Dassling

In 1924, Adolf Dassler started a shoe manufacturing business in his mother's scullery in Herzogenaurach, Germany. Later that year his brother, Rudolph, joined the business which became "Dassler Brothers Shoe Factory" (in German).

The Dassler shoes quickly developed a reputation amongst sportsmen for their craftsmanship, quality, performance and innovation. They were the first to develop lighter canvas and rubber spiked running shoes, as opposed to heavy metal spikes. US sprinting sensation Jesse Owens used Dassler's new spikes to win four gold medals at the 1936 Berlin Olympic Games.

In 1947, relations between the Dassler brothers broke down irretrievably and they went their separate ways. Adolf initially named his business "Adi Dassler", then "Adidas". The three-stripe logo was acquired in 1952 for EUR1,600 and two bottles of whisky. Brother Rudolf initially called his new business "Ruda", later rebranding it "Puma".

For decades thereafter, Adidas and Puma engaged in a bitter rivalry which divided the town of Herzogenaurach. German teams and sport stars were effectively forced to join either camp. Ultimately that competition made both companies stronger and better able to compete globally.

The sportswear market has consolidated over the last few decades. Today, the top three companies (including Nike), control over 70% of the sportswear market globally with Adidas the number two sport shoe and apparel brand by market share. Success historically has been driven by innovation, performance, quality, brand, distribution and economies of scale. The trend should continue because maintaining a leadership position requires very deep pockets.

More recently, sportswear has benefited from the growth of the "athleisure" category - wearing sports shoes or apparel as daily casual wear. Athleisure continues to take market share from traditional categories and the trend seems likely to continue, given the low penetration in developing markets and womenswear - a previously underserved category.

Over time, Adidas has leveraged its knowhow to expand (from athletics and football) into newer categories such as golf, cricket and American football. The company has also partnered with luxury companies to launch both co-branded and luxury branded sportswear in a symbiotic way which elevates the Adidas brand, rather than cannibalising it. For example, it launched Gucci "gazelle" shoes with the joint Adidas logo catering to a totally different clientele. Adidas has also successfully expanded into sneakers through a partnership with Kanye West (Yeezys) after he and Nike parted ways.

More recently there has been a shift in distribution from wholesale to owned retail, first through branded stores and more recently e-commerce, which accelerated the trend. The "direct to consumer" (DTC) shift is both an opportunity and a threat. DTC enables companies to benefit from direct engagement with their customers, tighter control of pricing and higher visibility of inventory. By cutting out middlemen (agents and distributors), DTC sales offer higher pricing and gross margins. ▶▶

However, there are higher fixed costs associated with operating retail (warehousing, distribution, staff, rent, etc.) compared to online stores (websites, mobile app, digital marketing, etc.). Different skillsets are therefore required to execute successfully.

Being bigger helps in DTC, as the fixed costs of developing and operating an online store can be leveraged over a larger base. In terms of online and retail fulfilment, to the extent local scale and density are achievable, higher operating leverage can be realised. By way of example, it would likely make sense to open an Adidas store on Oxford Street in London given the high footfall (pun intended), but not in Timbuktu (notwithstanding the much cheaper rent).

Equally, for a smaller brand it would make less sense to open its own store on Oxford Street; it would make more sense to stick to a (declining) wholesale channel including multi-branded stores like Footlocker. Similarly, if Adidas received an online order in London, it could be efficiently fulfilled from a local warehouse, whereas a smaller brand would be more dependent on third party or centralised warehousing which involves higher fulfilment costs and longer delivery times. Adidas has already proven successful in operating DTC, having the highest share of direct sales relative to peers (Nike, Puma), with more runway remaining.

Over the past decade, Adidas went from being a good business to a great one. Profitability improved and growth accelerated, buoyed by the aforementioned tailwinds. Just 12 months ago, Adidas shares traded at an all-time high but the price has since dropped almost 60%! To put that drop into perspective, during the 2008/9 global financial crisis, Adidas shares dropped approximately 40% - which was much less than the overall market. During the 2012 European debt crisis, Adidas shares dropped about 20%. By comparison, Nike – which has less exposure to Europe and more to the US, has dropped by approximately 40% from its high.

In our view, the weakness in the Adidas share price is likely to be transient.

- Covid related shortages meant that 2021 retailers' gross margins were temporarily elevated. In 2022, however, we are seeing the "bullwhip effect": companies that have overordered during the shortages last year, are now holding excess inventory, which many are discounting.

- Russia's invasion of Ukraine in February 2022 and the subsequent withdrawal of Adidas from the territory will directly impact sales by about 3%. However, the indirect effects could be more substantial, given that Europe comprises over a third of sales and it is facing an energy crisis which will impact consumers' discretionary spending. Higher energy prices are bound to moderate over the medium-term as supply normalises.

- China, which was previously a growth driver and comprises about a quarter of sales, has gone into Covid-related lockdowns at a time when the rest of the world is opening up. The recent tensions in the Taiwan Strait only add fuel to the fire of negative sentiment. We do not believe that China will stay locked down forever. China is not self-sufficient in natural resources; it is a mercantile economy (like Japan) and therefore strongly dependent on global trade.

Our sense is that the worst of all these impacts will be felt this year and the share price, already accounts for them fully. At its most recent half-year results in August, the company noted strong demand in markets outside of China. They did however express caution over the second half of the calendar year, given the current macroeconomic environment. Despite the extreme negative sentiment, the evidence from previous crises is that demand for sportswear typically remains relatively robust and rebounds quickly. Moreover, the World Cup football tournament this winter could provide some respite.

Surprisingly, late in August, Adidas announced that their board and CEO Kasper Rorsted had mutually agreed he will hand over his position during 2023 following the appointment of a successor. Rorsted's contract was only due to expire in 2026 and he has done a decent job to date under the most trying circumstances. Our sense from the press release is that the CEO is being scapegoated. We are not concerned, as there are many capable CEOs who would jump at the opportunity.

Longer term, the same fundamental drivers which made Adidas a great company 12 months ago remain intact. The major difference between now and then is that the Adidas share trades at a cheap valuation today, hence seems a compelling investment opportunity. As the saying goes, "buy on the sound of cannons and sell at the sound of trumpets". ■

Important notice