

By Raya Raphael

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## A Message to Our Clients & Readers

Welcome to our exclusive report on the 2014 global sport apparel industry. Active and healthy lifestyles dominate the society we live in today. People are becoming increasingly aware of the importance of integrating good nutrition and regular exercise into their daily lives. This trend is driving the global sport apparel industry as brands compete through diversification and expansion.

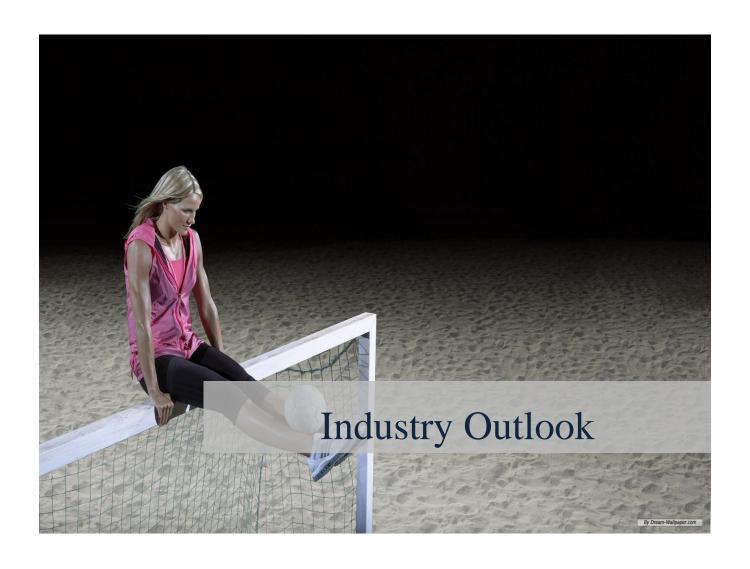
Our *Industry Disclosure* features key metrics, performance ratios, risk factors, main drivers and trends as well as the overall outlook for the industry. We hope that you will benefit from this analysis.



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## Industry as a Whole

### Industry as a whole

In regards to the industry as a whole, we expect to see higher sales and higher costs overall. The growth in sales will likely be due to expansion into international markets, an increase in global economic activity, a growing middle class in emerging economies and the recognition of returns from omni-channel retailing. The inflation in costs will be due to rising wages in developing countries as well as the rise in the price of raw materials. In order for companies to keep their margins high, they must be willing to increase prices and improve their manufacturing processes.

The risks we see going forward in this industry include, higher input costs, surprises that may arise from the pull back of cheap money by central banks globally, consumer confidence, consumer purchasing power, and employment numbers. We are also concerned with spikes in interest rates as this could deter demand and stump growth.

Brand recognition, customer loyalty, and innovation are key factors to success in this market. In order to compete and grab market share, companies need to be innovative and must lead when it comes

to new and upcoming trends. The companies who have produced robust numbers in this space and who we anticipate will be the top performers going forward include: Under Armour, Nike, and Lululemon.

### Macroeconomic Factors

### **Consumer Spending**

Consumer spending, which accounts for more than two-thirds of U.S. economic activity, is a key driver in this industry and companies' earnings generally follow consumer-spending trends.

Consumer spending is affected by several factors including: unemployment, consumer debt levels, reduction in home values, fluctuating interest rates and credit availability, fluctuating fuel and other energy costs, fluctuating commodity prices and general uncertainty regarding the overall future economic environment.

Currently, daily consumer spending has increased to \$94 in July, up from \$92 in June. However, this is still lower than the high of \$98 in May.

#### **GDP**

The Sport Apparel industry is highly correlated with GDP growth. Global GDP growth has been soft and in fact the World Bank has revised its Global GDP growth rate for 2014 down to 3.6% from 3.7%. However, with growing middle classes in emerging economies we expect to see solid growth going forward.

### Competitiveness

The industry is highly competitive as there are low barriers to entry due to low costs of capital and labor. This level of competitiveness puts pressure on companies' profit margins as they have to constantly be wary of pricing strategies and trends.

### Highly Informed, More-Demanding Consumers

In today's information age, the consumer has a lot of bargaining power, as he/she is able to scan prices of a particular product across various brands in minutes. This is a challenge for industry players who must be prepared to meet consumer expectations.

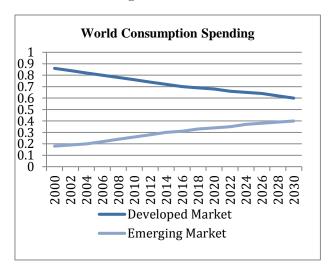
# Inflation of Wages & Raw Materials

Inflation of wages and raw materials pose a threat to companies in this industry as it puts upward pressure on costs, which will likely result in lower gross and operating margins. Wages in the developing world are increasing as demand for labor in those regions escalates.

## Macroeconomic Factors

### **Global Expansion**

Many companies are looking to expand globally going forward. Rising income levels in developing economies have been the driving force behind global expansion plans. Emerging markets are projected to be responsible for 40% of world consumption by 2030. This is due to a growing middle class and a rising standard of living.



### **Economic Recovery**

Despite tepid growth in Europe, the global economy is starting to pick up steam, particularly in emerging economies. We observe moderate growth rates of

2% in the United Kingdom and growth rates of approximately 3% in the United States.

With middle class spending power getting stronger in emerging economies, the global recovery could be more of a reality than a fantasy. However, as always, there are significant threats that stand in the way of global recovery, and as such pose a risk to this sector.

## **Industry Specific Factors**

### Women Driving the Market

According to the Women's Sports Foundation, more women than men participate in sports and fitness and women purchase more athletic shoes and apparel than men.

Consequently, big name brands such as Nike and Under Armour are focusing their efforts on their women's business. These brands see strong returns in growing their women's division as they anticipate that it will one day rival their men's business. Under Armour reportedly spent \$15 million this year on its biggest women's campaign to date starring professional ballet dancer Misty Copeland. Moreover, Under Armour has signed super model, Gisele Bundchen to endorse its brand.

### **Analytics**

Many more retail companies will adopt Software as a Service platforms to their business models. This will enable them to gather big data efficiently, which is imperative in this market. Adoption of these services will allow companies to gain detailed information on consumer behavior, implement efficient pricing strategies, and gain better insight into who their ideal customer is. In turn, this will improve profit margins.

#### Sustainable Fashion

Eco-fashion is becoming increasingly important as consumers grasp a better understanding of how their products are manufactured. Consumers want to feel good when they sport clothing from their favorite brands. Consequently, brands that are capitalizing on this movement will not only gather traction, but will ultimately bolster brand strength and customer loyalty.

### Wearable Technology

Wearable technology has taken the industry by storm and has enabled market players to maintain premium prices and to establish stronger brand recognition. Wearable technology enhances workouts and helps consumers produce efficient results during their exercises. As a result, consumers will be willing to pay top dollar for these items.

In addition wearables are integrated with apps that connect consumers to social media. This is a great analytics tool as it provides valuable information.

## **Industry Specific Factors**

#### More Awareness on Health

There is a high emphasis on health both at the national level and at the global level. Increased recognition about the benefits of exercise and healthy nutrition are driving forces within this industry.

### **Emphasis** on Style

Fashion is a big trend in this industry and companies are reacting by teaming up with well-known designers. In addition, fashion brands are also introducing active gear into their product lines. Companies in this space will have to anticipate trends in a timely manner in order to maximize revenues and lower inventory obsolescence going forward.

TIPU /D	4 CV
TEV/Revenue	1.6X
TEV/EBITDA	13.6X
P/E	22.8X
Inventory Turnover	3.3X
Revenue Growth (3-yr)	5.4%
Profit Growth (3-yr)	4.9%
EBITDA Growth (3-yr)	2.6%

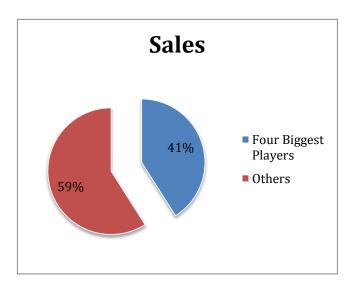
Latest as of May-15-2014

### **Industry Concentration**

The Global Sport Apparel Industry is a \$1.28 trillion industry. Revenue is moderately concentrated within the four biggest players who own about 41% of total sales. Nike, the biggest player generates about more than half of that (28%). However, smaller stores are still able to flourish in this environment, as brands compete on style and may cater to specific niche demographics.

These multiples represent the Global Sport Apparel Industry, which is a subset of the Global Apparel Industry. Sport Apparel is outpacing the broader Apparel market seeing increases in revenue of 7% from July 2013 to June 2014 compared to about a 1% rise in total apparel sales over the same period. In addition, Inventory turnover in this sub industry is almost double to that of the broader market: 3.3X vs. 1.8X.

Athletic apparel is a winning sector in this market as people start to wear their active gear just about everywhere driving demand to higher levels. This upcoming trend has helped fuel growth for companies within the industry, such as Nike, Lululemon and Under Armour.



### **Barriers to Entry**

The sport apparel industry has low barriers to entry because of high fragmentation, low capital requirements, and a high degree of unskilled labor.

#### **Price Trends**

Prices have increased by about 10% since the 2008 recession. However, this is much lower than the increases in overall prices in the economy. This may suggest that retailers are trying to keep their prices low to entice consumer demand.

### Seasonality

This industry is highly seasonal; a high percentage of sales occur during holiday seasons. In addition, consumers tend to wait out until sales times before making purchases at their favorite stores. This proves fatal to most retailers, as discounts are extremely costly.

For instance, Lululemon generated approximately 33%, 36%, and 37% of their gross profit during the fourth quarters of fiscal 2013, 2012, and 2011 respectively. Moreover, both Under Armour and Nike have stated in their annual

statements that a majority of their revenue is recognized during the last two quarters of the year.

Earnings may fluctuate based upon factors such as the timing of holiday seasons, weather, timing and level of discounts, and general economic conditions.

Food For Thought: Public companies are experimenting with giving away equity as an alternative to price reductions. This not only saves the business money, but also creates stronger brand loyalty between the company and its consumers.

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### Level of Competition

The level of competition in the industry is extremely high because the industry is highly fragmented and has low barriers to entry. In addition, foreign retailers are penetrating global markets increasing competition at the local level.

Furthermore with the increasing presence online, consumers are in control now more than ever as they are able to scan prices and products globally.

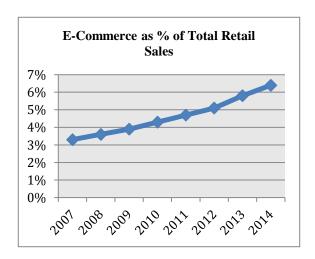
#### **Online Retail**

E-commerce has grown tremendously in the past few years as more and more retailers capitalize on this trend. E-commerce allows retailers to grab a larger market share by creating a medium where consumers — who do not want to visit physical stores— can shop.

"Online retailing could be a more profitable operation than stores."

-Edward Stack, CEO Dick's Sporting Goods

This in turn helps retailers increase margins by reducing operating expenses while simultaneously increasing sales.



CEO, Edward Stack of Dick's Sporting Goods has told analysts in the company's second quarter earnings call that the company will be putting more of its efforts and focus into e-commerce growth and profitability going forward. "Online retailing could be more profitable than stores within three years," says Mr. Stack.

Today, in the U.S., e-commerce is a two billion dollar industry and is expected to grow 57% by 2018. Online retailers must concentrate on tablet and mobile initiatives, site conversion, international growth, and multichannel efforts if they want to boost sales.

### Forecasting of Trends

A company's ability to quickly forecast consumer trends could make a big difference on a firm's gross margins. Consumers generally flock to retailers that have the next big trend readily available. However, trends don't last long, so the quicker a company is at anticipating the trend and bringing it to consumers the more sales it can generate.

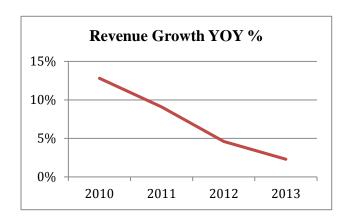
If a company fails to deliver trends in a timely manner it will lose out on profits and will be left with useless inventory, which can no longer be sold. This inventory will need to be discounted and will hurt a company's bottom line.

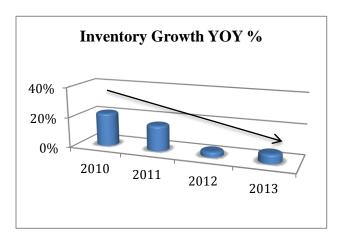
### **Inventory**

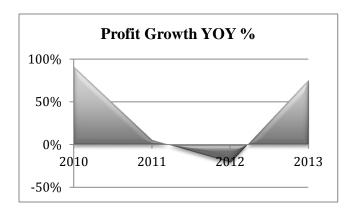
Inventory levels have a huge impact on gross margins. The higher the inventory turnover, the better. Inventory turnover over the past few years has been declining slightly and has remained relatively flat at 3.3X over the last year. This is possibly the result of softer demand coming out of the economic recession of 2008. In addition, consumers are more cost conscious now than ever before.

Inventory growth is another important metric and is highly correlated with profit growth. When evaluating inventory growth, we must observe its trend relative to revenue growth. Historically, if inventory growth is slower than sales growth, profit is said to increase and vice versa.

In our case, we observe a declining trend in both revenue growth and inventory growth. If we look closely, we can see that inventory growth is almost double that of revenue growth in 2013. This would likely suggest that profit would slow down in the current year.





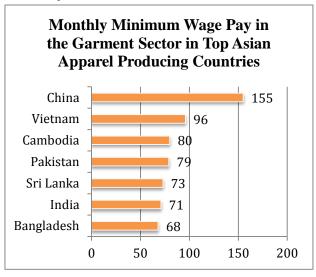


## **Industry Summary**

### Outsourcing

Outsourcing is moving away from China and towards places like Vietnam, Bangladesh, and Sri Lanka. This is primarily due to the wage inflation in China. As a result, many other emerging countries are competing for manufacturing jobs from big name apparel companies such as Zara and The Gap.

The minimum wage in Bangladesh has increased 79% to \$68 since last December at the request of some retailers, mainly due to the incident that occurred in Dhaka (the collapse of the garment factory). Consequently, this puts upward pressure on costs for companies manufacturing in the industry.



### **Near Sourcing**

Will wage inflation in emerging countries lead to a shift in near sourcing?

#### Advantages:

- Fewer language barriers and communication gaps
- Shorter supply chain cycle times
- Greater production flexibility with rapid response to design changes
- Fast reaction to fashion trends
- Fast repeat production of best sellers
- Corporate goodwill and positive brand association

#### Disadvantages:

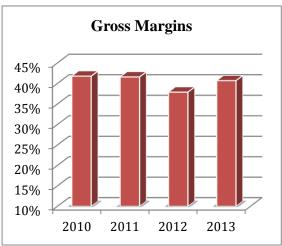
- Lack of fabric and raw materials suppliers
- Lack of capacity of large scale production
- High wages

## **Industry Summary**

### **Gross Margins**

Gross margin is affected in large part by inventory management. Fluctuations in the global apparel retail markets impacts the levels of inventory owned by apparel retailers. If sales do not meet expectations, then too much inventory may cause excessive markdowns and, therefore, lower than anticipated margins.

Gross margins are also affected by prices in raw materials such as cotton, wool, polyester, synthetic fibers, etc. Gross margins have increased by about 3% since last year, but otherwise have remained relatively flat. However, as sales have decreased over the same period, the increase in gross margins is likely due to lower direct expenses. This is a result of declining inventory.



We expect gross margins to tighten as product and labor costs rise.

### **Operating Margins**

Operating margins indicate profitability of a business and generally refer to income made after variable costs are paid out. Operating margins in this industry have declined slightly in 2013 to 7.4% from 7.6% in 2012. Since Gross margins have increased over the same period, the decline in operating margins is likely due to higher operating expenses, specifically higher marketing and operating overheads.

As gross margins tighten, and operating expenses ease, we expect operating margins to lie around the same level going forward.





### **Changing Global Lifestyles**

People and governments worldwide are recognizing the severity and benefits of healthy living. In the past few years alone, we have witnessed a ban on extra large sodas in New York; the introduction of salads and healthy meals at mega fast food chains, such as Mc Donald's and Wendy's; the USDA's extraction of sodas and junk food being served in high schools nationwide; and "Let's Move!" Obama's Michelle program aimed at tackling childhood obesity.

These immense efforts from the government to keep its nation fit is the result of the recognition that many diseases are caused by obesity and lack of good nutritional health. Several senators in the government of the United States have even gone as far as to propose a "Physical Activity Tax Incentive," and It's obvious why, just look at the chilling statistics:

- "Worldwide obesity has nearly doubled since 1980.
- 35% of adults aged 20 and over were overweight in 2008, 11% were obese.

- 65% of the world's population live in countries where overweight and obesity kills more people than underweight
- More than 40 million children under the age of 5 were overweight or obese in 2012."
   World Health Organization

The Physical Activity Tax Incentive is aimed to promote active and healthy lifestyles by enabling Americans to offset the costs of physical activity with pre-tax dollars. Essentially, Americans would be reimbursed using pre-tax dollars for expenses that directly tie to sports and fitness equipment intended for use in physical activity, gym memberships, exercise classes, etc.

In addition Walgreens, a big U.S. pharmacy, has set up a rewards program with the intention of promoting good health. The program awards consumers with points, which can be redeemed for dollars, when they make healthy choices. For instance, consumers get 20 points per mile when they run, walk, or cycle; they get an additional 20 points per weigh-in, blood pressure test, or blood glucose test.

This is great news for companies that sell sports goods, equipment, and athletic apparel, as the opportunity for increased sales and expansion are higher than ever.



#### **Fashion Trends**

Fashion trends have been driving growth in this industry as global consumer tastes shift towards athletic styled clothing for non-exercise purposes with big names such as Chanel designing and selling sneakers. Brands such as Lululemon, Adidas and Nike have all maximized on this new trend by integrating extremely stylish workout gear into their product lines.

For instance, Adidas has recently worked with London designer Mary Katrantzou and stylish celebrities like Rita Ora and Pharell Williams. Whereas Nike has teamed up with Givenchy's Riccardo Tisci

"I find a lot of women wear what they wear to go to the gym all day long."

Tory Burch

The lines between sport apparel and fashion are becoming increasingly blurred as more and more high fashion brands team up with sport apparel companies and produce lines of their own.

Brands who were previously absent in the sport apparel space are now making a presence in the market as they see strong growth potential. For instance, high fashion brand Tory Burch, has come out with a new collection that includes active gear. "I find a lot of women wear what they wear to go to the gym all day long," the founder of the brand told Women's Wear Daily.

The Gap also dipped its feet into the active wear market with its acquisition of Athleta, a yoga sports apparel brand. Another example would be H&M's integration of sports wear into their existing line. H&M sport even designed the official Swedish uniforms for the Sochi Olympics and executives at the company have recently stated that they are more focused on sports now than ever.

New Market Players	
Tory Burch	
H&M	
Chanel	
The Gap	
Forever 21	

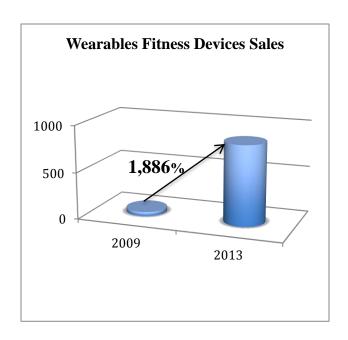


#### **Smart Gear**

Technology is another driving force behind growth in this industry as consumers yearn for the most efficient workouts possible. For instance, Nike's fuel band will help people count calories their progress, track whereas Instabeat's smart swim goggles will help swimmers measure their performance during a swim. These products enhance workouts and as such, are revered by consumers worldwide. As a result, brands that diversify into wearable technology experience a strengthening in both brand loyalty and brand recognition from consumers.

Technology in athletic gear goes as far as protecting consumers from cold weather, sweat, and even helps them shed extra calories. Under Armor's Cold Gear Infrared technology helps consumers keep warm during the colder months; Lululemon's "anti-stink" technology inhibits the growth of bacteria on clothing; and the Zaggora utilize Hotpants heating fabric technology meant to increase amount of calories burned by generating more body heat.

These technologies and applications by these respective brands show how getting the most efficient workout possible is what the consumer wants. As such, sport apparel brands must position themselves strongly in the market by integrating technology that will beat their competitors.



The market for wearable fitness devices has been growing at a staggering rate. Sales have grown from \$43 million in 2009 to \$854 million in 2013, that's an overwhelming 1,886% increase. This year, wearable fitness devices are expected to hit \$1.2 billion in sales.

# Power Players - Interesting Technology

Nike constantly seeks new technological advancements with the goal of strengthening its brand loyalty and maintaining its premium prices. One of its more recent innovations is a golf shirt that can help players improve their swing.

Another interesting innovation by the company, which was introduced in February 2012, is its shoe technology called "Flyknit." This innovation gives the shoe a sock like feel and greatly enhances the manufacturing process by improving labor productivity and reducing waste.

Under Armour another extremely innovative company in this market. Under Armour, established in known 1996, was well for its compression apparel and set the stage for the market with three synthetic performance apparel lines. HeatGear for warm to hot weather, ColdGear for cold and AllSeasonGear for weather, changing temperatures.

Under Armour annually hosts competitions where entrepreneurs showcase their ideas to executives of the

company. The entrepreneur with the most innovative idea wins the competition. Recently, Under Armour integrated a new zipper technology coined "MagZip" into their product line, which they found through one of these competitions. "MagZip" uses magnetic forces to enable consumers to easily zip their clothing with one hand.

"That is not expensive when you factor in its terrific growth rate. That's not the growth rate of an apparel company. It's the kind of growth we associate with tech."

- Jim Cramer

The list for Under Armour's innovation could go on and on and its highly innovative nature is the main reason that Jim Cramer of CNBC has continuously echoed that the company should be reclassified as a technology company. Looking at Under Armour's track record of innovation, Mr. Cramer's statements are not unfounded.

Investors are willing to pay about 90 times earnings for the company and as Cramer states "that is not expensive when you factor in its terrific growth rate. That's not the growth rate of an apparel company. It's the kind of growth we associate with tech."



### **Extreme Sports**

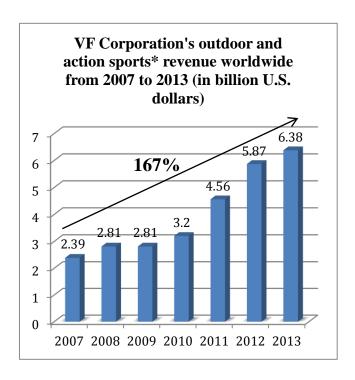
More and more people are looking to new and exciting ways to shed calories and keep fit and extreme sports is the way to go. The media has taken a bigger interest in action sports, broadcasting competitions like wakeboarding and cross skiing more often, and traditional brands are taking advantage of consumers' rising interest in extreme sports by marketing their products to appeal to consumers with an active lifestyle, such as BMW's Tourer commercial and more recently the Mitsubishi Outlander Sport.

Other brands are also trying to capitalize on the rising trend of extreme sports and as such have been showcasing their brands in ads centered on action sports. For instance, Japanese food giant Nissin, has recently come out with an ad for their cup noodles, which includes surfers, skateboarders and other extreme sports enthusiasts. The company aims to attract the millennial demographic.

Extreme sports tend to have lower barriers to entry than other traditional sports, as they don't require strict regimes or diets for participation.

Action sports encompass a more laid back lifestyle and many young people relate to that culture. The definition of extreme or action sports is debatable, and is not limited to the following: surfing, motocross, bmx biking, mountain biking, snowboarding, mountain climbing, skateboarding, and the like.

The action sports industry is growing tremendously. VF Corporation, one of the largest sports retailers globally, has seen their outdoor and action sports revenue increase over the years. VF Corporation's revenue has grown about 100% since 2010, from \$3.2 billion to \$6.38 billion in 2013.





### Yoga

Yoga has been a booming industry over the past few years and a key trend in the sport apparel market. The practice of yoga has picked up steam and is estimated to have about 22.4 million yoga participants in the United States in 2013, up about 38% since 2008.

### "Everyone is wearing yoga pants, even people who aren't doing it."

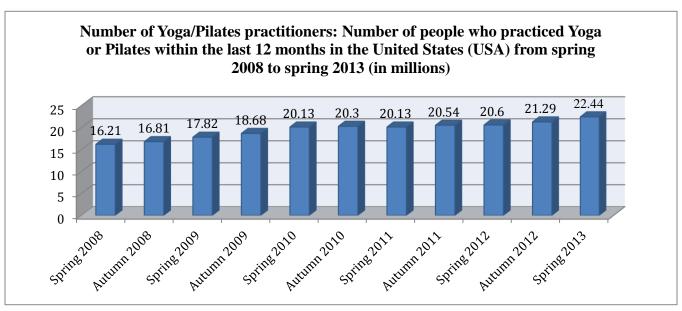
-Karen Score, owner of Yoga Mandali

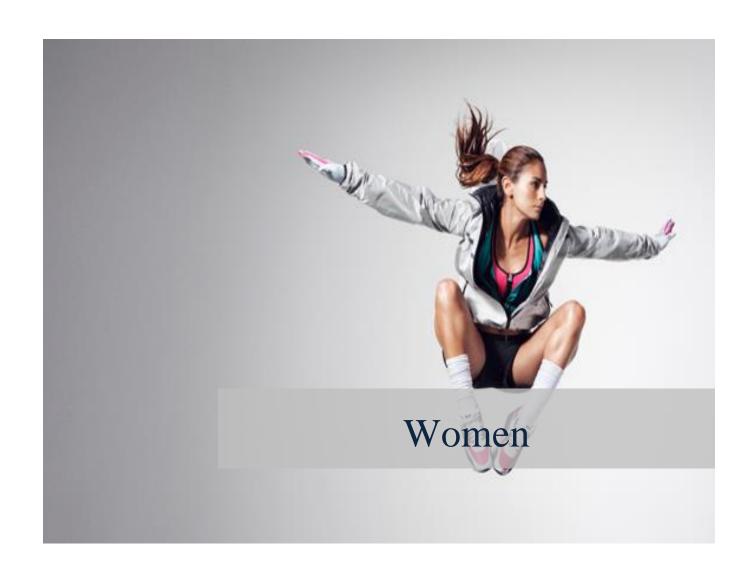
In 2008 and 2012, yoga practitioners, better known as "yogis," spent roughly \$5.7 billion and \$10.3

billion respectively. That is a whopping 80.7% increase in expenditures in just four years.

According to the Sports & Fitness Industry Association, yoga participation grew 4.5% and demand for yoga gear is outpacing growth in the broader athletic apparel market. "Everyone is wearing yoga pants, even people who aren't doing it," said Karen Score, the owner of Yoga Mandali, an independent yoga store in Saratoga.

Sport apparel brands are looking to capitalize on this growing trend. Under Armour, a brand known for menswear, has been shifting gears and has started to design apparel for women who enjoy yoga, pilates, and the like. Moreover, Columbia Sportswear has recently acquired prAna Living, a yoga brand, for about 11.8 times revenue.







#### Women

A key trend in the sport apparel industry is the focus on women. Men were always center stage for most companies in this market; however, this is all changing and has been changing for a while now. Nike, for instance, has been placing a high emphasis on women's fashion now more than ever.

### "Womenswear will equal or surpass our men's business in the future."

- Kevin Plank, CEO Under Armour

According to a press release, Nike's women's division increased revenue by 11%, beating overall revenue growth of 9%. This has motivated the company to focus on their women's business. Last year, Nike generated \$14 billion in men's sales and only \$5 billion in women's. In this case, the company sees growth potential in its women's division driven by the idea that it could rival its menswear division in the future.

Similarly, Under Armour has been extending its efforts into its women's line. Its new campaign targeting women

\$15 million and is said to be its largest women's campaign to date. The advertisement was awarded "Ad of the Day" by Adweek and has gained half a million views on YouTube already. The company has even redesigned its stores to look and feel more feminine.

Executives at the company have started to realize the tremendous potential in appealing to women through their brand. "Womenswear will equal or surpass our men's business in the future," CEO Kevin plank tells Women's Wear Daily. The company has also signed professional ballet dancer Misty Copeland and super model Gisele Bundchen to endorse the Under Armour brand.

According to the Women's Sports Foundation, "among adults, more women than men participate in sports and fitness and women purchase more athletic shoes and apparel than men." With women driving about 80% of all consumer spending globally, it's no wonder that there has been a major effort from sports brands to focus on enticing their female shoppers as well.



#### Sustainable Fashion

fashion Fast causes a tremendous amount of waste and pollution in our environment because of the high turnovers of inventory and low quality of apparel. Ethical fashion involves the manufacture, design, and distribution of apparel friendly, environmentally produced sustainably, absent of animal testing, absent of exploitative practices, and that adheres to fair trade practices.

"My team and I fundamentally believe that the more we can flow sustainable innovations into our business and into the market, the more we can show a vision of good and [provide] alternatives to the current state, and hopefully render the current state obsolete."

- Vice President of Sustainable Business & Innovation, Nike

Nike has been a front runner in this movement. The company has designed products like its Flyknit shoes that reduce manufacturing waste. The company also developed a water-free dyeing technique called ColorDry, and has researched alternative materials to cotton, such as a water intensive crop.

Sustainable clothing will help consumers feel good about their purchases, particularly since there has been more public recognition of how apparel and footwear is being manufactured.

"My team and I fundamentally believe that the more we can flow sustainable innovations into our business and into the market, the more we can show a vision of good and [provide] alternatives to the current state, and hopefully render the current state obsolete," says Nike's Vice-President of sustainable business and innovation. Under Armour, another industry leader has also taken steps towards integrating sustainable fashion into their product line. The company's "Catalyst" collection is made up of fabric that is created by melting down plastic bottles. This process has a low impact on the environment.

Other big name brands should follow suit if they want to capture this market as eco fashion has been said to be a lifestyle and not just a temporary trend.



### **Consumer Analytics**

Consumer analytics is a big trend shaking up the whole retail industry, not just sport apparel. In today's everchanging retail environment, firms are doing their best to keep up with consumer demands and consumer analytics can help them do just that. Retail players are taking advantage of the rise in technology by implementing advanced software services. which enable them to gather consumer and business information more efficiently. The result is lower costs and better outcomes. The driving force behind this trend is the capability of organizing big data efficiently to produce margins.

features The that consumer analytics bring are extremely paramount for players in the retail industry, where analytics can drive value in areas ranging from customer engagement to pricing and profitability management. These firms are hoping to stay ahead of the game by figuring out who their ideal customer is, what they want to buy, and how often; today it is all about the consumer. Given the ever-changing retail environment, marketing ploys have had to change as well. With a wide range of options available for firms to choose

from, this space seems more complex than ever. Consumer analytics allows firms to manage their media use by showing them which media outlets are most efficient and allowing firms to plan for the future.

Analytics can also help firms with their pricing procedures. While firms want to keep profits as high as possible, they also do not want to run the risk of losing customers because of their prices. By using analytics, firms can analyze large sets of data to conclude which pricing levels are most appropriate to use. This process allows firms to realize the optimal price of a single product or a range of products.

Consumer analytics is growing in use in the retail space and will continue to do so in the future. As consumer preferences get more and more complex, firms will look to technology to help gain some insight into consumer wants.

Under Armour recently acquired MapMyFitness, which is a fitness app, last December. MapMyFitness allows users to track their workout performances and offers them training plans, heart rate analysis, and audio coaching. The true advantage of MapMyFitness is that it allows Under Armour to gather analytics from the app to get a better idea of users' workout schedules in order to provide them with the apparel they need.



### Social Media & Marketing

Sport Apparel companies have become more active in the social media space, having profiles on Facebook, Twitter, and Instagram. Having a presence on social media platforms such as Facebook allows these companies to drive traffic either to their online stores or their brick and mortar stores or both.

The way they drive traffic is through status updates, which they share with their many followers. If a consumer follows their favorite brand, they will always receive updated news feed on the companies they follow. This is significant as it allows brands to reach out to thousands, if not millions of consumers in just one click. It also allows companies to gather consumer analytics.

Number of Facebook Followers by Brand		
Company Name	Followers (MM)	
Nike, Inc.	12.3	
Under Armour	3.048	
Lululemon	0.976	
Adidas	18	

Social media has been paramount when it comes to what the industry calls "sneakerheads." Sneakerheads, to state the obvious, are consumers who are extremely passionate about sneakers. Companies now seek to come out with new models of sneakers annually to capitalize on this demographic. Brands look to create hype and routinely announce dates for particular models in advance. Sneakerheads line up outside their favorite stores—in some cases the night before—to be the first to grab a pair of the newest models. This demographic generates about 5% of the total \$22 billion retail sneaker market and as such are getting a lot more attention from sport apparel companies.

Marketing is extremely important for big name brands and these brands seem to have an endless budget when it comes to their ad campaigns. To put this in perspective, Nike spends about \$2.8 billion on marketing, which is approximately 11% of its revenue.

	Marketing as a Percentage of Revenue				
:+	Social media has been paramount when				
	Nike, Inc.	10.8%			
	Adidas	12.5%			
	Under Armour	10.3%			

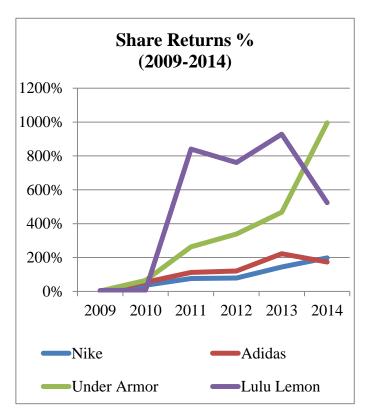


### **Power Players**

Lululemon and Under Armor have been outperforming big name giants such as Adidas and Nike. On the one hand, Lululemon has been facing a lot of public scrutiny lately and as a result its stock price has declined by 43% since its peak in 2013. On the other hand, Under Armor has seen a tremendous appreciation in its stock price since its uptick in 2013 by about 112%.

Lululemon has been dealing with a management turnaround and has come under fire for product quality and the rather infamous statements made about women's bodies by its founder Chip Wilson. Recently, however, Lululemon has received some attention from the private market as Advent—a private equity firm—acquired an 18.5% equity stake in the company for roughly an 8% premium.

Under Armor stock has experienced exponential growth over the past few years. Momentarily, shares of Under Armor have been outperforming its peers and revenue growth for the company far outpaces Nike, an industry giant, and Lulu Lemon, an industry favorite.



<u>Company</u>	Revenue Growth 2014	EPS Growth 2014
Lulu Lemon	13%	-1%
Nike	8.5%	13.9%
Under Armor	25.7%	22.7%

#### Lululemon

Lululemon is a solid company and has truly revolutionized sport apparel and yoga gear in particular. Lululemon was the first company to lead the fashion movement in the yoga apparel sector and many other companies have followed suit.

While most sport apparel brands look to focus on women, Lululemon sets its eyes on menswear. The company is also hoping to rebrand itself as a company that offers workout clothing in general, and not just yoga gear. The company has seen revenue from menswear up 9% in the last quarter.

Recently, the founder of the company, Chip Wilson, sold off half of his stake to Private Equity firm, Advent. This action is probably the result of the ongoing rivalry between Wilson and the Board of Directors. Since Wilson's sell off, the stock price has increased 1.5% as the market sees this action as a stabilizing force.

Lululemon has a strong balance sheet and an even stronger cash flow. The company has reported current ratio of 9.3X, quick ratio of 7.2X and cash from operations to current liabilities

ratio of a solid 3.1X during the last twelve months.

These ratios far outpace any of its competitors. By comparison, Under Armour reports ratios of 2.8X, 1.2X, and 0.3X respectively. However, the company's high liquidity ratios may not be reason to celebrate. This could indicate that the company is not putting its cash to efficient use. Moreover, its recent decision to put \$450 million (80% of operating cash flow) into repurchasing stock over next two years has left most analysts confused. The increasing level of competition and the plans by the company to expand internationally suggest that more cash will be demanded by the business.

Over the coming years Lululemon will face intense competition as its peers seek to capitalize in the womenswear market and this will subsequently put pressure on the company's notoriously high gross margins.

•	Lululemon	Market
TEV/Revenue	3.1X	1.6X
TEV/EBITDA	11.4X	13.6X
P/E	20.3X	22.8X
<b>Inventory Turnover</b>	8.8X	3.3X
Revenue Growth (3- yr)	24.4%	5.4%
Profit Growth (3-yr)	30.4%	4.9%
EBITDA Growth (3- yr)	27.3%	2.6%

#### **Under Armour**

Under Armour has been a sensation over the past few years and has seen its stock price soar to ever higher levels. The company has seen 17 consecutive quarters of at least 20% sales growth and following its second quarter report last month saw its shares rise 15% in a single day. What's more is that management has raised guidance for the third time for fiscal year 2014. Management projects revenue increases of 28% to 29%, up from 24% to 25%.

This begs the question; can the company see its stock inch even further? We would like to argue that it could. Under Armour is an extremely profitable company and is rivaling big name brands such as Adidas and Nike.

The company has a lot of upside potential in several key areas such as women's fashion, footwear and above all, international expansion. In fiscal 2013, the company generated about 94.1% of its total revenue in North America. By comparison, Nike generated approximately 53% of its total revenue in foreign markets last quarter. In the second quarter of fiscal 2014, international sales represented a paltry 8.5%. However, this represents

an increase of about 100% since last year. If the company is able to successfully penetrate foreign markets and prove brand strength abroad, the returns could prove to be immense.

In addition, Under Armour has room for growth in its footwear and women's divisions, which are both still premature. The company began offering footwear in 2008 and since then has seen its footwear division grow tremendously. Footwear revenue grew 34% in the second quarter of fiscal year 2014 alone.

The company also has plans to focus on its women's business, as it believes that women's sales could rival men's. The company is already redesigning stores to increase space for women's apparel. In the second quarter, women's sales grew 26% from the prior year.

8	<b>Under Armour</b>	Market
TEV/Revenue	4.5X	1.6X
TEV/EBITDA	37.0X	13.6X
P/E	89.8X	22.8X
Inventory Turnover	4.9X	3.3X
Revenue Growth (3-yr)	16.5%	5.4%
Profit Growth (3- yr)	18.7%	4.9%
EBITDA Growth (3-yr)	17.6%	2.6%

#### **Nike**

Nike is the largest and arguably the most celebrated sports brand in the world. The company's famous trademark swoosh is recognized globally. This industry giant captures about 28% of total revenue in this \$1.28 trillion market.

How is Nike able to stay on top in this highly competitive environment? Simple. Innovation, innovation, innovation. Nike is by far the most innovative company in its market providing consumers with wearable technology that range from a t-shirt that can help golfers improve their swing to wearable fitness devices that can help consumers track calories burned and steps taken throughout their day.

Nike's innovation does not end in its products; in fact, the company takes its innovation to its manufacturing process whereby it aims to reduce costs significantly and improve profitability. For instance, Nike's Flyknit shoe uses a single piece of thread, rather than layers of fabric. The company's ultimate goal is to implement a more automated manufacturing process and to make the process more efficient. As such, Nike has laid off nearly 100,000 contract

factory workers in the past year. Furthermore, the company ended contracts with 125 factories and presently works with 785, a 13% drop.

One of the company's key strategies going forward is the focus on growing its women's business. The company's men's to women's sales ratio is disproportionately skewed as it generated \$14 billion in men's sales last year compared to \$5 billion in women's. That is nearly a 3 to 1 ratio. Furthermore, Nike's women's business generated only 18% of revenue in fiscal 2014. However, revenue growth in women's sales grew by 11%, beating overall revenue growth of 9% in 2013.

Going forward, we expect Nike to benefit significantly from the rising middle class in emerging economies.

	Nike	Market
TEV/Revenue	2.3X	1.6X
TEV/EBITDA	15.3X	13.6X
P/E	26.4X	22.8X
Inventory Turnover	7.26X	3.3X
Revenue Growth (3-yr)	8.0%	5.4%
Profit Growth (3- yr)	5.0%	4.9%
EBITDA Growth (3-yr)	4.5%	2.6%

#### **Adidas**

After Germany-based Adidas' acquisition of Reebok in 2006, it is measured to be the second largest company in this industry after Nike.

Adidas and Nike have long been rivals, particularly in the apparel licensing space. However, Adidas has been seizing opportunity where Nike has been lax. For instance, Nike let its contract with Manchester United, one of the most famous soccer teams, expire this year and Adidas was more than happy to swoop in. Nike found that the contract with the soccer club was too expensive, and the German company was not shy of shelling out the cash to secure the licensing deal. Adidas was able to secure a contract with the club from 2015 to 2025. This is a big gain for the company, as soccer is the most famous sport in the world, with an estimated 3.5 billion fans according to Topendsports.

Currently, Adidas has about 5% of the footwear market in the U.S., which is said to be 40% of the global footwear market. In this regard, we observe some upside potential for Adidas, who still has room to steal more market share (by comparison, Nike has

about 50% of the U.S. footwear market).

While Adidas may not come to mind for many of us when thinking of innovation, the company does have some interesting technology. The athletic apparel company has recently developed devices that provide players with performance metrics. The devices are attached to the players' jerseys and allow coaches to determine which players on the field are performing the best, and which ones are tired. Moreover, it also provides information on each player's heart rate, speed, and acceleration.

Although Adidas may not produce numbers as strong as the rest of the players in the group, the company does have a significantly strong global brand and several upside opportunities to steal market share in the future. However, there remains some concern surrounding Adidas' "cool factor," with younger demographics when compared to its rival Nike.

A	Adidas	Market
TEV/Revenue	1.1X	1.6X
TEV/EBITDA	11.9X	13.6X
P/E	17.9X	22.8X
<b>Inventory Turnover</b>	5.5X	3.3X
Revenue Growth (3- yr)	2.85%	5.4%
Profit Growth (3-yr)	8.7%	4.9%
EBITDA Growth (3- yr)	8.2%	2.6%

#### **Patent Wars**

The flurry of innovation in the apparel industry and the sport apparel sub industry specifically has set off a wave of patent wars between brands. As competition heats up, brands latch on ever more tightly to the distinguishing features that their products bring to market.

A famous discord within this sector is the fight between Lululemon, G-III Apparel and Calvin Klein over similarities in Calvin Klein and G-III Apparel's performance pants. The lawsuit was settled and the claims remained confidential. Nike has been the most active company securing U.S. patents than its competitors. Since the beginning of 2012, it has secured about 650 patents. By comparison, Adidas has secured 30 and Under Armour (a much smaller company) has secured 24.

Number of U.S. Patents since the beginning of 2012			
Company Name No. of Patents			
Nike 650			
Adidas 30			
Under Armour 24			

### Signing Wars

Signing celebrities to endorse brands has never been quite as competitive and some would argue as essential as it is in the sportswear market. Generally, sports apparel companies go after athletes to endorse their brand, as they understand the emotional power these celebrities have with die-hard fans.

Recently, Under Armour has made a rich offer of \$265 to \$285 million over a 10-year period for the Oklahoma City Thunder star Kevin Durant who is currently signed to Nike. This deal is particularly important for Under Armour as the upcoming sportswear retailer seeks to capitalize in the basketball market. Under Armour has been lagging in this space and Kevin Durant can help the company grab market share in the sector, which is currently dominated by Nike.

Below is a list of athletes and how much they generate in endorsements compared to how much they generate on the filed.

Athlete	Off the Field	On the Field
Tiger Woods	\$65M	\$13.1M
Roger Federer	\$45M	\$7.7M
<b>LeBron James</b>	\$42M	\$17.8M
David Beckham	\$42M	\$5.2M



### **Recent Transactions**

#### **Recent Transactions**

Transaction activity in this pace has been relatively soft in the past three years. The most notable and relevant transactions in this market are listed below.

Most recently, the Vestis Retail Group acquired Sport Chalet, a big U.S. sports retailer, for about \$59 million. Sports Chalet has been performing poorly and has not turned a profit since 2007. After a public announcement of the acquisition, Sport Chalet saw its stock increase 37% to \$1.15. With the addition of Sport Chalet, the Vestis Retail Group will own more than 150 sporting good stores in the United States.

As yoga becomes a bigger trend, companies seek to capitalize by either offering yoga gear under their own brand or by acquiring an already established brand. For instance, Columbia Sportswear Company has made an effort to get into the yoga wear market through its acquisition of prAna Living for \$190 million, which is about 11.58 times revenue.

In January 2013, VF Corporation along with Altamont Partners made a joint bid on Billabong along with Paul Naude and Sycamore Partners. VF Corporation and Altamont Capital's bid was below AU\$0.50 per share, while Naude and Sycamore's bid was between AU\$0.55 and \$0.60 per share. Billabong decided to go with Naude and Sycamore's offer, however, they failed to reach an agreement and the deal fell through.

Date of Transaction	Buyer	Target	Transaction Value (\$ MM)	EV/Revenue
6/30/14	Vestis Retail Group, LLC	Sport Chalet, Inc.	58.83	0.2X
5/30/14	Columbia Sportswear Company	prAna Living, LLC	190.00	11.58X
7/23/14	Samsonite LLC	Gregory Mountain Products,Inc.	85.00	2.4X
7/7/13	Foot Locker, Inc.	Runners Point Group	97.00	0.45X
12/11/12	Iconix Brand Group	Nike's Umbro Business	225.0	2.2X

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