BERNSTEIN

MAY 2018

NIKE: OFF THE BENCH AND READY TO WIN

Nike is off to a running start in becoming a digital direct-to-consumer business

Domestically, innovation should continue to drive growth from strong consumer product traction. After a year of declining North American sales, we expect revenue and earnings growth to accelerate in fiscal 2019 and beyond.

Nike will deliver outsized growth internationally in the next five years, as it benefits from share gains in the athletic apparel and footwear category, supported by an increased focus on health and wellness globally.

Nike's transformation into a digitally-led direct-to-consumer company will support revenue growth. We estimate that, at scale, Nike's DTC business could be ~10% higher in operating margin than wholesale, bolstering ROIC and driving multiple expansion.

As a first-mover in the transformation to be closer to the consumer, we expect Nike’s shift to DTC to help drive double-digit EPS growth. We rate Nike Outperform, with a target price of $76.

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PORTFOLIO MANAGER'S SUMMARY

In April 2016, Phil Knight published his memoir *Shoe Dog*, about the creation of Nike. The book tells the story of an underdog building a brand with laser focus on how to make runners faster, who ultimately created the largest and most successful sneaker brand across the globe. Knight's story is one of innovation, persistence, and some luck. Over the years, some of the Nike origin stories have become the stuff of legend…how Bill Bowerman, Knight's former coach and partner in the creation of Nike, used his wife's waffle iron to create the sole of one of Nike's first shoes, the Waffle Trainer… how the first Jordans were (maybe) banned by the NBA for not conforming with the league's uniform rules…and helped create the aura of a scrappy brand that pushed boundaries and revolutionized sneakers. But for all the brand's history and size, investors have recently questioned whether Nike still has what it takes to drive the sneaker community as the company's biggest competitor, adidas, has gained share in Nike's domestic US market and as Nike's sales in North America have declined.

In this *Blackbook*, we cover why we are bullish on Nike's opportunities, despite recent North American challenges, as we expect revenue and earnings growth to accelerate in fiscal 2019 and beyond. In particular, we see room for share gains for the athletic apparel and footwear category internationally, driven by an increased focus on health and wellness, as the athletic category remains at lower levels of penetration in markets such as Europe, Asia, and Greater China. We expect Nike's international markets to be the company's fastest growing. In addition, Nike's recent product innovations have shown strong momentum, taking share and seeing strong consumer traction, giving us increased confidence in domestic growth opportunities.

Beyond the traditional growth path of selling more sneakers, Nike is also in the midst of a transformation, moving away from the traditional wholesale model to a digitally-led direct-to-consumer (DTC) model. In fiscal 2017, DTC was 28% of Nike's total sales, up from 16% in 2012, but we believe this could be over 40% of sales in the next five years, with the bulk of growth coming from Nike's DTC e-commerce channel. We believe this is the right strategy as more of retail moves online and favors big brands such as Nike. A DTC model will also support revenue growth — for example, if Nike sold exactly the same number of shoes in fiscal 2019 as it did in 2018, but sold them directly to customers rather than to wholesale partners, Nike's recognized footwear revenue would be ~70% higher! We estimate Nike's DTC business could be 10ppts higher operating margin than wholesale at scale and we believe consensus margin expectations are still too low over the next five years. This improvement in margin should also drive higher ROIC, which we believe also suggests Nike's stock merits a higher multiple compared to history. We rate Nike Outperform, with a $76 12-month target price.

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May 15, 2018

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EXHIBIT 1: **Financial overview**

	Nike	Under Armour	Lululemon
Rating	**O**	**U**	**M**
Current Price ($)	67.92	18.56	97.91
Target Price ($)	76.00	9.00	80.00
% Upside / (Downside)	12%	(52%)	(18%)
Market Cap ($ millions)	109,308	8,174	13,335
Price Range ($)			
52 Week Low	50.35	11.40	47.26
52 Week High	70.25	23.46	100.73
Share Price Performance			
YTD Performance	9%	29%	25%
TTM Performance	24%	(12%)	84%
Fiscal Year End			
Current Year (2018)	May 31	December 31	January 27
P/E (Bernstein)			
LTM	29.3x	109.0x	35.4x
NTM	25.7x	103.6x	30.4x
FY2018	29.3x	128.1x	31.3x
FY2019	25.7x	81.8x	28.9x
P/E (Consensus)			
LTM	28.8x	99.5x	35.9x
NTM	25.6x	83.3x	30.6x
FY2018	29.0x	102.9x	31.7x
FY2019	25.4x	61.9x	27.9x
EV/EBITDA (Bernstein)			
LTM	21.2x	25.5x	20.5x
NTM	18.5x	24.0x	17.6x
FY2018	21.2x	24.6x	18.2x
FY2019	18.5x	23.1x	16.6x
EV/EBITDA (Consensus)			
LTM	20.8x	25.0x	19.2x
NTM	18.6x	23.8x	16.7x
FY2018	20.9x	25.8x	17.3x
FY2019	18.5x	20.8x	15.4x

Note: The stocks are benchmarked against the S&P 500 that closed at 2,723 as of May 10, 2018.

Source: FactSet, company disclosures, and Bernstein estimates and analysis

SIGNIFICANT RESEARCH CONCLUSIONS

OVERVIEW

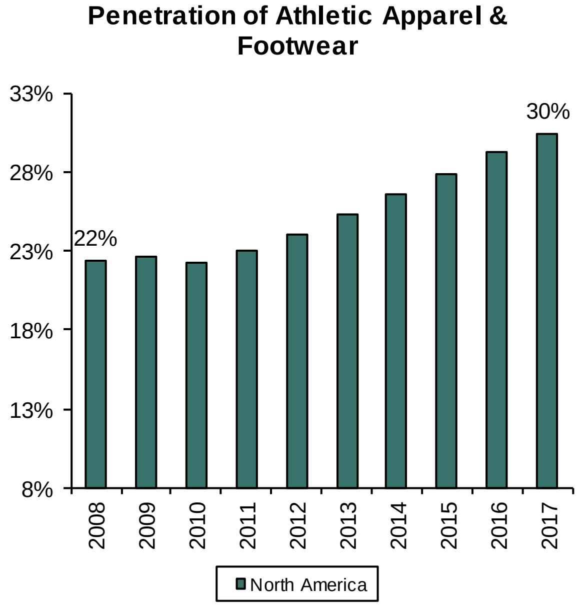
Nike is the global best-in-class athletic footwear brand and a key beneficiary of the structural shift toward health and wellness. Since 2008, Nike has seen its largest market share gains from the US, where it is the share leader with 20% share of the athletic apparel and footwear market. From May 2010 to May 2015, Nike grew revenue at a 10% CAGR and EPS at a 14% CAGR, but growth has been slower in the last three years, averaging just 5% on the top line and 8% in EPS, as stronger performance from adidas and destocking in the North American wholesale channel have caused questions about the sustainability of Nike's growth and market share.

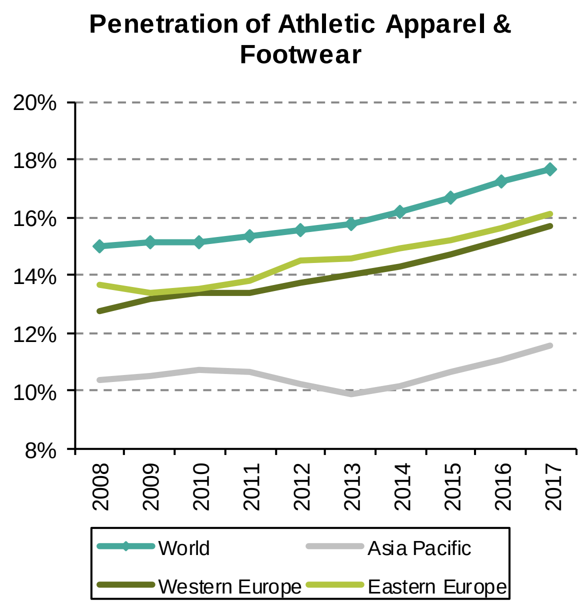
We expect Nike to return to mid-teens earnings growth in 2018-22, forecasting an 8% revenue CAGR and a 17% EPS CAGR over this period as: 1) the North American wholesale destocking comes to an end, 2) strong category growth continues internationally, 3) Nike's product pipeline supports growth both domestically and internationally, and 4) efforts in Nike's Direct-to-Consumer (DTC) business lead to margin and ROIC expansion. While some of this optimism has already been reflected in Nike's share price, with the stock trading at 25.7x our NTM EPS forecast, given our view that the mix shift to DTC will support increasing returns, we believe this multiple is justified.

GROWTH WILL INCREASINGLY BE DRIVEN INTERNATIONALLY

One of the most common questions investors ask about the athletic apparel and footwear category is: What is the growth opportunity? We continue to see significant opportunity for category growth, with the largest opportunity outside North America. While the category has grown from 22% of the North American apparel and footwear market in 2008 to 30% in 2017, it is just 18% of the market globally, with lower levels of penetration in international markets. On a regional basis, while North American growth has slowed down to mid-single-digits in recent years, Asia has become the fastest-growing market for athletic apparel and footwear, with growth averaging 10% since 2014 (see Exhibit 2).

EXHIBIT 2: **The athletic category makes up 30% of all apparel and footwear sales in North America; globally, the category is 18% of the market and gaining share in both Europe and Asia**

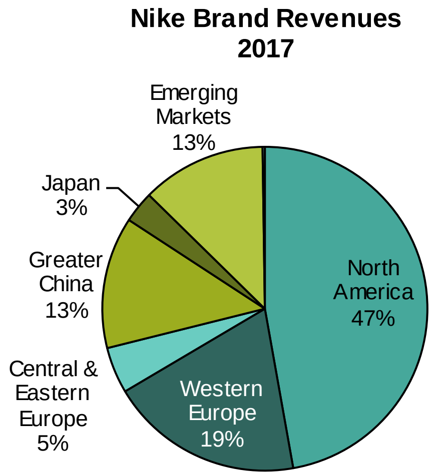


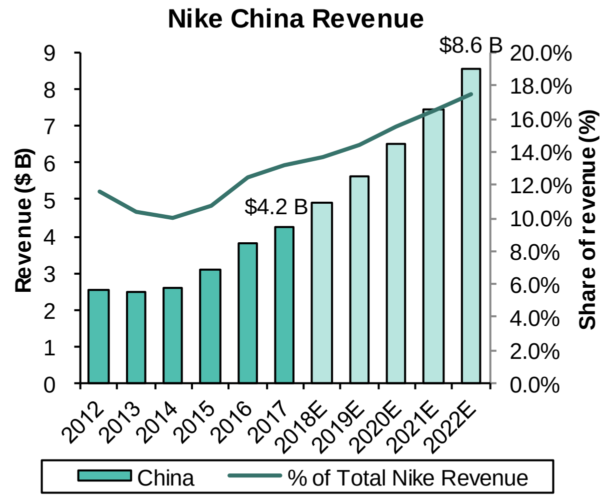


Source: Euromonitor and Bernstein analysis

We believe that Nike is best positioned as growth in the category shifts to outside North America, both in terms of its leading market share in other regions as well as its high profitability abroad. International markets represented 53% of Nike's sales in 2017 and we expect China to be Nike's fastest-growing region over the next five years. The Greater China segment was a $4.2B revenue business in 2017, constituting about 13% of Nike's revenue. We project that by 2022, Nike China will be at least twice its size today and make up about 18% of total Nike revenues, with an average constant-currency growth rate over the next three years of 16%. Greater China is also Nike's highest-margin business with operating margins of 36% in 2017, suggesting that this mix shift should be margin enhancing as well (see Exhibit 3 and Exhibit 4).

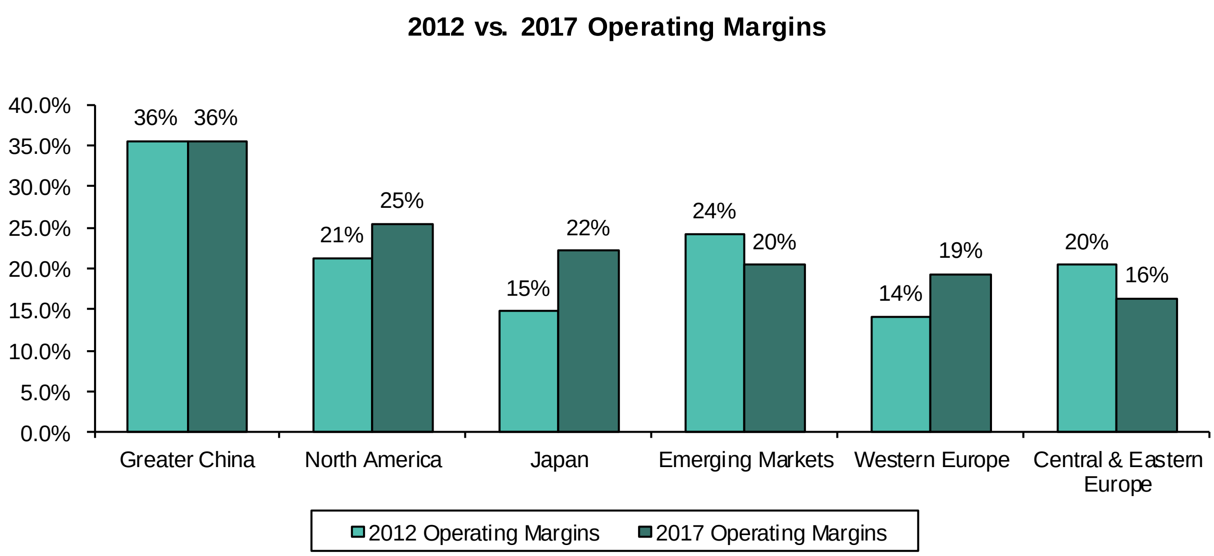
EXHIBIT 3: **Over 50% of Nike's revenues are from outside North America, and we expect Nike China to grow at an average of 16% CCY CAGR over the next three years**





Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 4: **Greater China is Nike's highest operating margin region**



Note: Nike has changed its reporting segments into North America, Greater China, EMEA, and Asia Pacific and Latin America as of FQ1 2018.

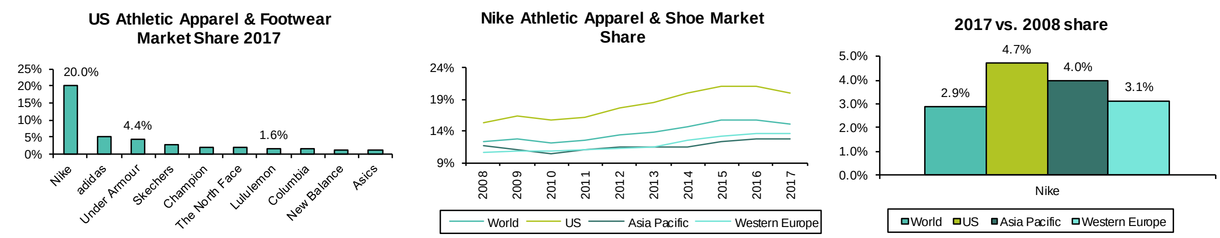
Source: Company disclosures and Bernstein analysis

INNOVATION WILL BE KEY IN DRIVING NIKE'S PRODUCT PIPELINE AND SHARE GAINS

Nike has been a share gainer globally in the athletic apparel and footwear category over the last decade (see Exhibit 5). We believe the basis for share gains has come from Nike's long track record of innovation, as the company has invested heavily in product development. This begins with consumers' and athletes' insights at Nike Sport Research Lab, where work on biomechanics, exercise physiology, engineering, and industrial design takes place alongside regular consultations with athletes, coaches, trainers, and doctors as they test out designs, materials, and concepts.

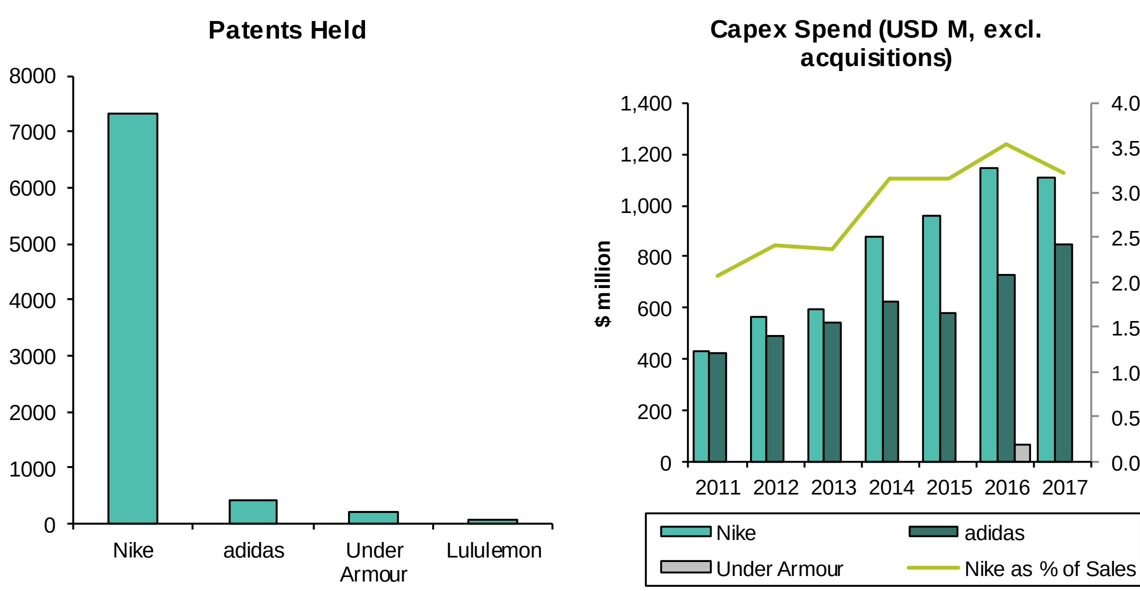
With this investment, Nike has built up a library of patents far greater than its athletic wear peers at over 7,000 patents, whereas the second most number of patents held is ~430 by adidas, about 1/17th of the patents held by Nike. Globally, Nike also leads in the number of patents held relative to its peers at approximately 8x of adidas (which is still a staggeringly high number relative to peers). Furthermore, Nike has outspent its competitors in capex consistently since 2011; in 2017, Nike spent 30% more in capex compared to the next biggest capex spender, adidas at $1.1B (see Exhibit 6). Nike has also partnered with third parties such as Apollo and Flex in order to develop new methods of manufacturing, in order to improve speed to market, increase automation, and develop quicker delivery of more customized product.

EXHIBIT 5: **Nike is the market leader in US athletic apparel and footwear...gaining share globally over the last decade, with the largest share gains coming in the US**



Source: Euromonitor and Bernstein analysis

EXHIBIT 6: **Nike holds the highest number of patents relative to peers, and has spent more in capex compared to competitors**



Note: Exhibit on the left based on number of patents assigned from 1976 through March 13, 2018. Adidas figures converted to USD at current spot rates for Exhibit on the right.

Source: US Patent and Trademark Office, company reports, and Bernstein analysis

CONSUMERS LOVE NIKE

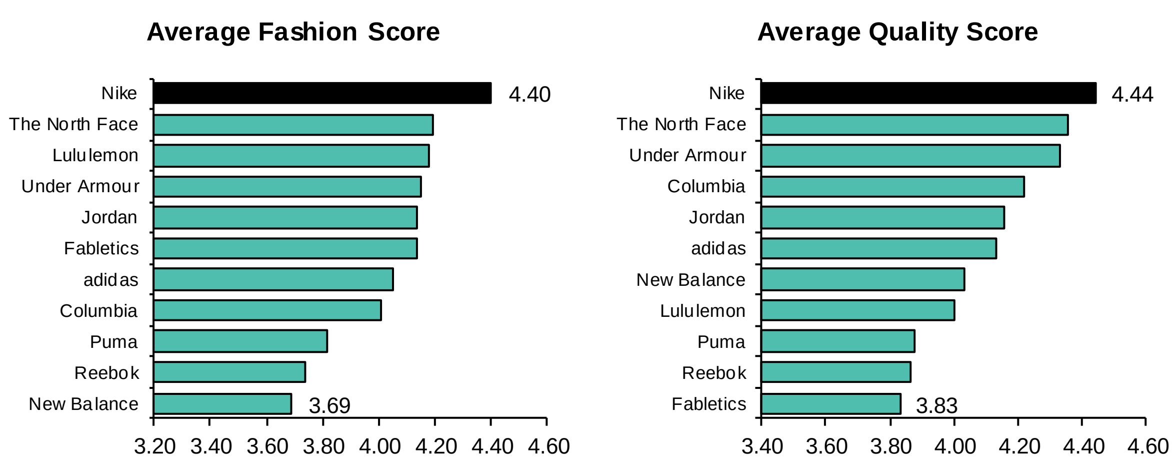
But what about Nike's brand traction? Investors have been concerned that Nike is slipping, as adidas has grown faster in North America over the last 10 quarters and Nike lost 100bps of market share in the US in 2017 (see Exhibit 5). Perhaps, investors speculate, the brand isn't cool anymore. In order to answer that question, in January 2018 we surveyed 1,000 people in the US about 18 athletic apparel and footwear brands, speaking to 501 men and 499 women, representative of the age and geographic and income distribution of the country. Contrary to investor concerns about issues with Nike's brand traction— Nike unambiguously scored at the top in: 1) brand awareness, 2) brand perception, and 3) purchase intent.

On brand awareness: Not only does Nike have the highest brand awareness among all brands, it also has the highest awareness and engagement across demographic groups, particularly among frequent exercisers and those with > $75K in annual income.

On brand perception: Nike ranked at the top position in all four attributes surveyed — quality, functionality, value, and fashion (see Exhibit 7). While adidas has benefited from the rise of the athleisure trend with its Yeezy's, Stan Smith's, and Super Stars, Nike scored at the top on fashion even among those who consider themselves sneaker heads.

On purchase behavior and purchase intent: Among those who know the brands, consumers have the highest purchase intent at Nike. Additionally, Nike was the brand most likely to see shoppers come back because of a replacement cycle in the category.

EXHIBIT 7: **Nike ranked highest on fashion and quality**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

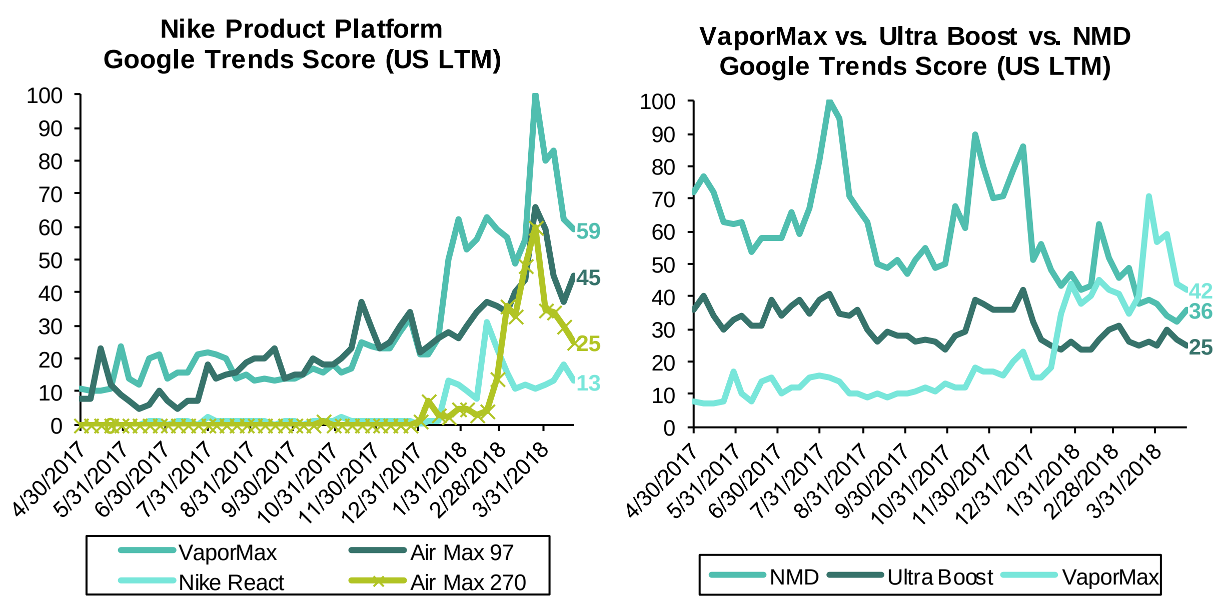
Beyond our surveys, we also see signs that recent product launches are gaining traction and surging past adidas' strongest products, suggesting that the pipeline of innovation is strong. Based on Google Trends, our proprietary stock-out data, and secondary market transactions data, we measured the progress of some of the key products that Nike highlighted during its 2017 Investor Day: VaporMax, Epic React, and Air Max 97 (see Exhibit 8).

VaporMax has ramped up strongly and now surpasses Ultra Boost in terms of search volume. We believe this is Nike's highest-volume new innovation and see good signs of traction for the product.

While it is early days, comparing the ramp of Ultra Boost over the long term versus the initial interest in the **Epic React** suggests strong relative interest in React. In addition, React has been stocking out quickly and is selling at a premium in secondary markets, again suggesting momentum behind the platform.

On the lifestyle front, while it is not a new product, Nike has reinvigorated **Air Max 97**. Air Max 97 outperforms other lifestyle sneakers such as Superstar, Stan Smith, Gazelle, and Vans Old Skool in Google search. The fashion-linked Silver Bullet, Gold Metallic, and Off-White collaboration seem to be the most popular styles.

EXHIBIT 8: **Of Nike's product platforms, VaporMax has gotten the most traction over the last 12 months...further, VaporMax has overtaken both NMD and Ultra Boost from adidas in 2018**



Source: Google Trends and Bernstein analysis

LEVERAGING "MANUFACTURING REVOLUTION" TO STAY AHEAD

As the pace of change in fashion trends accelerates with the rise of the Internet and social media, Nike is working on accelerating speed-to-market with specific manufacturing initiatives, which we believe will create competitive advantage over the medium term. In addition, as the world digests the threat of a US-China trade war, we believe that Nike's efforts in near-market sourcing and its "manufacturing revolution" or "man rev" are that much more relevant.

In the last five years, concerns about labor cost inflation and speed-to-market have caused Nike to rethink both the manufacturing process and the materials that the company uses in order to offset these pressures. Nike's efforts have focused on three types of manufacturing improvement: 1) sustainable manufacturing excellence, 2) manufacturing modernization, and 3) manufacturing innovation. With partners such as Flex and Apollo, increased automation even with traditional partners (Feng Tay), and new materials such as Flyknit and Flyleather, Nike management has suggested that the quarterly savings from "man rev" is now measured in the "tens of millions" of US dollars. If we assume conservatively that this means ~$40-$80M of savings annually, this would suggest 10-20bps of margin improvement. In addition, if Nike can shorten lead times, thus gaining more insight into demand and increasing full price sell through, this could also drive margin expansion.

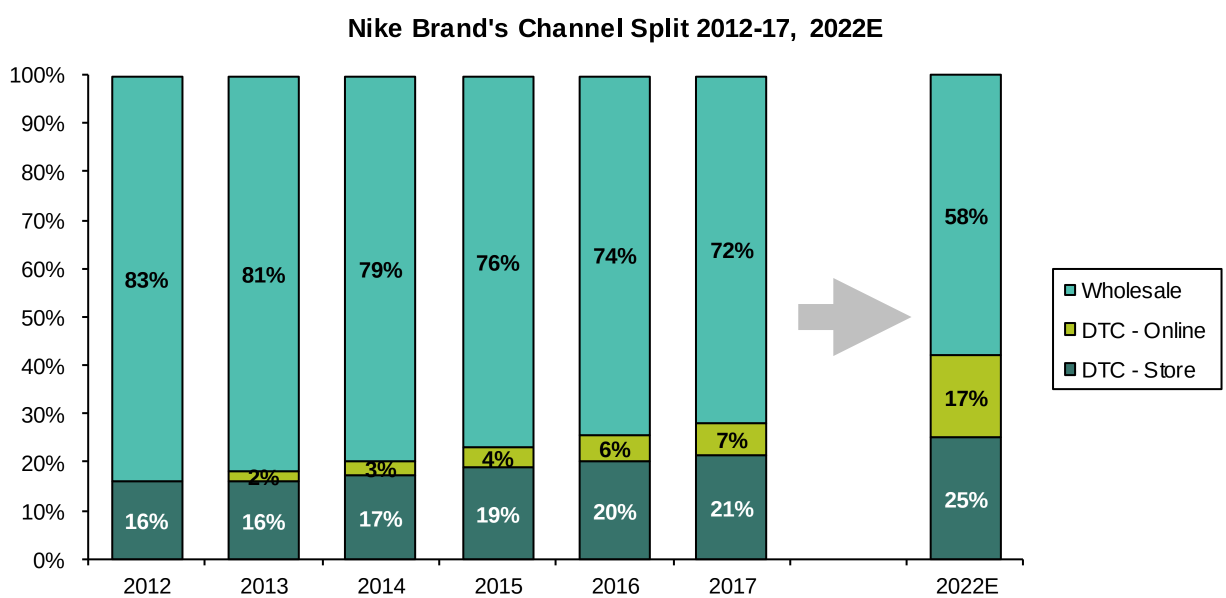
Through 2017, little benefit from automation or improved manufacturing techniques have been visible in Nike's reported gross margin. We would note though that mix likely plays a role here. Between 2012 and 2017, Nike's footwear business grew slightly faster than the apparel business (a 9.4% CAGR versus a 8.8% CAGR), and footwear on a unit basis has a higher ASP and higher product cost compared to apparel.

Nike's proactive approach to automation will allow it to stay ahead of competitors against cost inflation as well as increase speed-to-market, which will support Nike's focus on innovation.

HOW MUCH MARGIN UPSIDE DOES DTC PROVIDE?

Nike is undergoing a mix shift to its DTC business, which we believe provides clear margin upside. Currently, DTC constitutes about 28% of Nike's revenues and we expect it to increase to ~42% of sales by 2022 (see Exhibit 9).

EXHIBIT 9: **DTC constitutes ~28% of Nike revenues as of FY2017**



Source: Company disclosures, and Bernstein estimates and analysis

Based on Nike's disclosure, we estimate the gross margin differential between DTC and wholesale is ~24ppts, with wholesale gross margins of ~38% and DTC gross margins of ~62%. Given our estimate that Nike's realized retail price is 2x the wholesale price, this suggests that the gross profit contribution of a unit sold directly by Nike is 3.3x higher than the gross profit contribution of the same unit sold to a wholesale partner.

We have estimated the incremental operating costs of DTC based on a set of global peers, both from e-commerce pure plays and brick-and-mortar retailers. Our analysis suggests that Nike's wholesale operating margin is likely close to 12%, while DTC e-commerce margins are in the mid-teens and DTC store margin is ~22-23% (see Exhibit 10). As Nike's DTC e-commerce business digests recent investments in initiatives such as the cloud and the platform relaunch, we expect scale benefits should drive DTC e-commerce margins to or above DTC store margins.

Given our estimates for margin by channel, if wholesale falls to 58% of revenue by 2022, DTC e-commerce increases from 7% of revenue to 17% of revenue, and DTC stores increases from 21% of revenue to 25% of revenue, this would drive 90bps of operating margin expansion (and ~330bps of gross margin expansion). If margins of DTC e-commerce scale to DTC store margins, this would drive 200bps of operating margin (see Exhibit 11).

Ultimately, our analysis confirms that Nike's shift to DTC should be gross- and operating-margin enhancing for the company at the group level.

EXHIBIT 10: **At the group level, we estimate DTC contributes ~41% of Nike's profit compared to 28% of revenue**

	Scaled to Group Revenue/Profitability			
	Wholesale	DTC e-commerce	DTC Stores	Group
Revenue	72.00	7.00	21.00	100.00
% of group revenue	*72%*	*7%*	*21%*	*100%*
Gross Margin	37.7%	61.5%	61.5%	44.4%
Gross Profit	27.17	4.31	12.92	44.39
Total Operating Costs	18.63	3.15	8.18	29.96
Operating Costs as a % of Sales	25.9%	44.9%	38.9%	30.0%
Operating Profit	8.54	1.16	4.74	14.44
Operating Margin	**11.9%**	**16.6%**	**22.6%**	14.4%

Source: Company reports, and Bernstein estimates and analysis

EXHIBIT 11: **If margins remain at our current estimates, but we see continued mix shift to DTC (17% e-commerce, 25% stores), analysis suggests 90bps of margin expansion...with scale, it suggests 190bps of margin expansion**

	% of Revenue	Gross Margin	Operating Margin
Wholesale	58%	37.7%	11.9%
DTC e-com	17%	61.5%	16.6%
DTC stores	25%	61.5%	22.6%
Group	**100%**	**47.7%**	**15.3%**

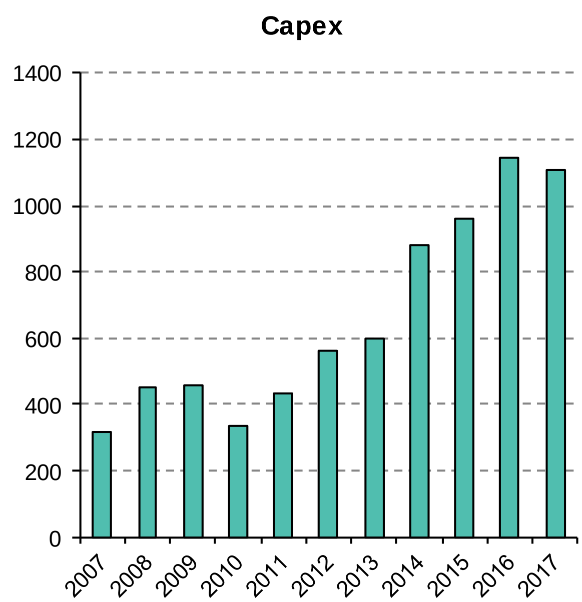
	% of Revenue	Gross Margin	Operating Margin
Wholesale	58%	37.7%	11.9%
DTC e-com	17%	61.5%	22.6%
DTC stores	25%	61.5%	22.6%
Group	**100%**	**47.7%**	**16.4%**

Source: Bernstein estimates and analysis

DIGITAL PRESENTS OPPORTUNITY

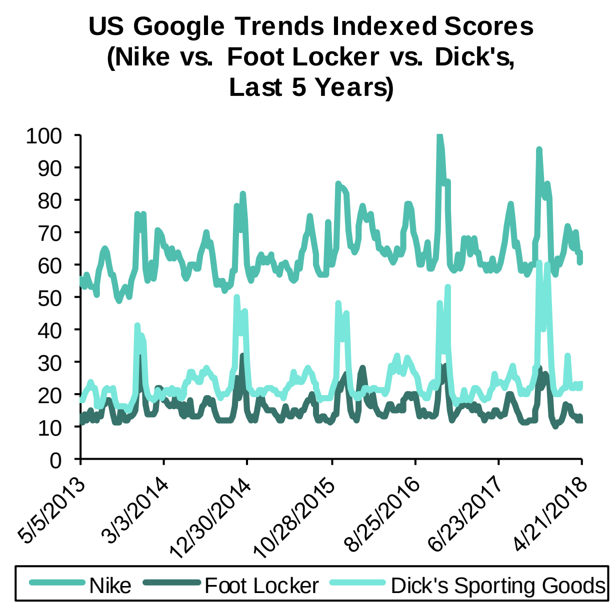
We believe there is good reason to believe that Nike will successfully expand its DTC e-commerce business. Over the last five years, Nike's investment in digital has ramped up as capex doubled on an absolute level, yet DTC online was only 7% of Nike's sales in 2017 (see Exhibit 9 and Exhibit 12). We believe that Nike is at an advantage relative to other brands and retailers as e-commerce continues to gain share of apparel retail, in part because the bulk of physical retail where Nike is sold is not owned by Nike, but instead owned by third parties, suggesting that they have not invested significant capital in physical retail. In addition, given Nike's brand awareness, customers are going directly to Nike's website/app rather than wholesale partners' websites, which is ultimately higher margin for Nike (see Exhibit 13). Without a significant owned-store base and with a flexible supply chain, Nike has recently built two fully-integrated distribution centers (in Tennessee and Belgium), which handle fulfillment for Nike to wholesale and DTC (stores and online), suggesting that Nike does not need to invest in stand-alone distribution for its e-commerce initiatives and, hence, the shift to direct should be margin enhancing for Nike as well.

EXHIBIT 12: **Nike's annual capex spending has doubled in the last five years**



Source: Company reports and Bernstein analysis

EXHIBIT 13: **Nike gets more traffic and search compared to its wholesale partners**



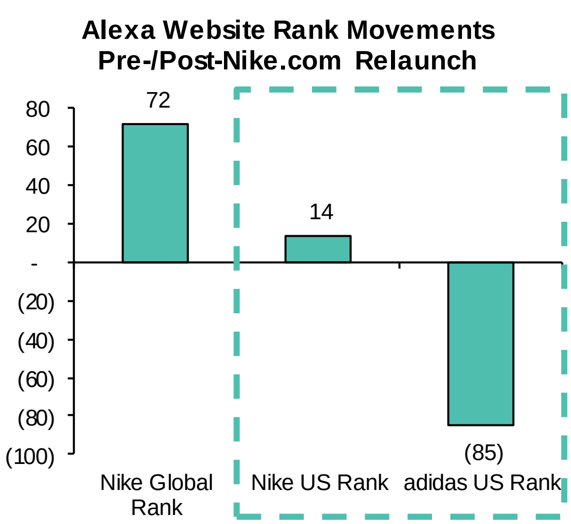
Source: Google Trends and Bernstein analysis

We believe these investments are now paying off. We see evidence of brand traction in the form of high and growing traffic to Nike.com when compared to peers. Specifically, since Nike.com's site relaunch in November, Nike.com has shown improvements in its Alexa traffic rank (see Exhibit 14) compared to adidas in the US and worldwide. Recent Google Trends data also suggest that while adidas has been closing the gap in search traffic between the two brands since 2013, the search volume gap has stabilized in the last 12 months (see Exhibit 15).

Nike+ membership program: Further, we believe that Nike apps will differentiate the company as both a brand and a retailer, as the entire portfolio of Nike apps are integrated under a single Nike+ membership program. Nike cited 100 million Nike+ members during its 2017 Investor Day and members on the Nike app spend 3x as much as customers on Nike.com. In the Apple App Store, Nike apps across the shopping and fitness categories have an average rating of 4.8 and lead in ranking relative to peers (see Exhibit 16).

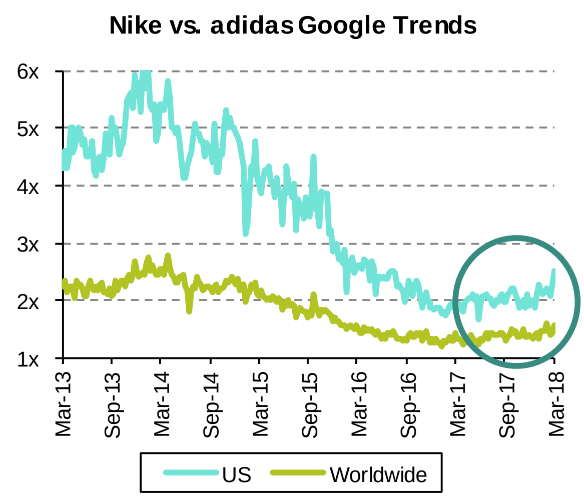
Nike's strategic partnerships with retailers such as Tmall and Zalando will help Nike reach incremental customers while allowing Nike to control more of its pricing and merchandising decisions, closely replicating the direct online experience that Nike offers through its own website and apps. Overall, we expect Nike's digital efforts to be a key driver of both top-line growth and margin expansion for the business over the next five years.

EXHIBIT 14: **Nike.com has shown improvements in its Alexa traffic rank since the site has relaunched**



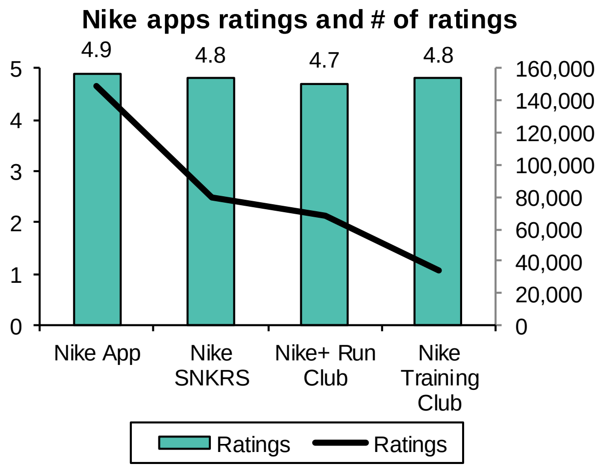
Source: Alexa and Bernstein analysis

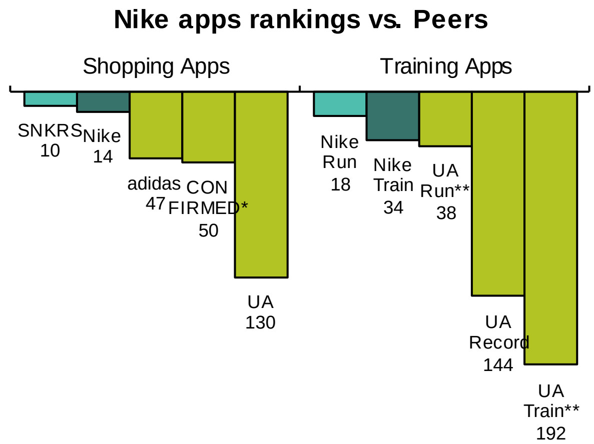
EXHIBIT 15: **While adidas closed the search gap vs. Nike since 2013, Nike has seen a recent (small) resurgence**



Source: Google Trends and Bernstein analysis

EXHIBIT 16: **Nike apps have an average rating of 4.8/5 and also lead in ranking on the Apple App Store**





Note: * CONFIRMED is the adidas sneakers app; **UA Run represents Map my Run (owned by Under Armour); UA Train represents Map my Fitness (owned by Uunder Armour).

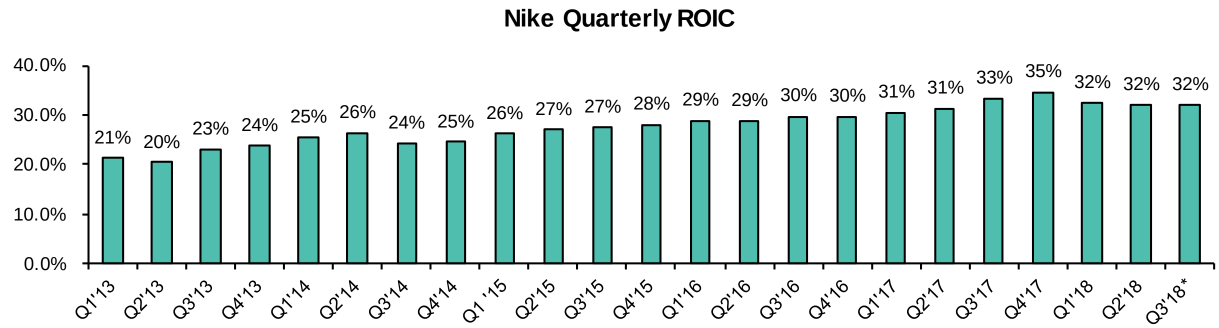
Source: Apple App Store and Bernstein analysis

CAN ROIC IMPROVE AS DTC GROWS? YES

Nike has seen steady improvements in its ROIC since 2013 (see Exhibit 17). In the context of gross and operating margin expansion opportunity driven by Nike's DTC business, investors have rightly asked us about the implications for ROIC as Nike shifts to this arguably more capital-intensive business.

We calculate a group lease-adjusted ROIC of ~34% for Nike overall in 2017. Of the three distribution channels, we estimate Nike's Wholesale ROIC currently at 41%, above group average, based on our assumption that the invested capital needs of a wholesale business are lower and more scalable compared to a direct business; of the Direct distribution channels, we estimate Direct store lease-adjusted ROIC at 29%, and Direct e-commerce at 26%. However, we believe that recent e-commerce investments in both P&L and capital have yet to scale, depressing margin and resulting in disproportionately high invested capital relative to sales. Looking ahead, as margins for DTC e-commerce improve and as capex scales, we expect DTC e-commerce ROIC to improve. Overall, given our assumptions, we estimate that Group ROIC could increase by ~3ppts in the next five years, largely driven by the increasing ROIC in the Direct e-commerce channel (see Exhibit 18).

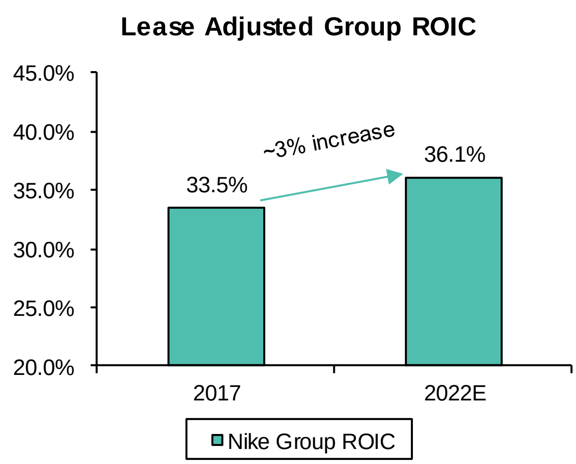
EXHIBIT 17: **Nike has seen steady improvements in its quarterly ROIC since 1Q 2013**



Note: 3Q 2018 represents tax-adjusted ROIC, adjusted for the one-off charge of $2B in FQ3 2018. Unadjusted ROIC in 3Q 2018 was 15.6%. Nike Quarter ROIC equals the trailing four quarters earnings before interest and after taxes divided by trailing five quarters average invested capital.

Source: Company disclosures and Bernstein analysis

EXHIBIT 18: **Taking the distribution channels together, we estimate a 3% increase in group ROIC**



Source: Company disclosures, and Bernstein estimates (2022E) and analysis

VALUATION METHODOLOGY

Please see Appendix for details on valuation methodology.

RISKS

Please see Appendix for details on risks.

INVESTMENT IMPLICATIONS

Please see Appendix for details on investment implications

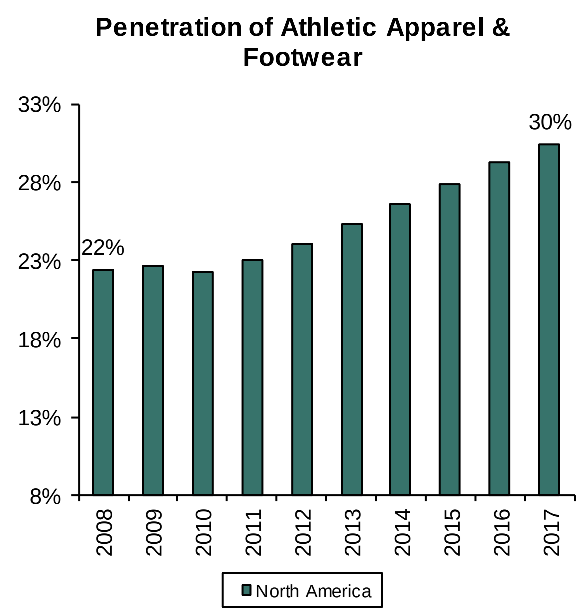
SNEAKERS TAKE ON THE WORLD

International sales will represent >80% of Nike's growth

OVERVIEW

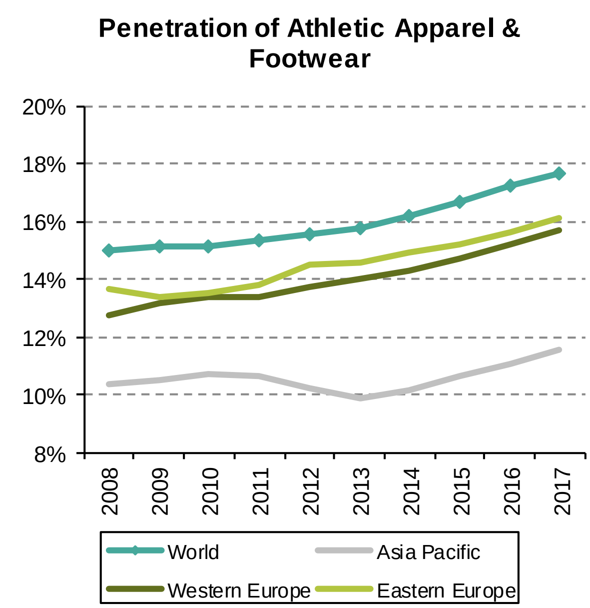
One of the most common questions investors ask about the athletic apparel and footwear category is what is the growth opportunity. We continue to see significant opportunity for category growth, with the largest opportunity outside North America. While the category has grown from 22% of the North American apparel and footwear market in 2008 to 30% in 2017, it is just 18% of the market globally, with lower levels of penetration in international markets (see Exhibit 19 and Exhibit 20).

EXHIBIT 19: **The athletic category makes up 30% of all apparel and footwear sales in North America...**



Source: Euromonitor and Bernstein analysis

EXHIBIT 20: **...globally, the category is 18% of the market and gaining share in both Europe and Asia**



Source: Euromonitor and Bernstein analysis

We believe that Nike is best positioned as growth in the category shifts to outside North America, both in terms of its leading market share in other regions as well as its high profitability abroad. International markets represented 53% of Nike's sales in 2017 and we expect China to be Nike's fastest-growing region over the next five years. The Greater China segment was a $4.2B revenue business in 2017, constituting about 13% of Nike's revenue. We project that by 2022, Nike China will be at least twice its size today and make up about 18% of total Nike revenues, with an average constant-currency growth rate over the next three years of 16%. Greater China is also Nike's highest-margin business with operating margins of 36% in 2017, suggesting that this mix shift should be margin enhancing.

Under Armour has delivered strong international revenue growth as the brand has expanded to major international wholesale partners, and we expect international sales to continue to grow faster than North American sales over the next five years, forecasting a five-year CAGR of 22% internationally. However, with international revenue representing 22% of total sales, we remain cautious about the long-term profit opportunity. We believe international profitability has been driven almost entirely by the company's license arrangement in Japan, with other regions losing money (Latin America) or delivering low levels of profit. For example, although EMEA is Under Armour's largest geography outside North America ($470M in revenue in 2017), the margin of this business was just 3.8% in 2017.

While we see room for Lululemon to continue to expand internationally, we believe that it will have to grow at a much more aggressive rate in order to meet the company's $1B international revenue target by 2020, with just ~$246M in revenue in 2017. Given that the company is still in an early stage of growth, Lululemon's international sales are not yet generating a profit; management has suggested that the company will break even in Asia, including Australia, in the near term and that it is somewhat further behind in Europe.

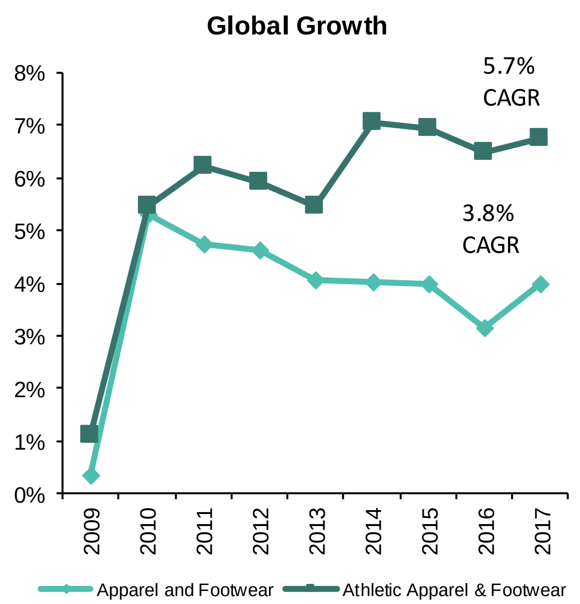
CATEGORY OVERVIEW

On a global scale, the athletic category has grown at a 5.7% CAGR since 2009, though growth has accelerated over the last few years at a 6.8% CAGR since 2013. This compares to overall apparel and footwear growth, which has grown at a CAGR of 3.8% (see Exhibit 21). Athletic footwear, in particular, has driven category growth, with a 10-year CAGR of 6.8% and growth averaging 8.6% since 2013 (see Exhibit 22).

Within athletic apparel, growth in sports-inspired apparel has overtaken that of performance and outdoor apparel in the last four years, though all three categories grew in the mid-single-digits in 2017. On the other hand, in athletic footwear, both performance and sports-inspired footwear have grown in the high-single-digits since 2014 (see Exhibit 23 and Exhibit 24). On a regional basis, while North American growth has slowed down to mid-single-digits in recent years, the developing markets have been catching up, as evidenced by the double-digit growth in Asia (see Exhibit 25).

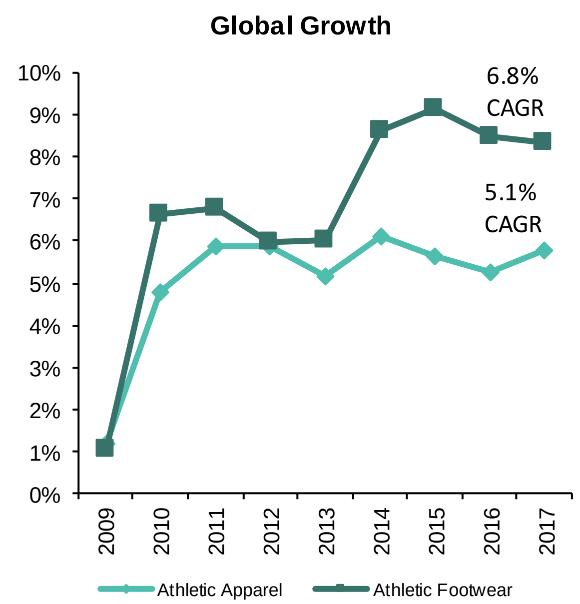
In terms of category spend, 61% of global spend in the athletic category was in athletic apparel in 2017. Asia had the lowest apparel mix percentage at 53%, whereas North America had the highest apparel mix percentage at 68% (see Exhibit 26). Within the categories, performance was roughly 50% of both total athletic apparel and footwear, outdoor was approximately 15% of both categories, with the balance in sports-inspired apparel and footwear (see Exhibit 27 and Exhibit 28).

EXHIBIT 21: **At a global level, the athletic category has grown at a 5.7% CAGR since 2008...**



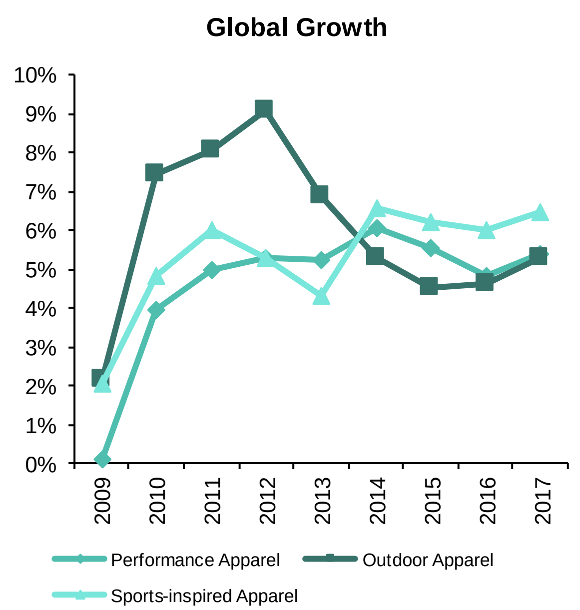
Source: Euromonitor and Bernstein analysis

EXHIBIT 22: **...with footwear growing faster at a 6.8% CAGR**



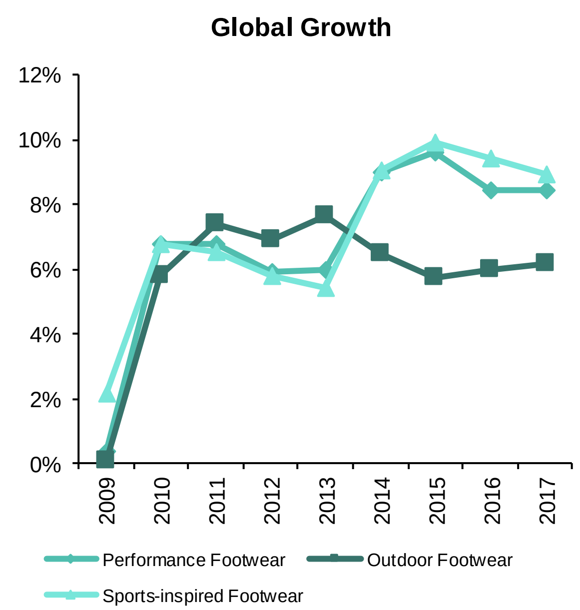
Source: Euromonitor and Bernstein analysis

EXHIBIT 23: **Within athletic apparel, sports-inspired apparel has been the fastest growing subcategory...**



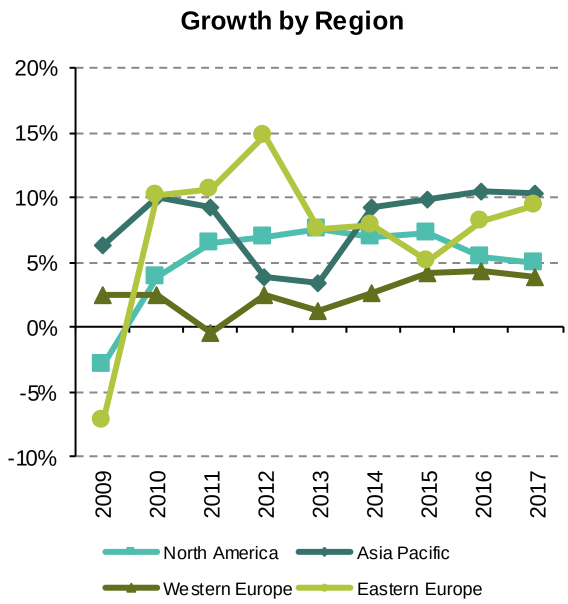
Source: Euromonitor and Bernstein analysis

EXHIBIT 24: **...while in footwear, sports-inspired and performance footwear have grown fastest**



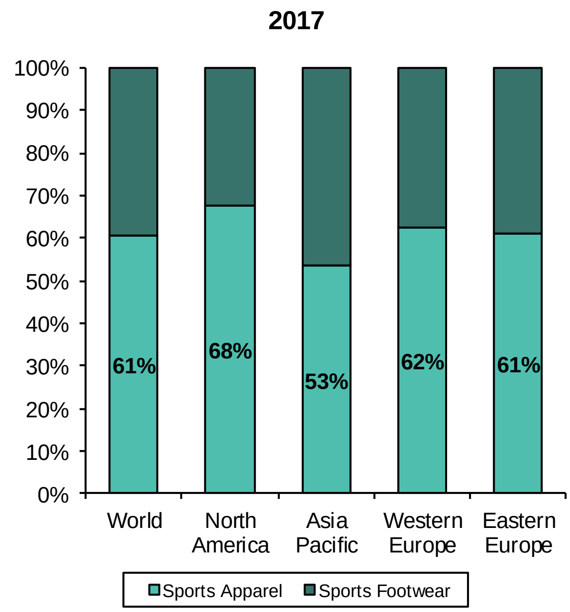
Source: Euromonitor and Bernstein analysis

EXHIBIT 25: **Regionally, Asia has been the fastest growing**



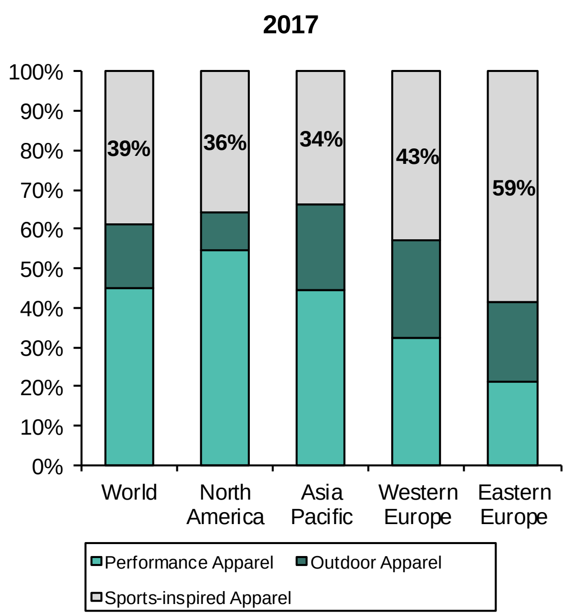
Source: Euromonitor and Bernstein analysis

EXHIBIT 26: **61% of the athletic market spend is in apparel...**



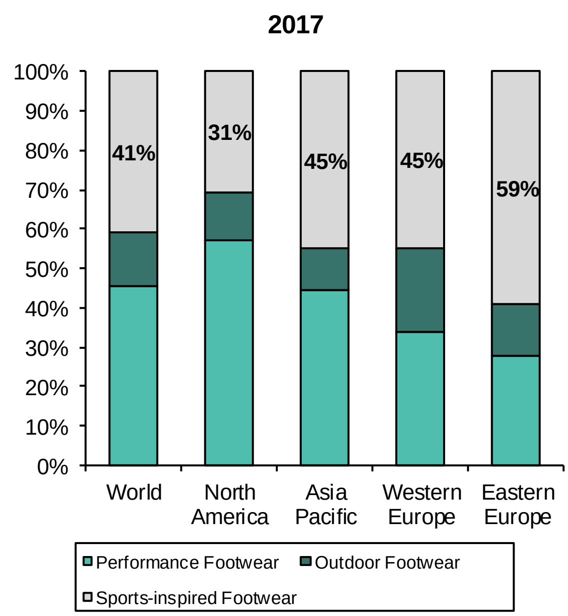
Source: Euromonitor and Bernstein analysis

EXHIBIT 27: **...with close to half of apparel spend on performance...**



Source: Euromonitor and Bernstein analysis

EXHIBIT 28: **...and a similar split in footwear**

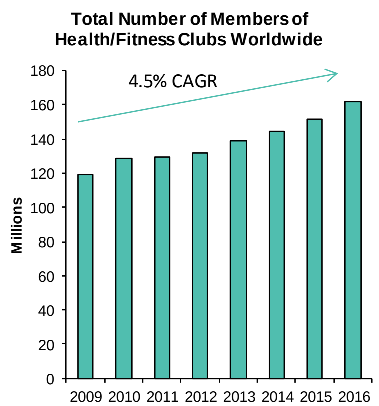


Source: Euromonitor and Bernstein analysis

HEALTH AND WELLNESS TRENDS SUPPORT FURTHER GROWTH INTERNATIONALLY

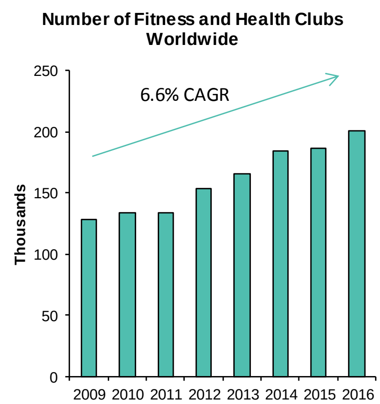
In North America, sports-inspired apparel and footwear growth have outstripped the market as the casualization of apparel and athleisure have helped drive the market. Globally, we believe that trends toward health and wellness will continue to support outsized growth of the athletic category, even if the rest of the world doesn't follow North America in wearing yoga pants to brunch. For example, the worldwide membership at health/fitness clubs increased at a 4.5% CAGR from 2009 to 2016 (see Exhibit 29). Over the same time, the number of health and fitness clubs have grown at an even higher rate of a 6.6% CAGR (see Exhibit 30). However, taking a closer look at health/fitness club membership by country shows that the US still constitutes the majority of gym memberships at 37% of the global total (see Exhibit 31).

EXHIBIT 29: **Worldwide health club membership has grown steadily...**



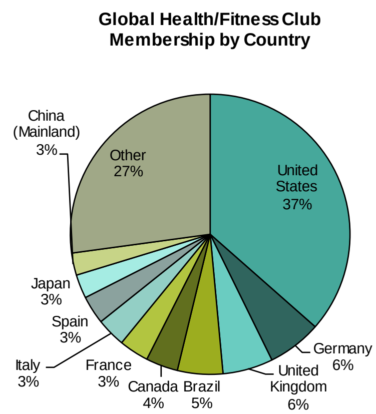
Source: International Health, Racquet & Sportsclub Association ("IHRSA"), Statista, and Bernstein analysis

EXHIBIT 30: **...as have the number of health and fitness clubs...**



Source: IHRSA, Statista, and Bernstein analysis

EXHIBIT 31: **...fitness club membership is dominated by the US**

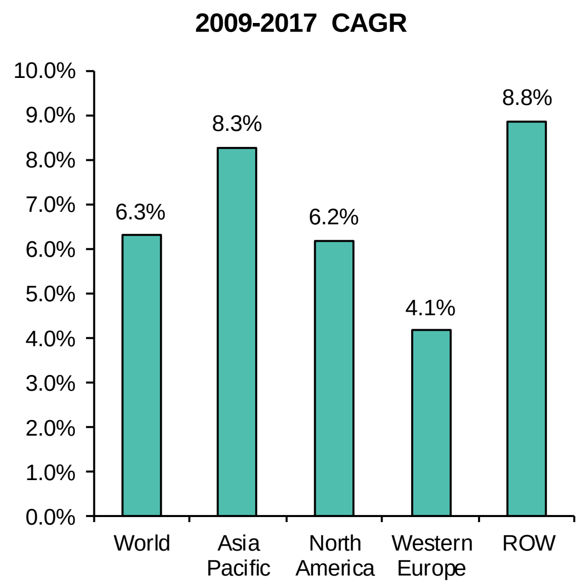


Source: IHRSA, Statista, and Bernstein analysis

International presents a growth opportunity for companies under coverage

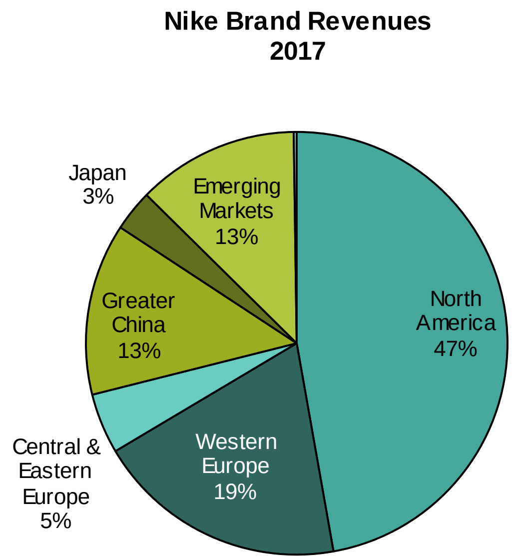
Between 2009 and 2017, the growth of athletic apparel was highest in Asia Pacific and other developing markets (see Exhibit 32) and we expect international growth in the category to continue to outstrip that of North America over time. For the companies under our coverage, Nike has the highest exposure to international markets — over 50% of its 2017 sales were generated outside North America (see Exhibit 33 to Exhibit 35).

EXHIBIT 32: **There is room for athletic wear to continue to grow its penetration in APAC**



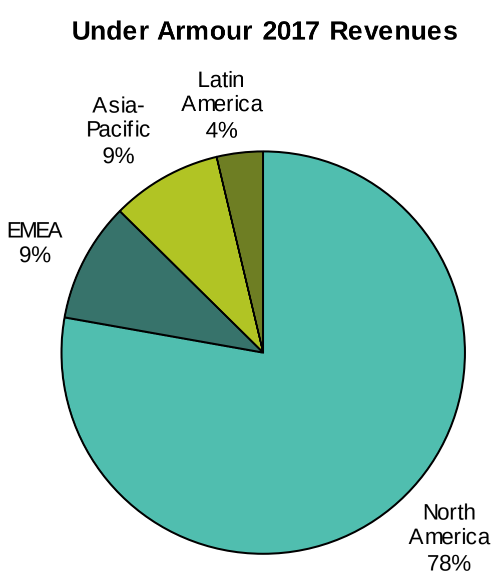
Source: Euromonitor and Bernstein analysis

EXHIBIT 33: **Over 50% of Nike's revenues are from outside North America**



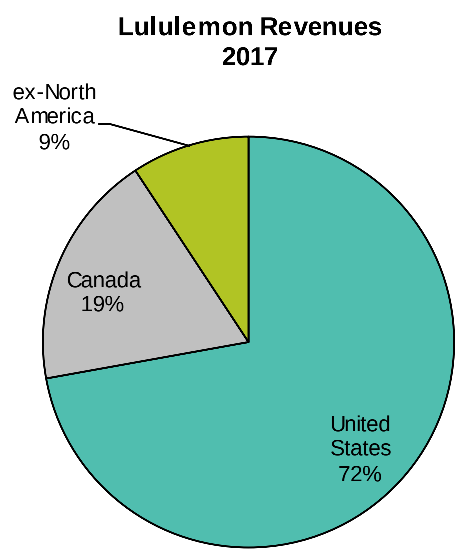
Source: Company reports and Bernstein analysis

EXHIBIT 34: **22% of Under Armour 2017 revenues were generated outside North America**



Source: Company reports and Bernstein analysis

EXHIBIT 35: **Only 9% of Lululemon 2017 revenues were from outside North America**



Source: Company reports and Bernstein analysis

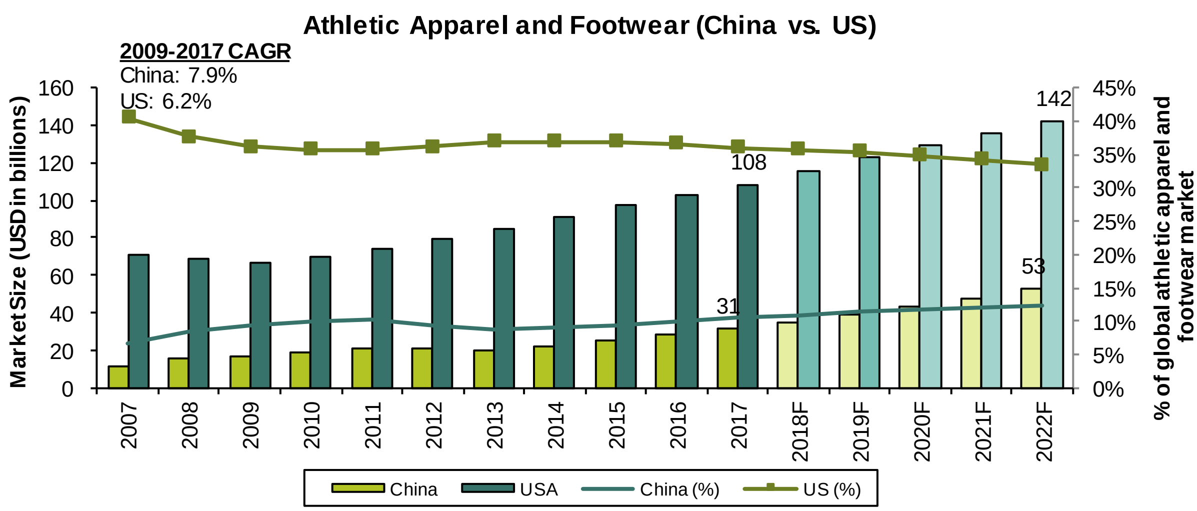
Brands are bullish about the China opportunity

Given the strong growth in the category in China, it's not surprising that athletic brands are focused on the opportunity. Nike has pointed to, for instance, the tremendous addressable market potential — projecting a consumer base that is more than 10 times larger than that of the North American primary consumer base of 50 million during its 2017 Investor Day. Under Armour, on the other hand, has ramped up its growth efforts in China since entering the market in 2010, opening hundreds of doors in the last year and intends to repeat it again this year. Lululemon has stated a combined revenue goal of $1B for China and Europe by 2020.

The brands' ambitions to grow in the market coincide with the new-found propensity to endorse health and wellness in the country. The State Council of China has stated a CNY5 trillion (US$813B) goal for the athletic industry by 2025 (compared to CNY1.5 trillion in 2016).[1] There is evidence of the increased interest in sports in the increase in the number of sports events. For instance, there were 328 marathons in 2016 with 2.8 million runners, up 85% versus 2015, according to *China Daily* and Fitch. Fitch also cited that the number of people using a private gym has increased 4-5 million each year since 2011.

At the category level, we continue to see opportunity for athletic apparel and footwear to take share in China. While the growth in the category has been robust at a 10% CAGR from 2007 to 2017, it is only a quarter of the US athletic apparel and footwear category in size (see Exhibit 36).

EXHIBIT 36: **While the Chinese athletic apparel and footwear industry is coming of age, it is still only around a quarter of the size of the US athletic apparel and footwear market**



Note: Market size based on nominal/current prices.

Source: Euromonitor historical data (2007-2017) and forecasts (2018-2022), and Bernstein analysis

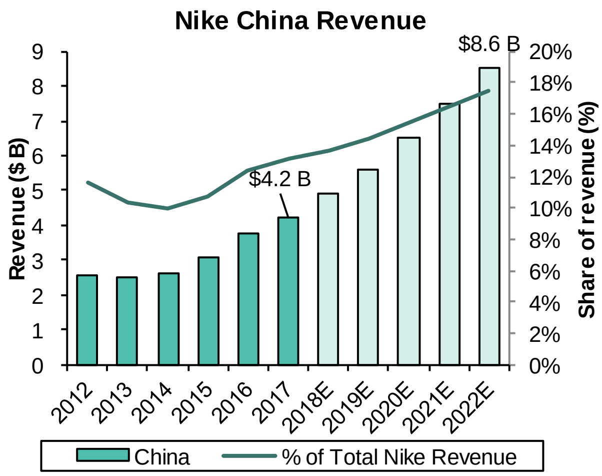
[1] China's sport sector could be the next big growth market

Nike: Nike has been a pioneer in the Chinese market, first building brand recognition in the country in the mid-90s by outfitting top Chinese athletes and sponsoring China's pro basketball league in 1995. In 2017, the Greater China segment was a $4.2B revenue business, constituting about 13% of Nike's revenue. We project that by 2022, Nike China will be at least twice its size today, and make up about 18% of total Nike revenues (see Exhibit 37). Nike is the number 1 apparel and footwear brand in China and the company's strategy in China is to help change the consumer lifestyle by inviting them into sport, doubling down on digital investments to better serve digital natives, and focusing on basketball — having recently launched its Jordan store on Tmall. Over the next five years, Nike is targeting a low- to mid-teens revenue growth rate in China. Constant-currency growth in China has averaged 21% over the last three years for Nike, and we expect growth of 16% in fiscal 2018 and for growth to average 16% in the next three fiscal years. While Nike is already the largest athletic brand in the market, we believe that product innovation and continued improvements in Nike's digital offering will continue to drive market share gains and growth. For example, Nike launched its SNKRS app in China in December 2017 and received two million downloads in the first month. Nike has yet to launch Nike+ membership in the country, and we expect it to help drive further customer loyalty and growth in the country.

Under Armour: Under Armour opened its first China store in Shanghai in April 2011 (concurrently launching its e-commerce business). While Under Armour does not disclose sales and profitability by country, APAC represented ~9% of revenue in 2017 (~$434M), having grown at an 83% CAGR since 2014 (see Exhibit 38). Under Armour lags its athletic apparel and footwear peers in market share in China at 0.3% in 2016, but is focused on growing its basketball business, most recently launching its latest Curry 4 sneakers in the Chinese market before dropping it in the US. In late 2016, Under Armour took back a license agreement in South Korea and began operating directly in the country. The company has not disclosed the impact of adding the South Korean business to 2017 growth, though Euromonitor estimates that South Korea is ~10% of the APAC market.

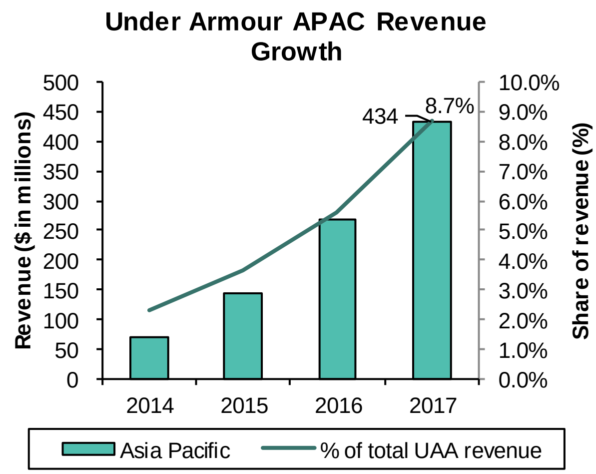
Lululemon: Lululemon established its first showroom in China in 2014 and has expanded to 11 stores in mainland China today (excluding one in Taipei and three in Hong Kong). Its Hong Kong IFC location produces over $5,000 in sales per square foot, though management believes that e-commerce could represent 40-50% of Lululemon's Chinese business over time. In 3Q 2017, Lululemon reported 450% Y-o-Y growth in the Chinese market, driven by new store productivity, as well as growth in its WeChat and Tmall business; during Singles Day in 2017, Lululemon tripled its business on the platform relative to last year.

EXHIBIT 37: **We expect Nike China to grow at an average of 16% CCY over the next three years**



Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 38: **Under Armour APAC revenue has increased at an 83% CAGR in 2014-17**



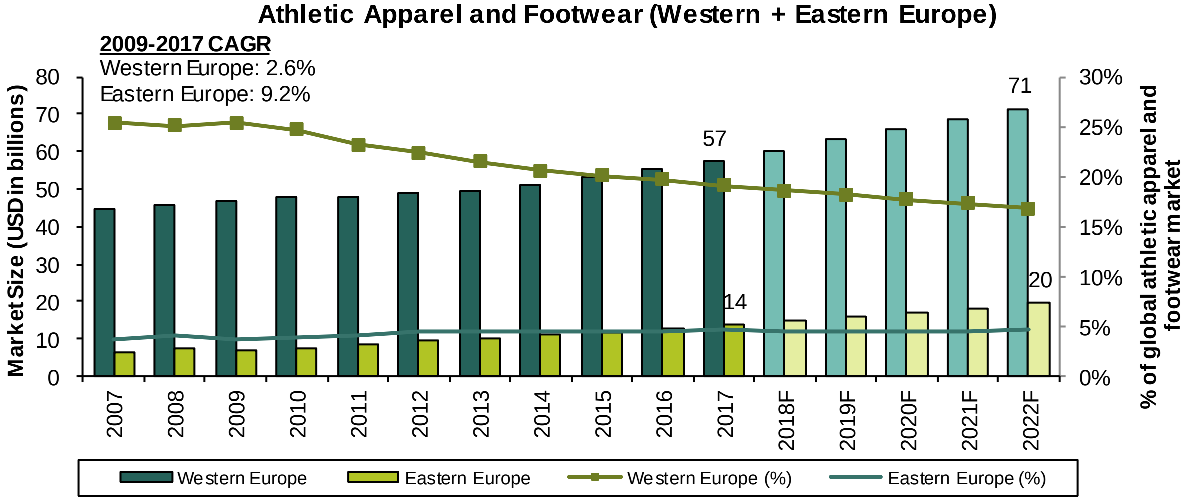
Note: Under Armour took back its South Korea distribution license in 2017.

Source: Company disclosures and Bernstein analysis

European opportunity

While the combined market value of both Western and Eastern Europe for athletic apparel and footwear was lower than that of the US in 2017, at 25% of the global market value of the category, Europe remains a key international market for athletic brands. Euromonitor expects Western Europe to continue to grow at a ~4.5% CAGR through 2022, while Eastern Europe is expected to grow at a faster rate; Eastern Europe has grown at a 9.2% CAGR from 2009 to 2017 and is expected to grow at a HSD 7.2% CAGR over the next five years as well (see Exhibit 39). Nike holds close to a 14% share of the Western Europe athletic apparel and footwear market; Under Armour only represents ~1% of the market, and Lululemon has not yet broken into the top ~60 brands in the region (see Exhibit 40).

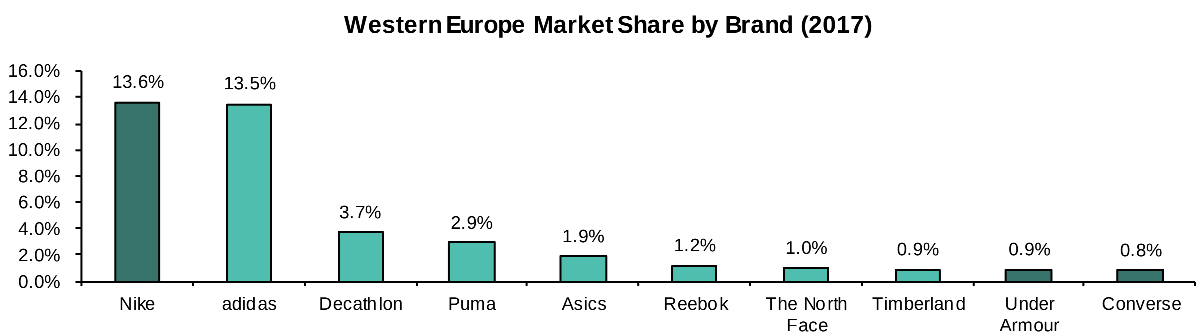
EXHIBIT 39: **While small, the Eastern Europe athletic apparel and footwear market has grown at a ~10% rate in 2009-17**



Note: Market size based on nominal/current prices.

Source: Euromonitor historical data (2007-2017) and forecasts (2018-2022), and Bernstein analysis

EXHIBIT 40: **While Nike already holds the #1 position by market share in Western Europe, Under Armour and Lululemon have low levels of share**



Source: Euromonitor and Bernstein analysis

Nike: In Western Europe, constant-currency growth at Nike averaged 15% over the last three years, and in Central and Eastern Europe, growth averaged 13%. We forecast constant-currency growth of 10% in EMEA this year and an average of 8% over the next three years (see Exhibit 41). Nike has seen strong results from its Express Lane strategy in Europe, aimed at targeting specific products to key cities faster, in order to capture current trends. In addition, digital efforts in EMEA have been led by a combination of nike.com as well as the company's partnership with Zalando, focusing on presenting a curated assortment to the "style and fit-obsessed" as it partners with Zalando's inventory sharing program.

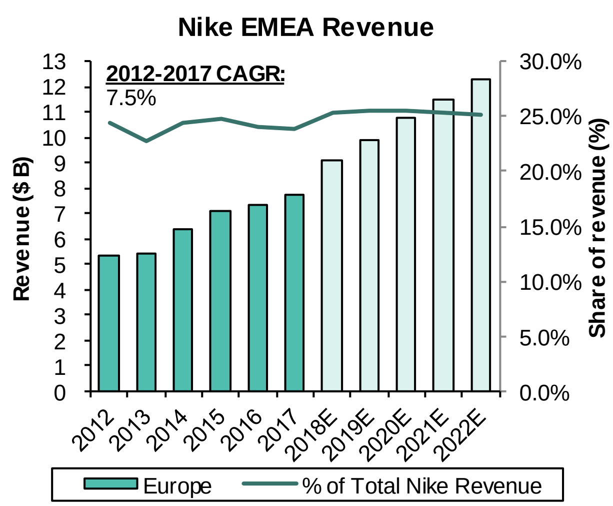
Under Armour: EMEA represents Under Armour's biggest region by revenue outside of North America and Under Armour's three key markets, the UK, Germany, and France, represent over 70% of the sales in the region (in line with these countries' economic representation in the region overall). Revenue in the region has grown at a 52% CAGR over the last three years and grew at 42% in 2017 (see Exhibit 42).

Under Armour has recently shifted to more of a DTC focus in its regional strategy after previously prioritizing both DTC and wholesale growth. Comparing Under Armour's presence in top athletic retailers in Europe to that of Nike, adidas, and Puma suggests that the brand is present at most of the wholesale distributors, though the breadth of product is more limited (see Exhibit 43). This suggests that for Under Armour to grow share through wholesale, the company will need to drive sell through and product breadth, as the first steps of increasing distribution to key partners has already been done.

Lululemon: As part of Lululemon's 2020 vision to reach $4B in revenue, international growth was cited as a key lever. Management expects international (everything excluding North America) to deliver $1B in revenue (25% of total) by 2020. Between 2014 and 2017, Lululemon grew its European physical footprint by ~4 doors each year and, combined with APAC, on average Lululemon has added ~10 stores each year internationally since 2014, or on average $30M each year in ex-NA revenues (see Exhibit 44 and Exhibit 45). That said, in 2017, international sales were just $246M or 9% of total sales.

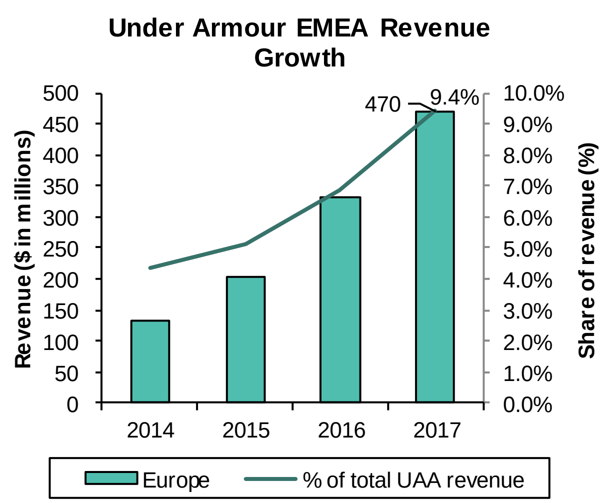
While management has cited tremendous growth in its key international markets, reporting most recently in 4Q 2017 a 42% growth in Europe, unless the company dramatically increases its pace of store openings, we do not expect the company to meet its goal of $1B in sales or 25% of revenue by 2020.

EXHIBIT 41: **Nike EMEA revenue grew at an ~8% CAGR in the last five years**



Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 42: **Under Armour EMEA revenue has increased at a 52% CAGR in 2014-16**



Source: Company disclosures and Bernstein analysis

EXHIBIT 43: **Across top sports retailers, Under Armour represents less than 10% of the total products listed in the UK**

Country- UK	**Number of Products Listed at Retailers**				
Retailers	**Sports Direct**	**Zalando**	**JD Sports**	**Littlewoods**	**Decathlon**
Under Armour	**1,314**	**754**	**316**	**141**	**0**
Nike	5,179	4,984	2,268	1,298	172
adidas	1,446	4,906	2,248	1,502	248
Puma	2,023	1,598	475	249	71
Total	11,276	12,242	5,702	3,331	491
% of total					
Under Armour	12%	6%	6%	4%	0%
Nike	46%	41%	40%	39%	35%
adidas	13%	40%	39%	45%	51%
Puma	18%	13%	8%	7%	14%

Source: Company websites and Bernstein analysis

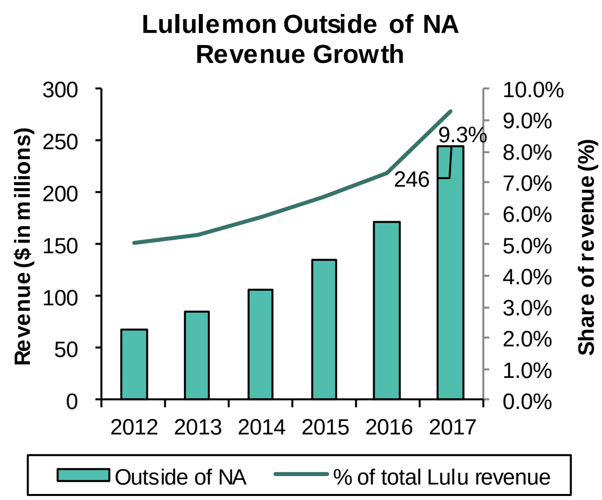
EXHIBIT 44: **Lululemon's Europe + APAC store expansion has been ~10 stores each year since 2014**

	2014	**2015**	**2016**	**2017**
Europe				
United Kingdom	2	6	9	9
Germany		1	1	2
Switzerland			1	1
Ireland				1
Store Count	**2**	**7**	**11**	**13**
Net Increase		*5*	*4*	*2*
APAC				
Australia	26	26	27	28
New Zealand	5	5	5	6
China			3	15
Hong Kong		2	3	0
Singapore	1	2	3	3
South Korea			2	3
Ireland				1
Taiwan				0
Store Count	**32**	**35**	**43**	**56**
Net Increase		*3*	*8*	*13*

Note: As of 4Q 2017, China includes one store in Taiwan and three stores in Hong Kong.

Source: Company disclosures and Bernstein analysis

EXHIBIT 45: **...yet Lululemon ex-NA revenue grew at a 29% CAGR in the last five years**



Source: Company disclosures and Bernstein analysis

REGIONAL PROFITABILITY

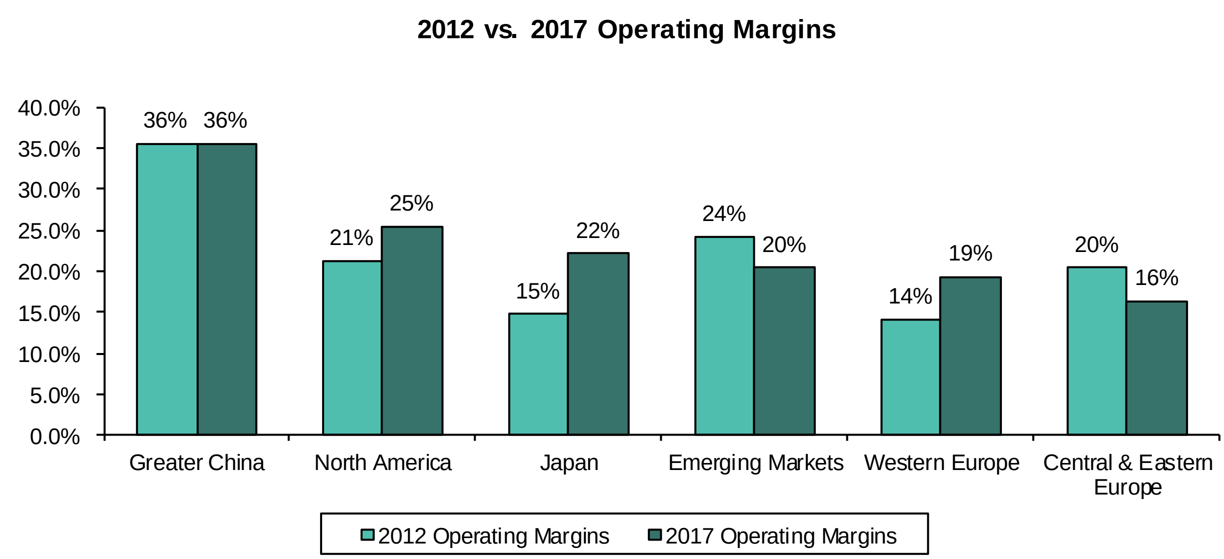
Nike: Greater China is Nike's highest profitability region, followed by North America, Japan, Emerging Markets, and finally Western and Eastern Europe (see Exhibit 46). As we expect that international growth will continue to outpace North American growth for Nike, and as Nike transitions from a wholesale to a more Direct-to-Consumer model, we believe that Nike will continue to improve its operating profitability in North America and other international regions over time.

Under Armour: At Under Armour, APAC also represents its highest operating margin region. At 19% in 2017, however, it is roughly half of Nike's Greater China operating margin, and we believe that profitability is driven by the company's license agreement in Japan (see Exhibit 47). Historically, APAC has offset all operating losses from EMEA and Latin America for Under Armour. Latin America has been a drag on operating profit since 2014, despite having improved over time. While EMEA is a higher revenue region than APAC, the region's profit contribution is much lower, despite having improved from negative to positive territory since 2014.

Today APAC continues to make up the majority of Under Armour's international profitability. We believe that two unique factors have contributed to Under Armour's success in the region. Frist, Under Armour benefits from its long-standing license agreement (20 years) with Dome in Japan. Second, Under Armour took back its South Korean distribution license in late 2016 and, as revenues are booked directly, Under Armour has seen a boost to its APAC revenue, but at a lower margin. As Under Armour anniversaries its South Korean distribution license, we expect revenues to grow at a more moderate rate in APAC and for margins to stabilize in the high teens.

Lululemon: Lululemon is still very much in the early stages of growth internationally and has not disclosed profitability of the region in detail, but has suggested that the company will break even in APAC, including Australia, in the near term and that it is somewhat further behind in Europe.

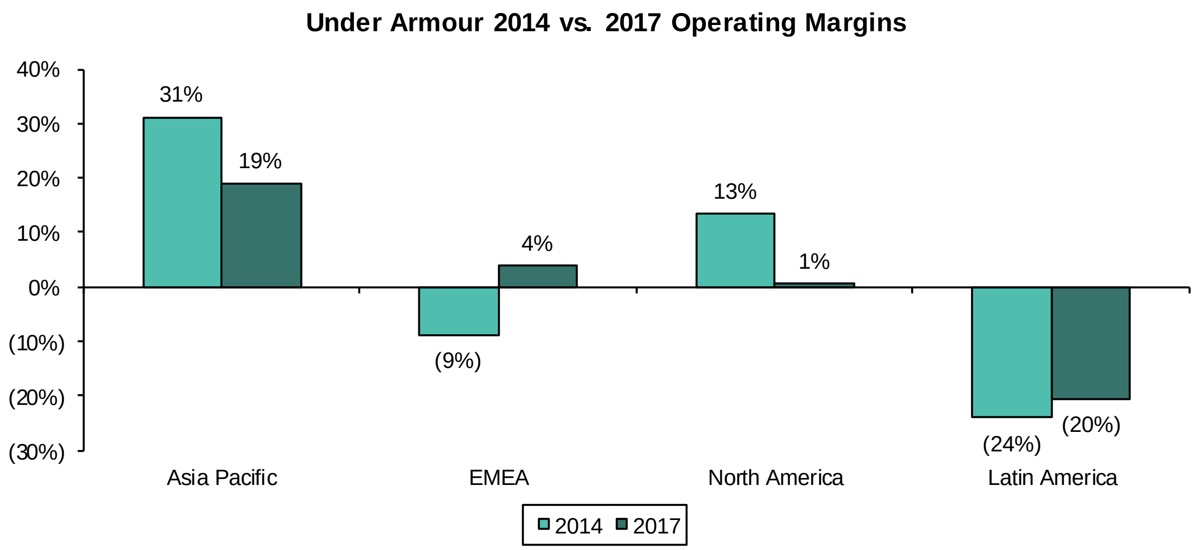
EXHIBIT 46: **For Nike, Greater China has the highest operating margin**



Note: Nike has changed its reporting segments into North America, Greater China, EMEA, and Asia Pacific and Latin America as of FQ1 2018.

Source: Company disclosures and Bernstein analysis

EXHIBIT 47: **Between 2014 and 2017, Under Armour's operating margins have deteriorated in both APAC and North America**



Source: Company disclosures and Bernstein analysis

AN "A" REPORT CARD ON NIKE'S PRODUCT PIPELINE

Innovation dominance continues

OVERVIEW

One of Nike's goals is to increase innovation. In this chapter, we examine the innovation pipeline and what (early) evidence we can find of product traction. We reach four conclusions:

- VaporMax has ramped up strongly and is now surpassing Ultra Boost in terms of search volume. We believe this is Nike's highest volume new innovation and see good signs of traction for the product.

- While it's early days, comparing the ramp of Ultra Boost over the long term versus the initial interest in the Epic React suggests strong relative interest in React. In addition, React has been stocking out quickly and is selling at a premium in secondary markets, again suggesting momentum behind the platform.

- On the lifestyle front, while it's not a new product, Nike has reinvigorated Air Max 97. Air Max 97 outperforms other lifestyle sneakers such as Superstar, Stan Smith, Gazelle, and Vans Old Skool in Google search. The fashion-linked Silver Bullet, Gold Metallic, and Off-White collaboration seem to be the most popular styles.

- On the other hand, the Zoom Vaporfly 4% has been less visible in terms of search momentum and supply remains very limited, both at retail and in the aftermarket. We expect that lower product heat is due to a combination of limited distribution and a more specialist customer for Vaporfly and, hence, less scalability to the mass market to date.

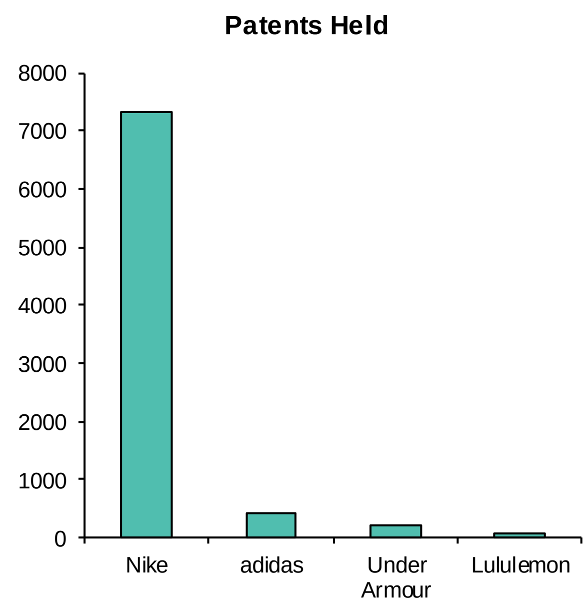
NIKE'S LONG TRACK RECORD OF INNOVATION

One of Nike's goals is to increase innovation. In this chapter, we examine the innovation pipeline and what (early) evidence we can find of product traction.

Nike has a long track record of innovation, investing heavily in consumers' and athletes' insights at Nike Sport Research Lab in the innovative process — where work on biomechanics, exercise physiology, engineering, and industrial design takes place, alongside regular consultations with athletes, coaches, trainers, and doctors as they test out designs, materials, and concepts. With this investment, Nike has built up a library of patents far greater than its athletic-wear peers at over 7,000 patents, whereas the second most number of patents held is ~430 by adidas, about 1/17th of the patents held by Nike. Globally, Nike also leads in the number of patents held relative to its peers at approximately 8x that of adidas (which is still a staggeringly high number relative to peers).

Furthermore, Nike has outspent its competitors in capex consistently since 2011; in 2017, Nike spent 30% more in capex compared to the next biggest capex spender, adidas, at $1.1B (see Exhibit 48 and Exhibit 49).

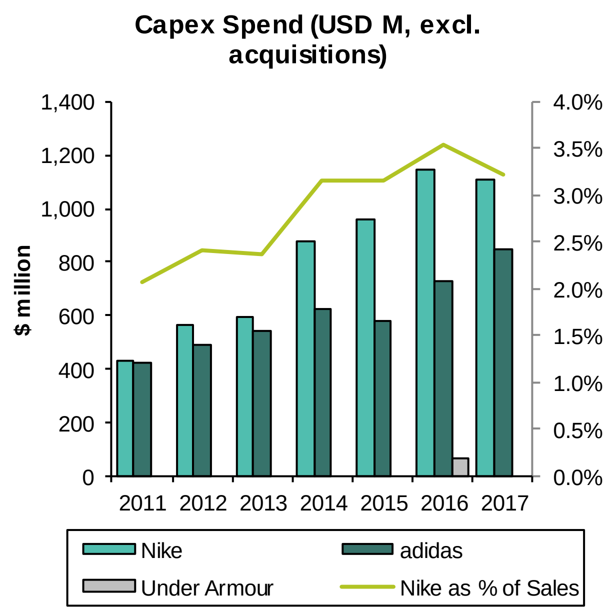
EXHIBIT 48: **Nike holds the most number of patents relative to peers**



Note: Based on number of patents assigned from 1976 through March 13, 2018.

Source: US Patent and Trademark Office, company reports, and Bernstein analysis

EXHIBIT 49: **Nike has spent more in capex compared to competitors**



Note: Adidas' figures converted to USD at current spot rates.

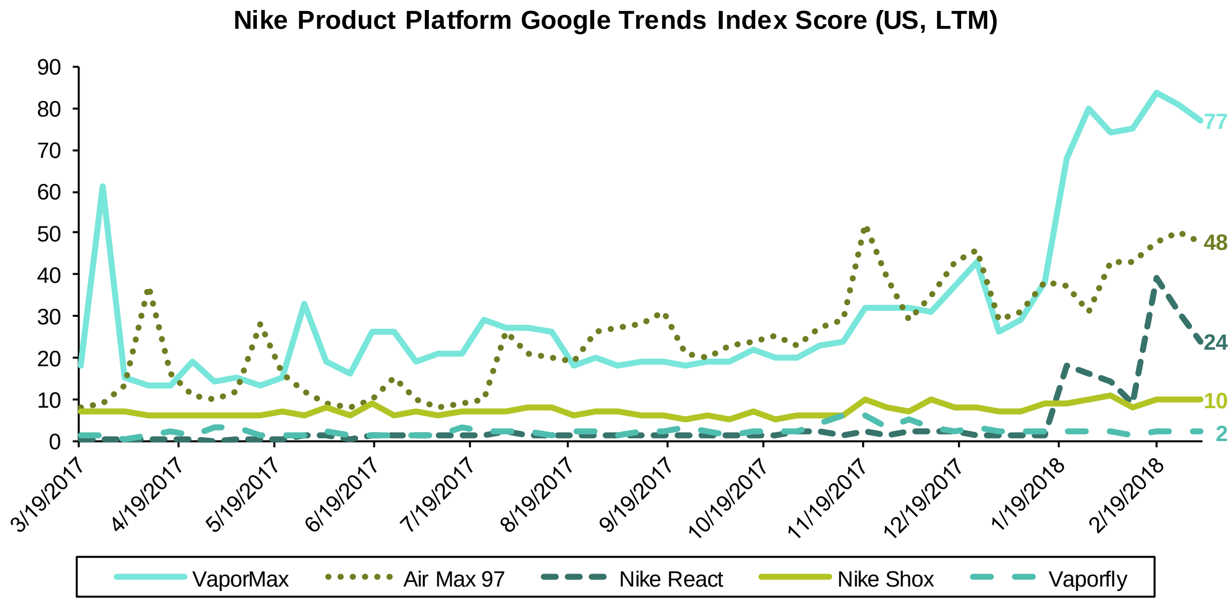
Source: Company reports and Bernstein analysis

PRODUCT PLATFORMS

True to its 2x speed mandate, Nike has been delivering on innovation at a rapid rate, rolling out several new product platforms over the last 12 months, while building on its existing platforms. While retailers such as Dick's Sporting Goods and Foot Locker have talked about an exciting pipeline of innovation from Nike, we wanted to see what evidence there is of early success. One of the key tools for consumer sentiment comes from Google Trends, and we used this to measure traction for the Zoom Vaporfly 4%, Air Max 97, React, Shox Gravity, and VaporMax (see Exhibit 50). According to the indexed scores, VaporMax is the clear outperformer in the group, followed by Air Max 97. VaporMax was launched by Nike in spring 2017, but has been ramping up steadily since then in terms of supply and consumer engagement. While the Air Max 97 is not a new shoe, Nike has taken steps with particular colorways to boost interest among the fashion influencer set and this seems to be yielding increased demand.

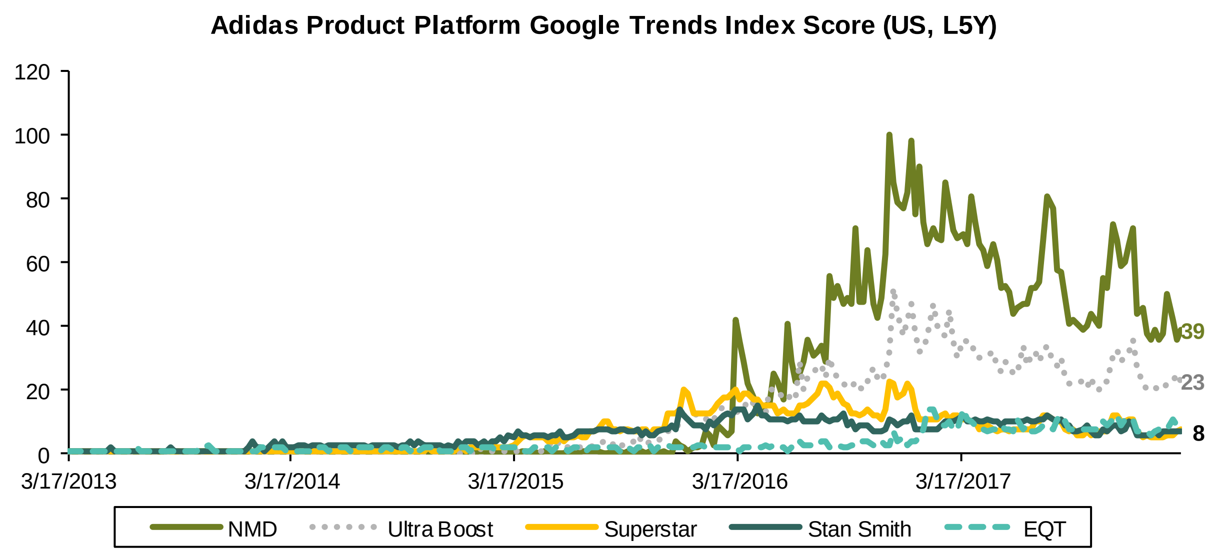
Given the strength of the adidas brand in recent years, we also looked at Google Trends for momentum in adidas' key platforms: in particular, the NMD, Ultra Boost, EQT, Stan Smith, and Superstar. While the classic Stan Smith and Superstar helped to drive adidas' resurgence, their Google search volume was dwarfed by the modern NMD and Ultra Boost. Interest levels in the NMD and Ultra Boost product platforms peaked in 2016 (see Exhibit 51).

EXHIBIT 50: **VaporMax has gotten the most traction over the last 12 months**



Source: Google Trends and Bernstein analysis

EXHIBIT 51: **Over the last five years, the most dominant adidas product platforms in terms of search volume are NMD and the Ultra Boost**



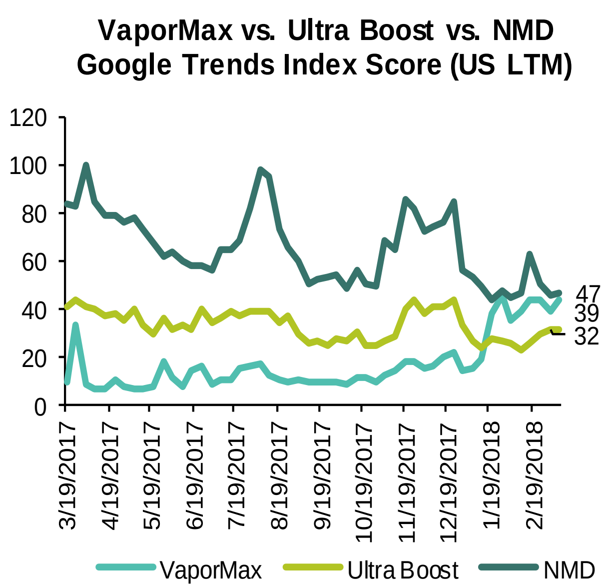
Source: Google Trends and Bernstein analysis

VaporMax

Nike stated during its 2017 Investor Day that it anticipates growing the entire Air business by several billion dollars over the next few years. VaporMax is Nike's newest Air platform. After launching through Nike.com in early 2017, VaporMax ramped up with wholesale retailers and in new colorways across 2017 and into 2018. Nike suggested on its 1Q 2018 earnings call that VaporMax had already become the number one selling shoe in the over $150 price point. This is consistent with Google Trends data, which showed that the shoe overtook adidas' Ultra Boost for the first time in January 2018 and is close to catching up with adidas' fashion-focused NMD (see Exhibit 52).

Beyond Google Trends, we also looked at StockX, a secondary market for sneaker resales and transactions, where buyers are able to get their hands on limited edition collaborations and/or sold-out products, colorways, or sizes. We found 250 listings for VaporMax products; we took 10% of the listing as a sample (see Exhibit 53). Overall, the Off-White collaboration saw the greatest number of transactions (1,710) and commanded the highest premiums. Overall, VaporMax was for sale with an average premium over listed retail price of 77% (29% excluding the VaporMax + Off-White collaboration). Only two of the 20 versions we looked at had average sales prices below the listed retail price, the Midnight Fog and Violet Dust.

EXHIBIT 52: **In January 2018, VaporMax overtook Ultra Boost for the first time**



Source: Google Trends and Bernstein analysis

EXHIBIT 53: **On average, VaporMax transacted at $364 or a 77% price premium to weighted average retail value**

Color	# of Sales	Price Premium	Average Sale Price
Off White	1,710	218.8%	$797
Off White 2018	197	235.6%	$839
Off White Black	27	234.4%	$836
Triple Black 2.0	1,595	24.2%	$236
Pure Platinum/OG	1,469	28.9%	$245
Asphalt	1,169	29.5%	$246
Triple Black 3.0	814	12.6%	$214
Be True 2017	392	58.5%	$317
Plus Bleached Aqua (W)	358	54.7%	$294
Plus White	287	22.6%	$233
Plus Triple Black	265	12.1%	$213
Pale Grey	189	43.7%	$273
Glacier Blue	154	22.6%	$233
Cargo Khaki	150	30.0%	$247
CDG White	145	56.1%	$515
Dark Team Red	142	0.5%	$191
Marc Newson	117	38.2%	$380
Be True 2017 (W)	107	63.0%	$326
Violet Dust (W)	57	(0.5%)	$189
Black Hot Punch 2.0	38	16.3%	$221
Midnight Fog	28	(12.6%)	$166
Black Mineral Gold	13	2.6%	$195
White Ice (W)	5	41.6%	$269
Black Hot Punch 2.0 W	1	4.2%	$198
Metallic Blue Fox	1	7.9%	$205
Total	**9,430**		
Average (Assuming weighted average retail price of $206)		**76.8%**	**$364**

Note: Data collected between February 22, 2018 and March 14, 2018. Average premium based on the weighted average price over the weighted average retail price.

Source: StockX and Bernstein analysis

Epic React

The Epic React is one of the key running product platforms that Nike launched this spring (2018), with a promise to deliver a better combination of energy return and durability than anything else in the marketplace. From a technology perspective, the React was digitally fine-tuned in a process that Nike refers to as "Quantum Craft," which enables Nike to run through thousands of iterations of athletic data from runners logging over 17,000 miles of data in one-third the time.

So far, React has garnered positive reviews across the board, ranging from sneaker fans[2] to mainstream media,[3] but to get a better sense of the relative performance of React, we again look to Google Trends (see Exhibit 54 and Exhibit 55). While total search volume for React still lags that of its largest competitor Ultra Boost, the product has ramped quickly in terms of interest, suggesting that its lower price point ($150 versus $180 for Ultra Boost) and soft cushioning characteristics are generating demand.

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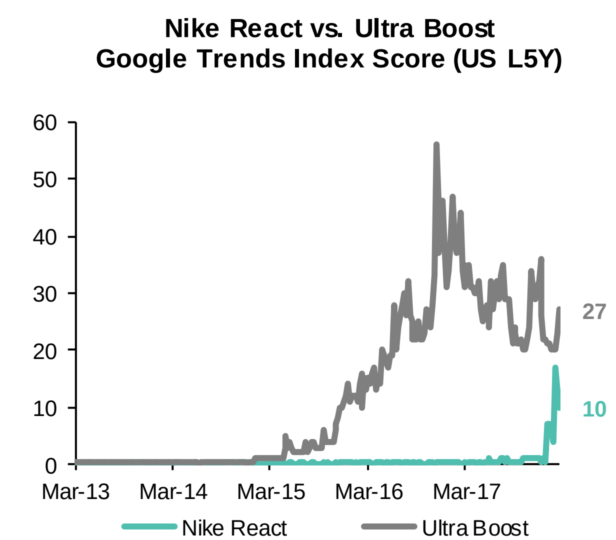
[2] Why the Nike Epic React Flyknit Is a Sneaker for All Athletes

[3] Nike's new running shoes that have more bounce than ever totally exceeded my expectations — here's what working out in them is like

Indeed, using our proprietary analysis in conjunction with WGSN data, we see evidence that Epic React is also selling through at a rapid rate (see Exhibit 56 and Exhibit 57). On average, the Reacts stocked out in the most common sizes for men and women within five days, compared to the VaporMax, which stocked out within ~20 days when it was first launched with limited wholesale partners last summer. We also see evidence of robust sell-through at different retailers, 33% of both men's and women's Reacts stocked out at Foot Locker, in addition to 50% that stocked out at Bandier for women's Reacts, once again, demonstrating the mass market appeal of the shoe. While some colorways are available at various retailers, Nike has completely stocked out of Epic React for men through its own site, again suggesting that customers go to Nike.com first for new innovation and products.

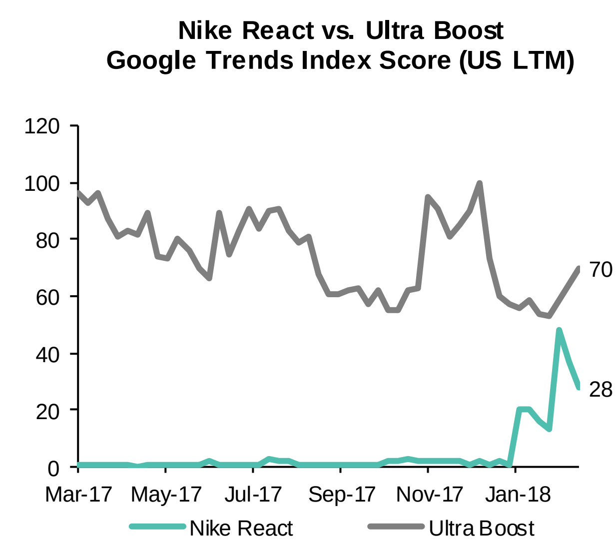
According to StockX, since Epic React was released on February 22, there have been 1,095 pairs transacted on the exchange, and on average at a ~25% premium to the retail price of $150 (see Exhibit 58). The positive momentum in Google Trends, in addition to the stock-outs at various retailers within a short span of time gives us confidence that React has more room to grow as the product becomes more broadly distributed in the marketplace.

EXHIBIT 54: **Ultra Boost began ramping in 2015, peaking a year later**



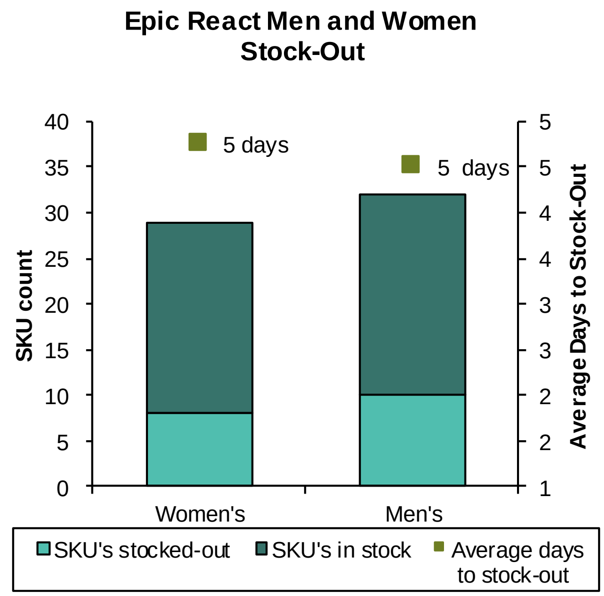
Source: Google Trends and Bernstein analysis

EXHIBIT 55: **Over the last month, the interest in React has increased significantly**



Source: Google Trends and Bernstein analysis

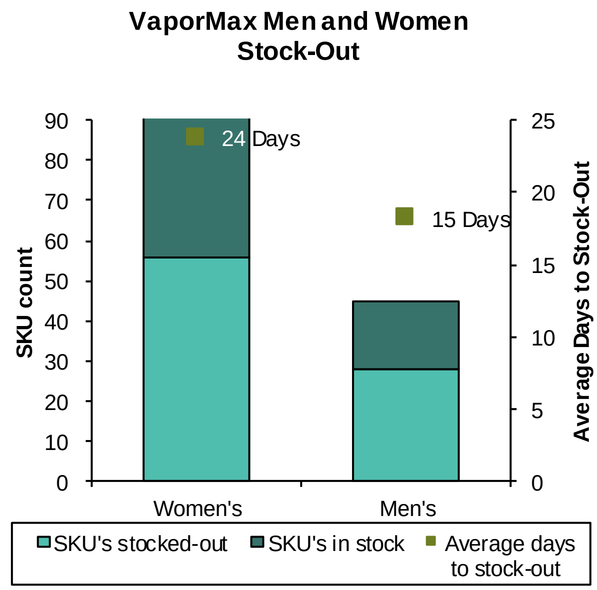
EXHIBIT 56: **Epic React on average stocked-out within five days in the most common sizes...**



Note: Data collected between February 22, 2018 and March 13, 2018.

Source: WGSN and Bernstein analysis

EXHIBIT 57: **...compared with VaporMax, which stocked out within ~20 days**



Note: Data collected between March 28, 2017 and September 13, 2017.

Source: WGSN and Bernstein analysis

EXHIBIT 58: **According to StockX, 1,095 pairs of Reacts have been transacted on the exchange since its release on February 22, on average at a ~26% premium to retail price**

Color	# of Sales	Price Premium	Average Sale Price
Black Racer Blue	321	26.0%	$189
White Racer Blue Pink Blast	269	28.7%	$193
White Racer Blue	268	31.3%	$197
College Navy	166	16.7%	$175
Black Dark Grey	29	9.3%	$164
Wolf Grey	19	10.7%	$166
White Racer Blue Pink Blast (W)	8	19.3%	$179
Black Racer Blue (W)	7	15.3%	$173
White Racer Blue (W)	6	24.7%	$187
College Navy (W)	1	(20.0%)	$120
Black Dark Grey (W)	1	(6.7%)	$140
Total	**1,095**		
Average (Assuming weighted average retail price of $150)		**25.6%**	**$188**

Note: Data collected between February 22, 2018 and March 14, 2018. Average premium based on the weighted average price over the weighted average retail price.

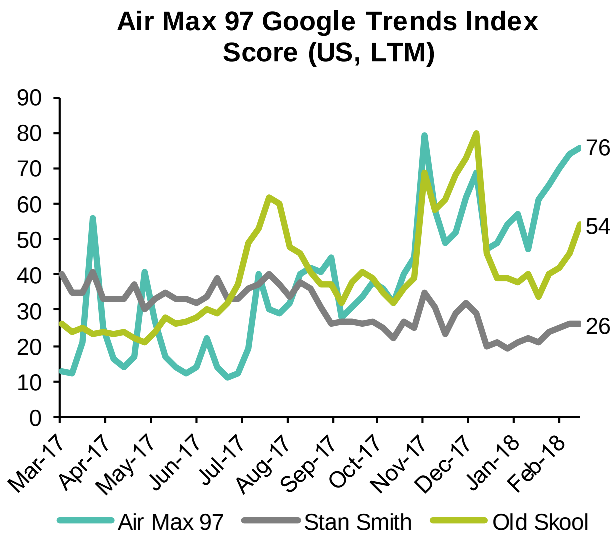
Source: StockX and Bernstein analysis

Air Max 97

Another key product in the Air platform is Air Max 97, which has quickly become a fashion-insider favorite — emerging as Nike's flagship "athleisure" shoe. While the technology itself was not innovative in the Air Max 97, the company employed strategies of scarcity and seeding with fashion elites in order to build momentum in the product. To make sure that it wasn't just the hype, we looked to Google Trends and saw that Air Max 97 overtook both Vans Old Skool and the Stan Smith in the last 12 months in search volume (see Exhibit 59).

When we looked for Air Max 97 on StockX, we were surprised to see over 100 different styles listed on the platform (we show a sample of the total listing in Exhibit 60); the variety of products was also consistent on Goat, another secondary sneaker exchange marketplace. Digging further, in our limited sample size, we saw that ~12,000 pairs have transacted on the platform over the last 12 months, and on average at a 66% premium based on the calculated weighted average retail price per pair of Air Max 97 at $170 in our sample size (see Exhibit 60). The regular colorways do not tend to trade at a premium on StockX. However, the collaborations and special edition releases trade at a high average price. The Off-white collaboration, for instance, transacted at $572 per pair on the exchange, whereas its retail price was $190, illustrating the fact that successful collaborations/unique designers have an outsized impact on the sneaker value in the aftermarket. In addition to the Off-White collaboration, we were interested to see that the fashion-focused "Silver Bullet" style and the Metallic Gold versions were the two styles traded in the highest volumes and at significant premiums to retail.

EXHIBIT 59: **Air Max 97 has taken over both Stan Smith and Vans Old Skool in the LTM...**



Source: Google Trends and Bernstein analysis

EXHIBIT 60: **Based on a sample of over 100 Air Max 97s that showed up in our search —over 12,000 pairs have transacted on the exchange in the last 12 months**

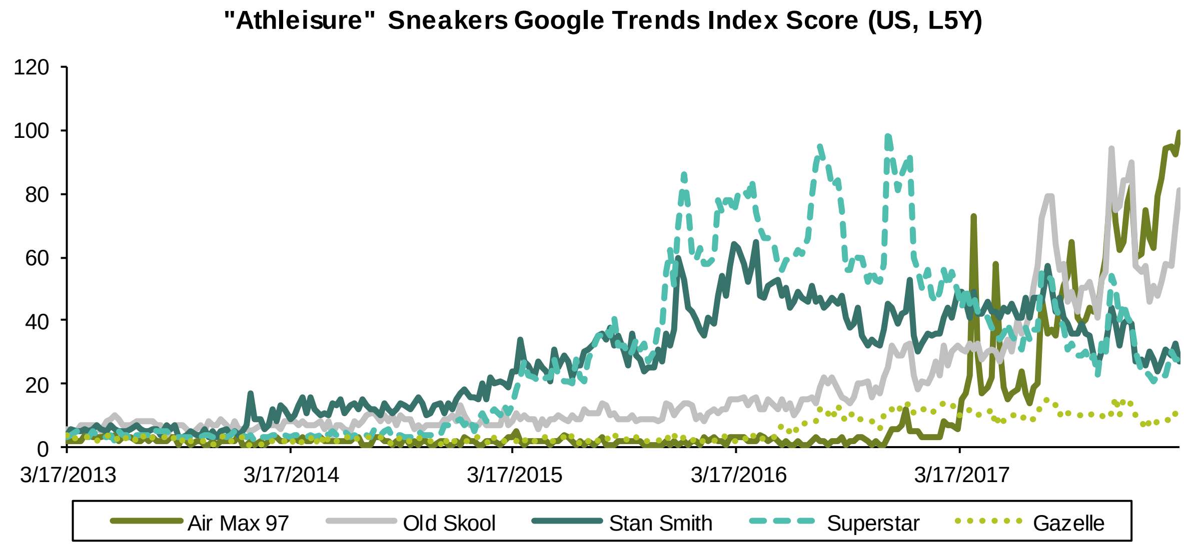
Color	# of Sales	Price Premium	Average Sale Price
Silver Bullet (2016/2017)	5,778	45.3%	$247
Metallic Gold (2017)	2,188	76.9%	$283
Off-White	1,468	201.1%	$572
Silver Bullet (2016/2017) (W)	412	5.7%	$185
Summit White	333	28.8%	$219
Particle Beige	296	19.4%	$203
Black Reflective Gold	216	23.8%	$198
Metallic Gold (2017) (W)	170	41.3%	$226
Silver Bullet (2016/2017) (GS)	156	15.3%	$173
Metallic Gold (Italy)	141	61.3%	$258
White Wolf Grey	133	10.0%	$176
Metallic Hematite	85	20.6%	$193
Midnight Navy Metallic Gold	79	0.6%	$161
Black White	66	3.1%	$165
Marina Blue (W)	64	15.6%	$185
Obsidian	53	(0.6%)	$159
Cobblestone	53	2.9%	$175
Light Pumice	50	(8.2%)	$156
Wolf Grey	49	7.1%	$182
Silt Red (W)	37	32.9%	$226
Light Bone	35	(7.1%)	$158
Bronze	35	16.3%	$186
Pull Tab Brown	28	42.4%	$242
Wool Cool Grey Mushroom	16	(7.1%)	$158
Black Dark Grey (W)	5	31.9%	$211
Wool Thunder Blue	5	(14.1%)	$146
Wool Sequoia	4	(31.8%)	$116
Bordeaux (W)	3	(21.8%)	$133
Metallic Leather Black (W)	2	(1.2%)	$168
True Baroque Brown	2		$273
Silver Bullet (2013)	2		$221
Metallic Gold (2010)	2	79.3%	$260
Cobblestone (W)	1	0.0%	$170
Neon (W)	1	36.9%	$219
Total	**11,968**		
Average (Assuming weighted average retail price of $170)		**66.3%**	**$283**

Note: Data collected between February 22, 2018 and March 14, 2018. Average premium based on the weighted average price over the weighted average retail price.

Source: StockX and Bernstein analysis

Aside from Air Max 97, the only non-performance sneaker that has continued to gain momentum in search volume on a 12-month rolling basis is the Vans Old Skool. From Google Trends, we see that, aside from Old Skool, the adidas Stan Smith, Gazelle, and Superstar have all seen decelerating growth — this trend is especially pronounced for the Superstar (see Exhibit 61).

EXHIBIT 61: **Air Max out performs all other "athleisure" sneakers**



Source: Google Trends and Bernstein analysis

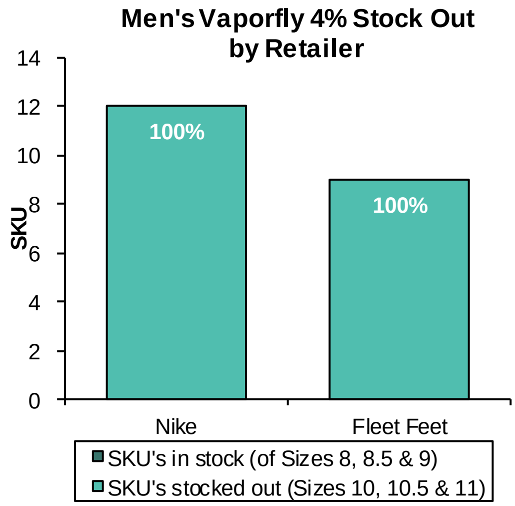
ZoomX

The Nike ZoomX is another platform that Nike highlighted during its 2017 Investor Day. The Zoom platform is capable of delivering up to 85% energy return, and Nike claims that it is by far the most responsive cushioning system it has ever developed — dedicated to pure speed and energy return. This year, Nike began to scale the Zoom with new versions of the Pegasus shoe (currently Nike's most popular running shoes), which is currently listed as the second-most popular running shoe on RunRepeat.com for March 2018. However, the most innovative product offering within the ZoomX line is the Zoom Vaporfly 4%, utilizing a ZoomX midsole (for responsive cushioning) as well as a full-length carbon foot plate (intended to minimize energy loss during toe bend without increasing demand for the calf). The 4% shoe aims to make runners up to 4% more efficient than Nike's previous fastest marathon shoe; it was launched in June 2017 and retails at $250 per pair.

As of our date of analysis (mid-March 2018), we did not see any Zoom Vaporfly 4% in stock at either Nike, Footlocker.com, or Finishline (with the exception of a men's size 4 or 5.5).

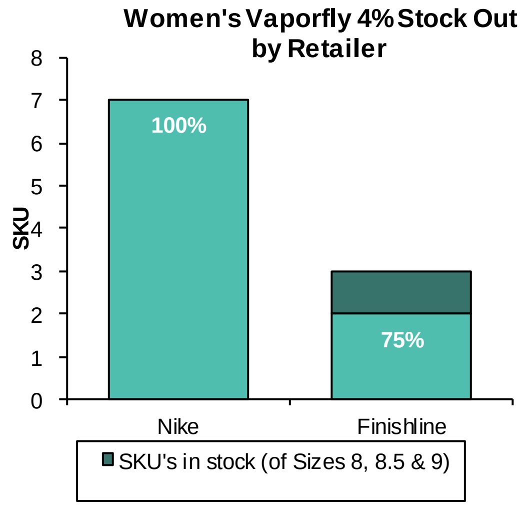
Based on our proprietary stock-out analysis, we see evidence that 100% of men's sizes in 10, 10.5, and 11 had stocked out at Fleet Feet almost immediately (see Exhibit 62). The same trend was evident in women's Vaporfly 4%, 100% of sizes 8, 8.5, and 9 stocked out at Nike.com, and 75% of them stocked out at Finishline (see Exhibit 63); the average period before stock out for both men and women is ~2 days (see Exhibit 64). Further, we looked at the secondary market for Vaporfly 4% and find that close to 700 pairs have transacted on the exchange at a ~30% premium (see Exhibit 65). Considering the technology behind the shoe has been released since 2017, the transaction volume seems to imply that distribution is limited. This is especially pronounced in the $600 retail value Vaporfly Elite, of which only 11 pairs have transacted since hitting the exchange on September 22, 2017. Further, the traded value of the Elite has appreciated 50% since its release. Taken together, the data points to the fact that the Zoom Vaporfly 4% is a coveted shoe not in wide circulation to date.

EXHIBIT 62: **100% of Vaporfly 4% in sizes 10, 10.5, and 11 stocked out at both Nike and Fleet Feet...**



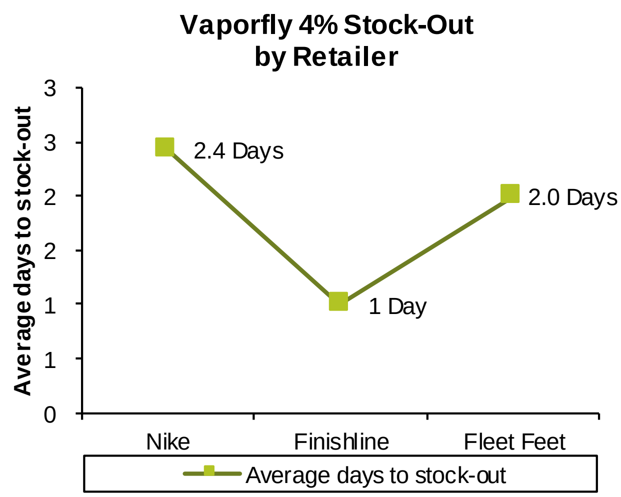
Source: WGSN and Bernstein analysis

EXHIBIT 63: **...and 90% of Vaporfly in Women's sizes 8, 8.5, and 9 stocked out overall**



Source: WGSN and Bernstein analysis

EXHIBIT 64: **On average, both men's and women's Vaporfly stocked out in two days**



Source: WGSN and Bernstein analysis

EXHIBIT 65: **On StockX, close to 700 pairs of Zoom Vaporfly 4% have been transacted since its original release in July 2017, and on average at a ~28% premium to retail price**

Color	# of Sales	Price Premium	Average Sale Price
Ice Blue	277	23.2%	$308
Bright Crimson	216	23.6%	$309
Blue Fox	64	50.4%	$376
Vast Grey	56	35.6%	$339
Hyper Royal	43	38.8%	$347
Nike Zoom Vaporfly Elite Breaking 2 at $600	11	116.3%	$1,298
Total	**667**		
Average Vaporfly 4% (Assuming retail price of $250)		**28.1%**	**$320**
Average Vaporfly Elite (Assuming retail price of $600)		**116.3%**	**$1,298**

Note: Data collected between July 10, 2017 and March 14, 2018.

Source: StockX and Bernstein analysis

CONCLUSION

We examined the innovation pipeline and what (early) evidence we can find of product traction in this chapter. Based on what we have seen with Google Trends, our proprietary stock-out database, as well as secondary markets, we conclude that:

- VaporMax has ramped up strongly and now surpasses Ultra Boost in search terms. We are encouraged by the volume this new iteration of Air can bring to market and believe this launch has been most meaningful to date.

- While it is early days, comparing the ramp of Ultra Boost over the long term versus the initial interest in Epic React suggests strong relative interest in React. In addition, React has been stocking out quickly and is selling at a premium in secondary markets

- On the lifestyle front, while it is not a new product, Nike has reinvigorated Air Max 97. Looking at Google Trends on Air Max 97 relative to lifestyle products such as Superstar, Stan Smith, Gazelle, and Vans Old Skool shows that the product has garnered more interest than all of them over the last 12 months

- On the other hand, a few of the other new Nike products seem to be getting less traction — specifically, Zoom Vaporfly. For Zoom Vaporfly, we saw limited availability both at retail and in the aftermarket. We expect that lower product momentum is due to a combination of limited distribution and a more specialist customer for Vaporfly and, hence, less scalability to the mass market.

WHY CONSUMERS LOVE NIKE

Reports of fading brand resonance have been greatly exaggerated

OVERVIEW

In January, we surveyed 1,000 people in the US about 18 athletic apparel and footwear brands to understand brand perception, future purchase intent, and use case. *This is an update of work last done in July 2017.* We spoke to 501 men and 499 women, ensuring that our sample was representative of the age and geographic and income distribution of the country. Over 60% of respondents self-reported as exercising more than twice a week, 31% of the respondents own four or more pairs of sneakers, and 33% of the respondents reported spending over $90 when buying a pair of sneakers.

Brand perception: Consistent with our July 2017 survey, Nike scored at the top position in all four attributes surveyed: quality, functionality, value, and fashion. Under Armour ranked between second and fourth on these attributes, scoring highest on functionality and lowest on value and fashion. Consistent with our July 2017 survey, adidas ranked seventh on fashion. While adidas's fashion score and rank did not change meaningfully for younger age groups in this survey, the brand's relative ranking jumped among those who own four pairs of sneakers or more (to third) and with those who reported spending $90 or more on a pair of sneakers (to second), suggesting that sneaker heads and those willing to spend more on the category rate the brand more favorably. That said, Nike continued to receive the top ranking on fashion even among these more-targeted demographics. Adidas ranked in the top half of the 11 brands included in our rankings, coming in sixth on quality, fourth on functionality, and third on value. Lululemon was considered the third most fashionable brand overall, but scored in eighth position or lower on the other attributes.

Purchase behavior and purchase intent: While most consumers (58%) expect to spend roughly the same amount on athletic clothes and shoes over the next 12 months as the last 12 months, 26% expect to spend more and 16% expect to spend less. Among those who know the brands, consumers have the highest purchase intent at Nike but lowest at Jordan, with percentage balance scores of 45% and 11%, respectively. Lululemon's percentage balance score declined to 22%, from 32% in the July survey.

While fashion and function were both important to the use case of the big three brands (Nike, adidas, and Under Armour), Jordan and Lululemon purchases were more likely to be motivated by fashion. Consistent with this finding, new styles or new functionality were more likely to be cited as reasons why shoppers might purchase Jordan or Lululemon compared to the other brands. On the other hand, Nike was the brand most likely to see shoppers come back because of a replacement cycle in the category. For all brands, price was cited most often as the determining factor for customers on the fence about buying, with promotions a good motivator to buy and high prices the largest deterrent.

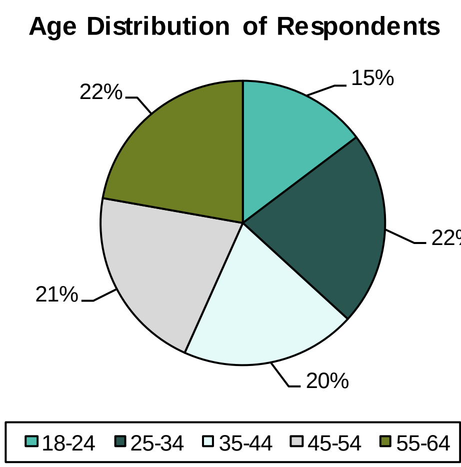
Overall, the survey results are largely consistent with our last survey, suggesting that Nike remains dominant, but also suggesting room for improvement for Jordan. Under Armour remains a brand best known for functional product, while Lululemon continues to be best known for fashion.

SURVEY DEMOGRAPHICS

Prior to initiating coverage in September 2017, we conducted a survey of US men and women to attempt to better understand how athletic brands are perceived by consumers.[4] This chapter updates that work. In January, we spoke to 1,000 men and women in the US, conducting a nationally-representative survey in conjunction with Toluna. We spoke to 501 men and 499 women in the US and ensured that our sample was representative of the age and geographic and income distribution of the country (see Exhibit 66 to Exhibit 69).

Additionally, we asked respondents questions regarding their exercise frequency, the number of pairs of sneakers owned, as well as their average spending on each pair of sneakers. We found that over 60% self-reported exercising more than twice a week, 31% of the respondents own four or more pairs of sneakers, and 33% of the respondents reported spending over $90 when buying a pair of sneakers (see Exhibit 70 and Exhibit 71). We also found that women tend to spend less on a pair of sneakers compared to men; ~25% of women reported spending over $90 on a pair of sneakers, whereas ~41% of men reported spending over $90 on a pair of sneakers.

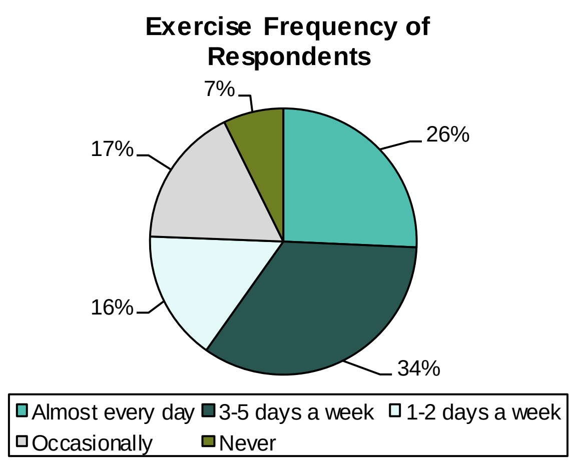
EXHIBIT 66: **Age distribution is in line with the national average...**



Note: Based on a sample size of 1,000 people (501 men and 499 women).

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 67: **...while over 60% report exercising more than twice a week...**

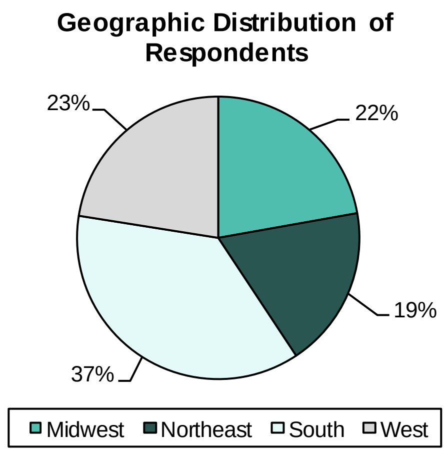


Note: Based on a sample size of 1,000 people (501 men and 499 women); based on self-reported exercise frequency.

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

[4] September 26, 2017 - Athletic Brands: What do consumers think?

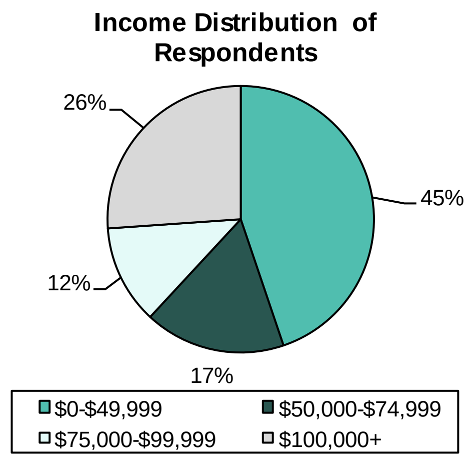
EXHIBIT 68: **...respondents represented the geographic distribution of the country...**



Note: Based on a sample size of 1,000 people (501 men and 499 women).

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

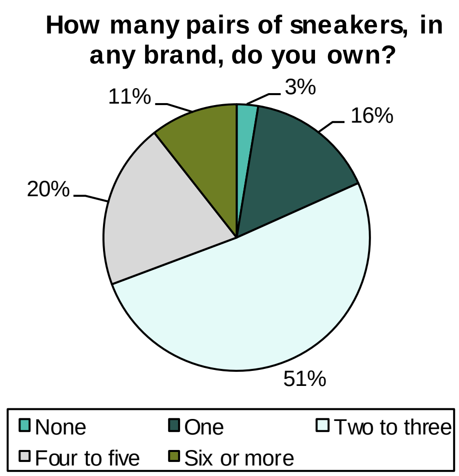
EXHIBIT 69: **...and the income distribution of the US population**



Note: Based on a sample size of 1,000 people (501 men and 499 women).

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

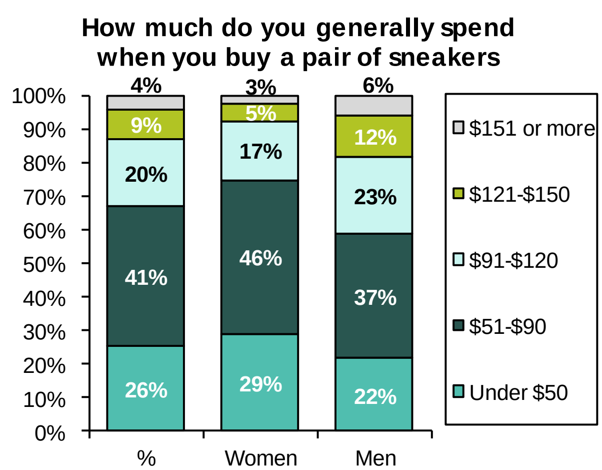
EXHIBIT 70: **Over 80% of respondents own two or more pairs of sneakers in any brand**



Note: Based on a sample size of 1,000 people (501 men and 499 women).

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 71: **...and ~75% of respondents spent over $50 on a pair of sneakers**



Note: Based on a sample size of 1,000 people (501 men and 499 women).

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

BRAND AWARENESS

We asked the consumers in our survey to choose their level of engagement among 18 athletic brands, ranging from highly engaged to not at all engaged/aware of the brand, with the following four options (see Exhibit 72):

- I have **bought** either athletic clothing or shoes from this brand in the past;
- I have **heard of** this brand **and have looked** at their athletic clothing or shoes in a store, department store or on a website at least once;

- I have **heard of** this brand **but have never looked** at their athletic clothing or shoes in a store, department store, or on a website; or

- I have **never heard of** this brand.

We found that seven out of the 18 brands had aided awareness over 85%. **Nike**, **adidas**, and **Reebok** topped the charts with over 98% aided awareness, followed by **New Balance**, **Under Armour, Puma,** and **Jordan**. **Lululemon** ranked tenth of the 18 brands, followed by numerous newer entrants to women's athletic apparel.

We also looked specifically at the brand engagement of **Nike**, **adidas**, **Under Armour**, and **Lululemon** for each of the demographic segments.

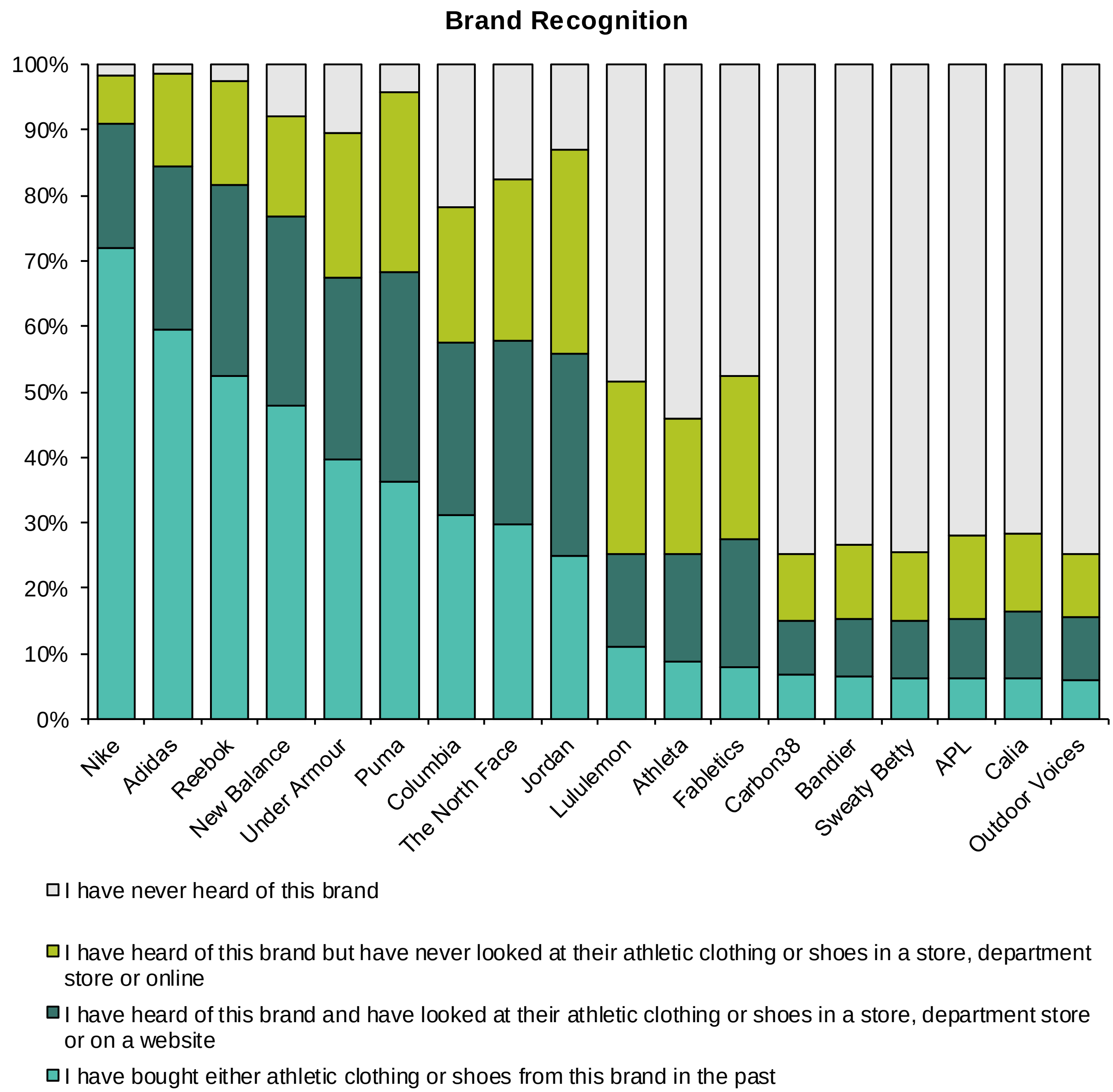
- **Nike** had the highest brand engagement across the board. However, it scored particularly well with those with income over $75K (76% have bought either athletic clothing or shoes from Nike in the past) and frequent exercisers (75% have bought either athletic clothing or shoes from Nike in the past) (see Exhibit 73).

- **adidas** scored second highest. Like Nike, the highest engagement levels were from the income over $75K demographic (66%) and frequent exercisers (65%). However, adidas scored lowest with women, as only 56% reported having bought either athletic clothing or shoes from adidas in the past (see Exhibit 74).

- **Under Armour** scored best with those with income over $75K (49% have bought either athletic clothing or shoes from Under Armour in the past), followed by frequent exercisers (48%). To our surprise, it scored lowest with men (39%) (see Exhibit 75).

- **Lululemon** had the lowest brand awareness/engagement of the brands under coverage. It scored best with those with income over $75K and frequent exercisers (20% and 16%) (see Exhibit 76).

EXHIBIT 72: **Our survey shows aided awareness of >85% for seven athletic apparel and footwear brands**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 73: **Nike has the highest aided awareness across the board, but particularly among those with income over $75K and frequent exercisers**

Nike	All	Women	Men	Under 35	Frequent Exercisers	Income over $75K
I have bought either athletic clothing or shoes from this brand in the past	72%	73%	71%	73%	75%	76%
I have heard of this brand and have looked at their athletic clothing or shoes in a store, department store or on a websites	19%	18%	20%	19%	17%	19%
I have heard of this brand but have never looked at their athletic clothing or shoes in a store, department store or online	7%	8%	7%	6%	6%	3%
I have never heard of this brand	2%	2%	2%	2%	2%	2%

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 74: **adidas ranked second on aided awareness, but scored best with those with income over $75K**

adidas	All	Women	Men	Under 35	Frequent Exercisers	Income over $75K
I have bought either athletic clothing or shoes from this brand in the past	60%	56%	63%	62%	65%	66%
I have heard of this brand and have looked at their athletic clothing or shoes in a store, department store or on a websites	25%	26%	24%	25%	22%	23%
I have heard of this brand but have never looked at their athletic clothing or shoes in a store, department store or online	14%	16%	12%	11%	11%	10%
I have never heard of this brand	2%	2%	1%	2%	2%	1%

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 75: **40% of respondents have bought either athletic clothing or shoes from Under Armour in the past, but the cohort that has the highest purchase engagement is those with income over $75K at 49%**

Under Armour	All	Women	Men	Under 35	Frequent Exercisers	Income over $75K
I have bought either athletic clothing or shoes from this brand in the past	40%	40%	39%	46%	48%	49%
I have heard of this brand and have looked at their athletic clothing or shoes in a store, department store or on a websites	28%	25%	30%	29%	27%	29%
I have heard of this brand but have never looked at their athletic clothing or shoes in a store, department store or online	22%	23%	22%	20%	18%	16%
I have never heard of this brand	10%	12%	9%	5%	8%	6%

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 76: **Lululemon has relatively low aided awareness, ranking in the bottom half of the brands surveyed**

Lululemon	All	Women	Men	Under 35	Frequent Exercisers	Income over $75K
I have bought either athletic clothing or shoes from this brand in the past	11%	11%	11%	15%	16%	20%
I have heard of this brand and have looked at their athletic clothing or shoes in a store, department store or on a websites	14%	11%	17%	19%	19%	23%
I have heard of this brand but have never looked at their athletic clothing or shoes in a store, department store or online	27%	27%	26%	26%	28%	29%
I have never heard of this brand	48%	51%	46%	39%	38%	28%

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

CUSTOMER PERCEPTION – QUALITATIVE METRICS (QUALITY, FASHION, FUNCTIONALITY, AND VALUE)

In order to understand brand perception, we asked respondents to rank each of the brands based on Quality, Fashion, Functionality, and Value from 1 to 5 (from worst to best). We ranked their scores by brand — excluding seven brands that did not achieve at least 50% brand awareness to ensure meaningfulness of the scores.

- **Quality:** Nike ranked at the top for Quality (4.44), while Under Armour ranked third (4.33). Jordan ranked fifth with 4.15, adidas followed in sixth place at 4.13, and Lululemon ranked eighth of the 11 brands with 4.00. The North Face (VFC) also scored well on Quality, ranking second with 4.36. When we asked respondents to indicate their perception of Quality change over the last 12 months for each of Nike, Under Armour, Lululemon, adidas, and Jordan, Nike had the highest net Quality score —indicating that more respondents felt that Quality at Nike has changed for the better, relative to other brands (see Exhibit 77 to Exhibit 80).

- **Functionality:** Nike and Under Armour ranked at the top again (4.49 and 4.38, respectively), while adidas ranked fourth at 4.17 and Lululemon ranked second from the bottom. Among the apparel brands in our coverage, The North Face scored well, ranking third. Once again, Nike scored best in the perception of Functionality change (see Exhibit 81 and Exhibit 82).

  - Among those who reported owning four or more pairs of sneakers from any given brand, all brands scored worse on Functionality compared to the overall population, suggesting that consumers who are buying multiple pairs of sneakers may be harsher critics when it comes to Functionality.

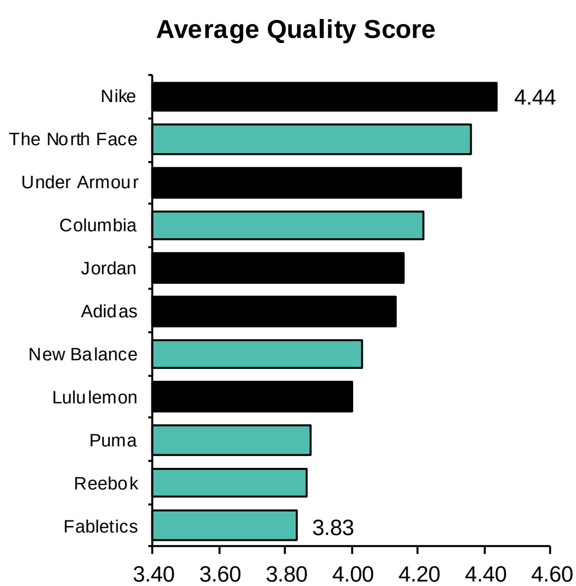
- **Value:** The largest brands scored well on Value, with Nike ranking first (4.03), and adidas and Under Armour ranking third and fourth, respectively. At the bottom, Jordan and Lululemon ranked tenth and eleventh, respectively. Adidas scored highest on the perception of Value change in the last 12 months, while Lululemon scored lowest (see Exhibit 83 and Exhibit 84).

  - Among those who reported spending $90 or more on a pair sneakers, our brands scored better on Value. Nike once again topped the chart, and scored +2.8 SD's above its overall Value ranking among this cohort (see Exhibit 85).

- **Fashion:** Nike ranked at the top on Fashion with a score of 4.40, while adidas ranked in the lower half at 4.05, below The North Face, Lululemon, Under Armour, and Jordan. Additionally, Nike outscored adidas on the perception of Fashionablility change as well (see Exhibit 86 and Exhibit 87). This is surprising given the strength of adidas in North America, and we believe can be explained by the success of the brand with the sneaker head community. While we did not see a meaningful difference among the younger cohorts on the perception of Fashionability for adidas, the brand's relative ranking jumped among those who own four pairs of sneakers or more and with those who reported spending $90 or more on a pair of sneakers (see Exhibit 88 and Exhibit 89).

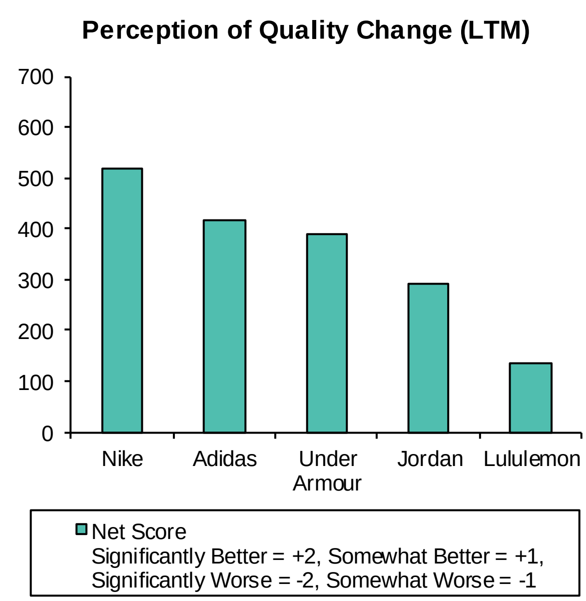
When comparing the perception scores between the July 2017 survey with the January 2018 survey we saw declines in the perception of Quality and Functionality scores for adidas and a drop in Value scores for Lululemon (see Exhibit 90 to Exhibit 93).

EXHIBIT 77: **Overall, Nike ranked highest in Quality, followed by Under Armour**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

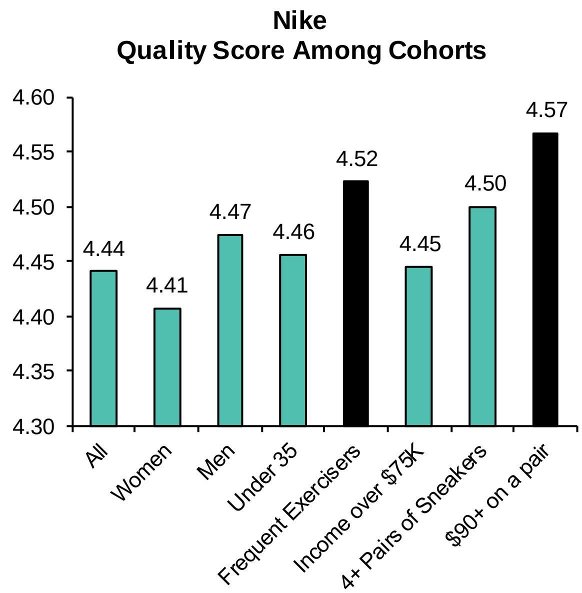
EXHIBIT 78: **Nike also scored most positively in the perception of Quality change, relative to other brands**



Note: Net score is calculated by attributing values to each response and taking the sum of all value-weighted response; neutral/no change is assigned 0.

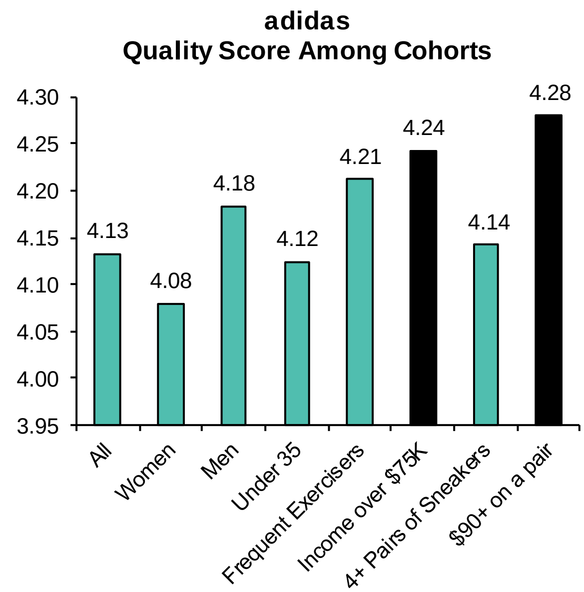
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 79: **Nike scored highest on Quality among those who spent $90 or more and frequent exercisers**



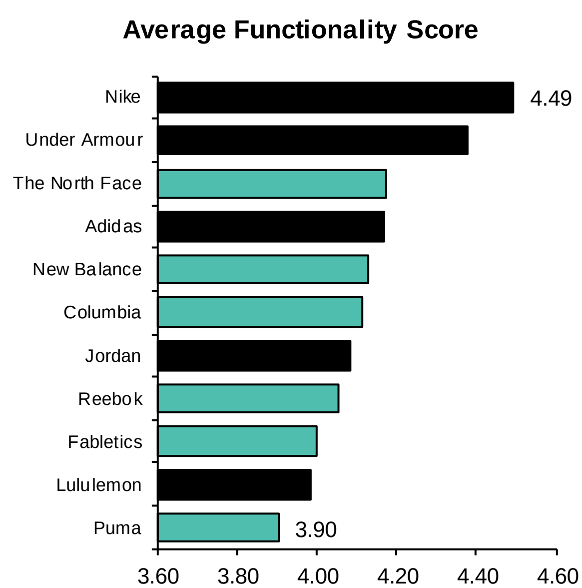
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 80: **adidas scored highest on Quality among those who spent $90 or more and over $75K income**



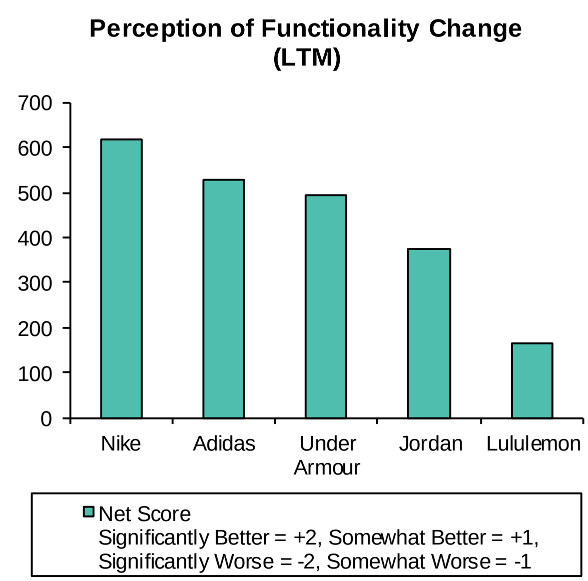
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 81: **Again, Nike topped the field on Functionality, while Lululemon scored lower**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

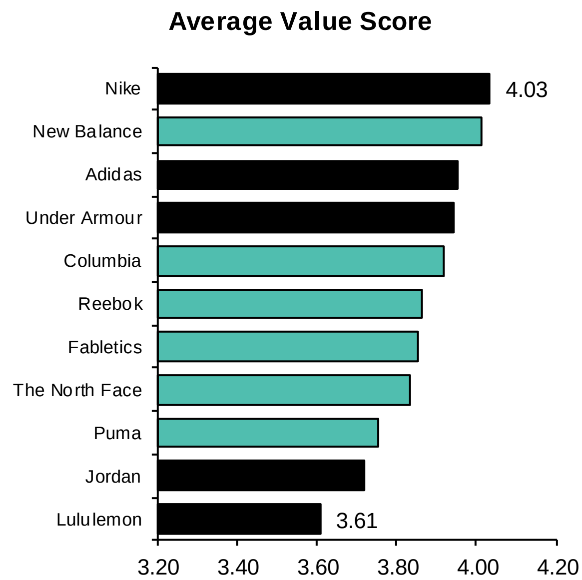
EXHIBIT 82: **Nike also scored highest on the perception of Functionality change**



Note: Net score is calculated by attributing values to each response and taking the sum of all value-weighted response; neutral/no change is assigned 0.

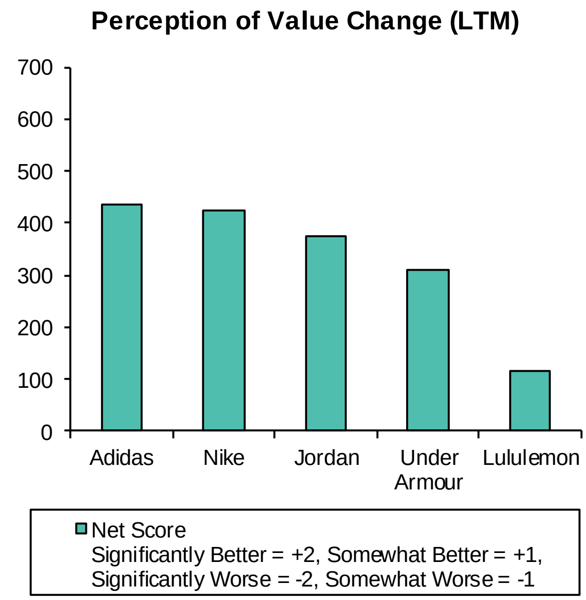
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 83: **Consistent with our last survey, Nike tops the chart when it comes to Value, closely followed by New Balance; Lululemon scored lowest on Value**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

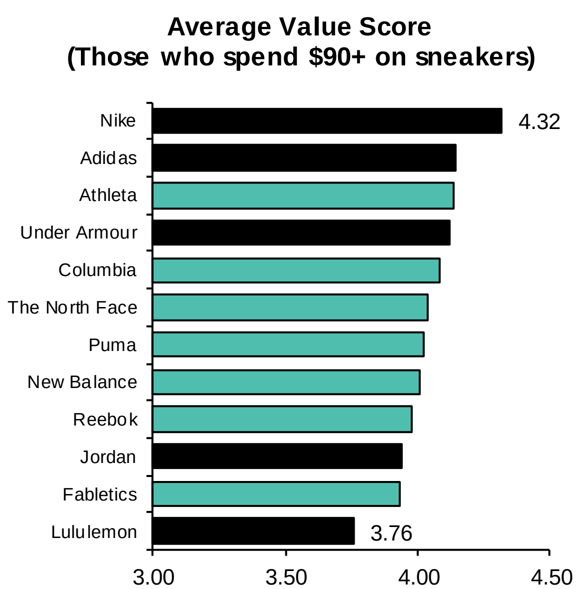
EXHIBIT 84: **adidas scored highest on the perception of Value change, whereas Lululemon scored lowest**



Note: Net score is calculated by attributing values to each response and taking the sum of all value-weighted response; neutral/no change is assigned 0.

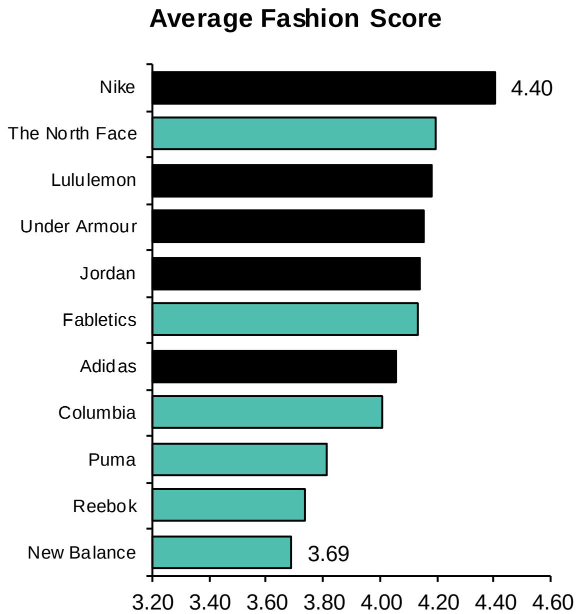
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 85: **Our coverage brands scored much higher on Value among those who spend more than $90 on a pair of sneakers**



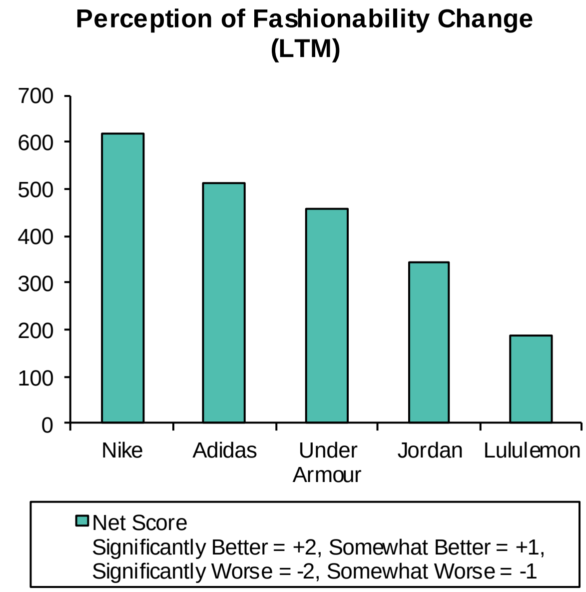
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 86: **Consistent with our last survey, Nike scores highly on Fashion as well, adidas is in the lower half despite being known for fashion/athleisure trends...**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

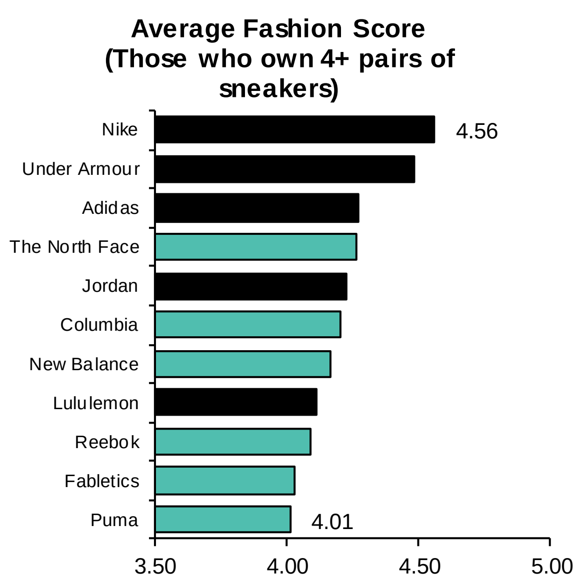
EXHIBIT 87: **...and is behind Nike on the perception of Fashionability change over the last 12 months**



Note: Net score is calculated by attributing values to each response and taking the sum of all value-weighted response; neutral/no change is assigned 0.

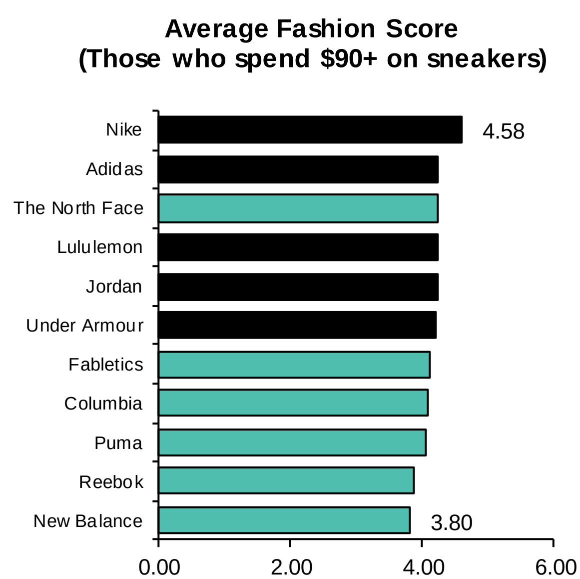
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 88: **adidas ranked third fashionable among those who own 4+ pairs of sneakers...**



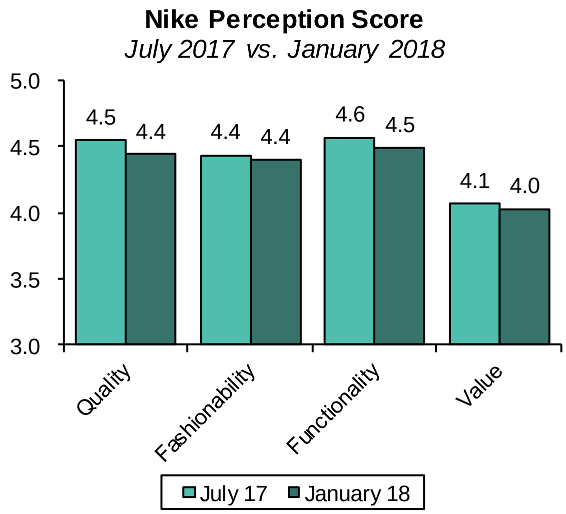
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 89: **...and second among those who spend $90+ or more on sneakers**



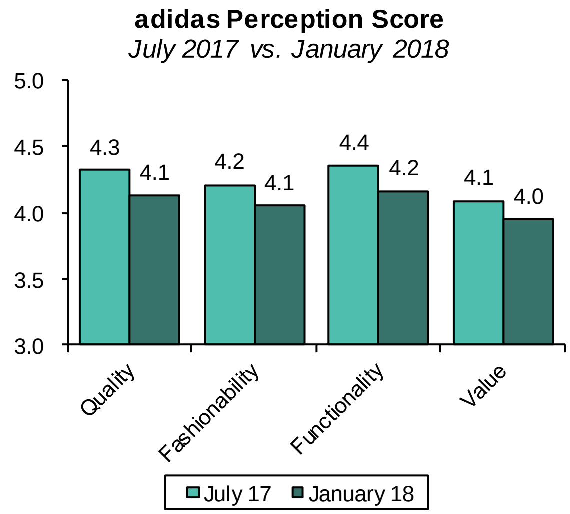
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 90: **Nike perception scores were mostly consistent from July to January...**



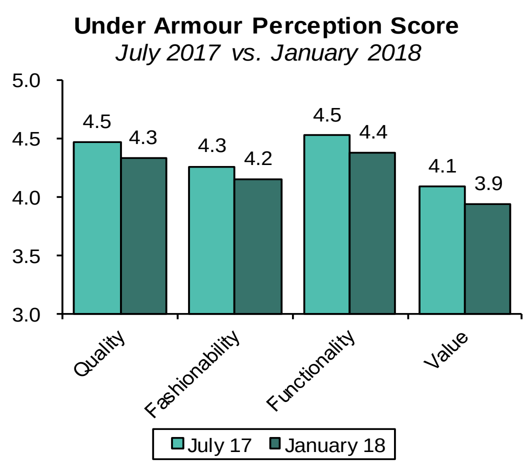
Source: Bernstein Proprietary Consumer Survey (January 2018 and July 2017) and analysis

EXHIBIT 91: **...whereas adidas saw declines in Quality and Functionality scores...**



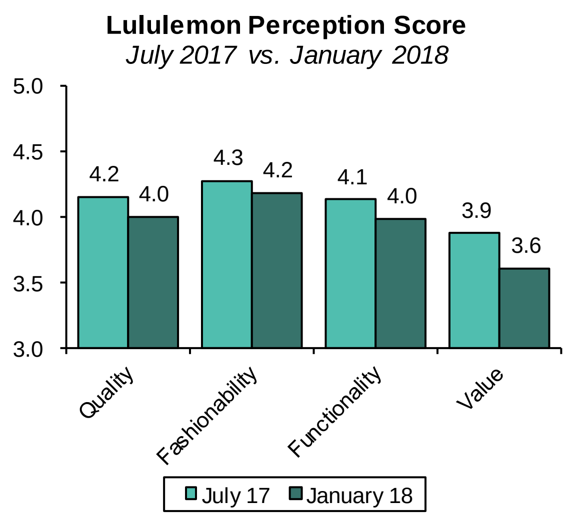
Source: Bernstein Proprietary Consumer Survey (January 2018 and July 2017) and analysis

EXHIBIT 92: **Under Armour scores were also consistent...**



Source: Bernstein Proprietary Consumer Survey (January 2018 and July 2017) and analysis

EXHIBIT 93: **...whereas Lululemon saw a decline in the perception of its Value scores**



Source: Bernstein Proprietary Consumer Survey (January 2018 and July 2017) and analysis

Consistent with the last survey, we also asked those respondents who reported shopping each of the brands, whether the purchase was primarily for fashion only, function only, or a combination of both. We found that the primary purchase driver was a combination of function and fashion for all brands except for Lululemon, which was primarily driven by fashion purchases (see Exhibit 94 and Exhibit 95).

- People suggested that they were most likely to purchase **Nike**, relative to other brands, for a combination of fashion and function (57% and 55% for athletic apparel and shoes, respectively).

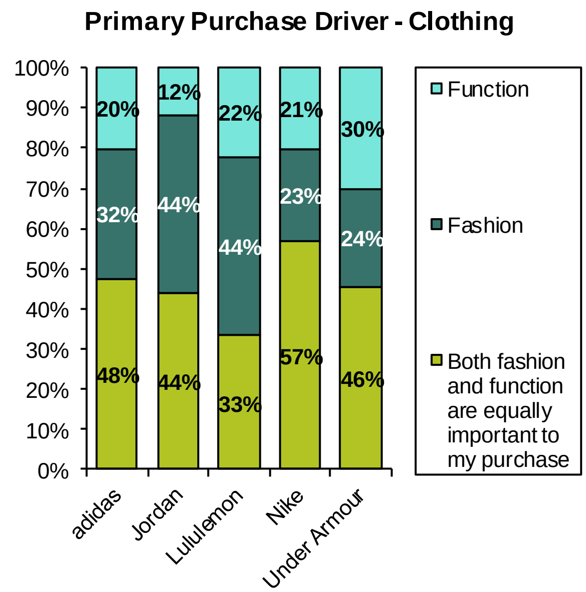
- While purchases at **adidas** were also primarily driven by the combination of fashion and function, a higher percentage of consumers purchased adidas clothing for fashion only (32% versus 23% for **Nike**), and similar trends were seen for the purchase driver of **adidas** shoes (25% fashion versus 20% fashion for **Nike**).

- Consistent with the results from our last survey, **Under Armour's** performance reputation was apparent in our survey data, as the brand had the highest percentage of customers citing function as the primary purchase driver for apparel (30%). However, fewer customers cited function as the primary driver for purchasing **Under Armour** athletic shoes compared to our last survey (22% versus 30% in the July survey). In fact, function was more frequently cited as the primary purchase driver for both **Nike** (26%) and **adidas** (23%) in the January 2018 survey.

- Consistent with the July survey, despite **Lululemon** management's focus on function, customers saw the brand as a fashion company, with 44% of customers suggesting that fashion is the primary driver of purchase (an increase of 4% from the July survey).

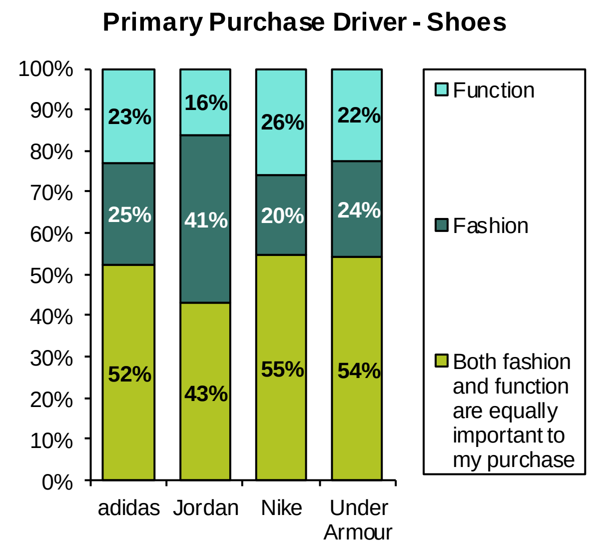
- We added **Jordan** to our January survey and found that the strongest reasons for purchasing **Jordan** were almost equally "both fashion and function" and "fashion" (44% and 43% of customers reported a combination of fashion and function as the primary driver for athletic apparel and athletic shoes, respectively, followed by 44% and 41% of customers who reported fashion as the primary driver alone).

EXHIBIT 94: **The primary purchase driver for Nike is a combination of fashion and function in athletic apparel...**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 95: **...and shoes**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

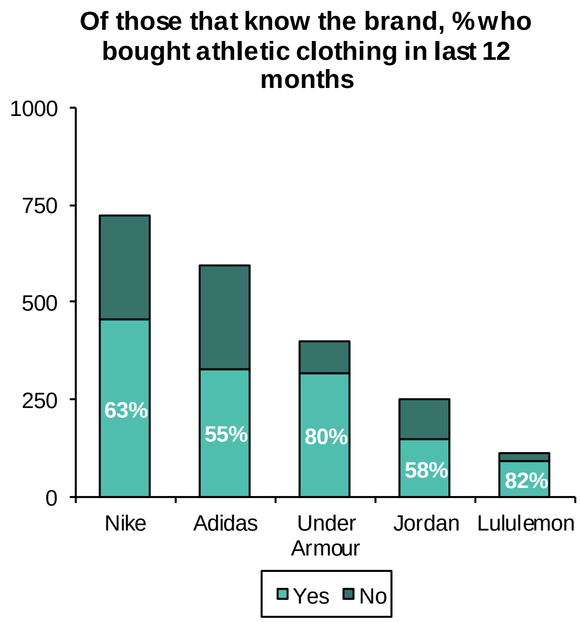
PURCHASE BEHAVIOR AND FUTURE PURCHASE INTENT

In order to understand purchase behavior, we asked consumers if they had purchased athletic clothing/apparel or shoes in the last 12 months (see Exhibit 96 and Exhibit 97).

- Of those who know the brand, those who know Lululemon and Under Armour were most likely to purchase apparel (82% and 80%, respectively). However, consumers were most likely to purchase shoes from Nike (74%, compared to 63% in the July survey) and almost half as likely to purchase shoes from Under Armour (41%).

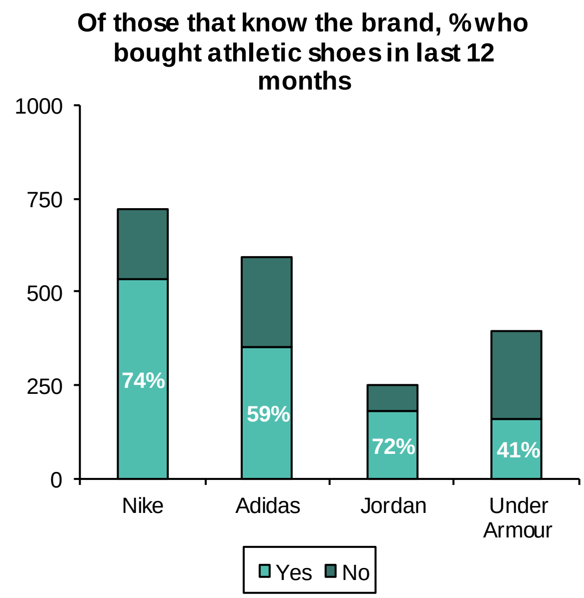
- We saw evidence that consumers continued to purchase through wholesale distribution channels such as department stores for both athletic apparel and footwear. Additionally, consumers were more likely to purchase Under Armour shoes through the Outlet or Off-price channels, compared to other brands (see Exhibit 98 and Exhibit 99).

EXHIBIT 96: **Of consumers who know the brand, those who know Lululemon and Under Armour exhibit the highest purchasing behavior for clothing**



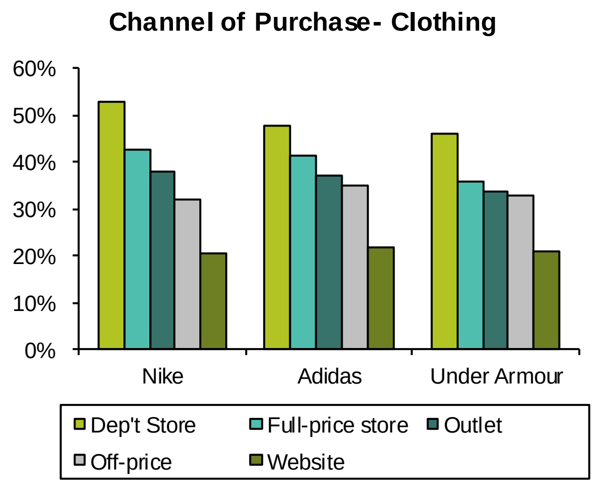
Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 97: **...while those who know Nike exhibit the highest purchasing behavior for shoes**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

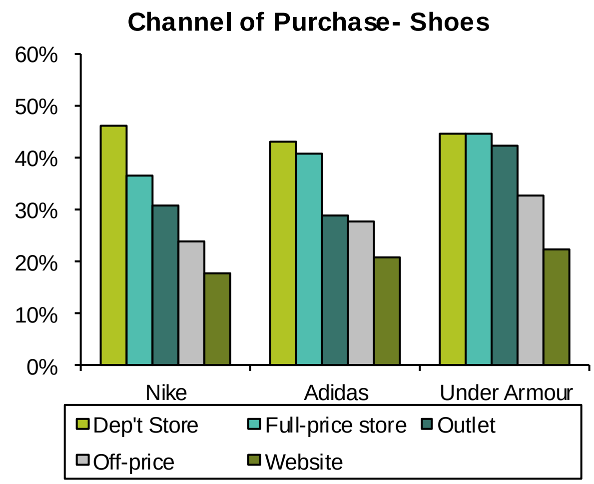
EXHIBIT 98: **Department stores remain the most likely channel for purchasing athletic clothing...**



Note: For Nike, based on 453 responses for clothing; for adidas, based on 328 responses for clothing; and for Under Armour, based on 316 responses for clothing.

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 99: **...and athletic shoes**



Note: For Nike, based on 534 responses for shoes; for adidas, based on 353 responses for shoes; and for Under Armour, based on 161 responses for shoes.

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

At the category level, 58% of survey respondents expect to spend about the same amount on the category as they have spent over the last 12 months, while 26% expect to spend more and 16% expect to spend less. Frequent exercisers have the highest future purchase intent, with 34% expecting to spend more on the category and just 13% expecting to spend less (see Exhibit 100).

- Of those who **know** the brand, future shopping intent is highest for Nike (54%) and lowest for Jordan (39%) (see Exhibit 101).

For those who said that they were unlikely to shop at these brands in the next year, we asked why and found that price and brand explained more than half the responses (see Exhibit 102).

- For Nike, 30% of customers who said they were unlikely to shop the brand cited price, while 45% said this decision was driven by the brand or product specifics (style, brand, or quality). Nike had the lowest percentage of respondents that suggested they don't like Nike's styles and tied with Lululemon for the lowest percentage of respondents suggesting that it was not a brand for them.

- For Jordan, 33% of customers not shopping the brand said that prices are too high, while 53% said that the decision was due to brand or product specifics.

- For adidas, only 18% said that the products are too expensive, while 59% said that the decision was due to brand or product specifics.

- For Under Armour, 24% attributed not shopping to price, while 59% attributed the decision to product or brand specifics.

- For Lululemon, 27% attributed the decision to price, while 56% attributed the decision to brand or product specifics. Among the five brands, Lululemon had the highest percentage of respondents reporting the decision was driven by poor quality (11%), with the lowest percentage of respondents saying it was not a brand for them.

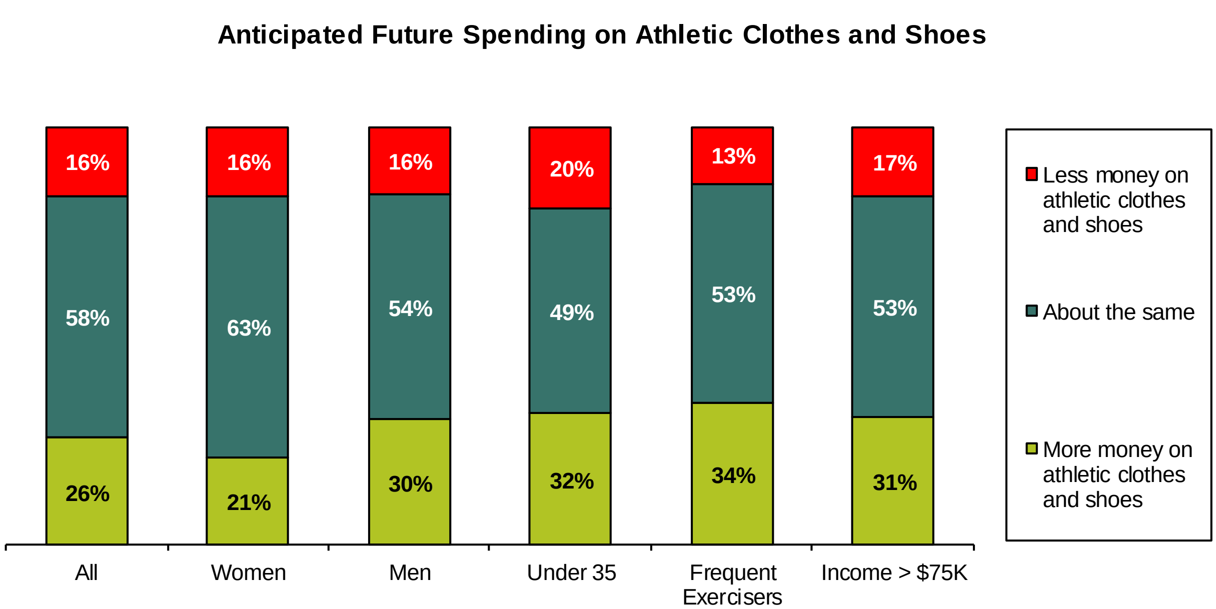
For those that said they will "Maybe" shop the brands in the next 12 months, we asked the following questions:

- You mentioned you may buy athletic clothes or shoes from Nike, Adidas, Lululemon, Under Armour, or Jordan in the next year. Please tell us which factor would make you MOST likely to buy:

- You mentioned you may buy athletic clothes or shoes from Nike, Adidas, Lululemon, Under Armour, or Jordan in the next year. Please tell us which factor would make you LEAST likely to buy:

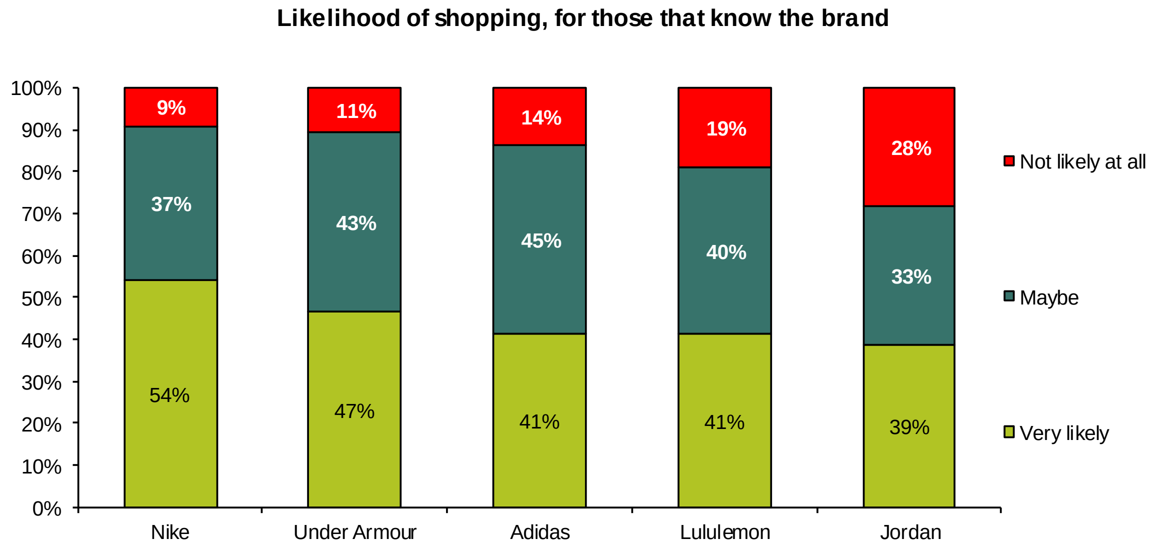
In both scenarios, pricing was the number one factor for swaying the respondents' decision to either shop or not shop the brands (see Exhibit 103 and Exhibit 104). In the first scenario, "A sale/lower prices" was most frequently cited as the reason for respondents *to shop* the brand; in the second scenario, on the contrary, "Prices are too high" was most frequently cited as the reason for respondents to *not shop* the brand. The two more fashion-oriented brands of Lululemon and Jordan had the highest percentage of respondents that suggested they would buy because of new styles or functionality. Nike was the brand most likely to see shoppers come back because of a replacement cycle.

EXHIBIT 100: **At the category level, 58% of respondents intend to spend the same on athletic clothes and shoes in the next 12 months, 26% expect to spend more, and 16% expect to spend less**



Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

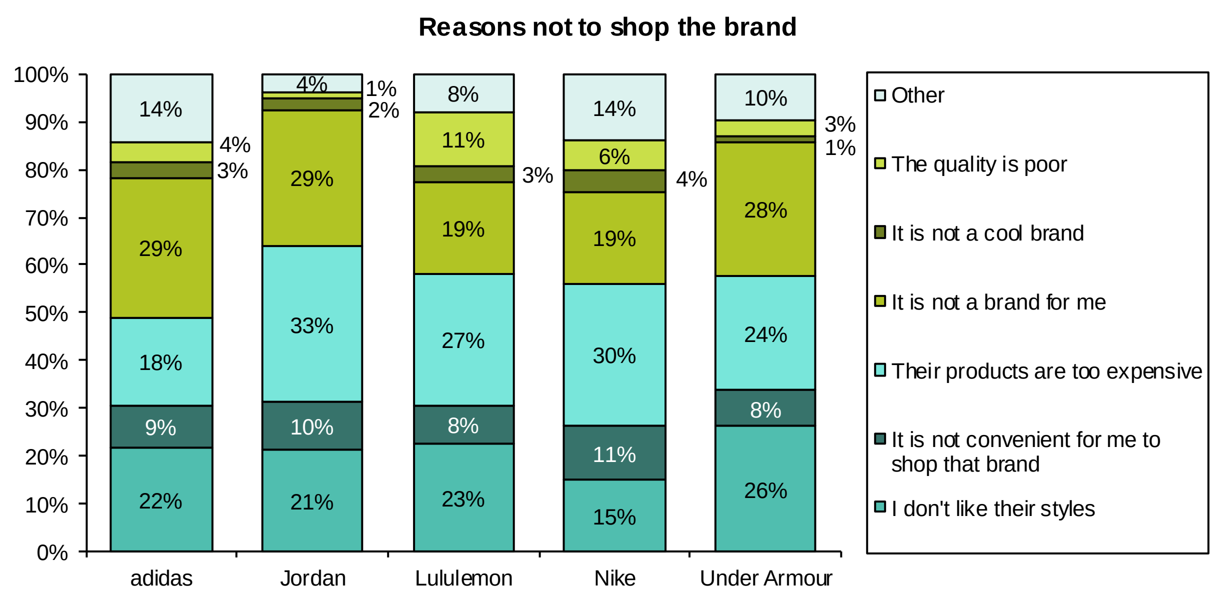
EXHIBIT 101: **Of those who know the brand, those who know Nike are most likely to shop the brand in the next year**



Note: Nike responses based on 910 respondents, adidas responses based on 845 respondents, Lululemon responses based on 252 respondents, Under Armour responses based on 675 respondents, and Jordan responses based on 558 respondents.

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

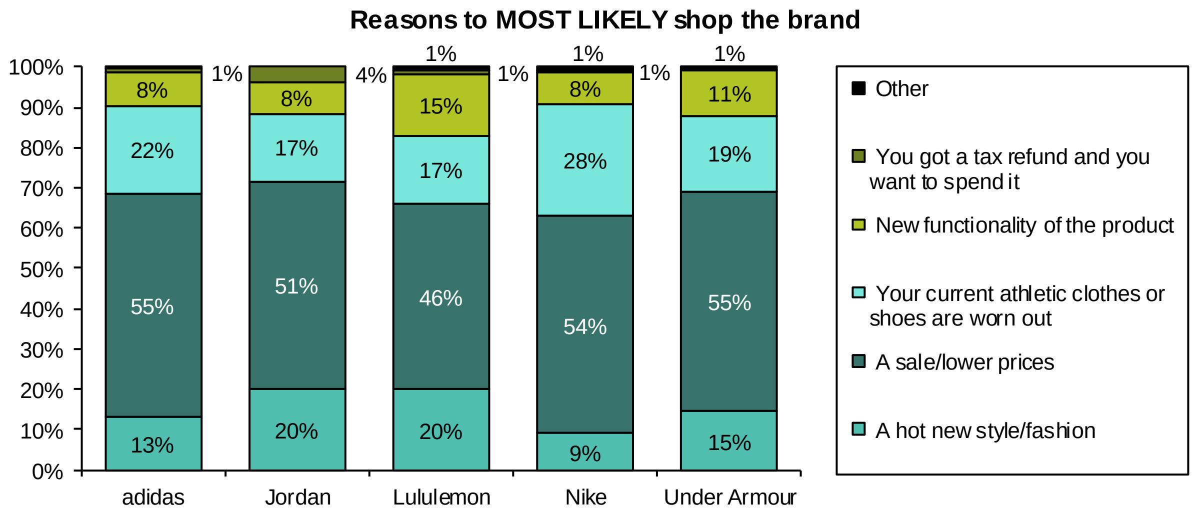
EXHIBIT 102: **Consumers are most likely to list "Too expensive" as a reason not to shop Nike, Lululemon, or Under Armour**



Note: Nike mix based on answers from 83 respondents who had indicated that they are less likely to shop the brand in the future, of those who know the brand, generating 114 reasons. adidas mix based on answers from 116 respondents who had indicated that they are less likely to shop the brand in the future, of those who know the brand, generating 147 reasons. Lululemon mix based on answers from 48 respondents who had indicated that they are less likely to shop the brand in the future, of those who know the brand, generating 62 reasons. Under Armour mix based on answers from 72 respondents who had indicated that they are less likely to shop the brand in the future, of those who know the brand, generating 92 reasons. Jordan mix based on answers from 158 respondents who had indicated that they are less likely to shop the brand in the future, of those who know the brand, generating 230 reasons.

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

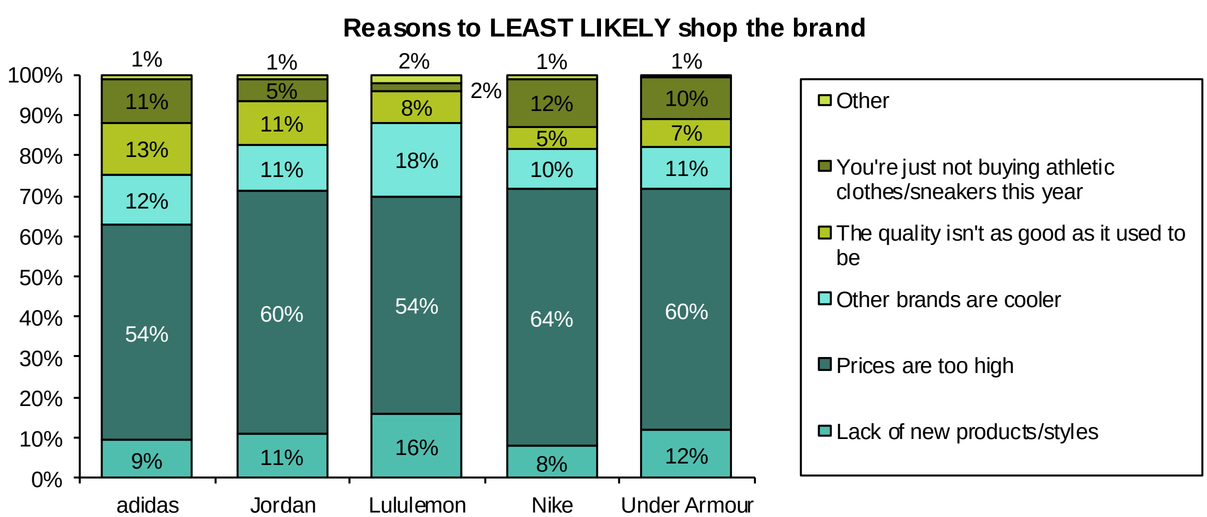
EXHIBIT 103: **"A sale/lower prices" was listed as the most compelling reason for consumers on the fence to shop the brands**



Note: Nike responses based on 334 respondents, adidas responses based on 379 respondents, Lululemon responses based on 100 respondents, Under Armour responses based on 289 respondents, and Jordan responses based on 183 respondents.

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

EXHIBIT 104: **Conversely, "prices are too high" is the most cited reason to not shop the brand**



Note: Nike responses based on 334 respondents, adidas responses based on 379 respondents, Lululemon responses based on 100 respondents, Under Armour responses based on 289 respondents, and Jordan responses based on 183 respondents.

Source: Bernstein Proprietary Consumer Survey (January 2018) and analysis

TALKING ABOUT A REVOLUTION (IN MANUFACTURING)

Why speed to market will be Nike's next leg of competitive advantage

OVERVIEW

As the world digests the threat of a US-China trade war, we believe Nike's efforts in near-market sourcing and its "manufacturing revolution" or "man rev" are that much more relevant. In the last five years, concerns about labor cost inflation and speed to market have caused Nike to rethink both the manufacturing process and the materials that the company uses in order to offset these pressures. Nike's efforts have focused on three types of manufacturing improvement: 1) sustainable manufacturing excellence, 2) manufacturing modernization, and 3) manufacturing innovation. With partners such as Flex and Apollo, increased automation even with traditional partners (Feng Tay), and new materials such as Flyknit and Flyleather, Nike management has suggested that quarterly savings from "man rev" is now measured in the "tens of millions" of US dollars. If we assume conservatively that this means ~$40-$80M of savings annually, this would suggest 10-20bps of margin improvement. In addition, if Nike can shorten lead times, thus gaining more insight into demand and increasing full price sell through, this could also drive margin expansion.

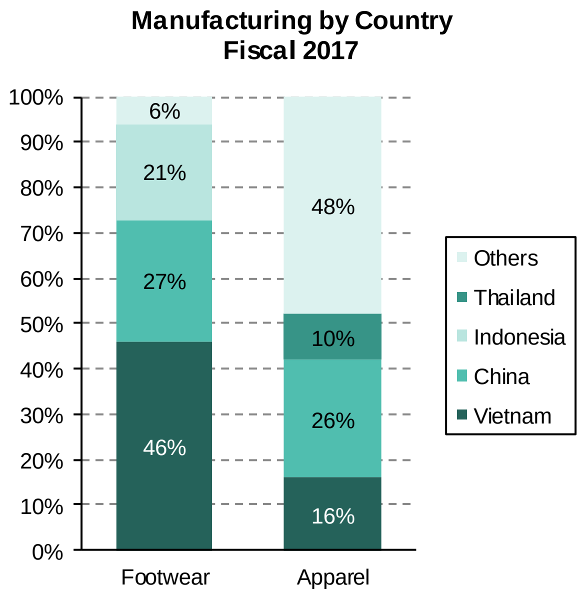
NIKE'S CURRENT SOURCING FOOTPRINT

In this chapter, we examine Nike's current sourcing landscape as well as how the company is working to change its manufacturing base in the future.

According to Nike's manufacturing map,[5] Nike sources from 42 countries and 554 factories, with just over one million workers. Breaking this down by product type, Nike's footwear is sourced from 13 countries, 123 factories, and 585K workers, though footwear production is highly concentrated in three countries (Vietnam, China, and Indonesia) and among five partners (see Exhibit 105 and Exhibit 106). Nike apparel is sourced from 37 countries, 335 factories, and 372K workers, and somewhat less concentrated when compared to footwear. While China has remained a key sourcing country for Nike, footwear production has increasingly moved to Vietnam (see Exhibit 107 and Exhibit 108).

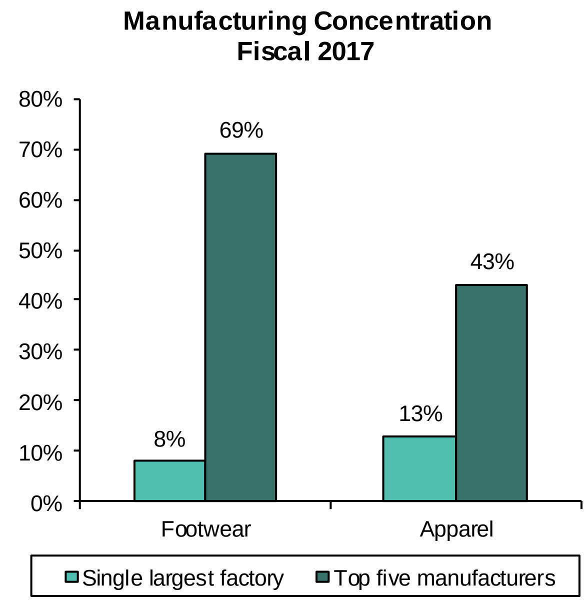
[5] manufacturingmap.nikeinc.com – updated as of February 2018

EXHIBIT 105: **Nike's footwear manufacturing is highly concentrated by country...**



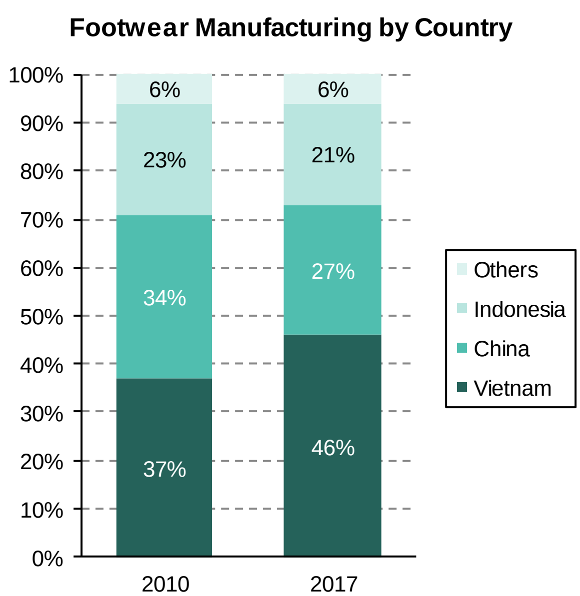
Source: Company reports and Bernstein analysis

EXHIBIT 106: **...and by manufacturing partner**



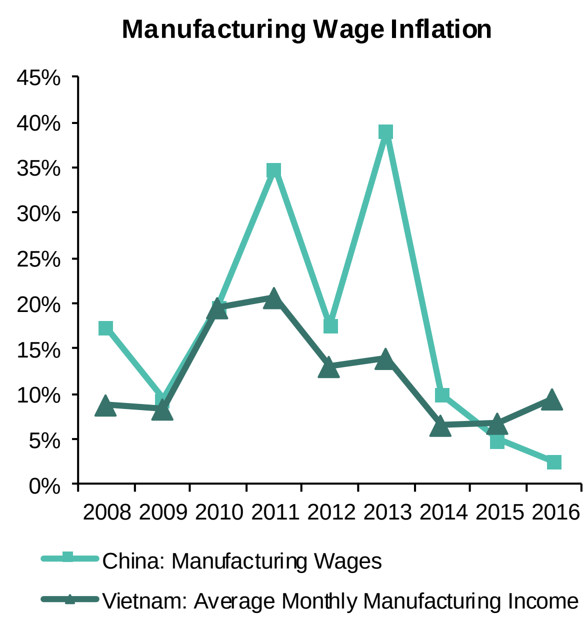
Source: Company reports and Bernstein analysis

EXHIBIT 107: **Nike's footwear manufacturing has moved increasingly to Vietnam since 2010**



Source: Company reports and Bernstein analysis

EXHIBIT 108: **Manufacturing wages are increasing across Nike's supply chain**



Source: Haver, China National Bureau of Statistics, Vietnam General Statistics Office, and Bernstein analysis

A brief history…

Growth in the athletic category and, more specifically, at Nike has put pressure on manufacturing processes and led to labor cost inflation. Given Nike's expectations for future growth, management expects this will continue and could result in a labor shortage over time. In addition, the company is interested in being faster to the customer, which may not be possible with a predominantly Asian manufacturing base, given that ocean freight takes a minimum of three weeks. These concerns have caused Nike to rethink both the manufacturing process and the materials that the company uses in order to offset these pressures. Nike first began discussing a manufacturing revolution at its 2013 Analyst Day. At that point, the manufacturing revolution was a portfolio of tools conceived to help Nike deal with labor cost inflation as well as be more responsive to changing consumer trends and comprised three big buckets: 1) sustainable manufacturing excellence, 2) manufacturing modernization, and 3) manufacturing innovation.

Nike suggested at the time that sustainable manufacturing was producing less waste and operating with more efficiency. This has involved materials such as Flyknit (launched in early 2012) as the first material that virtually eliminates waste in the manufacturing process of shoe uppers, as the product is knit together from yarn, rather than cut out from rolls of fabric. More recently, Nike unveiled its latest innovation, Flyleather, in October 2017. This material is made of at least 50% recycled leather scrap and is put on a roll, rather than a hide like traditional leather. This should also cut down on waste and make the manufacturing process faster. Additionally, Nike has reduced the number of materials that it uses and the number of material vendors it sources from.

Manufacturing modernization was meant to take individual steps in the manufacturing process and automate them. In 2013, management suggested that these initiatives could help drive overhead down and quality up as techniques such as automated stitching were implemented. This would allow Nike to be *more efficient* in value-added work such as stitching, while management also suggested techniques such as using an electroadhesion approach to moving components of the shoe through the manufacturing process (in collaboration with Grabit, an early-stage technology company) would help *eliminate* non-value-added work.

Finally, manufacturing innovation includes products such as Flyknit and Flyleather that have benefits on the product side, including making shoes lighter, which can help increase speed. In the case of Flyknit, the manufacturing process created 70% less waste than typical cut and sew manufacturing with 80% fewer components, and labor efficiency in making the shoe increased 2x. Manufacturing innovation also includes processes such as 3D printing and rapid prototyping.

…manufacturing today…

Almost five years into Nike's manufacturing revolution, what has changed and where could change still be incremental to costs and to the supply chain? In fiscal 2018, Nike plans to ship 1.3 billion products through 75 distribution centers around the globe. Progress on the three manufacturing initiatives of sustainability, modernization, and innovation continues.

Within its manufacturing footprint, Nike is working with a few key partners to bring manufacturing near shore and to add modern techniques and automation to the process.

Specifically, in apparel, Nike has partnered with Apollo to create a vertically-integrated apparel manufacturer Tegra, which today operates in four countries — the US and in Central America — across eight factories and with 11K workers. The idea behind this partnership is that Nike can unlock efficiencies in a more near-market, vertically-integrated supply chain, in which scale and production expertise can drive products to market faster (remember that apparel manufacturing has historically been considerably more fragmented than footwear manufacturing — see Exhibit 105 and Exhibit 106).

In footwear, Flex will make three million pairs of footwear for Nike in fiscal 2018, and Nike expects to produce tens of millions of pairs nearshore by 2023, with more than 25% delivered through Nike Direct on a short lead time responsive model. Nike has partnered with Flex, producing footwear in Mexico in one factory with 5K workers. This model should reduce the time from manufacturing to market from 60 days to 10 days or less. The Flex partnership, though, is more than just the current three million pair volume, as Flex is a strategic partner, helping Nike automate several processes. For example, Flex has sped up the Flyknit production process, allowing Nike to cut out 12 weeks from the traditional manufacturing process. While these partners are a small part of Nike's manufacturing supply chain today, they are an indication of what Nike is hoping to accomplish with its manufacturing revolution.

In addition, Nike has discussed "bring[ing] these capabilities to our entire source base." To that end, Feng Tay, who produces around one-sixth of Nike's footwear, has introduced automation in seven manufacturing lines. In these automated lines, headcount has been cut roughly in half compared to standard cut-and-sew processes. Automation has developed over the last five years, with 1,200 new automated machines focused on four core technologies — cutting, cementing, assembly, and bottom-making. To date, most of the innovation has been on the upper, but there are also innovations on the bottom. For example, Nike is working on a scalable solution to produce a pair of midsoles and outsoles in 2.5 minutes, compared to more than 50 minutes in the past. This process uses 75% less energy, 50% less tooling cost, and has a 60% reduction in labor. The techniques are also unique to Nike as unlike apparel factories, where several brands may be produced within the same factory, the factory facilities using automation for Nike are exclusive to Nike products.

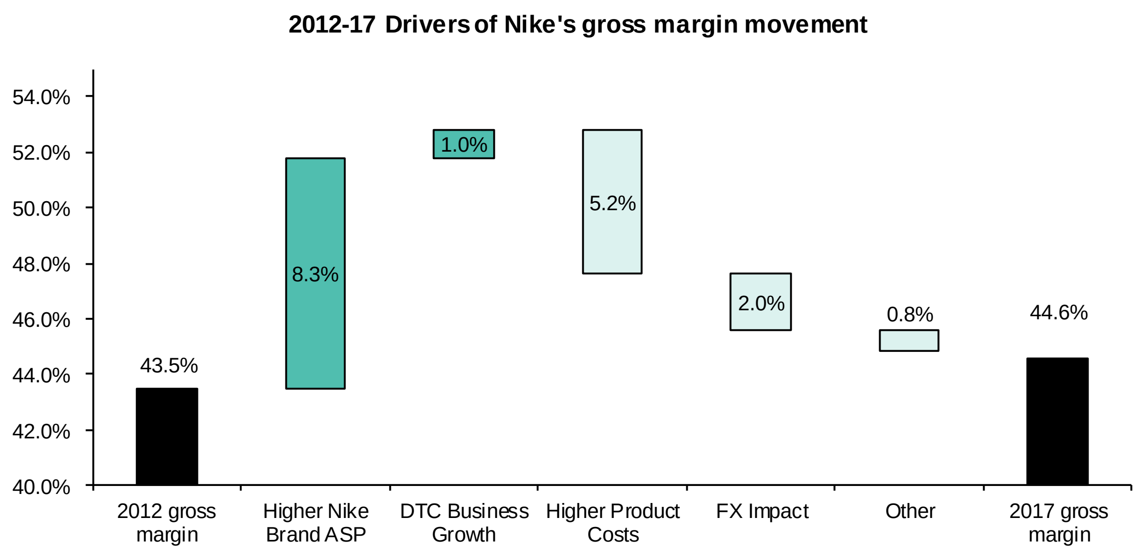
In addition to automation, Nike has begun using techniques to speed the process to market, such as digital printing for color, which allows the company to hold greige goods and decide color and print much closer to the point of sale. Nike has also begun rapid prototyping of products in its Advanced Product Creation Center (APCC), which can produce an upper with 30% fewer steps and up to 50% less labor compared to traditional manufacturing methods. The technologies used at the APCC can produce a complete pair of uppers in just 30 seconds at scale with less waste. On the topic of sustainability, Nike's most exciting development over the last year is Flyleather, which uses leather waste/scrap to produce a material with at least 50% leather fiber and can be made on a roll instead of on a hide. Flyleather uses 90% less water and has an 80% smaller carbon footprint that traditional leather manufacturing. To date, only one shoe, Nike's Tennis Classic, has been released in Flyleather. While the materials cost should be lower for Flyleather compared to traditional leather, Nike's Flyleather Tennis Classic retails for $85 compared to other similar style leather shoes such as the Blazer Low LE, which retails for $75.

…can "man rev" drive margin expansion?

With such a significant focus on reducing waste and offsetting labor cost inflation, the next obvious question for Nike is: Can we see the benefits of "man rev" in margin? Management has suggested that the quarterly savings is now measured in the "tens of millions" of US dollars. If we assume conservatively that this means ~$40-$80M of savings annually, this would suggest 10-20bps of margin improvement. In addition, if Nike can shorten lead times, thus gaining more insight into demand and increasing full price sell through, this could also drive margin expansion. Through 2017, little benefit from automation or improved manufacturing techniques have been visible in Nike's reported gross margin (see Exhibit 109). We would note though that mix likely plays a role here. Between 2012 and 2017, Nike's footwear business grew slightly faster than the apparel business (a 9.4% CAGR versus an 8.8% CAGR), and footwear on a unit basis has a higher ASP and higher product cost compared to apparel.

Where do we come out on the importance of automation in manufacturing? We believe automation can be a competitive advantage relative to peers by helping Nike increase speed to market and by better mitigating cost inflation in the supply chain, but believe it is a smaller "bucket" of margin expansion opportunity compared to the channel shift to direct-to-consumer (DTC). Ultimately, we continue to believe that DTC is the biggest opportunity to drive gross and operating margin expansion for Nike over the next five years.[6] We forecast 380bps of gross margin expansion and 340bps of total operating margin expansion between 2018 and 2022, driven by the combination of mix shift to DTC, forex tailwinds, and manufacturing-driven cost improvement.

EXHIBIT 109: **Over the last five years, the bulk of Nike's margin improvement has come from higher ASP, but mix plays a role and may mask some of the benefits of manufacturing improvements**



Source: Company reports and Bernstein analysis

[6] Please see our research on Nike's DTC and digital initiatives: February 15, 2018 - Nike - digital progress and opportunity; January 19, 2018 - Nike: How much margin upside does DTC provide?.

DO NOT UNDERESTIMATE THE OPPORTUNITY OF DTC

Shift to direct-to-consumer could drive 200bps of operating margin expansion

OVERVIEW

As Nike moves from a wholesale business to a more direct business, we believe there is clear margin upside from this shift. Based on Nike's disclosure, we can make a good estimate of the gross margin differential between DTC and wholesale, which we believe is ~24ppts, with wholesale gross margins of ~38% and DTC gross margins of ~62%. Given our estimate that Nike's realized retail price is 2x the wholesale price, this suggests that the gross profit contribution of a unit sold directly by Nike is 3.3x higher than the gross profit contribution of the same unit sold to a wholesale partner.

The next question is inevitably, but what about operating margin? Based on a set of global peers, both from e-commerce pure plays and bricks-and-mortar retailers, we have estimated the incremental operating costs of DTC. Our analysis suggests that Nike's wholesale operating margin is likely close to 12%, while DTC e-commerce margins are in the mid-teens and DTC store margin is ~22-23%. As Nike's DTC e-commerce business digests recent investments in initiatives such as the cloud and the platform relaunch, we expect scale benefits should drive DTC e-commerce margins to or above DTC store margins.

Given our estimates for margin by channel, if wholesale falls to 58% of revenue by 2022, DTC e-commerce increases from 7% of revenue to 17% of revenue, and DTC stores increases from 21% of revenue to 25% of revenue, this would drive 90bps of operating margin expansion (and ~330bps of gross margin expansion). If margins of DTC e-commerce scale to DTC store margins, this would drive 200bps of operating margin.

WE ESTIMATE THE GROSS MARGIN DIFFERENTIAL BETWEEN NIKE DTC AND WHOLESALE AT 24%

One of the questions we are asked most often about Nike is what the move to DTC will mean for group margins. While Nike management has suggested that DTC margins are higher, the company has not quantified the differential or the split between e-commerce and store margins. In this chapter, we look at Nike's disclosures, combined with some educated assumptions about store and e-commerce margins based on comparisons across the softline and specialty retail space in order to estimate Nike's margins by channel. We also use scenario analysis to size the margin upside as Nike continues to shift its business toward direct-to-consumer and look at the impact of mix shift on revenue growth.

What do we know already?

Nike actually discloses quite a bit of information to help us dissect margins by channel. The two most important numbers are "Sales Direct to Consumer" and "Sales from our

Wholesale Operations to Direct to Consumer Operations" or sales on a wholesale equivalent basis. Effectively, this tells us the retail selling value and the wholesale value of Nike's DTC business. Based on this, we can work out an approximate estimate of Wholesale Gross Margin and DTC Gross Margin — while DTC is 28% of reported revenue, we only assign it 20% of COGS, given that this is the split of wholesale equivalent revenue (see Exhibit 110). Using this as the basis to calculate gross margin suggests a Wholesale Gross Margin of 37.7% in fiscal 2017 and a DTC gross margin of 61.5%.

This is largely where Nike's disclosure stops... to go from gross margin to operating margin, we are going to need to use what we know about retail and make some educated assumptions.

EXHIBIT 110: **Based on Nike's disclosure, we estimate that DTC has a gross margin ~24ppts higher than wholesale**

	Annual 2017 May-17
(USD in millions, unless otherwise stated)	
Sales to Wholesale Customers	23,078
Sales Direct to Consumer	9,082
Global Brand Divisions	73
Total NIKE Brand Revenues	32,233
Sales to Wholesale Customers	23,078
Sales from our Wholesale Operations to Direct to Consumer Operations	5,616
Total NIKE Brand Wholesale Equivalent Revenues	28,694
Reported Gross Margin	44.6%
Reported EBIT Margin	14.4%
Est. COGS (for Nike Brand)	17,865
Est. Operating Costs (for Nike Brand)	9,728
Revenue Split	
Wholesale	72%
DTC	28%
Brand divisions	0%
COGS Split (allocated based on the split of wholesale equiv. revenues)	
Wholesale	80%
DTC	20%
Gross Margin	
Wholesale	**37.7%**
DTC	**61.5%**
Gross margin differential	**23.8%**

Source: Company reports, and Bernstein estimates and analysis

What does our analysis of other retailers suggest about operating costs?

Once we get beyond gross margin and move to operating margin, we have to make assumptions about Nike's incremental operating costs for DTC. We believe the key assumptions are:

- First, what is the operating cost for a unit of sneakers at the wholesale/Nike brand level?
- For DTC stores, what is rent as a percentage of sales?
- For DTC stores, what is labor as a percentage of stores?
- For DTC e-commerce, what is the fulfillment cost as a percentage of sales?
- For DTC e-commerce, what is the incremental warehousing cost as a percentage of sales?
- For DTC e-commerce, what is the labor cost as a percentage of sales?
- For both channels within DTC, what is the capital cost and associated depreciation and amortization?

At a group level, Nike's operating costs were ~30.2% of revenue in fiscal 2017, but this amount would overstate the true cost for wholesale, as Nike has already layered into this the operating costs of DTC. So, we believe it is more helpful to first look at the DTC costs and then back into the operating costs of wholesale, as retailers without wholesale can give us some guidance on these DTC costs.

First, with respect to e-commerce, we believe there are two big sources of operating costs that are new to DTC versus wholesale operations — distribution costs (aka fulfillment costs or shipping costs) and the labor cost of running a digital business. Pure-play apparel e-commerce retailers such as Asos, Zalando, boohoo.com, and Yoox Net-a-Porter provide some guidance here. For Asos and Zalando, distribution costs run between ~8% of sales and ~15% of sales, and generally are lower for distribution networks serving higher population density in regions close to the distribution center. For example, Asos has a low double-digit distribution cost in the UK, where it offers the best delivery terms (speed and cost), given that it has the highest scale/volume, the distribution center is in close proximity to the customer, and the region is densely populated. In contrast, in the US, the distribution cost is higher, as some US fulfillment still comes from the UK (a far distance), Asos' scale is smaller, and population density is lower. Given these comparisons, we will assume Nike spends 16% of sales on fulfillment. This cost will likely fall with scale, and we believe we may be over estimating the cost (see Exhibit 111 and Exhibit 112).

Pure-play apparel e-commerce retailers can also provide a guide on labor cost. Asos, Zalando, boohoo.com, and Yoox Net-a-Porter spend between ~7% of sales (Asos) and ~13% of sales (boohoo.com) on compensation. In our mini-model, we assume a 10% cost for Nike, which is the average of all four retailers (see Exhibit 113).

We expect warehousing costs, which are another 8% of sales for Zalando and Asos, are lower for Nike compared to e-commerce pure plays, as at least some of this cost is already included in Nike's wholesale cost structure (included in COGS), so we do not believe the incremental warehousing costs would be very high; we assume a 4% cost as a percentage of sales (see Exhibit 114).

Finally, we have to make an assumption about investment cost/depreciation and amortization of e-commerce related capital expenditure. Nike has said that while it expects e-commerce to be accretive at scale, the company has recently made significant investments in e-commerce development (such as the cloud), and our peer analysis suggests that capex for e-commerce is particularly bumpy (see Exhibit 115). As these investments scale, however, D&A for e-commerce pure plays is generally lower than store-based retailers (see Exhibit 116). In our margin model, we assume D&A for DTC e-commerce is 2% of sales.

For DTC stores, the two largest sources of operating costs are rent and labor. We actually have an estimate of rent for Nike based on its own disclosure of 5% of DTC sales (note this is 5% of total DTC, not DTC stores, so as a percentage of store revenue it is likely closer to 7% of sales), and is at the low end of other specialty retailers. With respect to labor costs, European retailers including Inditex, H&M, and Next can provide a guide of labor as a percentage of sales for store-based retailers. Similar to Nike and rent, this reflects total labor cost for the three retailers, not just store-based labor cost, and likely slightly under-represents the cost as a percentage of store costs. We estimate labor as a percentage of DTC store costs at Nike to be 15%.

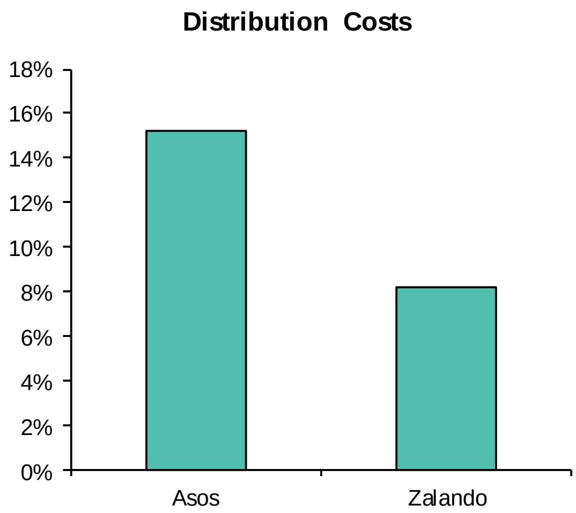
Given the capital cost of opening stores, we have also included an incremental D&A cost for DTC stores of 4%, similar to what we see for store-based retailers.

The last remaining cost is the operating cost associated with wholesale, which we assume is fixed on a unit level. This would include costs such as demand creation and corporate overhead. While we can debate whether Nike needs to spend incrementally on marketing for its own stores versus wholesale, and we would expect there is some incremental demand creation cost created by e-commerce in particular, this is likely small relative to the costs discussed earlier, given the strong global brand awareness already created by Nike's wholesale marketing initiatives. Based on the revenue split by channel disclosed by Nike, as well as reported group margins, we back into this line item in our mini-Unit Economics Model (see Exhibit 117 and Exhibit 118).

This analysis then provides what we think is a good baseline for estimating Wholesale, DTC e-commerce, and DTC store margins, which we estimate at ~11.9% in Wholesale, 16.6% in DTC e-commerce, and ~22.6% in DTC stores.

We expect that over time, as the DTC e-commerce business grows in scale, fulfillment costs, labor costs, and investments will scale, helping to boost DTC e-commerce margins. Indeed, Nike has said that DTC e-commerce will be accretive at scale, while pointing to recent investments in the platform relaunch, cloud investment, etc., implying that margins today may be below group average.

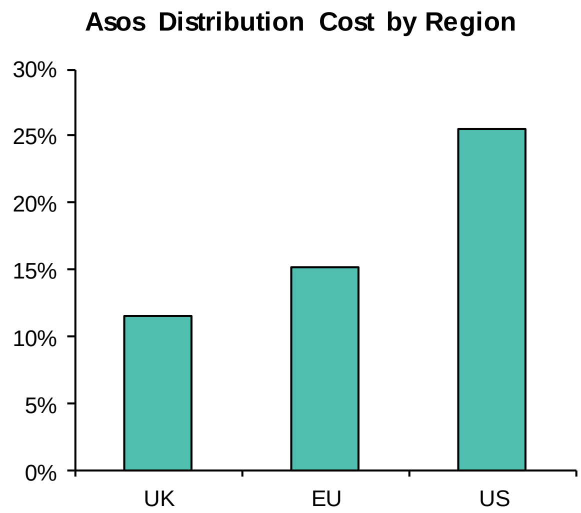
EXHIBIT 111: **Zalando and Asos demonstrate the cost advantages of concentrated distribution...**



Note: Based on an average of the last two reported fiscal years. Zalando's estimated distribution costs are one-third of the total fulfillment costs including warehousing and other.

Source: Company reports and Bernstein analysis

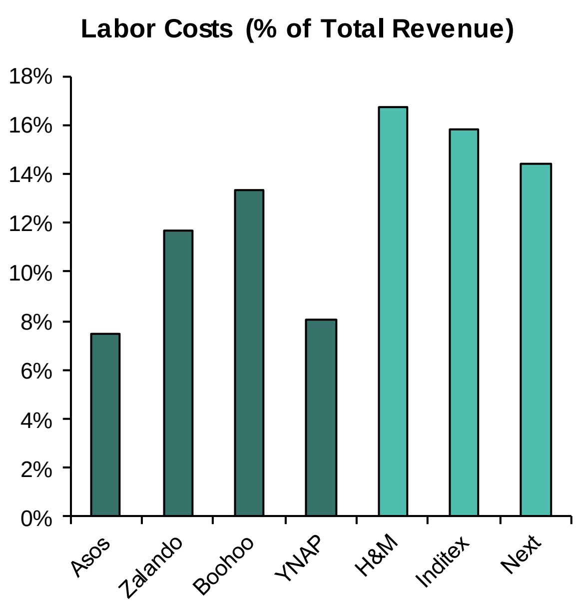
EXHIBIT 112: **...as Asos's distribution costs increase significantly in the US, where much is still fulfilled from the UK**



Note: Based on an average of the last two reported fiscal years.

Source: Company reports and Bernstein analysis

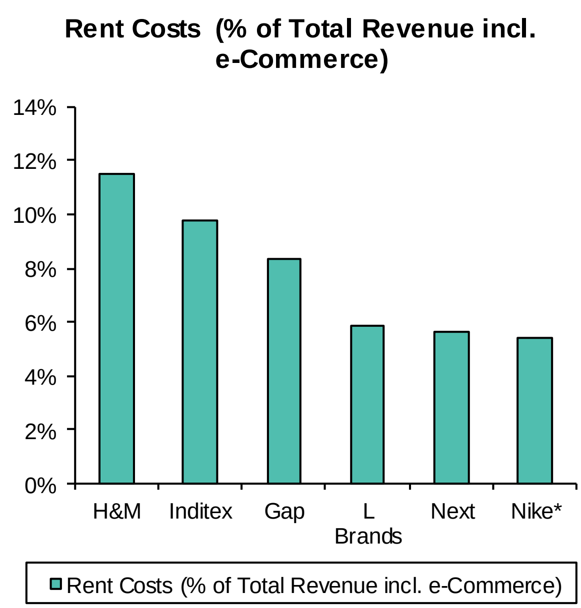
EXHIBIT 113: **E-commerce pure plays have a labor cost advantage relative to brick-and-mortar retailers**



Note: Based on an average of the last two reported fiscal years.

Source: Company reports and Bernstein analysis

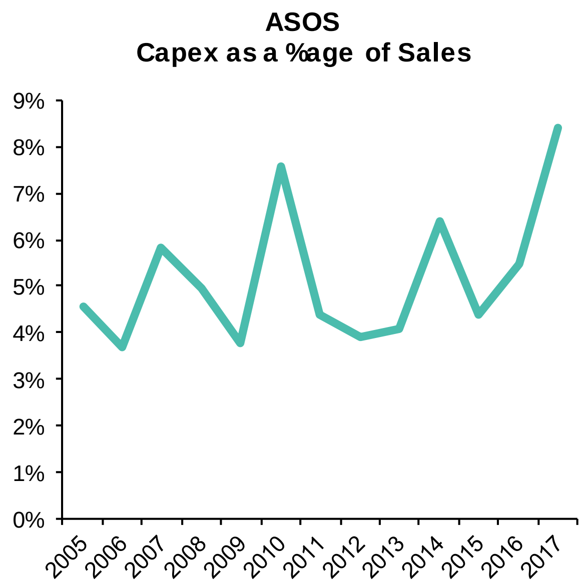
EXHIBIT 114: **Rent generally ranges from mid-single digits to low-double digits as a percent of retail sales**



Note: Based on an average of the last two reported fiscal years.
* Nike's rent cost based on the 2017 reported minimum cash operating lease payment due, divided by DTC revenue in fiscal 2017.

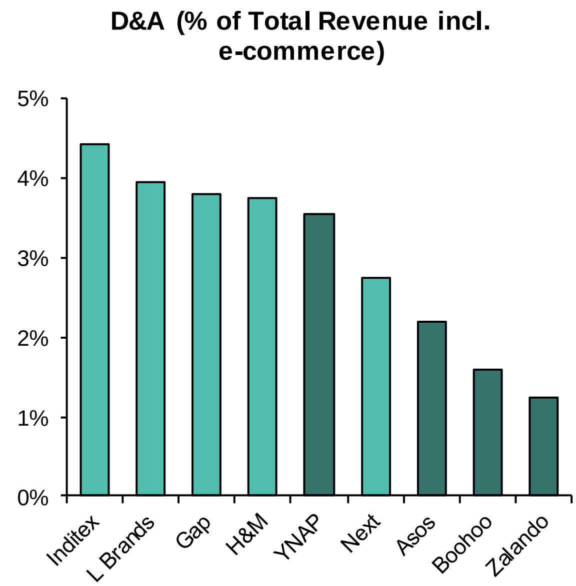
Source: Company reports and Bernstein analysis

EXHIBIT 115: **Capex for e-commerce retailers is bumpy due to investments in systems and warehouses...**



Source: Company reports and Bernstein analysis

EXHIBIT 116: **...but is lower as a percentage of sales relative to brick-and-mortar retailers, meaning lower D&A**



Source: Company reports and Bernstein analysis

EXHIBIT 117: **At the unit level, the key question for Nike's segment margins is where do they fall on the spectrum of rent, fulfillment, and labor costs**

		Unit Level Economics		
		Wholesale	**DTC e-commerce**	**DTC Stores**
Revenue		100.00	200.00	200.00
Gross Margin		37.7%	61.5%	61.5%
Gross Profit		37.74	123.00	123.00
Operating Costs for Wholesale		**25.88**	**25.88**	**25.88**
Operating Costs for DTC	**% Sales**			
Store Rent	**7%**	0	0	14.00
Store Labor	**15%**	0	0	30.00
Store D&A	**4%**	0	0	8.00
e-Commerce Labor	**10%**	0	20.00	0
e-Commerce Warehousing	**4%**	0	8.00	0
e-Commerce D&A	**2%**	0	4.00	0
e-Commerce Fulfillment	**16%**	0	32.00	0
Total Operating Costs		25.88	89.88	77.88
Operating Costs as a % of Sales		25.9%	44.9%	38.9%
Operating Profit		**11.86**	**33.12**	**45.12**
Operating Margin		11.9%	16.6%	22.6%

Source: Company reports, and Bernstein estimates and analysis

EXHIBIT 118: **At the group level, we estimate DTC contributes ~41% of Nike's profit, compared to 28% of revenue**

	Scaled to Group Revenue/Profitability			
	Wholesale	DTC e-commerce	DTC Stores	Group
Revenue	72.00	7.00	21.00	100.00
% of group revenue	*72%*	*7%*	*21%*	*100%*
Gross Margin	37.7%	61.5%	61.5%	44.4%
Gross Profit	27.17	4.31	12.92	44.39
Total Operating Costs	18.63	3.15	8.18	29.96
Operating Costs as a % of Sales	25.9%	44.9%	38.9%	30.0%
Operating Profit	8.54	1.16	4.74	14.44
Operating Margin	**11.9%**	**16.6%**	**22.6%**	14.4%

Source: Company reports, and Bernstein estimates and analysis

What can we expect from Nike's operating margin going forward?

Putting this all together and thinking through margin trajectory over the next five years suggests significant upside opportunity. If our analysis of the business's current margin structure is correct and margins in the three channels are unchanged, channel shift alone should drive margin expansion. For example, if wholesale falls to 58% of revenue, DTC e-commerce increases from 7% of revenue to 17% of revenue, and DTC stores increases from 21% of revenue to 25% of revenue, this would drive 90bps of operating margin expansion (and ~330bps of gross margin expansion) (see Exhibit 119).

If scale also helps drive improvement in Nike's DTC e-commerce operating margin, for example from ~16.6% to ~22.6% (in line with our current estimate of Nike DTC store operating margins), then we would estimate margin expansion of ~200bps to 16.4% (see Exhibit 120).

EXHIBIT 119: **If margins remain at our current estimates but we see continued mix shift to DTC (17% e-commerce, 25% stores), this would suggest 90bps of operating margin expansion**

	% of Revenue	Gross Margin	Operating Margin
Wholesale	58%	37.7%	11.9%
DTC e-com	17%	61.5%	16.6%
DTC stores	25%	61.5%	22.6%
Group	**100%**	**47.7%**	**15.3%**

Source: Bernstein estimates and analysis

EXHIBIT 120: **If scale leads to higher operating margins in DTC e-commerce, equivalent to our estimate of current DTC store margins, this would suggest 190bps of operating margin expansion**

	% of Revenue	Gross Margin	Operating Margin
Wholesale	58%	37.7%	11.9%
DTC e-com	17%	61.5%	22.6%
DTC stores	25%	61.5%	22.6%
Group	**100%**	**47.7%**	**16.4%**

Source: Bernstein estimates and analysis

What about revenue?

The mix shift to DTC also means that lower volume growth is needed to achieve the same level of revenue growth, even if there is no change in price. Based on a retail markup of 2x, which we believe is broadly consistent with the difference in realized wholesale and retail prices, we estimate that if DTC increases from 28% of revenue in FY 2017 to 42% in FY 2022, this mix shift will drive ~2ppts of annual sales growth on top of unit growth and absent any change in prices at the retail level. Essentially, because Nike is recognizing the higher retail price, rather than the wholesale price, this helps drive revenue growth (see Exhibit 121).

EXHIBIT 121: **If wholesale shrinks to 58% of revenue (from 72% in 2017), this mix shift would drive 2ppts of annual sales growth, given the retail markup of DTC**

Revenue Scenarios

FY 2017	Wholesale	DTC e-commerce	DTC stores	Total DTC	Group
Reported Revenue (USD in millions)	23,078	2,256	6,769	9,025	32,103
% revenue	72%	7%	21%	28%	100%
Units (based on retail markup)	230.78	11.3	33.8	45.1	275.91
% unit volume	84%	4%	12%	16%	100%

FY 2022E	Wholesale	DTC e-commerce	DTC stores	Total DTC	Group
Reported Revenue (USD in millions)	28,353	8,310	12,221	20,531	48,884
% revenue	58%	17%	25%	42%	100%
Units (based on retail markup)	283.53	41.6	61.1	102.7	386.18
% unit volume	73%	11%	16%	27%	100%

FY 2017-2022E CAGR	Wholesale	DTC e-commerce	DTC stores	Total DTC	Group
Revenue	4%	30%	13%	18%	**9%**
Unit Volume	4%	30%	13%	18%	**7%**

Source: Company reports, and Bernstein estimates and analysis

CONCLUSION

The mix shift to DTC and the improvement in DTC e-commerce margins are key components of our thesis on Nike, as we believe that at scale, the operating margins of DTC stores and DTC e-commerce should be significantly higher than wholesale, and this mix shift will lead to group margin expansion and higher EPS growth, absent any change in retail pricing. In addition, this mix shift will help boost revenue growth, given the higher contribution rate of DTC.

DIGITAL PROGRESS AND OPPORTUNITY

Investment paying off as Nike leads in digital positioning

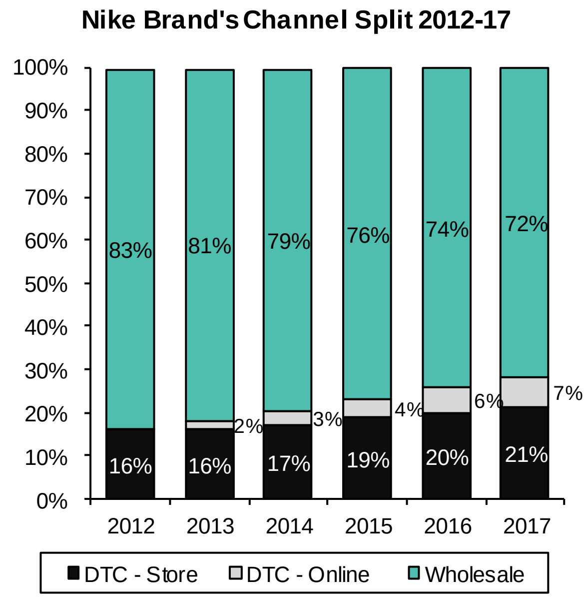
OVERVIEW

We expect e-commerce to continue to gain share of apparel retail. In Nike's case, this growth should be margin enhancing, given what we believe is the margin profile of Nike's DTC e-commerce business and the company's lack of owned stores. In this chapter, we discuss how we measure progress for Nike's digital investments, how the company's efforts in membership should drive loyalty, and what strategic partnerships offer beyond the DTC online experience.

One of Nike's Triple Double targets was to drive Nike digital e-commerce to ≥30% of revenue from less than 15% in five years. This is expected to drive over 50% of incremental revenue growth. In addition, Nike expects that digital will be the majority of revenue over the long term, up from ~15% today, with just 7% of total revenue through DTC e-commerce in 2017 (see Exhibit 122).

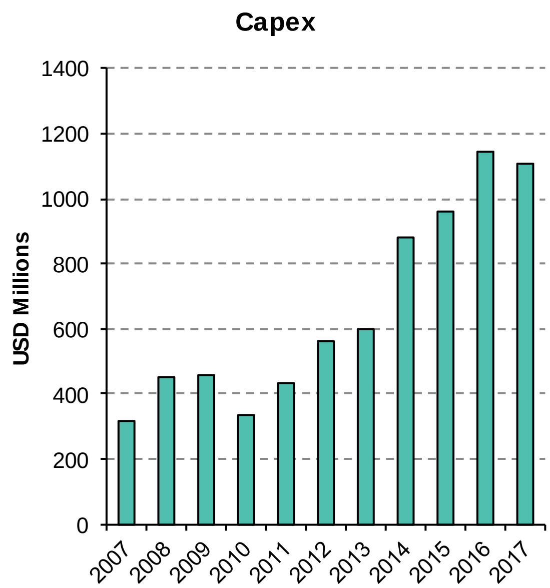
Nike's investment in digital has ramped up, and capital expenditure doubled on an absolute basis in the last five years (see Exhibit 123). Some of Nike's investment has been organic, though the company has also been willing to acquire technology capabilities, such as Virgin Mega (in August 2016) to "expand the community and functionality of Nike's core mobile experiences." We also believe that Nike is at an advantage relative to other brands and retailers, without a significant owned-store base and with a flexible supply chain. For example, Nike has recently built two fully-integrated distribution centers (one in Tennessee and one in Belgium), which handle fulfillment for Nike to wholesale, DTC stores, and DTC online, suggesting that the company does not need to invest in a stand-alone distribution network for its e-commerce initiatives.

EXHIBIT 122: **Nike's DTC online business was just 7% of sales in 2017**



Source: Company reports and Bernstein analysis

EXHIBIT 123: **Nike's annual capex spending has doubled in the last five years**



Source: Company reports and Bernstein analysis

We believe these investments are now paying off, with evidence of brand traction in the form of high and growing traffic to Nike.com when compared to peers. Further, we believe that Nike apps will differentiate the company as both a brand and a retailer, as the entire portfolio of Nike apps is integrated under a single Nike+ membership program. Nike cited 100 million Nike+ members during its 2017 Investor Day and that members on the Nike app spend 3x as much as customers on Nike.com. Finally, Nike's strategic partnerships with retailers such as Tmall and Zalando will help Nike reach incremental customers while allowing Nike to control more of its pricing and merchandising decisions, closely replicating the direct online experience that Nike offers through its own website and apps. Overall, we expect Nike's digital efforts to be a key driver of both top-line growth and margin expansion for the business over the next five years.

A KEY GROWTH DRIVER FOR NIKE

During Nike's Investor Day in November 2017, Nike stated several goals for 2022 — 30% digital, 50% innovation, and 75% international. Nike expects digital to drive over 50% of incremental revenue growth. So, what is Nike doing in digital?

Nike.com traction

Nike.com is currently available in more than 40 countries and the Nike and SNKRS apps are available in more than 20 countries. In November 2017, Nike refreshed Nike.com and the Nike app in its existing markets globally with "elevated entryways" that enable more logical shopping, more predictive and intuitive search results, and more well-rounded product information with a streamlined two-click checkout process.

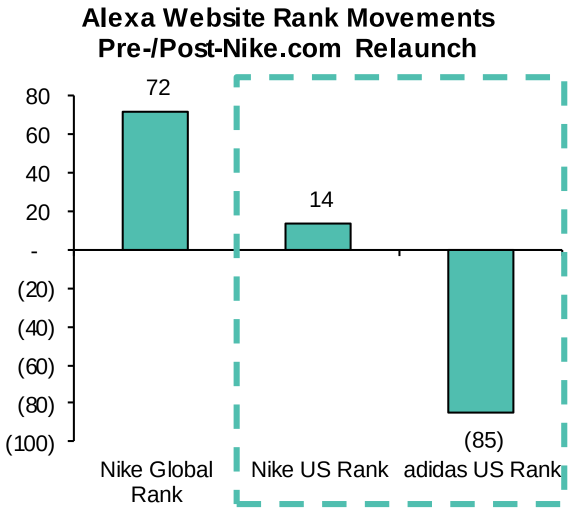
In order to examine the incremental impact from Nike.com's relaunch, we turned to Alexa Engagement Metrics and Google Trends to look for signs of incremental improvements in brand traction.

Since Nike relaunched Nike.com, Nike has moved up in its global website rank from 561 to 489. Specifically, in the US, Nike's largest market, Nike.com has moved up from 269 to 255 in its website ranking, whereas adidas.com has lost ground over the same period, moving from its US rank of 539 to 624 (see Exhibit 124). Furthermore, while we have seen an overall retail website traffic rally since mid-November, mostly spurred by holiday shopping, we have seen a flattening out in traffic ranks for most of the other brands in 2018. We continue to observe upward momentum for Alexa Traffic Ranks for Nike.com in recent months, further implying that Nike.com has attracted higher traffic since its global relaunch (see Exhibit 125 to Exhibit 127).

Further examination of key Alexa engagement metrics shows that Nike.com attracts a more engaged audience than other brands (see Exhibit 128 to Exhibit 133). Not only is Nike.com ranked higher in Alexa Traffic Ranks both globally and in the US compared to other athletic brands and retailers, but Nike.com also has the lowest bounce rate among its peers, with only 28% of the visits to Nike.com consisting of a single-page view. Nike scores well on other metrics, with an estimated second highest daily time on site (mm:ss) per visitor to the site, second only to adidas, albeit with a much higher traffic audience, and the second lowest in terms of visits from a search engine (second to Underarmour.com), once again among a much higher audience base. Finally, Nike.com has the highest estimated daily unique pageviews per visitor among its peers.

Google Trends supports Alexa traffic trends as well, as indexed Google Trends scores show that Nike has much stronger brand traction compared to other brands and athletic retailers in the US (see Exhibit 134). Further, while adidas steadily gained popularity relative to Nike in the US from 2013 through 2016, as evidenced by the multiple of the indexed score between Nike and adidas declining from 6x at its peak to 2x at its trough, it has remained stable since late 2016. Looking at adidas's 12-month moving average on a Y-o-Y basis, search growth has stabilized in recent months (see Exhibit 135 and Exhibit 136).

EXHIBIT 124: **Nike.com has shown improvements in its Alexa traffic rank since the site was relaunched...**

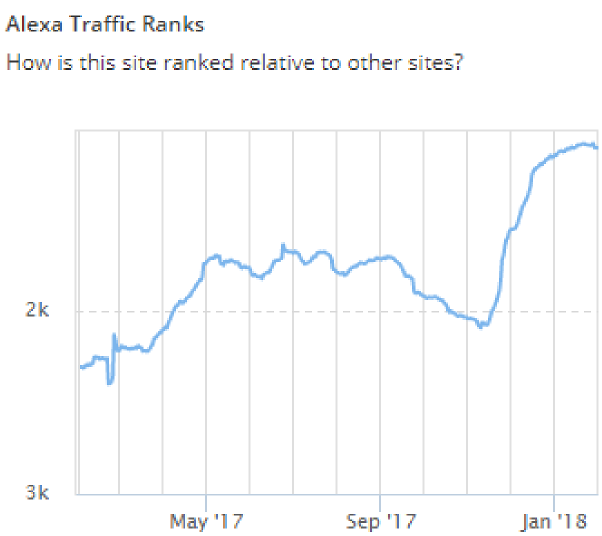


Source: Alexa and Bernstein analysis

EXHIBIT 125: **...further, we have yet to see the flattening of traffic rank that is evident in other brands...**

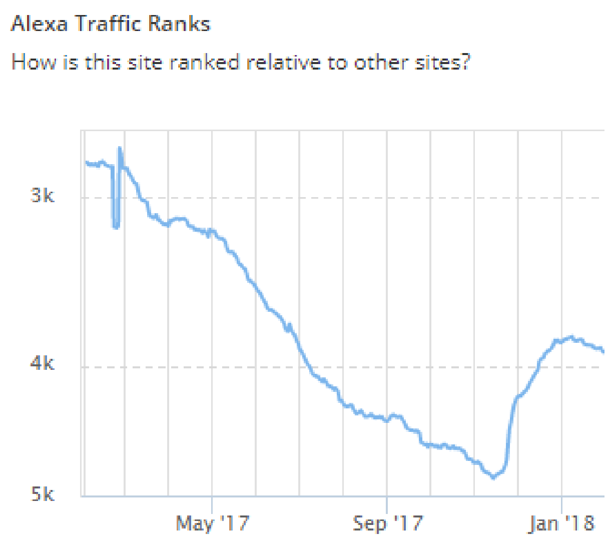
Source: Alexa and Bernstein analysis

EXHIBIT 126: **...adidas has seen a slowdown since the holidays...**



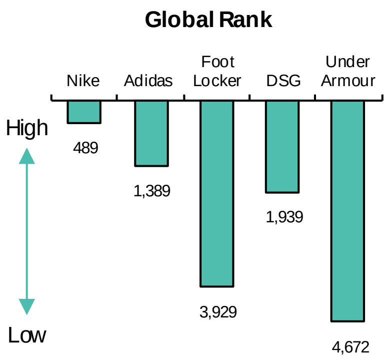
Source: Alexa and Bernstein analysis

EXHIBIT 127: **...as has Footlocker.com**



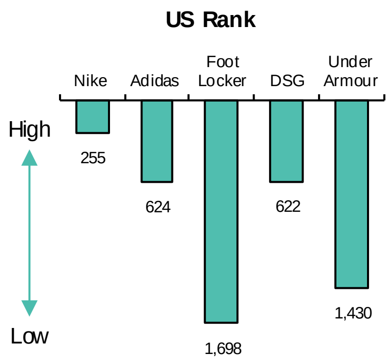
Source: Alexa and Bernstein analysis

EXHIBIT 128: **Nike.com is by far the highest ranked brand globally...**



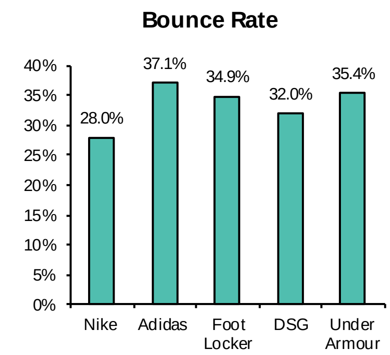
Source: Alexa and Bernstein analysis

EXHIBIT 129: **...and in the US**



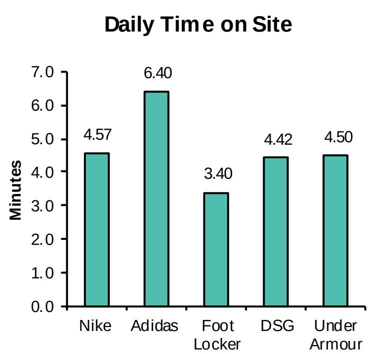
Source: Alexa and Bernstein analysis

EXHIBIT 130: **Nike.com has the lowest bounce rate...**



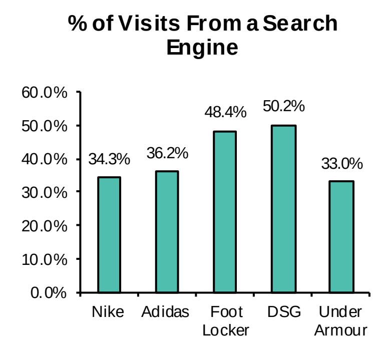
Source: Alexa and Bernstein analysis

EXHIBIT 131: **...and one of the highest daily time on site...**



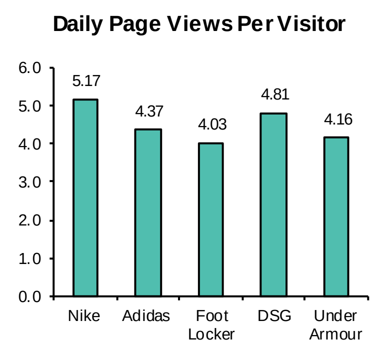
Source: Alexa and Bernstein analysis

EXHIBIT 132: **...one of the lowest percentage of visits from a search engine...**



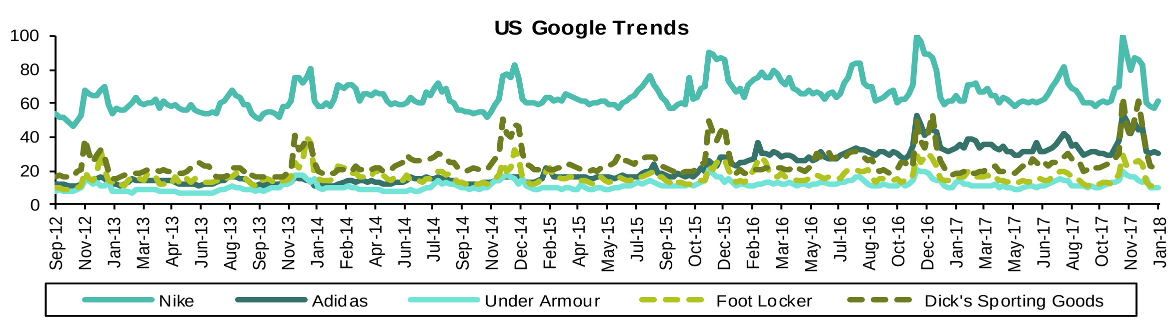
Source: Alexa and Bernstein analysis

EXHIBIT 133: **...and the highest daily pageviews per visitor**



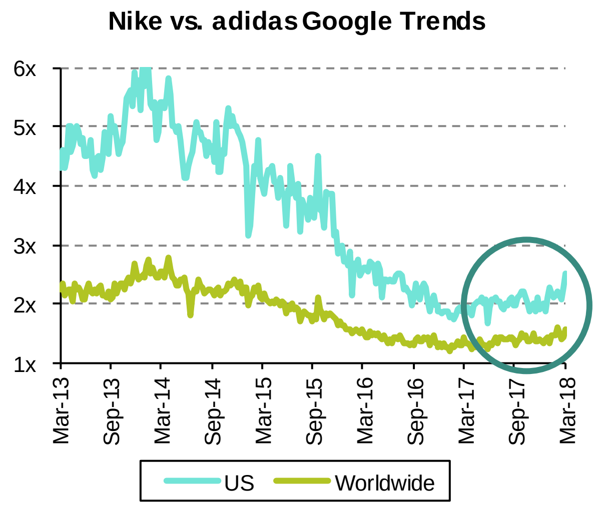
Source Alexa and Bernstein analysis:

EXHIBIT 134: **Further, Google Trends suggests that Nike has stronger traction compared to other sports retailers in the US**



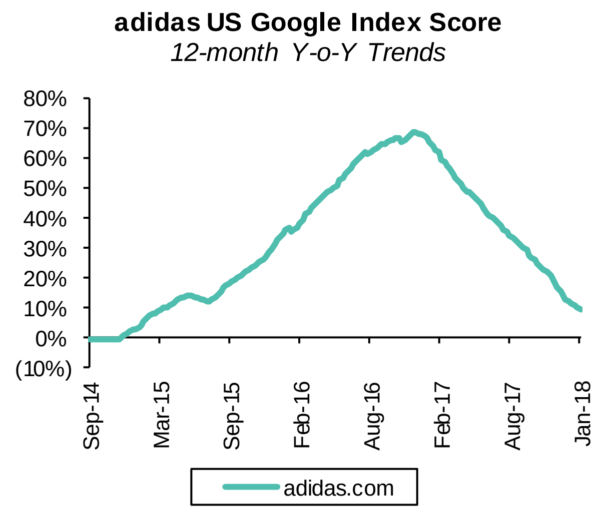
Source: Google Trends and Bernstein analysis

EXHIBIT 135: **While adidas closed the search gap vs. Nike since 2013, Nike has seen recent (small) resurgence...**



Source: Google Trends and Bernstein analysis

EXHIBIT 136: **...and adidas search has stabilized in the last year**



Source: Google Trends and Bernstein analysis

MEMBERSHIP

A large part of what will drive Nike's success in digital rests on Nike's ability to integrate its Nike+ membership program. We believe that Nike apps will differentiate Nike as both a brand and a retailer over the next five years, especially since all of its application platforms are integrated under the Nike+ membership program. Nike cited 100 million Nike+ members during its 2017 Investor Day and expects this membership to more than triple over the next five years with 4x as many buying members.

Furthermore, Nike's membership community should allow Nike to better drive merchandising decisions with consumer-led insights at the membership level. Going forward, Nike has discussed its aspirations to become increasingly like an Inditex — able to utilize consumer insights to drive higher full-priced sell-through, targeting 65% full-price sell-through in-season, 25% markdown in season, and less than 10% being sold out of season.

The Nike and SNKRS apps are also the highest-ranked brand-specific retail apps[7] in the US Apple App Store and the company is using its direct efforts to create an increasingly differentiated assortment that will become more distinct to Nike.com and the Nike app, relative to its retail partners, over time. Nike mobile app members get to see limited product first, or exclusively, and even reserve ahead of drops. According to the company, members on the Nike app spend 3x what other guests spend on Nike.com. Nike's SNKRS app has four million Nike+ members, and they have the highest annual spend per buying member (see Exhibit 137).

On average, the four Nike apps have an average rating of 4.8 with the highest number of reviews when compared to other brand-specific apps. Nike SNKRS and Nike app also lead

[7] Nike SNKRS ranks 10th and Nike ranks 14th on the Top Free Shopping Apps charts; apps ranked higher than Nike apps are marketplaces apps such as Amazon, Poshmark, OfferUp, etc.

in the Shopping apps category where they are ranked 10th and 14th, respectively. Additionally, the Nike Run and Training Club apps rank higher at 18th and 31st, respectively, in the Health and Fitness category compared to apps owned by its peers (see Exhibit 138 and Exhibit 139). The high rankings and ratings suggest that the popularity of Nike apps will allow Nike to obtain valuable consumer insights from the data — for instance, when training with Nike Run Club, the app asks members what sneakers they are wearing — which helps inform Nike's ability to track its Nike+ members' preferences, as well as how soon or likely the Nike+ member will need another pair of sneakers. This insight allows Nike to timely suggest sneakers to the member at the right point of the replacement cycle.

As part of Nike+ Unlock, Nike's membership reward system that delivers exclusive members-only experiences, Nike is prioritizing its focus on personalized experiences. It released its first three features in November 2017. These include: Experts on Demand, Exclusive Shop, and Reserved for You. In February 2018, Nike also rolled out additional experiential features and incentives for its members.

- **Nike Experts on Demand** allows members to tap on screen and chat live with an expert (it had driven 80% conversation and 3x average order value in its pilot mode). It was rolled out online in November 2017 and was rolled out to 50 stores by year-end 2017.

- **Exclusive Shop** allows members to purchase members-only products, including collaborations, with options to personalize that product.

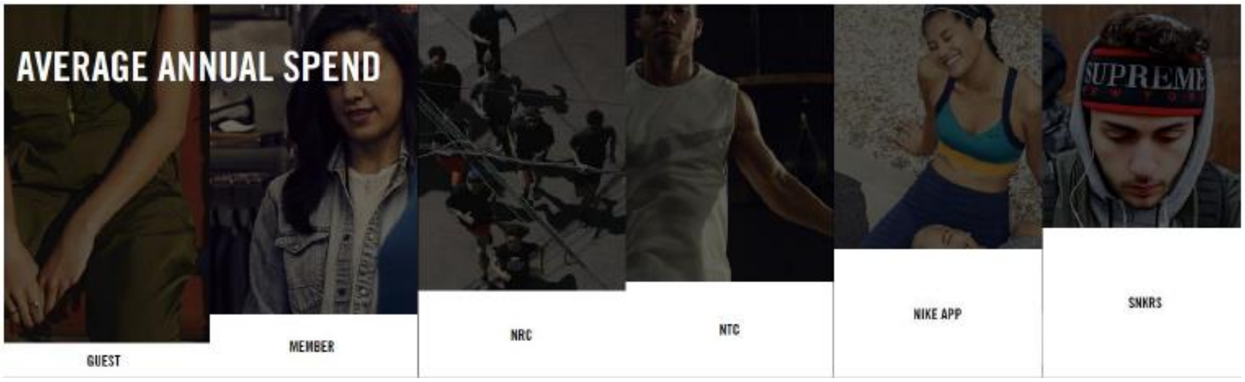
- **Reserved for You** enables members to get access to new products before the public release date or to members-only shopping events.

- In addition, Nike will be creating more personalized invitations to events — races, Q&A sessions with premier athletes such as LeBron, and Nike+ partners such as Apple Music and ClassPass — to create an even more well-rounded experience around the brand.

    - As of February 2018, Nike+ has begun offering different levels of incentives based on how engaged the Nike+ member is with Nike products. New incentives include free curated Apple Music playlists, guided meditation exercises, free ClassPass classes, and membership discounts.

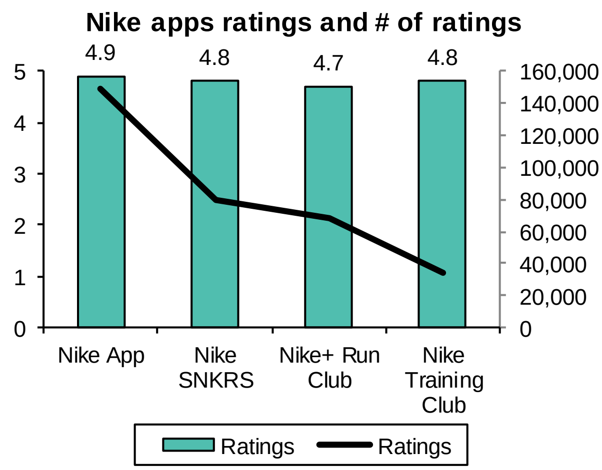
Nike has also begun working with Instagram and WeChat on integrating purchasing into its social media platforms. Nike's Instagram handle ranks16th on the platform, but it is the highest-ranked retailer with 76 million followers. Nike also has a comprehensive segmentation strategy on Instagram — creating separate handles for @nikewoman, @nikesportswear, @nikerunning, @niketraining, @nikelab, @nikebasektball, @nikefootball, @nikenyc, etc. Earlier in 2017, Nike launched a pilot on Instagram that enables followers to shop and buy on the platform and Nike has seen strong engagement on the @nikewoman and @nikesb accounts. Additionally, Nike has been working on its WeChat product integration. Currently, Nike's WeChat page allows users to get access to Nike products, events, and updates. In the spring of 2018, Nike+ membership will be integrated into WeChat. As members drive more value for Nike, and as Nike leverages membership programs with strategic partners, we believe that it will increase member engagement with Nike content, brand loyalty, and retention and has significant potential to drive growth.

EXHIBIT 137: **Average annual spend is highest among Nike SNKRS app and Nike app users**



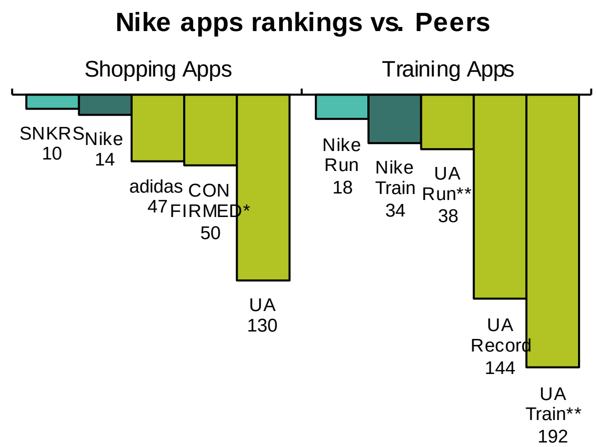
Source: Nike 2017 Investor Day slides

EXHIBIT 138: **Nike apps have an average rating of 4.8/5**



Source: Apple App Store and Bernstein analysis

EXHIBIT 139: **Nike apps also lead in ranking**



* CONFIRMED is the adidas sneakers app; **UA Run represents Map my Run (owned by Under Armour); UA Train represents Map my Fitness (owned by Under Armour).

Source: Apple App Store and Bernstein analysis

WHAT ARE OTHER BRANDS DOING IN DIGITAL?

adidas

Digital was also identified as one of adidas's key growth drivers during adidas's Investor Day in March 2017. During its Investor Day, adidas cited Digital Brand Commerce, Mobile Communities (its running app, runtastic), and Digital Creation as its three digital foundations. Like Nike, adidas believes that digital is where it can build the most direct relationships with its consumers, and believes that with the right wholesale partnerships, it would be able to deliver the right product to the right consumer at the right time. Further, adidas has updated its 2020 e-commerce ambition from €2B to €4B, growing from its 2016 e-commerce revenue of €1B. However, adidas did acknowledge that digital is not yet where they could be or want it to be. As seen earlier in the Alexa and Google Trends data (see Exhibit 128 to Exhibit 133), adidas websites rank lower than Nike's in terms of traffic rank in the US and globally. In terms of adidas apps, once again, adidas ranks lower than Nike on the Apple App Store and is rated lower (see Exhibit 140).

Under Armour

Under Armour began building its Connected Fitness/digital segment in 2013. Under Armour's digital assets are housed under its Connected Fitness Platform with four different apps that allow users to track health/fitness metrics with mobile or wearable devices.

- MapMyFitness: Under Armour bought MapMyFitness, the parent of the MapMyRun and MapMyRide apps, for $150M in 2013. These apps allow users to record and measure their runs and rides.

- Endomondo (based out of Copenhagen): Bought for $85M in2015, Endomondo is similar to MapMyFitness.

- MyFitnessPal: Bought for $475M in 2015; it is currently the number 6 free app under "Health and Wellness" in the App Store, and users can track and store their diet, sleep, and activity information.

- UA Record: Released in 2015, it aggregates user data from a variety of devices. UA Record is supposed to be a dashboard for all activities, sleep, and work outs.

Under Armour had 220 million registered users as of its 3Q earnings report, a ~30 million increase from the 190 million users it had disclosed at year-end 2016 (though we note that registered users are not necessarily active users). From Under Armour's perspective, its original vision was to take a product- and brand-centric view with the Connected Fitness platform and leverage user data from these apps to glean insights into product trends. However, despite over $1B of app acquisitions since 2013, the Under Armour portfolio of applications also ranks lower than Nike's on the Apple App Store (see Exhibit 140).

As a business segment, Connected Fitness was approximately 2% of Under Armour's revenue in 2017 (and we model it at similar revenue contribution levels through 2022). At the operating income level, it was a $55M drag in 2017. In 3Q 2017, Under Armour took $29M of goodwill impairment related to the Connected Fitness business because of the reduction of expected future cash flows from the platform. Additionally, Under Armour has, since 3Q 2017, decided to de-emphasize certain ancillary revenue streams, including Connected Fitness and related web and mobile app development. Instead, Under Armour will be leveraging Connected Fitness across its core products going forward. For instance, Under Armour's first HOVR shoe includes an embedded connected sensor that tracks distance, cadence, pace, and shoe life, which is aimed to not only provide users with data on the shoe, but also integrate with Under Armour apps into a community of runners.

As far as apps/digital assets are concerned, we believe Nike's digital platform, where it is an integrated platform of apps driven off of one membership program (Nike+) is better geared toward better aligning products with consumers' shopping habits and preferences.

EXHIBIT 140: **Nike apps rank higher than apps of peers**

	Rank	Ratings
Nike Apps		
Nike App	14	4.9
Nike SNKRS App	10	4.8
Nike+ Run Club	18	4.7
Nike Training Club	34	4.8
Average		*4.8*
adidas Apps		
adidas	47	4.6
CONFIRMED-Sneakers	50	4.8
Average		*4.7*
Under Armour Apps		
Under Armour	130	4.8
Map my Run (UAA)	38	4.8
Map my Fitness (UAA)	192	4.7
UA Record (UAA)	144	4.4
Average		*4.7*

Source: Apple App Store and Bernstein analysis

STRATEGIC DIGITAL PARTNERSHIPS

Aside from building its direct e-commerce platform, Nike has emphasized building strategic partnerships online with marketplaces such as Tmall and Zalando. While we expect this kind of partnership to be lower margin than Nike's DTC online business, we believe it allows Nike to reach incremental customers and, when done as a partnership, leaves the pricing and merchandising decisions in the hands of Nike, closely replicating the direct online experience that Nike offers through its own website and apps.

We have already identified Tmall as one of the key levers of growth for brands in China.[8] At over 70% share of the total Chinese apparel and footwear e-commerce category, Tmall is the largest digital retail platform globally, reaching over 500 million consumers. During Nike's 2017 Investor Day, Nike cited that it is already the top-performing brand on Tmall, and recently launched its stand-alone Jordan store on the platform as well. We looked to Nike's Tmall storefront "fanbase" to gauge Nike's brand performance and found that indeed, the combined fanbase of Nike's official storefront and Jordan's official storefront stands at approximately 13.7 million, slightly higher than adidas at 13.5 million. This is despite the fact that Nike has 20% fewer followers than adidas does on the Weibo platform (see Exhibit 141 and Exhibit 142).

Tmall's operating model is such that it functions essentially as an online mall, charging a commission fee ("rent"), while allowing brands to exert full control over the look and feel of their e-storefronts on the platform as well as control and operate merchandising. Nike's Tmall landing page looks essentially the same as Nike.cn's landing page — enabling Nike to have a streamlined and cohesive go-to-market strategy in the Greater China region. Furthermore, we estimate that Tmall charges between 6% and 7% commission on its

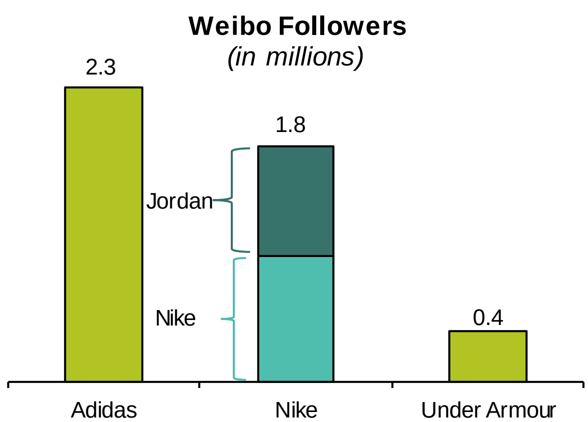
[8] How to grow in China

platform (compared to ~15% at Amazon), and it offers a compelling value proposition for Nike as the economics of operating through Tmall is similar to operating Nike e-commerce DTC (see Exhibit 143 and Exhibit 144). As Nike continues to work with Tmall and integrates insights from its consumer data partnership, it will be able to better serve consumers with personalized targeting.

Nike also has a robust partnership with Zalando, Europe's online marketplace and fashion platform. We believe one of the features of the Nike-Zalando partnership that Nike hopes to replicate in other geographies and with other partners is the connected inventory program, where Nike and Zalando are able to share inventory availability on the backend to ensure a seamless transaction experience for customers, better matching demand with supply. Ultimately, this should also allow Nike to sell more product at full price and reduce markdowns.

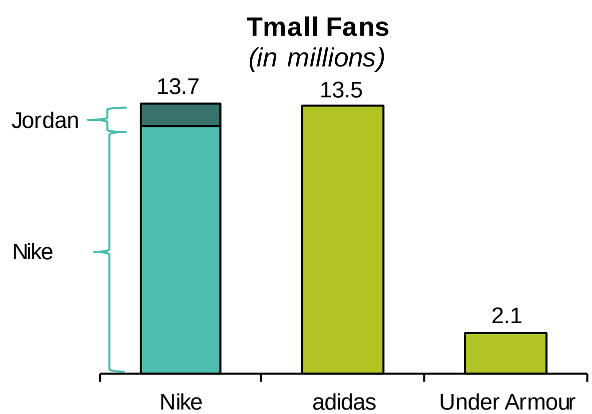
Finally, Nike is running a pilot program with Amazon and with other online marketplaces around the world. Farfetch, for instance, began providing online access to NikeLabs in Chicago and New York with a "buy-online, pick-up-in-store" delivery option and it will soon offer "same-day delivery service." While the Amazon pilot tends to get the most interest from investors, the Nike product being sold by Nike to Amazon so far is relatively basic in nature (t-shirts and socks).

EXHIBIT 141: **Nike has fewer Weibo followers than adidas...**



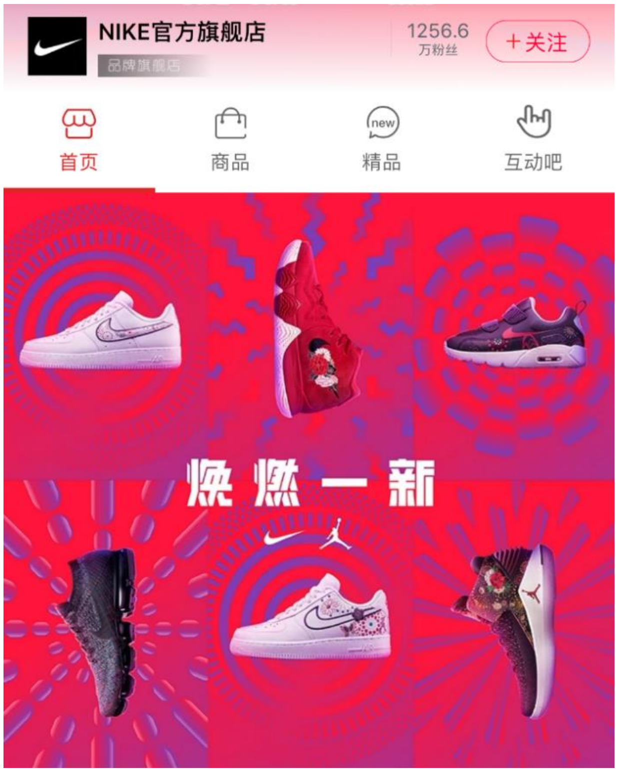
Source: Weibo and Bernstein analysis

EXHIBIT 142: **...but slightly more fans on Tmall**



Source: Tmall and Bernstein analysis

EXHIBIT 143: **Nike's Tmall storefront...**



Source: Tmall

EXHIBIT 144: **...is identical to Nike's China direct website**

Source: Nike.cn

OTHER INITIATIVES

Beyond these major initiatives, Nike is also engaged in many other projects to drive its digital presence, enabled by its apps. Some of the other iterations of Nike's digital platform that we thought particularly compelling include: Nike Connect, which will allow members to snap and buy in real life with the Nike App camera, and the Nike App at Retail, which will launch in spring and allow members to have instant access to color and availability based on the product they see in the store.

Overall, these initiatives reflect a company that is truly digitally focused and which we expect to be a leader in setting consumer expectations for how to interact with a brand. Importantly, this should also help drive margin expansion for the group, leading to our expectations for mid-high teens annual earnings growth.

CAN ROIC IMPROVE AS DTC GROWS?

A resounding "Yes"

OVERVIEW

We believe Nike's move to direct-to-consumer (DTC) will drive both gross and operating margin expansion at the group level,[9] but investors have rightly asked us about the implications for ROIC as Nike shifts to this arguably more capital-intensive business.

While Nike's net working capital days have remained relatively steady even as DTC sales have increased as higher inventory days have been largely offset by the declining receivable days in the working capital cycle, capex and, therefore, PP&E is higher in the Direct channel and Direct stores also require capital as we capitalize operating leases.

We calculate a group lease-adjusted ROIC of ~34% for Nike overall in 2017. Of the three distribution channels, we estimate Nike's Wholesale ROIC currently at 41%, above group average, based on our assumption that invested capital needs of a wholesale business are lower and more scalable compared to a direct business; of the Direct distribution channels, we estimate Direct store lease adjusted ROIC at 29% and Direct e-commerce at 26%. However, we believe that recent e-commerce investments in both P&L and capital have yet to scale, depressing margin and resulting in disproportionately high invested capital relative to sales. Looking ahead, as margins for DTC e-commerce improve and as capex scales, we expect DTC e-commerce ROIC to improve. Overall, given our assumptions, we estimate that Group ROIC could increase by ~3ppts in the next five years, largely driven by the increasing ROIC in the Direct e-commerce channel.

NIKE'S SHIFT TO DTC AND IMPROVING ROIC PROFILE

In this chapter, we explore what the shift to DTC means for group ROIC, as investors worry that the same margin-enhancing move may be a drag on ROIC. We use a combination of Nike disclosures and industry benchmarking for each channel to make educated assumptions about the ROIC of Direct store, Direct e-commerce, and Wholesale.

Since 2011, Nike has seen its DTC segment grow from 16% to 28% of its total revenues (see Exhibit 145). Despite this mix shift, since 1Q 2013, Nike's group ROIC has improved steadily, according to the company's own calculation, though we note a slight drop in fiscal 2018 (see Exhibit 146). As of 3Q 2018, Nike's adjusted ROIC has been approximately ~32% for the last three quarters. We note that in Nike's ROIC calculation, the company includes net cash in the invested capital base and does not make any adjustment for operating leases in the invested capital base. In our standard calculation, we do not include net cash in the invested capital base and we adjust for leases, which is most relevant to

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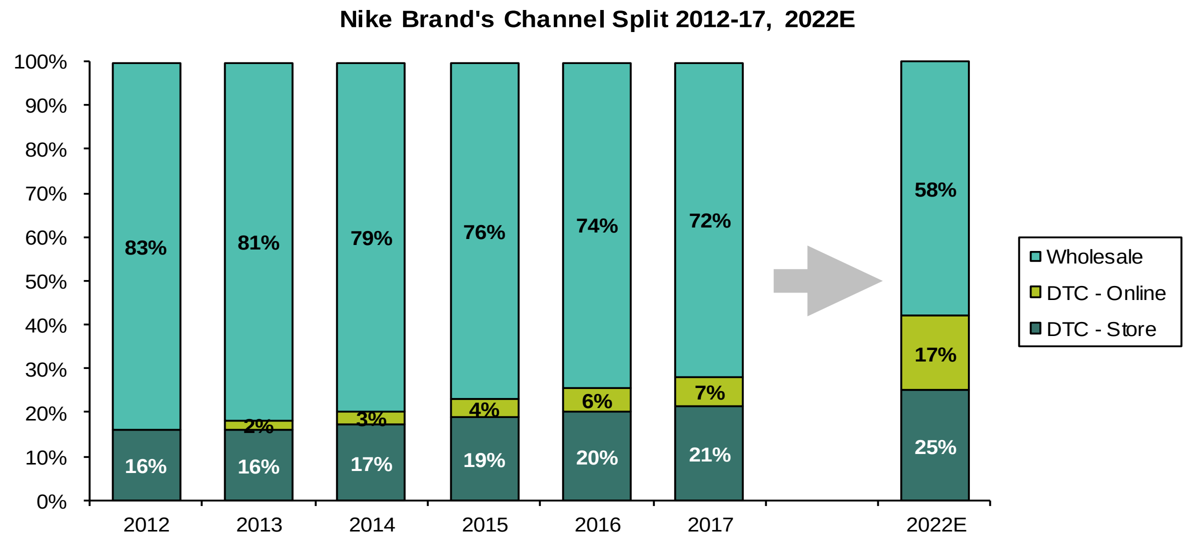
[9] January 19, 2018 - Nike: How much margin upside does DTC provide?

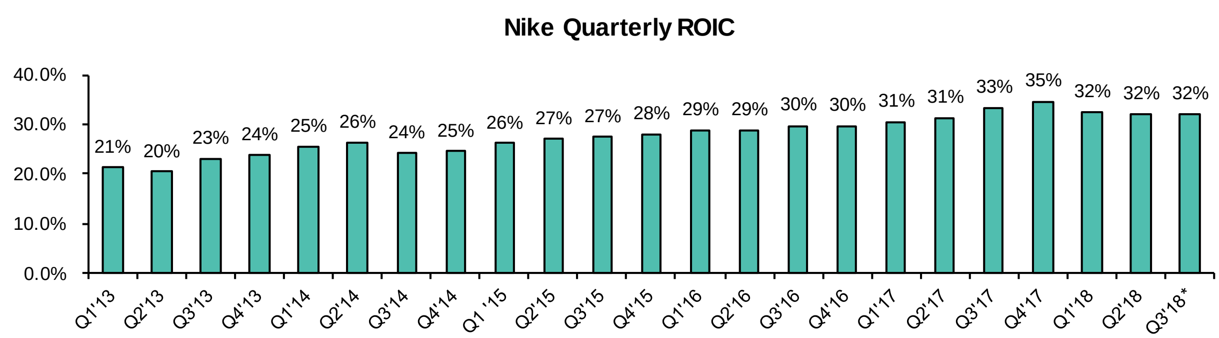
ROIC for Nike's DTC stores. Thus, our calculations of ROIC will differ from Nike's reported ROIC.

EXHIBIT 145: **DTC constitutes ~28% of Nike revenues as of FY2017**



Source: Company disclosures and Bernstein analysis

EXHIBIT 146: **Nike has seen steady improvements in its quarterly ROIC since 1Q 2013**



Note: 3Q 2018 represents tax-adjusted ROIC, adjusted for the one-off charge of $2B in FQ3 18. Unadjusted ROIC in 3Q 2018 was 15.6%. Nike Quarterly ROIC equals the trailing four quarters earnings before interest and after taxes divided by trailing five quarters average invested capital.

Source: Company disclosures and Bernstein analysis

ROIC BY DISTRIBUTION CHANNEL ASSUMPTIONS

NOPAT

Any analysis of ROIC requires two things, a NOPAT assumption and an invested capital assumption. Our Nike DTC margin work provides the basis of our NOPAT assumption by channel. Based on Nike disclosures in 2017, we estimate sales by channel as follows: 72% Wholesale, 7% Direct e-commerce, and 21% Direct stores (see Exhibit 147). We assume that in 2017 margin by channel was 11.9% in Wholesale, 16.6% in Direct e-commerce, and 22.6% in Direct stores (see Exhibit 148). For other income (expenses) below the operating profit line, we assume the wholesale equivalent cost allocation 80% Wholesale, 5% Direct e-commerce, and 15% Direct stores (see Exhibit 149). Using the assumptions laid out earlier, our calculated NOPAT by channel was $2,406 for Wholesale, $337 for Direct e-commerce, and $1,390 for Direct stores in 2017 (see Exhibit 150). Given that we believe invested capital should be adjusted for lease obligations, we must also add tax-adjusted rent to NOPAT in our ROIC calculation.

EXHIBIT 147: **We estimate that Direct (e-commerce + stores) was 28% of revenues in 2017...**

Revenue mix assumptions	
Distribution Channel	**2017**
Wholesale	72%
Direct e-Commerce	7%
Direct stores	21%
Total	**100%**

Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 148: **...and assume that Direct e-commerce, stores margins were 16.6% and 22.6%, respectively**

Margin Assumptions	
Operating Margin	**2017**
Wholesale	11.9%
Direct e-Commerce	16.6%
Direct stores	22.6%
Total	**14.4%**

Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 149: **For other items, we allocate based on the wholesale equivalent cost basis of the three channels**

Other income/(expense) allocation	
Distribution Channel	**2017**
Wholesale	80%
Direct e-Commerce	5%
Direct stores	15%
Total	**100%**

Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 150: **Wholesale constitutes 58% of NOPAT, despite making up 72% of revenues**

NOPAT Mix	
Distribution Channel	**2017**
Wholesale	$2,406
Direct e-Commerce	$337
Direct stores	$1,390
Total	**$4,133**

Source: Company disclosures, and Bernstein estimates and analysis

Invested capital

As Nike transitions to DTC, which should have greater capital cost than wholesale, investors have asked us how much capital will be required. We bucket invested capital into: 1) working capital needs, 2) PP&E, 3) intangibles and goodwill, and 4) operating leases.[10] Although we believe DTC is higher margin than Wholesale, it is also likely higher invested capital, given the need for stores, technology investment, distribution capabilities, and potentially higher inventory as Nike will own products longer through the selling season. The first question we must pose when thinking about invested capital is what has happened to these metrics so far during Nike's ongoing shift to DTC and how would we allocate these investments by channel. The second question is what does this suggest about group ROIC going forward?

Net working capital

As we might expect, as Nike has shifted to DTC, inventory days have increased from 76 days in 2011 to 93 days in 2017 (see Exhibit 151). Offsetting this, there has been a steady and consistent decline in Nike's receivable days over time, notably coinciding with the same period since Nike began transitioning more to a DTC business (see Exhibit 152). We expect that as Nike sells more directly to consumers, it is also getting paid for its merchandise more quickly on a per unit transaction level. Lululemon, for instance, reported two

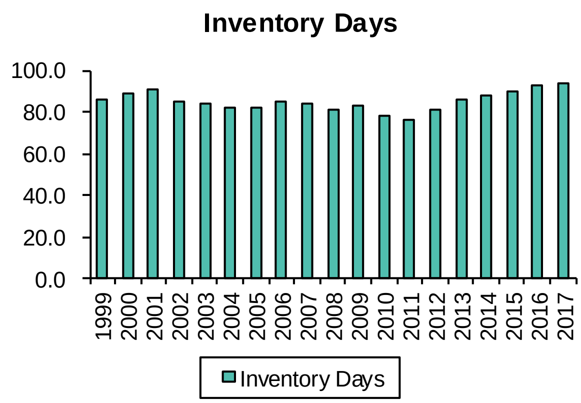
[10] We exclude Deferred Tax Assets and Deferred Tax Liabilities in our ROIC calculation, which Nike includes.

receivable days at the end of its FY 2017 and, in our experience, most direct retailers have receivable days in the single digits or low-double digits. While we do not expect Nike to lower its receivable days to that level (given that Nike will not be 100% direct), there is plenty of room for Nike here.

Nike's net working capital days have remained relatively steady even as direct sales have increased as higher inventory days have been largely offset by declining receivable days in the working capital cycle (see Exhibit 153).

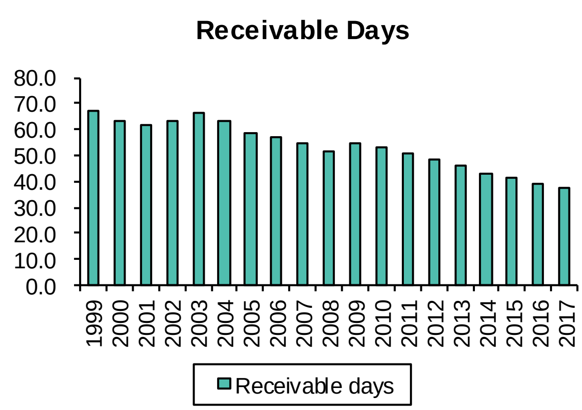
What we take away from this trend is that Nike's shift in distribution channels has not meaningfully extended or shortened its working capital cycle (due to the offsetting effects) and, to that end, we believe that allocating Nike's net working capital by revenue mix provides with us a reasonable proxy for estimating working capital by distribution channel.

EXHIBIT 151: **Nike's group inventory days has increased modestly since becoming more direct...**



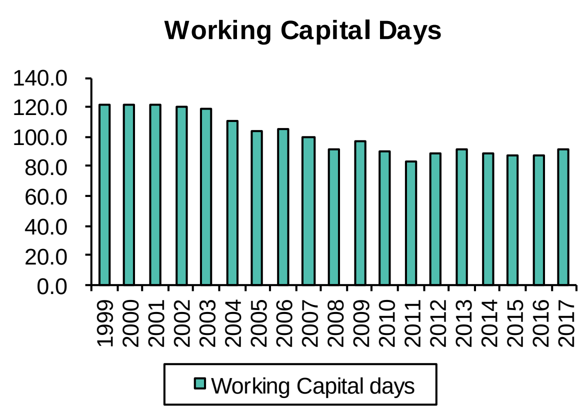
Source: Company disclosures and Bernstein analysis

EXHIBIT 152: **...however, Nike's receivable days has decreased 44% (30 days) over the same period**



Source: Company disclosures and Bernstein analysis

EXHIBIT 153: **Ultimately, Nike's working capital days has declined 25% (30 days) since 1999 and been stable**



Source: Company disclosures and Bernstein analysis

Property, plant, and equipment

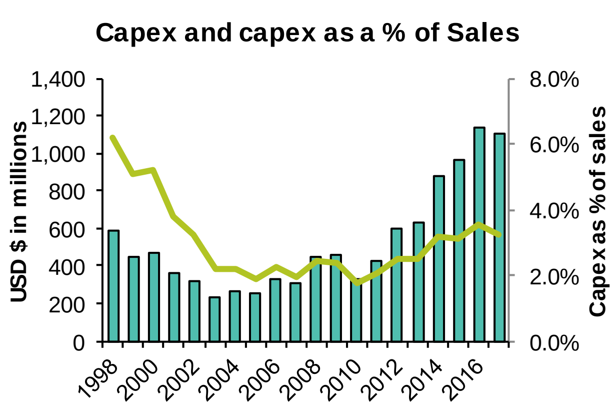
Nike has increased its capex as a percentage of sales as well as in absolute dollar value as direct sales have increased. In each of 2016 and 2017, Nike spent over $1B in capex and continues to expect to spend 3-4% of sales on capex each year through 2022 (see Exhibit 154).

Furthermore, Nike's PP&E balance has more than doubled since 1998, directly correlated to the increase in revenue penetration from DTC (see Exhibit 155). Just how much of the growth in PP&E can be attributed to the direct channels?

Given that growth in PP&E over the last few years coincides with the ramp up in DTC as a percentage of sales, and that PP&E was fairly stable in the decade prior, we believe that the PP&E balance in 2011, when DTC was 16% of sales, serves as a proxy for Wholesale PP&E. Assuming that all of the growth in PP&E since 2011 is attributable to Direct would suggest that Wholesale PP&E represented ~44% of total PP&E in 2017. This would likely underestimate the Wholesale PP&E slightly, however, and as such in order to account for steady-state growth over the last five years in the Wholesale channel, we assign ~50% PP&E allocation to Wholesale distribution, and assign 25% and 25% PP&E allocations to the Direct e-commerce and store components, respectively, in 2017 (see Exhibit 156).

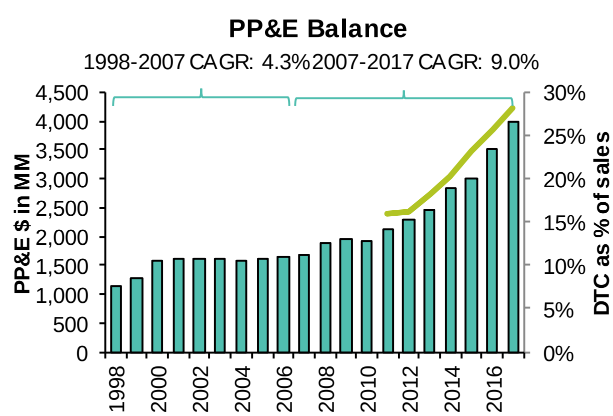
This is by no means exact. However, it is meant or at least attempts to reflect the incremental PP&E-related investments that Nike has made in recent years on the direct distribution channels.

EXHIBIT 154: **Capex has increased in both absolute value and as a percentage of sales as Direct has grown...**



Source: Company disclosures and Bernstein analysis

EXHIBIT 155: **...in addition, Nike's PP&E balance grew at 2x speed between 2007-17 versus 1998-2007**



Source: Company disclosures and Bernstein analysis

EXHIBIT 156: **We assume the following for PP&E allocation**

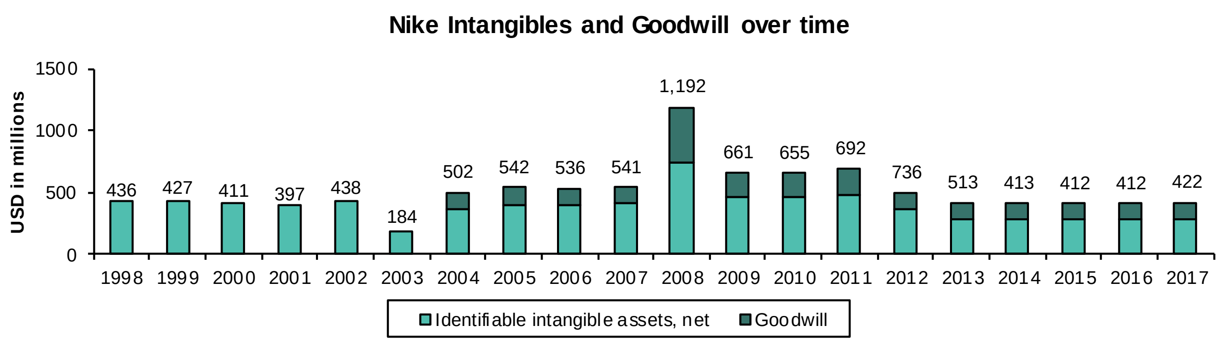
PP&E Allocation	
Distribution Channel	**2017**
Wholesale	50.0%
Direct e-Commerce	25.0%
Direct stores	25.0%
Total	**100.0%**

Source: Company disclosures, and Bernstein estimates and analysis

Intangibles, Goodwill, and Others

To our surprise, Nike's Intangibles and Goodwill balances have been remarkably flat in recent years, despite acquisitions of tech companies and platforms such as Virgin Mega, Speekeasy, Invertex, and most recently Zodiac, as Nike builds out its Direct e-commerce infrastructure (see Exhibit 157). The meaningful exception was in 2008, when Nike acquired Umbro, and allocated the acquisition to Goodwill, unamortized trademarks, and other amortized intangible assets. As recent trends in Intangibles and Goodwill do not suggest a disproportionate growth aligned to Direct e-commerce and Direct stores distribution, we make the assumption that Intangibles and Goodwill are allocated to the three channels based on their respective cost composition — similar to how we allocate COGS (see Exhibit 158).

EXHIBIT 157: **Aside from 2008, Nike's Intangibles and Goodwill has been remarkably stable**



Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 158: **We assume the following for Intangibles and Goodwill allocation**

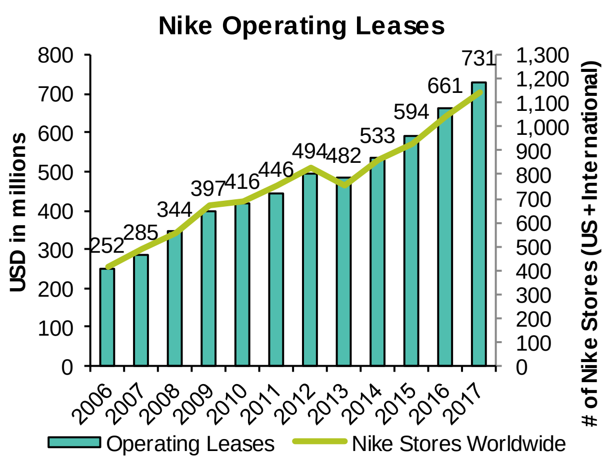
Other income/(expense) allocation	
Distribution Channel	**2017**
Wholesale	80%
Direct e-commerce	5%
Direct stores	15%
Total	**100%**

Source: Company disclosures, and Bernstein estimates and analysis

Operating leases

Historically, Nike operated predominantly as a wholesale business, and its exposure to stores and corresponding operating leases were limited. As Nike's DTC store business has grown, lease obligations have become increasingly important (see Exhibit 159). As such, for calculating ROIC for Nike DTC store business, we include a capitalized lease obligation (8x multiple) in the store invested capital base (see Exhibit 160).

EXHIBIT 159: **Nike operating leases have grown at a 10% CAGR since 2006**



Source: Company disclosures and Bernstein analysis

EXHIBIT 160: **We have laid out our Operating Lease assumptions below**

Operating Lease Assumptions	
Distribution Channel	**2017**
Wholesale	11%
Direct e-Commerce	1%
Direct stores	88%
Total	**100%**

Source: Company disclosures and Bernstein analysis

ESTIMATED 2017 ROIC BY CHANNEL

Wholesale

Applying the assumptions listed earlier, we estimate that the ROIC in the Wholesale channel was ~45% prior to any operating lease adjustments. Adjusting for a slight operating lease overhead by allocating 5% of the operating leases to Wholesale distribution, we arrive at ~41% in lease-adjusted ROIC for the Wholesale channel. As expected, given our assumption that the invested capital needs of a wholesale business are lower and more scalable compared to a direct business, we estimate that Nike's Wholesale ROIC is above group average, at 41% and 33.5%, respectively (see Exhibit 161).

EXHIBIT 161: **Based on the following assumptions, we believe that Wholesale ROIC was ~41% in FY2017**

(USD in millions, unless otherwise stated)			**Wholesale**	**Group**
NOPAT Calculation			**2017**	**2017**
Revenue			34,350	34,350
% Wholesale			72.0%	
Wholesale Revenue			**24,732**	
Operating Margin %			*11.9%*	*14.4%*
Operating Profit			2,931	4,959
Other (income) expense, net			196	196
Allocated to % wholesale			*80.4%*	
Earnings before interest and taxes			2,773	4,763
Tax rate			*(13.2%)*	*(13.2%)*
Taxes calculated			(367)	(630)
NOPAT			**2,406**	**4,133**
Rent-adjusted NOPAT			***2,475***	***4,768***
		amount attributable to wholesale distribution		
Invested Capital Calculation	*% Allocation*	**2016**	**2017**	
Net Working Capital	**72%**	**3,064**	**3,412**	
Plus: PP&E, Intangibles, Goodwill and DTA	*% Allocation*			
Property, plant and equipment, net	50%	1,760	1,995	
Identifiable intangible assets, net	80%	226	228	
Goodwill (excluding $65mm in Converse)	80%	53	60	
PPE and Intangibles		**2,039**	**2,282**	
Invested Capital		**5,103**	**5,694**	**Average**
2016/2017 Average Invested Capital			**5,398**	**8,669**
ROIC			**44.6%**	**47.7%**
Lease Adjustment	*% Allocation*			**2017**
Operating leases (rent costs)	11%	71	79	731
Capitalized Operating Leases (at 8x)	11%	571	632	5,848
Lease-adjusted IC		**5,674**	**6,325**	**Average**
Average Lease-Adj. Invested Capital			**6,000**	**14,237**
ROIC (Lease-Adjusted)			**41.3%**	**33.5%**

Source: Company disclosures and Bernstein analysis

Direct e-commerce

For the Direct e-commerce channel, we estimate that the unadjusted ROIC was ~27% prior to any operating lease adjustments. Adjusting for 5% of the operating lease allocation, assumed to be the combination of e-commerce's share of corporate offices lease globally, we arrive at ~26% lease-adjusted ROIC, about 8% lower than the group ROIC of 34% (see

Exhibit 162). We note that part of the reason ROIC is low in this case is that we believe investments for e-commerce, both on the P&L and in terms of capital, have yet to scale, depressing margin and resulting in disproportionately high invested capital relative to sales, compared to what we expect for this division at scale.

EXHIBIT 162: **Based on the following assumptions, we believe that Direct e-commerce ROIC was ~26% in FY2017**

(USD in millions, unless otherwise stated)			DTC e-Commerce	Group
NOPAT Calculation			2017	2017
Revenue			34,350	34,350
% Direct e-Commerce			7.0%	
Direct e-Commerce Revenue			**2,405**	
Operating Margin %			*16.6%*	*14.4%*
Operating Profit			398	4,959
Other (income) expense, net			196	196
Allocated to % DTC e-Commerce			*4.9%*	
Earnings before interest and taxes			388	4,763
Tax rate			*(13.2%)*	*(13.2%)*
Taxes calculated			(51)	(630)
NOPAT			**337**	**4,133**
Rent-adjusted NOPAT			***344***	***4,768***
Invested Capital Calculation			amount attributable to DTC e-Commerce	
	% Allocation	2016	2017	
Net Working Capital	**7%**	**298**	**332**	
Plus: PP&E, Intangibles, Goodwill and DTA	*% Allocation*			
Property, plant and equipment, net	25%	880	997	
Identifiable intangible assets, net	5%	14	14	
Goodwill (excluding $65mm in Converse)	5%	3	4	
PPE and Intangibles		**897**	**1,015**	
Invested Capital		**1,195**	**1,346**	**Average**
2016/2017 Average Invested Capital			**1,271**	**8,669**
ROIC			**26.5%**	**47.7%**
Lease Adjustment	*% Allocation*			**2017**
Operating leases (rent costs)	1%	7	8	731
Capitalized Operating Leases (at 8x)	1%	56	61	5,848
Lease-adjusted IC		**1,250**	**1,408**	**Average**
Average Lease-Adj. Invested Capital			**1,329**	**14,237**
ROIC (Lease-Adjusted)			**25.9%**	**33.5%**

Source: Company disclosures and Bernstein analysis

Direct stores

For Direct stores, we estimate that the unadjusted ROIC was a staggering 72% prior to any operating lease adjustments. However, after adjusting for the operating leases, we allocate ~90% of Nike's lease cost to this division, Direct Stores ROIC decreases. On a lease-adjusted basis, we estimate a ~29% ROIC (see Exhibit 163).

EXHIBIT 163: **Based on these assumptions, we believe that Direct store lease-adjusted ROIC was ~29% in FY2017**

(USD in millions, unless otherwise stated)			DTC Store	Group
NOPAT Calculation			2017	2017
Revenue			34,350	34,350
% Direct Store			21.0%	
Direct Store Revenue			**7,214**	
Operating Margin %			*22.6%*	*14.4%*
Operating Profit			1,630	4,959
Other (income) expense, net			196	196
Allocated to % DTC Store			*14.7%*	
Earnings before interest and taxes			1,601	4,763
Tax rate			*(13.2%)*	*(13.2%)*
Taxes calculated			(212)	(630)
NOPAT			**1,390**	**4,133**
Rent-adjusted NOPAT			***1,949***	***4,768***
			amount attributable to DTC Stores	
Invested Capital Calculation	*% Allocation*	2016	2017	
Net Working Capital	**21%**	**894**	**995**	
Plus: PP&E, Intangibles, Goodwill and DTA	*% Allocation*			
Property, plant and equipment, net	25%	880	997	
Identifiable intangible assets, net	15%	41	42	
Goodwill (excluding $65mm in Converse)	15%	10	11	
PPE and Intangibles		**931**	**1,050**	
Invested Capital		**1,824**	**2,045**	**Average**
2016/2017 Average Invested Capital			**1,935**	**8,669**
ROIC			**71.8%**	**47.7%**
Lease Adjustment	*% Allocation*			**2017**
Operating leases (rent costs)	88%	583	644	731
Capitalized Operating Leases (at 8x)	88%	4,661	5,155	5,848
Lease-adjusted IC		**6,486**	**7,200**	**Average**
Average Lease-Adj. Invested Capital			**6,843**	**14,237**
ROIC (Lease-Adjusted)			**28.5%**	**33.5%**

Source: Company disclosures and Bernstein analysis

WHAT WILL THE FUTURE BRING? ESTIMATING ROIC IN 2022

We believe the next question is: What will happen to group ROIC as the mix of the business shifts further toward DTC? We note that **the analysis performed here does not reflect our Nike group margin estimates, capex estimates, or PP&E estimates**, but is instead an exercise in thinking through ROIC as DTC grows and as e-commerce scales. Beyond the potential for channel growth and margins, which we considered in an earlier research report,[11] we believe that there are two factors that will shape the future of ROIC for Nike:

- Capex, for estimating PP&E; and
- Store growth, for estimating operating leases.

Capex assumption by channel: Direct stores

In order to estimate capex needs and additions to Nike's invested capital base, we looked at traditionally brick-and-mortar retailers as industry benchmarks for Nike Direct Stores. The peer set included Dick's, Foot Locker, JD Sport, and Inditex (see Exhibit 164). Historically, the peer group on average has a higher capex spend as of percentage of sales than Nike does.

Among athletic apparel and footwear retailers, despite their large store bases, they have kept average capex under 5% of sales over the 1999-2017 period. On the other hand, Inditex, which has grown its store base aggressively over that same period, averaged 10% spend on capex. Given the type of store that Nike operates (a mix of flagship and outlet stores), we expect capex will likely be well below that of Inditex, but toward the high end of the athletic retailers.

As Nike continues to drive Direct store growth at similar rates as it has in the last five years, we expect Nike to continue to invest in its store base. We estimate a 4.25% capex (as a percentage of sales) between now and 2022. We also expect the depreciation of the store base to slightly below the group average at 1.75% over the same period (see Exhibit 165 and Exhibit 166). Together, this suggests the PP&E capital base for Nike's Direct Store business will grow by 2.5% of sales each year (see Exhibit 167).

Capex assumption by channel: Direct e-commerce

For Direct e-commerce, we looked at historical capex spend at two retail e-commerce pure plays, ASOS and Zalando (see Exhibit 164). While capex for e-commerce pure plays is typically lumpier than store capex as investments in technology and distribution centers tend to be less regular than store openings, e-commerce typically has lower average capex in the long run. Average capex spend (as a percentage of sales) for ASOS was 4.2% and 3.8% for Zalando between 2011 and 2017. In addition, Nike operates integrated distribution centers globally that handle all of wholesale, Direct e-commerce, and Direct stores distribution, which suggests that the typical lumpiness of e-commerce capex related to distribution build out may not be representative of the capex needs of Nike's e-commerce business.

While we believe that Nike is currently investing heavily in its e-commerce channel and estimate capex as a percent of sales could be as high as 6.5% for the channel today, we

[11] January 19, 2018 - Nike: How much margin upside does DTC provide?

expect that as Nike scales, capex as a percentage of sales should shrink. We assume capex at 3.5% of sales for DTC e-commerce by 2022. On the D&A front, since most software is relatively new, we assume a 1.5% running D&A rate (see Exhibit 165 and Exhibit 166).

Capex assumption by channel: Wholesale

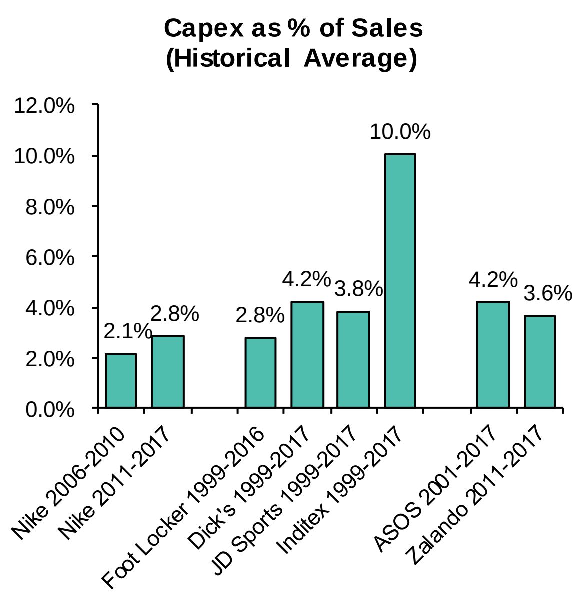
For Wholesale, we looked at Nike's capex spend, as a percentage of sales prior to 2010, when Nike mostly operated in Wholesale, at 2.1% (see Exhibit 164). We estimate that Wholesale is roughly running at 2.5% of sales today; however, we estimate the D&A associated with the channel to be highest at 2.25% (see Exhibit 165 and Exhibit 166).

Store growth — Direct stores only

While we do not anticipate store growth and operating lease expense escalation to play a role in the ROIC of the Wholesale and e-commerce distribution channels, we assume that Direct stores will continue to grow at a similar growth CAGR from 2017 through 2022, as they did in 2013 through 2017. We assume that leases will also grow at historical rates of roughly ~8.5% through 2022 (see Exhibit 168).

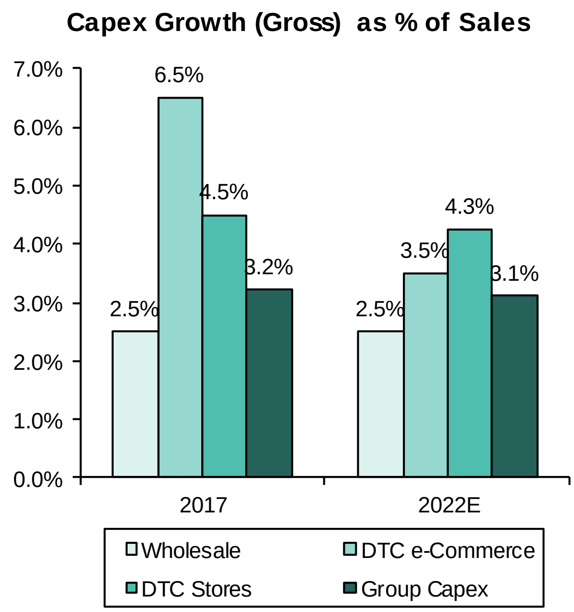
For consistency, we are holding the remainder of the invested capital base equal (holding NWC constant as a percentage of sales) and only altering the capex/PP&E, as well as operating lease assumptions. We lay out our key assumptions and calculations for 2022 for each distribution channel (see Exhibit 169 to Exhibit 172). While Direct store ROIC continues to lag behind, Direct e-commerce ROIC is expected to overtake Wholesale ROIC. Overall, this analysis suggests lease-adjusted ROIC would improve across the three distribution channels and increase 3% at the group level to 36% by 2022.

EXHIBIT 164: **Looking at peer capex spend, we see that that e-commerce is not more capital-intensive**



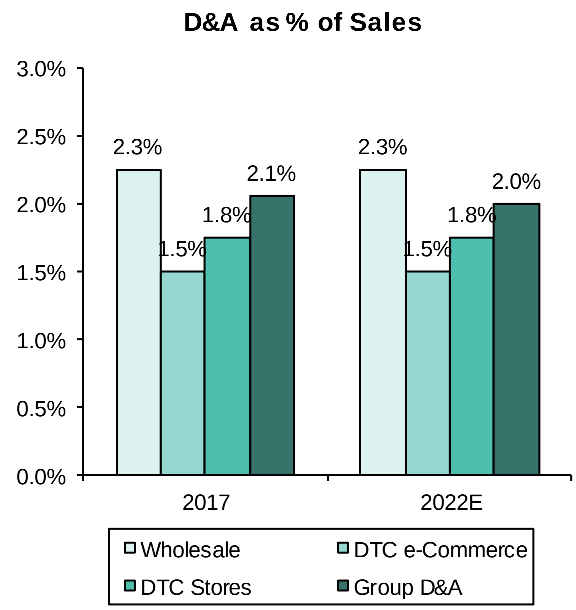
Source: Company disclosures and Bernstein analysis

EXHIBIT 165: **Gross capex as percentage of sales is expected to scale in the e-commerce channel...**



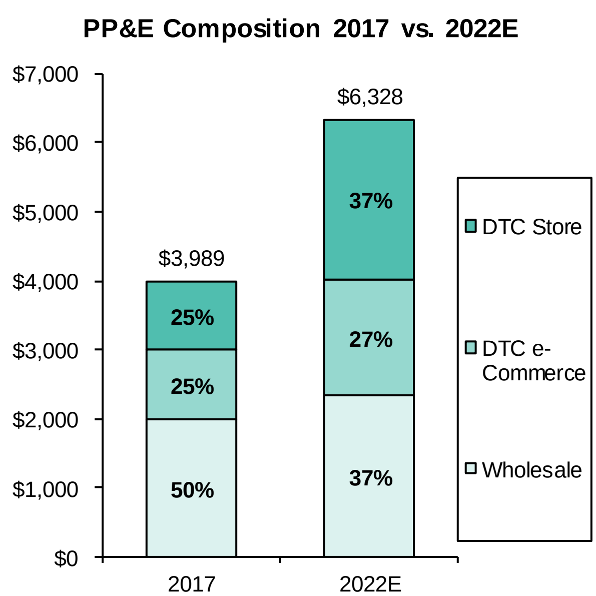
Source: Company disclosures and Bernstein analysis

EXHIBIT 166: **...we also assume different D&A levels for each of the distribution channels**



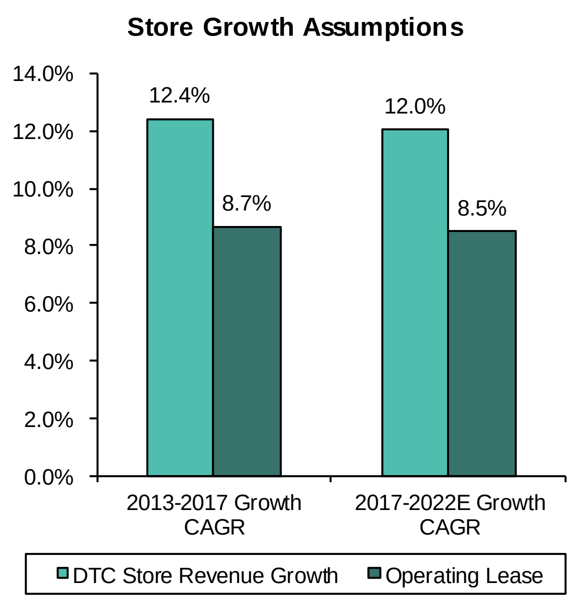
Source: Company disclosures and Bernstein analysis

EXHIBIT 167: **We estimate the following PP&E composition by channel in 2017 and 2022E, respectively**



Source: Company disclosures and Bernstein analysis

EXHIBIT 168: **For direct stores, we assume that stores grow at roughly the same rate in the next five years**



Source: Company disclosures and Bernstein analysis

EXHIBIT 169: **Estimated 2022 ROIC, Wholesale versus Group**

(USD in millions, unless otherwise stated)			**Wholesale 2022**	**Group 2022**
NOPAT Calculation				
Revenue			48,758	48,758
% Wholesale			58%	
Wholesale Revenue			**28,280**	
Operating Margin %			*11.9%*	*16.4%*
Operating Profit			3,351	7,996
Other (income) expense, net			196	196
Allocated to % wholesale			*69%*	
Earnings before interest and taxes			3,216	7,800
Tax rate			*(14.0%)*	*(14.0%)*
Taxes calculated			(450)	(1,093)
NOPAT			**2,765**	**6,708**
Rent-adjusted NOPAT			***2,820***	***7,617***
Invested Capital Calculation				
	% Allocation	**2021**	**2022**	**2022**
Accounts receivable, net	58%	1,880	2,133	
Inventories	58%	2,806	2,932	
Prepaid expenses and other current assets	58%	864	667	
Current Assets	58%	5,549	5,732	
Accounts payable	58%	1,271	1,188	
Accrued liabilities	58%	1,761	1,746	
Income taxes payable	58%	49	49	
Current Liabilities (non-interest bearing)	58%	3,082	2,983	
NWC	**58%**	**3,624**	**3,902**	**6,727**
Plus: PP&E, Intangibles and Goodwill				
Property, plant and equipment, net		2,259	2,330	6,328
Identifiable intangible assets, net	69%	195	195	283
Goodwill (excluding $65mm in Converse)	69%	51	51	139
Total		**2,506**	**2,576**	**6,750**
Invested Capital		**6,130**	**6,478**	**Average**
Average Invested Capital			**6,304**	**12,968**
ROIC			**43.9%**	**51.7%**
Lease Adjustment	*% Allocation*			
Operating leases (rent costs)	9%	64	64	1,058
Capitalized Operating Leases (at 8x)	9%	509	509	8,462
Lease-adjusted Invested Capital		**6,639**	**6,987**	**Average**
Average Invested Capital			**6,813**	**21,124**
Lease-adjusted invested capital			**41.4%**	**36.1%**

Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 170: **Estimated 2022 ROIC, DTC e-Commerce versus Group**

(USD in millions, unless otherwise stated)			**DTC e-Commerce**	**Group**
NOPAT Calculation			**2022**	**2022**
Revenue			48,758	48,758
% e-Commerce			17%	
Wholesale Revenue			**8,289**	
Operating Margin %			*22.6%*	*16.4%*
Operating Profit			1,873	7,996
Other (income) expense, net			196	196
Allocated to % e-Commerce			*13%*	
Earnings before interest and taxes			1,849	7,800
Tax rate			*(14.0%)*	*(14.0%)*
Taxes calculated			(259)	(1,093)
NOPAT			**1,590**	**6,708**
Rent-adjusted NOPAT			***1,606***	***7,617***
Invested Capital Calculation				
	% Allocation	**2021**	**2022**	**2022**
NWC	**17%**	**1,062**	**1,144**	**6,727**
Plus: PP&E, Intangibles, Goodwill and DTA				
Property, plant and equipment, net		1,520	1,686	6,328
Identifiable intangible assets, net	13%	35	35	283
Goodwill (excluding $65mm in Converse)	13%	9	9	139
Total		**1,564**	**1,730**	**6,750**
Invested Capital		**2,627**	**2,874**	**Average**
Average Invested Capital			**2,750**	**12,968**
ROIC			**57.8%**	**51.7%**
Lease Adjustment	*% Allocation*			
Operating leases (rent costs)	3%	19	19	1,058
Capitalized operating leases (capitalized at 8x)	3%	149	149	8,462
Lease-adjusted Invested Capital		**2,776**	**3,023**	**Average**
Average Invested Capital			**2,899**	**21,124**
Lease-adjusted invested capital			**55.4%**	**36.1%**

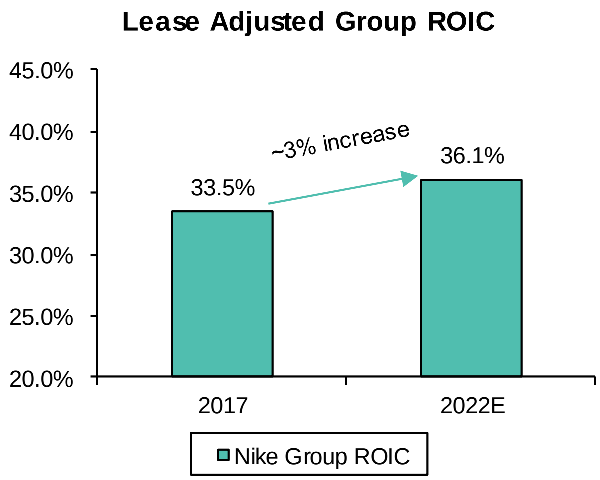
Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 171: **Estimated 2022 ROIC, DTC Stores versus Group**

(USD in millions, unless otherwise stated)			Direct Stores	Group
NOPAT Calculation			2022	2022
Revenue			48,758	48,758
% DTC Stores			25%	
Wholesale Revenue			**12,189**	
Operating Margin %			*22.6%*	*16.4%*
Operating Profit			2,755	7,996
Other (income) expense, net			196	196
Allocated to % DTC Stores			*18%*	
Earnings before interest and taxes			2,719	7,800
Tax rate			*(14.0%)*	*(14.0%)*
Taxes calculated			(381)	(1,093)
NOPAT			**2,338**	**6,708**
Rent-adjusted NOPAT			***3,177***	***7,617***
Invested Capital Calculation				
	% Allocation	**2021**	**2022**	**2022**
NWC	**25%**	**1,562**	**1,682**	**6,727**
Plus: PP&E, Intangibles, Goodwill and DTA				
Property, plant and equipment, net		2,008	2,313	6,328
Identifiable intangible assets, net	18%	52	52	283
Goodwill (excluding $65mm in Converse)	18%	14	14	139
Total		**2,074**	**2,379**	**6,750**
Invested Capital		**3,636**	**4,061**	**Average**
2016/2017 Average Invested Capital			**3,848**	**12,968**
ROIC (Excess cash adjusted)			**60.8%**	**51.7%**
Lease Adjustment	*% Allocation*			
Operating leases (rent costs)	89%	899	976	1,058
Capitalized Operating Leases (at 8x)	89%	7,193	7,804	8,462
Lease-adjusted Invested Capital		**10,829**	**11,865**	**Average**
Average Invested Capital			**11,347**	**21,124**
Lease-adjusted invested capital			**28.0%**	**36.1%**

Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 172: **Taking the distribution channels together, we estimate a 3% increase in group ROIC***



* Group ROIC represented on a cash- and lease-adjusted basis; lease-adjusted Group ROIC in 2022 is estimated to be 35%, from 27% in 2017.

Source: Company disclosures, and Bernstein estimates and analysis

APPENDIX

This chapter comprises the following sections:

- Summary financials
- Valuation methodology
- Risks
- Investment implications

SUMMARY FINANCIALS

Exhibit 173 to Exhibit 176 provides financial statements for Nike.

EXHIBIT 173: **Income statement**

NIKE Income Statement										
USD in millions, except per share data	**2013**	**2014**	**2015**	**2016**	**2017**	**2018E**	**2019E**	**2020E**	**2021E**	**2022E**
Revenues	**25,313**	**27,799**	**30,601**	**32,376**	**34,350**	**35,924**	**39,065**	**41,994**	**45,295**	**48,758**
Cost of sales	(14,279)	(15,353)	(16,534)	(17,405)	(19,038)	(20,214)	(21,590)	(22,789)	(24,127)	(25,582)
Gross profit	**11,034**	**12,446**	**14,067**	**14,971**	**15,312**	**15,711**	**17,475**	**19,205**	**21,168**	**23,176**
% of sales	*43.6%*	*44.8%*	*46.0%*	*46.2%*	*44.6%*	*43.7%*	*44.7%*	*45.7%*	*46.7%*	*47.5%*
Demand creation expense	(2,745)	(3,031)	(3,213)	(3,278)	(3,341)	(3,506)	(3,812)	(4,098)	(4,420)	(4,661)
Operating overhead expense	(5,051)	(5,735)	(6,679)	(7,191)	(7,222)	(7,895)	(8,703)	(9,439)	(10,227)	(11,057)
Total selling and administrative expense	**(7,796)**	**(8,766)**	**(9,892)**	**(10,469)**	**(10,563)**	**(11,401)**	**(12,515)**	**(13,537)**	**(14,647)**	**(15,718)**
Other income / expense, net	15	(103)	58	140	196	(44)	0	0	0	0
EBIT	**3,253**	**3,577**	**4,233**	**4,642**	**4,945**	**4,265**	**4,960**	**5,668**	**6,521**	**7,458**
EBIT margin	*12.9%*	*12.9%*	*13.8%*	*14.3%*	*14.4%*	*11.9%*	*12.7%*	*13.5%*	*14.4%*	*15.3%*
Interest income / expense, net	3	(33)	(28)	(19)	(59)	(63)	(63)	(63)	(64)	(64)
Income before income taxes	**3,256**	**3,544**	**4,205**	**4,623**	**4,886**	**4,202**	**4,897**	**5,605**	**6,456**	**7,395**
Income tax expense	(805)	(851)	(932)	(863)	(646)	(2,434)	(686)	(785)	(904)	(1,036)
Income tax rate	*25%*	*24%*	*22%*	*19%*	*13%*	*58%*	*14%*	*14%*	*14%*	*14%*
Net income from continuing operations	**2,451**	**2,693**	**3,273**	**3,760**	**4,240**	**1,768**	**4,211**	**4,820**	**5,552**	**6,359**
Earnings per common share										
Basic	1.38	1.52	1.90	2.21	2.56	2.34	2.68	3.16	3.74	4.38
Diluted	1.35	1.49	1.85	2.16	2.51	2.32	2.65	3.13	3.70	4.33
Weighted average common shares outstanding:										
Basic	1,795	1,767	1,723	1,698	1,658	1,625	1,574	1,525	1,486	1,452
Diluted	1,833	1,812	1,769	1,743	1,692	1,643	1,592	1,542	1,502	1,469
Dividends declared per common share	0.41	0.47	0.54	0.62	0.70	0.78	0.85	0.93	1.03	1.20
Dividend payout	*29.3%*	*30.5%*	*28.4%*	*28.0%*	*27.4%*	*33.4%*	*31.6%*	*29.4%*	*27.5%*	*27.5%*

Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 174: **Balance sheet**

NIKE Balance Sheet										
USD in millions	2013	2014	2015	2016	2017	2018E	2019E	2020E	2021E	2022E
Cash and Cash Equivalents	5,965	5,142	5,924	5,457	6,179	4,968	4,166	4,574	5,554	7,136
Accounts Receivable	3,117	3,434	3,358	3,241	3,677	3,877	4,150	4,527	4,858	5,226
Inventories	3,484	3,947	4,337	4,838	5,055	5,363	5,873	6,296	6,784	7,321
Other Current Assets	1,064	1,173	1,968	1,489	1,150	1,758	1,689	1,768	2,026	2,116
Total Current Assets	**13,630**	**13,696**	**15,587**	**15,025**	**16,061**	**15,967**	**15,877**	**17,165**	**19,222**	**21,799**
Property, Plant and Equipment	2,452	2,834	3,011	3,520	3,989	4,409	4,836	5,255	5,678	6,166
Goodwill and Intangibles	420	413	412	412	422	421	421	421	421	421
Other Non-Current Assets	1,043	1,651	2,587	2,439	2,787	2,576	2,805	2,951	3,226	3,470
Total Non-Current Assets	**3,915**	**4,898**	**6,010**	**6,371**	**7,198**	**7,406**	**8,062**	**8,627**	**9,325**	**10,057**
Accounts Payable	1,669	1,930	2,131	2,191	2,048	2,409	2,559	2,707	2,973	3,182
Short Term Debt	155	174	181	45	331	208	222	298	280	308
Other Current Liabilities	2,138	2,923	4,020	3,122	3,095	3,889	3,879	4,192	4,638	4,905
Total Current Liabilities	**3,962**	**5,027**	**6,332**	**5,358**	**5,474**	**6,505**	**6,660**	**7,197**	**7,891**	**8,395**
Long Term Debt	1,210	1,199	1,079	2,010	3,471	3,469	3,469	3,469	3,469	3,469
Other Long Term Liabilities	1,292	1,544	1,479	1,770	1,907	3,578	3,941	4,239	4,555	4,926
Total Non-Current Liabilities	**2,502**	**2,743**	**2,558**	**3,780**	**5,378**	**7,047**	**7,410**	**7,708**	**8,024**	**8,395**
Shareholder's Equity	5,187	5,868	6,776	7,789	8,641	9,617	10,705	11,822	13,041	14,364
Retained Earnings	5,620	4,871	4,685	4,151	3,979	828	(212)	(311)	215	1,326
Other	274	85	1,246	318	(213)	(624)	(624)	(624)	(624)	(624)
Total Shareholder's Equity	**11,081**	**10,824**	**12,707**	**12,258**	**12,407**	**9,821**	**9,868**	**10,887**	**12,633**	**15,066**

Source: Company disclosures, and Bernstein estimates and analysis

Exhibit 175: **Cash flow statement**

NIKE Cash Flow Statement										
USD in millions	2013	2014	2015	2016	2017	2018E	2019E	2020E	2021E	2022E
EBIT	3,253	3,577	4,233	4,642	4,945	4,265	4,960	5,668	6,521	7,458
Depreciation and Amortization	438	518	606	649	706	742	798	863	930	1,000
EBITDA	**3,691**	**4,095**	**4,839**	**5,291**	**5,651**	**5,006**	**5,757**	**6,530**	**7,451**	**8,458**
Interest	3	(33)	(28)	(19)	(59)	(63)	(63)	(63)	(64)	(64)
Tax	(805)	(851)	(932)	(863)	(646)	(2,434)	(686)	(785)	(904)	(1,036)
Free Funds from Operations	**2,889**	**3,211**	**3,879**	**4,409**	**4,946**	**2,510**	**5,009**	**5,683**	**6,482**	**7,358**
Capex	(598)	(880)	(963)	(1,143)	(1,105)	(1,035)	(1,243)	(1,304)	(1,380)	(1,513)
Changes in Working Capital	43	(542)	(636)	(470)	(800)	37	(632)	(653)	(553)	(696)
Free Operating Cash Flow	**2,334**	**1,789**	**2,280**	**2,796**	**3,041**	**1,512**	**3,133**	**3,726**	**4,549**	**5,149**
(Acquisitions)/Disposals	800	3	3	10	13	0	0	0	0	0
Proceeds / Repayment of Debt	947	(2)	(89)	801	1,748	(143)	14	76	(18)	28
Dividends	(703)	(799)	(899)	(1,022)	(1,133)	(1,242)	(1,332)	(1,419)	(1,526)	(1,749)
Buybacks	(1,674)	(2,628)	(2,534)	(3,238)	(3,223)	(3,594)	(3,920)	(3,500)	(3,500)	(3,500)
Other	(621)	520	2,871	(61)	224	2,078	1,064	1,333	1,236	1,401
Net Cashflow	**1,083**	**(1,117)**	**1,632**	**(714)**	**670**	**(1,389)**	**(1,040)**	**217**	**741**	**1,329**

Source: Company disclosures, and Bernstein estimates and analysis

EXHIBIT 176: **Segment figures**

NIKE Segment Figures										
USD in millions, unless otherwise stated	**2013**	**2014**	**2015**	**2016**	**2017**	**2018E**	**2019E**	**2020E**	**2021E**	**2022E**
Revenues										
North America	11,158	12,299	13,740	14,764	15,216	14,733	15,384	16,103	16,856	17,644
EMEA					7,698	9,147	10,377	11,004	11,805	12,554
Greater China	2,478	2,602	3,067	3,785	4,237	4,908	5,629	6,511	7,482	8,552
APAC & Latin America					5,009	5,148	5,642	6,266	6,960	7,733
Global Brand Divisions	115	125	115	73	73	82	82	82	82	82
Total NIKE Brand	**23,881**	**26,112**	**28,701**	**30,507**	**32,233**	**34,017**	**37,115**	**39,966**	**43,186**	**46,565**
Converse	1,449	1,684	1,982	1,955	2,042	1,889	1,950	2,028	2,109	2,193
Corporate	(17)	3	(82)	(86)	75	18	0	0	0	0
Total NIKE, Inc. Revenues	**25,313**	**27,799**	**30,601**	**32,376**	**34,350**	**35,924**	**39,065**	**41,994**	**45,295**	**48,758**
Revenue Growth (%)										
North America	17.0%	10.2%	11.7%	7.5%	3.1%	(3.2%)	4.4%	4.7%	4.7%	4.7%
EMEA						18.8%	13.5%	6.0%	7.3%	6.3%
Greater China	(3.2%)	5.0%	17.9%	23.4%	11.9%	15.8%	14.7%	15.7%	14.9%	14.3%
APAC & Latin America						2.8%	9.6%	11.1%	11.1%	11.1%
Global Brand Divisions	3.6%	8.7%	(8.0%)	(36.5%)	0.0%	12.3%	0.0%	0.0%	0.0%	0.0%
Total NIKE Brand	**8.5%**	**9.3%**	**9.9%**	**6.3%**	**5.7%**	**5.5%**	**9.1%**	**7.7%**	**8.1%**	**7.8%**
Converse	9.4%	16.2%	17.7%	(1.4%)	4.5%	(7.5%)	3.2%	4.0%	4.0%	4.0%
Total NIKE, Inc. Revenues	**8.5%**	**9.8%**	**10.1%**	**5.8%**	**6.1%**	**4.6%**	**8.7%**	**7.5%**	**7.9%**	**7.6%**
Constant Currency Sales Growth										
North America	17.0%	10.0%	12.0%	8.0%	3.0%	(3.5%)	4.4%	4.7%	4.7%	4.7%
EMEA						9.8%	10.3%	6.0%	7.3%	6.3%
Greater China	(5.0%)	3.0%	19.0%	27.0%	17.0%	16.4%	17.9%	15.7%	14.9%	14.3%
APAC & Latin America						7.1%	9.5%	11.1%	11.1%	11.1%
Global Brand Divisions	8.0%	6.0%	(2.0%)	(30.0%)	2.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total NIKE Brand	**11.0%**	**11.0%**	**14.0%**	**13.0%**	**8.0%**	**4.0%**	**8.7%**	**7.7%**	**8.1%**	**7.8%**
Converse	9.0%	15.0%	21.0%	2.0%	6.0%	(9.3%)	3.0%	4.0%	4.0%	4.0%
Total NIKE, Inc. Revenues	**11.0%**	**11.0%**	**14.0%**	**12.0%**	**8.0%**	**3.2%**	**8.4%**	**7.5%**	**7.9%**	**7.6%**

Source: Company disclosures, and Bernstein estimates and analysis

VALUATION METHODOLOGY

US Softlines and Specialty Retail

We establish our 12-month price targets for the U.S. Softlines and Specialty Retail sector using an equally weighted combination of a target price-to-earnings multiple to our earnings forecast and a target EV/EBIT multiple to our EBIT forecast, and then verifying these against our DCF valuation. We apply these multiples to our forward estimates four quarters from now (Q5-Q8). Our DCF analysis is based on cash flow forecasts over an explicit period, combined with a continuing value component intended to capture the firm's value into perpetuity. The fair-market value of common equity determined by each valuation method is then divided by the current diluted share count.

Nike: We rate NKE Outperform with a $76 target price. We set our 12-month target price by applying a target price-to-earnings multiple to our earnings forecast and a target EV/EBIT multiple to our EBIT forecast, and then verifying these against our DCF valuation. For NKE, we apply a target P/E multiple of 25.0x and an EV/EBIT multiple of 20.0x to our forward estimates four quarters from now (Q5-Q8).

Under Armour: We rate UAA Underperform with a $9 target price. We set our 12-month target price by applying a target price-to-earnings multiple to our earnings forecast and a target EV/EBIT multiple to our EBIT forecast, and then verifying these against our DCF valuation. For UAA, we apply a target P/E multiple of 30.0x and an EV/EBIT multiple of 20.0x to our forward estimates four quarters from now (Q5-Q8).

Lululemon: We rate LULU Market-Perform with a $80 target price. We set our 12-month target price by applying a target price-to-earnings multiple to our earnings forecast and a target EV/EBIT multiple to our EBIT forecast, and then verifying these against our DCF valuation. For LULU, we apply a target P/E multiple of 24.0x and an EV/EBIT multiple of 16.9x to our forward estimates four quarters from now (Q5-Q8).

RISKS

US Softlines and Specialty Retail

Within our U.S. Softlines and Specialty Retail coverage, our 12-month price targets are contingent on the companies in our coverage achieving our forward earnings forecasts and valuation multiples matching our targets. We base our forecasts on stable economic environments in domestic markets, and stable macroeconomic and political conditions and exchange rates in international markets — any adverse changes would impact our forecasts. We also assume that our coverage will remain independent and that the companies will keep broadly similar capital structures; significant change in ownership, bids for the companies or recapitalizations would impact our price targets. In addition, our forecasts are subject to various other industry and company-specific risks, including changes in:

- Consumer preference for particular categories or brands, or broader changes in consumer demand and spending;
- Shopping by channel (e.g., brick-and-mortar, e-commerce, department stores, and off-price), which differ from our forecasts;
- The supply chain, such as trade terms and access to product;
- The competitive landscape such as new competitors; and
- The cost structure, including rent and labor, among other factors.

Nike

- While we strongly believe in the reacceleration of North American sales, timing is somewhat uncertain, which may delay the share price upside we see; and
- Other downside risks include continued innovation and share gain from adidas, a more extended destocking in North American wholesale than we expect, and a slower mix shift to DTC than expected.

Under Armour

- Short interest is very high (~36%) and so any positive result could see a short squeeze leading to short-term upside in the stock; and
- Under Armour's margin is depressed relative to peers and the company may pull back on investment or at the least make investment more focused and work to improve margin.

Lululemon

- On the downside, we see some risk that the e-commerce problems of early 2017 could repeat, given that much of Lululemon's e-commerce business is outsourced (digital photography and some coding). As e-commerce continues to evolve, so too will Lululemon's site. Without ownership, Lululemon risks being caught flatfooted. Other downside risks include slower-than-expected comparable store sales ("comps") improvement.

- On the upside, we believe the short-term issues have been addressed and expect near-term improvement in comps. If comps are better than we expect, multiples may not contract as we expect, suggesting further upside in the stock. Other upside risks include acquisition by a buyer at a significant premium and faster acceleration in the comparable store sales trend than expected.

INVESTMENT IMPLICATIONS

Nike

Outperform, 12-month target price $76: Nike is the best-in-class athletic apparel and footwear brand and the leader in market share globally. Given the pipeline of innovation, the strength of the R&D platform, and the ability to invest in athletes, driven by the size of the balance sheet, share gains will continue. In addition, the product development cycle has been accelerating, with platforms such as React and Air ramping up and the VaporMax platform continuing to build. Supported by the mix shift to DTC, we forecast an 8% revenue CAGR to fiscal 2022e.

The mix shift to DTC should also drive margin expansion. We forecast 380bps of gross margin expansion and 340bps of total operating margin expansion between 2018 and 2022, driven by the combination of mix shift to DTC, forex tailwinds, and manufacturing-driven cost improvement. Combining our forecasts for revenue, margin, and cash return, we expect Nike to deliver a 17% EPS CAGR from 2018.

While the stock has rerated and now trades ~26x NTM EPS on an absolute basis, one standard deviation above historical average, Nike trades in line with its five-year historical multiple relative to the S&P 500. While we are not counting on further multiple expansion in arriving at our target price, if Nike delivers mid-teens earnings growth and continued improvement in ROIC as we expect, we believe that will support the multiple.

Under Armour

Underperform, 12-month target price $9: In our view, Under Armour is now in growth purgatory — we do not believe recovering back to 20%+ annual revenue growth will occur on a sustainable basis, forecasting group revenue to grow mid-high single digits. After building a brand based largely on men's performance apparel, Under Armour has begun to diversify to new categories and channels, yet our analysis suggests problems with both. New categories of focus include women's, footwear, international, sportswear, and DTC. Footwear has been one of Under Armour's bigger product pushes over the last decade, but remains subscale at ~$1B in revenue. Even as Under Armour suggests that DTC is a priority for growth, the company has also expanded wholesale, beginning to sell through several mass-market retailers in 2017 (Kohl's, DSW, and Famous Footwear).

Yet P/E multiples remain highly elevated, with the stock trading at 104x our NTM EPS estimates. Our estimates are below consensus (4 cents in 2018) and we believe multiples will grind lower as growth remains below the 20% level. Further, we believe the next catalyst for the stock will come in 2H 2018, when management has suggested that inventory will be healthier (guidance up <20% at the end of 2Q) and that gross margins will improve Y-o-Y. Given the continued sales challenges and inventory overhang, we believe gross margin guidance and consensus for 2018 still looks too optimistic.

Lululemon

Market-Perform, 12-month target price $80: We see both puts and takes for Lululemon. On the plus side, the brand has clear opportunities to grow its men's business (~20%) of sales and its international business (~10% of sales). This will help support positive comps and continued store expansion for the retailer.

On the downside, we see risks to the company's women's business, particularly given results from our Bernstein proprietary consumer survey work, which suggest that close to half of Lululemon customers shop the brand for fashion alone. We expect these customers to be particularly fickle as trends change, suggesting that this is a customer demographic that may cheat with other athletic apparel brands or with other apparel categories altogether.

Recent performance for Lululemon shares has been strong and we believe near-term momentum continues to drive accelerating sales trends. However, this is already reflected in the stock, which sharply rerated (from 20x NTM EPS in May 2017 to 30x in May 2018). This higher multiple also creates downside risk if Lululemon misses estimates. In the short term, our estimates are largely in line with consensus and we believe the stock is fairly valued.

VALUATION METHODOLOGY

Please see Appendix for details on valuation methodology.

RISKS

Please see Appendix for details on risks.

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  Market-Perform: Stock will perform in line with the market index to within +/-15 pp in the year ahead.

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12-Month Rating History as of 05/13/2018

Ticker	Rating Changes
LULU	M (IC) 09/11/17 M (DC) 07/05/16
NKE	O (IC) 09/11/17
UAA	U (IC) 09/11/17

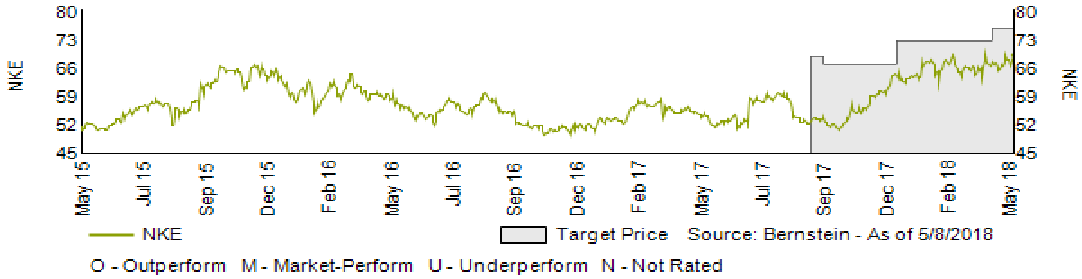
Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated

Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

NKE / Nike Inc

Date	Rating	Target(USD)
09/11/17	O(IC)	69.00
09/27/17	O	67.00
12/22/17	O	73.00
04/13/18	O	76.00

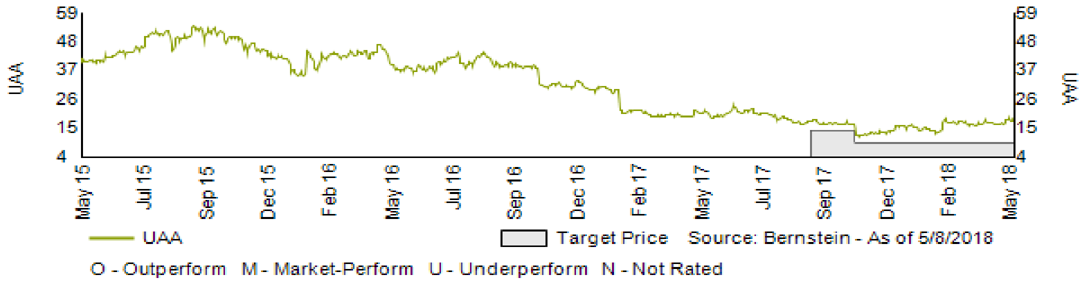
IC - Initiated Coverage



UAA / Under Armour Inc

Date	Rating	Target(USD)
09/11/17	U(IC)	14.00
11/01/17	U	9.00

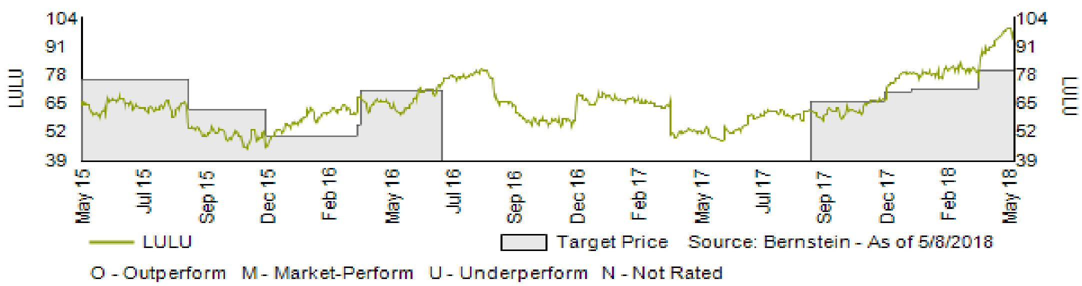
IC - Initiated Coverage



LULU / Lululemon Athletica Inc

Date	Rating	Target(USD)
05/01/15	O	76.00
09/11/15	O	62.00
12/10/15	M	50.00
03/28/16	M	55.00
03/31/16	M	71.00
07/05/16	M(DC)	71.00
09/11/17	M(IC)	66.00
12/07/17	M	70.00
01/09/18	M	72.00
03/28/18	M	80.00

DC - Dropped Coverage
IC - Initiated Coverage



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