INTUITION

26 MAY 2023

Adidas – Endurance required

The Adidas logo is instantly recognisable the world over. The brand transcends language or culture, being the largest sportswear manufacturer in Europe, and the second largest in the world after Nike. However, 2023 has been one of its toughest years yet due to both internal and external challenges. The ongoing war in Ukraine, Covid-19 hangover and multi-decade high inflation caused Germany's broad market index to fall by 12% in 2022, while the MSCI World Textiles, Apparel and Luxury Goods Index decreased by 24%. Adidas is a constituent of both yet ended 2022 down almost 50%. This article will focus on the main reasons behind the weakness and highlight the medium-term opportunities which will provide tailwinds for Adidas to return to the podium.

Nick Rogers

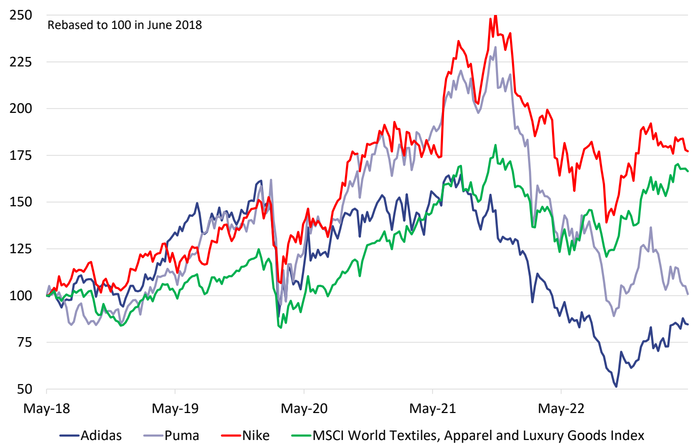
Every successful brand starts with a story to help the consumer understand why he/she should part with their money. But first, you need an innovative product. In 1926, a German cobbler by the name of Adolf "Adi" Dassler created the first athletic track shoe with a complete leather sole and hand-forged spikes. A decade later, Jesse Owens became the first black athlete to win not one but four Olympic gold medals in Berlin. He was wearing Adi's spiked shoes and so the story begins. Reputation is built on consistent results over time. The German football team, wearing Adidas shoes, won the World Cup final match in 1954. Fast forward to 2022 when the "Impossible is Nothing" World Cup brand campaign became the most watched Adidas campaign ever with 2.3 billion views. Lionel Messi, one of the greatest footballers of all time, has been a global ambassador for

The 2022 FIFA World Cup catapulted Lionel Messi's legacy to rival the likes of Pele, a marketing 'bulls-eye' for Adida.

SPEED READ

- **Global brands Adidas and Puma were formed by brothers Adolf (Adi) and Rudolf Dassler respectively, after they fell out in 1949, closing their Dassler Brothers Shoe Company which they formed in 1923.**
- **Jesse Owens became the first black athlete to win not one but four Olympic gold medals in Berlin. He was wearing a pair of Adi's hand-forged spiked shoes.**
- **In 1970, Adidas delivered the first official FIFA World Cup ball, the TELSTAR. It was designed to improve visibility on black and white television and Adidas has provided every official match ball since.**
- **Lionel Messi, one of the greatest footballers of all time, has been a global ambassador for Adidas since 2006, having signed a $1 billion lifetime sponsorship deal.**
- **After last year's fall-out with American rapper Ye (formerly Kanye West), 2023 revenues and operating profit were projected to fall by around €1,2 billion (of which Yeezy-related lost sales accounted for c€1 billion) and €700 million (Yeezy c€500 million) respectively.**
- **Indonesia represented Adidas' largest sourcing country in 2022 (34%) followed by Vietnam (32%) and China (16%). Overall, 97% of the total 419 million pairs of shoes were produced in Asia.**

COMPARATIVE PERFORMANCE OVER 5 YEARS



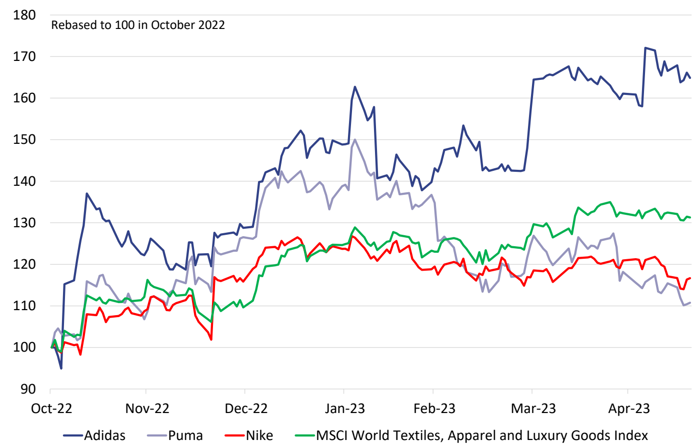
Adidas has underperformed both its peers and sector over 5 years, but the tide is turning as it begins to address the losses from its 'own goals'.

Adidas since 2006. His $1 billion lifetime sponsorship deal may seem excessive, however, the post of him lifting the trophy for Argentina, wearing the Adidas-branded jersey of Argentina, became the most-liked Instagram content piece of all time. Priceless. As a result, Adidas saw football-related sales jump +50% (c€400 million) in 2022 and will profit for years to come due to Messi's legacy.

Given the momentum above, why then did 2022 group sales only rise 1% and profit before tax (EBITDA) plummet by 39%? Adidas' partnership with influential American rapper Ye (formerly Kanye West) seemed like a match made in heaven after he split with Nike in 2013. His 'Yeezy' brand generated an estimated $2 billion a year or c10% of the company's annual revenue (according to Morningstar). Unfortunately, from a sales point of view, Adidas was forced to cut ties with Ye after his brazen antisemitic attacks on social media made the partnership untenable. The share price fell below €100 around the time (October '22) having hit €320 a year earlier. This contributed to the very pessimistic outlook for 2023 in which revenues and operating profit were projected to fall by around €1,2 billion (of which Yeezy-related lost sales accounted for c€1 billion) and €700 million (Yeezy c€500 million) respectively. Yet the share price is up 70% off its lows. Why? Partly because new CEO Bjørn Gulden indicated in the recent Q1 results that the plan is now not to destroy the unsold Yeezy inventory but to sell the sneakers and donate the proceeds to charity, though he stressed that no final decision has been made. More importantly, the latest update estimates a material improvement of over €500 million in the operating loss to c€186 million for 2023, some good news at last for shareholders.

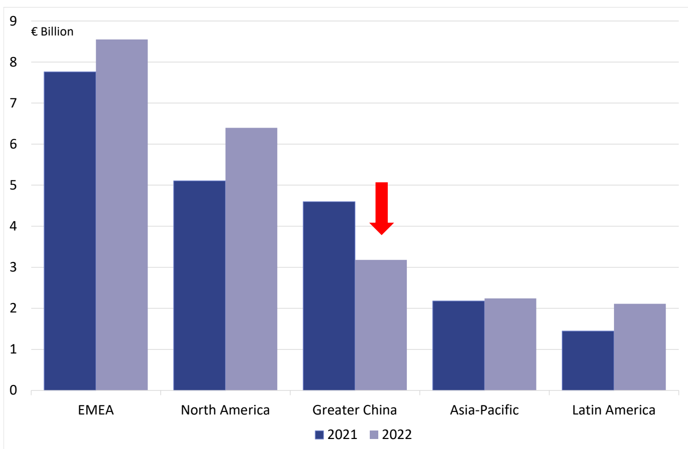
A resurgent Chinese consumer has also contributed to the recent recovery. China had already become a key growth driver for major global sportswear brands. Although the US is the largest sportswear market globally, its growth rate was just 2.5% in 2021. China's sportswear market boasts a compound annual growth rate (CAGR) of above 9% (according to UBS). In 2010, China accounted for 8% of Adidas' sales. By 2020, this had grown to 24% of sales and 37% of profits. However, due to the stringent hard lockdowns in China, 2022 revenue plummeted 36% versus 2021. Local Chinese brands have wasted no time in exploiting the supply disruptions prevalent over the last three years. Western brands will have to work extremely hard to win back market share. Adidas was a major sponsor of the Beijing Winter Olympic Games last year and has 8,000 sales points in China. Pent-up demand drove strong sportswear sales throughout the Chinese New Year and Adidas is well placed to benefit over the medium-term.

COMPARATIVE PERFORMANCE OVER 6 MONTHS



Q1 results provided evidence of a new dawn.

ADIDAS REVENUE BY GEOGRAPHY



Sales in China fell 36% in 2022 due to Covid Lockdowns and local Chinese brands stealing market share. The company is aiming to take advantage of the Chinese re-opening and consumer-led recovery.

As the Covid-19 pandemic consigned country by country to lockdowns in 2020, live sport may have come to an abrupt halt but there was a dramatic shift in human behaviour. Suits and ties were abandoned as the new world of work-from-home (WFH) became the norm. The pandemic, for all its negatives, has created positive structural changes in the way we live and behave which will provide decades-long tailwinds for sportwear manufacturers like Adidas and Nike. Firstly, Athleisure (Athletics + Leisure) became mainstream. Why? Almost everyone suddenly became more aware of the need to exercise during lockdown. Formal clothes were replaced with casual clothing and more importantly, comfortable clothing. There is nothing more comfortable than active wear and Adidas has a wide range offering the latest in technology. The rise of athleisure on social media has been crucial to driving sales via collaboration with celebrities, influencers and their social media accounts. Millennials and Generation Z want to display the best version of themselves on the internet which has also become a powerful sales tool. The late Chanel designer, Karl Lagerfeld, once said, "Sweatpants are a sign of defeat. You lost control of your life so you bought some sweatpants." How things have changed. Gucci's collaboration with Adidas is a prime example of what athleisure looks like in 2023. For instance, the most expensive Adidas shoes are the 'Human Race NMD Pharrell x Chanel' which can reach $20,000 (almost R400,000 a pair)!

CHANEL

The most expensive Adidas shoes are the Human Race NMD Pharrell x Chanel which can cost up to $20,000 per pair, as "Ath-Luxury" becomes a new niche market.

Unfortunately, given its global footprint, there are many moving parts. The biggest impact on profits has been excessive inventory levels which leapt by 49% relative to 2021. Adidas is thus still under pressure to clear stock via discounts and write-offs, and lower prices mean lower profits. Competitors like Nike and Puma compete fiercely on price so maintaining gross margins above 50% is crucial. The 2022 gross margin decreased by 7% to 47.3% (2021: 50.7%) and was 44.8% in the first quarter. Furthermore, freight rates hit record highs last October so this has impacted profits as input costs rose. Broad-based price increases were thus more than offset by the strong increase in supply chain costs, discounting and one-off costs reflecting the company's decision to wind down its business in Russia. Fortunately, Adidas received a further €384 million from its sale of Reebok, having already realized a gain of €666 million in 2021. This allowed the company to complete a €2.5 billion share buyback as well as pay shareholders dividends worth €610 million. However, debt levels remain uncomfortably high. To reduce the ratio of Net Debt / EBITDA from a lofty 3x to a more sustainable 2x, Adidas has decided to suspend both its share buyback program and its dividend for the 2023 financial year. Short-term pain is necessary to re-direct cash to where it is needed most and to get Adidas back onto a firm footing.

SEGMENTAL PROFIT GROWTH

	Inventory (€ millions)	Gross Margins	EBITDA (€ millions)
2018	3,445	52%	2,882
2019	4,085	52%	3,845
2020 (Covid)	4,397	50%	1,967
2021	4,009	51%	3,066
2022	5,973	47%	1,874
Change v 2021	49%	-7%	-39%

Excessive levels of inventory have hurt both gross margins and profits (EBITDA). 2023 should see a reversal of this trend.

In conclusion, shareholders need patience in the current environment. Growth in the sporting goods industry is highly dependent on consumer spending and consumer confidence, which are both under pressure and being exacerbated by 'sticky inflation". China is the one bright spot due to its consumer-led recovery but it is early days and geo-political tensions remains a risk for Western brands. The CEO, Bjørn Gulden, has his work cut out but is under no illusions stating, "2023 will be a transition year to build the base for 2024 and 2025, we can then start to build a profitable business again in 2024." On a lighter note, although Springbok rugby fans will be cheering on their Nike-sponsored Rugby World Cup players as they face the Adidas-sponsored All Blacks, it is great for fans, players and sponsors alike to witness the resurgence in global sporting events and fitness trends which are providing a silver lining to the dark Covid-related clouds.

Our next Insight seminar will take place in June and provide an update on what has driven markets over the first six months of the year, and what might lie ahead for the balance of the year. We are very excited to be expanding our seminar program to Cape Town.

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Topic:	Mid Year Market Update
Natal Midlands	
Date:	Thursday, 22nd June 2023
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	Tuesday, 13th of June
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	Wednesday, 14th of June
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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