Nike and Adidas Change Up Their Game to Boost Profits

While Nike, Inc. (NKE) enjoys a strong 54% leadership position in the $15 billion U.S. running shoe market, Adidas (ADSX.DE; ADDYY) is one of many competitors scrambling to gain a piece of that share. At O’Neil Equity Research, we are particularly interested in how these two companies are using innovation to increase margins. Nike’s latest running shoe innovation, a knit, one-piece upper, has the potential for huge cost-savings and more flexibility in the location of manufacturing centers. Adidas is differentiating itself with both a one-piece upper and a new extra-spongy sole that runs counter to the current trend of minimalist running shoes. Our question is: Which innovations will most affect stock performance?

As of 7/22/2013

<table>
<thead>
<tr>
<th></th>
<th>Nike Inc.</th>
<th>Adidas AG</th>
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</thead>
<tbody>
<tr>
<td>Symbol</td>
<td>NKE</td>
<td>ADSX.DE</td>
</tr>
<tr>
<td>Market capitalization (billion)</td>
<td>$56.5</td>
<td>$23.3</td>
</tr>
<tr>
<td>3-year earnings growth rate</td>
<td>10%</td>
<td>6%</td>
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<tr>
<td>3-year revenue growth rate</td>
<td>11%</td>
<td>12%</td>
</tr>
<tr>
<td>EPS rank</td>
<td>89</td>
<td>50</td>
</tr>
<tr>
<td>RS rating</td>
<td>66</td>
<td>79</td>
</tr>
<tr>
<td>FY2013 gross margin</td>
<td>43.6%</td>
<td>47.7%*</td>
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<tr>
<td>FY2013 pretax margin</td>
<td>12.9%</td>
<td>7.5%**</td>
</tr>
<tr>
<td>FY2013 return on equity</td>
<td>23.1%</td>
<td>15.2%**</td>
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*2012 results **2012 results excluding goodwill impairment
Nike’s Flyknit reduces manufacturing waste and labor costs

Introduced by Nike last year, Flyknit technology focuses on producing an ultra-lightweight shoe (5.6 ounces), woven out of synthetic yarn to form a one-piece upper. The shoe is designed to mimic the feel of a sock, which is supposed to improve comfort and reduce stress on the foot, leading to better athletic performance. The traditional manufacture of athletic shoes requires more than 30 pieces of material be cut and sewn together, resulting in large amounts of wasted material. The new Flyknit manufacturing process, with its “micro-level precision engineering,” uses a 15-foot long machine equipped with computer-controlled weaving technology to create the upper of a shoe. This woven upper-shoe reduces material waste by 80%.

Besides the savings in materials, the Flyknit technology requires less labor to produce. The sewing together of 30 pieces is labor-intensive and costly, which is why Nike has, over the years, fully transitioned production to countries where labor is low-cost. The benefits of reducing dependence on cheap labor are significant and may provide Nike with the capability to respond more quickly to changing consumer tastes. It also reduces the cost of distribution. Currently, much of the low-cost labor Nike uses is in Asia, requiring greater transportation cost and time for shoes to arrive in North America, Nike’s largest market.

Moreover, low-cost labor in Asia is becoming more expensive. China plans to increase its minimum wage by 13% annually before 2015, and other Asian markets are expected to follow suit over time. When those costs rise, along with shipping costs, the benefit of this manufacturing model becomes less attractive to U.S. manufacturers like Nike.

The effects of these changes are likely part of the pressure Nike’s gross margins have seen over the last few years, despite rising shoe prices. Although 96% of its shoes are manufactured in low-cost labor markets, such as Vietnam, China, and Indonesia, Nike’s gross margins have decreased from 46.3% in FY2010 to 45.6% in FY2011 to 43.5% in FY2012. The two-fold benefit of reduced materials and less labor-intensity offered by the Flyknit shoe should translate into better margins for Nike, assuming all else remains the same. These benefits are already starting to become evident after approximately

Nike and Adidas in Court

Last year Nike filed an injunction against Adidas claiming its adizero PrimeKnit represented an infringement on its Flyknit technology. In a skillful argument, Adidas argued that the supposedly innovative weaving technology implemented by Nike has been around since 1940. The German court ruled in favor of Adidas, lifting the injunction, but Nike remains committed to protecting its technology.
one year on the market: Nike’s Q4 and year-end gross margins for FY2013 increased 110 and 10 basis points, respectively, reversing the downward trend of previous years.

Adidas anticipates great things from Energy Boost

We added Adidas (ADSX.DE; ADDYY) to our Global Focus List for developed markets on September 10, 2012. One of Adidas’s largest opportunities for improving its revenues lies in better penetration of the $15 billion U.S. running market, in which it now holds roughly 4% market share, ranking sixth behind smaller competitors and well behind Nike’s dominant market share of 54%, according to SportsOneSource.

Outside the U.S. market, Adidas is running toe-to-toe with Nike, even outperforming it in key markets such as China. While Nike shed excess inventory in China this past year by offering deep discounts, Adidas addressed the same inventory problem much more quickly—discounting earlier—and is already reaping the benefits. Last year, Adidas enjoyed 15% sales growth on a currency-neutral basis in Greater China. Nike, on the other hand, is still looking to get back to growth in China, after seeing sales decline 5% on a currency-neutral basis during its latest fiscal year.

Adidas has its own knitted shoe design, the adizero Primeknit, also launched last year (see sidebar), which appears to be offering Adidas the same manufacturing benefits as Nike. Adidas reported a record gross margin of 50.1% for Q1 FY2013, exceeding 50% for only the second time in its history. However, Adidas views its latest release, the Energy Boost featuring an innovative midsole, as the “game changer” that will allow it to gain the U.S. market share it needs.

Potential for 3D-Printed, Custom Footwear

Both Flyknit and adizero Primeknit technology offer the potential to take personalized footwear to a new level. Weaving machines could be programmed to reinforce certain areas of the shoe, if desired, or change colors of yarn at any time. Include the possibility of 3D printing the shoe’s sole, and customers may be offered endless customization options. Although 3D printing of shoes isn’t quite here yet, Nike and Adidas have both successfully used it to reduce the time and manpower involved in the development of prototypes. 3D printing enables both companies to produce many more iterations of a shoe prototype to optimize the design.
Adidas teamed with German chemical manufacturer BASF to create the technology behind the new midsole, which is made of melted foam capsules that look like Styrofoam, to deliver a bouncier feel and less strain on runners’ feet. Adidas believes so strongly in the innovation that it anticipates selling over one million pairs in 2013 and plans to incorporate the design into its other shoe lines next year. General consensus on Energy Boost is positive, but it is too early to tell how much the new running sole will resonate with runners in the U.S., who have largely overlooked Adidas running shoes so far.

**Sources:**
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9. www.adidas.com

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