BARRONS.COM

BARRON'S NOVEMBER 7, 2006

Adidas Got Game

By CHRISTOPHER C. WILLIAMS

NO COMPANY GOT

a bigger kick out of the summer's world Cup than Adidas, the No. 2 sporting-goods maker behind Nike.

The German company served as the official sponsor of the quadrennial soccer extravaganza, which was played in its home country. **Adidas** (ADS:GR) covered stadiums with its ads, clothed teams in jerseys and shorts adorned with the iconic three-stripe logo and sold 15 million soccer balls. World Cup sales drove a 60% surge in second-quarter revenue and set the company on pace to generate 1.2 billion ($1.5 billion) from soccer-related sales this year.

The World Cup has also helped Adidas score points with investors, who have bid up the shares 12% over the past month on the Frankfurt exchange, to a recent 39. (Adidas' American depositary receipts, which lack liquidity, trade for $25 on the over-the-counter pink-sheet market.) Worries about weak sales at Adidas' new acquisition, Reebok International, knocked Adidas from the high of 44 it hit in January.

But recent stronger-than-expected quarterly results and more upbeat assessment of the U.S. sporting-goods business are prompting some bulls to see Adidas sprinting into the low-50s over the next year or two. The trick will be for management to realize cost savings from integrating Reebok, boost market share in the U.S. and increase operating margins.

Analysts also expect Adidas to push up annual sales and earnings at a spiffy double-digit pace by exploiting its leading brand-identity in the world's most popular sport, soccer which should help it expand in emerging markets such as Asia and Latin America, where sales grew more than 30% in the first half.

Adidas, which sells everything from jerseys to socks to golf clubs through TaylorMade and Reebok as well as its own brands, gets 42% of its revenue from Europe, and 33% from North America thanks mainly to Reebok. Founded in 1949 by Adolf Dassler, Adidas, like Nike, made its name as a footwear company; shoes kicked in about half of last year's revenue of 7 billion.

The addition of Reebok, which Adidas bought in January for $3.8 billion, is expected to pump up overall sales by more than 40% this year, to about 10 billion. Adidas already is benefiting from Reebok's powerful U.S. distribution network, and it's making a promising push in basketball gear, long the domain of Nike.

Net profit, driven by the Adidas brand and TaylorMade golf business, could increase 33% this year to 510 million, or 2.46 a share, analysts say. Next year, sales should grow 10%, a more sustainable pace, to around 11 billion, while net income increases to 631 million, or 3.05 a share, thanks to improvement at Reebok.

The market is valuing Adidas at 18.4 times analysts' 2006 earnings-per-share estimates, a discount to the 19.7 price-to-earnings ratio of Susquehanna Financial Group's index of European athletic-brand companies like **Puma**.

Money manager Francis Claro of Evergreen Investment Management sees 30% upside in Adidas, to about 51, in coming years: "If they execute well in 2008, the shares could do even better." That would require that management realize 175 million of cost savings by 2008 from the Reebok acquisition, and turn around the brand. Reebok sales began slipping late last year, in part because buyers shunned classic footwear, Reebok's main offerings. Analysts generally don't expect a full turnaround at Reebok until next year. Then, operating margins could climb to at least 10% from about 9% now.

Success on both fronts could help Adidas generate earnings before interest, taxes, depreciation and amortization, or Ebitda, of 1.5 billion by '08, from an estimated 1.2 billion this year, and free cash flow of 500 million in '08, from an estimated 420 million in '06, say some analysts.

Adidas will need that cash to pay down the 2 billion-plus of debt it took on to buy Reebok. Adidas debt-to-capital ratio jumped to 53.4% at the end the second quarter, from 35.1% the year before.

Adidas management declined to comment for this article; the company is in a quiet period as it prepares to report third-quarter results Nov. 9. But Chief Executive Officer Herbert Hainer told investors in August he expects to cut Adidas net borrowing levels to near 50% in the "medium term," and that the deal should be accretive to earnings this year.

Much of this sunny view is rooted in the fact that Reebok showed improvement in backlog between the first and second quarters, and some analysts think that trend continued into the third. Analysts are expecting 1.17 a share, although currency fluctuation could throw off predictions.

Since creating the first soccer shoes with removable cleats in 1954, Adidas has been synonymous with soccer, and, according to market sources, controls 38% of the global soccer market, versus 31% for **Nike**. For its part, Nike claims to be the sport's "leading brand leader," generating $1.5 billion soccer-related sales.

Nike's overall dominance of the sporting-goods market is unquestioned. The Swoosh ran away from the rest of the field by riding the popularity of basketball and Michael Jordan in the 1990s; today, Nike has 37% of the $24 billion global branded athletic-shoe market, versus 22% for Adidas/Reebok, says consumer and retail research firm Sporting Goods Intelligence. And Nike has a virtual lock on the U.S. basketball-shoe market, with a 78% share.

Tired of playing also-ran, Adidas is launching its biggest assault ever on the U.S. basketball market. it signed an 11-year deal this spring to provide uniforms to the National Basketball Association, taking over from Reebok. Adidas has also packaged its NBA shoe endorsers, including Tracy McGrady of the Houston Rockets, into a marketing campaign emphasizing teamwork separating itself from Nike's look-at-me individual approach. Nike says it's unfazed. "Our focus," says Nike spokesman Alan Marks, "is to continue to grow the brand and the sport."

Adidas' share of the U.S. basketball-shoe market, excluding Reebok, inched up to 10% from 9% a year ago, according to SportsOneSource, a market-research outfit in Charlotte, N.C. Adidas' new T-MAC, $125 kicks by McGrady, are off to a strong start, auguring well for upcoming NBA offerings.

"Frankly, in the past some of their shoes were some of the ugliest I'd seen," says veteran industry analyst John Shanley of Susquehanna. "But Adidas has made a concerted effort to improve styling and marketing." Adidas, meanwhile, must display some fancy footwork to stem the slide in its share of the U.S. running-shoe market. It's introducing a slew of products, including the Adidas 1, a $250 "smart" shoe that automatically fits to runners' feet, sneaks produced with Porsche Design Group and new models of its Supernova line.

Ohio public-relations account manager Cheryl Besl, who's completed three marathons since 2002 wearing Adidas, is an ardent fan of Supernovas. She buys at least two pairs of Adidas a year, including a bright-green pair after the Columbus Marathon last month. "They are very comfortable," she says. "I won't try another brand."

In all, Adidas' U.S. businesses could post double-digit growth this year, CEO Hainer has said.

Adidas does face challenges. Higher energy and labor costs could crimp margins this year, and the consolidating retail market in the U.K. is hurting sales. Some also fear Reebok will be a drag on earnings, as Salomon Group turned out to be. Adidas bought the ski business in 1997, but sold the faltering unit last year.

Chastened by the Salomon misstep, Adidas appears to be making all the right moves with Reebok. It integrated Reebok management quickly, added marketing and design executives from Adidas and other companies to its Canton, Mass., subsidiary, and aims to reduce discounting to retailers. It's also refocusing Reebok toward performance and rap-inspired styles.

"We expect the shares to be re-rated, once the benefits of the Reebok acquisition become more tangible," says Standard & Poor's analyst Alessandra Coppola, who has a 12-month price target of 55, up 41% from now. "The deal represents one of the biggest growth opportunities available to the Adidas Group." There are others, like golf, which management expects to grow to 1 billion within five years from 709 million in revenues now.

And Adidas' sponsorship of the '08 Beijing Olympics could help push Adidas ahead of Nike in China. "Adidas is a power brand with huge opportunities," observes Marshal Cohen of NPD Group, "and they haven't capitalized on all of them yet."

The Bottom Line

Adidas shares, which trade for 39 in Frankfurt, could top 50 as the Reebok brand lifts revenue by 50%.

Adidas might never upset Nike as Sneaker King, but the shares are poised for a victory lap as Adidas, with a refurbished Reebok, earns its stripes in the U.S.

FINANCIAL GLOSSARY

Words used in this article: quiet period, retail market, money manager, price target, free cash flow