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After a Tough Stretch, Adidas' Run Resumes

By CHRISTOPHER C. WILLIAMS

The German footwear maker, an official sponsor of soccer's World Cup, looks set to win a trophy of its own. Profits are poised to rise smartly amid a turnaround at Reebok.

THE WORLD CUP COMPETITION might have ended last month, but Adidas' run is far from over.

Shares of the German sporting-goods giant have rallied 30% in the past year on the Frankfurt stock exchange, spurred in part by the company's official sponsorship of the quadrennial soccer spectacle, and better-than-expected quarterly results. **Adidas**' American depositary receipts (ticker: ADDDF) are up, as well, by more than 20%. The stock, which now fetches 42 euros, could sprint to €50 in the next 12 months, as the company's Reebok division, which markets a popular leg-toning shoe, gains traction in the U.S.

Enlarge Image

Mike Hewitt/Getty Images

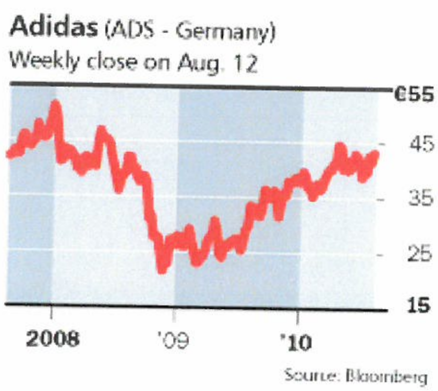
Adidas' World Cup ball

Reebok, which was founded in the U.K. and purchased by Adidas (ADS.Germany) in 2006 for almost $4 billion, first rose to prominence in the early 1980s with the Freestyle, the original aerobic-dancing shoe. It later struggled in the face of competition from **Nike** (NKE) and others, and has performed poorly for Adidas until now.

Sales in this year's second quarter shot up 16%, however, bolstered by a 30% increase in North America, an indication Adidas management finally is turning the business around. Average selling prices rose 20% in the first half of the year as Reebok upgraded its product line and hopped on the toning-shoe trend, and HSBC analyst Erwan Rambourg thinks the brand could earn €30 million t €40 million ($38.3 million to $51 million) for the full year, after losing €170 million in 2009. Continued success with Reebok, which accounts for about 15% of overall revenue, and the core Adidas business, could help Adidas gain global market share and boost earnings sharply in coming years.

Citing a 60% increase in sales of soccer-related products, Adidas reported that total revenue rose 11% in the quarter before currency adjustments, and 19%, to €2.92 billion on an adjusted basis. Sales of the Adidas brand, which accounts for 72% of the sales, were up 13%, although the company's TaylorMade golf unit and Rockport footwear suffered declines. Geographically, emerging markets in Latin America and Europe were stand-outs, with 20%-plus growth in the quarter.

Second-quarter profit jumped to €126 million from €8 million a year ago, due in part to higher sales and lower input costs, which boosted gross margins by 4 percentage points, to 48.9%. The company acknowledged that input costs—for such things as rubber, transportation and labor—could rise later in the year, erasing some of that margin improvement. Still, for the second time this year Adidas, based in Herzogenaurach, Germany, raised its full-year profit guidance. The company now expects to earn between €2.50 to €2.62 a share in 2010, up from prior guidance of €2.05 to €2.30.



Analysts have pegged this year's earnings at €533 million, or €2.58 a share, on estimated sales of €11 billion—up sharply from last year's €245 million, or €1.22 a share. The consensus estimate for next year is €3.17 a share, based on higher sales at Reebok, a turnaround in China, where the company has struggled with excessive inventory, and renewed margin expansion.

While Nike skated through the recession in relatively good shape, Adidas stumbled under its heavy exposure to Russia, and the weakness at Reebok. That explains, in large part, why Adidas sells for only 13 times 2011 estimates, while Nike sports a price/earnings multiple of 17. But Morgan Stanley sees Adidas' earnings growing at a compound annual rate of 24% in the next two years, compared with 13% growth at Nike. The differential and other expected improvements ought to earn the company a P/E multiple of at least 15, which would imply a stock price of 50, or more.

THAT COULD BE AN EASY HURDLE if the Reebok unit continues to improve. When Adidas bought Reebok, it wound up with out-of-fashion shoes and other inventory problems. Adidas management, led by Chief Executive Herbert Hainer, thought Reebok would add to earnings in the very year it was purchased—a shot on goal that missed by a mile. *Barron's* similarly expected an instant hit ("**Ready to Score: Adidas' Smart New Playbook**," Nov. 6, 2006), but Adidas' stock has been just about flat since then. Hainer wasn't available to comment.

To fix its mistake and combat the recession, Adidas, which was founded in 1949, restructured in 2009. The company cleared out inventory and strengthened its relationship with retailers, among other things. It also hit retailing gold with the introduction of EasyTone shoes, just as the popularity of leg-toning footwear was starting to grow. EasyTones look like stylish sneakers, but have "balance pods" in their soles, which create a slight instability and thus work the leg muscles harder. They are designed, the company says, "to help give definition to your legs and butt."

The Bottom Line

Adidas' shares, which trade in Frankfurt for €43, could rally to €50 in the next year or so as the discount narrows between the company's valuation and Nike's, based on 2011 earnings.

A defined derriere doesn't come cheaply; the shoes cost more than $100 a pair, but are flying off shelves even faster than Reebok can make them. Matt Powell of SportsOneSource expects sales of toning shoes to surge 400% this year, to $1.5 billion. Reebok, with a 28% market share, hopes to sell up to 11 million pairs globally, while **Skechers USA** (SKX) leads the category with a 67% share. Nike largely has been left on the sidelines, but suggests that's intentional. "Nike knows you have to train to tone," said a Nike spokesman. "There are no shortcuts."

Even some analysts dismiss toning shoes as a gimmick, but Adidas is aiming to extend the concept to apparel and men's shoes later this year. In the meantime, the success of EasyTones could help the company score more shelf space for its other brands.

NIKE IS THE UNDISPUTED LEADER in U.S. sports footwear, with a market share exceeding 35%, versus a current 4.9% for Adidas and 2% for Germany's **Puma** (PUM.Germany). Adidas' share has fallen from 5.6% a year ago. Christopher Svezia, an analyst at Susquehanna Financial who rates the stock Neutral, says the company needs to focus on growing other products in addition to toning shoes, including its Classics brand. Adidas is launching several new lines, including Fluid Trainer, a lightweight running shoe, and Mega, a cross-training shoe, which could help boost market share next year.

A Spring in Their Step

Shares of athletic-footwear companies have rallied nicely in the past 12 months, even as consumer spending stayed weak.

Ticker	ADS.Germany	NKE*	PUM.Germany
Recent Price	€41.78	$71.52	€214.90
12-Mo Change	32%	24	15
Market Value (bil)	$11.2	34.4	4.2
2009 Revenue (bil)	€10.4	$19.1	€ 2.5
EPS 2010E	€2.58	$4.23	15.48
P/E Ratio 2010E	16.2	16.9	13.9
Market Share**	4.9%	35.9	2.0

*Fiscal year ends the following May. **Share of U.S. sports-footwear market. E=Estimate. *Sources: Bloomberg; SportsOneSource*

Given its enormous and sports-mad population, China is an important market, but Nike is eating Adidas' lunch there. Adidas tripped in China, with too many products, but since has cleaned up its inventory. It expects China, which chips in 7% of sales, to start growing again later this year.

Adidas faces other challenges, including the threat of higher product costs, which could make earnings comparisons with prior quarters more difficult. A stronger dollar also could hurt sales. The company says it is 75% hedged for 2011, at "slightly above" an exchange rate of €1.35 to $1 (compared with a rate of $1.275 now).

Adidas has been paying down debt, which fell 60% in the past year, to $1 billion, or 27% of total capital, at the end of the latest quarter. Despite its challenges, the company continues to churn out cash. Francis Claro, of Wells Capital Management, expects Adidas to generate more than €800 million of free cash in two years. Some analysts see €575 million of free cash flow this year.

Ample cash, less debt and new products could put Adidas on better footing relative to rivals, especially if consumer spending perks up. Any gain in market share and profits could leave its shares better-toned too.

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