SCFI Index would imply >100% in 2024
Shanghai (Export) Containerized Freight Index, y/y



Source: BofA Global Research, Eikon

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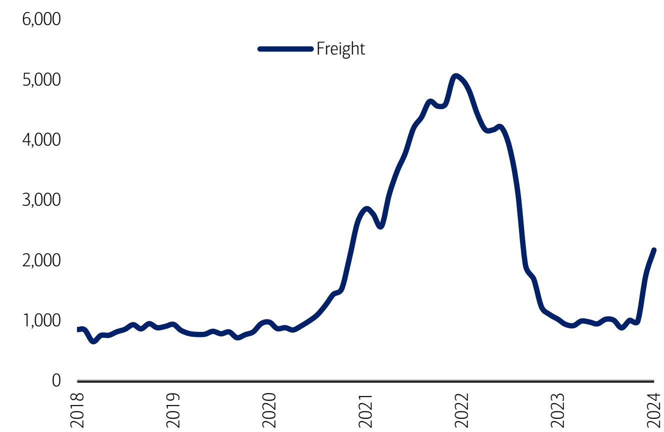
Exhibit 2: SFCI Index is up >100% since early December
Shanghai (Export) Containerized Freight Index



Source: BofA Global Research, Eikon

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Expectations don't reflect freight risks

At this stage, most companies across sportswear and general retail are flagging the immediate risks from the Red Sea disruptions :1) potential product availability issues, and 2) surcharge costs on existing contracts to go around the Cape of Good Hope.

However, none are flagging the delayed implications should freight prices hold at current levels and contracts renew at these much higher rates. Similarly, we think the increased freight risks are not reflected in consensus expectations, given gross margin expectations are relatively unchanged since the start of the Red Sea issues.

Exhibit 3: Gross margin estimates have moved up slightly on average since Red Sea issues started
CY24E Gross margin consensus (Visible Alpha) revisions (today vs 16 Oct 23)

Company	16-Oct-23	Today	Change
Frasers	42.3%	43.5%	1.2%
On Holding	59.4%	59.7%	0.3%
adidas	48.9%	49.1%	0.2%
PUMA	47.2%	47.3%	0.1%
JD Sports	48.1%	47.6%	-0.5%
Weighted average	47.6%	47.7%	0.1%

Source: BofA Global Research, Visible Alpha 31 January 2024. NOTE: We take the nearest FY to CY, hence JD Sports and Frasers based on FY25E. Weighted by CY24E sales.

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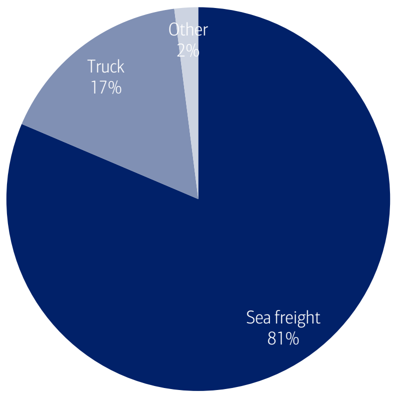
Understanding sportswear exposure

Sea freight makes up >80% of sportswear volumes

Most sportswear products are transported by sea (Exhibit 4) from manufacturers in APAC to global destinations. Companies sometimes use airfreight for select seasonal drops or in periods of acute supply chain challenges such as we had during the pandemic.

Exhibit 4: Sea freight is the biggest transport mode for sportswear product
adidas good transport split by volume (2022)



Source: BofA Global Research, company report

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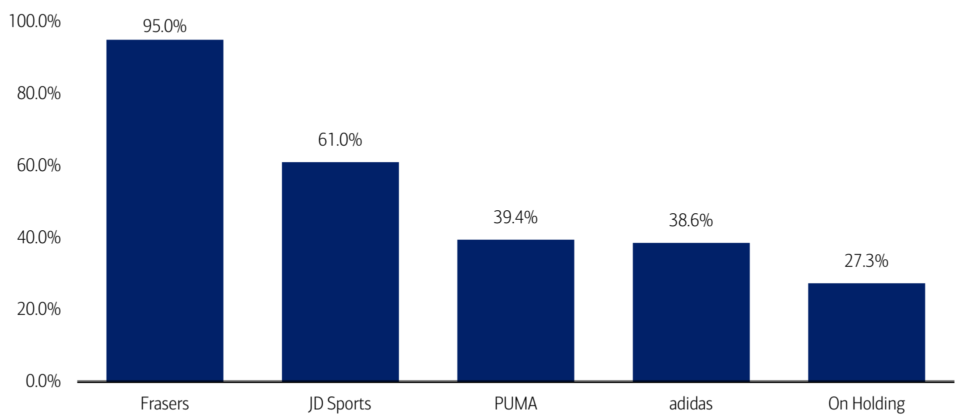
Red Sea c.25-40% of brand volumes, 60-95% of retailers

Europe is the largest end-market for European sportswear companies, with EMEA accounting for about half of revenue for our coverage. However, this differs meaningfully, with EMEA 25-40% for brands and 60-95% for retailers (Exhibit 5). Almost all of sportswear product retailed in Europe is transported through the Red Sea from our understanding, given the bulk of manufacturing is in Asia East Asia and China. As such revenue share from EMEA is a good indication of volume exposure to the Red Sea.

Exhibit 5: Retailers are more exposed to Europe than brands, and more reliant on product transiting the Red Sea
Revenue share from EMEA (LTM)



Source: BofA Global Research estimates, company report

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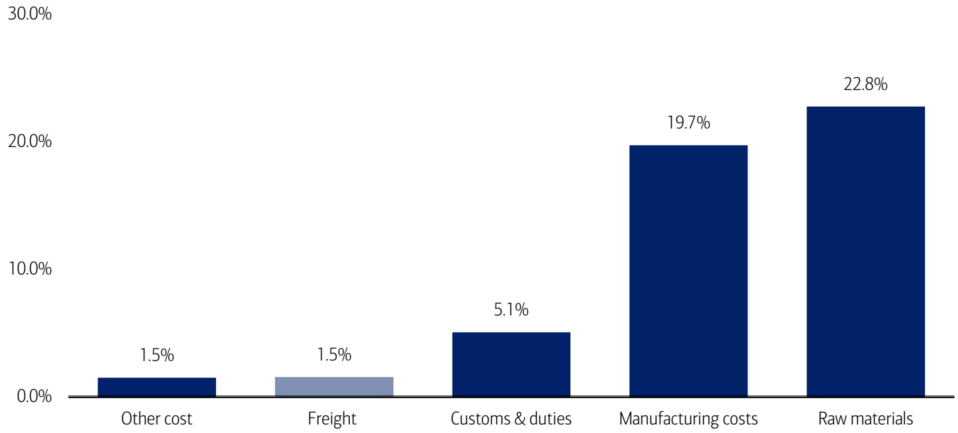
Nature of freight contracts

Freight costs are about 1.5% of European sportswear brand revenues

We estimate freight is around 1.5% of brand revenues (3% of COGS). Brands purchase products from manufacturers on a FOB basis (at origin) and absorb the freight charge, whereas retailers purchase from brands on a CIF basis (at destination), and don't pay for freight. Ultimately however freight cost inflation flows through pricing over time to retailers, though the impact on brands will be more immediate than for retailers.

Exhibit 6: Freight is around 1.5% of revenue for brands
Estimated brand COGS breakdown for a €100 pair of sneakers (% of revenue)



Source: BofA Global Research estimates

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Fixed freight contracts are renewed around mid-year

Brands typically negotiate fixed price contracts with shipping partners around mid-year. This is echoed in brand commentary (see below). It takes around a quarter for the full impact from a change in the contract price to translate into the P&L based on PUMA's commentary.

PUMA 3Q23 earnings call
"**We had until mid of the year '23 contract, which came from '22**, with higher freight costs and then new **negotiated freight costs started to kick in from 1 of July onwards.**

Of course, **that takes a little bit until it translates into the P&L**, but the full impact we will see in Q4 and then going forward as our contract is running until mid of '24. But that will be clearly a tailwind for us."

adidas 3Q23 earnings call
"It's very positive [freight] and it will continue to be positive for the next couple of quarters."

Earnings sensitivity to freight situation

Freight could fuel 1ppt gross margin pressure

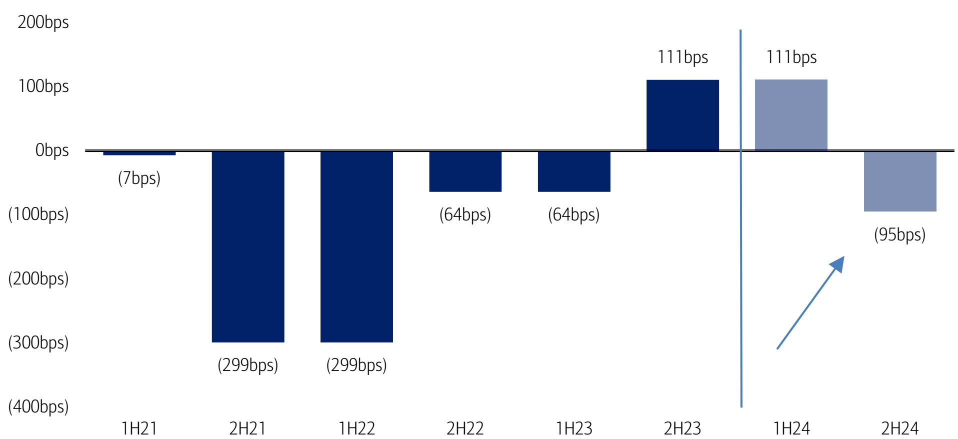
Sportswear brands should continue to see a tailwind to gross margins in 1H24 from lower freight rates annualising, however we see the greatest risk to expectations from 2H24 onwards should spot rates hold and contracts reset higher.

We present a gross margin scenario for European sportswear brands making assumptions on the mechanics behind freight contract renewals. We assume:

- 100% of sourcing is transported by sea freight.
- Freight contracts are 12 months and run from 1 July.
- Contracts assume the average of the two preceding months (i.e. May, June).
- Freight makes up 1.5% of revenue (3.0% of COGS).
- We weight freight prices by route mix (40% Europe, 30% US, 30% other).

Based on these, we expect freight to be a c.110bps theoretic tailwind for European sportswear brands in 1H24 as the industry cycles through lower contract prices over the past 12 months. Assuming spot holds, we forecast a c.90bps headwind to the industry from 2H24 as freight costs reset +65% higher, using a weighting of each route (with the spot index +100% higher for Europe, 28% for US and 50% for other, as of 1 July).

Exhibit 7: Freight could present a 1ppt annualised gross margin headwind if spot levels hold
Estimated gross margin impact from freight for European sportswear, assuming immediate P&L impact



Source: BofA Global Research estimates

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Potential EBIT hit of up to c.10%

Taking our scenario further, we run a sensitivity on Visible Alpha consensus CY25E EBIT to a +65% increase in freight costs. This exercise is meant to determine the annualised impact from higher freight costs, and we acknowledge this would likely only start in late 2024 but then run into 2025. We make the following assumptions in our scenario:

- Freight makes up 1.5% of revenue (3.0% of COGS).
- No price offset.
- We assume brand aggregate freight inflation is passed through to brands.

This in our view represents a worse-case scenario, in which a brand or retailer absorbs the full input inflation from higher freight rates but is unable to offset this in price.

Exhibit 9: Should spot freight prices hold, this could impact sportswear EBIT by up to c.10%
Sensitivity of consensus CY25E EBIT to a +65% increase in freight costs

Company	Annualised EBIT impact
adidas	(12.8%)
PUMA	(11.9%)
JD Sports	(10.2%)
Frasers	(9.5%)
On Holding	(7.0%)
Weighted average	(11.3%)

Source: BofA Global Research, Visible Alpha. NOTE: We take the nearest FY to CY, Hence JD Sports and Frasers based on FY25E. Weighted by CY24E sales. NOTE: This is based on consensus prior to adidas 31 January 2024 profit warning

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It all depends on price offset, but that looks challenged

Ultimately the potential earnings impact depends on the ability of a brand or retailer to pass through input cost pressure in the price to customers. However, we think incremental pricing may be tough to achieve. JD Sports' recent profit warning suggests consumers remain price sensitive. Furthermore, the sportswear industry has achieved +MSD price inflation since 2019 and is arguably coming off a high base.

Both factors make incremental pricing more difficult in our view. Below we show the potential impact on consensus CY25E EBIT (as of 31 January) from a range of assumptions on freight and price inflation.

Exhibit 10: The potential impact from freight inflation varies
Consensus CY25E EBIT impact from of 1) freight inflation and 2) price inflation scenarios

		Freight contract inflation				
	(11%)	45%	55%	65%	75%	85%
Price inflation	0%	(8%)	(10%)	(11%)	(13%)	(15%)
	1%	4%	2%	0%	(1%)	(3%)
	2%	15%	14%	12%	10%	8%
	3%	27%	25%	24%	22%	20%
	4%	39%	37%	35%	33%	32%

Source: BofA Global Research estimates

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BofA already below consensus

Our EBIT estimates are already 9% below consensus in 2024E (as of 31 January prior to the adidas warning which consensus is yet to adjust for). We are only slightly below consensus on gross margin, but within this we factor in a net -50bps freight headwind (-100bps annualised). A bear case scenario would present downside to our 2025E forecasts however.

Exhibit 11: We are 9% below consensus EBIT for the sector in 2024E
Visible Alpha consensus vs BofA (nearest calendar year)

		CY23E			CY24E			CY25E			CY26E		
		Consensus	BofA	% Diff	Consensus	BofA	% Diff	Consensus	BofA	% Diff	Consensus	BofA	% Diff
Sales (m)	FY YE												
adidas (reported)	DEC	21,561	21,596	0%	23,078	23,103	0%	25,184	24,935	(1%)	27,501	27,429	(0%)
adidas (underlying)	DEC	NM	20,846	NM	NM	22,253	NM	NM	24,935	NM	NM	27,429	NM
PUMA	DEC	8,694	8,601	(1%)	9,191	8,978	(2%)	9,937	9,693	(2%)	10,754	10,464	(3%)
On Holdings	DEC	1,797	1,809	1%	2,314	2,334	1%	2,914	2,926	0%	3,578	3,563	(0%)
JD Sports	JAN	10,515	10,448	(1%)	11,329	11,190	(1%)	12,313	12,184	(1%)	13,517	13,217	(2%)
Frasers	APR	5,775	5,693	(1%)	6,044	5,877	(3%)	6,309	6,002	(5%)	6,376	6,131	(4%)
Average (sales weighted)				(0%)			(1%)			(2%)			(2%)
cFX Growth (%)	FY YE												
adidas (reported)	DEC	(0%)	0%	46bps	8%	8%	(38bps)	9%	7%	(181bps)	9%	10%	98bps
adidas (underlying)	DEC	NM	2%	NM	NM	8%	NM	NM	11%	NM	NM	10%	NM
PUMA	DEC	8%	7%	(125bps)	7%	5%	(194bps)	8%	8%	(47bps)	8%	8%	15bps
On Holdings	DEC	55%	56%	59bps	31%	29%	(225bps)	27%	25%	(154bps)	22%	22%	(72bps)
JD Sports	JAN	8%	7%	(58bps)	7%	8%	92bps	8%	9%	40bps	8%	8%	41bps
Frasers (sports Retail)	APR	3%	1%	(250bps)	3%	2%	(100bps)	3%	1%	(150bps)	3%	1%	(200bps)
Average (sales weighted)		5%	4%	(44bps)	8%	7%	(46bps)	9%	7%	(102bps)	8%	8%	29bps
Gross Margin (%)	FY YE												
adidas (reported)	DEC	47.7%	48.0%	35bps	49.1%	49.3%	20bps	49.8%	50.6%	85bps	50.2%	51.0%	85bps
adidas (underlying)	DEC	NM	47.1%	NM	NM	48.7%	NM	NM	50.6%	NM	NM	51.0%	NM
PUMA	DEC	46.3%	46.4%	11bps	47.3%	47.2%	(10bps)	47.8%	47.6%	(16bps)	48.2%	47.9%	(27bps)
On Holdings	DEC	59.2%	59.5%	22bps	59.7%	59.7%	(2bps)	60.2%	60.0%	(20bps)	60.5%	60.0%	(54bps)
JD Sports	JAN	47.5%	47.5%	3bps	47.6%	47.2%	(42bps)	47.8%	47.5%	(30bps)	47.8%	47.6%	(21bps)
Frasers	APR	43.3%	43.0%	(25bps)	43.5%	43.1%	(44bps)	43.7%	43.2%	(47bps)	44.9%	43.3%	(164bps)
Average (sales weighted)		47.1%	47.3%	16bps	48.0%	47.9%	(8bps)	48.5%	48.7%	22bps	48.9%	49.0%	7bps
Adj EBIT (m)	FY YE												
adidas (reported)	DEC	197	225	14%	1,304	1,150	(12%)	2,010	2,005	(0%)	2,578	2,705	5%
adidas (underlying)	DEC	NM	(75)	NM	NM	900	NM	NM	2,005	NM	NM	2,705	NM
PUMA	DEC	621	622	0%	701	620	(12%)	821	708	(14%)	954	797	(17%)
On Holdings	DEC	211	217	3%	295	283	(4%)	406	373	(8%)	536	468	(13%)
JD Sports	JAN	986	977	(1%)	1,042	1,007	(3%)	1,179	1,166	(1%)	1,301	1,295	(0%)
Frasers	APR	559	542	(3%)	607	585	(4%)	647	618	(5%)	665	636	(4%)
Average (sales weighted)				6%			(9%)			(3%)			(2%)
Adj EBIT Margin (%)	FY YE												
adidas (reported)	DEC	0.9%	1.0%	13bps	5.6%	5.0%	(67bps)	8.0%	8.0%	6bps	9.4%	9.9%	49bps
adidas (underlying)	DEC	NM	(0.4%)	NM	NM	4.0%	NM	NM	8.0%	NM	NM	9.9%	NM
PUMA	DEC	7.1%	7.2%	9bps	7.6%	6.9%	(72bps)	8.3%	7.3%	(95bps)	8.9%	7.6%	(126bps)
On Holdings	DEC	11.7%	12.0%	26bps	12.8%	12.1%	(62bps)	13.9%	12.7%	(119bps)	15.0%	13.1%	(183bps)
JD Sports	JAN	9.4%	9.4%	(2bps)	9.2%	9.0%	(20bps)	9.6%	9.6%	(1bps)	9.6%	9.8%	18bps
Frasers	APR	9.7%	9.5%	(15bps)	10.0%	9.9%	(10bps)	10.3%	10.3%	4bps	10.4%	10.4%	(5bps)
Average (sales weighted)		5.3%	5.3%	6bps	7.5%	7.0%	(50bps)	8.8%	8.7%	(16bps)	9.6%	9.6%	(0bps)

Source: BofA Global Research estimates, Visible Alpha. NOTE: average is weighted by FY22 sales, ex adidas underlying

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Appendix: Company views on Red Sea risk

PUMA 4Q24 conference call responses on freight issues, 24 January
"…When you look at the disruption on the Red Sea, let's first put it into perspective. Around one-third of our freight goes through the Suez channel. When we talk about our freight rates, I think we also informed you last time that we have an agreement which goes until the middle of this year. There are obviously, due to the new routes which need to be taken, certain surcharges, which need to be applied. We believe this is a temporary impact, which would obviously only last a few months. But this will not have material impact on our profitability. I think the lead times we do expect are extending up to 20 days. That is something as we speak, since it was clear that we need to take different routes, where we're reprioritising certain products. But as of today, we feel comfortable that we are managing the challenge very well, both from a lead time perspective, as well as from a surcharge perspective."

JD Sports 3Q24 conference call responses on freight issues, 4 January
"On the current shipping disruption, the issue is not only the negative impact coming from the Far East, but also for the containers that are retuning back. We see a little bit of risk for Easter and we are starting to take action to make sure that we get the stock because of Chinese New Year. The only positive we can takeaway is that the current disruption does not affect the US."

"We only pay for transport for our own brands which represent 10% of our sales, so that is more an issue for the brand partners than for us. Especially when it is a short-term agreement. When it's a long-term agreement, by definition the brands will incorporate charges in the price we pay, but when it's short-term, the brands have full responsibility because we buy at port."

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R1]Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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