Is Nike's sports supremacy enough to justify its high valuation?

CASE STUDY

VALUATION MASTER CLASS

by

A. Stotz INVESTMENT RESEARCH

Valuation Master Class

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Ask Ajarn Andrew

Is Nike’s sports supremacy enough to justify its high valuation?

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NIKE

Sector: Cons. Disc.

Largest manufacturer of footwear and sports apparel in the world with an estimated brand value of over US$30bn

My value estimate:

US$112

(Downside 22%)

SELL

3 things to know about this company

- ★ Digital expansion bears fruit, driving top-line growth
- ★ Reengineering retail business could enhance margin further
- ★ Competitive position means profits beat those of biggest rival

Key statistics

Analyst consensus (38)	PE ratio	Dividend yield
US$185 (Upside 29%) **BUY**	**29x**	**0.7%**

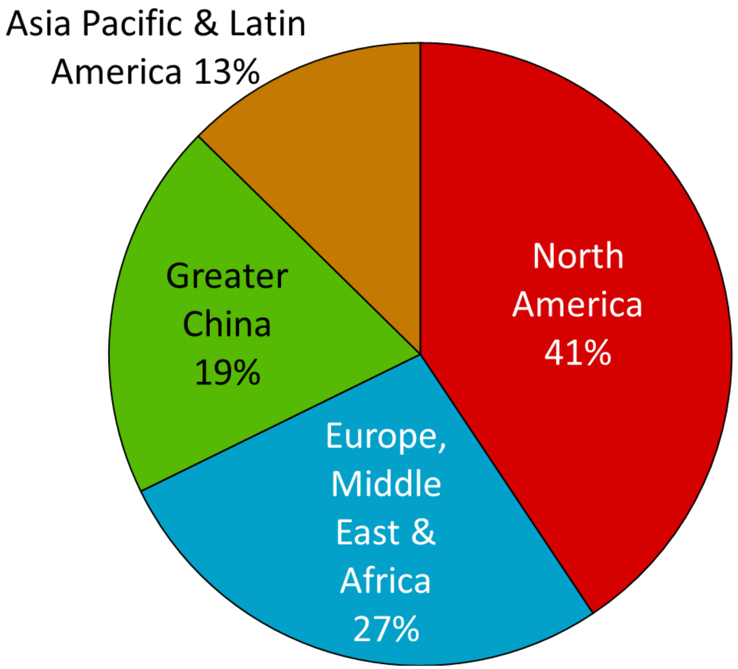
Revenue breakdown 2021

Footwear 66%

Clothing 30%

Equipment & Licensing 4%

Breakdown by region



Sources: A. Stotz Investment Research, company data

Price turned bearish

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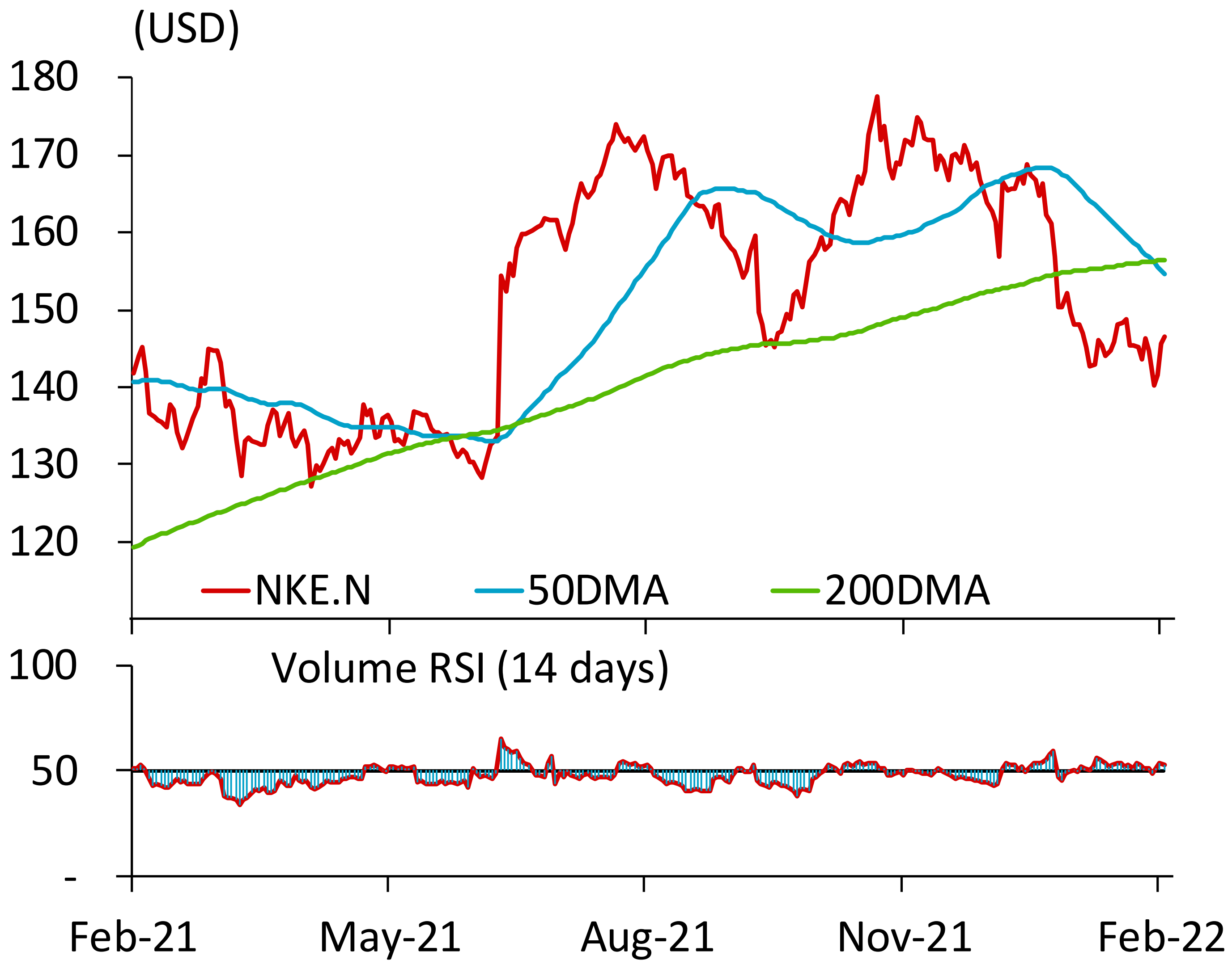

- ★ The share price has shown strong volatility over the past few months
  - **Most recently, the 50 DMA has fallen below the 200 DMA, which could be the start of a bearish trend**
- ★ Volume RSI is still slightly above the 50%-line, but not providing a clear signal yet

Sources: A. Stotz Investment Research, Refinitiv

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1 Digital expansion bears fruit, driving top-line growth

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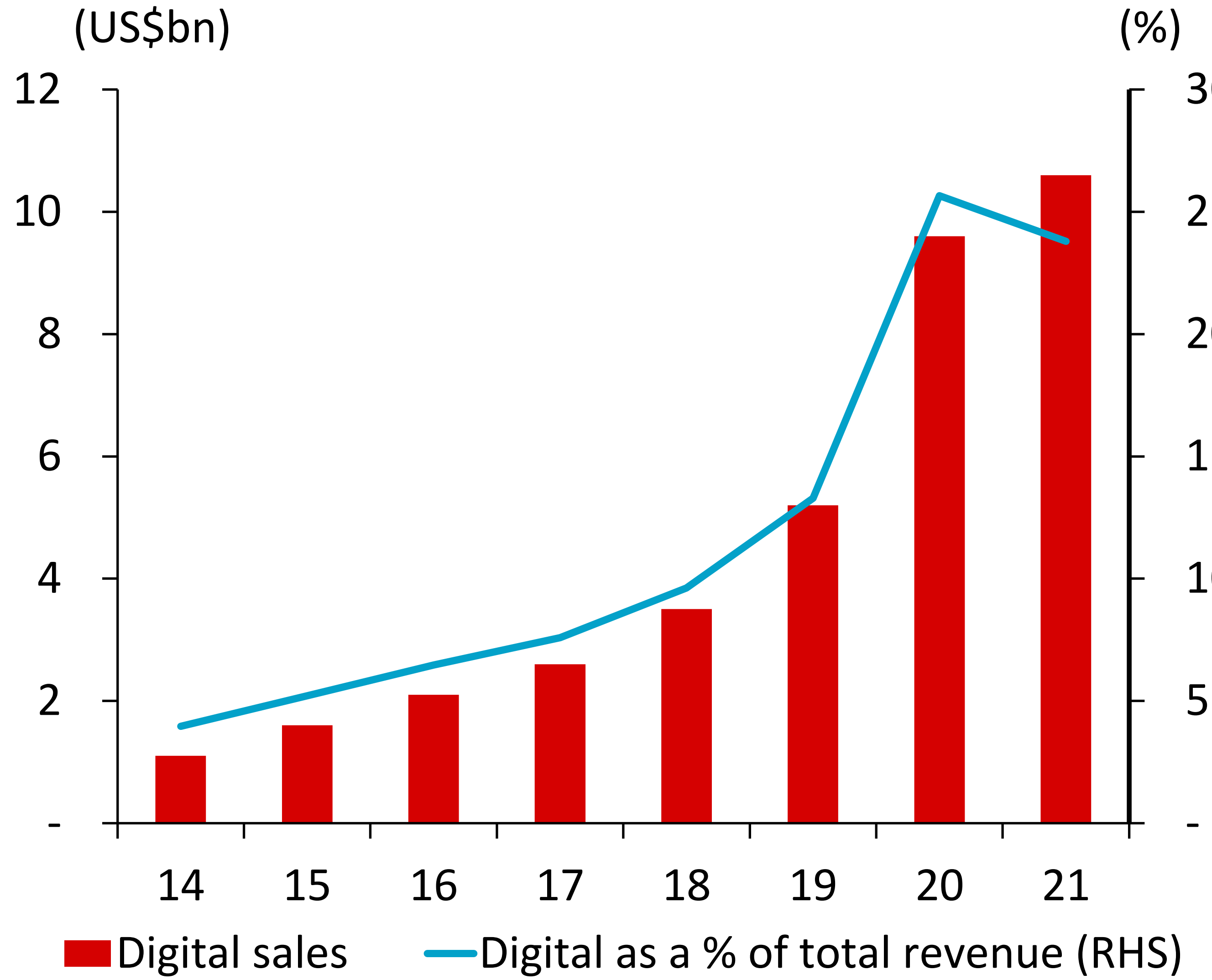
- Sales
- **Story**
- FVMR
- Value
- WCB
- Risks



★ Digital sales already make up around 25% of Nike's revenue in 2021 compared to 5% in 2014

★ Compared to its competitors, Nike already expanded early in its digital channels, which delivered high growth
  - **Especially during the pandemic, its early efforts paid off big**
  - **The new normal could continue to push digital sales further up**

Sources: A. Stotz Investment Research, company data

Digital penetration is part of its strategy shift

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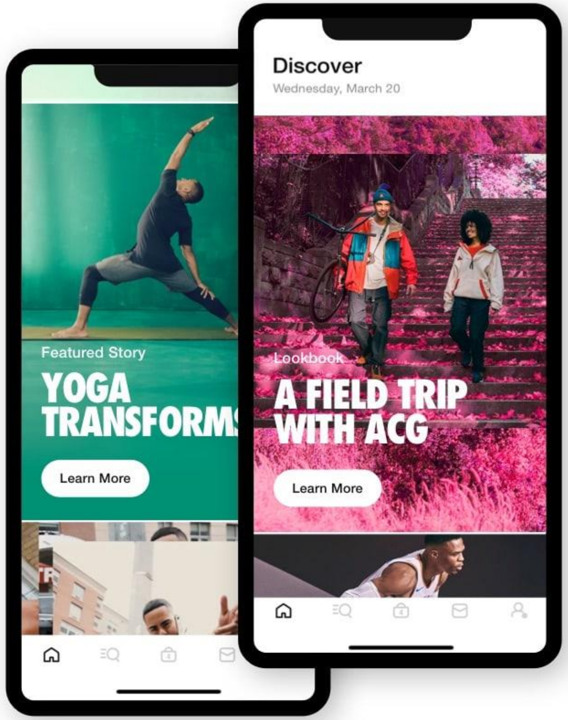
★ The company increasingly focuses on direct-to-customer sales

- **Under its campaign "Nike Direct" it aims to promote its own retail stores and expand its online platform**

★ The objective is to create a monobrand experience and reduce the reliance on wholesalers

- **As a result, Nike can yield a higher average selling price**



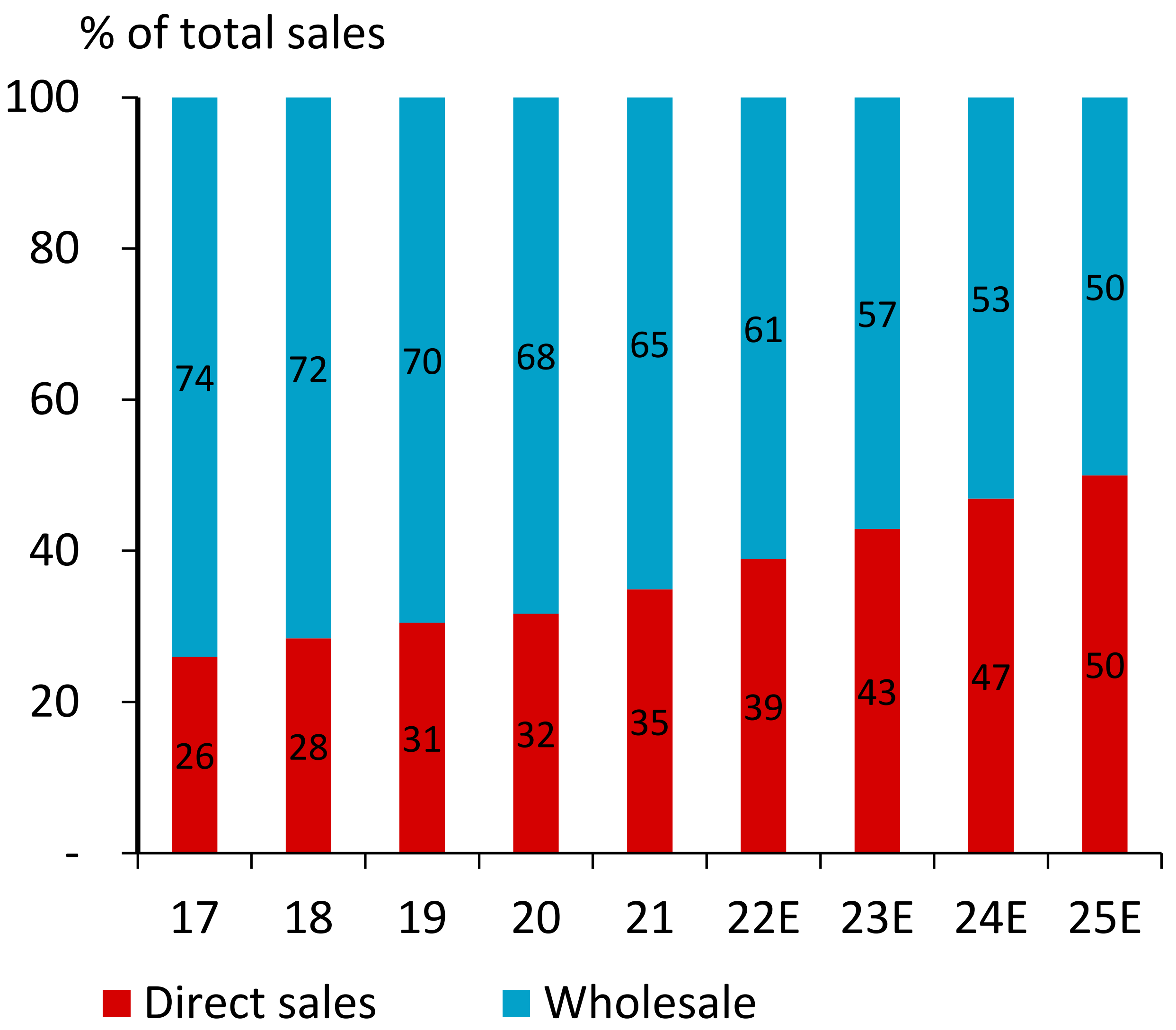
Sources: A. Stotz Investment Research, company data

How I incorporated the story into my forecast

Revenue (US$bn)	19	20	21	22E	23E	24E
Digital	5.2	9.6	10.6	12.7	15.3	18.3
Non-digital	33.9	27.8	33.9	34.7	36.9	39.1
Total revenue	39.1	37.4	44.5	47.4	52.2	57.4

Expanding digital sales comprises the key growth driver in the future

Reengineering retail business could enhance margin further



- In 2021, Nike's direct sales make up 35% of total revenue compared to 26% in 2017
- By 25E, the company aims to ramp up the contribution of direct sales to 50%, cutting out wholesalers
  - **Wholesale partners tend to offer large discounts when reselling, devaluing the brand**
  - **The shift also enables Nike to regain price control of its products**

Sources: A. Stotz Investment Research, company data

Cutting out the middleman should result in margin expansion

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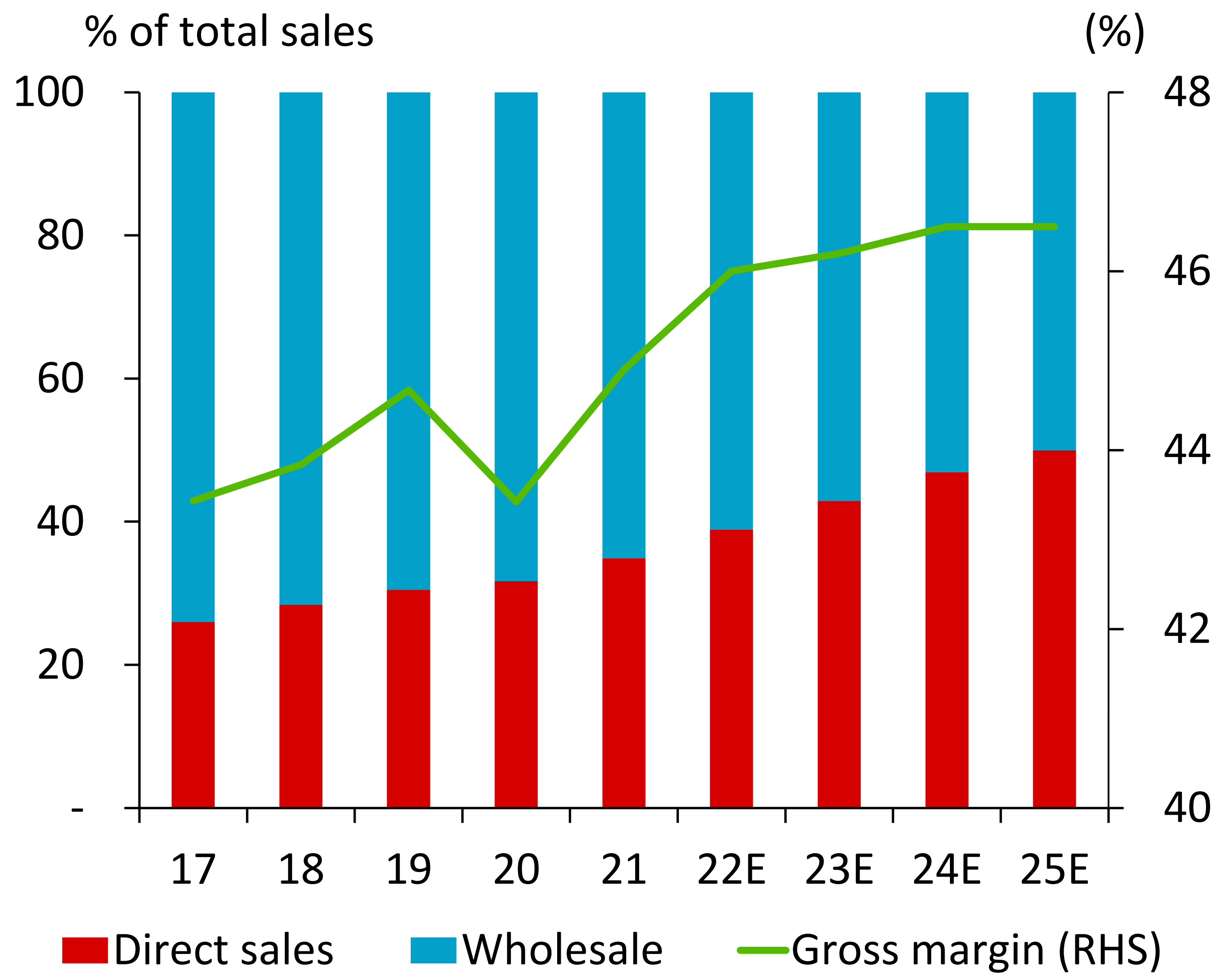

- Focusing on direct sales could enhance Nike's gross margin by 2ppts over the near-term future, with further potential over the long run
- In my opinion, this strategy makes sense as the company, unlike in its initial growth stage, is no further dependent on wholesalers to raise brand awareness

Sources: A. Stotz Investment Research, company data

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Non-digital	33.9	27.8	33.9	34.7	36.9	39.1
Total revenue	39.1	37.4	44.5	47.4	52.2	57.4
# of retail stores						
United States	384	338	325	320	315	310
International	768	758	723	717	711	705
Total	**1,152**	**1,096**	**1,048**	**1,037**	**1,026**	**1,015**
Profitability (%)						
Gross margin	44.7	43.4	44.9	46.0	46.2	46.5

- Scarcity creates demand; Nike continues to reduce its own retail stores making their products more desirable
- The increasing management's efforts to shift to direct sales should be rewarded with a significant gross margin expansion

3 Competitive position means profits beat those of biggest rival

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5-yr average	adidas	NIKE
Revenue CAGR	1.8	6.8
Gross margin	49.4	44.1
EBIT margin	9.2	12.3
Net margin	5.8	9.5
Asset turnover	130	149
Assets/equity	2.6	2.7
ROE	21.0	37.0
ROIC	25.5	46.0

- Nike's 5-yr revenue 6.8% CAGR was 4x higher than 2nd largest sports giant Adidas
- ROE of 37% at Nike clearly beat 21% at Adidas, while ROIC was 2x larger than Adidas
- Nike's profit is remarkably high, of course the risk is that it can only fall from here
  - **Meanwhile, Adidas has room to improve**

Sources: A. Stotz Investment Research, company data

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What is the role of cash in invested capital?

19-yr. avg. US$trn	Global	Cons. Disc.
Avg. # of companies	*12,079*	*2,127*
Debt	11.1	1.6
Equity	15.6	2.0
Invested capital	**26.7**	**3.6**
Cash and ST-invest	(4.3)	(0.7)
LT investments	(1.4)	(0.2)
Non-oper. assets	**(5.7)**	**(0.9)**
Operating IC	**21.0**	**2.7**
NOPAT	**2.0**	**0.2**
ROIC (%)	**9.4**	**8.8**
ROE (%)	11.8	11.8

Ask
Ajarn
Andrew

Massive value creation is already priced in

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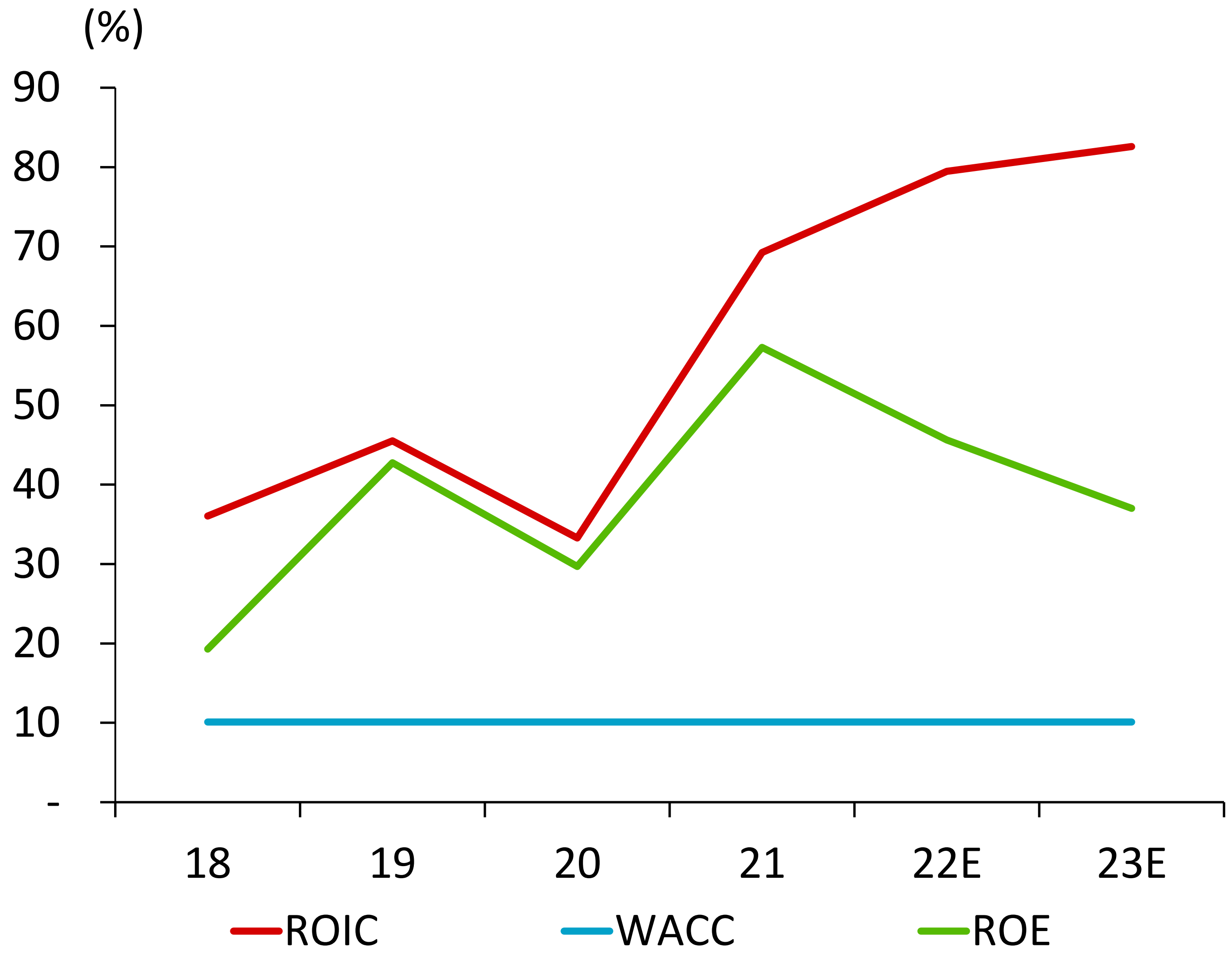

- In 2021, Nike delivered an astonishing ROIC of 69% and could maintain the heightened level over the short run
  - **I forecast that Nike can grow its extreme level of ROIC over time as it generates a lot of cash**
  - **Still, it does not lead to any upside which makes me assume that the consensus is too bullish about Nike's growth prospects**

Sources: A. Stotz Investment Research, company data

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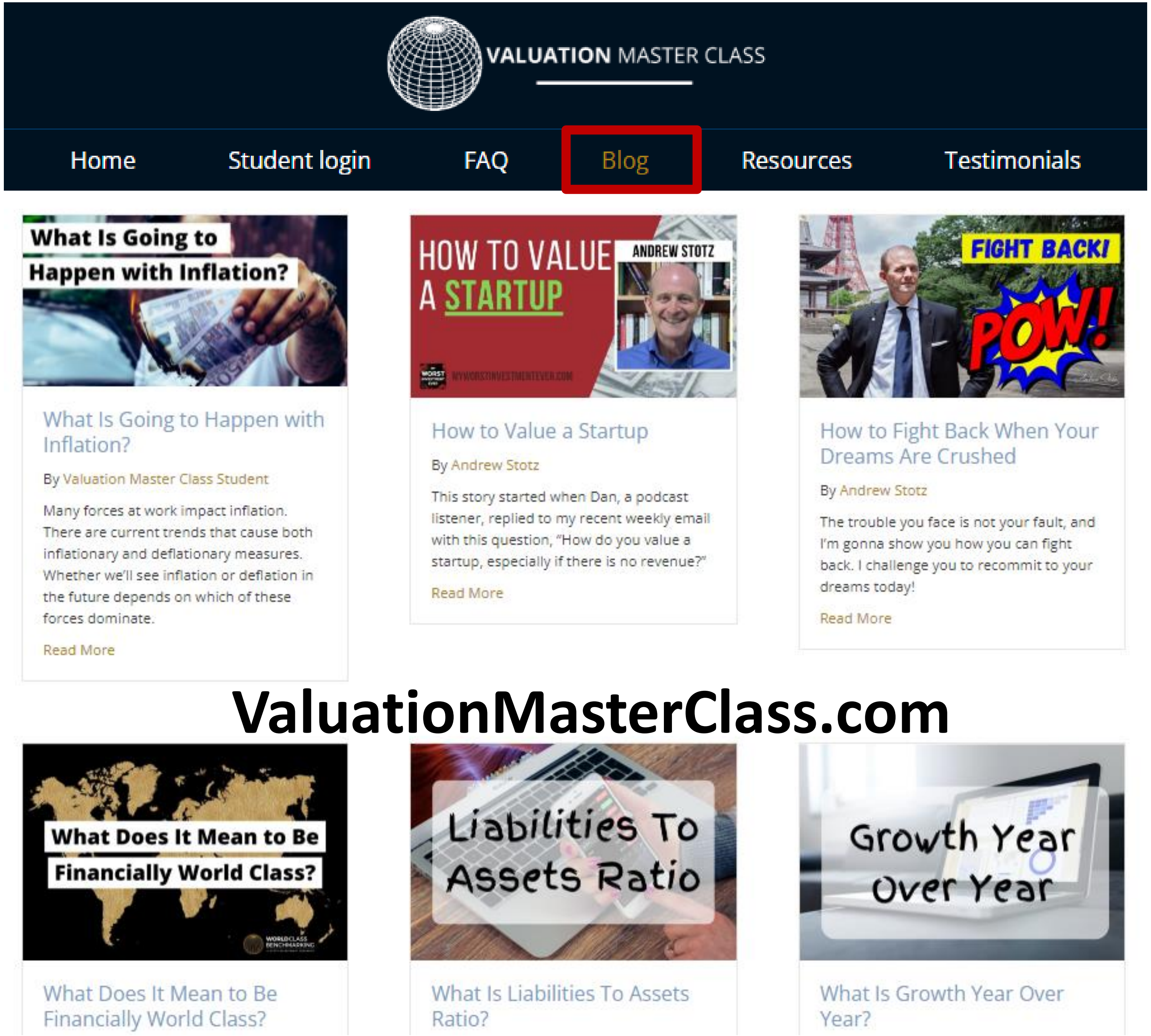
Profitability (%)						
Gross margin	44.7	43.4	44.9	46.0	46.2	46.5
ROE	42.7	29.7	57.3	45.6	37.0	32.4
ROIC	45.5	33.3	69.2	79.5	82.6	83.4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By Valuation Master Class Student

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By Andrew Stotz

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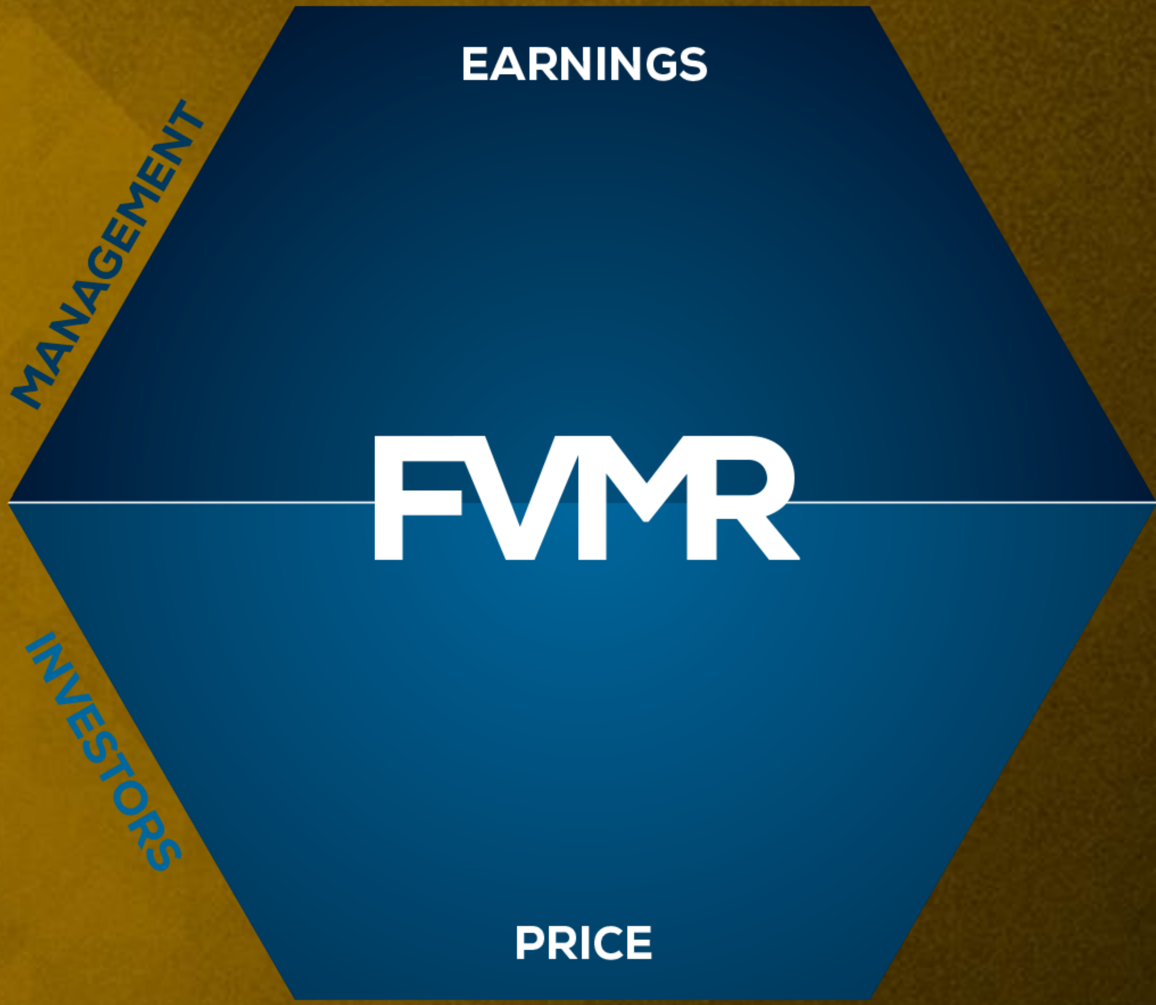
It's usually up within 24h.

Now let's look at the FVMR Scorecard

- Which measures attractiveness relative to all other companies in that market
- We base the score on four elements
  - **Fundamentals, Valuation, Momentum, and Risk**
- And rank the company from 1, Best, to 10 Worst



Strong profitability driven by high turnover

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Fundamentals

W B

(%)	May-18	May-19	May-20	May-21	PTM**
Operating profit margin	12.0	12.1	8.2	16.0	16.2
Recurring net margin	10.4	10.3	7.7	13.4	13.7
Asset turnover	159.0	169.1	135.9	128.9	129.8
Return on assets	16.6	17.4	10.5	17.3	17.7
Recurring return on equity	34.2	42.7	33.9	57.5	53.5

Valuation

W B

(x)	May-18	May-19	May-20	May-21	PTM**
Price-to-sales	3.0	3.5	3.5	4.8	6.0
Price-to-earnings	29.0	33.8	45.5	35.7	43.7
Price-to-book	10.8	14.6	16.0	16.4	18.8
PE-to-EPS growth (PEG)	nm	3.9	nm	0.3	0.4
EV/EBIT	23.9	27.6	42.5	28.9	35.5

Momentum

W B

(%)	May-18	May-19	May-20	May-21	PTM**
Revenue growth	6.0	7.5	(4.4)	19.1	23.7
Recurring EPS growth	(8.7)	8.8	(26.9)	104.4	101.4
Operating profit margin chg. (bps)	(170)	7	(395)	779	722
	6mth	3mth	1mth	3wk	1wk
Price change	27.3	4.3	(3.0)	0.7	1.3

Risk

W B

(x)	May-18	May-19	May-20	May-21	PTM**
Current ratio	2.5	2.1	2.5	2.7	3.2
Net debt-to-equity (%)	(14.6)	(13.1)	10.8	(31.8)	(29.7)
Times-interest-earned	29.4	36.2	20.2	24.0	25.0
	5yr	3yr	1yr	6mth	3mth
Beta	1.1	1.1	1.4	1.6	0.8

Note: Benchmarking against 2,160 non-financial companies in USA.

Sources: A. Stotz Investment Research, Refinitiv. Notes: *Bars are decile rankings of the most recent period. **Past 12 months of published data. na = not available, nm = not meaningful. Valuation is based on historical prices.

Remarkable return on equity

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Fundamentals

W | | | | | | | | | B

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Recurring return on equity	34.2	42.7	33.9	57.5	53.5

Recently, I created a short online course explaining my FVMR investing approach

I usually sell it for $97 but for a limited time I am offering it for FREE

Consensus is strongly bullish

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Analyst consensus valuation

Recommendation	Oct-21	Nov-21	Dec-21	Current
Strong buy	9	9	9	9
Buy	19	19	20	21
Hold	4	4	6	6
Sell	1	1	1	1
Strong sell	1	1	1	1
Average score	**2.0**	**2.0**	**2.1**	**2.1**

Price target	Nov-21	Dec-21	Jan-22	Current
Median	180	180	185	185
Mean	180	180	184	183

38 analysts

Upside: 29%

Analyst consensus 3-year forecast

(%)	19	20	21	22E	23E	24E
Revenue growth	2.5	(4.4)	19.1	5.8	13.9	10.0
Gross margin	44.7	43.4	44.9	46.4	47.3	48.0
EBIT margin	12.2	8.3	16.1	14.7	16.8	17.6
Net margin	10.3	6.8	12.9	12.7	12.3	14.9

- ★ Most analysts have a BUY recommendation, while 2 analysts issued a SELL
- ★ Consensus is rewarding management's efforts to focus on direct-to-customer sales
  - **They forecast a gross margin expansion of 3 ppts over the next 3 years, which might be a bit too optimistic**

Sources: A. Stotz Investment Research, Refinitiv

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Profit & loss statement

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(YE May, US$ m)	2020A	2021A	2022E	2023E
Revenue	37,403	44,538	47,433	52,176
Cost of goods & services	(21,162)	(24,541)	(25,614)	(28,071)
Gross profit	**16,241**	**19,997**	**21,819**	**24,105**
SG&A	(13,126)	(12,811)	(13,756)	(15,131)
Other operating (exp)/inc	-	-	-	-
EBIT	**3,115**	**7,186**	**8,064**	**8,974**
Interest expense (net)	(89)	(262)	(222)	(196)
Other non-operating inc/(exp)	191	36	36	36
Earnings before taxes (EBT)	**3,217**	**6,960**	**7,878**	**8,815**
Income tax	(348)	(934)	(1,119)	(1,252)
Earnings after taxes (EAT)	**2,869**	**6,026**	**6,758**	**7,562**
Equity income/Minority interest	-	-	-	-
Earnings from cont. operations	**2,869**	**6,026**	**6,758**	**7,562**
Forex/Exceptionals before tax	(330)	(299)	0	0
Net profit	**2,539**	**5,727**	**6,759**	**7,563**

- Net profit is driven by both continued revenue growth and gross margin expansion

Sources: A. Stotz Investment Research, Refinitiv

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Balance sheet - assets

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(YE May, US$ m)	2020A	2021A	2022E	2023E
Cash & short-term investments	8,787	13,476	17,586	21,884
Accounts receivable	2,749	4,463	3,953	4,348
Inventories	7,367	6,854	6,403	6,940
Other current assets	1,653	1,498	1,829	2,011
Total current assets	**20,556**	**26,291**	**29,771**	**35,183**
Long-term investments	-	-	-	-
Net fixed assets	7,963	8,017	8,641	9,552
Intangible assets	274	269	265	260
Goodwill	223	242	276	315
Other long-term assets	2,326	2,921	3,213	3,534
Total assets	**31,342**	**37,740**	**42,166**	**48,844**

- ★ Defensive balance sheet with 1/3 of its assets in cash
  - **As CAPEX requirements are moderate, the company might decide to return part of its cash in form of share repurchases at some point in the future**

Sources: A. Stotz Investment Research, Refinitiv

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Balance sheet - liabilities

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(YE May, US$ m)	2020A	2021A	2022E	2023E
Overdrafts & short-term loans	251	2	-	-
Accounts payable	6,307	8,541	8,182	9,357
Other current liabilities	1,726	1,131	1,309	1,439
Total current liabilities	**8,284**	**9,674**	**9,491**	**10,796**
Long-term debt	9,406	9,413	9,225	9,040
Other long-term liabilities	5,597	5,886	5,768	5,826
Total liabilities	**23,287**	**24,973**	**24,484**	**25,663**
Minority interest	**-**	**-**	**-**	**-**
Paid-up capital - Common shares	8,302	9,968	9,968	9,968
Paid-up capital - Preferred shares	-	-	-	-
Retained earnings	(191)	3,179	8,094	13,594
Revaluation/Forex/Others	(56)	(380)	(380)	(380)
Total equity	**8,055**	**12,767**	**17,682**	**23,182**
Total liab & shareholders' equity	**31,342**	**37,740**	**42,166**	**48,844**

- Balance sheet size is almost 2x bigger than its rival Adidas

Sources: A. Stotz Investment Research, Refinitiv

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Ratios

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(YE May)	2020A	2021A	2022E	2023E
General growth (YoY, %)				
Revenue	(4.4)	19.1	6.5	10.0
Assets	32.1	20.4	11.7	15.8
Gross profit	(7.1)	23.1	9.1	10.5
Operating profit	(34.7)	130.7	12.2	11.3
Attributable profit	(37.0)	125.6	18.0	11.9
EPS	(36.1)	124.8	17.3	11.9
Recurring EPS	(25.9)	109.2	12.2	11.9
Du Pont analysis (%)				
Net profit margin	6.8	12.9	14.2	14.5
Revenue per US$100 of assets	135.9	128.9	118.7	114.7
Assets/equity (x)	3.2	3.5	2.7	2.2
Return on equity	29.7	57.3	45.6	37.0
Others (%)				
Effective tax rate	12.1	14.0	14.2	14.2
Dividend payout ratio	52.5	28.0	27.9	28.0

- ★ Thanks to its margin expansion, Nike could see its EPS grow faster than its revenue

Sources: A. Stotz Investment Research, Refinitiv

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Ratios (cont.)

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(YE May)	2020A	2021A	2022E	2023E
Internal liquidity (x)				
Current ratio	2.5	2.7	3.1	3.3
Quick, or acid test ratio	1.6	2.0	2.5	2.6
Working cap. mgmt (Days)				
Inventory conversion period	110	104	93	86
Receivables collection period	34	29	32	29
Days from raw mat to coll	144	133	125	114
Payables deferral period	112	109	118	112
Cash conversion cycle	32	25	8	2
Profitability ratios (%)				
Gross profit margin	43.4	44.9	46.0	46.2
EBIT margin	8.3	16.1	17.0	17.2
EBIT return on avg assets	11.3	20.8	20.2	19.7
Return on average assets	9.2	16.6	16.9	16.6
Financial risk (x)				
Liabilities-to-assets (%)	74.3	66.2	58.1	52.5
Debt-to-equity	1.2	0.8	0.5	0.4
Net debt-to-equity	0.1	(0.3)	(0.5)	(0.6)
Times-interest-earned	25.4	27.0	30.7	34.8
Effective interest rate (%)	2.2	3.1	3.1	3.1

- Nike's gross margin is below its competitor Adidas which averaged 49% over the past 5 years

Sources: A. Stotz Investment Research, Refinitiv

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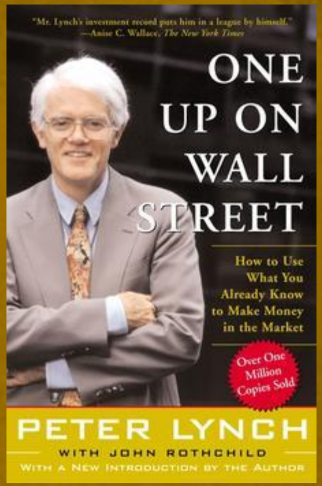
A. Stotz Investment Research Stock Picking Checklist



Inspired by

Peter Lynch's book

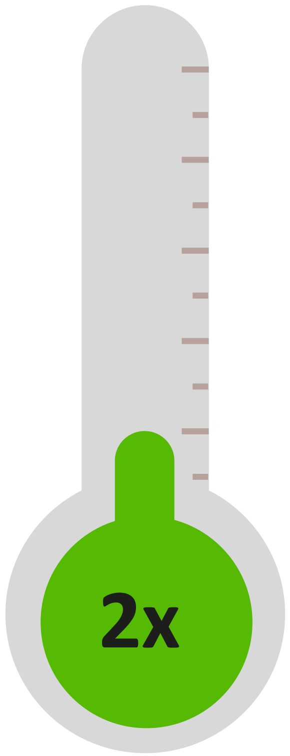
- Where he talked about "ten baggers" (stocks that go up 10x)
- We did extensive research on ten baggers and found…
- 9 factors that drive long-term share price performance

Stock Picking Checklist

Can this company be a ten bagger?

Checklist	Potential	Comment
1. **Management** is committed to growth	Good	Over the past 10 years, revenue grew at a CAGR of 7.4%
2. **Growth** can hit double-digits	Moderate	Emerging markets provide growth, but not more than high single-digits
3. Gross **Margin** can remain high	Good	Nike remains the dominant player
4. **Earnings** are predictable	Weak	Exceptional items lead to high volatility in net profit
5. **Efficient** at deploying assets	Good	Asset turnover is above average at 130%
6. **Cash Conversion** cycle is low	Good	Cash conversion cycle is 25 days, much lower than the sector average
7. **Cash Flow** is consistently positive	Good	Nike delivered strong operating CF over time
8. **Capital** is readily available	Good	The company is net cash
9. **Valuation** is reasonable	Weak	Trades slightly higher on both PE and PB compared to US Cons. Disc.

10x Bagger Potential



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Free cash flow

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Risks

(YE May, US$ m)	2020A	2021A	2022E	2023E
EBIT	3,115	7,186	8,064	8,609
Est tax rate (%)	*12*	*14*	*14*	*14*
NOPAT	**2,740**	**6,178**	**6,918**	**7,386**
Add: Depre & amort	721	797	819	892
Less: CAPEX	(1,086)	(695)	(1,035)	(1,396)
Chg in A/R	1,523	(1,714)	510	(395)
Chg in inventory	(1,745)	513	451	(627)
Chg in oth curr assets	315	155	(331)	(183)
Chg in A/P	(576)	2,234	(359)	1,297
Chg in oth curr liabs	790	(595)	178	131
Less: Chg in working cap	**307**	**593**	**449**	**223**
Less: Chg in invest cap				
Free cash flow to firm	**2,682**	**6,873**	**7,150**	**7,105**

- CAPEX requirements are low, leading to high sustainable FCFF

Sources: A. Stotz Investment Research, Refinitiv

This is not investment advice and it's not a recommendation.

Value estimate

VALUATION MASTER CLASS

- Sales
- Story
- FVMR
- **Value**
- WCB
- Risks

Forecast assumptions

3-year average	Consensus	My assumptions
Revenue growth (CAGR)	9.8	8.8
Gross margin	47.2	46.2
EBIT margin	16.3	17.2
Net margin	13.3	14.5

My valuation method

Market: United States of America	
Market risk-free rate	2.5
Market equity risk premium	8.0
Market return	**10.5**
Company beta (x)	1.0
COE	**10.5**
WACC	9.9
Terminal growth rate	4.0

Valuation Method: FCFF

- ★ I expect lower revenue growth than consensus but higher net margin, leading to similar earnings forecast
- ★ With a 4% terminal growth rate, I am already on the optimistic side
  - **Also, I assume the company to maintain its massive ROIC over time**

Sources: A. Stotz Investment Research, Refinitiv

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VALUATION MASTER CLASS

Sales

Story

FVMR

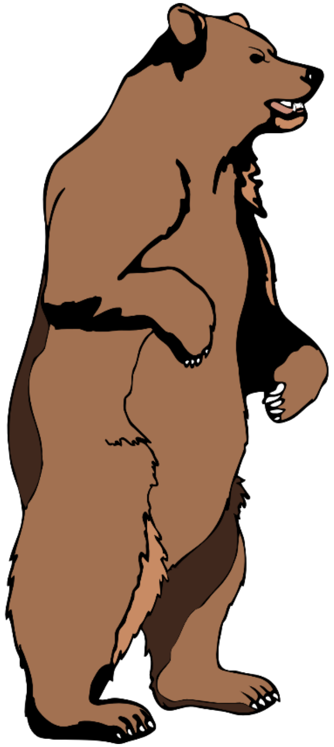
WCB

Ratios

Value

Risks

Bear	Base	Bull
US$100	US$112	US$123
(Downside 30%)	(Downside 22%)	(Downside 14%)



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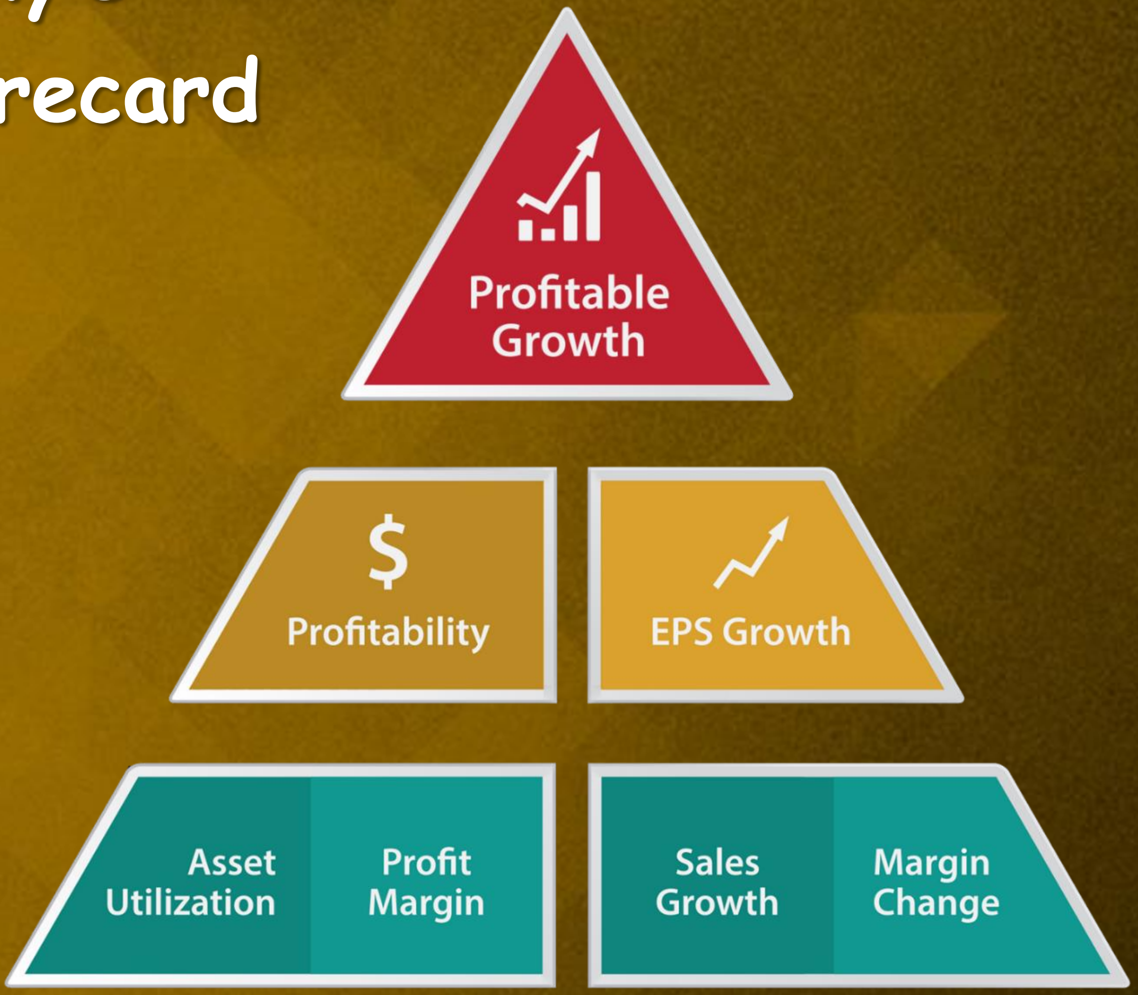
Next let's consider the company's World Class Benchmarking Scorecard

- To identify the company's competitive position relative to global peers
- We use a composite rank of profitability and growth, called "Profitable Growth"
- And a scale from 1 which is best, to 10 which is worst



Strong profitability, but volatile growth

VALUATION MASTER CLASS

- Sales
- Story
- FVMR
- Value
- **WCB**
- Risks

Profitable Growth

'18	'19	'20	'21	PTM
1	1	2	1	1

Profitability

'18	'19	'20	'21	PTM
1	1	2	1	1

Growth

'18	'19	'20	'21	PTM
8	5	8	2	4

Benchmarked against 1,010 large Cons. Disc. companies worldwide.

Sources: A. Stotz Investment Research, Refinitiv

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Key risk is intense competition

VALUATION MASTER CLASS

Sales

Story

FVMR

Value

WCB

Risks

- ★ Entrance of new players joining the fitness and sports market with niche products
- ★ Failure to meet local customer requirements, in particular emerging markets
- ★ Consolidation of retail shops might impair ability to sell

Sources: A. Stotz Investment Research, company data

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CONCLUSION

- Direct-to-customer selling approach raises brand value and could enhance margin
- Early digital expansion gives it timing advantage over competitors
- Valuation is not cheap, bullish rally probably over


CASE STUDY
VALUATION MASTER CLASS
by
A. Stotz INVESTMENT RESEARCH
Is Nike's sports supremacy enough to justify its high valuation?