Adidas AG

Party's over. Major markets are stalling out.

1. High concentration, two-strong pattern and robust industry prosperity continue to be the norms of the sportswear industry.

2. Adidas's rapid growth in 2014-2018 is mainly due to the "athleisure" trend, first-class execution of strategy and exploration of emerging markets.

3. We expect margin to climb by 0.3-0.4 pp per year by 2021 owing to the scale effect of supply chain consolidation and marketing investment.

4. We expect that future market share growth in US to be limited due to Nike's re-accelerating and that a decline in European market due to macro slowdown. The Asia-Pacific market will be the best performing sector.

5. We initiate a sell recommendation with a target price of €176.00 based on DCF model using CAPM.

Equity

Germany

Sportswear Industry

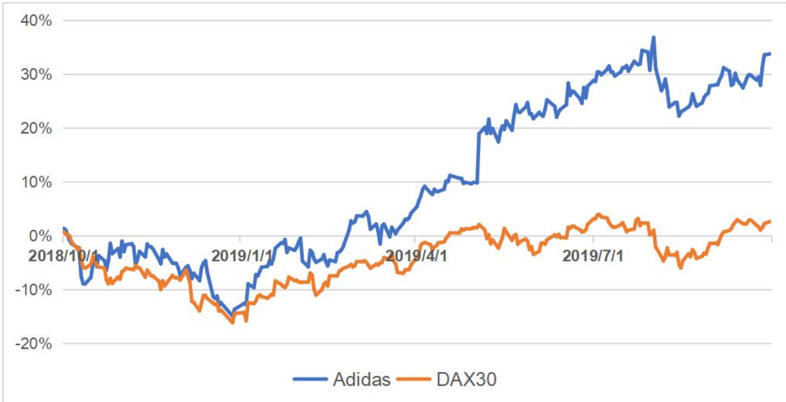
SELL

12-month Price Target	**€ 176.00**
Current Price	**€ 271.60**

RIC: ADSGn.DE **BBG**: ADS GY

Trading data and key metrics

52-wk range	€178.15-296.75
Market cap.	€53.94b
Shares	199m
Free Float	100%
Avg. Daily Volume	576K
P/E Ratio	30.57x



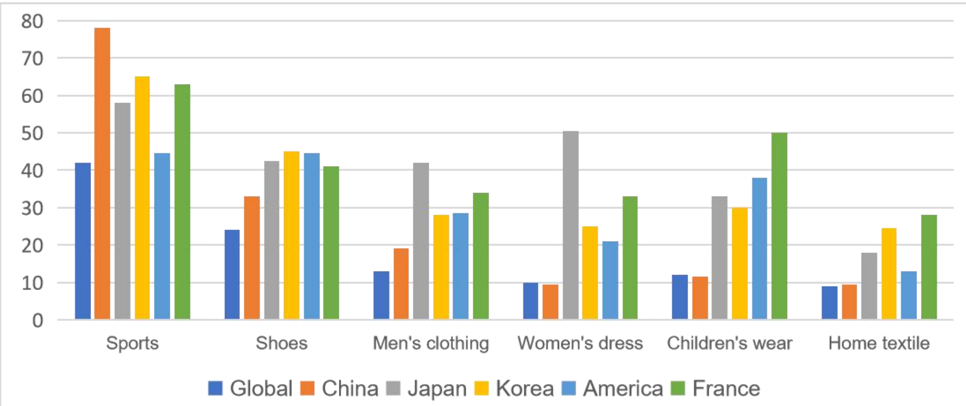
Industry Analysis

1.1 Basic characteristics of sportswear industry

1) High concentration

CR10 represents the sum of shares occupied by the 10 largest companies/brands in an industry, which is used to measure industry concentration. As ***Exhibit 1*** indicates, **the global sports shoes and apparel category are extremely concentrated**. Sportswear's CR10 is over 40%, much higher than others such as men's, women's, and children's wear. From the perspective of countries, the concentration of mature markets such as developed countries and China is high, and the concentration of developing countries is steadily increasing.

Exhibit 1 CR10 in sportswear and shoes industries compared to other categories in 2018 - %

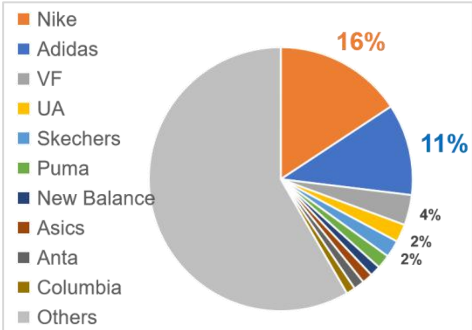


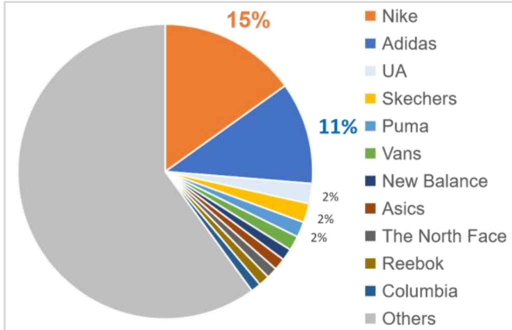
Source: Euromonitor

2) Nike & Adidas's two super strong pattern

Nike and Adidas's market shares by brand were 15.8% and 11.2% respectively in 2018, far surpassing other brands and has maintained a steady increase over the past decade. Among other brands, the brand market share of UA, Skechers, Puma and Vans were 2.2%, 2.1%, 1.7% and 1.6% respectively.

Exhibit 2 Global sportswear market share by company in 2018 (left)
Exhibit 3 Global sportswear market share by brand in 2018 (right)



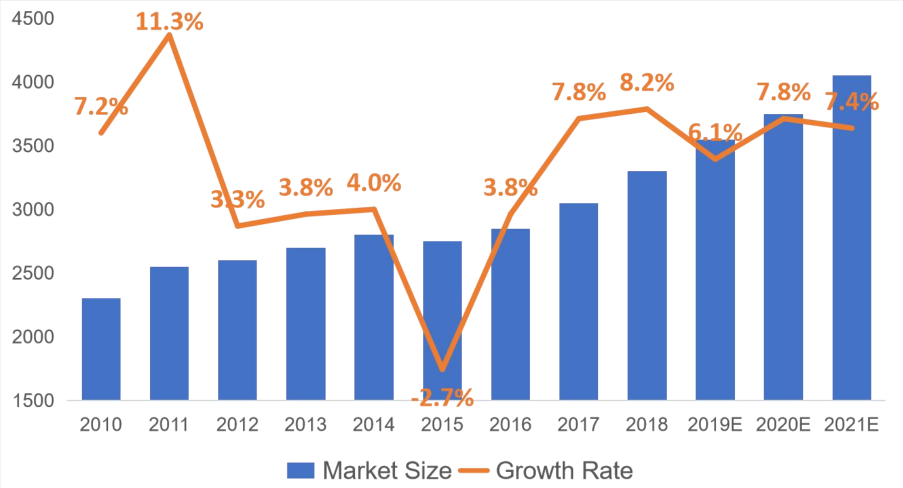


Source: Euromonitor

3) Robust industry prosperity

The global sports market in 2018 was $335b, with a steady increase over the past decade and a 4.1% CAGR 2008-18. Looking forward, under the support of factors such as health awareness, sports and leisure trends and consumption upgrades, it is expected that the sportswear industry will remain a steady growth.

Exhibit 4 Global sportswear market size ($100m) and growth rate



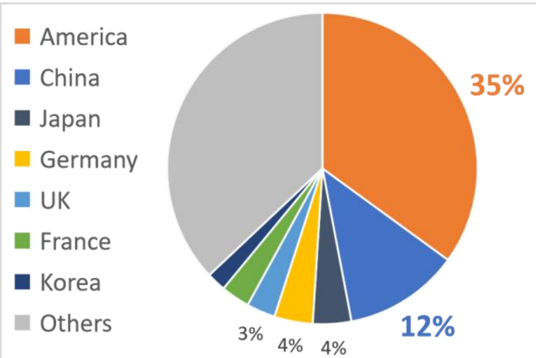
Source: Euromonitor

1.2 Market size and market trend

Among the $330b global sportswear market, **America has the largest market size** (35% market share), with $122b in value. **The second is China market**, which is about 1/3 of American market. The total market size of America, China, Japan and Germany is over 60%.

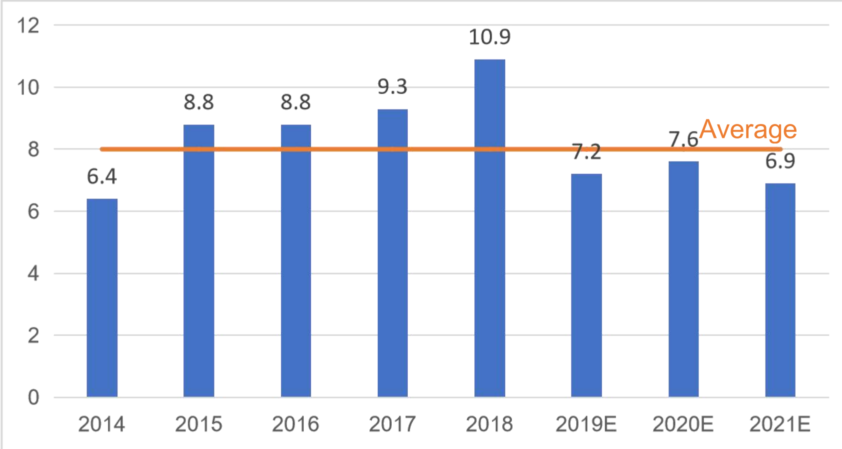
Exhibit 5 Sportswear market share by country in 2018 - %

Source: Euromonitor



1.2.1 Asia Pacific

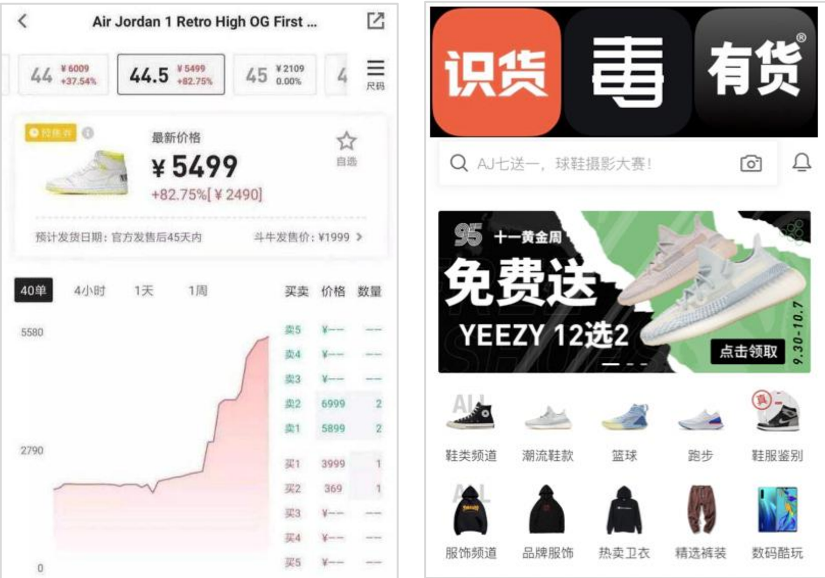
Exhibit 6 Sportswear market growth 2014-21e in Asia-Pacific - %



Source: Euromonitor

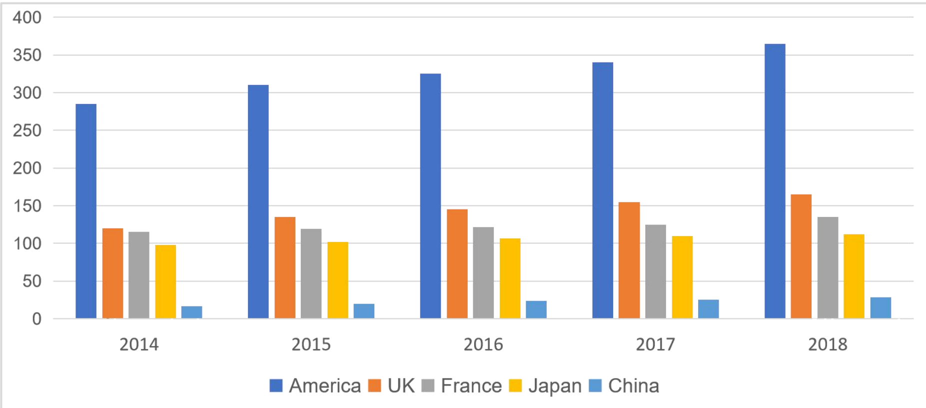
The Asia-Pacific sportswear market remains a high growth rate at around 8% CAGR in average from 2014-21e and China ought to be the core growth driver of the region, who has reached its historical high in growth rate at 17.1% in 2018 owing to the extremely popular sneaker culture. In China, the younger generation prefers to share and socialize, and **the integration of social media and e-commerce meets their needs**. Sportswear shopping websites, represented by *Poison*, are enjoying fast sales growth and there is even an exchange (with candlesticks charts and all that) trading fancy sneakers like Yeezy. Different from the traditional e-commerce, these platforms adopt the trinity mode of "seller delivery, platform identification, buyer receipt", which adds credibility to the shoes being traded and gains millions of users who love this athleisure trend.

Exhibit 7 Screenshots of *Posion*, a Chinese shopping guide platform



Source: Poison mobile application

Exhibit 8 Sportswear expenditure per capita - $/year



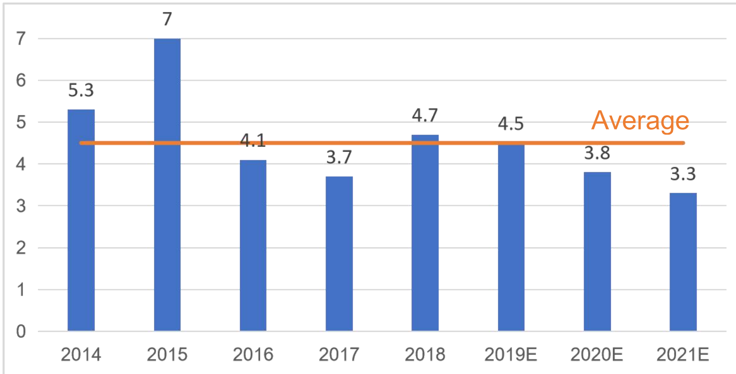
Source: Euromonitor

Exhibit 8 shows that the sportswear consumption expenditure per capita in China increased from $16.4 to $28.8 in 2014-18 (11.9% CAGR), indicating **the rising awareness of healthy lifestyle and fitness among citizens**. Due to large population base and income inequality, per capita expenditure of China is still smaller than that of other countries, which suggests great potential for future growth.

1.2.2 North America

Despite the rapid growth before 2015, **we expect the American market to encounter a gradual slowdown in the following years** (4.5% for 2019e, 3.8% for 2020e and 3.3% for 2021e). Yet the market will still remain solid as the biggest sportswear market in the world. 2015 till now, the combination of performance and fashion has been the main theme. Based on sports functions, shoes with fashion designs are more welcomed by American customers. Brands like Lululemon and Balenciaga are earning market share from those who are famous for professional uses such as UA and Asics.

Exhibit 9 Sportswear market growth 2014-21e in North America - %



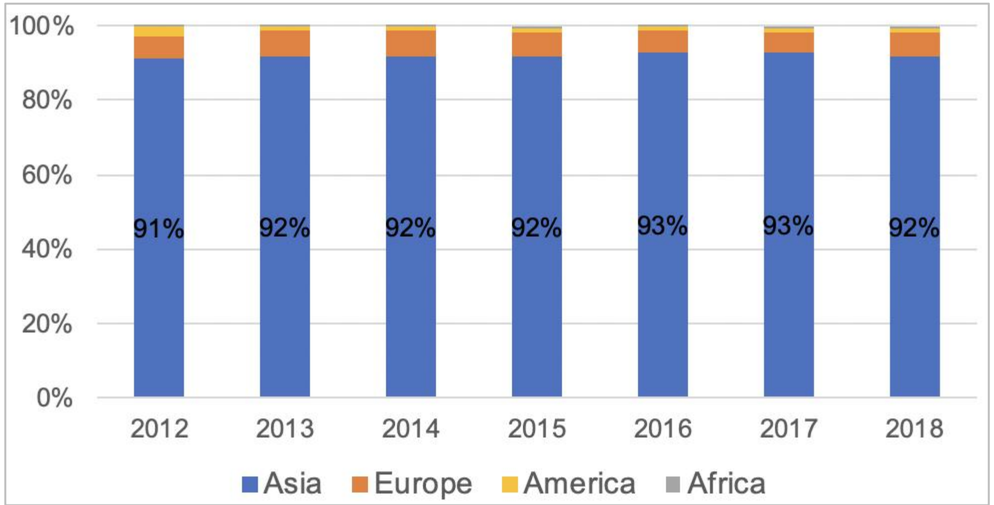
Source: Euromonitor

1.3 Supply chain analysis

(See the supply chain model in the next slide)

The moderately flexible supply chain model transformation requires enterprises to carry out systematic transformation at the level of the general supply chain. Among them, the commodity planning process is required to better grasp the terminal real sales (analysis-driven). It requires designing the sample producing procedure to further shorten the development cycle (digitally driven). Additionally, it demands the processes of procurement, production and logistics distribution to match the balance of more efficient response and more stable supply in the fast-reaction mode (ecological and intelligent drive). Further, it requires channel sales to truly achieve omni-channel operation.

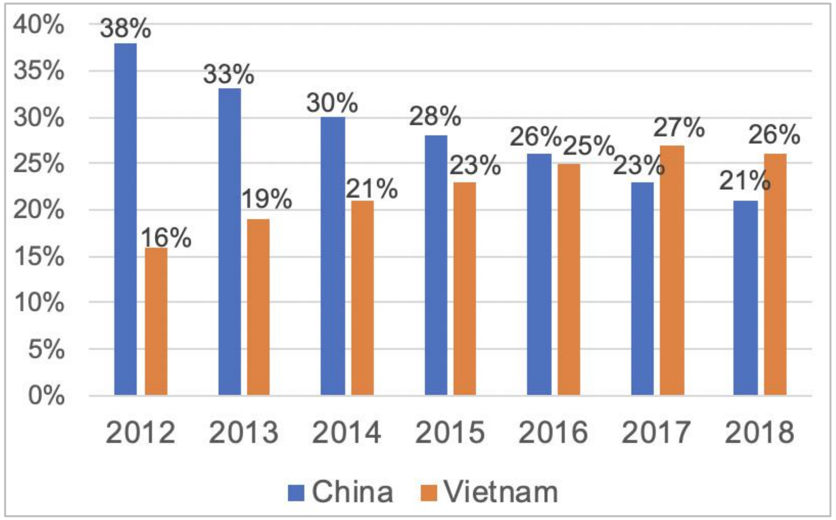
Exhibit 10 Adidas sourcing market breakdown in volume in 2012-18



Source: Adidas annual reports

Most sportswear company choose Asia as their main sourcing market because the low production costs and they produce over 80% of sportswear products in Asia. Take Adidas for example, over 90% of its products come from low-cost countries in Asia, which mainly includes China and Vietnam.

Exhibit 11 China & Vietnam share of Adidas sourcing mix in 2012-18

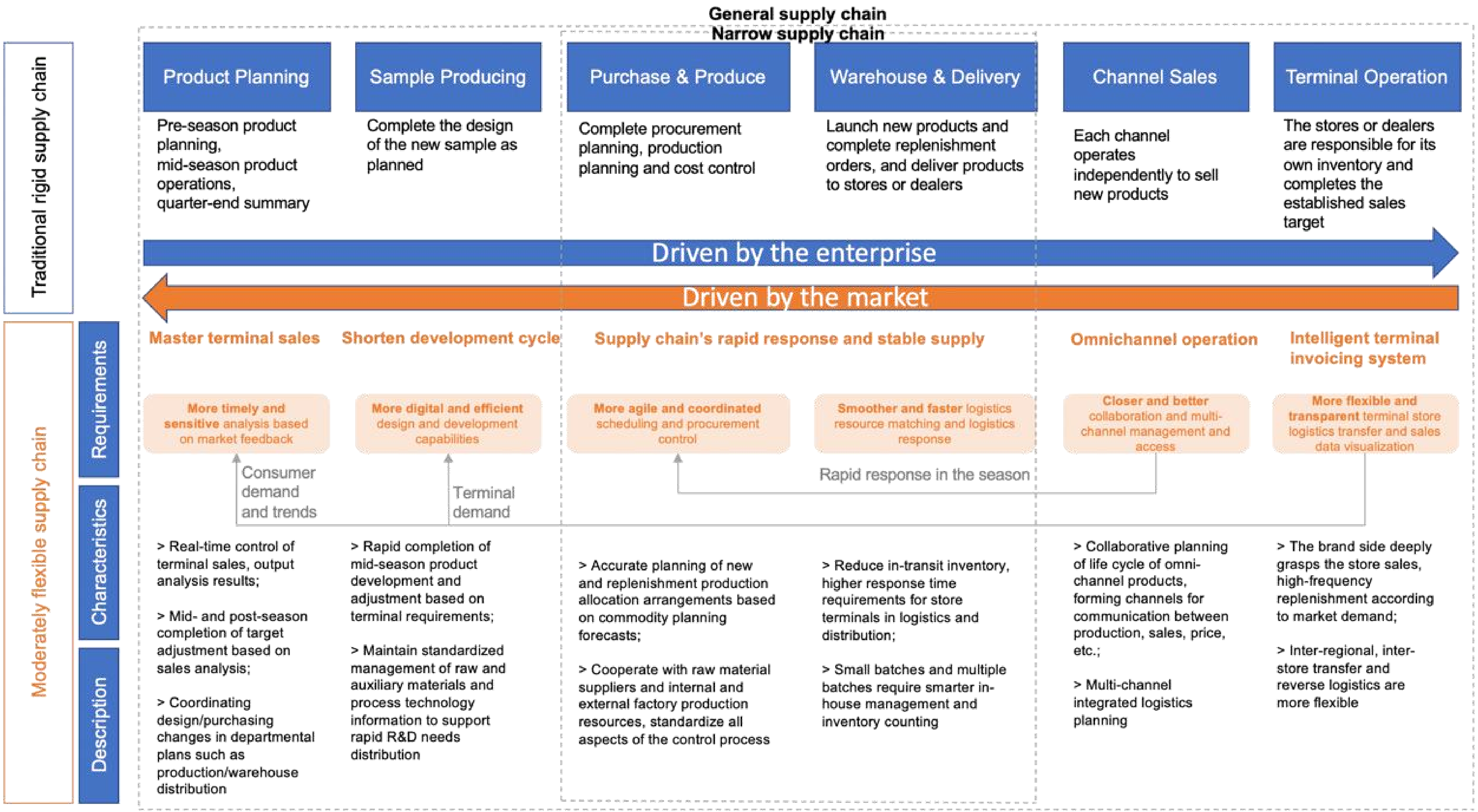


Source: Adidas annual reports

In Asia, China and Vietnam are the two most common countries for sportswear company choose to produce their products. For instant, Adidas has over 50% products produced in Asia sourcing markets products that are from these two countries. From 2012 to 2018, there is a tendency that move more production plants from China into Vietnam to further lower its production costs.

Exhibit 12 The general and narrow supply chain of sportswear industry

Source: Roland Berger



Company Analysis

2.1 Business Overview

Founded in 1949, Adidas is the world's second largest sportswear company which specialized in designing, developing and marketing **footwear, apparel and hardware** in sportswear industry.

2.1.1 Originals (Trefoil)

Source: Adidas Website

The sign Trefoil was created in 1972. The brand position is '**light fashion**', which focus are the uniqueness and novelty of the styling, and **suitability for daily life and casual use**. Its production paid more attention to the plate and appearance, mainly made by pure cotton, polyester fiber and polyester, which is good-looking but not suitable for strenuous sports.

2.1.2 Performance

Source: Adidas Website

The sign was born with Adidas itself by its founder *Adolf Adi Dassler* in1949. **It focuses on professional sports and most of its Products are 'born for sports'**. Therefore, most of the fabrics are made of breathable, sweat-absorbent materials. The texture of the garment is soft and comfortable, and the fabric is relatively thin. The shoes are light in weight and suitable for running sports and other sports as well.

2.1.3 Style (neo)

Source: Adidas Website

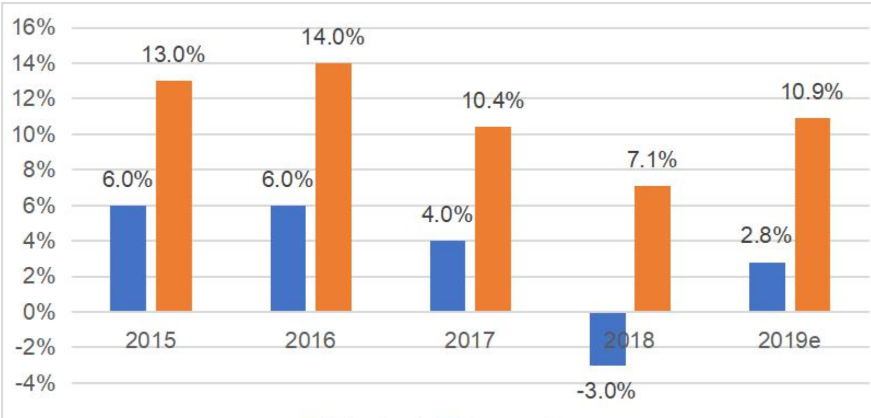
The sign was design by Yohji Yamamoto in 2005. This is a try to create a new sub-brand mainly **face young people** and **put fashion on its most important place**. The price of most products of neo are relatively low compare with other two sub-brands to attract potential customers.

2.1.4 Reebok

Source: Adidas Website

Besides its own 3 sub-brand, Adidas has also finished the acquisition of Reebok in 2006.The main purpose of the acquisition is **to infiltrate the US market** as Reebok has great influence in NFL and NBA. However, although the acquisition has improved Reebok's operation, it still cannot catch up with the average growth of the sector. **We expect the process of 'Reebok revival' to be long and costly**.

Exhibit 13 Revenue growth YoY: Reebok vs the sector

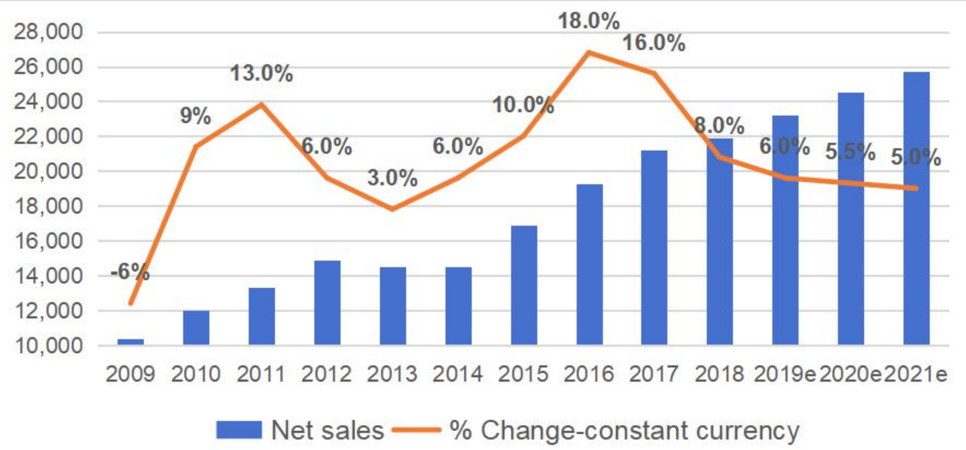


Source: Bloomberg

2.2 Financial Analysis

2.2.1 Revenue and Income

Exhibit 14 Net Sales (€m) and Currency-Neutral Growth Rate YoY

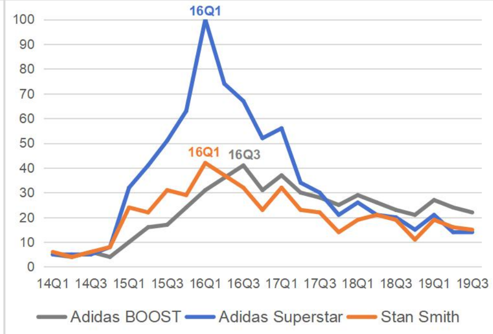


Source: Adidas Annual Reports

During the past 2014-2018 period, Adidas has enjoyed a rapid growth with a 12.9% CAGR in revenue. Three factors can be attributed to this outperformance against the sector (11% CAGR):

1) The emerging awareness of healthy lifestyle and wellbeing in major markets (i.e. North America, West Europe and China) and the fashion trend "athleisure" that emerges consequently. This fashion cycle has brought Adidas great brand momentum, making sneakers the fastest growing product in Adidas's product mix. The exhibits show how the three key franchises of sneakers have soared during the past 5 years (1.8% to 17% of group sales in 2013-2018).

Exhibit 15 Stan Smith+SuperStar+BOOST contribution to sales (left)
Exhibit 16 Search Trends on Google Shopping (Indexed) (right)

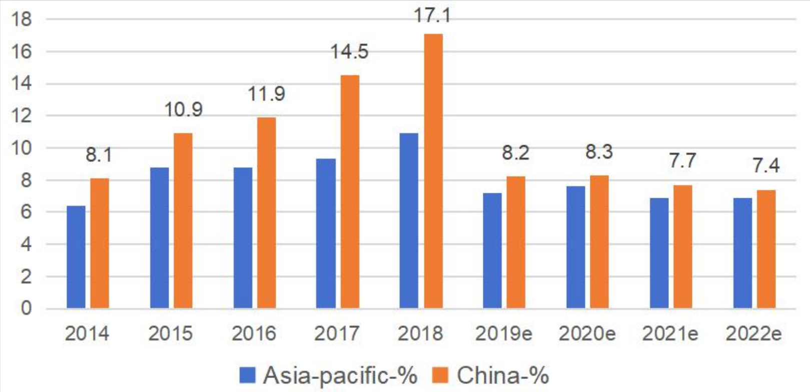


Source: Morgan Stanley
Source: Google Trends

2) First-class execution of corporate strategy. In 2016 current CEO *Kasper Rørsted* took office, who is well-known for cost control and had been managing the Henkel Group for almost a decade. His decisions to expand e-commerce channels and reduce ineffective marketing expenses have proven to be successful.

3) The exploration of emerging markets. China is a case in point. During the past 5 years, Adidas has been aggressively expanding retail business (including the e-commerce channels) in tier 1&2 cities in China, where the sportswear market enjoys an exceptionally high growth rate (12.5% CAGR). Additionally, Adidas is perceived as a high-profile sports brand among Chinese customers, which gives the brand higher pricing power and brand premium (18% of group sales and 30% of EBIT). This successful infiltration has made China the largest profit contributor to Adidas in geographic sense.

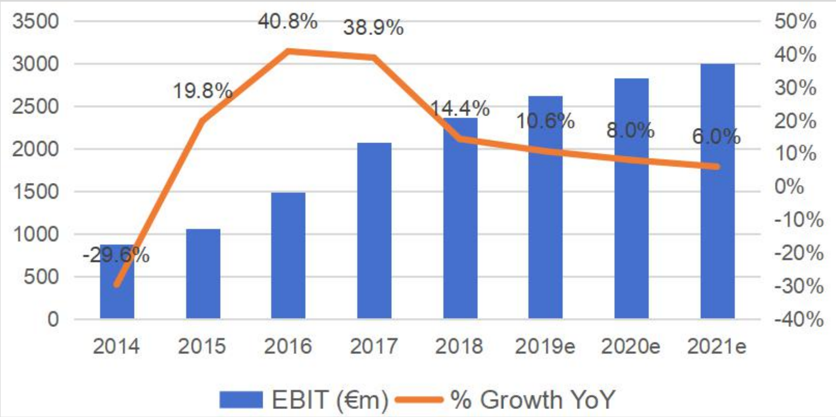
Exhibit 17 Sportswear Market Growth in Asia-Pacific and China - %



Source: Euromonitor

The income side, EBIT has shown leveraged fluctuation compared to sales. After the 2014 headwind, operating profit has rebounded by 168% within 5 years, with operating margin increased by 4.7pp to 10.8%. Despite the decrease in EBIT growth rate in 2018-21e, **we expect margin to climb by 0.3-0.4 pp per year** by 2021 owing to the scale effect of supply chain consolidation and marketing investment.

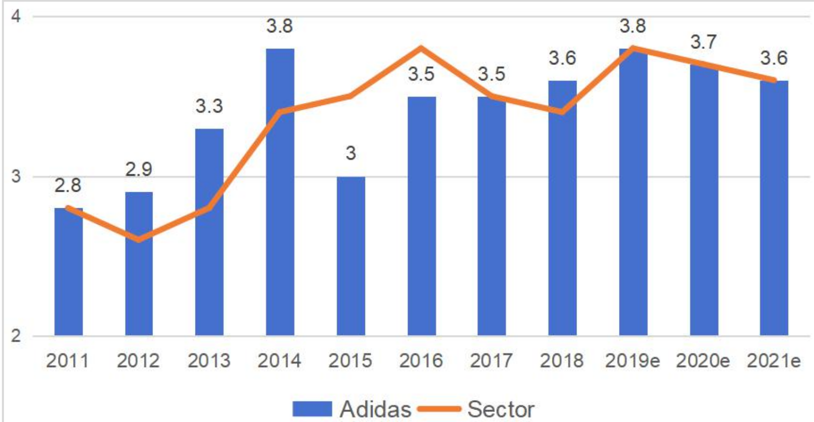
Exhibit 18 EBIT (€m) and Currency-Neutral Growth Rate YoY



Source: Adidas Annual Reports

2.2.2 Expense

Exhibit 19 capex/sales ratio (%) for Adidas vs the sector 2011-21e



Source: Adidas Annual Reports & Euro-monitor

The solid growth of group revenue cannot live without a constant investment in brand and supply chain. After 2013, Adidas has maintained the capex/sales over 3%, this is due the enlarging retail exposure of the group. Management guidance shows that capex intensity should not slow down, as capex/sales ratio is targeted at 3.5-4.5%, which will be driven by the investments in retail network, IT infrastructure for e-commerce and warehousing.

Exhibit 20 Adidas's retail exposure vs the sector 2008-21e

Source: Adidas Annual Reports & Euromonitor

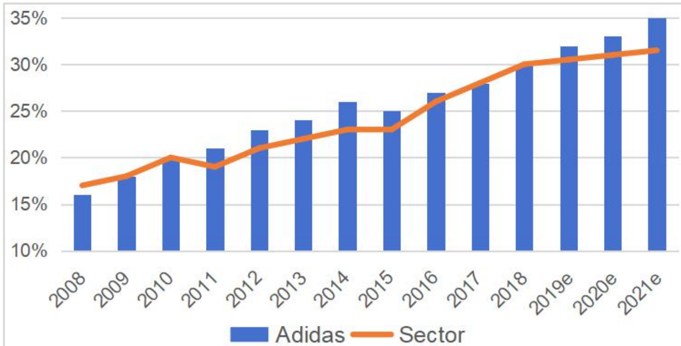
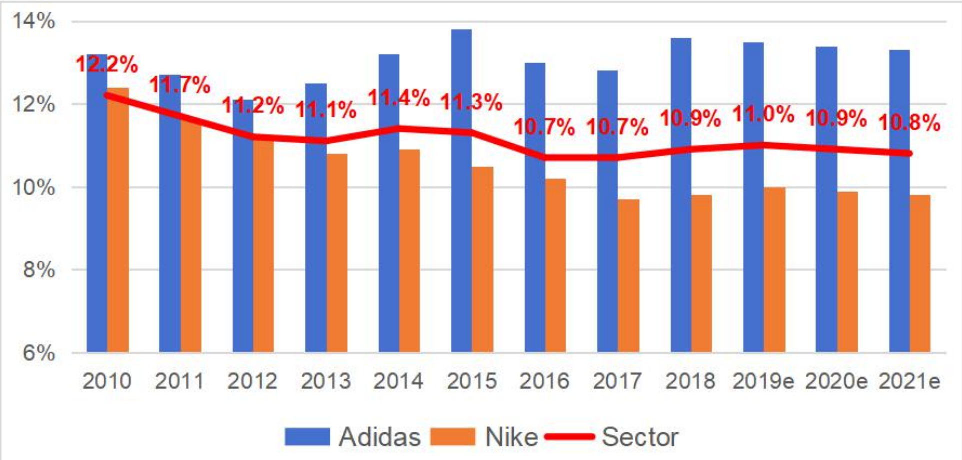


Exhibit 21 Marketing expense as a % of sales 2010-21e



Source: Adidas & Nike Annual Reports and Euromonitor

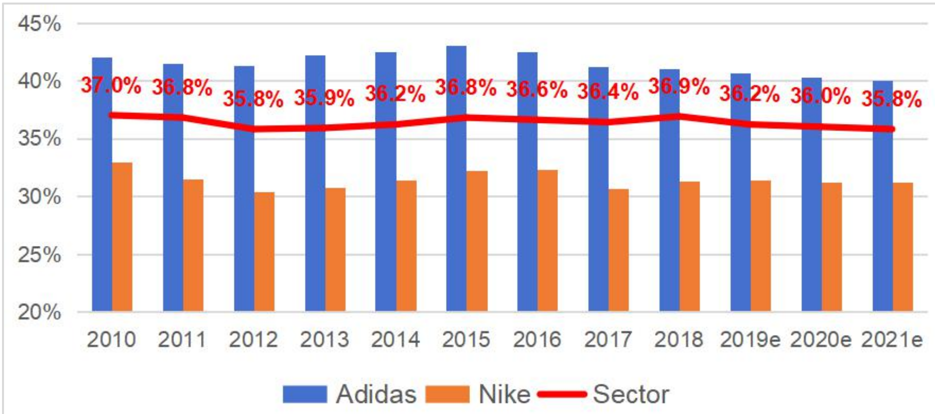
The marketing expense ratio provides an indication of marketing intensity in terms of sales & distribution spend, advertisement & promotion and digital costs. Adidas maintains 1.9pp (10y average) above the sector in marketing expense since **the management is trying to improve brand visibility in sports events and team naming** (especially targeting Nike in US). It is worth noting that the 3.6pp (average of 2015-21e) gap between the marketing expense rate of Nike and that of Adidas is due to the scale effect achieved by Nike in the US market (1.4x of Adidas's revenue), which does not imply a strategic drawback of Nike on marketing.

In terms of opex ratio, the sector's is fixed at 35-37% in the long-term, indicating a bottom line for a sportswear company. We expect Adidas's opex ratio to fall by 1.0pp to 40% by 2021e due to the scale effect, yet it should be dynamically above the sector average.

We think Adidas is now well positioned given the above-sector capital investment intensity (capex/sales at 3.6% vs sector at 3.5%) along with higher marketing spend (11% of sales) above the sector.

Looking forward, opex and capex is only a prerequisite, not sufficient conditions for growth. The above-sector opex has helped Adidas to recover from its 2012-14 headwind, yet the success cannot be reached without effective product strategy. Risk exists that unsuccessful product launches occur, yet **we deem an underinvestment to be an even greater mistake**. As Adidas approaching the end of fast expansion cycle and the macro gets tough, competition will be intense as ever, which will force the group to sacrifice margin for revenue (i.e. product markdown). In this case, cutting marketing investment could exert long-term negative impact on brand impulse and customer perception. Therefore, we expect Adidas to maintain capex equal/above the sector, opex constantly 4-5% above the sector, and marketing expense ratio above 10.5%.

Exhibit 22 Opex as a % of sales 2010-21e



Source: Adidas & Nike Annual Reports and Euromonitor

2.2.3 Earnings Forecast

By geographic sector

Exhibit 23 Segmental Revenue Breakup of Adidas

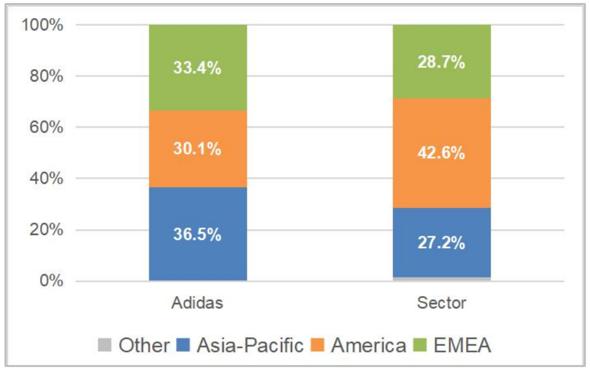
Revenue Breakdown (€m)	2014	2015	2016	2017	2018	2019e	2020e	2021e
Western Europe	4112	4539	5291	5933	5885	5767	5594	5426
% change	*+8%*	*+17%*	*+20%*	*+13%*	*-1%*	*-2%*	*-3%*	*-3%*
North America	2972	2753	3412	4276	4689	4923	5170	5325
% change	*-6%*	*+5%*	*+24%*	*+27%*	*+15%*	*+5%*	*+5%*	*+3%*
Asia Pacific				6403	7141	7998	8798	9502
% change					*+15%*	*+12%*	*+10%*	*+8%*
Latin America	1622	1783	1731	1907	1634	1667	1667	1634
% change					*+6%*	*+2%*	*0%*	*-2%*
Emerging Markets				1300	1144	1235	1310	1375
% change					*-3%*	*+8%*	*+6%*	*+5%*
Russia/CIS		739	679	660	595	631	650	670
% change		*-11%*	*+3%*	*-13%*	*1%*	*+6%*	*+3%*	*+3%*
Other businesses		1467	1475	739	827	1009	1320	1800
Total Group	14534	16914	19290	21218	21915	23230	24508	25732
% change	*+6%*	*+10%*	*+18%*	*+16%*	*+8%*	*+6%*	*+5.5%*	*+5%*

Footnote: 1. All % changes are in constant currency. 2. All forecasts (2019e-21e) are on currency-neutral basis.

Source: Adidas annual reports

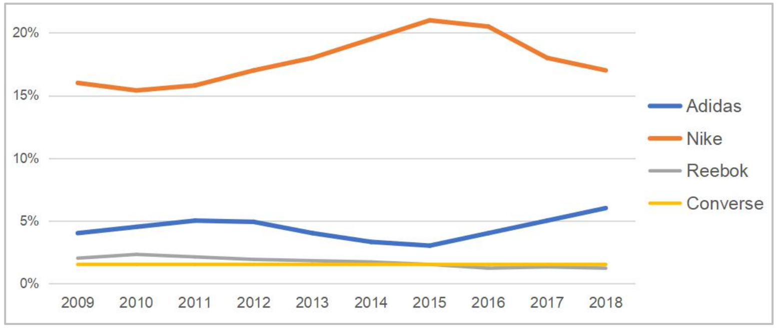
During the past five years, Adidas has experienced robust growth in its major markets: Western Europe (9.4% CAGR), North America (12.1% CAGR) and Asia Pacific. Its geographical exposure varies from the sector. Its American business takes a lower share (30.1% vs sector 42.6%), which is mainly due to the competition with Nike. **The group relies heavy on Asia-Pacific** (36.5% vs sector 27.2%) **and the European market** (33.4% vs sector 28.7%). According to Euromonitor, in 2018 Adidas's market share in 3 main geographical sectors is 6% in North America, 14% in West Europe and 16% in Asia Pacific.

Exhibit 24 Adidas's geographical exposure vs the sector - 2018



Source: Euromonitor

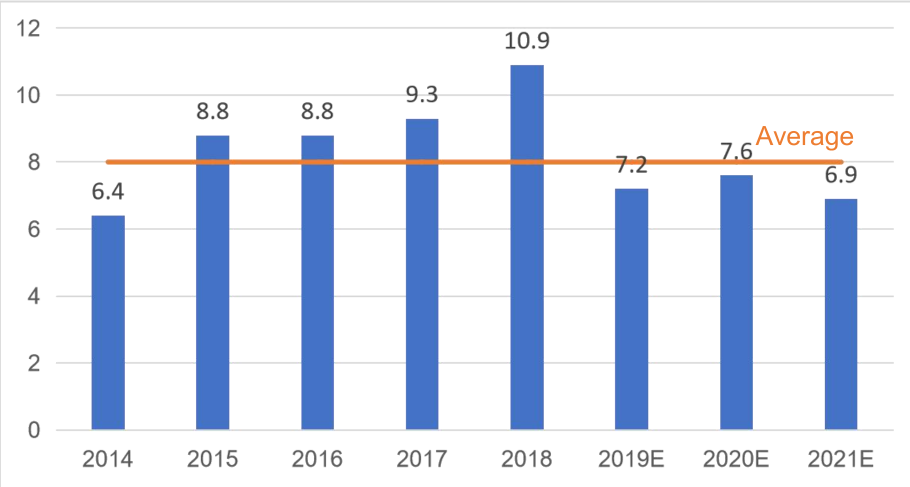
Exhibit 25 North America market share of Adidas, Nike & sub-brands



Source: Euromonitor

In terms of the America market, Adidas has been aggressively taking market shares (up 3.0pp in 2014-18e) due to effective product positioning which is in line with the current fashion trend. Yet **we view the potential for future market share growth to be limited** as its growth is now directly taking Nike's share, which will make gaining per unit of market share more costly and difficult than before. Management guidance has proved this point. On 2017 Investor Day, the North America sales is guided at €5b, which is equivalent to a mid-term 9% CAGR. Besides, Euromonitor has initiated an even lower expectation, which we use as growth rate forecast in Exhibit 9.

Exhibit 26 Sportswear market growth 2014-21e in Asia-Pacific - %



Source: Euromonitor

We expect that Asia Pacific to be the best performing sector in Adidas's geographic mix, with mid-term CAGR expected at 7.0-8.0%, and **that Adidas continuously outperform the sector by 2-4% (that is, 8-12% CAGR) to over €10b in scale by 2022e**. This is due to the different perception also the rising disposable income per capita in the region (i.e. China's citizens' disposable income rises at 11% CAGR). That is, the brand Adidas is perceived as a high-profile sports brand, which brings lower bargaining power from customers and gives the company more space in pricing adjustment. In the case of market slowdown, management may have to face a dilemma between an expense cut or a lower margin in markets like US where the competition is already intense. However, in Asia-pacific, higher pricing power and lower production cost indicate more options other than this-or-the-other.

Besides the positive prospects, we do expect the thrilling growth rate in China to slow down by 3-4%. It is because Adidas has finished the expansion of retail network in tier 1&2 cities and the establishment of e-commerce infrastructure in China. **The group is now trying to explore the tier 3&4 cities in retail, which will may not result in organic growth from our perspective.** The traits of tier 1&2 cities versus tier 3&4 cities vary dramatically: the latter has a much lower disposable income per capita and has a much larger counterfeit market. One vivid example is PuTian, a city in Fujian Province, whose counterfeit shoe production exceeds 1 billion pairs per year. The fake shoes are sold through official-like distributors and e-commerce platforms to customers who may or may not be aware of its nature.

Exhibit 27 Counterfeit shoes on Taobao.com

Top 3 sellers of Adidas Yeezy shoes on Taobao, largest online shopping platform of China whose parent company listed as BABA in NYSE, sell over 16k pairs per quarter of counterfeit shoes manufactured in Putian City. The price range for a pair of fake Yeezy is around €30-50, while the official price is €300-600. According to our investigation with one of the Putian shoe sellers, **most of these counterfeits are sold to the youngsters in tier 3&4&5&6 cities** based on the post address buyers provide.

2.3 Competitive Analysis

The main competitor of Adidas is the US company Nike, which is the largest sportswear company in the world. At the end of 19Q3, the market value of Adidas is $61.6b vs $145.6b for Nike.

Exhibit 28 Revenue (€m) comparison between Adidas and Nike

Source: Adidas & Nike Annual Reports

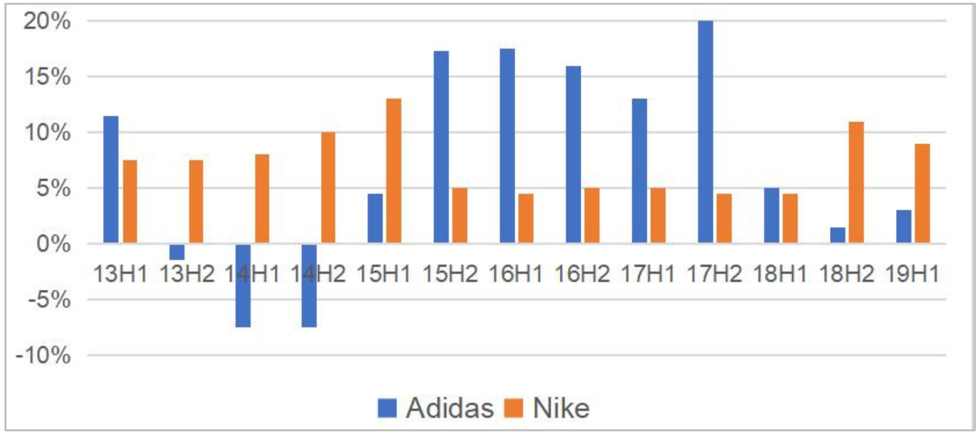
Although outperforming the sector in the past 5 years (12.9% vs 11.0% in CAGR), Adidas is falling behind Nike in terms of group sales. **The revenue gap** (€12.4b) **is almost entirely due to the US market**, where Nike has achieved economies of scale and holds its market share firmly. For example, the average income per store for Nike is €6.1m vs €1.9m for Adidas. In addition, Reebok, as Adidas's pathfinder to the US market, is also suffering a headwind. Therefore, **we deem it difficult for Adidas to exceed Nike in 2019e-21e**.

The mainly strategic differences are reflected in two aspects:

1) Company focus and revenue pattern

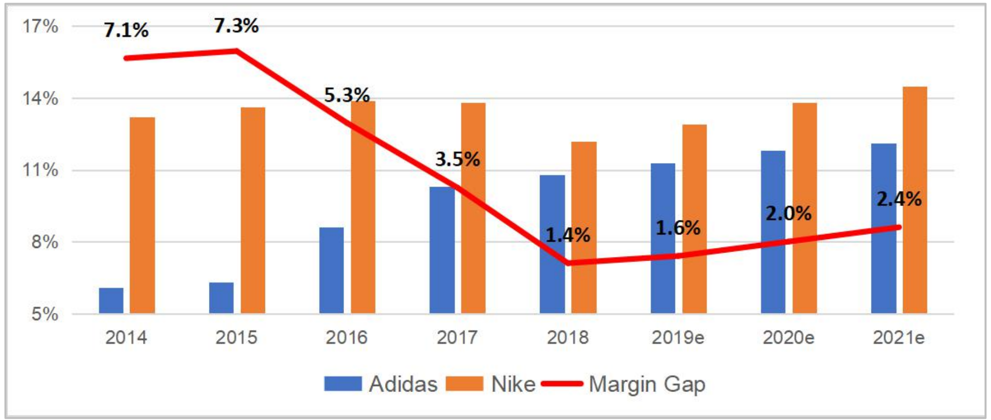
Adidas's performance is less stable but leaves more space for imagination. The variance of its sales growth is much higher than that of Nike. This is because **Adidas bets more chips on the fashion cycle**: sales are easy to boom when new products are in line with the trends, but may slip dramatically when the trends cool off. On the other hand, with a positioning on functionality, Nike possesses a higher customer adhesiveness, which smooths the revenue curve despite the low likelihood to beat expectation.

Exhibit 29 Sales growth of Adidas and Nike 2013-19



Source: Adidas and Nike annual reports, Bloomberg

Exhibit 30 EBIT margin of Adidas and Nike 2014-21e



Source: Adidas and Nike annual reports, Bloomberg

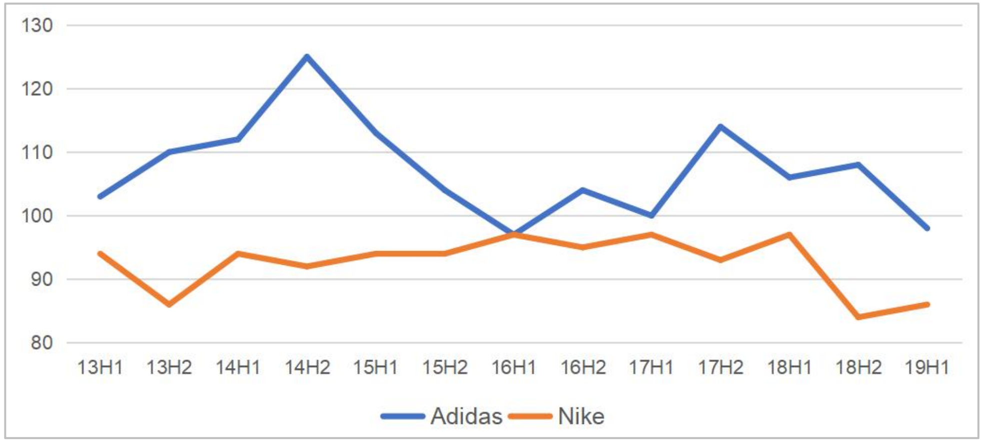
In 2016, Adidas Original published a new global theme, 'future'. To create the heat and stress fashion, Adidas hired 8 fashion photographers to make its advertisement. Therefore, in 2016 and 2017, the EBIT of Adidas increased sharply. However, as the fashion theme becoming out of style, we expect that the growth of Adidas's margin to slow down (EBIT margin to climb by 0.3-0.4 pp per year by 2021 vs 0.9pp per year during 2014-18) and that **EBIT gap between Adidas and Nike to start expanding once more**.

2) Supply chain strategy

Adidas's strategy on supply chain is also different from Nike's. Adidas's management chooses small suppliers to limit their bargaining power, but **the production flexibility of supply chain is not enough** and cannot satisfy the downstream needs when faced with the sharp increase in demand (i.e. US and China market).

In contrast, Nike's strategy is global production and intensification, orders are concentrated to large OEMs to achieve stable supply chain. As the graph shows, Nike's inventory day is stable and always shorter than Adidas's. Adidas's strategy is to sacrifice turn over and gain more bargain power, then lower the cost. According to the performance (revenue gap), Nike's strategy may more fit to the changes of the demands.

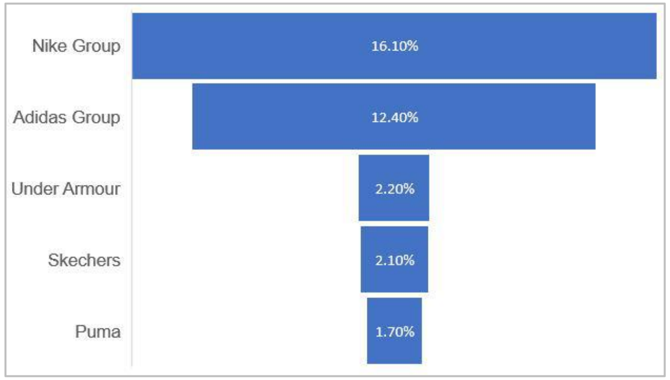
Exhibit 31 Inventory day of Adidas and Nike (days)



Source: Adidas and Nike annual reports, Bloomberg

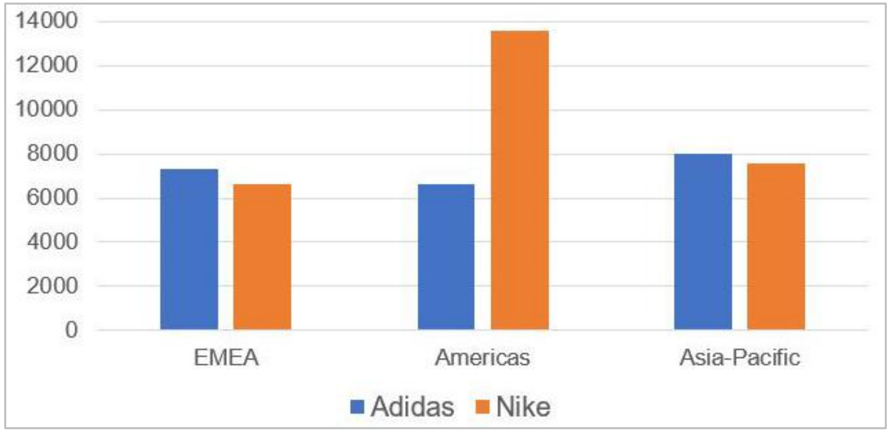
In addition to the strategic difference, another weakness of Adidas, is the imbalance development in different areas. According to the graphs, it could be seen that in 2018, Adidas's global market share is Nike's 77%. The difference in EMEA and Asia-Pacific is in the normal range, however, in Americas, Adidas's revenue only reached Nike's 48.6%. It seems Adidas's acquisition to Reebok does not play the value it deserves.

Exhibit 32 Global main sportswear company market share 2018



Source: Euromonitor

Exhibit 33 Revenue by regions of Adidas & Nike in €m for 2018



Source: Adidas and Nike annual reports, Bloomberg

In conclusion, Adidas still has a long way to go to challenge Nike, especially in the US market as the current gap in EBIT margin and market share is enlarging. Therefore, innovation from fundamental for Adidas, especially a different strategy for America market is required.

Investment Thesis

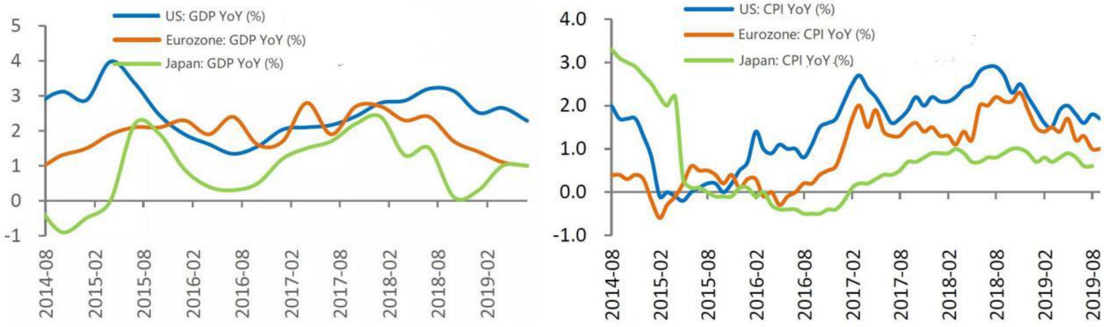
1) Macro gets tough

The world economy is now at the top of a long-term debt cycle. As the recent trade tension has accelerated the global economic downturn (IMF estimates the current tariffs will reduce global GDP by 0.8%), economies including US, the Eurozone and emerging markets have started to cut the interest rate in order to stimulate inflation. Nearly 30 central banks have cut interest rates since 2019. On 19 Sept 2019, the FOMC announced to cut the Federal Funds Rate by 25bp to 1.75%-2%, stating **that the global economy is weak especially in the Eurozone, and that geopolitical events bring significant threats to the global economies.**

In terms of US, Adidas's main battlefield against Nike, although the consumption remains robust and unemployment rate stays low, **leading economic indicators have suggested significant downside pressure**. The August Markit Manufacturing Industry PMI has fallen below 50 and the September ISM Manufacturing Industry PMI reports 48, which are all at 10-year low after the financial crisis. In addition, consumer confidence has slipped to a 3-year low. OECD leading indicators also suggest an economic slowdown in the upcoming quarters.

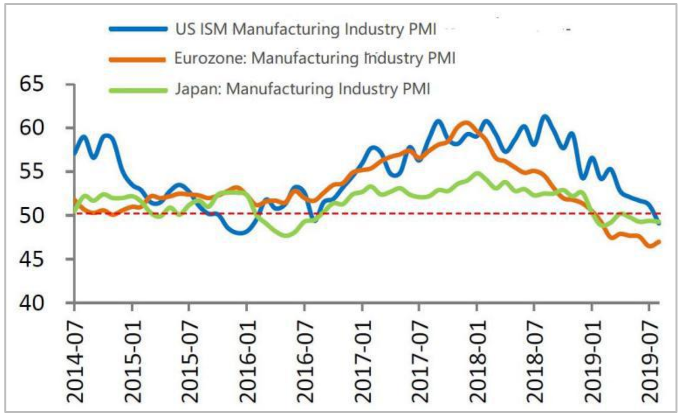
Looking at the **Eurozone, signs of depression are even more obvious**: manufacturing investment remains weak and deflation risks arise. As 19Q2 GDP growth hit 1.00%, ECB announced an interest rate cut by 10pp to -0.5% and restarted QE, hoping to stimulate investment and inflation (CPI reports at 1.0%, below target 2.0%).

Exhibit 34 GDP YoY (%) and CPI YoY (%) for US, Eurozone & JPN



Source: Wind, EVERGRANDE Research Institute

Exhibit 35 Manufacturing Industry PMI in US, Eurozone & Japan



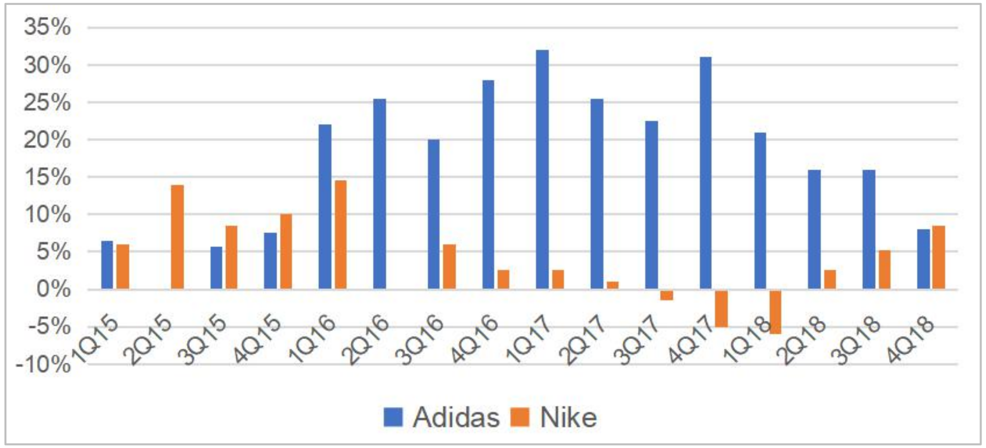
Source: Wind, EVERGRANDE Research Institute

As the world's leading emerging economy, **China is also suffering a macro slowdown**: Manufacturing investment remains weak (August manufacturing investment growth hits 2.6%, 0.7pp lower than that of Jan-July; PMI reports below threshold), deflation risk rises (PPI falls below zero), retail consumption real growth continues to drop (reports at 5.6%, down 0.1 pp from July) and exports decline by 1%.

2) Trend cools off, environment gets more competitive

Starting from 2014, the "athleisure" trend has brought the sportswear industry significant growth, benefiting industry leaders like Nike and Adidas even more. Looking forward, as leading indicators like Google Trends for *Stan Smith*, *SuperStar,* and *BOOST* (3 key franchises of Adidas sneakers) indicate (see Exhibit 16), although the products remain appealing to customers, they are no longer growth drivers for the group. This trend is in line with the results of customer surveys conducted by Euromonitor, suggesting that the fashion trend is cooling off and that the sector will remain a solid growth but with a lower growth rate (6-8% CAGR in the midterm). As Nike raises it speed for expansion (see Exhibit 29), **we are afraid that Adidas's party for market share gaining is over and it will suffer from a softer brand momentum.**

Exhibit 36 North America organic growth of Adidas & Nike



Source: Adidas and Nike Annual Reports

In the US market, Adidas has enjoyed a rapid market growth in 2014-16, and **Nike is now re-accelerating**. Despite the remaining appeal of the brand to the customers, we expect Adidas to face a dilemma between an expense cut or a lower margin in order to maintain its market share as the competitive environment worsens.

In the Eurozone, we deem the consensus to be overoptimistic about the macro and we expect Adidas to suffer a slight decline in sales (negative 1-3% in 2019e-22e) due to **weak manufacturing investment, deflation risks and slowing customer consumption**. The tough macro may also result in currency depreciation and therefore exchange lost.

We expect that Asia Pacific to be the best performing sector in Adidas's geographic mix, with mid-term CAGR expected at 7-8%, and that Adidas continuously outperform the sector by 2-4%. The rationale behind the variance is the different perception of Adidas brand for Chinese customers and the rising disposable income per capita. Yet do expect the thrilling growth rate in China to slow down by 3-4%. It is because Adidas has finished the expansion of retail network in tier 1&2 cities and is now trying to explore the tier 3&4 cities in retail, which will may not result in organic growth due to **relatively lower income per capita and significant counterfeit issue**.

Exhibit 37 Estimated growth rate (YoY) forecast for Adidas vs sector

Growth rate forecast	2014	2015	2016	2017	2018	2019e	2020e	2021e
Western Europe - sector	+2%	+3.7%	+3.5%	+2.5%	+2.9%	+3.7%	+3.6%	+3.3%
- Adidas	+8%	+17%	+20%	+13%	-1%	-2%	-3%	-3%
North America - sector	+5.3%	+7%	+4.1%	+3.7%	+4.7%	+4.5%	+3.8%	+3.3%
- Adidas	-6%	+5%	+24%	+27%	+15%	+5%	+5%	+3%
Asia Pacific - sector	+6.4%	+8.8%	+8.8%	+9.3%	+10.9%	+7.2%	+7.6%	+6.9%
- Adidas					+15%	+12%	+10%	+8%
sector - global	+4%	-2.7%	+3.3%	+3.8%	+7.8%	+6.1%	+7.8%	+7.4%
Adidas - global	+6%	+10%	+18%	+16%	+8%	+6%	+5.5%	+5%

Footnote: All forecasts (2019e-21e) are on currency-neutral basis.

3) Reebok "revival" to be long and costly

Although there are stories of successful turnovers like Fila and Champion, Reebok is not moving forward as expected. It performance continues to fall behind the niche sector (-3.0% vs sector 7.1% in 2018, see Exhibit 13). The main issue now is that its strategic positioning is unclear and too-niche, which made the brand miss the opportunity of athleisure.

We do see opportunities in Reebok Turnover, though, in terms of its rich heritage, global awareness and a diversified product offering. Yet it takes time and money for these potential advantages to materialize. We expect a mid-term CAGR of 3% for Reebok, below sector.

Valuation

As systematic errors are made by the market from time to time, especially in this timeframe when the macro is fast-changing and riskier, recognition of market risk is important as ever. Therefore, we deem the use of comparables inappropriate as the consensus could make wrongful judgments about assets. Therefore, **a DCF model is used for fair pricing of assets.**

We use the sales of geographic sectors as weights for calculating the adjusted risk free rate **in order to reflect the macro exposure of Adidas's business.** The adjusted risk-free rate is 2.56%.

Income Statement (€m)	2014	2015	2016	2017	2018	2019e	2020e	2021e	Growing Perpetuity
Revenue	14534	16914	19290	21218	21915	23230	24508	25732	27018
Cost of Sales	(7610)	(8748)	(9912)	(10514)	(10552)	(11197)	(11764)	(12532)	(12969)
Gross Profit	6924	8166	9378	10704	11363	12033	12744	13380	14049
Margin %	47.6%	48.3%	48.6%	50.4%	51.8%	51.8%	52.0%	52.0%	52.0%
Opex	(6281)	(7323)	(8263)	(8882)	(9172)	(9455)	(9877)	(10293)	(10807)
% of net sales	43.2%	43.3%	42.8%	41.9%	41.9%	40.7%	40.3%	40.0%	40.0%
EBITDA	1288	1451	1916	2522	2827	2830	3119	3339	3242
Operating Profit	883	1058	1490	2070	2368	2339	2610	2812	2842
Margin %	6.1%	6.3%	7.7%	9.8%	10.8%	10.1%	10.7%	10.9%	10.5%
EBT	835	1040	1444	2023	2378	2309	2580	2782	2842
Tax	(271)	(353)	(424)	(592)	(669)	(647)	(722)	(779)	(767)
Net Income	564	687	1020	1431	1709	1663	1858	2003	2075
Reported Net Income	490	635	1018	1173	1687	1659	1858	2003	2075
% Change		*+29.6%*	*+60.3%*	*+15.2%*	*+43.8%*	*-1.7%*	*+12.0%*	*+7.8%*	*+3.6%*

Based on our previous analysis of industry trends, market prospects and business strategy, the future net incomes are forecast as above (**please see the full statement forecast in excel**). **We use CAPM (Capital Asset Pricing Model) to price the market risk and estimate the discount rate for Adidas equity.** Using a risk-free rate of 2.56%, equity beta of 1.0 (adjusted for Adidas's capital structure) and market risk premium of 6.5% (derived from trading metrics of German DAX Index), we arrive at the discount rate of 9.1%, which is the required return of equity for Adidas shareholders.

Using the discount rate and forecast net income, Adidas is valued at €35B.

Therefore, **we initiate a TARGET PRICE of €176.00 and a SELL recommendation on the stock**.

Risks

How could we be wrong?

1) Fast emergence of new, successful products

Although we believe that the athleisure trend is cooling off based on current data, it is possible that Adidas may predict the next trend and take action. The scale effect of marketing investment may create surprise in certain franchises. We might be underestimating the creativity and public perception of Adidas brand and products.

2) The development of e-commerce

As retail business is of higher margin, Adidas has been constantly investing in building retail network and e-commerce infrastructures in multiple markets. Albeit we believe the further exploration of electronic channels is costly and difficult in China, especially for the tier 3&4 cities, it is possible that Adidas may create surprise by expanding e-commerce channels in emerging markets like Russia and Latin America, whose citizens' income enjoys a rapid growth.

3) The relief of global trade tension

As China has been one of the most important players in Adidas's upstream (21% in 2018), its trade dispute with US is highly concerned with the manufacturing costs. It is possible to China to reach a trade deal with the Trump administration.

4) Nike

Our thesis on the US market is based on the intense competition from Nike, who has re-accelerated its sales growth for quarters. Yet Nike may also suffer from a wrong brand positioning or product strategy like Adidas in 2013. The under-performance of Nike will provide Adidas with more opportunities and space for growth.

5) The Macro environment

Despite the major economic and financial institutions has downgraded the world's economic prospect (i.e. IMF, World Bank, Fed), there may be a soft-landing for the global economy. This primarily depends on the effectiveness of the fiscal and monetary policies taken by regional governments. From our perspective, the Zero Lower Bound is threatening the effectiveness of the ECB and, in the future, the Fed. QE may only delay deflation and investment decline in the short term but cannot reverse the downward trend from the top of debt cycle.

6) Other general risks

Market risks.
Foreign currency risks.
Regulatory risks.
Legal risks.