B111

Final Project

Group Final: M&A Analysis

Minerva Schools at KGI

Fall 2018

The Reebok company was bought by Adidas group in 2005, with strategic ends in mind: a broader portfolio of world-renowned brands, and extended geographic reach with more market share. Nevertheless, sweet as projected benefits may sound, the deal was by no means smooth sailing. This paper analyzes the financial impacts of the acquisitions, the risks involved, and strategies Adidas developed to address these risks.

A. Adidas' financial performance before and after Reebok acquisition, analyzed by business functions

Before the acquisition, Adidas was doing moderately well, but there were rooms for improvements for its Operations, Marketing, and Management departments:

DuPont Analysis	**Adidas**	**Industry average**
Margins	5,87%	7,19%
Asset Turnover	115%	84,8%
ROA	6,78%	6,10%

Figure 1. *Adidas' financial performance in 2005 compared to the industry average (Data: Damodaran, 2018). The company enjoys an ROA of 6.78% in 2005, higher than the industry average of 6.10%*[1]*. However, its net margin was below average (5.87% versus 7.19%). Regarding Asset Turnover, Adidas performed better than average (115% versus 84.8%) which indicated the efficient use of assets. Nevertheless, there were rooms for improvement.*

The low Net margin indicated a problem with its Operations regarding cost control: Adidas was a premium brand aimed at the upper-middle class, which should have brought

[1] Refer to Appendix A for detailed Dupont Analysis and Common Size Analysis.

high margins. However, its failure to achieve a lean manufacturing process and an end-to-end supply chain created high costs that drove down net income (Adidas, 2006). For Asset Turnover, a common size analysis shows that Adidas kept too much cash on hand (22.9% of total revenue versus 9.97% of industry average) - a mistake attributable to Adidas' Management function as the cash was left idle without making profits. The excess cash would have been better invested somewhere to cut costs or make profits - in this case, Adidas could have invested in creating an end-to-end supply chain, for example by establishing its own distributors to improve supply chain efficiency. According to Best, McPhee, & Hamburg (2017), for sports footwear companies, delivery speed from factories to retailers correlates highly with ROA.

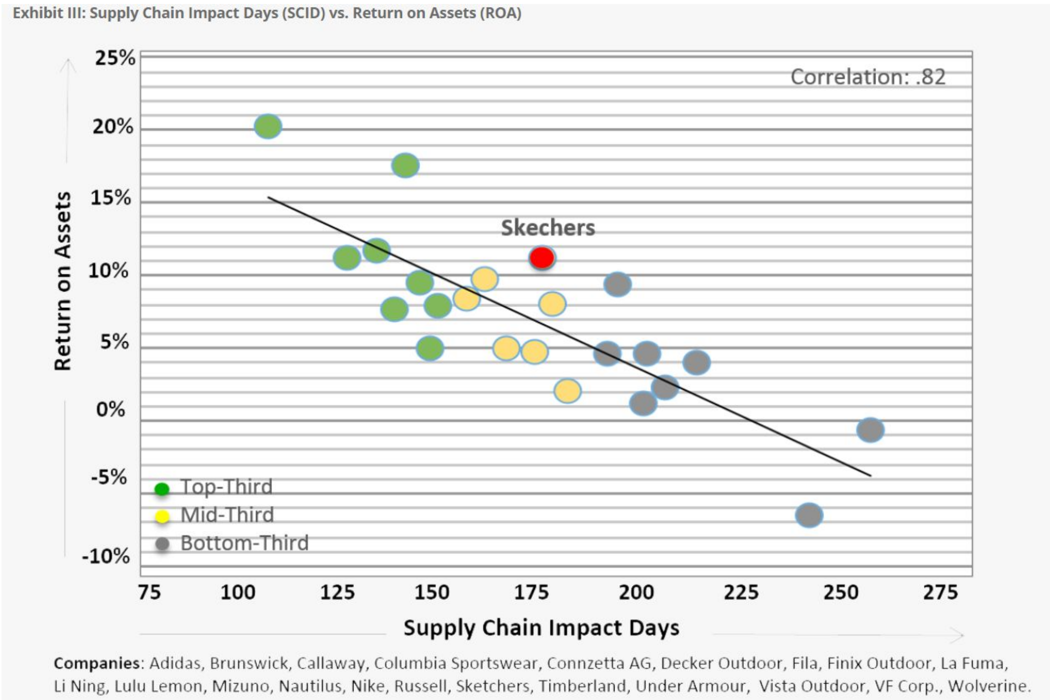

Figure 2. *Correlation between ROA and Delivery days (titled Supply Chain Impact days) (Best et al., 2017). Skechers is the benchmark company used in the paper. As can be seen, the fewer days the company take to deliver the product, the higher their ROA is. Specifically,*

improving the delivery speed by one day translates to an increase of 0.82% in ROA, ceteris paribus.

Another option was to invest in profitable projects - which Adidas attempted to with the acquisition of Reebok, whose impacts are analyzed below:

DuPont Analysis	**Adidas**	**Industry average**
Margins	4.9%	7.97%
Asset Turnover	120%	125%
ROA	5.88%	9.96%

Figure 3. *Adidas' financial performance in 2006 (after Reebok acquisition) compared with the industry average. The acquisition seemed ineffective in improving asset management and profitability: Net margin took a dip in the 2005-2006 period after Adidas acquired Reebok (5.87% to 4.9%) and fell further behind the industry average. However, this was reasonable as Reebok was a lower-margin brand and understandably pulled down the group's margins. Nevertheless, Asset Turnover also underperformed (120% versus 125% average), compared to its above-average 2005 performance. With low Net Margins and Asset Turnover, Adidas' ROA also fell behind the industry average.*

The low Asset Turnover is attributable to low Sales due to poor branding (from the Marketing function). Indeed, the report confirms that after extending its market to the US with Reebok acquisition, Adidas struggles in establishing a brand in the US, while Nike's "swoosh" logo is widely recognizable (McCall, 2005). This might be due to the initial lack of synergy - Adidas was unable to leverage Reebok's existing brand image to introduce its own brand.

It is recommended that Adidas invest in marketing analytics to better understand its new market - the US. The financial implications are two-fold. First, data-driven decision making was a rising field at the time (Press, 2013), which might have provided Adidas with solutions for its marketing problems, particularly pricing and segmentation. Two, it makes efficient use of the abundant cash Adidas had. In fact, according to Germann, Lilien, & Rangaswamy (2010), investments in marketing analytics lead to an average increase of 8% in ROA among Fortune 1000 companies.

Another necessary step for Adidas was to address synergy issues - which is a longer-term problem. Strategies and risks regarding synergy are discussed later in the paper.[2]

B. Risks related to the acquisition

Acquiring Reebok helped Adidas to lower its systematic risk. However, other risks were introduced, most notably the lack of synergy.

1. **Systematic risk**

Systematic risk is the non-diversifiable risk measured by the company's correlation with the movements of the market (beta). As a premium brand targeting upper-middle class consumers, Adidas a high beta as it would suffer in a market downturn as people would move away from premium goods, and take off during prosperous times. Meanwhile, as a more affordable brand with lower price points, Reebok had a lower beta (1.371 - also much

[2] **#bizfunctions**: Here we analyzed how Adidas' financials before and after the acquisition were impacted by decisions from three business functions: Operations, Marketing and Management. We also looked at potential improvements to those decisions (e.g. invest in market analytics) and proved our suggestions' validity with specific research/examples of success.

lower than the industry average of 2.4 - Damodaran, 2018), thus its sales would not fluctuate as much with different market movements.

The acquisition of a brand with lower beta would lower Adidas' systematic risk as a whole: during bad times, the group is backed by the more affordable Reebok, while in good times it benefits from the sales increase in the premium Adidas. Qualitatively, this meant higher safety and sustainability for Adidas. Quantitatively, it meant an increase in the company's valuation through a lower discount rate.

$$\text{Cost of Equity} = \text{Risk-free rate} * \beta * \text{Market premium}$$

Figure 4. *CAPM Model. Assuming that the two market-dependent variables of Risk-free rate and Market premium stay unchanged, a lower beta results in a lower cost of equity. This will lower the group's Cost of Capital (WACC = D/(D+E)*Cost of debt + E/(D+E)*Cost of equity), provided that its capital structure stays unchanged. A lower cost of capital, in turn, increases the group's valuation (such as its NPV), ceteris paribus. This makes Adidas more appealing to the investor.*

Adidas' systemic risk is further reduced by its extra market presence in North America. Before acquiring Reebok, Adidas' main market was Western Europe. Acquiring Reebok allowed Adidas to access North America. Should the market decline in Western Europe, there is a chance that North America still performs well and vice versa. This is a less risky situation for Adidas.

2. Risk of lack of synergy

Acquiring Reebok, Adidas expected an annual $150 million in cost savings from operational synergy (Adidas, 2005). However, two significant risks are associated with the acquisition:

2.1. Cultural differences

The German-based Adidas was more process and performance-oriented, while the American-based Reebok was more entrepreneurial (Garbham, n.d.). This means managers and employees at Adidas focused more on productivity and doing well individually, while those at Reebok emphasized being driven, passionate and establishing a network. This difference in culture, and thus expectations of internal operations and work environment could create managerial and employee-related issues.

First, it would be challenging to decide on a unified management approach - employees at Adidas were used to having performance and efficiency goals, which was not necessarily the case for Reebok's employees. Pushing on with Adidas' approach would alienate Reebok workers. And should Reebok employees be integrated into Adidas, their getting used to another culture would take time and efforts.

Aside from driving up SG&A costs, these issues would negatively impact all departments including marketing and operations and pose challenges for synergy.

2.2. Brand image differences

Another challenge to synergy is differences in the brand image. Adidas had an image of a premium brand that was one of the frontrunners in sports, innovative and authentic (Adidas, n.d.). Meanwhile, Reebok was perceived as a more affordable brand with a greater focus on people (Kaushik, 2013). Given their global size and vastly different images, merging Reebok and Adidas' brand images risked damaging their brand equity, thus lower sales and profitability. For example, Adidas might lose its premium status as people associate it with Reebok, and might have to lower prices to stay in the game. Risks of cannibalization also loomed.

These risks might have been the driving force behind Adidas' aforementioned dip in financial performance. Its strategy to achieve synergy and curb these risks will be analyzed in the following section. [3]

C. Analysis of strategies to address risks and suggested improvements[4]

Adidas team developed several strategies to address the risks of synergy between Adidas and Reebok:

1. **Fostering a sense of belonging**

Adidas ensured that Reebok employees develop a sense of belonging to Adidas - and therefore, do not feel like the losers of the acquisition. Every person involved in the acquisition was asked to give her/his expertise for the company function in which she/he was participating. Moreover, for every position both Adidas and Rebook employees were considered on equal terms to ensure fairness in the hiring process (Garbham, n.d.).

2. **Culture unification**

Adidas employed several strategies for cultural unification. First, it declared its mission statement as "to be the leading sports brand in the world", which gave both Reebok and Adidas a unifying mission of beating their all-time rival Nike (Adidas, n.d.). Secondly, to create a single culture and ensure that all employees work as one, Adidas implemented a carefully planned communications strategy. In addition to CEO letters to all employees and email updates, the company carried out regular monthly surveys of company leaders to identify top concerns of employees to take timely action (Garbham, n.d.).

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[3] **#bizrisk:** We identified two major types of risk associated with the acquisition: systematic, and lack of synergy. We analyzed how those risks are impacted by the acquisition (e.g systematic risk decrease), quantify the impact where relevant, and explained potential consequences (e.g. lack of synergy raises SG&A costs and lower sales)

[4] **#strategize:** We explained the existing strategies of Adidas and Reebok in regards to the company's development after the acquisition. We discussed the strengths and weaknesses of the current strategies the companies employed and suggested improved strategies to move forward (with validity proven by research), taking into consideration potential risks.

3. Keeping brand images separate

As identified above, merging the brand images of Reebok and Adidas might have negative consequences. Therefore, the corporate management kept the two brands independent (Hainer & Stalker, 2005) - which we still see today - and evolved them simultaneously. Reebok would stay the more affordable brand focused on individuality (e.g. its recent marketing campaign “Be more human”) and Adidas would stay the premium brand emphasizing performance goals (e.g. a Winning culture - Adidas, n.d.)

4. Strategy evaluation and suggestion

The above strategies addressed key risks identified in the risk section - a sense of belonging as well as a unified mission statement allowed Adidas to smoothly integrate its new workforce. Additionally, frequent “pulse-checking” surveys ensured that Adidas could create a suitable working environment for new employees, thus maintain productivity across functions. This would mean lower SG&A costs and better synergy among departments. Furthermore, by keeping Reebok and Adidas separate, the group strategically addressed the needs of customers - an important stakeholder - as there would not be any confusion of brand image and their price points. Risks of cannibalization were also eliminated. This can be visualized by a perceptual map:

Figure 5. *Perceptual map of 10 most popular shoe brands on the market. The horizontal axis is brand equity, which is a measure of how highly customers value the brand. The vertical axis represents price, while the size of the bubbles represents a variety of products. Reebok and Adidas are circled blue, while their biggest competitor, Nike, are circled red. Adidas and Nike are competitors with many similarities in positioning, thus they overlap. As can be seen, keeping two brands separate without merging their pricing strategies prevents cannibalization (they do not overlap) and covers a wider area of the market. This helps them to be more competitive against Nike. Also, with Reebok and Adidas situated separately, there is no confusion of brand image.*

Therefore, these strategies effectively addressed risks of lack of synergy. This can also be seen from Adidas' superior financial performance 2 years later (2008):

- The group's net margin was 5.96% - though only marginally higher than 2006 (4.9%), it was nearly twice as high as the industry average (3.36%). The low average was probably due to the impact of the 2008 financial crisis, and being able to maintain a consistent performance amidst crisis was a feat.

- Asset Turnover was 113.2% versus the industry average of 89.8% - showing a more efficient use of assets to generate sales compared to other companies.
- The gross margin of the Adidas Group increased from 47.4% in 2007 to 48.7%. This is the highest annual gross margin since the 1995 IPO. The improvement was mainly thanks to an improved regional mix, further own-retail expansion, and a more favorable product mix.

Nonetheless, good as these numbers were, there were rooms for improvements. Unlike Adidas sales, Reebok's revenue in 2008 as compared to 2005 declined by about 21% due to Adidas' group inability to operate Reebok efficiently. Suggestions of what Adidas group could have done are as follow:

- Lower sales might have stemmed from Reebok's low brand awareness. It might have been advisable for Reebok to utilize Adidas' existing strengths to increase brand awareness, for example by leveraging Adidas' extensive network of mono-branded stores to feature ads for Reebok products. This would have had more people knowing Reebok and increased sales without any additional costs to the brand.
- Back at the time, online shopping was booming with a 17% growth in the US (Thomas, 2015). Reebok could have utilized the digital space by launching global websites and e-commerce channels across markets, especially underperforming ones. This increase in online presence would have fostered brand awareness and driven online sales.

All in all, though theoretically beneficial, the Reebok acquisition was not an immediate positive financial move for Adidas due to risks of lack of synergy, but it was a strategic move - Adidas Group's systematic risk was lowered, making it more sustainable, and subsequent strategies helped synergy to manifest and improved their financial performance. [5] [6]

(1520 words excluding headings, citations, and captions)[7]

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[5] **#bizstrategy:** We identified Adidas' strategies to address the risk of lack of synergy and analyzed their effectiveness qualitatively and quantitatively (with perceptual map), as well as identifying potential rooms for improvement (for Reebok who was underperforming) and suggested specific strategies (what they could and should have done).

[6] **#dataviz:** Throughout the paper we used appropriate methods of visualizing data (tables, perceptual map, regression, more tables in appendix) to quantitatively support our argument. Visualizations are clear, relevant to paper as well as colorful for a lively reading experience.

[7] **#organization:** The paper is clearly structured, the organization of the paper reflects its purpose. Our thoughts are well-communicated, taking into account our target audience and the arguments are supported with relevant evidence, using appropriate citations.

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APPENDIX A

Adidas	2008	2007	2006	2005	2004
Sales	10,799	10,299	10,084	6,636	5,860
COGS	5,543	5,417	5,589	3,439	3,047
Net Income	644	555	496	390	321
Assets	9,533	8,325	8,379	5,750	4,434
Inventory	1995	1629	1607	1230	1155
ROA	6.76%	6.67%	5.92%	6.78%	7.24%
Asset TurnOver	1.13	1.24	1.20	1.15	1.32
Net Margin	5.96%	5.39%	4.92%	5.88%	5.48%
Inventory Turn Over	2.78	3.33	3.48	2.80	2.64
Nike	2008	2007	2006	2005	2004
Sales	18627	16326	14955	13739	12253
Net Income	1883.4	1492	1392	1211	946
Assets	12442	10688	9870	8794	7909
ROA	15.14%	13.96%	14.10%	13.77%	11.96%
Asset TurnOver	1.50	1.53	1.52	1.56	1.55
Net Margin	10.11%	9.14%	9.31%	8.81%	7.72%
Inventory Turn Over	4.5	4.4	4.3	4.4	4.4

Appendix A: Dupont Analysis and Common Size Analysis: Dupont Analysis is conducted using financial data from Adidas and Nike (2004-2008) and presented above. Common Size Analysis is presented in a separate spreadsheet here.

APPENDIX B

Name	Brand equity (measure of brand image)	Price	Variety
Nike	10	115	9
Adidas	9	130	10
Jordan	6	140	1
Testoni	8	210	3
Converse	4	100	6
Vans	5	40	7
Reebok	7	85	8
Johnston&Murphy	3	135	2
Puma	2	60	5
Bostonian	1	95	4

Appendix B. Data for the perceptual map. The data is taken from the brands' main website as well as online reviews of each brand (to measure how highly the customer value the brand). Variety is graded on a scale of one to ten, depending on how diverse the brand offerings are.

APPENDIX C

Members' contributions

Individual research:

https://docs.google.com/document/d/16q8ZKbtOwnbY-6P9yM-MbRCeBbPY07evrxAKjJUF5rE/edit#

https://docs.google.com/document/d/1-1tomRRbDSScQV3QgdzSu1YKDQfPQHCLr2Kqi3KUsXc/edit?usp=sharing

https://docs.google.com/document/d/1jtkRV3i_zips5E8y6QwUmkOB5gX3qggAx691L2jO_ys/edit

Member	Contribution
Hai	Individual research. #bizrisk, helped with calculations of financial metrics and assist with other LOs.
Long	Individual research. #bizfunctions, Dupont and common size analysis, references.
Maria	Individual research. Focused on #bizstrategy, formatting, helped with researching additional information, footnoting and editing.