NIKE, INC.
ATHLETIC FOOTWEAR AND APPAREL
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Slow and Steady Growth for America’s Brand

Despite innovative strategy changes, Nike has failed to keep up with key competitors in their home market.

▪ This report serves to assign a sell recommendation on the common equity of Nike with an expected 12 month price target of $55.12.

▪ The company has struggled to reach revenue growth targets and has seen margin pressure in recent years, additionally changes in consumer preferences and disruption in the industry look

▪ In addition to margin pressure, the company has seen an erosion of their market share in the North American market which accounts for 45% of company revenues.

▪ The company recently introduced a new strategy in order to bolster their direct to consumer business while also decreasing the product creation timeline. This, coupled with their focus on growth in Greater China and Asia Pacific, should have a positive impact on revenue expansion

▪ In addition to improving the top-line, the company has announced intentions to reduce their workforce by 2% worldwide while consolidating from 6 regions into 4. This development should help to increase net margins.

Company description

Nike, Inc. Is a leader in the design, development, marketing, and distribution of athletic and athletics-inspired footwear, apparel, equipment, accessories, and services worldwide. The company was founded in in 1964 in Beaverton, Oregon by Phil Knight and Bill Bowerman and is listed on the New York Stock Exchange.

Company Report

Recommendation: Sell
Vs Previous Recommendation Sell

Price Target FY18: 55.12 $
Vs Previous Price Target 55.12 $

Price (as of 8-Jan-18) 63.48 $

Bloomberg

52-week range ($) 50.35-65.19
Market Cap ($B) 104.385
Outstanding Shares (B) 1.3
Average 3 month Volume (M) 9.9

Source: Bloomberg

Company Financials:

<table>
<thead>
<tr>
<th>(Values in $ millions)</th>
<th>2016</th>
<th>2017</th>
<th>2018F</th>
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<tr>
<td>Revenues</td>
<td>32,376</td>
<td>34,350</td>
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<td>Gross Margin</td>
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<td>Operating Income (After Tax)</td>
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<td>Income Margin %</td>
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<td>Sales Growth %</td>
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<td>COGS % of Sales</td>
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<td>P/E</td>
<td>25.66</td>
<td>21.11</td>
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Source: Bloomberg

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Valuation

In valuing the equity of Nike, a two-prong approach was taken. First a Discounted Cash Flow model was constructed in order to value the company based on projections of internal metrics. Secondly, a relative multiples analysis was conducted in order to value the company relative to its peers based on key performance and operating metrics.

DCF:

The discounted cash flow model took into account company and analyst projections for growth as well as an overall analysis over the macroeconomic environment and its potential impacts on the industry and company. A detailed breakdown of the assumptions used in the model can be found in the appendix.

Model Results:

The DCF Model determined that the fair value of the company’s equity was approximately $55.12. This gives reason for a sell rating on the common equity of Nike. While there are several scenarios under which the findings of the DCF model could have returned a different value, the most common scenario is that growth would actually not live up to company forecasts and thus free cash flow would not grow significantly beyond current estimates.

Sensitivity:

As a sensitivity analysis, top-line growth was reduced in key markets such as Greater China and APAC to represent the potential for growth in these areas that does not live up to expectations. Additionally, Cost of Goods Sold was increased to represent the potential for additional trade tariffs or an increase in friction in international trade. Under both of these scenarios, the value of Nike’s equity decreased and reinforced our sell recommendation.
Multiples Valuation:
Overvalued. Based on a selection of fourteen industry peers, the relative multiples valuation indicates the Nike’s common equity is currently overvalued. Nike’s Price to Earnings ratio, indicates that it is currently trading at a significant premium vs its peer companies. Additionally, at 26.0851, Nike is also trading at a premium to the wider S&P 500 index (25.49). When considering this and other multiples, and acknowledging that Nike has exhibited weak top-line growth and margin pressure in recent years, the multiples valuation clearly indicates that Nike is currently trading at a level which is unsubstantiated by fundamentals.

Price to Earnings Ratio: Nike has a P/E ratio significantly higher than the peer average, suggesting that Nike’s equity is currently trading at a level which is not supported by earnings. Nike’s P/E ratio has retreated a bit since reaching a high during 2015, however, it still sits significantly above the peer average.

Price to Cash Flow: Similarly to P/E, Nike’s P/CF ratio is currently at a premium to that of it’s peers.

EV to EBITDA: Nike’s EV/EBITDA of 15.87 is nearly 50% greater than the industry average. The company has exhibited EBITDA growth that lags behind their closest peers.

Price to Sales: Nike’s Price to sales ratio is also currently nearly twice that of the industry average.

Sales Growth %: One of the greatest causes for concern is Nike’s stagnant sales growth. As seen in the exhibit Nike’s sales growth falls significantly behind that of their closest peers.

Profit Margin: The indicator which Nike performs most favorably in is their profit margin, 10.47%, which is currently above the industry average. Despite currently being above the industry average, they have faced some margin pressure and have had difficulty expanding their margins in recent years.
Nike, Inc. is a leader in the design, development, marketing, and distribution of athletic and athletics-inspired footwear, apparel, equipment, accessories, and services worldwide. The company’s wide-array of products can be generally broken down into nine categories: running, NIKE basketball, the Jordan brand, football, men’s training, women’s training, action sports, sportswear, and golf. In addition to these core areas, the company markets products designed specifically for kids as well as sports specific products including but not limited to cricket, lacrosse, tennis, volleyball, wrestling, walking, and outdoor activities. One of the company’s major strengths lies in its partnerships and licensing deals with various collegiate and professional athletic programs. Outside of the apparel space, the company also sells various performance equipment items including bags, socks, gloves, protective equipment, and other equipment for sports activities.

In addition to the core businesses previously mentioned, the company’s wholly-owned subsidiaries including Converse Inc., which designs, markets, and distributes athletic and casual footwear, apparel and accessories, and Hurley International LLC, which designs markets and distributes action sports and youth lifestyle footwear apparel and accessories. Converse sales, which are reported separately in the company’s financials, generated $2,042,000,000 in revenue during the 2017 fiscal year, accounting for 5.94% of overall company earnings.

Outside of the company’s core operating activities and wholly-owned subsidiaries, Nike, Inc. also engages in licensing deals with third-parties to manufacture and sell apparel, digital devices, and applications and other equipment for sports activities under the NIKE-owned trademark. The most prominent recent example of these activities includes Nike’s 1 Billion dollar deal to serve as the official apparel provider of the NBA, WNBA, and NBA Development League for at least the next eight years. While
Company Overview (Continued)

While accurately quantifying the revenue generated as a direct result of the deal is impossible without internal company data, the deal is seen as a marketing play. Quantifying the expense associated with these deals is more simple, as the contracts are regularly reported in the news media. Adidas previously paid a reported 400M for the rights to the NBA for a ten year period, while Nike’s new deal will cost the company 1 Billion dollars for the next eight years. Adidas has shifted their strategy towards increasing the number of players they sponsor within the league, as they believe this will allow them more direct reach to potential consumers. Nike currently controls 95% of the American Basketball Shoe business and continues to be the most dominant player in the space despite recent attempted inroads by competitors such as Adidas and Under Armour.

When analyzing the wider U.S. Athletic Footwear Market, we see that Nike holds a dominant position as the clear market leader. It is important to note that Jordan Brand is often listed separately from Nike in Market Share comparisons, despite being a wholly-owned brand of Nike. In total, Nike and Jordan Brand control 46.5% of the U.S. Athletic Footwear Market.
Company Overview (Continued)

Nike’s overall command of the U.S. shoe market is encouraging, however, there are signs that this commanding position is being diminished as Adidas has made significant inroads into the space. According to data from NDP, Adidas nearly doubled its share of the U.S. sneaker market in the first nine months of 2017, while Nike’s core brand saw its share fall from 39% to 37%. Given Nike’s stated focus on international markets, the company may be susceptible to market share losses in their home market, which accounted for 45% of 2017 revenues.

![Share of U.S. Sneaker Market](chart.png)

Nike hopes to replicate the success they have seen through their sponsorship of the National Football League. Despite paying what was seen as an exhorbent amount for the rights ($220 Million per year), the company has been able to increase both revenue and brand outreach. Though data is not available to showcase the exact revenue generated through the NFL contract, the company recently chose to extend the contract in a signal of overall satisfaction with the results.
Company Overview (Continued)

The company distributes its products through three major channels:

**Wholesale Distributors:** The company sells 67% of its products through wholesale distributors such as footwear distributors, athletics stores, department stores, and sport-specific stores.

**Direct to Consumer:** A focus of the company’s triple-double initiative, the company currently sells 27% of its products directly to consumers through Nike-owned retail stores and internet websites, mobile applications, and independent distributors and licenses. Additionally, as of June 2017, the company has begun selling on Amazon in an effort to crack down on third party sellers who previously profited from the company’s absence.

**Other Sales:** The third distribution channel accounts for Converse sales, as well as sales to global brand divisions and makes up 6% of overall firm revenues.

There has been some recent evolution in the overall share of sales derived from direct to consumer activities as the company has increased focus on this channel. Direct to consumer sales now account for 27% of overall company sales vs. 21.68% in 2015. This shift is a deliberate attempt by company management to increase interactions with consumers in order to create a premium shopping experience while building brand loyalty. As a part of their Key cities initiative, the company hopes to transform flagship stores into shopping destinations in order to increase appeal and decrease the need for discounting which deteriorates margins.

**Key Cities**
- New York
- London
- Shanghai
- Beijing
- Los Angeles
- Tokyo
- Paris
- Berlin
- Mexico City
- Barcelona
- Seoul
- Milan
Company Overview (Continued)

Geographic segment breakdown

The company has long been the leader in the American Sports apparel landscape and maintains this position today despite increased competition from Adidas and Under Armour, among others. The company has focused recently on expansion in Greater China and other Emerging Markets. Currently the company has a geographical revenue breakdown as follows: North America (45%), Europe, Middle East & Africa (23%), Asia Pacific & Latin America (14%), Greater China (12%), and Other including Global Brand Divisions (6%).

A pillar of the company’s revenue strategy, Greater China grew at a significant clip in 2017 both in gross terms, and relative to the rest of the business. During the 2017 fiscal year, sales in Greater China generated 4,237 Million USD, representing an 11.94% increase from 2016. The company is betting heavily on continued double digit growth in this region in order to make up for less impressive growth in North America of 3.06%
Company Overview (Continued)

Segment Breakdown

The company breaks its major product lines down into four categories and the percentage of revenue across the four lines during the 2017 fiscal year were as follows: Footwear (62%), Apparel (28%), Equipment (4%), Other including Corporate and Global Brand Divisions (6%)

Historical Evolution

Footwear: The evolution of revenue by product segment highlights the importance of footwear sales to overall company revenue. Accounting for nearly 61.5% of revenues in 2017, footwear sales grew by 6.09% YoY despite a weakening of the firms hold on the North American footwear market. Footwear sales in Europe and North America grew at relatively weak rates of 2.95% and 4.14% while sales in both Greater China and Asia Pacific and Latin America were impressive, growing at 12.35% and 12.12% respectively.
Company Overview (Continued)

**Apparel:** Apparel remains an important piece of Nike’s overall revenue generation strategy. With significant resources going towards marketing and partnerships with Professional and Collegiate teams and athletes, the company relies heavily on branded apparel sales. The company has seen significant growth in Greater China and Europe the Middle East and Africa with 12.61% and 11.45% growth respectively in 2017. Growth in Asia Pacific and Latin America was in-line with overall revenue growth at 6.09% while North American growth lagged, gaining just 2.95% during the year. Given the increased marketing expense associated with taking over the rights to the NBA, the company expects future growth in North American Apparel to increase as fans purchase Nike Branded basketball apparel.

**Equipment:** Accounting for only 4% of company revenue, the equipment business is largely focused in North America. Negative Sales growth for the segment in the region is a cause for slight concern, though given the relatively small contribution to overall company success it does not signal a stronger downward trend.

**Shareholder Structure**

Nike began trading publicly on December 2nd 1980 at a price of $0.18 per share. In total, the company has a free-float of approximately 1.28 Billion with 1.89% of this amount held by insiders including the Knight family. Nike, Inc. Is widely held by institutional investors, with 81.38% of shares outstanding being held by institutional investors, and the remaining 16.73% being held by other investors. Institutional holding of the equity is very concentrated, including 28.80% being held by just seven institutions including Vanguard Group and BlackRock Inc.
Shareholder Structure (Continued)

Nike's Share price has enjoyed stable growth even during global recessionary periods. The chart above, does not account for a 2-for-1 stock split during 2015.
Sector Analysis

The Consumer Goods sector and the Apparel Footwear & Accessories Industry in particular is undergoing significant changes both in distribution channels and in customer preferences. Nike has long been the leader in their peer group from a total sales perspective, however, these changes in consumer trends have presented unique opportunities and risks industry wide.

Disruption: Changes in consumer preferences, encouraged by the increasing convenience and penetration of online shopping has had and will continue to have major consequences on the industry. For the first time in history, Online sales are set to be larger than in-store sales during the holiday shopping season in 2017 in the United states. On a global basis, Singles day, Alibaba’s version of cyber Monday, generated sales of $25.3B in China, while Cyber Monday sales reached $6.59B. The writing on the wall is clear, Online shopping is here to stay and will likely continue to grow as a percentage of overall consumer expenditure; The ability of Nike and it’s peers to adapt to this trend will largely dictate their success going forward.

To this end Nike, reluctantly, began selling through Amazon in June, 2017. The company stated that the move was largely driven by their desire to crackdown on third-party sellers who were previously profiting from their absence on the platform, rather than an effort to increase overall volume. While it is too soon to assess the overall top-line impact of the decision to sell on Amazon, there are early signs that the company has been able to cut-down on third party sellers.

According to Data collected by eMarketer, 55% of consumers reported using Amazon and other third-party online retailers to purchase clothing and apparel, making the industry the third most impacted by this shift in shopping preferences behindonly Electronics and Books at 70% and 67% respectively. It is important to note that these two product segments were the original target market of Amazon, and therefore many consumers have grown accustomed to ordering them online.
Marketing & Partnership Expenses:
A major theme within the industry which is still being shaken out is the future of large-scale, expensive marketing partnerships with leagues, teams, and athletes. In the past, Nike, Adidas, and Under Armour have spent significant marketing dollars on aligning themselves with big names in sports in order to drive demand. This year, Nike will replace Adidas as the primary sponsor of the NBA, while Adidas has shifted towards partnerships with Pop-Icons such as Kanye West and Pharrell Williams.
Sector Analysis (Continued)

Despite holding some of the largest partnership deals in world sports, Nike does not spend as much as Adidas or Puma on partnerships as a percentage of overall revenue. Nike’s expenditures on partnerships have remained relatively stable in this regard as their strategy has remain largely unchanged. Adidas has seen a slight uptick in this category as they have worked towards forming partnerships with pop-culture icons such as Kanye West in a largely successful bid to increase their media presence. After spending a significant amount on partnerships and marketing in the early part of the decade, Under Armour has looked to decrease their expenditures. Puma spends a high percentage of revenues on partnerships, largely due to their relatively low overall revenue when compared with the other three category competitors.

Competitive Landscape:

Nike’s most similar competitors include Adidas, Under Armour, and Puma. Nike currently enjoys significant market share as the market leader and has generally been able to generate better margins than these competitors. Despite a significantly higher EBITDA margin than their competitors, Nike’s EBITDA margin has faced pressure in recent years.

When considering Net Income Margin, Nike clearly stands out as the market leader. Despite difficulty increasing top-line growth at the same rate as some competitors, Nike has remained flexible from a cost perspective which has enabled them to maintain a double-digit Net Income margin.
Sector Analysis (Continued)

Footwear Competition Heating Up:
While Nike’s position as the king of footwear is relatively stable for the time-being, competitors have begun to make major inroads. As previously mentioned, Adidas overtook Jordan brand for the first time in 2017 as the second highest grossing sneaker brand in the U.S. market and Nike’s growth in overall share of the Global Athletic footwear space has slowed.

Retail Store Closings/Penetration of online ordering:
As previously mentioned, Consumer preferences are rapidly changing. Amazon and other online retailers have continued their rapid expansion of market share in the United States and around the world, primarily at the expense of brick and mortar retailers. 2017 has been the clearest example of this trend, as analysts estimate that more retail stores will close this year than during any year in recent history. Extrapolated data predicts that there will be as many as 8,640 store closings this year, almost 40% more than there were during the previous peak in 2008.

More Specific to Nike, major athletic footwear and apparel wholesaler Sports Authority declared bankruptcy in 2016 and has shut its doors, while other Nike friendly retailers such as Foot Locker and Finish Line have
Sector Analysis (Continued)

struggled greatly due to the rise in online shopping and direct to consumer sales. Both chains have announced significant store closures which will continue to weaken Nike’s wholesale reach.

**Important shifts in the way consumers are spending their money:**
An important shift is underway as consumers seek out the most convenient ways of spending their hard-earned dollars, and companies who are able to adapt have the opportunity to capitalize on soaring consumer confidence as well as unemployment rates not seen in recent history. Consumers are increasingly shopping using cellular phones, as mobile applications become easier to use and more secure.

**New and Diverse Competitors:**
While direct and increased competition from industry regulars such as Adidas and Under Armour has been given much of the attention, brands who are less associated with the athletic footwear and apparel segment have also begun stealing market share. Aasic recently announced a pivot from being solely a shoe company to a full-scale health and wellness brand. LuluLemon has captured a largely female audience through its yoga-inspired line of athletic apparel and has proven to be a formidable competitor for market share. The traditional players such as Nike and Adidas will likely be forced to choose which areas they would like to compete in, as customer acquisition expense will continue to be a key driver of operating margins.

As of 2016 approximately 80% of lululemon revenue came from women, though international expansion where the brand is less associated with women is helping the company to diversify this with a goal of 40% of sales from mens clothing in the short to mid term.

In addition to lululemon, Asics has announced intentions to diversify product offerings and saw their Net Income increase by 52.07% in 2016 from 2015. Additionally, Amazon recently announced that Asics Men’s sneakers were the top selling fashion item in all categories during the 2017 holiday season.
Macroeconomic Environment

Global Growth Trends

Globally, 2017 was a solid year for growth with world-wide GDP likely to have grown as much as 3.8% vs. 3.1% in 2016 according to UBS. According to IMF estimates, the number looks to have been closer to 3.6% Diving a bit deeper into the 3.8% global growth number, it is particularly encouraging that every single G20 country experienced growth, a feat accomplished just six other times in the past 30 years. Looking forward to 2018, many of the positive economic trends are likely to continue. The United States, and Japan will continue to benefit from strong labour markets, corporate earnings growth, and relatively low interest rates. In Europe, growth may face headwinds as a strong euro and Brexit negotiations weigh on consumer sentiment and purchasing power. China may also face headwinds, as growth normalizes in the country, while emerging markets such as Brazil and India look poised to continue the strong growth exhibited in 2017. Overall, growth should remain relatively stable in the near-term with emerging market economies outpacing developed markets.

![IMF Global Growth Forecast](image)

Risks to Growth:

While global growth is largely expected to continue at the same encouraging clip in 2018, there are specific and significant risk factors which could way on global growth.
Macroeconomic Environment (Continued)

Central Bank Actions:
As the US Federal Reserve looks poised to continue on its path of increasing the federal funds rate while beginning its goal of decreasing the size of the balance sheet, and the European Central Bank begins to decrease its open-market purchases of debt from 60B each month to 30B between January and September, questions remain regarding stubbornly low levels of Inflation and the overall ability of markets to withstand the withdrawal of Central Bank support. In Asia, the BoJ is set to continue providing monetary stimulus, while the People’s Bank of China will continue interest rate and exchange rate reform while aiming to keep the yuan basically stable.

While these central bank moves have been clearly forecasted and are largely priced into markets, risks remain. A major risk would be any event which causes central banks to tighten monetary policy more quickly than previously forecasted. For example, a rapid increase in the price of oil and thus the pace of inflation due to disagreement or war in the middle east and/or other OPEC members, would likely cause major central banks to increase the pace at which they increase rates – it is unclear whether global financial markets are healthy enough to handle a shock of this type.

Additionally, history shows us that changes in monetary policy are highly correlated with the market moves that follow. Every US downturn in the last 45 years has been preceded by an aggressive Fed Rate hike cycle, and while there are questions as to whether or not these policy changes were the cause of any of the downturns, it will be important for the federal reserve to keep this fact in mind while determining the path of interest rates.

Geopolitical Tensions:
Geopolitical tensions seem to be increasing on a daily basis, however, global financial markets have shown extreme resilience and appear to be discounting the actual impact of these tensions. The ongoing spat between the United States and North Korea, could pose a major risk to the region and financial markets should it turn into an armed confrontation. Additionally, tensions have continued to rise in the Middle East, and any large-scale confrontation in the region could threaten world oil supplies.

Impact on the Sector and Nike in Particular:
With consumer sentiment at all-time highs, historically low unemployment, and interest rates still hovering near zero, there are many incentives for consumers to spend money. Additionally, as tax reform has become a reality, there is the
Macroeconomic Environment (Continued)

potential for many consumers to be encouraged to spend more than in previous years, especially during the holiday period. Nike and other retailers will look to capitalize on these strong factors in an effort to not rely as heavily on discounting products in order to drive demand as they have in previous years.

Tax Policy:
The “Tax Cuts and Jobs Act” passed both houses of congress and was signed by the President on December 22nd. Companies domiciled in the United States look set to reap the benefits of a large-scale cut in the corporate tax rate from 35% to 21%. Nike however, has consistently paid an effective annual tax rate much less than this so the actual impact of the tax cut on Nike is yet to be determined. Overall, the bill has been well-received with some companies such as AT&T and Comcast announcing additional employee bonuses and capital investment, although some other companies such as Goldman Sachs have announced significant decreases in profitability based on changes on the accounting for deferred tax assets and liabilities.

The above-mentioned risks, could have a mixed-impact on the retail sector. Thus far, global financial markets have largely been immune to the recent rise in geopolitical tensions, and as there are currently very few signals that inflation is picking up in any of the major markets where Nike operates, this risk factor should be considered more-so from a long-term standpoint.

Risks
While there are several risk factors facing Nike, the factors highlighted below are seen as having the greatest potential of having a material impact on the company’s operations and cash flows.

Risk: Cyclicality of the apparel, footwear, accessories, and luxury goods sector. The company’s core business is subject to a moderate level of cyclical based on wider consumer spending trends. While global growth has been impressive since the financial recession, this can not be expected to endure indefinitely. By analyzing Nike revenue and net income growth patterns, we can gain insight into the impact of wider economic performance on the company.
By and large, the company has had a steady growth trend since the early 1980s. Despite their position as a premium retailer within the athletic footwear and apparel space, Nike's international and product diversification has allowed them to escape major economic downturns largely unscathed. During the 1990's, the company had three years with negative earnings growth (1994, 1998, and 1999), neither of which directly correspond with the economic down turns seen during this decade. During the 2000's the company has followed a similar path, with only 2003, and 2009 having negative growth from a net income perspective. The negative net income growth during 2009 and negative revenue growth in 2009 and 2010 can be partially attributed to the sub-prime mortgage crisis and resulting worldwide recession.

**Mitigant:** In order to reduce their exposure to economic downturns Nike has continued to diversify their geographic exposure. While being the dominant player in the North American market has been the driver of much of their historical success, greater security can theoretically be gained by diversifying cash flows to different regions. Additionally, entering any business lines which are seen as being less cyclical would benefit Nike's business. The consumer nondurables segment is seen as being less cyclical than the luxury, more discretionary segment, and therefore should be a focus of the company. The company believes that by developing their direct to consumer channel they will have a greater ability to sell through to consumers regardless of the wider macroeconomic environment.
Risks (Continued)

Risk: Increased competition from existing competitors as well as new entrants into the segment. Nike’s primary competitors; Adidas, Under Armour, and Puma have had mixed results in enacting their respective new strategies. Adidas has had particularly strong results as of late, exhibiting a nearly 20% growth in revenues in the first half of 2017. These competitors are risks to Nike’s market share. In addition, companies who were not historically viewed as direct competitors of Nike such as Asics, and Lululemon, have expanded their product offerings and in doing so, have captured pieces of important market segments such as fashion sportswear and leisure wear.

Mitigant: In order to maintain market share Nike has looked towards high-profile professional league partnership deals with the NFL and NBA as well as continuing their strategy of sponsoring high profile athletes within these leagues. The company will need to continue to strike the right balance between demand creation and partnership expense and bottom-line growth. Nike has focused more heavily on Greater China than other competitors who are looking to steal market share in North America.

Risk: Changes in consumer preferences. As consumer preferences shift, R&D and data analytics will play an increasing role in the product development life-cycle and overall success of the firm. There have been very few times in history when consumer preferences and choices changed as quickly as they are currently, if Nike is to succeed they will be required to stay ahead of the curve as far as developing products which consumers want to purchase. Adidas has spent a significantly higher portion of revenue on marketing expense in recent history and are now seeing the benefits with double-digit revenue growth.
Risks (Continued)

**Mitigant:** Nike has agreed to an extension of their deal with the NFL and also takes over as principal sponsor of the NBA this year. With these two deals as well as ongoing and new contracts with professional, and collegiate teams and athletes, it is possible that overall marketing expense may increase.

**Risk:** Industry Disruption. The retail industry as a whole has been one of the most targeted from a disruption standpoint. 2017 has seen a sharp increase in brick and mortar retail store closings, and companies offering innovative shopping such as Amazon and Alibaba have prospered. The risk to Nike’s business stems from the closure of stores operated by their wholesale partners. Closures of Sports Authority, Foot Locker, and Finish Line stores has directly impacted Nike’s retail reach.

**Mitigant:** The company must diversify their distribution channels in order to mitigate this risk. The move towards selling on Amazon, coupled with the firm’s “triple-double” approach which promotes direct to consumer sales are crucial towards the goal of distribution channel diversification.

**Risk:** Reputation/Brand Image. As we see a sharp increase in the number of investors looking to both earn a return and positively impact society with their investments, Nike should pay special attention to the value of their brand and reputation. In 2015 Environmental Social and Governance funds saw inflows of 2.6 Billion, a record at the time since eclipsed by the 4.9 Billion in 2016. The company has had isolated issues in the past regarding working standards at factories producing their goods, and does not have nearly as high of a reputational standing as their primary competitor Adidas (6th most reputable brand).
Risks (Continued)

Mitigant: For the first time, in August of this year Nike agreed to a deal with the Workers Rights Consortium which will look to improve conditions for workers at the companies factories in Asia. The company will conduct inspections on factories producing certain Nike goods. Much of the impetus for this agreement came from protests on college campuses surrounding the working standards for factory workers who produced university branded apparel.

Risk: Changes in Tax/Trade policy – Being a global brand and company, Nike has significant exposure to international trade law and foreign exchange rates. We have recently seen the United States Administration take a harder stance on international trade which would threaten any business which operates in multiple regions. In addition to trade policy, changes in tax policy have the potential to greatly impact Nike’s cash flows. While the final impact of the tax bill is still being analyzed, it is important to note that Nike has already paid an effective annual rate much lower than the new proposed corporate tax rate in recent years.

Mitigant: Nike has had a long-standing hedging policy in order to protect themselves from international currency exchange issues. This policy has been largely successful.

Nike Strategy Commentary:

In June, 2017 Nike announced a new consumer direct focused strategy aimed at increasing the speed at which they serve consumers. The three key pillars of the strategy are: accelerating innovation and product creation, moving closer to the consumer through key cities, and deepening one-to-one connection and Nike’s CEO, Mark Parker was quoted as saying “The future of sport will be decided by the company that obsesses the needs of the evolving consumer – through the Consumer Direct Offense, we’re getting even more aggressive in the digital marketplace, targeting key markets, and delivering product faster than ever.”

Accelerating Innovation: In order to accelerate innovation the company has made personnel changes and created the President of Categories and Product role. The aim here is to integrate multiple groups within the company in order to realize synergies and ultimately increase the speed at which new products are designed, marketed, and sold.

Key Cities: The company has chosen to focus on 12 key cities: New York, London, Shanghai, Beijing, Los Angeles, Tokyo, Paris, Berlin, Mexico City, Barcelona, Seoul, and Milan. The company has projected that nearly 80% of growth will come from these key cities through 2020.
Nike Strategy Commentary (Continued)

Deepening one-to-one connections: In deepening connections with consumers, the company hopes to increase the feeling of membership with consumers. The company plans to increase offerings via mobile applications, while also giving existing customers and members advanced notice of new product offerings.

Impacts on top-line growth: The ultimate effectiveness of this strategy is yet to be seen, however it does seem like a step in the right direction. As consumer preferences shift rapidly, it is vital that the company has the ability to shorten the time between idea generation and eventual sale of the product. Additionally, through their key cities program the company will be able to create premium shopping experiences at Nike stores in these cities. Adidas has deployed a similar strategy, opening a new global flagship store in New York City that has been received with raving reviews. Consumer perception is tantamount to success in this industry, and Nike will have to ensure that they continue to be seen as a brand of choice.

Geographic diversification strategy: Nike has invested aggressively in less traditional markets such as Greater China, Central & Eastern Europe and Emerging markets and has seen their revenue grow in these areas both in gross terms and as a percentage of their overall revenue. This strategy, coupled with differing strategies by competitors has led to a decrease in Nike’s market share in North America, which remains their most important market.

Despite a weak trend in North American Sales, it must be pointed out that Greater China has provided Nike with significant growth and should remain a double digit growth market for the firm in the near term, bar any major economic disruptions in the regional

Improving the bottom line: Facing margin pressure in recent years, the company has looked to multiple areas for a remedy.

Regional Segmentation: The company will re-organize from six geographic segments to four; North America, China, Europe the Middle-East and Africa, and Asia-Pacific and Latin America. The impact on the bottom line, while still yet to be fully realized, is expected to come from an announced reduction in global headcount by 2% globally. The company is looking to eliminate back-office functions which were previously being done across six regions and will therefore no longer be necessary under the new structure.
Nike Strategy Commentary (Continued)

**Acceleration of Product Pipeline:** the company is counting on their strategy to increase the speed of product development in order to help them remain relevant in consumers minds while also increasing their ability to sell products at full-price and rely less on discounting and promotions – this should have an impact on margins.

**The Future of the Sector:**

**Changes in Consumer Preferences:** Consumer preferences will likely continue to shift in the direction of online shopping as penetration of mobile devices grows. Nike has invested heavily in increasing the quality of their web and mobile platforms and should be able to keep up with this trend in the short-term.

**Renting vs. Buying:** A potential long-term trend in apparel and fashion is that of renting vs. Owning. While still a relatively new and unproven phenomenon, Rent the Runway saw a 125% increase in business over the last 12-months and have added dozens of new brands. The company predicts an era where women no longer use closets to store their clothing. This trend is harder to predict as it is so new, and therefore is not foreseen to have any short-term impact on company performance.

**Direct to Consumer:**

Nike and their closest competitors are looking to cut out the middle man in the sale of their products. When selling through wholesalers, companies are forced to heavily discount prices and therefore decrease margins. Nike and Adidas have focused on building out new stores in an effort to attract new and existing customers. Nike has targeted 12 cities and should be able to positively impact revenues as well as net income. Capital Expenditures will likely increase slightly as these stores are built out and transformed.

**Liquidity & Solvency Analysis**

Nike generally enjoys a comfortable liquidity situation given the nature of their business. In comparison with their peers, Nike enjoys a shorter cash conversion cycle, and the business by nature is a high cash, low capital investment business in comparison with more capital-intensive industries. An important trend to consider is the amount of long-term debt on Nike's balance sheet; in 2017 the firm reported long-term debt of 3,471 million vs 1,993 million in 2016. This increase stems from the company's October, 2016 bond issue of 1,000 million in
Liquidity & Solvency Analysis (Continued)

the United States with a maturity of 2026. The company was able to issue the bonds at an extremely attractive rate of 2.38% paid semiannually, which is only slightly higher than the US 10 year yield at the time. At the same time, cash on hand increased by greater than 21% which has helped Nike to maintain a strong short-term liquidity situation.

In analyzing Nike’s solvency one measure stands out and should be monitored going forward. Nike’s Interest Coverage Ratio detiorated significantly from 2016 to 2017. The reason for this is due to the increase in interest expense associated with the new bond issue and relatively small growth in EBIT, however, it is vital that EBIT grow in the future in order to return this solvency ratio to a number more in line with the historical average.

In conclusion, there is no anticipation of any liquidity or solvency issues with the company as they have a strong history of generating ample cash to meet both short-term and long-term obligations – this is reflected in part, by their ability to issue debt at such low yields and the AA- rating assigned to that debt issue by S&P Global Ratings.

Explanatory Exhibits

The company has experienced a high degree of variability in their effective annual tax rate. There are a few factors which have influenced this variability, including changes in the share of income derived from the United States and other relatively high tax rate countries, and also one-off tax benefits which are not likely to continue in the future. For FY2018, the company will likely see an increase in the effective annual tax rate; given Nike’s fiscal calendar, any change in US tax policy will have a minimal effect on this year’s cash flows, additionally, the tax benefit which contributed to the tax rate falling from 18.70% in 2016 to 13.20% in 2017 is not expected to repeat in 2018.
Explanatory Exhibits (Continued)

Debt/EBITDA

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<th>-25%</th>
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When comparing Nike’s Debt/EBITDA to that of their competitors, we see that it is extremely healthy. For comparison, Adidas has a current Debt/EBITDA level of 1.22. Given that ratings agencies generally assess companies in this industry to have adequate levels of debt coverage as long as they have a debt/EBITDA ratio better than 1.5, Nike is considered to have a very strong liquidity position based on this metric.

Revenue Growth

During the last two years. This trend is increasingly troubling considering that some of Nike’s closest competitors have experienced increased sales growth during this same period. Nike believes that their recent strategic shifts and implementation of the triple-double operational model will allow them to return to high-single digit growth in the coming years, however, many risk factors have the potential to impact these projections.
### Financial Statements

#### Notes to Consolidated Financial Statements

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#### Outstanding Notes

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- **Note 4**: Accounting for Income Taxes
- **Note 5**: Accumulated Other Comprehensive Income
- **Note 6**: Fixed Asset Retirement Obligations
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- **Note 8**: Commitments and Contingencies
- **Note 9**: Contingencies
- **Note 10**: Off-Balance Sheet Arrangements
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**Note 29.26**: Management's Discussion and Analysis
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Report Recommendations

<table>
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<th>Action</th>
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<tr>
<td>Sell</td>
<td>Expected negative total return (including expected capital gains and expected dividend yield) over a 12-month period.</td>
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