The Reed Report

Company Spotlight – Nike

12/15/2016

Business Overview

Nike, Inc. (Ticker: NKE) is the world's leading designer, marketer, and distributor of authentic footwear, apparel, equipment and accessories for a wide variety of sports and fitness activities. Nike sells their products to retail accounts, through NIKE-owned retail stores and internet websites ("Direct to Consumer" or "DTC" operations), and through a mix of independent distributors and licensees throughout the world.

Previous Quarter

On 9/27/2016, Nike reported fiscal Q1 2017 results (Nike's fiscal year is from June to May). EPS (earnings per share) was $0.73 which beat estimates by $0.17 and revenue was $9.06 billion which beat estimates by $0.2 billion. More importantly, Nike reported 7% futures growth when analysts were expecting 8%. Futures are signed contracts between Nike and retailers for products that will be delivered and sold by the retailer over the next 3 months. This figure is the key metric used to determine how well the business is performing. Also, gross margins decreased by 200 basis points (2%) during the quarter and inventory increased 11% from prior year. Analysts and investors were disappointed with Nike's earnings report.

On the conference call, Nike CEO Mark Parker gave his explanation of why Nike did not meet expectations. For the futures growth, it is now less correlated with future revenue growth due to an increase their fast growing DTC business. DTC revenue was up 22% in Q1 2017 from prior year and a big part of that was 49% growth in the Nike.com business. In order to take some of the focus off of the futures orders growth, Nike is changing their futures reporting. Futures will be referenced in the guidance given on the conference call instead of a metric in their earnings release.

The gross margin decrease was due to a shift in Operating Overhead to Cost of Goods Sold, a higher off price mix, and their exit from the Golf business. Cost of Goods Sold now includes investments in innovation, Manufacturing Revolution, and other product creation-related resources which have increased significantly. The Manufacturing Revolution involves developing new technologies to enhance Nike's manufacturing with investments in automation, modernization, and sustainability. This leads to waste reduction, more efficient use of labor and materials, and profit growth. The higher off price mix was due to clearance of excess inventory. Nike's exit from the golf business includes them no longer selling golf balls, bags, and clubs. Nike will continue to sell golf footwear and apparel. The reason behind the exit is the golf industry has struggled to attract younger players. According to Matt Powell from the market research firm NPD Group, "From the golf-industry statistics, we know that rounds are down. We know that millennials are not picking up the game, and boomers are aging out. The game is in decline." Nike believes that these issues are temporary but will impact gross margins for rest of the year. For Q2 2017, Nike expects gross margins to be down 125 basis points (1.25%) from prior year and flat for the rest of the year. Nike is seeing the benefit of these investments including higher full average selling prices (ASP) and lower product costs due to the Manufacturing Revolution.

The increase in inventory was primarily related to an increase in the value of Nike's inventory not units. Out of the 11% increase, 3% was due to units and 8% units were due to value. Also, inventory in Nike's largest segment North America declined in both units and value. The higher off price mix is what lead to this increase in inventory as cheaper excess inventory was cleared during the quarter.

Growth Opportunities

Nike expects to report $50 billion in annual sales by 2020. Revenue for fiscal year 2016 was $32.3 billion. Nike plans to achieve their 2020 revenue goal by driving innovation for athletes, transforming the global marketplace, and deepening their commitment to personalized performance.

Nike isn't just about new for the sake of new. Their innovation all starts with a goal to make athletes better. The best way to do that is to figure what athletes need. This is why Nike invests in athlete sponsorships to not only build the brand but to get access to elite athletes. Their roster includes, Lebron James, Kevin Durant, Kyrie Irving, Cristiano Ronaldo, Neymar, Serena Williams, Roger Federer, Rory McIlroy, Alex Morgan, Odell Beckham Jr. and Mike Trout. From conversations with their athletes, Nike finds out what's hindering their performance. Then, Nike goes back to their Nike Sports Research Laboratory and 60 researchers and over 700 designers come up with new products that help solve the issues communicated to them by their athletes. Lebron James had the following to say about Nike "they make me better by just pushing the envelope." For example, take the athletes who are involved in high intensity training. They needed footwear that would allow to them to be stable as they run, cut, jump, and lift at high intensity. To help these athletes, Nike came up with the Metcon. A recent article on Bloomberg.com suggests that Nike is winning the Crossfit sneaker war against Reebok. Nike does a great job communicating with athletes and giving them what they need to perform at their best.

Some of Nike's popular technologies are Air, Free, Lunar, and Dri-Fit. Air is lightweight, durable cushioning that provides maximum protection for repetitive landings. Free merges the natural healthy motion of a bare foot with the protection of traditional footwear. Lunar is a lightweight cushioning created to enhance running performance. Dri-Fit is a high performance fabric that moves sweat away from the body and to the fabric surface. The technology that has dramatically transformed the way Nike approaches product design is Flyknit. Flyknit is a method of making a shoe upper that is impossibly light and incredibly strong. Consumers loved the lockdown feel of the shoe and the lightness that would ensure speed at the same time. The introduction of the Flyknit Magista in fall 2014 changed the way athletes think about their soccer shoes. This innovation sent Nike into the number one position in global soccer and now leading in all of Western Europe in market share. In spring 2015, Nike brought Flyknit to the modern comfort of their sportswear business. The lockdown was less of a benefit, but the lightweight, aesthetic was an immediate hit with the sportswear consumer. Flyknit has added to Nike's premium business as they are able to sell these products at higher ASPs. For example, Roshe, Nike's most popular model, normal model retails for $75. The premium Flyknit edition retails for $120 and is the fastest selling edition.

Nike's relentless innovation mindset enables them to continue to create growth opportunities. For example, running is a category that delivers both performance and style innovation in both footwear and apparel. This innovation resulted in double digit revenue growth in Q1 2017 which is the highest ever for the category. In the past few years, there has been shift in society towards healthy living especially with women. Nike plans to take advantage of this opportunity by creating innovative products and services for women to serve all of their fitness needs. Nike expects their women's business to grow from $5.7 billion in FY15 to $11.0 billion in FY2020. As long as Nike keeps their innovation mindset, they will continue to live up to their reputation as a growth company.

Nike serves consumers across 6 geographies, 31 territories, and almost every country around the world. Nike's strategy for transforming the global marketplace starts with the consumer. Nike's goal is to provide consumers with easy access to Nike's products, services, environments, to enable consumers to shop wherever, whenever, and however they choose. Nike has a strategic approach called the Integrated Marketplace that allows them to segment and differentiate the marketplace while enabling consumers to shop across a broad spectrum of channels and across price points. The Integrated Marketplace includes connecting the marketplace to Nike.com, growing the marketplace through Nike stores, and multi brand partners like Foot Locker.

Nike connects consumers to the brand through Nike.com, by offering the full breadth of their categories and making it easy for consumers to shop any time through any device. For Q1 2017, Nike.com revenue growth was 49% and they expect DTC to grow from $6.6 billion in FY 2015 to $16 billion in FY 2020. The growth will be driven by mobile because that's where consumers are. This will enable Nike to serve consumers more personally and more seamlessly and expand nike.com globally into more markets around the world. Nike.com is available in the U.S., UK, Canada, Switzerland and Norway. Nike has the ability to connect physical and digital shopping experiences for consumers. In more places than ever, NIKE consumers can now shop in-store and through mobile at the same time in a single transaction. Another critical part of the success of Nike.com continues to be seamless integration with Nike+. It delivers access to their running, training and sneaker apps with one single sign-on. All three apps continue to be refreshed with the new features that are more directly tailored to the user.

Nike stores are an important expression of the brand. That's where Nike builds personal relationships with our consumers, help them reach their potential, and bring the emotion of sport to life. One way Nike stores do this is by offer unique services such as run analysis, bra fitting, and soccer boot trialing. Some of the best performing stores are in New York, London, Shanghai, Los Angeles, and Seoul. Nike Factory stores provide consumers with great value and premium experience. These stores sell excess inventory and help the community where they are located by supporting local school sports programs and offering local employment opportunities. The more relationships Nike can build with their stores will result in more revenue and income they are able to generate in the future.

Nike has learned a lot from their DTC business and has passed the information along to their multi brand partners. Nike works closely with each of their partners to determine a target consumer by concept and leverages their vast catalog of products to deliver the right product at the right time, in the right quantity to the partner. Some examples of Nike working with their partners are targeting young Nike Basketball consumers through House of Hoops and Foot Locker, targeting the football obsessed teens with Inter Sport, targeting young and fast runners through Finish Line and Jack Rabbit Sports, and targeting youth teams through gear up moments with Dick's Sporting Goods.

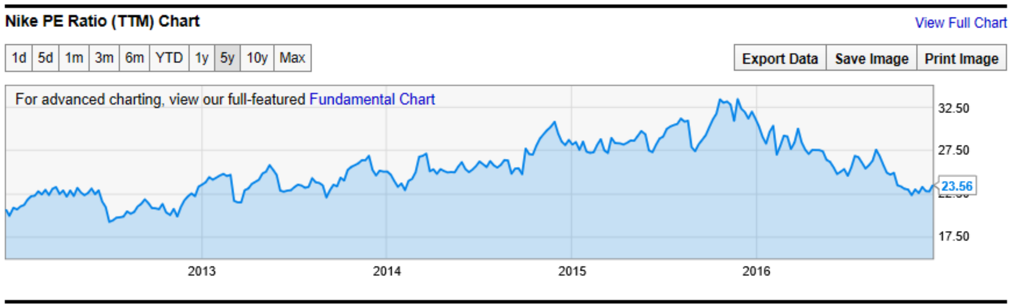
Personalized products and services where and when you need them is the future of Nike. Consumers in 24 countries are now able to personalize their own Nike shoes through Nike ID customization service, choosing their personal combination of style, color, and fit. Nike ID shoes are designed by the consumer, made for them by Nike, and delivered right to their door. An important part of personalized performance is the Manufacturing Revolution. Nike is transitioning from cut and sow to digital design. They are using computational design that uses algorithms to create innovations. Digital design enables Nike to deliver a completely new, personal, performance shoe cushioning system and accelerate speed to market for consumers. Prototypes that used to take months now take hours. Nike's ecosystem and innovation will continue to provide revenue and income growth for years to come.

Technical Analysis

Below is the chart for Nike for 2016.

The stock has traded lower most of the year due to Nike reporting revenue and futures growth that are lower than Wall Street's estimates. This is related to increased competition from Under Armour and Adidas. Under Armour's footwear business has grown 53% so far this year driven by sales of the Curry 2 basketball sneaker. In 2016, the consumer trend has moved towards classic footwear like the Adidas Stan Smith shoe. The classic footwear category has grown more than 29% in 2016 through October, according to a blog post from NPD Group footwear analyst Matt Powell. That's five percentage points higher than at the same time last year. Adidas's retro product line grew 50% this year. So how long will these trends last? We may be seeing the end of them soon. On November 18, 2016, Foot Locker held their Q3 earnings conference call and said the sales of the Curry 3 started slower than the first two editions. They also mentioned that while Adidas is on a great run, there has been tremendous success across the Nike Brand. On October 14, 2016, the investment bank Piper Jaffray released the results of their annual teen survey. Out of ten thousand teens, Nike came out as the top clothing and footwear brands receiving 29% and 51% of the vote respectively. Fashion trends come and go but athletes will always look for a way to get an edge to perform their best. Nike is the place they go to get it.

The price-earnings ratio (P/E Ratio) is the ratio for valuing a company. It measures the company's current share price relative to its per-share earnings. For example, suppose that a company is currently trading at $43 a share and its EPS over the last 12 months were $1.95 per share. The P/E ratio for the stock could then be calculated as 43/1.95, or 22.05. Nike's P/E is 23.56 the lowest level since January 2014. Also, Adidas's P/E is 28.89 and Under Armour's P/E is 61.44. Under Armour's P/E is higher than the other two because they are expected to grow revenue at a higher rate. Another way to value these companies is using the price/earnings to growth ratio (PEG ratio). This is a valuation metric used to determine a stock's value while taking the company's earnings growth into account. The PEG ratio is a stock's price-to-earnings (P/E) ratio divided by the growth rate of its expected earnings. The lower the PEG ratio, the more the stock may be undervalued. Nike's PEG ratio is 1.96, Under Armour's is 3.01, and Adidas's is 2.07. Nike is the cheapest among the major brands when it comes to P/E and PEG ratio while being the number 1 company in its industry. See the chart below for details.



When reviewing an income statement, I primarily focus on the year over year change in revenue and margins. I already mentioned the Q1 FY17 decrease in gross margins. For Q1 FY17 and FY16, revenue was up 8% and 6% respectively. Also, gross margins for FY16 were up 20 basis points (0.2%). While Nike expects gross margins to decrease this fiscal year, they also expect high single digit revenue growth. I will keep an eye on the gross margins and revenue growth going forward. Refer to the Q1 FY17 and FY16 statements below for more details.

NIKE, Inc.
CONSOLIDATED STATEMENTS OF INCOME

(Dollars in millions, except per share data)	THREE MONTHS ENDED 8/31/2016	8/31/2015	% Change
Revenues	$ 9,061	$ 8,414	8%
Cost of sales	4,938	4,419	12%
Gross profit	4,123	3,995	3%
Gross margin	*45.5%*	*47.5%*	
Demand creation expense	1,041	832	25%
Operating overhead expense	1,856	1,745	6%
Total selling and administrative expense	2,897	2,577	12%
% of revenue	*32.0%*	*30.6%*	
Interest expense (income), net	7	4	—
Other (income) expense, net	(62)	(31)	—
Income before income taxes	1,281	1,445	-11%
Income tax expense	32	266	-88%
Effective tax rate	*2.5%*	*18.4%*	
NET INCOME	**$ 1,249**	**$ 1,179**	**6%**
Earnings per common share:			
Basic	$ 0.75	$ 0.69	9%
Diluted	$ 0.73	$ 0.67	9%
Weighted average common shares outstanding:			
Basic	1,672.0	1,709.0	
Diluted	1,708.9	1,754.5	
Dividends declared per common share	$ 0.16	$ 0.14	

NIKE, Inc.
CONSOLIDATED STATEMENTS OF INCOME

(Dollars in millions, except per share data)	THREE MONTHS ENDED 5/31/2016	THREE MONTHS ENDED 5/31/2015	% Change	TWELVE MONTHS ENDED 5/31/2016	TWELVE MONTHS ENDED 5/31/2015	% Change
Revenues	$ 8,244	$ 7,779	6%	$ 32,376	$ 30,601	6%
Cost of sales	4,458	4,186	6%	17,405	16,534	5%
Gross profit	3,786	3,593	5%	14,971	14,067	6%
Gross margin	45.9%	46.2%		46.2%	46.0%	
Demand creation expense	873	819	7%	3,278	3,213	2%
Operating overhead expense	1,893	1,776	7%	7,191	6,679	8%
Total selling and administrative expense	2,766	2,595	7%	10,469	9,892	6%
% of revenue	33.6%	33.4%		32.3%	32.3%	
Interest expense (income), net	5	4	—	19	28	—
Other (income) expense, net	(58)	(58)	—	(140)	(58)	—
Income before income taxes	1,073	1,052	2%	4,623	4,205	10%
Income tax expense	227	187	21%	863	932	-7%
Effective tax rate	21.2%	17.8%		18.7%	22.2%	
NET INCOME	**$ 846**	**$ 865**	**-2%**	**$ 3,760**	**$ 3,273**	**15%**
Earnings per common share:						
Basic	$ 0.50	$ 0.50	0%	$ 2.21	$ 1.90	16%
Diluted	$ 0.49	$ 0.49	0%	$ 2.16	$ 1.85	17%
Weighted average common shares outstanding:						
Basic	1,682.4	1,715.0		1,697.9	1,723.5	
Diluted	1,723.1	1,759.6		1,742.5	1,768.8	
Dividends declared per common share	$ 0.16	$ 0.14		$ 0.62	$ 0.54	

When reviewing a balance sheet, I calculate the debt ratio. The debt ratio is total liabilities divided by total assets. Anything less than 1 means the company has more assets than debts. I use this to determine if a company is having any financial issues. Nike's debt ratio is 0.43 and that's not including goodwill and other intangible assets. Refer to the balance sheet below for more details.

NIKE, Inc.
CONSOLIDATED BALANCE SHEETS

(Dollars in millions)	August 31, 2016	August 31, 2015	% Change
ASSETS			
Current assets:			
Cash and equivalents	$ 2,659	$ 3,246	-18%
Short-term investments	2,128	2,162	-2%
Accounts receivable, net	3,526	3,288	7%
Inventories	4,896	4,414	11%
Prepaid expenses and other current assets	1,380	1,751	-21%
Total current assets	14,589	14,861	-2%
Property, plant and equipment, net	3,572	3,112	15%
Identifiable intangible assets, net	284	281	1%
Goodwill	139	131	6%
Deferred income taxes and other assets[1]	2,572	2,376	8%
TOTAL ASSETS	**$ 21,156**	**$ 20,761**	**2%**
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities:			
Current portion of long-term debt	$ 44	$ 106	-58%
Notes payable	22	23	-4%
Accounts payable	2,088	1,933	8%
Accrued liabilities[1]	3,147	3,142	0%
Income taxes payable	62	75	-17%
Total current liabilities	5,363	5,279	2%
Long-term debt	1,993	1,072	86%
Deferred income taxes and other liabilities[1]	1,635	1,516	8%
Redeemable preferred stock	—	—	—
Shareholders' equity	12,165	12,894	-6%
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	**$ 21,156**	**$ 20,761**	**2%**

Recommendation

The greatest advantage I have as an individual investor is time. I can put my money in a stock for as long as I want. Money managers have to perform every quarter or they will lose clients. So when a company like Nike has short term issues, they sell and look for a better opportunity. These companies can get oversold and this is the case with Nike. The stock is down 23% from its all-time high, and at a multi-year PE low. Meanwhile, they are still the industry leader in sports footwear and apparel and continue to grow revenue by high single digits. I've seen this happen with Disney when the stock traded down from $120 to $90 because of concerns over ESPN subscriber losses. The stock is now a little below $104. I've also seen it with Apple when the stock traded down from $134 to $90 because of concerns on IPhone sales and if Apple can produce another innovative product. The stock is now above $115. In both of these cases, short term issues caused the stock to be over sold giving investors an opportunity to buy a blue chip company for a bargain price. When it comes to Nike, I would put half of a position on now and wait until after they report earnings on December 20, 2016 to buy more.