5th August 2016

Luxury & Consumer Goods

adidas Group

Price EUR145.00

All lights are green, except for our upside potential…

Fair Value EUR136 vs. EUR124 (-6%) **NEUTRAL vs. BUY**

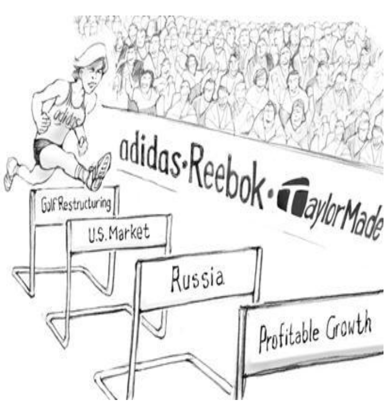
Bloomberg	ADS GY
Reuters	ADSG.F
12-month High / Low (EUR)	148.8 / 63.7
Market Cap (EURm)	30,336
Ev (BG Estimates) (EURm)	31,211
Avg. 6m daily volume (000)	874.0
3y EPS CAGR	24.7%

	1 M	3 M	6 M	31/12/15
Absolute perf.	13.8%	28.9%	56.1%	61.3%
Consumer Gds	1.6%	4.6%	4.8%	-2.0%
DJ Stoxx 600	2.4%	1.8%	2.8%	-7.6%

YEnd Dec. (EURm)	2015	2016e	2017e	2018e
Sales	16,915	19,168	20,504	22,051
% change		*13.3%*	*7.0%*	*7.5%*
EBITDA	1,442	1,854	2,188	2,441
Rep. EBIT	1,059	1,413	1,696	1,912
% change		*33.4%*	*20.0%*	*12.7%*
Net income	630.0	966.3	1,166	1,321
% change		*53.4%*	*20.7%*	*13.2%*

	2015	2016e	2017e	2018e
Rep. EBIT margin	6.3	7.4	8.3	8.7
Net margin	3.7	5.0	5.7	6.0
ROE	11.1	16.9	18.0	18.0
ROCE	10.0	13.1	15.4	16.7
Gearing	8.1	15.4	5.7	-2.7

(EUR)	2015	2016e	2017e	2018e
EPS	3.32	4.74	5.69	6.44
% change	-	*42.7%*	*20.1%*	*13.2%*
P/E	43.7x	30.6x	25.5x	22.5x
FCF yield (%)	2.0%	1.7%	2.9%	3.3%
Dividends (EUR)	1.60	1.85	2.15	2.40
Div yield (%)	1.1%	1.3%	1.5%	1.7%
EV/Sales	1.8x	1.6x	1.5x	1.4x
EV/EBITDA	21.4x	16.8x	14.0x	12.3x
EV/EBIT	29.1x	22.1x	18.1x	15.8x



Whilst many consumer stocks are affected by a more challenging macro environment, ADS enjoyed impressive top-line and earnings momentum in H2. It is clearly not over according to management, who expressed confidence throughout the conference call yesterday. Following the definitive H1 results and the upgraded FY guidance, we have raised our estimates by 12% for 2016, leading to our new FV of EUR136 vs. EUR124. We believe that investors have mostly anticipated this amazing outlook in light of the breathtaking rally (+61.3% ytd, +69% vs. the DAX30 index!), but we see reduced upside potential at this stage. Hence our Neutral recommendation vs. Buy previously.

ANALYSIS

- **Robust operating performance in North America over H1.** Having been of the sources of the group's turmoil in 2014, this region is now at the forefront of ADS' successful turnaround: sales soared 24% in H1 (+32% for **ADS brand**) with a balanced performance between Lifestyle and Performance, such as Running which grew by 60% in Q2! In this category, the brand is simultaneously pushing the high end of the footwear market (e.g. *Ultra Boost Uncaged* sold at USD180) and the mid-tier segment with the new AlphaBOUNCE franchise (retail price: USD100), which has already sold-out. As for **RBK** (-8% FX-n), the rationalization of the distribution network is almost complete and a return to growth is expected as early as H2 16. This solid top-line development and the favourable product/price-mix had a positive impact on the region's profitability (GM: +160bp to 38.2% and EBIT margin: +560bp to 6.2%)

- **Originals or how to sustain the MT growth (+50% FX-n in Q2).** Indeed in order to avoid any risk of over-distribution and brand dilution, Originals carefully manages its portfolio of six footwear franchises (*Stan Smith*, *Superstar*, *ZX Flux*, *Tubular*, *NMD* and *Yeezy Boost*) and monitors the volumes introduced into the market. The objective is also to maintain balanced growth. As an example, *NMD* and *Yeezy Boost* were the best-performing franchises in Q2 16, whilst the *Superstar* franchise led the pack in Q2 15. Growth in H2 will be partly fuelled by the relaunch of the iconic *Gazelle* model and the openings of Yeezy stores to better showcase this brand.

- **TMaG: signs of improvement ahead of the sale.** While the sale process of TM, Adams Golf and Ashworth is underway, the 7% FX-n recorded in Q2 was clearly driven by TM (+24% FX-n), whose GM has significantly improved in Q2 (Other businesses' GM was up 860bp). Management has confirmed it had received several expressions of interest although the environment surrounding this sport remains fragile, as highlighted by Nike's decision to also exit the golf equipment business (i.e. clubs, balls, bags) while remaining in footwear and apparel (as a reminder, ADS will keep its adidas-Golf brand).

- **Third sales and earnings guidance upgrade this year.** Besides the sales target upgrade in February ("double-digit growth vs. "high single digit"), the Group has increased its sales and earnings guidance three times in a row, as highlighted in the table below. ADS now expects top line growth in the high teens and considering the above-mentioned margin tailwinds, ADS is targeting a 35-39% increase in net income from continuing operations to EUR975-1,000m.

Main FY16 guidance:

	March '16	April '16	May '16	July '16
Sales FX-n growth	+10-12%	"Around 15%"	"Around 15%"	"High teens"
Operating margin	6.5%	6.6-7%	"Around 7%"	"Up to 7.5%"
Net income * growth	+10-12%	+15-18%	"Around +25%"	+35-39%

** Net income from continuing operations* *Source: Company Data*

- **We increase our FY16 assumptions by 12%.** We now expect a FX-n sales growth of 18% (vs. 15% previously), which implies a 15% FX-n increase over H2, but note that the comparison base will be higher (+12% in H2 15 vs. +7% in H1 15). We have also increased our EBIT margin assumption (7.4% vs. 7.1%) to reflect the one-off gain (early termination of the Chelsea contract: ~EUR70m) and the group's capacity to almost entirely offset the FX headwind (~400bp in Q2, higher impact expected in H2) and achieve positive operating leverage.

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VALUATION

- Our new FV of EUR136 vs. EUR124 reflects our higher FY16 assumptions. Despite this significant upwards revision, we must downgrade our recommendation to Neutral vs. Buy as we have a downside potential of 6%.
- **Why this downgrade when the momentum is so strong?** Note that the share price has soared 61% ytd after +56% in 2015. We see three main reasons this explain this amazing rally: **(i)** the German Group has achieved an abrupt and successful turnaround over the past 18 months, **(ii)** the share price has certainly benefited from a "fly-to-quality" move, as some many stocks within our consumer sample were affected by subdued organic growth rates and weak operating performances and **(iii)** the market might have already anticipated an ambitious margin expansion over 2017-2020.
- Indeed, *ceteris paribus*, **the current share price would require us to retain a margin improvement of 450bp vs. 2015 to 11% in 2020 (vs. our current assumption of 9%), this level becoming our new normative margin level as of 2020 (vs. our current normative EBIT margin of 10% from 2022).**
- Mr Kasper Rorsted (who takes the helm of ADS on 1st October) and the Executive Team may revise up the 2020 targets next year, but at this stage we feel comfortable with our current EBIT margin forecasts: +250bps vs. 2015 to 9%e in 2020, a level the Group has not reached since 2008 (9.9%).

Table 1: adidas Group quarterly FX-neutral growth:

% change	Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	Q2 16
Western Europe	11	12	18	30	25	29
North America	7	0	3	8	22	26
Greater China	21	19	15	16	30	30
Russia/CIS	-3	-14	-7	-16	2	7
Latin America	6	9	20	12	19	8
Japan	6	-6	6	-4	44	21
MEAA	10	16	13	17	17	14
Total	**9**	**5**	**13**	**12**	**22**	**21**

Source: Company Data

Table 2: quarterly FX-neutral growth for the adidas Group's three main brands:

% change	Q1 15	Q2 15	Q3 15	Q4 15	Q1 16	Q2 16
adidas	11	10	14	16	26	25
Reebok	9	6	3	5	6	7
Other businesses	-1	-14	10	-3	6	6
o/w TaylorMade-adidas Golf	*-9*	*-26*	*7*	*-15*	*-1*	*7*

Source: Company Data

NEXT CATALYSTS

- adidas Group will report its Q3 16 Results on 3th November 2016.

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Analyst:
Cédric Rossi
33(0) 1 70 36 57 25
crossi@bryangarnier.com

Consumer Analyst Team:
Nikolaas Faes
Loïc Morvan
Antoine Parison
Virginie Roumage

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London
Beaufort House
15 St. Botolph Street
London EC3A 7BB
Tel: +44 (0) 207 332 2500
Fax: +44 (0) 207 332 2559
Authorised and regulated by the
Financial Conduct Authority (FCA)

Paris
26 Avenue des Champs Elysées
75008 Paris
Tel: +33 (0) 1 56 68 75 00
Fax: +33 (0) 1 56 68 75 01
Regulated by the
Financial Conduct Authority (FCA) and the
Autorité de Contrôle prudential et de
resolution (ACPR)

New York
750 Lexington Avenue
New York, NY 10022
Tel: +1 (0) 212 337 7000
Fax: +1 (0) 212 337 7002
FINRA and SIPC member

Munich
Widenmayerstrasse 29
80538 Munich
Germany
+49 89 2422 62 11

New Delhi
The Imperial Hotel Janpath
New Delhi 110 001
Tel +91 11 4132 6062
+91 98 1111 5119
Fax +91 11 2621 9062

Geneva
rue de Grenus 7
CP 2113
Genève 1, CH 1211
Tel +4122 731 3263
Fax+4122731 3243
Regulated by the FINMA

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