Just Do It - Again.

Nike - BUY

Target Price $183, 149% Upside

Disclaimer: this article was written on the day of the CEO change announcement, September 19th when stock was trading at around 73 Euros, as reflected in our calculated target price and upside.

Introduction

Nike Inc., the company with the largest global market share in the footwear category, was founded in 1964 in Oregon by Phil Knight - we highly recommend the book 'Shoe Dog' for a well-written and witty chronicle of the brand's history.

Nike hit record $51.2bn revenue in full financial year 2023. However, strong concerns rose at the end of June 2024 following a disappointing fourth quarter earnings call; the market lost confidence in the stock as the results were below an already lowered guidance. Nike executives expect sales to drop 10% during its current quarter on the back of soft sales in China.

The stock consequently fell by 20%, erasing $28 billion from its market capitalization in one day. However, FY reported revenues were +1% on a currency-neutral basis, reaching $51.4bn, and quarterly revenue was flat ($12.6bn). Quarterly wholesale revenues grew +8% cfx reaching $7.1bn. The main area of concern was NIKE Direct sales (Direct To Customer retail channel), down -7% cfx, at $5.1bn.

Reasons for weakness in market sentiment

In our view, this share price fall was an overreaction as the wholesale revenue channel still represents the majority of sales and grew at a healthy rate (would need to look at CAGR for more granularity) and the strategic misstep of focusing efforts on the DTC channel should have already been priced in when the now former CEO Donahoe announced this strategy back in in 2020. This was also an overreaction also because Donahoe did actually deliver on the $50bn 2024 revenue goal he had set at the beginning of his tenure.

Fundamentally, the core of Nike's recent weakness lies at its helm, CEO Donahoe, who started in January 2020, steering Nike through COVID-19 but also leading the company to trade at record lows. The place where this company is finding itself right now is the product of a chain reaction of multiple strategic and managerial missteps taken by him in the last five years which we will run through in the following paragraphs..

Most importantly, Donahoe made the executive decision of pushing the DTC retail channel and removing Nike from the shelves of all the long-standing sportswear wholesalers. This left literal shelf space to rapidly growing competitors such as Hoka and On, resulting in Nike losing market share. This decision's negative effect was exacerbated by Nike's lack of innovation. More specifically, Nike has been relying heavily on its best-sellers (Dunks and Air Force 1s) instead of channeling resources into developing new models and designs. In FY2024, footwear accounted for 68% of Nike's sales, amounting to $33bn. Lacking granular data, we assume that the majority of this proportion comes from Dunks and AF1 based on Nike's statement in March 2024 when they announced that they would be cutting back production of AF1s to focus on innovation. However, credibility and evidence of innovation is still pending as they had already released a similar statement in December 2023.

This falling market share pressure is heightened due to Nike's competitors' exceptional and constant level of innovation, which has enabled their explosive growth (Hoka's chunky eye-catching runners and On's unique and air-light shoes).

Furthermore, Donahoe restructured company divisions under men's, women's, and kids', instead of those previously categorised by individual sports. This led to inefficiencies and internal discontent due to the layoffs of hundreds of employees as a subsequent cost-cutting strategy.

A possible method to quantify how much Donahoe's strategic and managerial missteps cost the stock is by looking at the stock price percentage change between the end of 2019 and before the new CEO was announced last week (86 to 73 euros). This translates into around a -15% fall in stock price, implying the recent CEO change announcement will presumably cause reratings (as has indeed been observed over the past week).

Catalysts

Clearly, the key BUY catalyst was the announcement of new CEO Elliott Hill on September 19th because, as outlined above, the fall in stock price can be explained by the internal strategic and managerial missteps of Donahoe. The announcement has had visible influence over market sentiment as well - stock is up around 9.6% (19th vs 28th September) and 'stock market value increased by $11 billion in extended trade following announcement'. However, it will be interesting to see whether this higher sentiment is just an announcement effect or will be sustained in the coming weeks.

Hill is a promising CEO as he started his journey at Nike as an intern, meaning he embodies the brand values and has unique insight on the company's historical performance through the highs of 2021 and lows of 2024. Furthermore, Nike has only had 5 CEOs in its 60 year-long history, implying that a lot of influence and trust is bestowed upon the individual at the helm.

A reason why a CEO turnover could be enough to return Nike to its glory days is because the company's brand is already established with many important brand ambassadors and a significant global presence - it is just a matter of regaining lost market share by adjusting the sale strategy and generating brand heat with new products. Nike has the competitive advantage of being one of the oldest companies operating in the sector, hence having the most consumer data and sturdy brand awareness.

Short term catalysts for further movements in market confidence could be quarterly results to be released on October 1st and the first investor day in 9 years due in November. If results on October 1st are relatively underwhelming as they have been in recent quarters and the uplifted market sentiment stemming from the CEO announcement is not enough to sustain an upward trajectory of stock price, we would take this as a further opportunity to Buy.

These short term catalysts are too early to judge the quality of Hill's leadership; it is ultimately important to buy on the back of potential weakness of quarterly results or the Investor Day.

Green shoots

A first green shoot is that the CFO mentioned that the consumer had been showing positive response to their innovative designs in Q4 results. This statement is backed up by the fact that they are taking action to further pull back on AF1 production. This should bolster market confidence that their consumer will be responsive to incoming innovation.

Another important green shoot mentioned during the earning call was that the 'production decrease will most likely happen on the DTC business side and was not made because of a decrease in popularity or demand'. This should give long term confidence to investors as efforts are already being made to reverse Donahoe's strategic misstep and demand remains sturdy.

A final green shoot is that in the most recent quarter, Nike Wholesale channel grew at +7% cfx implying that despite their previous pull-back from wholesale, they are capable of successfully recapturing the foregone market share. This provides a solid beginning to the reversal of the Donahoe 2020 strategy for Hill to take the reins.

Furthermore, it is important to keep in mind that the rationale behind the guidance cut (on which the market sentiment plummeted) was the weak Chinese consumer backdrop which is a wider industry characteristic. Namely, analysts are warning that Adidas margins in China should also fall to the low-to-mid 20% from the mid-30s in the past. Chinese weakness is essentially affecting all companies in the Consumer Discretionary space - with Hermes being the exception, meaning that the market is overvaluing this sales weakness.

Valuation *(with respect to September 19th)*

With respect to the stock's current valuation, the market is pricing in at least one more downgrade/underwhelming result quarter, hence it is safe to start building a new long position. It is fair to assume it will take at least 12 months before the new CEO can start delivering on a new strategic direction, but in the meantime, we believe current valuation offers a floor to the share price.

In terms of absolute valuation, Nike is trading at a 71% discount to its historical peak in 2021 (peak price was at the end of 2020 with share price of 170$, driven by Michael Jordan documentary, AF1/Dunk heat, and start of running craze) which presents an attractive entry point.

Additionally, the stock is trading at a 86% discount to Adidas and 45% discount to Asics - the relative valuation is also offering a favorable entry point.

For the scope of this article, we conduct a simple valuation by PE multiple. The target PE is the median between peak and current PE. The rationale behind overvaluation at the peak and current undervaluation (the stock is currently trading close to where it was before the pandemic - unjustified). The target PE of 54x implies a 132% upside to current price (assuming EPS of 3.4$). This is a rerating call because it will take time for the earnings to go up relative to expectations, but I argue that the multiple will expand ahead of the EPS upgrades (not an upgrades call).

Investment Risks

The most prominent risk for Nike is a sustained weakness in the Chinese consumer as this would make Hill's brand turnaround challenging and could lead to earnings related downgrades. We believe that this risk is more significant than the continued expansion of rising competitors. Their explosive growth rates seem alarming but they are coming from a very easy comp base. A bigger menace would therefore be sustained Adidas market share growth or a company of similar size.

Another investment risk for this company would be Hill's incapability of turning around Nike's brand image through innovation; this could be in the form of unsuccessful/unpopular designs. Another negative scenario could be Hill not actively continuing to turn away from the DTC-focused strategy, despite innovating some designs. This reminds us of the case of Burberry, the British luxury house, which has been underperforming with little to no hopes of a turnaround by analysts. Burberry has recently been characterized by a high CEO turnover paired with call announcements explaining that their (unsuccessful) strategy will however remain the same under the new leader.

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