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ADS.DE - Q3 2019 Adidas AG Earnings Call

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OVERVIEW:

Co. reported 3Q19 revenue of EUR6.4b, net income from continued operations of EUR644m and basic EPS from continued operations of EUR3.26.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. I am Emma, your Chorus call operator. Welcome, and thank you for joining the adidas AG Q3 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.

Sebastian Steffen *- adidas AG - SVP of IR*

Thank you very much, Emma, and good afternoon, ladies and gentlemen, from my side as well. A warm welcome to our third 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 your Q&A session. And 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.

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

Thank you very much, Sebastian. I'll go through the business update. Harm will take us through the financial update in greater details. I will briefly speak about the outlook for the remaining part of the year, and then Harm and I look forward to take your questions. So let's get started.

After 25 successful years at adidas, Eric Liedtke has informed the Supervisory Board that he will not be available for the entire next strategic cycle starting 2021, but would like to go back to the U.S. with his small children and put them back into school. To ensure his successor can already be fully integrated into developing the strategy beyond 2020, Eric will step down from the Board by mutual agreement at the end of this year. He has done a great job in positioning adidas as a creative brand, and I can only praise his marketing expertise, his passion for our brand and his commitment to sustainability. At the beginning of next year, Brian Grevy will return to adidas after his successful tenure as CEO and Chief Marketing Officer at Gant. He brings a profound knowledge of the adidas brand, vast international experience and strong leadership skills. Brian held leadership positions of increasing responsibility during his 20 years tenure at adidas from 2014 and 2016 and he has successfully led Training, our largest sports business, as a General Manager. And -- so we really see Brian as an internal candidate who has got some external exposure. He was also part of creating new strategy and knows the direction of our company exceptionally well, that the company is taking. We also wish to Eric all the best for the future endeavors and Brian would like to welcome him on board, but of course, Eric stays onto the end of the year and [we still have] with Eric being part of the management team.

We'll leave some of the consumer highlights diving into those. I'll not mention all of them, but maybe take out a couple. One is MYSHELTER, the yellow jacket you see, that's our first jacket franchise, which is driving exceptional growth for outdoor, almost triple digit numbers. So very, very strong growth. We launched the OZWEEGO [silhouette] from Archives with immediate commercial transaction. We signed Ninja, who is one of the most influential gamers. He has more than 15 million -- 40 million followers. So we need to make certain that we're now also able to connect the physical and the virtual sport. We signed Mikaela Shiffrin to support our Outdoor and Training business. And we entered into a multiyear relationship with the global #1 female alpine skier who will most likely break all winning records within the next 2 to 3 years.

On the Blackburn SPZL, we once again had strict limited releases to drive brand desirability. The 200 pairs of the Blackburn SPZL Nightsafe edition kind of resale prices of over EUR 50,000 per shoe, not for both. And on the Nano 9 from the Reebok, we saw exceptionally strong growth with the latest release of the Nano 9, which is outperforming its predecessor by 150% in sales. So overall, we do not only launch great products in the third quarter, we also entered into agreements that will help us drive brand, and, of course, commercial value into the company for the future.

That brings me to the strength and weaknesses of the quarter. We continue to see progress in our strategic growth areas; North America, Greater China and eCom, all had double-digit growth. We returned to growth in Europe. So we're seeing that the initiatives that we've undertaken are starting to show progress. We had minus 3% in the first quarter, 0 in the second, 3% in the third quarter, and we expect also a very strong fourth quarter from our European business.

We saw top line growth supported by all channels, so wholesale revenues accelerated and became positive. And we saw apparel growing at double-digit. Basically, what we're seeing on the apparel growth is that the supply chain shortages are fading and the launch of premium apparel franchises across several businesses drove the strong growth in apparel. And as I said before, I mentioned the MYSHELTER, while also, of course, the VRCT product that many of you have seen, the VRCT jacket has supported the Training area.

On the challenging side, we saw supply chain shortages with expected impact really only impact on the profitability. We're more or less out of the constraint when it comes to a supply situation. We'll have the latest impact in the fourth quarter with some airfreights and then we're completely out of it. And we saw a deceleration in our footwear. The deceleration in footwear is mainly related to two topics, which we have planned for and actually one of them we already spoke about. The first, and as I said, as previously mentioned, YEEZY was not planned and did not grow in the third quarter as it was competing against the biggest YEEZY released ever, which was executed in the prior quarter -- same quarter in prior year. So this is what we spoke about to you a quarter ago.

Secondly, the football -- footwear business declined as we get ready for relaunches in 2020, leveraging the momentum arising from the EURO 2020. All other major categories, Training, Running, Outdoor, and Originals not only recorded healthy growth, but actually show footwear growth accelerating in the third quarter. So we continue to be confident about our footwear product portfolio and pipeline, which is reflected in our expectation for significant top line acceleration in the fourth quarter.

We saw the underlying gross margin go down due to air freight costs and price reinvestments, and as also communicated, we saw net income down year-over-year as guided, due to top line phasing and OpEx timing.

On the P&L highlight, revenue increased 6% currency-neutral and 9% in euro terms, up to EUR 6.4 billion. So adding close to $0.5 billion to our top line. The gross margin up 30 basis points to 52.1%, driven by favorable FX. The operating margin down 130 basis points to 14% due to planned increases in operating expenses and also mix changes as we've spoken about. And net income from continued operations decreases 2% to EUR 644 million. Basic EPS from continued operations flat at EUR 3.26 due to reduced outstanding share count because of our share buyback program.

If we look upon the continued progress in our strategic growth areas, adidas North America grew 10% compared to 6% in the second quarter and 3% in our first quarter. We saw China grow at 11%. So we see China continues to deliver very profitable growth at scale. Top line growth is now added EUR 0.5 billion to our business in China in the first 9 months. We continue to be confident about the market and our business in China, not least due to ongoing investments. As I'm certain you know, we have put a local creation team in place, where the target is to have more than 200 people creating local task force, and in the last 2 years, we've built a digital hub. So we continue to overinvest in China.

If there's one concern then it's our transaction exposure. Given China's weight and our overall profit mix, a devaluation of the renminbi against the euro would negatively impact our bottom line. And while this would have a negative financial impact to the short term, it still would not change the very strategic outlook for our business in the country.

eCom grew 14% on top of the 76% increase in Q3 2018. It's almost like singing the same song again, but this is really, again, related to the massive YEEZY release we had in the third quarter last year, and you should assume that we'll get to a more -- back to a more normalized growth rate for eCom in the fourth quarter. So very much in line to the guidance we gave you around the third quarter in August.

The adidas brand grew 6%, and with a double-digit improvement in North America, emerging markets and Russia. We saw Sports Performance increased 8% and Training, our largest business group, continues its growth trajectory, so continue to increase the growth rate. Sport Inspired grows 4%, and that growth reflecting acceleration in the YEEZY business. And different to the first half, we're not seeing any growth from YEEZY in Q3 as we said many times.

In Apparel, revenue increases 13%, supported by introduction of new franchises. And of course, also the relief in our supply chain that now allows us to ship more freely.

We continue to see top line stabilization at Reebok growing at 2%. As you know, the Reebok brand returned to profitability in 2018, thanks to the execution of our Muscle-Up program that we continue to execute upon. The third quarter was another like small step towards achieving profitable growth by 2020. And starting today, we'll reunite the Reebok brand under one logo, the Vector. The Vector was first introduced nearly 30 years ago, and the Vector still remains Reebok's most recognizable symbol and will help us truly realize the potential of the brand. Gross margin down in Q3, following exceptional expansion in prior years. So another growth quarter for Reebok.

Our e-commerce grew -- revenue grew 14%, as we've spoken about before. Our digital platforms continue to expand, which is very important for us. So the store partnership is one example of how we leverage digital platforms to drive consumer engagement on sales conversion as Snapchat video game in collaboration with DICK's, where users can buy our products directly through Snapchat is another change -- is another example. So we continue to make certain that we expand the capability in our digital platforms. And we saw the integration of Runtastic into the digital ecosystem is being complete. So former Runtastic running and training apps have been rebranded into adidas by Runtastic. Runtastic is now fully integrated into, as I said, our digital ecosystem. What it means to real life, for example, is that the Creative Club members can now collect points through workouts that they record in the adidas by Runtastic gaps. This will help us drive traffic across our different digital platforms, of course, down to our transactions engines and then drive revenue growth on our eCom platforms.

With this, I will hand you over to Harm, who will take us through the details -- the financials in greater detail.

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

Thank you, Kasper. Please allow me some more minutes on the details on the financials. First and foremost is the known chart that you have on the growth across all the market segments. And we have to say, for the first time in 3 years, we've recorded growth across all regions in Q3. Before I discuss all 3 main markets in more details, let's briefly look into our 3 other markets, which all proved their resilience in the face of various challenges.

Starting with emerging markets. They increased 14% despite geopolitical tensions in some countries and the segment's operating margin decreased actually by 250 basis points as the gross margin normalized and was only partly offset by a lower OpEx ratio.

Revenues in Latin America increased 5% despite an unfavorable macro backdrop and political turmoil in several countries. The segment's operating margin decreased 140 basis points as the gross margin expanded slightly and was more than offset by continued investment into our brands.

Revenues in Russia/CIS, were up 13% amid continued challenging market conditions. The segment's operating margin increased 160 basis points as the gross margin decline was more than offset by a lower OpEx ratio.

As an aside, you might have noticed that Other Businesses declined by 31% in the quarter. As I already explained in our Q2 conference call, this is because we shifted our global clearance unit into our market segments to ensure that the accountability of regional management is better reflected in our reporting setup.

When it comes to North America, we have strong growth for both brands. It was 10% overall on a currency-neutral basis. The adidas brand revenue is actually up 10%, driven by growth in both Sport Performance and Sport Inspired. And overall, there was an acceleration from 5% in the market in the first half to 10% now in Q3. The Reebok brand contributed to that as well with an increase of 17%, driven by double-digit growth in Sport. As Kasper mentioned already earlier on the supply chain challenges, better product and channel mix offset by negative pricing and higher air freight costs to mitigate the supply chain shortages that we had on the capacity side. Overall, the operating margin decreased by 190 basis points to now 16.1% due to the gross margin decline and a continued investment into the OpEx.

When it comes to Asia Pacific, overall, a growth of 8%, supported by growth of Greater China of 11%, and the adidas brand were up by 9%, again driven by double-digit growth in Sport Performance. The Reebok brand revenues were down by 11% due to declines in both Sport and in Classics. Gross margin down by 70 basis points to 56.5%. This again was to better channel mix that was more than offset by less favorable product and pricing mix. Overall, the operating margin decreased by 40 basis points to now 35.1%, again driven by the gross margin decline.

When it comes to Europe, Europe is back to growth, as Kasper mentioned earlier, minus 3% in Q1, 0 in Q2 and now plus 3% in Q3, and we're going to build on that in the fourth quarter. The adidas brand actually increases 5%, driven by growth in both Sport Performance and in Sport Inspired. And the Reebok brand sales decreased by 8% due to declines in both Sport and Classics. So you can really see the turnaround is now clearly visible and the recovery is accelerating going to the fourth quarter. We expect the fourth quarter, of course, to be supported by UEFA EURO 2020. And as a result, this should lead to a slight increase for the full year despite a decline of 2% in the first 6 months. So we expect to grow for the full year in Europe.

The margin expansion and price reinvestments have been taking effect in Q3 and supported the return to growth. Besides an array of other measures that we have implemented. The gross margin increase was driven by FX, both hedged but also unhedged portion because our hedging policy is always up to 80%, and there will always be an unhedged portion to it during the course of the quarter, while pricing mix was a negative driver as we had planned and communicated earlier.

When it comes to the P&L, we mentioned earlier, 9% nominal growth on the top line, 6% on a currency-neutral basis, and the gross margin expanding by 30 basis points. So before I go to the gross margin, next to the net sales, I want to reiterate again, this is more than EUR 500 million in one quarter on the top line to have expanded it.

On the gross margin, once again supported by favorable FX developments, which more than offset an expected underlying decline. I will comment further on our gross margin and how we see it evolving from here, especially in Q4 and moving into 2020.

OpEx increased by overall 6% on the marketing investment and 17% on the operating overhead, overall 13%. The rise in OpEx was mainly due to a planned shift of OpEx from the fourth into the third quarter to achieve a more balanced distribution of expenses throughout the second half of the year. The operating overhead increase reflects the planned cost shift as well as a continuation of the over proportionate growth in D2C. Please remember, Wholesale was up 4% and D2C was still growing 11% in Q3. But at the same time, we continue to invest in our brands, which is reflected in the marketing investment of 6% over prior quarter.

I would also provide some more details on the OpEx development in a separate slide in a couple of minutes. Net income was down as expected by 2%. This already includes the negative impact of IFRS 16 on our bottom line in that quarter, roughly EUR 15 million on net income, which is in line with our expectations from the beginning of the year. As Kasper mentioned earlier, earnings per share is flat given the share buyback that we continue to execute.

So please allow me with this chart to go a little deeper into the gross margin expansion and try to decompose it for you what is the underlying drivers of the gross margin expansion of 30 basis points. We expected a gross margin decline in Q3 and the underlying development was indeed negative to 50 basis points, mainly reflecting our strategic investment into pricing in Europe and to increase use of air freight to compensate for our supply chain shortages. However, the underlying development was less negative than expected as eCom growth was plus 14% on top of 76% was a positive surprise with positive gross margin implications relative to the call that we had 3 months ago on Q2.

In addition, we experienced higher-than-anticipated benefits from FX, 80 basis points, as we gained more than planned from unhedged currencies across several markets. I just want to mention a few, with Mexico, Russia and Turkey. And of course, the growth, the double-digit growth that you've seen in Russia and emerging markets is contributing that on top of it.

While we confirmed our full year gross margin guidance, we now see gross margin coming in slightly above 52% in 2019. This implies a decline in Q4, which is related to a number of drivers. And that is a very important part of our presentation today, and hopefully prevent some questions later on during the call. First and foremost, we will continue to use the air freight also in Q4, that is similar to Q3. We have continued price investments, particularly in Europe, and they are funded out of the gross margin. It's similar to Q3 as well. What is new in Q4, there will be headwinds from less favorable FX hedges in the second half, and they're amplified by the first deliveries of spring/summer '20 products with different hedge rates as we carry a different hedge rate already in Q1 or the first half 2020. And this is, of course, linked to the Chinese New Year products that we're delivering early this year. It's also linked to some of the EURO 2020 products. That is a new thing for Q4. Of course, the overall importance of the promotional events around Black Friday, Cyber Monday and also Singles Day will represent a headwind from the pricing point of view, from the margin point of view relative to Q3. And lastly, we also take into consideration, the negative implications from tariffs, which will start to weigh on our gross margin in Q4 and more than just a rounding number, and of course, for the first time relative to Q3.

But I also want to be very clear, so while these are important considerations for Q4 to get to our full year guidance, you shouldn't interpret it our implied Q4 guidance as an indication for 2020 gross margin run rate, as only the FX hedges of the first half 2020 will be an indication going to next year. So there will be less air freight, there will be less price investments, and we will have the right pricing on the new products. And of course, the tariffs will fade over the year. And the promotional event is a Q4 event. But for the full year, that is not something that will repeat itself for the full year. That is on the gross margin.

Please also allow me to go a little deeper in the OpEx phasing as that might be some of your concerns, especially on the 10% growth in the quarter and 17% on to the operating overheads. Historically, Q3 was always the peak profitability quarter for us, whereas Q4 was barely generating any profits due to an uneven distribution of OpEx. Looking at 2018, OpEx was -- in Q4 was EUR 450 million higher than Q3, even so the quarters are fairly similar from a top line point of view. This imbalance becomes very evident when looking at quarterly OpEx ratio for 2018, 50.5% in Q4 versus 37.3% in Q3, as you see on the chart.

By adopting a proactive approach in the second half of 2019, we are aiming to establish a more balanced profitability profile across quarters, and this is a major driver of the 13% or EUR 300 million OpEx growth in Q3.

Besides the phasing, we keep investing into specific IT areas, which form part of our digital agenda and set out the future of IT or tech, as we call it now in adidas. We actually announced to set up 2 new tech hubs, one in India and one in Bogotá, Colombia, to support our digital agenda and follow the sun to support the respective markets, the Americas and Asia in the future. These 2 tech hubs will be on top of the digital hubs that we already established in China, in Shanghai, and on top of tech hubs that we have in Zaragoza in Spain. They've always supported our growth in our digital agenda, specifically on the adidas app and on e-commerce. All of this is reflected in our confirmed fiscal year outlook, which calls for an operating margin expansion of 50 to 70 basis points to a level of 11.3% to 11.5%.

And please let me say it again, I'm not worried at all about the Q3 cost given the phasing and given the one-time costs that I explained, and looking at the second half overall, where we will leverage the cost in the fourth quarter as we had planned all along. I was more worried about the first half with a 10% increase on top of the top line growth that we had, and we reacted immediately to that, and that's what you will see in Q3 and Q4 and for the full year.

Let me now move to operating working capital. The operating working capital went down to 18.1%, another improvement of 160 basis points compared to the quarter a year ago. Inventories were up 12%, reflecting our planned top line acceleration in Q4. We feel very comfortable with our inventory position at the quarter end. The aging of our inventories actually has improved compared to the prior year. And while there is not a one-to-one relation between sales and inventory development, the increase should be intuitive given the significant top line acceleration we are expecting in Q4.

This development, overall, is directly related also to tangible results on our non-trade procurement initiative, which has led to improved payment terms with our company's vendors. We continue to expect and analyze this improvements, and hence, don't see average working capital as a percentage of net sales to decrease further. As I've said on various occasions, I would be very happy with a level of around 19%.

Just really briefly on the net cash and equity position. Our net cash position is at EUR 342 million. Our equity position increased by EUR 612 million year-on-year, and the equity ratio is actually down by 6.5 percentage points. This is 100% due to the IFRS 16 first-time application in 2019.

Just to reflect on the share buyback. Also there, we continue to drive towards the EUR 800 million that we announced for 2019 after the EUR 1 billion in 2018. We have completed EUR 629 million by the end of the third quarter, which equals to 2.5 million shares, and we are absolutely committed for the period until May 2021 to fulfill the EUR 3 billion share buyback as we communicated earlier.

With that, I would like to hand over to Kasper again to give you some more details on our outlook.

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

Thank you very much, Harm. The first slide of our areas of focus you know and I'm not going to take you through them -- everyone in detail, but I do want to just proactively raise one, and that is our continued commitment to invest with impact. So one is to become more effective in what we do. But I do want to stress that our marketing investment this year will go up extra, compared to previous years. So we're not saving ourselves to beauty here. We have today, the highest relative spend to revenue in the industry, and we have the highest -- second highest marketing working budget. We continue to spend, but you cannot look upon that every quarter has the same spend profile. You should look upon it over the entire year, and that's why we'll continue to invest. And the marketing spend this year will be above the marketing spend last year.

We continue to deliver over a portion of net income growth, and we will tackle also in the future challenges decisively. You've seen the outcomes of the European turnaround. You've seen also the outcome of the supply chain shortages we had that we're now coming to the end of.

When we look upon leveraging multiple dimensions of innovation, this is an important part, and we see far in the success of our first Home of Classics pack. We relaunched all-time favorites, like the Super Court or Continental 80 in new colorways. With BOOST, we have grown into a multibillion euro horizontal concepts and continue to see expansion. We enable BOOST printing, as you can see, the example of David Beckham. We also have BOOST edition, which allows for even more product iterations. We continue to expand [BOOST HD], which puts 20% more BOOST into a mid-sole without increasing its size through products like the PULSEBOOST winterized for cold days, and we continue to innovate in all matters around sustainability.

We presented the first fully recyclable hoodie as an adidas Stella McCartney prototype. We introduced the Infinite Play projects in the U.K. to extend the life cycle of products by allowing consumers to trade in used gear, gift cards and Creative Club membership points. And then there's, of course, the UEFA EURO around the corner, and we're going to launch the official match ball tonight and the first jersey is to come soon. And that's why, of course, you're going to see some of the impacts of the EURO 2020 in the fourth quarter as we've originally said in previous quarters.

We're also very happy with the London flagship store opening, our most digital store. It opened at the end of November. Our store is the most digital globally with over 100 digital consumer touch points. It's a seamless integration with the app, i.e., Bring It To Me, the features enabling size requests and purchases anywhere in the store, meaning that if you ask for something and you move around the store, we can actually find you in the store. We have interactive changing rooms with mirrors providing product information and immersive experience, i.e., as on stadium and trying on the jerseys. We are running global local campaigns. Global is our assortment, sneakers, [high wall] and bespoke areas growth, YEEZY, Stella, and Y-3 (inaudible) Spokane products designed only for this store. [We have our main] for product customization, with product tests and running labs or private bra fittings.

So let me just stay with Running for a second. Our UltraBOOST franchise continue to be very strong and grows double-digit, more than 20% this quarter. And today, our BOOST business is EUR 2.5 billion and continues to grow. So BOOST in it's -- the current duration, which, of course, we continue to innovate on every year, is and will remain a very strong franchise for us also in the years to come.

And on sustainability, our store is 100% powered by green energy, and there's a dedicated permanent space for Parley of the Ocean area. We've seen sales and conversions in the first weeks were significantly surpassing our expectations. And I'd encourage each of you who has a chance to go and see [adidas] store and of course also buy a product at full price over the next weeks and months.

We expect a significant top line acceleration in the fourth quarter of 2019. And the building blocks, as you know, we see the products continue to scale due to our successful launches, whether it be UB19, PULSEBOOST, Home of Classic, MYSHELTER as well as major innovations, sustainability and materials, the Parley and the 4D. We continue to see the turnaround in Europe to unfold and recovery will be accelerating.

On the UEFA 2020, we're seeing the first positive impact from related product sales in the fourth quarter. We're seeing the Chinese New Year in the fourth quarter, where we're getting sales in, that means you will not see it in the first quarter. We're seeing minimal impact or hardly any impact on the top line from our supply chain shortages. We will see some bottom line or margin impact due to air freight. And of course, the prior year comparison is a different one. We grew 5% growth in Q4 last year, and we do grew 8% in Q3 last year. So we are getting into a different territory. And that's why, just to substantiate our comment, we believe we're well positioned to significantly accelerate not only from a product standpoint, but of course, also from an inventory standpoint, which is why we took the inventories up.

And with the 9 months development according to our plan, we confirm our 2019 outlook and reiterate our confidence about a significant top line acceleration in Q4. This will put us in the middle of the 5% to 8% range, probably around the 6.5% to be more specific when it comes to top line growth. We expect our gross margin to come in slightly above the 52%, as already mentioned by Harm. And that means that we are confirming our outlook, driving double-digit bottom line growth. The first 9 months are according to the plan that we put out. We are on track to achieve a full year outlook. We have the building blocks in place for significant top line acceleration in Q4. '19 will be another success year. And right now, the only thing we're focusing on is to ensuring that we deliver in '19 and '20 before we communicate the new strategy beyond 2020 in November of next year.

So we are completely focused on delivering our net sales CAGR growth of 10% to 12%, our operating margin at 11.5% or greater, and our net income between 22% and 24%. We believe we've come a long way, but it's still too early to celebrate. So we'll continue to ensure that we deliver what we promised to you. And that's why all of our eyes are on bringing 2020 Home, while in parallel, and I want to stress this, of course, we are developing at this point of time, the strategy for 2025. This is done by a very small group of people to ensure that we don't get distracted for, first, taking the 2020 strategy over the finish line, and at that point of time, then announce the new strategy and the new financial ambitions for us by 2025. Well, let's make certain that we recognize we still have 14 months to go before we cross the finish line.

With this, I'd like to close our more formal presentation, and Harm and I look forward to take any questions you would like to answer -- ask. Thank you very much.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from the line of Antoine Belge with HSBC.

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

It's Antoine Belge from HSBC. So 2 questions. First of all, could you maybe elaborate a bit on your developments in Asia? I think there are 2 parts. One is Korea and Japan are a bit weak at the moment. So is it purely down to the market or some macro? Or do you think that there is specific issues and your -- that you're losing market share? And how do you address that? And then the other part is obviously China. I think you seem to be satisfied with the level of growth. Do you think that's the sort of reasonable -- sustainable growth that you need to have in China? Or do you think that actually this could pick up a bit next year?

The second question is more about next year, and I would expect, of course, guidance a bit more to see if there is a logic to expect a bit of a reversal of this year. So in 2019, H1 was, I would say, a bit soft in terms of top line in H1 and that's picking up in H2, but the margins were, specifically the gross margin was super strong in H1 and will be weaker in H2. So in other words, should we expect in H1 '20 with a strong top line on a weak comparative, but also some margin pressure, which in terms of gross margin that you couldn't really fully compensate when it comes to the operating margin? So basically, operating margin could be down year-on-year in H1.

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

So Antoine, let me start with the second question you asked. We'll give detail guidance in March. And I think you know us well enough that, that's not what we're doing at this stage. So I understand your question. We'll give you answers to that question when we give our annual guidance following our full year announcement in March. Let me then go through the 3 countries you just spoke about. On Korea, we -- we are working to ensure that we get our Korean business back to growth. It's been negatively impacted by the slowdown of Chinese tourists over the last couple of years. We believe that business will get back to growth next year. I was in Asia last week and went through that in quite a level of detail. So we believe that business will get back to growth next year. This year, we've seen slight growth in Japan. We think that we can probably take that growth at the same pace or slightly above next year. That is one where we will never expect strong growth simply just due to the dynamics of the market. So you should not expect a greatly different growth picture from our Japanese business.

And our China business with 11%, that is the slowest growth that we've seen in a number of years in China, and that's why we proactively invested into the Chinese market in 2 areas where we've done substantial investments. And of course, we expect those investments to start eventually paying off. One is to build a local creation center with more than 200 people creating products in China for China, which will help push the growth in China. And the second is building a digital hub, which we worked on now for 2 years and which has greatly helped our structure in our market engagement when it comes to digital. So I will not comment on growth rate for China, again, at this stage. Of course, we will do our utmost to make sure that we grow and continue to expand in China. But I can assure you that we're making the right investments into our Chinese business when it comes to headcount, when it comes to product development and when it comes to digital engagement.

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

Yes, maybe just to make sure, I -- regarding the gross margin early next year and the reason why I ask is that there was a comment that we shouldn't extrapolate the exit rate of Q4, which we [expect] to be quite negative. So it's just that -- is it fair to say that H1 will see some negative development for gross margin, but maybe of a lesser magnitude that the one that we are likely to see in Q4 '19?

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

Again, Antoine, as for your understanding, Harm commented that the implied guidance for our gross margin in Q4 shouldn't be seen as a guidance for 2020 as we will provide the guidance for 2020 in March of next year. So that's all we're going to be saying about 2020 at this point.

Operator

The next question comes from the line of Piral Dadhania with Royal Bank of Canada.

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

Firstly, back to Asia, if I may. I think you commented on a less favorable pricing environment. Are you able to provide any further comments or details around what that might entail and whether that's expected to continue as we go into the fourth quarter? Is that an online comment or is that in relation to sell-in to your franchise, the operators? And then secondly, just on the gross margin again, apologies, but I think Harm commented on the promotional days that we expect in the fourth quarter, Black Friday, Singles Day, et cetera. My understanding is those are every year. So is there -- to call it out, does that suggest that perhaps this year, you're expecting a bigger kind of sale event versus the prior year because otherwise, I would have expected it to have a similar impact on a year-on-year basis?

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

Piral, this is Kasper. I'll take the first question, but they're actually interrelated. We did not make any comments. And if we did, then it was -- we were not clear enough. We don't see anything on pricing. Right now, the only thing we see related to pricing is, of course, if you have major promotional events like 11/11. So that's where, of course, pricing comes in. But related -- we have made no other comments related to pricing in Asia for the third or the fourth quarter. But of course, you're going to have 11/11, which is a substantial event. And I'll hand over to Harm, who'll just describe that maybe a bit more in detail.

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

Yes, you're absolutely right, Piral. I mean the events are repeating itself from year-over-year. But what we are really seeing is, on the one hand, if you look at Singles Day in China, I mean, it's -- every year, it's expanding, right? And it's definitely expanding at a rate also for us, not just [October] event, overproportionate to the overall growth in the market, right? And then, of course, we're repeating similar events in December again. I even don't know what the name is again in December that we have said. But I know there's another event happening in China in December again. And then things like Black Friday and Cyber Monday are becoming a global event. It used to be a U.S. event. And every year, more markets are being added to that event. And that's where, again, as the sum overall, it's an overproportionate growth that we have around these events in the fourth quarter. And that's really what's impacting the gross margin overall. But again, we are not naïve. These events will repeat themselves. They are just getting bigger by nature.

Operator

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

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

I guess, a couple of questions for me. First, on the supply chain challenges. Has that impacted how any of your North American mid-tier partners are ordering into spring/summer '20? And then second question on Beyoncé. You didn’t really talk about that on the call. Should we see some of the product, I know it's going to be small in the fourth quarter? Or is that more of a 2020 release or launch at this stage? And then just lastly, on e-commerce. Obviously, a little bit light in the quarter given the comparison, you talk about normalization in the fourth quarter. But do you still feel comfortable with the EUR 4 billion target for 2020, just given the ramp that would be assumed as we go throughout the balance of the year for the plan?

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

On North America, you can't rule out that some of the mid-tier partners have been impacted. But they have been impacted this year by our supply chain shortages, which is why you saw the [36] in the 10 ramp. So that's not complete. So it could be excluded. As I said, we have completely recovered from a supply chain standpoint.

From Beyoncé standpoint, yes, you should assume that you will see some products in the fourth quarter. They will not have any relevant revenue impact because we are launching around 2 brands. We're launching around Ivy Park and then Beyoncé adidas. So you're going to see several launches coming up, but they have no substantial revenue impact and this has been part of the plan all the time. You will see that change throughout next year.

When it comes to e-commerce, we'll just go back and then just do the stack. So -- so you see it, we've been growing between 35% and 40% pretty much every quarter over the last several years. But if you take the 2 last years, that means that we've had a stack growth around 75% to 80% per quarter when you do the 35% to 40% per quarter. We did 75% last year in the third quarter. And we did...

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

14.

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

14. That means, we did 90% staggered growth over the 2 years. So we're still aiming at the $4 billion. And as I've told many times, whether it's 3.8 or 4.1, doesn't matter. We're still aiming at a very high number, and that's why you should look upon it on a stagger and you could see we had a growth around the 35% in the first couple of quarters. You should assume a similar growth rate also moving forward.

Operator

The next question comes from the line of Jurgen Kolb with Kepler Cheuvreux.

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

Two questions. First of all on Reebok. It looks like the brand continues to be or started to be strong in the North American market, 17% up. But in all the other markets, some weakness. Maybe, a comment on how you feel comfortable with the brand still? And what is really behind that? And then secondly, maybe on a more broader scheme, sustainability is obviously becoming a bigger topic, the first fully recyclable hoodie, the Futurecraft Loop also. Is that maybe something you want to integrate into a separate brand, so that you can push, maybe, the sustainability topic on a more broader base? Maybe some comments on that front.

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

Jurgen, first, on Reebok. First and foremost, we had a Muscle-Up program that is not finished yet. It goes into 2020. We are very happy where we are. We also said that by 2018, we became profitable again as a brand. Now it's important to grow. And when it comes to North America, of course, we had the deepest restructuring in North America, where we closed a lot of retail stores, and that's why we have finished this one in 2018. That's why you see a pronounced growth in 2019 because it's very clean, what we have done there. And again, other markets will follow. But that is really where we are. That was the biggest impact to bring it down first in North America from a sizing point of view. That's why you see the pronounced growth in North America, and that is something that we want to see in other markets going forward as well. And again, we're not looking at quarter-by-quarter, but we're happy with the progress that we made on the Reebok brand, and we will move into 2020 to continue to have sustainable growth and a sustainable profitable growth for Reebok.

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

Jurgen, on your question regarding sustainability, let me state the following. We believe that sustainability represent one of the biggest, if not the biggest growth opportunity for us in the years to come. And you've seen our efforts in Parley, where we initially will sell approximately 11 million pairs of shoes. You'll see a substantial expansion of our sustainability-related products under 2 sub-brands emerge next year to make sure that we hit different price points with a broader range and with brands that we completely control. You've seen the (inaudible) shoe that's come out -- that's out. You've seen the Future, the fully recyclable hoodie. So what we see is coming more and more is that sustainability is one of the most prolific and important differentiators in our industry and that's why we're pushing it so aggressively as we do. So you should assume that they will continue to be a driver, and you should assume that 2 sub-brands will emerge moving forward to support our activities in sustainability. So things that will be announced next year.

Operator

The next question comes from the line of Elena Mariani with Morgan Stanley.

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

My first one is about the Footwear development, plus 1% versus Apparel up 13%. I just like to better understand what gives you confidence on a sequential reacceleration in this segment? And whether you feel confident that you're going to get into a new product cycle into 2020? And still part of this question, I'd like to understand whether, as part of your Q4 implied low double-digit growth, you would expect a more balanced growth between Footwear and Apparel? And also, how much of this is part of the carryforward due to the Chinese New Year and benefits from the EURO Cup on 2020? And secondly, still on the gross margin, I understand you don't want to give any view on fiscal year '20, but perhaps to help us understand a little bit the moving parts, you've been kind enough give us the FX impact on the third quarter, which is 80 basis points. What is the FX impact that you have recorded over the 9-month period and particularly in the first half of the year?

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

So let me start with the questions around Footwear, we really don't guide quarter-by-quarter on Footwear and Apparel growth, and I think that's the important starting point. The reason why we feel confident that we will see growth is, of course, that we didn't see any growth from YEEZY in the third quarter, which last year was the biggest YEEZY quarter ever, so that has an impact. As I said in my presentation, that we expect a more positive picture from the football side with a number of new launches. And really going back and looking upon that our biggest franchise we have in Footwear is our BOOST franchise, and our UltraBOOST business was growing 20%. And we'll, of course, have a number of new product introductions. So I would not over-interpret 1/4 of the balance of Footwear and Apparel and make any trajectories of that. Of course, what we do is we strive to, over time, have a balanced growth profile, but it's linked to new product introductions. Of course, also pick up of new products. And right now, we don't believe that we have an issue in this area. We actually think we have a strong pipeline coming out that will continue to drive the balance in the appropriate way. Harm?

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

Yes. And just on the gross margin, we'll repeat ourselves. We'll give a detailed guidance in March 2020 for the full year 2020, but what I said on roadshows as well, we will not have, based on what we see today, a tailwind in 2020 as we had in 2019. But on the other hand, we will also have less air freight that is impacting the gross margin in 2019. And that's what we need to work through. And that's all we can say today. And the rest, please understand, we'll give guidance in March 2020.

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

No, I understand. Just 2 small follow-ups. My question was related to the past. If we look at the 9 months gross margin development in full year '19, what was the impact from FX gains? And then the second small follow-up is, when we think about Q4 2019 and the implied low double-digit growth from the 6.5% you've mentioned, I guess, we should not extrapolate that 12% for next year. So how much do you think is going to be the effect from the earlier Chinese New Year and the upcoming EURO 2020?

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

Elena, we're not going to go into the level of detail that you just requested. We gave some insights on what the FX element is on high level, but we're not going to go to the level of detail of what is Chinese New Year or early spring/summer '20 products. So please bear in mind, we will come back to you in March 2020.

Operator

The next question comes from the line of Omar Saad with Evercore ISI.

Omar Regis Saad - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Softlines, Luxury & Department Stores Team*

I wanted to ask for a little bit more detail and update on the footwear platforms within the Originals franchise. What are some of the developments going on in those businesses. Maybe an update on Stan Smith, how you're thinking about Stan Smith and that kind of a whole silhouette? There's an opportunity to bring that back in a bigger way. But just generally speaking, the Originals franchise on the footwear piece, kind of where we are and where you're headed?

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

Thank you very much for your question. We've had a number of, we believe, exciting launches over the last 12 months. We've had the OZWEEGO that's been picked up extremely positive for the market. We have the Home of Classics, where you're going to see a number of iterations. You have the ZX and the ZX 4000, which is an iteration to 4D Carbon. We've had the Continental that is coming out in different colorways. And as you know, that we're going to have next year, the 50th anniversary of our Superstar products. So we continue to put out new products in. And what I would stress is that if we look upon the introduction of products in 2019 compared to the products of 2018, we've had a substantially more stable and more successful introduction of new products. A lot of the products that we do put into the market, we don't drive to volume immediately because we want to make certain that we get the highest lifetime value out of them. And that is, of course, we do that very diligently. We do expect and we have seen an acceleration of the OZWEEGO footwear throughout the year, in particularly also the overall Originals footwear business. So the Originals footwear businesses accelerate throughout the year. And that's what was max for us and I said that in my presentation, there's been no growth coming from YEEZY in the third quarter. The growth came from Originals. So you need to look upon the underlying. But overall, we are content with the development we're seeing on the Originals franchises we put into the market.

Omar Regis Saad - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Softlines, Luxury & Department Stores Team*

And could I also ask, maybe, if you could talk about an update on the manufacturing and the speed factory. You had the Georgia plant, I think, open for about a year now. What are some of the advantages? What are some of the learnings? Is this a scalable platform for adidas?

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

So without going into a great level of details, we are looking into the next generation of SPEEDFACTORY, and we'll announce that in the weeks to come. And of course, one element of SPEEDFACTORY that will play key role moving forward is, of course, the printing. We've seen that, what we call the 4D print or the 3D print, whatever you want, is really breakthrough technology and is delivering a high level of functionality into the product. So I have to ask you for a bit of patience, but you're going to see in the weeks to come that the next-generation of SPEEDFACTORY will be more focused on sophisticated technology built around print because we think that's where the future is. But of course, many of the learnings we've taken already from what we have today and move back. But the future of Speed is more when it comes -- is more built around printing.

Operator

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

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

Two quick ones for you. Just going back to your gross margin slide. Within underlying developments, does that include channel mix? So does that, say, 40, 50 basis points or whatever the number is in terms of channel mix, in which case, what are the kind of the other negatives within that mix? And the second thing is just within Beyoncé. I mean, as you mentioned, the volumes, specifically, will be quite low. I imagine the big appeals over the first couple of years is going to be more of the halo effect to the brand as a whole. So are we going to see a kind of big marketing campaign at a group level around the Beyoncé launches, even if the volumes are low?

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

Well, first, Simon, on the gross margin again, I mean, it is impacted by -- everything is in for the -- to answer the question. So the channel mix is in, but the channel mix is also impacted by air freight, by pricing, but also the sales event that I mentioned earlier that are happening in D2C, primarily on our side. So -- but it's all in.

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

When it comes to the marketing campaigns regarding Beyoncé, I'm certain understand that we don't really disclose this. We've had varying marketing campaigns. When you look upon some of our other creators, whether Stella or Farrell or Kanye, and we're not going to disclose the details of how and when, with which magnitude we're going to push the Beyoncé product into the marketplace. But what you can be assured of is that the primary vehicle for the launch is going to be digital vehicle.

Operator

The next question comes from the line of (inaudible) Exane BNP Paribas.

Unidentified Analyst

I've got 2 questions. Firstly, could you comment on what you're seeing on average selling prices in the adidas brand, perhaps split out between footwear and apparel? And secondly, because I'm sure you want to know the gross margin question. It was very helpful slide, splitting out the factors in Q3. Just sort of applying that framework to Q4, is your message that both the underlying development and the FX impact will become more negative in Q4 or are you just signaling it's an FX impact.

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

We're not disclosing ASPs by footwear and apparel work. And then on gross margin side, you're correct. I mean, both columns will be impacted in Q4. So the FX is fading primarily with the spring/summer '20 shipments. And the underlying pricing, as I said, again, we see sales events and some other continued investments, they are slightly underlying worse compared to Q3 as well.

Unidentified Analyst

But just to be clear, you talked about fading FX impact, but you're not talking about negative impact. Or you're not being -- you just don't want to be specific enough at this stage, given it's early days?

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

No, there's a fading impact, right, absolutely, because the fall/winter '19 is still the same. But again, we have pricing impact that is on the underlying and then the spring/summer '20 will be negative then.

Operator

The next question comes from the line of Cedric Lecasble with MainFirst.

Cedric Lecasble - *MainFirst Bank AG, Research Division - Research Analyst*

I have 2 follow-ups. The first one on the shift of OpEx from Q4 to Q3. Could you maybe quantify a little bit, I wanted to be sure on your numbers on the comments that you did on the specific slide? And so second question is not a forward statement, it's just regarding your hedging rate. Could you tell us maybe at what rate you are hedged and how much of your exposure is hedged today.

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

Well, first, on the operating overhead, I mean, it has been a significant part of the increase in Q3 based on the phasing and the onetime event. I'm not going to disclose what the exact amount is, but it was a significant part that explains the increase. That's why, again, on an H2 consideration overall, the costs are under control and I'm not worried about it. Secondly, we're not going to disclose our hedging rates, neither the current nor the going forward rates. But again, our hedging policies, we always hedge 12 to 18 months out. And then we are hedging up to 80% of our exposure as we have also volatility in the volumes. That's our hedging policy that we are transparent about. And so we're not going to disclose the details, and we will talk about it in March 2020 then.

Sebastian Steffen - *adidas AG - SVP of IR*

Emma, we have time for one more question, please.

Operator

The final question comes from the line of John Kernan with Cowen.

Krista Kerr Zuber - *Cowen and Company, LLC, Research Division - VP*

This is Krista Zuber on for John. As it relates to the inventory build in Q3, could you sort of parse out further the components of that increase and kind of where you expect inventory levels to be by year-end? And then secondly, just on the North American operating margins, with the contraction in Q3, although at a lesser pace in Q2, kind of where do you expect an inflection or a return to expansion in the region margins?

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

Well, first, on the inventory, as I said, I'm not worried about the 12%. It's not a one-to-one relation to what we expect in Q4. But of course, we are gearing up for the events that we have around Singles Day and Black Friday and all these things, and for the events around the Euro. And also building up for what we intend to ship in November, December for spring/summer '20 products for Chinese New Year. So that's really what it is. An important note is also that the aging of the inventory has actually improved. So there's more current inventory and a lot of that will ship in Q4. I'm not going to give a forecast for the end of the year because that's something we are managing at the end of the year. We are not forecasting that, but -- and again, it's an indication what we have right now going into Q4. When it comes to North America, the margin, it has been impacted in 2019 by the capacity situation that we have and delayed shipments to some of the accounts and not satisfying some of our consumers on the e-commerce side as well. So we should expect that we are improving that situation in 2020 as the supply chain has been sorted out. So all I can say and refer to the March 2020 guidance, again, but we expect to improve the margin picture in North America going into '20.

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

Before I hand over to Sebastian, let me just give you some closing remarks from my side that we came out in the third quarter very much along the expectations that we had and that we guided around when we had the similar conversation with you in August, following the second quarter, so a slight acceleration, a slightly lower net income and a slightly lower margin due to mix. You could see that we had growth in all the regions, which gives us a better platform on the fourth quarter. As we also said throughout the year, we see a significant acceleration for the reasons that we've given you, which will drive us to the midpoint of our guidance around the 6.5, 11.3% to 11.5% from a margin standpoint. And of course, net income between 10% and 14% as we also said. So that is what we're doing. Of course, what we're trying to do is give you some guidance so you can work out the fourth quarter based on the guidance we've given you here. We believe that it will be a year, which has, within the circumstance, been a good year. And we are right now seeing accelerations in many areas, but of course, we have many moving parts. We believe that we have managed this year according to what we've guided towards, and we feel very comfortable also with the inventory position that we have now put in place to ensure that we can deliver the fourth quarter because if we didn't have the inventory position, we can't deliver the fourth quarter. So that is very fundamental for that.

So within the range, we believe that we're now taking a good step towards the 2020 target. We'll give you the guidance of 2020 by March next year. But of course, we're very focused on ensuring that we pull the right levers to do so. And that's why we continue to invest in our brand above previous year. And as I said in my presentation, the highest -- relative and the second highest absolute, and we continue to make substantial investments and also take cost to build digital structures in Europe or outside of Europe and, of course, take costs related to moving structures from Europe, outside Europe to build digital hubs for the future.

With this, I'd like to hand over to Harm -- no, to Sebastian, who will make the formal closing.

Sebastian Steffen *- adidas AG - SVP of IR*

Thanks very much, Kasper. Thanks very much, Harm. Ladies and gentlemen, this completes our call for today. Our next reporting date will be the 11th of March of 2020, when we are going to disclose our fourth quarter results and also talk about our guidance for 2020. In the meantime, 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, be it on our gross margin or other topics, please don't hesitate to reach out to Adrian, myself and any other member of the IR team.

With that, I would like to thank you for your participation in today's call. Bye-bye, and have a great day.

Operator

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