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ADS.DE - Half Year 2019 Adidas AG Earnings Call

EVENT DATE/TIME: AUGUST 08, 2019 / 1:00PM GMT

## OVERVIEW:

Co. reported 2Q19 revenues of EUR5.5b, net income from continued operations of EUR462m and basic EPS of EUR2.33. Expects 2019 net sales to grow 5-8%.



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**Sebastian Steffen** *adidas AG - SVP of IR*

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## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by. I'm Haley, your Chorus Call operator. Welcome, and thank you for joining the adidas AG Q2 2019 Conference Call. (Operator Instructions) I would now like to turn the conference over to Sebastian Steffen, Senior Vice President of Investor Relations. Please go ahead.

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### Sebastian Steffen - *adidas AG - SVP of IR*

Thanks very much, Haley, and good afternoon, ladies and gentlemen. Also, from my end, a warm welcome to our second quarter results conference call. Our presenters today are our CEO, Kasper Rorsted; and our CFO, Harm Ohlmeyer. Before I will hand over to Kasper in a second for his prepared remarks, I would like to once again ask you to limit your questions to 2 during our Q&A session.

In addition, please keep in mind that all figures that we will be talking about will be stated on a currency-neutral basis and will be discussed for our continued operations.

And now without any further ado, over to you, Kasper.

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### Kasper Bo Rorsted - *adidas AG - CEO & Member of Executive Board*

Thank you very much, Sebastian. Before we go into the details of today's call, let me just inform you about the extension of our management board contracts with Karen Parkin and Harm Ohlmeyer, which was decided yesterday at our Supervisory Board meeting, which is good corporate governance in Germany, which means that we have also strong management team moving forward. So of course, we are very happy with this development.



Now let me move in to the business update. The quarter was in many ways characterized by a set of new products being brought into the marketplace. We saw further rollout of our UB19, UltraBOOST 19, which has been taking up exceptionally well by the consumer. The Nite Jogger started its global launch and activation in April and is now starting to rollout in more volume.

Among others, we upgraded our Paris flagship store. We had our Run For The Oceans event that a couple of years ago had 50,000 runners and today has 2.2 million. So we see the efforts that we're putting into Parley is paying off. And the last one is our partnership with Missoni. When we look up high and say, when we use external creators, we continue to drive brand heat into our product sets in many different ways. Of course, it's more volumes, but super important to ensure that all our consumers see newness in our product, not only coming from adidas but also from our creator base. So overall, a quarter with a lot of new products on the street.

So what were the strengths and weaknesses of our quarter? We continue progress. We're seeing progress in our strategic growth areas, particularly the double-digit growth we saw in China and our e-commerce business. China up 14% and e-com up 37%. On the new products, we saw -- they started to gain commercial traction in our DTC business driving our DTC business up to double-digit growth. And what we see is, where we control this space, we continue to see a very positive uptick for our products.

We saw Reebok coming back to positive growth. As you know, last year, we returned to profitability. Our target is to have an ongoing profitable growth business with Reebok by 2020, so we continue to make progress, and you're starting to see the next steps here. But of course, we need to make sure that we do it in a more sustainable way, and that is our target by 2020.

However, there are also matters that didn't go quite to our satisfaction. Not surprisingly came the shortage from our supply chain as we saw in the first quarter, also had its impact in the second quarter, particularly weighing on the growth and the profitability of the U.S. Harm will speak more about it in details, but the late arrivals and the way we ship products into the U.S. had a negative impact on our overall margin situation in the U.S.

We're now seeing growth in our wholesale business. Many of our new products that we introduced in the second quarter are not yet scaled, which of course is also having impact on our growth. We saw a decline in our Sport Performance business, mainly due to football last year. We had a very successful football event, which had a big uptick in our second quarter, and that is also particularly the reason why you're seeing negative growth in Russia in the second quarter after a very, very strong first quarter. Underlying without World Cup, this would had been positive. And lastly, we're seeing OpEx leverage being masked by increased marketing spend but also our expansion in the overall DTC space, not only in new stores but a continued focus on our online business.

Coming to the numbers. Our revenue increased 4% currency-neutral and 5% in nominal terms to EUR 5.5 billion. Our gross margin went up 120 basis points to 53.5%, predominantly driven by FX. Our operating margin went up 40 basis points to 11.7%, despite increased brand investment and, of course, DTC costs where we're seeing a big part of our -- all our growth is coming from. The net income from continuing operations increased 10% to EUR 462 million, and our basic EPS up 13% to EUR 2.33. The delta, as you know, is due to the share buyback program we launched and which we extremely worked on, and Harm will also give you an update on this later on the call.

So when we look up on our strategic growth areas, America came in at 5%, impacted by the supply chain shortages. And let me just stay here for a second. We expect supply chain constraints in the first, second and also in the third quarter, and they will be more or less sorted out by the fourth and will have no impact next year. So there is no change to the guidance we have given you around the decisions we're taking around our supply chain. But of course, you are seeing the impacts of North America.

Greater China, 14% growth, very, very strong; and our e-commerce 37% growth. So the focus on our 3 strategic growth areas, North America, Greater China and e-commerce, continues to pay off, and we would have seen, as I said, a higher growth rate have we not had the supply constraints in North America.

The adidas brand growth in most markets, our Footwear growth accelerated. Overall, the brand grew by 4%. Sport Performance declined by 2%, as I said, predominantly driven by Football, also negative is Running, but we're seeing double-digit growth in Training and Basketball. Sport Inspired grew 9%, reflecting growth in Originals and Yeezy. And of course, the actual size difference between the 2 is quite substantial. So it's very important that we have a solid growth in our Originals business, which is the biggest foundation that we have. And we saw Footwear revenue increase 5%.



And as I said before, around North America, the supply chain shortages is weighing in on the growth in apparel because we've had either no delivery or late delivery for certain parts that came in, which is why we gave the guidance we did in the month of March.

Moving on to Reebok. Reebok revenue increased 3%, driven by double-digit growth in North America and Latin America, but also seeing growth coming out of Europe. We're seeing growth in Classics driven by a robust increase in Footwear. The gross margin is slightly down by 160 basis points to 43.2%, after several years of expansion of our gross margin. So we're now getting closer to the model with Reebok, but I still want to say the end target is 2020. And before then, it would be too early to read through.

Coming to our e-commerce business, up 37% and also underlying traffic where we don't report that. In actual terms, we're seeing a strong increase in underlying traffic. We're also seeing the overall growth is coming from double-digit growth across all regions. We launched our Creators Club in U.K. and Germany, which is a loyalty program, which has been taken extremely well in the countries where it's been launched with more than 15 million members. And our adidas app is now live in close to 30 countries. So we continue to make progress in our strategic area, digital, and that will continue to be a cornerstone also moving forward. And let me just, again, repeat what we have said many times. The single most important store in the world is and will remain our dot-com business.

With this overview, I'd like to hand over to Harm, who'll now take you through the financials more in detail. And then at the end, I'll wrap up, and we'll have the Q&A. So Harm, please.

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**Harm Ohlmeyer** - *adidas AG - CFO, Labor Director & Member of Executive Board*

Thank you, Kasper. I would like to go and start with the growth by the market segments. And before I discuss all 3 main markets in more detail, let's briefly look into our 3 other markets, which all proved the resilience and the faith of various challenges.

So starting with emerging markets, increasing 12% despite headwinds from geopolitics in some countries. And the segment's operating margin actually expanded by 490 basis points to now 28.5%, mainly driven by the strong gross margin expansion of 480 basis points.

Revenues in Latin America increased 5% despite a challenging macro backdrop, and the segment's operating margin decreased by 190 basis points to now 14.6%, as continued investment into our brand more than offset the stable gross margin. And of course, Latin America was slightly impacted still in Q2 by the comps of the World Cup 2018.

The same for Russia/CIS, down 4%, due to the tough comparisons related to the 2018 World Cup, and the segment's operating margin slightly decreased by 110 basis points as the gross margin normalized. It was only partly offset by lower OpEx ratio.

Just as a side to your information, you might have noticed that other businesses declined by 24% in the quarter. This is mainly because we shifted our clearance unit that has been centrally driven into our market segment. It is a small portion. It's a big portion of the businesses, but it's a small portion in the markets. To just add some additional transparency, we're not going to get that question later on.

When it comes to North America, as Kasper mentioned, the top line of the margin impacted by our supply chain shortages. Overall, the market growing 6%, currency-neutral. The adidas brand revenue is up 5%. Both on the Sport Performance and on the Sport Inspired side, those are growing. The Reebok brand revenues increased 10%, driven by double-digit growth in Classics. And the gross margin actually decreased by 150 basis points to 39.3%. Better product, channel mix and lower sourcing cost more than offset by higher air freight cost and less favorable pricing mix.

And just on the gross margin, I want to mention again, air freight is significant piece of that. You get an idea in the gross margin what's the significance of the air freight was in North America. But as Kasper said, it's not just lateness, but even if you get the air freight in you might be late, it's impacting sell-throughs being late in the market. You get charged (inaudible) accounts. So that's where we're seeing the gross margin, you get a feel for the profitability impact of the supply chain challenges that we had. At the same time, we remain committed to the market and keep investing on the brand marketing side, but also on our DTC network and our infrastructure overall as we continue to invest in the North America.

When it comes to Asia Pacific, significant growth, driven by Greater China, overall 8%. Greater China was 14% in the second quarter after 16% in the first quarter. Adidas brand sales up 9%, driven by double-digit growth in Sport Inspired. Reebok brand down by 11% due to declines in both Sport and Classics, but also there gross margin up by 230 basis points to now 59.7%. This is primarily driven by positive FX impact, but definitely also better products, channel mix and lower sourcing cost. But again, there again, the majority is on FX impact driven by the currencies.

Operating margin, up 60 basis points to 34.9%. And again, the gross margin expansion partially offset by OpEx investments. So as you see, China being up 14%, the region being up 8%, so definitely there's a healthy Southeast Asia. But in the more mature market, Japan and Korea, especially the latter, is being challenged -- one of the effects there's less tourists in Korea. So these are the markets that are being challenged in Asia.

When it comes to Europe, after 4 quarters of decline, and as we indicated you for many quarters already, we are now at a stable revenue top line with currency-neutral sales being flat. The adidas brand, which is a majority part of it is being flat as well. Growth in Sport Inspired offset by slight decline in Sport Performance, but also Sport Performance are primarily impacted by the 2018 World Cup, as the Football business on the jerseys definitely happening into second quarter last year as well.

The Reebok brand up 4%, driven by growth in Classics; and the gross margin improved by 390 basis points to now 52.2%. And also there, it's a combination of FX, the better channel mix and lower sourcing cost. But clearly, the majority of that is FX related as we already indicated in Q1. And as an outlook in Europe as well, we continue to expect the region to return to growth in the second half. And with that, we're also expecting growth for the full year in Europe as we communicated earlier.

When it comes to the overall P&L. Net sales in nominal terms up 5%; in currency-neutral, as we said, 4%. Gross margin, again expanded by 120 basis points to now 53.5% over prior year. And the operating expenses, I want to focus here right away on the marketing and the operating overhead expenses of our new segments, as we reported. So you see we keep investing into marketing. It was 5% up, in line with the top line. Still at a very high level of 13.5%. So we keep investing into the brand across the road. And the operating overheads up by EUR 100 million or plus 7%, and this is primarily driven by the expansion of the DTC business. And as a reminder, wholesale was declined or was down by 2%, and DTC growing by 16%, and that's what you see in the mix effect even more pronounced on the operating expenses, and the majority of that is contributing to the plus 7%. And you see the benefit of that part in the gross margins as well.

When it comes to the operating profit, we expanded it by 40 basis points, now 11.7%. And the net income, as Kasper mentioned earlier, up by 10%. If we would do that before IFRS 16, actually it would have been 12% on the net income. And we also talked about the earnings per share being up given the share buyback plan. But also we're going to mention, when it comes to the operating profit, because we had quite a debate last year in Q2 2018 about the other operating income, with the new segments that we're reporting, if I take -- if we still report another operating income that you see on the third line, we still would have had EUR 42 million benefit last year in Q2 that we compensated in this quarter as well. So there was net of EUR 42 million other operating income due to litigation gains and some release of operational accruals in Q2 2018 that did not repeat in 2019. So definitely want to get some credit for that a year later.

When it comes to the gross margin decline in the second half, I talked about it on several road shows already, and I want to be consistent on this. First and foremost, it will be less favorable sourcing cost and increased use of air freight, as Kasper said. We are not out of the weeds in the third quarter. It will end in the fourth quarter because supply chain will have been fixed. But you also know that a lot of companies are moving out of China, and it's not getting easier to get capacity up and it's not for free. So that's something you've already seen in the second half.

As we plan to return back to growth and win with the key accounts in the second half, you will see a more balanced growth across the channels. So wholesale is expected to grow in the second half that will have an impact on the gross margin. We always said that we have selective price investments in Europe. It's not across the board, but you see it already from Q1 to Q2 that the benefits on the same hedging is less in Q2 compared to Q1, and that will continue in the second half through the selective price setups that we have. And the tailwind of course from FX hedges I will say not just in Europe but also in China, we've had very favorable hedges in the first half compared to last year.

And lastly, definitely we'll get into tougher comparison, not from a net sales point of view but from a margin point of view in the second half. And I specifically want to mention again the successful democratization of Yeezy last year in September that we will not going to repeat in Q3 and that will also weigh on the margin because it's a highly attractive business for us. So overall, this is the direction, and that's why we're saying taking all



these factors into account, we confirm our full year guidance for gross margin expansion to a level of around 52%, and these are the main sectors leading to that.

When it comes to the average operating working capital, we see we are still very disciplined with inventories only up 5%; receivables, according to our wholesale business, only up 1%; and payables due to our efforts also on non-trade procurement and being more disciplined toward our external vendors up 14%. And again, I'm very, very happy with the 18.3%. But also there, as we accelerate into the second half and moving into 2020, don't expect that this can be repeated necessarily. I always said that a lever around 90% is something that I'm very satisfied with. So 18.3%, given where we are in the business is good, and we should be proud of that in the organization. But going forward, 90% is probably an acceptable level for us going forward.

When it comes to the net cash and equity position, despite the share buyback, we still have a very positive development also in net cash, and the net debt as well as. The EUR 362 million, EUR 273 million up, and equity ratio is down by 790 basis points, but that is solely due to the IFRS 16 change is just an accounting matter.

When it comes to shareholder return, I just want to give you a quick update on the share buyback. We actually completed in the amount of EUR 301 million in the first half. That is not exactly what will bring us to the EUR 800 million because the share price developed very favorably in the first half, as you all know, and that's why the bank finished at the lower end of our range. But we already committed that second tranche for the second half that will lead us to around EUR 800 million. We're fully committed to that after EUR 1 billion in 2018, we will get to around EUR 800 million in 2019 and then we will complete by May 2021 with EUR 3 billion share buyback program consistently and always being in the market.

With that, I would like to hand over to Kasper again.

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**Kasper Bo Rorsted** - *adidas AG - CEO & Member of Executive Board*

Thank you very much, Harm. Let me just speak a bit about the outlook before we get to the question-and-answer sessions.

As we've already spoken about, we believe we have right elements in place to ensure that we hit our 2020 numbers. And that means, we'll continue to drive innovation into the marketplace through different vehicles. We'll continue to invest with impact, as we call, into brand desire and into a business model to ensure that we drive better scalability into our business. And again, if you were to look upon the headcount numbers, you'll see more stable headcount. Also this quarter is where you can see -- we're starting to see some of the elements showing us early signs.

Our target is to deliver overproportionate net income growth on the back of sustainable operating margin expansion, which is very much in line with the guidance we've not only given for this year but as you know also the long-term guidance. And we have and we'll continue to address issues when and if they come up.

Europe is expected to return to growth by the end of this year and have a sustainable growth pattern into next year. And our supply shortages will be completely passed out. When we're done with the fourth quarter, then we'll have a normalized year next year. But I just want to remind everybody that through Q1 to Q3, we will continue to see impact with it, and we'll continue to see so.

We also continue to bring new products into the marketplace. And I spoke about the Nite Jogger that we've been very happy with, and we're starting to launch as we speak. We're also starting to bring the first new additions in, our UB19, which was launched in February, that's coming into volume, and right now that has been very successful across the board where we're celebrating UltraBOOST technology. And then UltraBOOST OG also remains in very high demand, particularly when we do bespoke versions, whether it's a country version or regional version or a city version.

One of the biggest launches we have is our Home of Classics where we're bringing 10 different white leather sneakers into the collection. Whether it's Super Court, OZWEEGO or LXCON, we're continuing to focus on driving our Originals business forward. And our Home of Classic is an important launch this year, but also will be a milestone for how we drive business next year.

We're also using innovation to drive new launches. Our Futurecraft 4D that many of you know, we have dramatically expanded the volume this year. And one of the coolest shoe we actually launched this year was the Futurecraft 4D in combination with the Parley, which was immediately sold out, but it is driving innovation and brand heat.

And we also continued to develop BOOST. Many of you've asked what's after BOOST. We believe there will be many different iterations of BOOST moving forward, and that's why it's important that we continue to drive new products into the marketplace. With BOOST HD, we found a way to put 20% more BOOST into the midsole without increasing the size, as the density of the palettes is higher. The result is an increase in stability without any sacrifice of the great energy returned that BOOST is known for. The PULSEBOOST HD is a shoe that we co-created with runners from key cities, and it's the first product to feature BOOST HD and was launched in June, so still very early days, but this of course we'll continue to expand our BOOST franchise.

And then we're also, of course, using our collaborations, whether it's Toy Story where we brought a limited addition of UB19 into the market model where we brought a new creation into the market, Manchester United and UltraBOOST, or the latest adidas by Pharrell, the solar shoe released updates (inaudible) with new colorways. And by the way, as many of you know, we're celebrating our 70th anniversary tomorrow and both Pharrell and also Stan Smith will be here. So these are to mention a few. I will also mention the (inaudible) or the Victoria Beckham products that we have through Reebok, all new releases and new products that are coming into the market through our creator partners. As you know that we don't only create ourselves, but we're also very much into cool relationships with creators across the globe that bring products into the market that are unique.

Looking at how and why we believe that the top line will accelerate in the second half, we believe we have the building blocks in place. We believe that we have the right products, and I spoke about them throughout the presentation that we'll scale more in the second half due to launch days. We will see Europe return to growth in the second half, and we put the foundation for recovery in. We're seeing the upcoming year of 2020, where you're going to see the first positive impulses in the fourth quarter, earlier Chinese New Year in Q4, the impact of our supply chain will fade particularly in the fourth quarter. And then we also have a lower base. Last year, we had 10% growth, 10%, 8% and 4%. So we feel quite confident when we look upon our guidance based on reaching the guidance we gave for the first half 3% to 4% coming out of 4%. We have a guidance for 5% to 8% for the remaining of the year, which indicates or assumes an acceleration for the second half. And we're fully confident that, that acceleration will come.

We also give you some guidance how the quarters are going to come because I think it's interesting or it's important for you to understand. So we expect this sequential top line acceleration towards the end of the year. We're going to see a modest improvement in Q3 followed by a step in Q4. We're going to see, as Harm spoke about, a gross margin decline in the second quarter. In the second half due to air freight costs, fading tailwinds and also investing into tough comps.

We're going to see OpEx spend more even a distributor across the quarters, which will impact the operating margin and profile development. And we're going to see a bottom line growth skewed towards the fourth quarter. And what I'm saying here is very important. We believe that the third quarter net income to be down year-over-year due to the top line facing and margin profile. Last year, we had an operating margin of 15.3% in the third quarter. This was due to the largest ever Yeezy launch we had. This will not repeat itself. So for us, there is no news in what we're saying, we just want to make sure that you don't get surprised when you see, a, an accelerating top line, which we're guiding to but with a kick in the fourth quarter and a declining year-over-year third quarter profit improvement, simply because we're now guiding 15.3% profit margin that we -- due to the fact that we're not having a large Yeezy launch. This is not new. This was calculated all the time. So I'm just saying don't be surprised, we have confirmed our guidance and we're very certain that we're going to hit our guidance, so which brings me to our guidance.

We expect net sales of 5% to 8%; gross margin around 52%, as Harm spoke to you about and operating margin increase of 50 to 70 basis points. And you can see the impact before and ex IFRS. So right now, there's actually no change to the guidance we went out and gave in Q1 confirmed now here in Q2. This is what you should expect for adidas in the second half.

So summing up. First half according to plan, that was 3% to 4%. We came out at 4%. We continue to see a double-digit bottom line growth, 13% in the first half, 10% for Q2. We have the building blocks in place to accelerate our top line in the second half. And '19 will be another year of top and bottom line growth. We're still very much focused on the execution and creating the new to ensure that we not only hit the guidance we're giving for this year, but of course also the long-term guidance we've given for our complete 2020 period.



With this, I'd like to thank you for listening. And then Harm and I will be happy to take your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) First question comes from the line of Antoine Belge of HSBC.

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### **Antoine Belge** - HSBC, Research Division - Global of Consumer and Retail Research

Antoine Belge at HSBC. Two questions. First of all, you listed quite a long list of reason why the gross margin should be down in H2. Is it possible to be a bit more precise, especially on the 2, maybe the most important one FX and channel mix? So out of the 180 basis points gross margin improvement with less precisely the impact of FX on channel mix. And do we expect those 2 to be negative in H2 or just to be less than in H1? So gross margins are down in H2. Is it possible for you to escape gross margin decline in 2020 when the U.S. dollar strength will be a bit more challenging?

And my second question is regarding Asia. 8% was slightly below the -- just on 1 quarter, below the target for the year of 10%. China didn't really slow much. So can you highlight maybe 1 or 2 other Asian markets which explain the slowdown?

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### **Kasper Bo Rorsted** - adidas AG - CEO & Member of Executive Board

I will take the second, and Harm will take the first. We saw a slight slowdown in China, as you saw 2 points, and the remaining was really Korea we're seeing fairly solid business across the board, and that's the 2. So -- that is I'm not trying to be short on my answer, that is the effect of where it is and 14% growth in China still is very, very strong. And as Harm said, the Korea businesses is predominantly due to the consistent slowdown in traffic, sales traffic. So that's why it is. Harm?

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### **Harm Ohlmeyer** - adidas AG - CFO, Labor Director & Member of Executive Board

Yes. On the first one, the gross margin, yes, I listed the 5 examples why the second half is rather declining compared to the first half. Again, it's not negative on the FX in the second half, but it's fading and is not giving us a lot of tailwinds. So there are 2 things happening. On the one hand, the tailwind is fading. On the other hand, all the work that we did over the previous years on FOB mitigation is slightly coming to an end as it's getting more convoluted in the supply chain, although the manufacturing capacities in Asia versus lot of brands moving out of China into other markets. That's what we're seeing in the second half of 2019. I don't want to disclose more details of that, but rest assured that majority of the benefits are coming out of FX, and FOB mitigation and some of it will be used strategically for repricing clearly in Europe. That's where we are.

Good question towards 2020. Of course, it's not getting easier in 2020, and that's why -- but we're not giving a guidance today. But we know what we have done. From a hedging point of view, we know where the currencies are today. But currencies are still moving, I would say, on a daily basis. But we also have some of the benefit next year as we have addressed the supply chain shortages, we will have less air freight. There will be some positives as well than we have negatives this year and that's what you need manage and we come as the guidance in March 2020 then.

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### **Antoine Belge** - HSBC, Research Division - Global of Consumer and Retail Research

Just a follow-up. So regarding the channel mix. So it was quite positive, so you don't want to disclose it for H1. For H2, I understand that wholesale should pick up, but is it your assumption that wholesale will outgrow DTC in the second half?

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**Harm Ohlmeyer** - *adidas AG - CFO, Labor Director & Member of Executive Board*

No. You shouldn't assume this. But the key thing is that wholesale gets back to growth. And again, the primary growth factor that you saw was 37% is e-commerce. And in the overall mix, we're still at a 10% of the total, right? So that's why we're saying the mix effect on the margin is as significant from a channel point of view yet.

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**Operator**

Next question is from line Jurgen Kolb from Kepler Cheuvreux.

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**Jurgen Kolb** - *Kepler Cheuvreux, Research Division - Analyst*

Two questions. You mentioned that Basketball was actually picking up in the performance category. Maybe a few words. What really drove that positive development? I think we've heard that -- I haven't heard that for a long time that Basketball was mentioned in the -- as a positive in the performance category.

And then secondly, on the cost lines, you mentioned you were investing in the scalability of the business model and you're seeing higher costs associated with the DTC business. Maybe some of the core elements of this, where the money is going, where your investments are going in these 2 areas so that we may better understand what the core elements of investments are in these 2 elements probably also being a factor for 2020.

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**Kasper Bo Rorsted** - *adidas AG - CEO & Member of Executive Board*

Jurgen, this is Kasper. I'll take the first one on the Basketball side. As you know, we've had a decline in Basketball business for a while, also because we got out of the NBA contract. In the legacy, it got along with us to make sure that we sold out the last jerseys. But we are saying, we're actually seeing quite solid growth or good growth in both our Footwear and apparel business. While the business is still small, it's a good sign in the right direction that we're seeing continue to pickup of our products. In a market that where we've not seen a lot of growth for many years, so there's no doubt that we gained market share in this quarter, but of course we need to continue to expand our business. The business is predominantly in the U.S. and China, that's 90% -- about 90% of the business. So that's summary in Basketball. Footwear and apparel both growing in North America and China.

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**Harm Ohlmeyer** - *adidas AG - CFO, Labor Director & Member of Executive Board*

Yes. On the cost side. Jurgen, primarily the growth that you're seeing is impacted by our direct-to-consumer growth. In addition to the direct-to-consumer growth, of course, we invested into our DC network, not just in China, but also in the U.K. and also in the U.S., as we indicated earlier. Of course, given the growth with e-commerce, there's tremendous shipping cost towards the end consumer, which is part of it, and we keep investing into our digital environment, whether it's in apps, our Creator Club. This is where the money is going. On the other hand, you do not see the benefits of our own adidas initiatives yet around nontrade procurement and global business services. But we're coming to the end of these investments and the dependencies will be more visible in 2020.

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**Operator**

The next question is from Graham Renwick of Berenberg.

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**Graham Ian Renwick** - *Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst*

Just two questions for me, please. Firstly, on the revenue guidance, it's the reiterated guidance implies wide range for the second half of 6% to 12%, given you have greater visibility now on order books across the second half. So I wondered why the range was still this wide. What have you



assumed for coming at the top end of the range versus a bottom end? And clearly, long tailwinds you highlighted that should support solid acceleration across the second half. So just wondered where you still see the biggest risks or uncertainty.

And secondly, it's on the Beyoncé partnership. When it was announced, I think you still, at that stage, trying to work out what the partnership with Beyoncé would look like commercially 3 months out. Can you offer any detail on what commercial terms would be now with Beyoncé? Have you started to design products? Do you have a clearer view on the product launch time line? Will you be using Beyoncé in marketing campaigns ahead of the initial launch? Appreciate the product launch is unlikely to be material themselves in the near-term, but just trying to get sense on when this could start drive a lot brand heat for you particularly in the women's category?

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**Kasper Bo Rorsted** - *adidas AG - CEO & Member of Executive Board*

So starting with the second half guidance, we don't narrow the guidance because we try to stick to the guidance that we have, and we don't comment whether it's the upper end or the lower end. We do think that we do need to see an acceleration, and we are seeing. That's why we explained the building blocks. And as you saw, it's going to be more fourth quarter than the third quarter simply because of the supply constraints.

Maybe also on the guidance of the income growth. Last year, as you saw, we made an operating margin of 15.3%. We had some criticism from some of you that why are we doing such normally a big launch. Because if we're not doing it this year, then we have subsequent the lower income, and that is a simple as that as. I would be very careful putting any kind of overrating of that into it.

We're trying to spread the Yeezy business equally across the year and what you see in the first and the second quarter has been an expansion of the market -- margin. You're not going to see that in the third quarter. You'll see that in the fourth quarter. And that's why we're also confirming the margin guidance for the full year. That is how basic that is. So this is it. Don't make it -- I will just ask everybody not to make more complex than that.

On the Beyoncé, we'll start seeing the first product this year. And for obvious reason we're not going to give you an insight, part of the way you actually drive brand heat and excitement around Beyoncé or Pharrell or Kanye, there's also the element of surprise. We are building product line out. And as I said, we'll see the first product launches this year. You should assume, which you also stated correctly, it will have limited revenue impact this year.

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**Operator**

The next question is from line of Elena Mariani of Morgan Stanley.

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**Elena Mariani** - *Morgan Stanley, Research Division - Executive Director of Luxury Goods and Brands*

A couple of questions for me, please. Just going back on your FX hedging policy, is it something more that you could share with us because FX seems to have a much more volatile impact for you versus peers. And then you've guided very much precisely on the second half of the year what we should expect, but you did not in the first half of the year when the surprise was positive. So what are you doing differently versus your peers? How should we expect this to impact fiscal year 2020 on the basis of what you've hedged already today? This would be very helpful given that it seems to be one of the most important factors in your quarterly swing.

And then a second question on the supply chain constraints. Could you help us understand a little bit more, which precise measures you've taken to solve the issue? Some of your OEMs have mentioned that you might have raised some of the manufacturing prices up to 30%, just to make sure you could secure some capacity. Is it getting more and more difficult to secure capacity? What is the impact that we should expect to come up from these measures, both in the second half of this year and also in 2020?

**Harm Ohlmeyer** - *adidas AG - CFO, Labor Director & Member of Executive Board*

Yes. First on the FX hedging, Elena. First and foremost, our hedging policy is always 12 to 18 months out, and we want to cover our product cost if you're more reliable in our guidance and our quarters. And you can go back into spring/summer '19, if you go 12 to 18 months back, we had a different U.S. dollar, that's why it was more positive in the first half. And of course, the dollar, despite the fact that a lot of banks told us it's weakening, it hasn't. And that's why the second half wasn't as good or as well hedged as the first half was. And again, the benefit was not much better in the first half.

And secondly, compared to the competition, our business has a lower percentage of overall net sales in the U.S. where you would have a natural hedge through the net sales. And the main competitor has a benefit there because our share in Europe and also in China is higher than theirs, and that's why we have more of a natural hedge that we are missing. That's why North America is so strategic for us also in the mid and the long run even from a hedging point of view.

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**Kasper Bo Rorsted** - *adidas AG - CEO & Member of Executive Board*

Let me speak about the supply constraints. As we already explained, following the first quarter, we were in a supply constraint situation. When you go out and ask for more capacity, most capacity is already used. So the way you get extra to capacity in the short term is through overtime or through very expensive capacity -- "idle capacity" where there's very little. The second part is, which is a cost associated with it, and Harm has been quite clear on that has been -- than the subsequent consequences of air freight. We have mitigated as much as we could in the first, second and also the third quarter, and that is why you're seeing pretty much a more and more unconstrained situation in the fourth quarter and also going into the new year.

You should assume for the capacity we have next year is very close to normalized rates. It does not preclude that the overall pricing is going up, but that's the market situation. But the marginal increase that we had this year for where we had supply constraint, of course, we're not continuing next year because we're not in the overtime, we're into a normalized manufacturing scenario. So next year you should assume there's -- you don't have neither same amount of air freight nor the same amount of marginal cost on the large product.

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**Operator**

The next question is from line of Andreas Inderst of Macquarie.

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**Andreas Inderst** - *Macquarie Research - Senior Equity Analyst*

My first question is on North America. There's lots of talk about consumer slowdown, weakness, promotional environment, not necessarily in the sporting good space. But maybe you can elaborate on that? Your take would be highly appreciated on that.

And second question is on Europe. You seem to be quite confident that you will see improvements in the second half of the year. You have clearly outlined several drivers. But given the development in H1, group wise and also in Europe, do you feel you are broadly in line with your expectations, slightly ahead? Or do you have to step up materially versus your budget?

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**Kasper Bo Rorsted** - *adidas AG - CEO & Member of Executive Board*

Starting with the last question. We had negative growth in the first quarter of 2019. We have 0 growth to neutral position in the second. So what you are seeing, you're seeing what we, of course, are betting on a sustainable improvement and that you're going to see, maybe not linear but throughout the remainder of the year, so Europe will come back to growth as we said in the fourth quarter and will be in a growth scenario next year. We have no reason to believe that the improvement we're seeing is not going to be of a sustainable character. It has taken us 4 quarters to turn around. I think that was more or less what was it last year that we looked up on a sustainable improvement and not a short-term, whether it would be a disappointment.



So with all the indicators that I spoke about and of course also football comparison, you don't have a football element in the second half or you do have one which is the euro. So we don't really believe that the assumptions we put in place are the appropriate ones. U.S. continue to be very impulsive market. We're not seeing a substantial slowdown in U.S. Of course, we've seen a slowdown in our business due to some of the factors that I mentioned.

The competitive pressure, I would say, remains high in all the key markets. And I can't say that it's been any higher or any lower from a substantial standpoint in the second quarter. So still good trading environment in the U.S. Continues to be competitive. But when you bring new products in, like some of the ones we discussed, either through our own or through our creators, we continue to see great demand for our products in the market.

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### Operator

The next question is from the line of Piral Dadhanian of RBC.

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### **Piral Dadhanian** - RBC Capital Markets, LLC, Research Division - Director of Premium Brands

On e-commerce, if I may, obviously, another strong -- very strong quarter of growth. Could you just help us understand the contribution of growth across the key platforms? Is it coming mainly from your website? Is Instagram contributing? Is your app now outsized in terms of contribution? How is Creators Club impacting that revenue growth? What do you think is the mid-term growth rate for that -- for the e-commerce channel going forward to get to that EUR 4 billion target? I think that you've said, it requires a sustained level of high growth. Is that still sort of the base case assumption?

And then secondly just on Reebok, first positive growth in a number of quarters now. Is this the beginning of the turnaround? Should we expect to sustain positive growth trajectory for Reebok as we go into 2020 and beyond?

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### **Harm Ohlmeyer** - adidas AG - CFO, Labor Director & Member of Executive Board

Yes, Piral, Harm speaking, just on the e-com side. So it is indeed primarily still the website, but in the website it's primarily the mobile traffic that we're converting. So that's the biggest piece that we're seeing. Of course, the app is successful as well. But again, it's a minor piece of the overall business, but it's important for the loyal consumers that we have to convert them higher to get more frequency out of them. And of course, linked to that is also the Creators Club or Instagram Checkout.

But the majority of the business is a traditional website, but the traffic is more and more coming from mobile, especially when it's in China, it's almost completely mobile, and that's really what we're seeing on the website. In the mid-term, we're not going to give the guidance beyond what we have in 2020, and that's where we want to get to as part of our targets. But you can expect that it's an overproportion growth on online sales. That's why we keep investing into all aspects of our digital endeavors.

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### **Kasper Bo Rorsted** - adidas AG - CEO & Member of Executive Board

On the Reebok side, you saw, I would say, the first very last of last year when we got the Reebok brand back to profitability. But right now, you're seeing the first quarter of growth. We deliberately did not say whether this is sustainable. What we are saying is that by the end of 2020, we have a sustainable model where we are growing profitability, and we're not going to give sequential guidance. We'll give, of course, guidance when we give -- into next year, but we're not going to give sequential guidance. But you should assume that we're working diligently on it. I cannot rule out that we're going to have one or the other quarter without growth. But of course, the target our commitment is to deliver what we promised you by 2020, sustainable profitable growth.



**Piral Dadhanian** - *RBC Capital Markets, LLC, Research Division - Director of Premium Brands*

Okay. Maybe just on that, Kasper, do you feel that the businesses is in the right place? Obviously, profitability has been stabilized and improved, but do you feel like all the building blocks and ingredients are in place to now drive forward? I'm not asking you to commit to sequential quarters of growth, but do you feel that the business is now in the right place and you're happy with it from that perspective?

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**Kasper Bo Rorsted** - *adidas AG - CEO & Member of Executive Board*

No. If you grow the way we're going right now, I can't be happy. I don't think we should be satisfied. So we're getting more and more building blocks in place. But I still think we have a way to go. We have shown that we can make a lot of progress, but I don't think by any means we're finished with getting Reebok to the state where it needs to be.

So without going into further details we need to -- I still think there's work to do, and the entire management team have a business review meeting with Reebok next Monday, where in the 1 and 2 weeks' time. I was here last week and most of our people also spend time on it. So on the right way, but we don't yet have all the building blocks in place, better this year than last year, which is why the numbers are better.

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**Operator**

The next question is from the line of Erinn Murphy of Piper Jaffray.

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**Erinn Elisabeth Murphy** - *Piper Jaffray Companies, Research Division - MD & Senior Research Analyst*

Great. So two questions for me. First is on China. Could you talk a little bit more about what you saw in terms of the digital trends in China versus the off-line business? And then where are you seeing -- or what did you see in terms of store growth there? And then my second question, in North America, Harm, could you quantify how much air freight impacted the EBIT margin decline this quarter? And then just given the supply constraints through the third quarter, are you expecting EBIT for the North American region to remain pressure for the year?

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**Kasper Bo Rorsted** - *adidas AG - CEO & Member of Executive Board*

So we still see -- I will take the China. We still see a good mix between brick-and-mortar and online growth. And when we open very large boxes, we just open a very large box or the biggest we have in Chongqing, which is the largest city in China. So what we're going to expect very, very large high number of visitors in our current biggest store in China. In Shanghai, we have 20,000 and 30,000 visitors a day. We expect that to continue. So we see, when the brand experience is good, we're seeing a very high interest.

At the same time, digital is at the forefront in China, I would say, also from a mobile perspective. And that's why we built a digital team in China. So you should assume that the digital growth will by far outpace the physical growth, but at the same time we still see opportunities for opening up stores, particularly in lower-tier cities across the Chinese continent. It is such a vast country. We don't give guidance on the number of doors, but of course, we are seeing a slowdown in the opening of new doors, which is also the guidance we have given in the past. So we're seeing a different size of the box slowdown in the opening. But of course, we'll continue to open new doors where appropriate.

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**Harm Ohlmeyer** - *adidas AG - CFO, Labor Director & Member of Executive Board*

On the EBIT impact of air freight in North America, we're not going to give the details on that, Erinn. But what I can tell you, as a direction, when you look at the gross margin decline of 150 basis points, a significant part of that is impacted by air freight. That's where we leave it. But when it comes to the EBIT other things in there as well. As I mentioned earlier, from a brand investment, from an infrastructure investment. But when it comes to the gross margin, significant part of that is impacted by air freight.

**Sebastian Steffen** - *adidas AG - SVP of IR*

Haley, we have time for 2 more questions.

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**Operator**

The next question is from the line of John Kernan of Cowen.

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**John David Kernan** - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Can you just talk about -- you've reached the high end for your margin guidance for 2020 in -- with your high end of your guidance for this year implies that you've reached the 2020 target. Can you just talk about some of the operating leverage that's embedded in the second half guidance? And what specific line items you're seeing the ability to lower within that OpEx ratio?

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**Harm Ohlmeyer** - *adidas AG - CFO, Labor Director & Member of Executive Board*

I'm not sure when you say we have achieved the guidance for 2020. Yes, we are definitely -- when you look at the first half, we made good progress. And as we always said, in -- the fourth quarter is always a quarter where we have lower operating margin historically. It will be more balanced this year. And of course, we talked lengthily already early about the impact on Q3 where we target to be below prior year on the net income line. And of course, correspondingly, in the operating margin as well.

So again, we continue to spend on the marketing side. We continue to invest into our business, and we're committed to our e-commerce growth. Now we'll drive some of the operating overheads. But as I said earlier, you will see the first visible benefits of ONE adidas in 2020 as some of these investments come to an end in 2019 and it had been built, and that's the direction that we're going to go. But please keep be reminded that in Q3, it will be a different operating profit than we had prior year. In Q4, we'll get again not similar to the previous year, but we want to get into more balanced quarter-by-quarter going forward.

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**John David Kernan** - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Got it. And then maybe just a quick follow-up. We've seen some more Yeezy launches here in the U.S. in the first half of 2019, even more so than the second half of last year. And the sell-throughs have been extremely strong in both the primary and resale retail markets. So I was just wondering what you expect out of Yeezy going forward? Is it this type of launch cadence that we should expect in the back half of the year as well?

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**Kasper Bo Rorsted** - *adidas AG - CEO & Member of Executive Board*

So thank you for asking this question because it's actually really paramount to the way our business is running right now. Last year, we had fewer launches with larger volumes. What we have now is we have more launches with less volume. So the business is being spread much more out. And the launch that I spoke about the last one was where we had a different launch every hour. So you could buy one different shoe every hour, of course, with a limited volume. But what we are doing is we're spreading it out to avoid having these very large elements in 1 quarter, which basically makes the comparison very different. So you should assume that we'll bring more Yeezy products in, also as we speak.

The volume will not fundamentally change. We're not fundamentally growing our Yeezy business. We think it's a very good level here. So we might see slight growth, but not seeing a substantial growth at all. But it's going to be spread much more evenly out, which of course also will mean that you're not going to have the very large variances in one quarter or (inaudible) from a margin standpoint because it's simply not how we're going to launch the product. So what you saw in the U.S. was the launch with different models every hour, you will see, I'll not disclose it, but you'll see that one in the regions also this quarter in Europe, this quarter in the Rest of the World, but of course not with the volume that we saw last Q3.

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**Operator**

The next question comes from the line of Simon Irwin of Crédit Suisse.

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**Simon William George Irwin** - *Crédit Suisse AG, Research Division - Director*

Two questions on product. Can you just talk a little bit more about UB19, in terms of how you expect to scale it through the rest of this year and into next? I don't think I've seen anything on Instagram basket for the last quarter or so, and I'm surprised here it's still kind of well above mass market.

And secondly, can you -- I know you've already been asked about Beyoncé, but just kind of conceptually, where are you looking to position this? Is this going to be Yeezy-style pricing? Or will you be looking to bring in product at around kind of upper end of existing product?

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**Kasper Bo Rorsted** - *adidas AG - CEO & Member of Executive Board*

So on the UB19, as we said, it has been a successful launch. And at this stage as we're seeing a lot of products also that it's just difficult that you don't have unlimited supply. That's why we're also not seeing any price take down. So sell-through is good. We've had substantial social media activity across the board. But we continue to see growth of our UltraBOOST business with more than 30% this year.

So UltraBOOST not only the UB19, but also the OG continues to be very well, and we're very happy with the development. I'm sorry to close on a low. I'm not going to give you any details on the Beyoncé. We think that -- we don't want to call the cat out of the bag before. We're there, and we think we'll be [deciding] what we have to say, but we're not going to give any details on it beyond what we've given today, which means that you're going to see the first product hitting by the end of the year (inaudible) portfolio. And with this, I'd like to hand the call to Sebastian.

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**Sebastian Steffen** - *adidas AG - SVP of IR*

Okay. Thank you very much, Kasper. Thanks very much, Harm. This completes our conference call for today. As you know, our next reporting day will be the 6th of November for our third quarter results. We look forward to speaking and seeing many of you over the next couple of weeks and months. As always, if you have any questions in the meantime, please don't hesitate to reach out to Adrian, myself or any other member on the IR team. With that, I would like to thank you for participating in today's call. Bye-bye, and have a great day.

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**Operator**

Ladies and gentlemen, the conference is now concluded, and you may disconnect your telephone. Thank you for joining, and have a pleasant day. Good bye.

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