Nike: Can They Still Do It?
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Nike is a household name in the sportswear industry, known for its iconic swoosh logo and innovative designs. With over USD 50 billion in annual revenues, it is the largest athletic footwear and apparel brand in the world. Its key brands include Nike, Jordan and Converse, which is a casual footwear brand. Nike sells its products through 1000+ company-owned and franchised stores as well through third party retailers. The company was founded in 1964 and is currently headquartered in Beaverton, Oregon.

Footwear accounts for almost two thirds of Nike's sales with key categories being basketball, running and football. North America accounts for ~45% of total sales and the rest is equally split between EMEA (Europe, Middle East and Africa) and Asia. China has also been a big contributor to Nike's revenues in the last 5-6 years and still contributes to almost 15% of total sales.

Since its inception 60 years ago, Nike has long dominated the sportswear market, fuelled by innovative products, global reach, strategic athlete partnerships and out-of-the-box marketing. Though what was lacking for Nike was its lack of e-commerce and digital footprint. To tackle this, Nike Board appointed Mr John Donahoe as Nike CEO in January 2020, succeeding former CEO Mark Parker, a long-time Nike employee and designer with a passion for innovation. Before joining Nike, Donahoe spent many years leading tech companies including ServiceNow Inc. and EBay.

Under his leadership, Nike spent aggressively on increasing online sales and its direct-to-consumer presence and it yielded quick results as the world reopened post pandemic with sales growing by ~19% in FY21, driven by strong growth in online sales. The strong sales performance didn't go unnoticed the investors and its peak in late 2021, Nike had a market capitalisation north of USD 275 billion.

However, since then its shares have lost more than half of its value. At the start of this year, the Company announced an aggressive cost cutting plan of USD 2 billion over the next 3 years as a result of softer sales. Despite this, sales are still struggling and the company issued a rather weak guidance for FY2025. Additionally, the board relented to the pressure from investors and agreed to replace Mr Donahoe with a long-time veteran Mr. Elliot Hill who was at Nike for 32 years and held senior leadership positions across Europe and North America.

So, what went wrong for the American sportswear giant? Let's understand the reasons in detail.

- **Lack of innovation amongst shifting consumer preferences:** Under Donahoe, the focus on the company shifted more towards increasing its digital presence. However, this came at the expense of innovation. While Nike's strategy of leveraging familiar designs that resonated with customers proved effective during the pandemic, the reopening of the world revealed a growing consumer demand for innovation that exposed Nike's lack of fresh offerings. Nike's reliance on its most popular shoe – the Air Force 1, which

debuted over 35 years ago – is a clear example of this.

- **Increasing competition from other brands:** Rival brands including Roger Federer-backed On and Decker's Hoka are attracting shoppers and retail partners with sneakers considered more fashionable and trendier. On the lifestyle side, Adidas is seeing wins with its retro looks like the Samba, Campus and Gazelle. Even athleisure apparel brands like Alo, Lululemon and Vuori are slowly taking marketspace away from Nike.

- **Loss of wholesale partnerships:** Under Donahoe's leadership, Nike prioritized its own sales channels over wholesale retailers. It severed ties with major wholesale retailers like Urban Outfitters, Macy's and Foot Locker which was an intentional move to improve margins and build a direct connection with customers. However, the move backfired as it further strained its sales channels allowing rivals to quickly take the shelf space left vacant by Nike. Furthermore, its wholesale partners started aggressively pushing rival brands further denting Nike's fortunes.

- **Rising Inventory levels:** Nike's overcommitment to online commerce backfired, with inventory buildup issues. Historically, Nike used to have the right balance, but it changed its stance and started aggressively pushing DTC (Direct-to-Consumer) in hope for higher growth and profitability. Initially successful, this strategy began to falter as competitors gained market share and Nike's DTC sales declined, leading to bloated inventory levels. Nike had a peak inventory of $9.7 billion by the end of 2022 which meant that Nike had to offer discounts, which impacted profit margins.

- **Slowing Consumer given high inflation:** Higher inflation led to depletion of built-up savings during the pandemic over a period of time which forced consumers to cut down on their discretionary spend. Additionally, the company's struggles in the Chinese market given slowing consumer, a significant revenue source, have also contributed to its current slump. Nike faced a temporary backlash from local Chinese consumers due to its stand against Xinjiang-made cotton, leading to a decline in sales growth. Conversely, Chinese rivals gained market share by leveraging on local consumer preferences and nationalistic sentiments.

Financials:

Company did report weaker sales in Q4 FY24 with sales down 2% QoQ. The management also issues a much weaker guidance for FY 25 with a revenue guidance of mid-single digit declines vs prior guidance for revenues to be up. Q1 25 revenue guidance was for a revenue decline of 10% which spooked investors. Nike's fiscal 2024 gross margin of 44.6% was below fiscal 2022 gross margin of 46% driven by weaker sales. Its EBIT margin also fell to 13% in fiscal 2024 which has led to a cut in analyst estimates across the board.

Guidance for fiscal 2025 assumes a turnaround in sales momentum in the second half of the year which could be difficult given the worsening macro environment.

Way Forward:

Nike still enjoys a very strong brand value and its global market share in terms of revenue (currently at 18%) is still more than double that of world's second-largest sportswear firm, Adidas. Hiring a 32-year insider Elliott Hill as the new CEO, is a step in the right direction due to his credentials which says that he is well versed with the company and its products. In addition, Hill is known-and-liked internally and with retail partners, potentially driving an immediate morale boost. This is quite important as several rounds of cost cuts and senior departures amongst falling share price had really dampened the morale of employees.

One of his key priorities should be re-building its relationship with wholesale retailers after it spent several years focusing on DTC channels and pulling out of major wholesale doors.

Nike needs to direct money saved via efficiency improvements towards R&D and they need to prioritize developing new, innovative products again. Sneakers is all about the culture and community and Nike seems to have lost some of its identity. It needs to work on developing its community via innovative brand ambassadors who can help the brand connect to women and millennials. In fact, Nike still relies on men for 50% of its sales and there is tremendous potential to increase its market share amongst youth and women.

All the above makes the investor day on November 19 very critical where the new CEO needs to deliver a clear and confident message on the path to growth going forward.

Key Risks:

- ***Economic slowdown***:

  The company is highly dependent on the consumer and consumers tend to cut discretionary spend during times of economic slowdown. In today's current environment, there is still a risk of a recession given heightened geopolitical risks and softening consumer sentiment.

- ***Increasing Competition:***

  Nike's dominance in sportswear has been threatened by new brands like Hoka, On which have developed a strong connect with consumers given their innovative and trendy designs.

- ***Slowing China Economy***:

  China used to be one of the biggest growth drivers for Nike. However, the economic slowdown in China driven by falling property prices and stock markets has really dampened the growth prospects. Moreover, Chinese consumer has become most cost conscious thus favoring local brands over western brands.

Valuation:

Nike is expected to show declining sales this fiscal year and costs are likely to remain elevated depressing earnings. However, the stock is now trading at almost 2.3x Price/Sales and around a Price/Earnings multiple of 21x which is quite cheap vs history. In the long run, I expect Nike to return to its high levels of revenue growth in a couple of years. Additionally cost cuts and operational efficiencies should drive decent earnings growth in a couple of years.

Recommendation:

Fig 1. Price Chart of Nike, Source: Bloomberg (Data as of 19th Sep, 2024)

Nike share price is down almost 50% from it's all-time high driven by uncertainties around sales outlook given fading brand momentum. The company has realized there is an issue and thus the appointment of Elliott Hill (a Nike veteran) as the new CEO. Stock has had a nice pop post his appointment. Given the recent surge, I don't think there's a need to rush into buying the stock. Instead, I would suggest taking advantage of the expected volatility over the next 6-12 months to gradually build a position. The stock demands patience from investors at this point. However, Nike's strong brand presence and its unparalleled lineup of athlete endorsements provide significant advantages. The current discounted trading price has already drawn attention from activist investors like Bill Ackman's Pershing Square, which acquired Nike stock in the second quarter of this year.

There are no question that the business is facing challenges, but Nike has the brand strength to rebound, recapture its valuable wholesale relationships, and reinvent itself. It may take a

while for a turnaround to materialize, but the stock has fallen far enough that there will be substantial upside if Nike can return to its historical growth rate.

Other Notes:

Short interest as a percentage of free float is quite low at around 1.9%. The recent management change had driven many short investors out of the stock. Technically, the stocks is in an overbought territory with RSI at 71 levels. The stock is still trading below its 200-day average, and I think that would provide a stiff resistance to the stock and cap its upside. Moreover, a three-month at-the-money call option is priced at approximately 7% which seems expensive.

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Abstract

Across the years, Nike has most definitely established itself as a leader in the athletic footwear and apparel brand industry. However as of late, the company has faced significant challenges especially with its heavy reliance on direct-to consumer (DTC) sales. However, this shift had its own downsides with reduced product innovation, rising competition and bloated inventories. This has allowed competitors such as On, Hoka and Adidas to be almost on par with Nike in certain aspects. The newly appointed CEO Elliot Hill is trying to address the shortcomings ofNike by focusing on innovation, wholesale relationships, and R&D. However, in the long run, I believe that the company is positioned for a turnaround making Nike stock an attractive option for a gradual investment.