Nike (NKE)

Earnings Update | July 8, 2021
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Hold

Thesis, Key Metrics, & Rating

Although most apparel companies suffered substantially in the past year due to store closures and supply chain constraints, Nike has come out of the pandemic a stronger company. Nike's management team mentions that the pandemic accelerated trends towards a digital shopping environment, which is something that Nike had already been investing in for years. Because of this, Nike was able to capitalize on its strong connections with consumers, as their fast-growing direct-to-consumer business performed exceptionally well during a tough period for the company. Even with stores reopening, their investment in their digital supply chain continues to pay off, as the company is able to use data analytics to optimize inventory, drive higher full price realization (discount less items), and have lower fulfillment costs as they receive more demand from digital channels. This generates higher profit margins for Nike, who aims to have their digital business represent 40% of total revenue by 2025.

It seems like the company was able to hit an inflection point during the quarter, as management adjusted their outlook for 2025 to include EBIT margins in the high teens and low double-digit revenue growth. This was largely unprecedented, which is why the company's stock price was re-rated with a 14% increase since the earnings call. With that in mind, it seems like the upside for Nike is somewhat limited based on our current models, as my base case valuation projects a mid-single-digit annual return. That being said, wide moat businesses tend to exceed expectations and create value for shareholders in unexpected manners, which is why I have a 'hold' rating on this asset.

Earnings Recap

4Q21 Recap

During the 4th quarter of this fiscal year, Nike reported revenues of $12.3bn, a year-over-year increase of roughly 96%. With the company seeing a strong segmental shift towards Nike Direct (which includes digital sales), the company's gross margin expanded by 850 basis points, while their EBIT margin reached 15.5% This meant that the company was able to generate diluted earnings per share of $0.93 for the quarter ($3.56 for the full year), even with higher logistic costs and store closures.

Exhibit 1: Fourth Quarter Financial Performance

	1Q21 vs PY		Variance	
	1Q21	1Q20	$	%
Revenue	12344	6313	6031	96%
Cost of Sales	6689	3960	2729	69%
Gross Profit	5655	2353	3302	140%
Gross Margin				
Demand Creation Expense	997	823	174	21%
Operating Overhead Expense	2745	2368	377	16%
Total SG&A Expense	3742	3191	551	17%
% of Revenue	30%	51%		
Interest Expense	63	50	13	26%
Other (income) expense	-4	-84	80	-95%
Income before income taxes	1854	-804	2658	331%
Income tax expense	345	-14	359	2564%
Effective Tax Rate	18.6%	1.7%		
Net Income (loss)	1509	-790	2299	291%
Earnings (loss) per share				
Basic	0.96	-0.51	1.47	288%
Diluted	0.93	-0.51	1.44	282%
Weighted avg. shares				
Basic	1579	1555.7	23.3	1%
Diluted	1614.9	1555.7	59.2	4%
Dividends declared per share	0.275	0.245	0.03	12%

The company was largely able to achieve this because of the strong performance of their digital business, which has more than doubled since the beginning of the pandemic, bringing its current revenue to $9bn. This means that Nike's digital business now represents 21% of total revenue, which is more than three years ahead of management's plan.

Their Nike Direct (direct-to-consumer) strategy continues to pay off, as it now approaches 40% of the company's revenue. The growth of this segment allows the company to collect more data for their demand creation efforts, as well as reduce inventory and supply chain costs. This has allowed them to execute on their "Triple Double Strategy" outlined in 2017, which included cutting product creation times in half, increasing membership in Nike's mobile apps, and improving the selection of key franchises while reducing its styles by 25%.

Commentary & Outlook

Performance by Geographic Segment

<u>North America</u>
In Q4, revenue in North America grew 141%. This was largely due to strong growth in Nike Direct revenue of 121% as Nike owned stores returned to positive sales growth and digital sales continued to increase by 50%.

For the full year, revenue in this region grew by 19%, driven by strong 25% growth in footwear.

<u>EMEA</u>
Revenue in this region grew by 107%, reflecting strong growth in the UK, Ireland, France, Germany, and Italy. Even with company owned stores being closed, Nike Direct grew by 57%, largely driven by 30% growth in digital sales.
For the full year, EMEA's revenue grew by 23%, with apparel driving performance in this region with growth of 31%.

<u>Greater China</u>
Revenue in this region grew by 9% during the quarter, as the company faced 'difficult marketplace dynamics.' This is most likely due to the boycott that took place in China over allegations of forced labor in the region of Xinjiang. The company mentioned that they experienced sharp declines in revenue during the months of April and May, with Nike digital sales being down around 2%, but trends are slowly reverting back to normal, with the company only experiencing a slight decline in June.

The company was able to mark the seventh consecutive year of double-digit growth in this region, with revenue growing by 24%.

<u>APLA</u>
Revenue in this region grew by 76% during the quarter, with growth being particularly strong in Japan, South Korea, and Mexico. Digital sales grew by 50% in this region during the quarter, with the company seeing elevated levels of demand from Nike Direct channels.

For the full year, revenue in this region increased by 6%, as continued store closures affected the company's operations in Latin America and several parts of Asia.

Other Commentary from Management

In terms of specific categories, sneakers grew in demand by 90% in Q4, as monthly active users in the Nike footwear apps grew by 80%.

For the full year, their women's business grew by 22%, while the Jordan brand grew by 31%. The growth of these categories was largely boosted by digital sales, which have more than doubled in the past two years to $9bn.

Management decided to provide commentary on what they expect through fiscal 2025, as they have seen an acceleration in revenue and profits due to the company's ability to shift their revenue mix towards the more profitable Nike Direct portion of their business.

Exhibit 2: FY 25' 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.

FY 22' Guidance

For the next year, the company expects revenue to grow low double-digits and surpass $50bn. Management expects first half growth to be higher than second half growth due to easier comps from store closures in the first half of FY 21. They expect gross margin to expect 125 – 150 basis points next year, reflecting the continued shift in revenue towards the direct-to-consumer channels. Therefore, they expect EPS to grow by mid to high teens.

Key Q&A Topics

Topic 1 – The Continued Shift to Direct-to-Consumer and Its Financial Impact

- Management mentioned that there has been a fundamental shift in consumer behavior towards digital purchases, reflecting a 20-point mix shift towards Nike Direct.
- This shift towards digital is responsible for the inflection in the business, as it drives efficiencies in their operations from a digital supply chain standpoint, while also creating more frequent and recurring revenue from customers.

Topic 2 – Details on Specific Categories and Regions

- From a categorical standpoint, management outlines their women's business and the Jordan brand as two categories that are experiencing strong momentum. They are seeing very strong growth in these areas in North America, but they expect them to grow internationally as well.
- Management mentions that they are investing heavily in product creation in terms of their NIKE Live concepts. They mention that these events account for 50% of total women sales, and they see this channel continuing to drive growth in demand going forward.

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.

Competitive Analysis

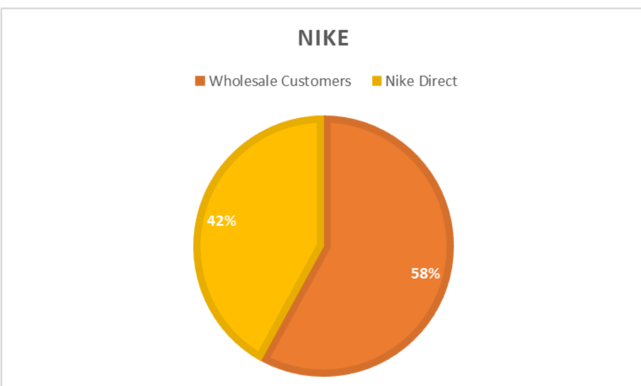
According to Morningstar, Nike is the only athletic apparel company with a wide moat. The company's global scale and image as the leading premium sportwear brand allows Nike to charge a high premium for its products. Although Adidas and Columbia sportwear have higher gross margins than Nike, neither 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.

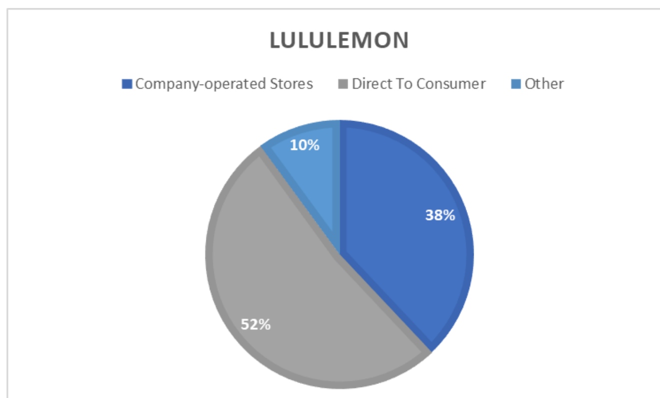
After doing research on Lululemon last year, it was apparent that this is the only true comparable company to Nike in terms of premium brands and financial performance. Therefore, I decided to do an in-depth comparison of company specific metrics, which include revenue breakdown by category, geography, and customer base.

Nike vs. Lululemon

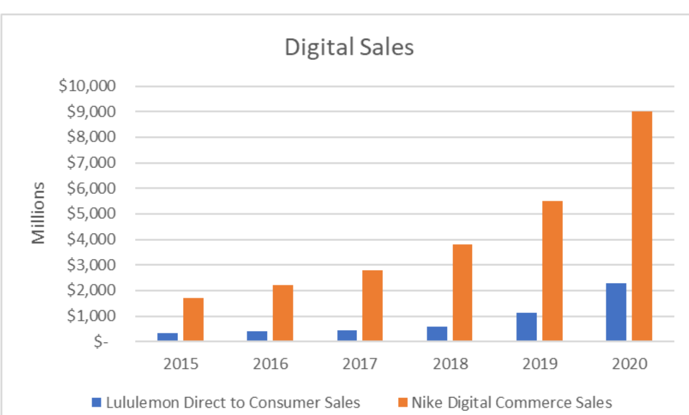
The first and most important comparison in for these companies is their revenue breakdown by customer base. Nike has historically relied on wholesale partners to scale their brand, which is why 58% of their revenue comes from wholesale customers, while only around 10% of Lululemon's sales come from similar channels. This means that Lululemon is able to control the pricing and profitability of almost 90% of their merchandise, which translates to higher gross and operating margins in comparison to Nike.

Exhibit 3: Sales by Customer Base





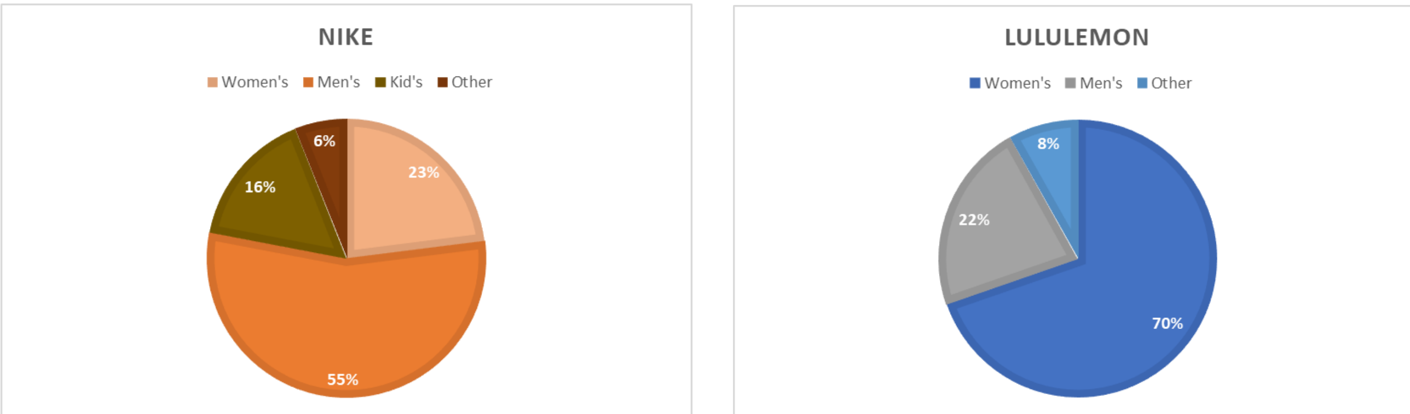
Lululemon's loyal customer base allowed the company to concentrate their efforts on their direct-to-consumer strategy from a very early stage. Because Lululemon targets affluent, high income consumers who tend to shop online, they were able to start gain momentum in online channels earlier than Nike was. While Nike has been able to build out its supply chain to keep up with recent demand for digital purchases, its sales from online channels have not grown at the same pace as Lululemon's.



	CAGR
Lululemon Direct to Consumer Sales	39%
Nike Digital Commerce Sales	32%

Lastly, the growth drivers are very different for each company. Nike's growth will stem from the women's category which currently makes up 23% of the company's revenue, while Lululemon is focused on the men's category to drive growth as it currently makes up 22% of its revenue mix. Therefore, these companies are increasingly trying to compete in each other's areas of dominance, which could be dangerous for Lululemon, who does not have the global scale or resources that Nike has. At the same time, these companies are both competing for dominance in China as this region has proven to be a growing market for premium athletic apparel. Nike has a very strong edge in this area, as nearly 20% of all its revenue comes from China, while Lululemon's international segment (which includes Europe, areas of Latin America, and China) only make up 17% of its total revenue.

Exhibit 4: Sales by Category



In conclusion, Nike has a stronger edge in terms of scale and resources, meaning that the company is better suited to compete in different areas of athletic apparel which Lululemon currently dominates. Both brands have a strong and loyal customer base, but I doubt that Lululemon can break into Nike's area of dominance when it comes to men's footwear, where sponsorship deals are key to generating revenue. In its niche, however, I believe that lululemon is more agile and better suited to benefit from growth of online shopping, specifically for the products (like leggings) in which the company is known to have the best technology available to consumers. Overall, I could see international expansion being difficult for Lululemon. They have struggled to take market share in Europe, and although Asia could be a massive area of growth in the future, I believe that companies like Nike will be very competitive in those regions for the products that Lululemon offers.

Valuation

With the company's impressive performance in the fourth quarter, along with management's updated guidance, Nike's valuation has become stretched. However, it seems like most apparel retail companies are on the higher end of the spectrum in terms of valuation. Even with Nike trading at 32x forward earnings and 27x forward EV to EBITDA, Lululemon trades at higher multiples with only single digit higher expectations of earnings growth. Both companies have mid-single-digit expected rates of return, showing that high quality companies in this industry are trading at a significant premium at the moment.

Exhibit 5: Sensitivity Analysis for Nike and Lululemon

Nike Total RoR Sensitivity				
		Est. EPS growth rate		
		15%	17%	19%
P / E	20.0x	(1.5)%	0.1%	1.8%
	25.0x	2.8%	4.6%	6.3%
	30.0x	6.5%	8.3%	10.2%

LULU Total RoR Sensitivity				
		Est. EPS growth rate		
		19%	23%	27%
P / E	25.0x	(6.3)%	(3.2)%	(0.0)%
	38.0x	1.9%	5.3%	8.7%
	50.0x	7.6%	11.2%	14.9%

Appendix

Exhibit 4: EPS Projection

NKE.4Q21.Valuation.
Model.pdf

Exhibit 5: Tearsheet

NKE.Tearsheet.pdf

Exhibit 6: Valuebands

NKE.VB.5YRS.pdf NKE.VB.10YRS.pdf

Exhibit 7: Comps

NKE.Comps.pdf

Exhibit 8: Earnings Release

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Exhibit 9: Press Release

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Exhibit 10: Morningstar

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Exhibit 11: Value Line

NKE.4Q21.ValueLine.
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Exhibit 12: Free Cash Flow Valuation Model

NKE.FCF.Valuation.p
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Exhibit 13: Company Specific Comparison

NKE.LULU.pdf

Exhibit 14: Lululemon Tearsheet

LULU.Tearsheet.pdf