Nike (NKE)

Earnings Update | December 22, 2021
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Market Perform

Thesis, Key Metrics, & Rating

Summary

Factory closures in Vietnam continue to impact Nike's performance, with the company confirming that they have lost three months' worth of production due to these issues. Because of these factory closures, the company has been unable to meet market demand throughout the world and has chosen to shift their supply towards their direct-to-consumer operations to achieve the highest pricing possible on the limited supply that they are able to sell. Despite these headwinds, North America and EMEA performed relatively well, beating expectations with combined growth of 20% in Digital sales. China, however, continued to struggle, with management citing that COVID restrictions and supply chain challenges impacted performance for the quarter. Overall, however, the strategic shift of inventory towards Nike Direct channel led to higher-than-expected growth, and it looks like the company's current headwinds will not impact their long-term performance.

Risks

This marks the second quarter in which China sales have declined significantly. Although the explanation for the company's issues (COVID restrictions and supply chain issues) in the region make sense, it is hard to ignore the political tensions that have been rising in that region and it makes me question if there is a structural issue with China for Nike. In March of this year, the company was linked towards the use of forced labor in China, and although the company denied these allegations, one of their previously sponsored athletes led a social awareness campaign for the issue after cutting ties with the company. Management recognized that they would receive some temporary backlash from this, but they have not spoken about this incident since March, and it makes me wonder if this had a lasting effect on the brand in the region. At the same time, with tensions between the Chinese and US governments and the amount of control that the Chinese Communist Party exerts on their population, it makes me question if the government is imposing anti-American rhetoric which could affect their sales levels in the region.

Growth Drivers

The company's DTC segment now represents 48% of revenue, with Digital demand making up 25% of total sales. Not only has this segment been growing at a much faster rate than their wholesale business, but it is also significantly more profitable. This means that as these sales become an increasingly bigger part of their mix, the company's margins will continue to expand.

Although it has its drawbacks, the company has a very significant exposure to China, which is positioned to be the fastest growing athletic apparel market in the world due to rapid income and population growth throughout the region. The popularity of American sports in this region has continuously grown over time, and with this, the brand has established itself as the leader in this enormous market. Even though there obviously are concerns about this region, its current sales levels have not recovered from pre-pandemic levels in the way that regions like North America and EMEA have, which leaves a significant opportunity for this region to improve as the company fully recovers from the impacts of the pandemic.

Earnings Recap

2Q21 Recap

- Nike generated $11.4 billion in revenue in the quarter, up 1% in comparison to the prior year period
- Nike Brand revenues were $10.4 billion, flat relative to the prior year, with strong Nike Direct growth being offset by lower revenues in the wholesale business
- Nike Brand Digital sales increased 12% in the quarter, led by 40% growth in North America, while Nike-owned stores grew 4%
- Because the company optimized inventory to be sold through Digital channels, gross margin increased 280 bps to 45.9%
- A 15% increase in operating expenses, however, saw net income increase by only 7% in the quarter
- This meant that EPS grew by 6.4% in this quarter
- Announced a dividend increase of 11% to $0.305 per share

Exhibit 1: Earnings Variance

*figures in millions except EPS	2Q22	2Q21	2Q20		Variance vs 2021	Variance vs 2020
Revenue	11357	11243	10326		1.0%	10.0%
Cost of Sales	(6,144)	(6,396)	(5,782)		-3.9%	6.3%
Gross Profit	5,213	4,847	4,544		7.6%	14.7%
Gross Margin	*46%*	*43%*	*44%*			
Demand Creation Expense	(1,017)	(729)	(881)		39.5%	15.4%
Operating Overhead Expense	(2,742)	(2,538)	(2,443)		8.0%	12.2%
Total SG&A Expense	(3,759)	(3,267)	(3,324)		15.1%	13.1%
% of Revenue	*33%*	*29%*	*32%*			
Interest Expense	(55)	(70)	(12)		-21.4%	358.3%
Other (income) expense	102	(54)	41		-288.9%	148.8%
Income before income taxes	1,501	1,456	1,249		3.1%	20.2%
Income tax expense	(164)	(205)	(134)		-20.0%	22.4%
Net Income (loss)	1,337	1,251	1,115		6.9%	19.9%
Net Margin	*12%*	*11%*	*11%*			
Weighted avg. diluted shares	1,617	1,610	1,594		0.5%	1.5%
Diluted Earnings (loss) per share	$ 0.83	$ 0.78	$ 0.70		6.4%	18.6%
Nike Brand Revenue By Geographic Region						
North America	4,477	4,006	3,982		11.8%	12.4%
EMEA	3,142	2,958	2,537		6.2%	23.8%
Greater China	1,844	2,298	1,847		-19.8%	-0.2%
APLA	1,347	1,471	1,468		-8.4%	-8.2%
EBIT by Region						
North America	1,235	1,023	875		20.7%	41.1%
EMEA	806	660	510		22.1%	58.0%
Greater China	569	891	694		-36.1%	-18.0%
APLA	338	424	377		-20.3%	-10.3%
Nike Brand Revenue by Product Category						
Footwear	6,780	6,801	6,206		-0.3%	9.2%
Apparel	3,648	3,585	3,287		1.8%	11.0%
Equipment	382	347	341		10.1%	12.0%
Nike Direct Sales	4,700	4,310	3,265		9.0%	43.9%
Nike Digital Sales	2,688	2,400	1,300		12.0%	84.0%

Commentary & Outlook

Performance by Geographic Segment

Last quarter, all regions were impacted by factory closures in Vietnam and Indonesia which led to a significant reduction in available inventory. In total, the Vietnam factory closure caused Nike to cancel production of 130 million units, meaning that roughly three months of production volume was lost. Regions like North America and EMEA were the most impacted in the last quarter due to longer transit times from their product sourcing base.

On a positive note, all factories in the region are now operational, with footwear and apparel production now being at roughly 80% of pre-closure volumes.

This quarter, North America and EMEA benefitted from having high levels of in-transit inventory, resulting in prior season supply that was arriving late due to longer transit times. Greater China and APLA, however, are closer to the company's product sourcing base and have shorter standard transit times, leading to a decline in units sold in Q2 due to lower available supply from lost production.

North America

Revenue in the quarter grew by 12%, as demand for Nike branded products remained incredibly high. Holiday retail sales across the total market grew double digits, driven by the continued momentum of the return to sport and the beginning of an outstanding holiday season. Women's retail sales grew double digits during the quarter, while performance sport categories like Running, Fitness, and Basketball all delivered double digit retail growth

This strong performance was driven by the optimization of inventory towards their direct-to-consumer operations, which led to higher levels of full-price realization. Nike Direct overall grew 30% in the region in comparison to the prior year, with Digital brand sales growing by 40% and setting records on black Friday week. Nike-owned stores also delivered strong double-digit growth, with in-store traffic trending towards pre-pandemic levels.

Because the company chose to optimize inventory towards their higher margin Nike Direct segment, sales in the wholesale channel declined 1%, as longer transit times limited the available market supply to meet increased demand. This meant that a higher mix of Nike Direct revenue contributed to the strong EBIT growth of 21% in the region.

<u>EMEA</u>

Revenue in this region grew 6% in comparison to the prior year, driven by double digit growth in holiday retail sales across the overall market. The region continued to have strong demand, driven by the start of the global football season and the Champions League tournament across the entire continent.

Nike Direct grew 6% during the quarter, led by double digit growth in Nike-owned stores as the company lapped a period of store closures. This growth was slightly offset by a decline in Nike Digital, which declined 1% in comparison to the prior year, due to the company lapping high sales volumes through the Digital channel from the liquidation of excess inventory. This meant that during this quarter, full price realization in the Digital business grew over 20%, resulting in a 30-point improvement in full price sales mix.

The wholesale segment for this region also grew 6% during the quarter, rebounding from lower sales levels in the previous year from market closures.

Overall, EBIT grew 22% as higher priced and higher margin items were sold during the quarter

<u>Greater China</u>

Revenue in the second quarter declined 24 percent, as COVID-related lockdowns and lower inventory supply due to the Vietnam factory closures impacted performance.

Nike Direct sales declined 21% for the quarter, with Nike Digital sales dropping 27% in comparison to last year. Management partially attributes this decline to a delay in product launch timing on the SNKRS brand. On the other hand, wholesale revenue also took a significant hit during the quarter, declining by 27%.

This increased volatility and poor performance in China del to a decline of 36% in EBIT, but management mentions that they are seeing encouraging signs as inventory supply begins to normalize, and that they expect to see a sequential improvement in the upcoming quarters for this specific region

<u>APLA</u>

Revenue in this region declined 6% during the quarter, as Asian Pacific territories faced a greater impact from Vietnam factory closures.

Nike Direct grew by 6%, led by Nike Digital growth of 25%, with Mexico's Digital business more than doubling during the quarter.

EBIT for this region declined 8%, as supply disruptions and door closures in the Pacific impacted performance.

Management Commentary

<u>Growth Drivers</u>

Management pointed to three key growth drivers for the business going forward: the Women's category, the Jordan brand, and Apparel

- For Women's, the company announced that they launched a brand-new shoe designed specifically for dancers in a collaboration with choreographer Parris Goebel.
- Announced a new partnership with fitness athlete Tunde Onyeneyin.
- In North America, the Women's retail sales grew by double digits, more than double the rate of the men's, for both footwear and apparel

- Jordan launched a new AJ36 shoe, the first shoe using leno-weave, a process that is uniquely strong, lightweight, and adaptable to all shoe sizes, making it the lightest Air Jordans ever

- For apparel, the company launched the newest NBA City edition and MLB City connect uniforms after listening to local team communities.
- Launched Dri-FIT AV, the next generation of performance apparel that combined weather ready technology and innovative design to help athletes take on extreme conditions

<u>Nike Membership and Digital Business</u>

- Nike Digital is now 25% of revenue, up 3 points vs the prior year and more than double the digital mix in 2019, with more than 40% of digital demand coming from their mobile applications.
- The company now has more than 79 million engaged members across the Nike ecosystem of applications
- As this ecosystem grows, they are seeing the "compounding benefits of scale," as they can create a better consumer connection and utilize inventory more efficiently
- The company continues to use the SNKRS platform to livestream and promote new product launches on a weekly basis. Management reported that these livestreams have three times the customer engagement of the industry average

<u>Wholesale Business</u>

- Nike has elevated their brand appeal by strengthening their DTC operations and relying on fewer more impactful wholesale partners
- Over the past four years, the company has reduced the number of wholesale accounts by roughly 50% in North America, while recapturing demand through their Direct-to-Consumer offerings
- This led to strong growth for Nike Direct, which has grown at a CAGR of 16% since 2016 and now makes up 48% of sales.
- Wholesale, on the other hand, has only grown by 3% in the past five years and now makes up 47% of sales, in comparison to the 70% that it represented in 2016.
- The company announced a partnership with Dick's Sporting Goods which allows shoppers to link their Nike member account and their Dick's Sporting Goods account together to unlock exclusive offers

<u>Supply Chain</u>

- Factory re-openings are going to plan in Vietnam and Indonesia, with footwear and apparel production at 80% of pre-closure levels.
- Nearly all impacted factories began re-opening in October, and as of December 20th, all factories are operational and employee attendance levels continue to improve
- The company is confident that supply will normalize going int o FY 2023, but they still see challenges in Q3 of FY 2022
- Since the start of the investment in their digital supply chain, the company has added more than one thousand robots in distribution centers to handle growth of digital demand
- In their digital distribution center in Memphis, robots handled more than 10 million units that would have otherwise required manual labor
- The company also opened two new regional service centers on both coasts which can deliver more units to customers with shorter delivery times, while also enabling their store fleet to ship merchandise to customers.

<u>Metaverse</u>

- In Q2, the company launched the 3D immersive world of Nikeland on Roblox, where they are engaging with young "athletes" through new virtual experiences
- The company also acquired RTFKT, a company which creates virtual sneakers and other NFTs.

Future Guidance

Due to the closures of factory operations in Vietnam along with the resurgence of COVID-19 throughout the world, management expects the operating environment to remain volatile from potential disruptions.

For Q3, management expects revenue to grow single digits in comparison to the prior year due to the ongoing impact from lost production in Vietnam. However, the company expects to continue benefitting from exceptional demand even if they have limited available inventory by optimizing supply towards higher margin channels

Due to these dynamics, the company expects revenue to grow mid-single digits for the full fiscal year of 2022. This is obviously a downgrade from management's prior guidance of low double-digit growth, but it is only due to the supply chain impacts previously described. However, the optimization of inventory to higher margin channels will lead to full price realization levels above their long-term target, which will allow for gross margins to expand 150 basis points.

Despite all the short-term challenges, the company still expects the business can reach the goals outlined in their outlook for 2025 (excluding FY 2022).

Exhibit 2: Previous FY 2025 Outlook

Nike's Financial Outlook

	Previous	New *(Through FY25)*
Revenue	High Single Digit Growth	High Single Digit to Low Double Digit Growth
Gross Margin	Expansion as much as 50 basis points per annum	High 40s by FY25
EBIT Margin	–	High Teens by FY25
EPS	Mid Teens Growth	Mid to High Teens Growth
ROIC	Low 30% Range	Exceeding Low 30% Range
Capital Expenditures	3-4% of Revenue	Roughly 3% of Revenue

Nike's financial outlook represents forward-looking information that involves known and unknown risks and uncertainties, which may cause actual performance and financial results to differ materially from our current outlook. Please refer to our SEC filings for a discussion of these risks.

Key Q&A Topics

<u>China</u>

- Nike was the number one sportswear brand in Tmall during the last quarter in China
- Demand creation investment (advertising and promotion costs, including costs of endorsement contracts, and media costs) was up 40% vs the prior year and they are seeing a favorable consumer response because of it
- As supply normalizes, they expect to see a sequential improvement in results in comparison to this second quarter
- "The results this quarter in China were absolutely -- were overwhelmingly impacted by supply disruptions from Vietnam."
- Nike had to navigate through local measures that were put in place to reduce the spread of COVID.
- 25% of partner retail stores were impacted in the quarter in some way as a result of local mandates to affect operations, and 50% of our factory stores in Greater China were similarly impacted

<u>Pricing</u>

- Last call, the company exceeded 65% full-price sales realization goal put forward in the last investor day as the target for 2025

- The biggest driver for this is the optimization of inventory to digital channels and lower markdown rates versus what management anticipated for a holiday season
- Management is expecting full-price realization to stay high, and above, the goal that we provided at Investor Day, especially in North America and EMEA, as the company expects discount rates to remain low.
- The year-over-year impact from tighter supply, higher full price realization, and lower markdowns had a lesser of an impact in the second quarter than the first.
- As inventory supply normalizes, management would expect full price realization to come back down to where the pre-Vietnam factory closure levels, but due to the investment in the supply chain, the company is also operating a far more agile operating model at this point in time.

Interpretation of Financial Statements

Although Nike operates in the tough apparel industry, it has done well to maintain healthy operating and net margins over the past ten years. The company started to increase investments into the company from 2014 to 2020 to build out their digital supply chain, causing their capex to revenue to increase from 2% to 4%, which impacted their free cash flow generation. However, the company has hit an inflection point in 2021, as they expect their operating margin to be in the high teens by 2025, which would be a serious improvement from the 13.2% that the company had in FY 2012. The company is now expected to have a deceleration in their capital expenditures going forward, which should allow them to grow free cash flow at a much higher CAGR than in the past five years as revenues are expected to accelerate in the coming years.

I recently ran through the calculation of return on incremental invested capital for Nike, arriving at a reinvestment rate of 54% and a return on incremental capital investments of 24%. With the company providing more color on how their investment back into the business went into the automation of their supply chain and distribution systems, it seems like their historical investments are beginning to pay off.

Competitive Analysis

According to Morningstar, Nike is the only athletic apparel company with a wide moat. The company's global scale and image as the leading premium sportwear brand allows Nike to charge a high premium for its products. Although Adidas and Columbia sportwear have higher gross margins than Nike, neither of them are nearly as efficient, as they both have net margins in the mid-single-digit range, while Nike boasts a net margin of 13%. The only truly comparable company to Nike is Lululemon, whose high margins and stable returns outperform Nike from a financial standpoint. Lululemon is the strongest premium brand when it comes to women's premium apparel, specifically leggings. However, when it comes to footwear and men's clothing, Nike continues to dominate those categories.

Valuation

Valuation remained somewhat unchanged from my last report, as earnings are still positioned to growth by single digits in the upcoming year due to the company's inability to meet market demand because of their supply constrictions. Beyond that however, I believe earnings will grow at the high teens rate that management pointed out in their long-term targets during the earnings call. The pull-forward in TTM EPS led to a higher EPS figure in five years' time, and with a multiple of 30x, Nike is expected to deliver a 7.3% rate of return.

I understand that a 30x multiple could be a stretch for a base case multiple, but with the business expected to have higher margins and expected growth rates than they had in the past five and ten years, the market has re-rated Nike for its improvements and dominance in the marketplace and I feel like the business will trade for around this level in the upcoming five years.

Even though the expected rate of return is better, the multiples for Nike are still very elevated, with the company trading at around 35x forward earnings, making it unattractive relative to other companies with similar growth prospects in our portfolio

Exhibit 3: EPS Forecast Through FY 2025

Ticker: NKE
Price: $165.77

5 Year EPS Forecast

								P/E	Total Return Price	PV	5 YR Return	Annual Return
Bear	**EPS**	**Current**	**1**	**2**	**3**	**4**	**5**	25.0x	$173.85	$112.99	4.9%	**1.0%**
		$3.82	$3.97	$4.53	$5.16	$5.89	$6.71	30.0x	$207.40	$134.79	25.1%	**4.6%**
			4%	*14%*	*14%*	*14%*	*14%*	35.0x	$240.95	$156.60	45.3%	**7.8%**
Base	**EPS**	**Current**	**1**	**2**	**3**	**4**	**5**	25.0x	$197.58	$128.42	19.2%	**3.6%**
		$3.82	$4.09	$4.78	$5.60	$6.55	$7.66	30.0x	$235.88	$153.31	42.3%	**7.3%**
			7%	*17%*	*17%*	*17%*	*17%*	35.0x	$274.18	$178.20	65.4%	**10.6%**
Bull	**EPS**	**Current**	**1**	**2**	**3**	**4**	**5**	25.0x	$223.93	$145.54	35.1%	**6.2%**
		$3.82	$4.20	$5.04	$6.05	$7.26	$8.71	30.0x	$267.50	$173.86	61.4%	**10.0%**
			10%	*20%*	*20%*	*20%*	*20%*	35.0x	$311.06	$202.17	87.6%	**13.4%**

Discount rate: 9%

Exhibit 4: ROR Sensitivity Analysis

Total RoR Sensitivity

$3.82		**Est. EPS growth rate**		
		12%	**15%**	**18%**
P / E	**25.0x**	1.0%	3.6%	6.2%
	30.0x	4.6%	7.3%	10.0%
	35.0x	7.8%	10.6%	13.4%