

Nike, inc. case study

Education



Nike Valuation At North Point Group we believe we have developed the formula for investing success. As you know better than anyone, our Large-cap fund has exceeded all possible expectations in recent years as it outperformed the S&P 500 by 30% with respect to returns in 2000 and has continued the trend into 2001; as of the end of June 2001 it has already produced returns of 6.4% while the S&P 500 has continued to struggle producing a return of -7.3%. We believe these results are made possible by our “workhorses” of the market as we like to call them.

For those of you that don't know these “workhorses” are our holdings in companies that have been there through the history of modern America. These companies are those such as 3M, General Motors, McDonalds, and ExxonMobil, which have gone through the many roller-coaster type rises and falls that defines our nation's economy and has utilized these experiences to prosper and grow step for step with our nation. We are here today to share and discuss our recent findings in our search for another candidate worthy of investment from our Large-Cap Fund.

The company originally named “Blue Ribbon Sports,” now Nike Inc. has caught our attention. Initially known for their athletic performance shoes, Nike has developed itself into a sporting good and apparel monster while maintaining their domination in the athletic shoe sector over the last fifty years. In 1997, Nike reached the top of their game in terms of revenue, when they reported \$9 billion in revenues in their annual report; however, since then their revenues have been at a virtual stand-still, hovering around \$9 billion for the past five years.

Despite their lack of improvement in the last half-decade we see progress in their near future, especially with them already well into the stage of recognizing problem issues within the company. They have realized that one of their major issues is that which made them into what they are today, their athletic shoes. They have maintained a large share of the athletic shoe market throughout their history but they have only just recently noticed that this share is slowly diminishing through time, as it has dropped six percent from 1997 to 2000.

After taking a step back and looking at the big picture they realized their error in the recent past, they have placed too much of their focus on producing high-end, high-priced athletic shoes and have forgotten about the mid-priced shoes segment which fueled their growth for decades, and yet still remained the producer of 30% of their revenues. This focus will help bring the Nike brand shoe back into the homes of any American home no matter their income level.

Along with their shoes, Nike has other plans to rejuvenate their corporate performance. The biggest of all was the acquisition of top exec, the former president and chief executive of the Polo Jeans division of rival Jones Apparel Group, Mindy Grossman. Nike sought out Ms. Grossman because of her exceptional performance in the clothing industry in hopes that she would take their apparel division to the top; a result which is not far beyond belief when considering the vast resources and influence that Nike already possesses.

The hopes within the company are that these tweaks to their corporate approach along with some minor cost cutting adjustments in the company's operations and administration will drive the company up the incline of revenue growth. With Nike reigniting their pursuit for excellence and fueling this fire by restoring their staple, mid-priced athletic shoes fit for every American, to its glory; it's easy to believe in the potential of Nike, Inc. and jump on the bandwagon. Even though we believe in the potential of Nike, further financial evaluation is necessary before a decision affecting everyone in this room can be made.

We got excited about the prospect of Nike becoming part of our fund not because of the name, and the reputation it carries with it, but because of their remarkable success through numerous decades and varying economic conditions. These factors paired with their current economic struggles and the impact those on the market price of Nike makes them a prime value investing candidate. WACC: We choose the weighted average cost of capital to use as our discount rate. We did this because we calculated future cash flows using the free cash flow to the firm method.

By using this method we are able to account for the total free cash flows available to the owners after all expenses. This means that debt is accounted for in the intrinsic value of the company. In order to compute the WACC the following inputs must be calculated; cost of equity, after tax cost of debt, weight of equity and weight of debt. In this section of the analysis we will give a step by step breakdown of how we computed those inputs. Cost of Debt: The cost of debt is rate at which a company pays on its current outstanding debt. This rate is comprised of things like loans or bonds.

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Nike conveniently has only one issue of publicly traded debt. This is a bond that pays a 6.75% coupon semi-annually. It was issued on 7/15/10 and is mature on 7/15/21. The current market price is \$95.60. To calculate the cost of debt we found the YTM of the only current outstanding bond issue. As of today we are nine days away from a coupon payment on 7/15/21. After this coupon payment there will be 40 more coupon payments. We are making the assumption that a coupon is paid on the date of maturity. As stated the price of the bond listed today is \$95.60.

If the bond were actually to be bought and sold the price would need to reflect the interest accrued since the last coupon payment. To calculate this we subtracted the number of days since the last payment, 173, from the number of days in the period, 182 = .95. We then took that number and multiplied it by the coupon payment divided by 2 in order to realize the coupon payment per period. $(6.75/2) \times .95 = 3.375 \times .95 = \3.2 . Based on these calculations we have calculated the following inputs to solve for the YTM.

Cost of Equity: The cost of equity is the return that stockholders require to invest in a company.

There are many different ways to compute this value. We will look at CAPM, DDM and the earnings capitalization ratio. CAPM: We looked at two different ways to calculate CAPM. First using the 3 month T-Bill as a risk free rate (3.59%) along with the arithmetic average of returns from 1926-1999 (7.50%) to calculate the market risk premium. We used a beta of .8 which is the average of the last 6 years. We believe this to be a good estimate because it accounts for volatility and decreased possible variance. Below is our calculation for the cost of equity.

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In the alternative CAPM model we used the 10 year Treasury bond as the risk free rate instead of the 3 month. We also used the geometric average of historical returns as the market risk premium. Below is the estimation of the alternative Cost of Equity. We believe that the second calculation of the CAPM using the 10 year bond and the geometric average is a more accurate representation of the cost of equity. The 10 year bond rate is a better indication of the real risk free rate since the fund is looking at value stocks which are generally held for longer periods of time.

The geometric mean is also a more realistic calculation of the market risk premium because it calculated real return, as opposed to the arithmetic average which is just a straight average calculation. DDM: The calculation of the dividend discount model required a dividend growth rate and the current stock price. We obtained the dividend growth rate of 5.5% from Valueline. The current share price is \$42.09. The calculation of the cost of capital using the DDM is below. The dividend discount model works best with companies that follow the constant slow growth path. This is because their dividends are generally a good reflection of earnings.

Since Nike is not a slow growing company and their dividends are not highly correlated with changes in earnings we do not recommend using the DDM to estimate the cost of equity. Earnings Capitalization Rate: The earnings cap rate is the opposite of the P/E ratio. The inputs include an implicit growth rate which we calculated by multiplying current ROE by the current retention ratio of earnings. This growth rate is used to project EPS for the next year. The inputs and calculation of the cost of equity is shown below. The earnings









capitalization ratio is not a good estimate of the cost of equity for the same reason the DDM was not a good model.

This is because the retention ratio and the dividend payout ratio are dependent on each other. Since the dividend payout ratio is not a good indication of earnings than neither is a model that uses the retention ratio.

Value of Debt: To effectively calculate the value of debt we used the market value of debt instead of the book value. This gives a better approximation of the current value of the debt. To calculate the market value we discounted the LT debt value that we obtained from the balance sheet. Below are the inputs and the present value of the LT debt.

In addition to the market value of long term debt we need to add short term debt. This includes the current LT debt payment and the notes payable as found on the 2001 balance sheet. After adding these values we obtained the total market value of debt. Value of Equity: To find the value of the equity we used the market value of the current equity instead of using the book value. The market equity is calculated by multiplying the current number of shares by the current market price. Calculation is shown below. Capital Structure: Based on the market value of the debt and equity we calculated the capital structure.

The numbers are shown below.   WACC

Calculation: To calculate the WACC we combined the weights of equity and value with the cost of each. The equation is as follows:  
   $(11,503/12,550) \times 3.42\% + (1,047/12,550)$
 $\times 2.12\% = 9.44\%$   

custom-shape} {draw: custom-shape} Discounted Cash Flow Analysis:

Revenue: To have a better estimate of Nike's current condition, we calculated its discounted cash flow in order to find its NPV and a more realistic measure of Nike's share price.

We estimate that in the next 10 years Nike will have a revenue growth ranging from 6 to 7 percent. In 2002, revenue growth is projected to be at 7 percent. From 2003 to 2005, revenue growth will be 6.5 percent. In the last 6 years of the forecast, Nike will experience a growth rate of 6 percent. The rationale behind this sales growth forecast is that Nike will be developing more midpriced shoes and increasing its apparel line. The midpriced shoes will offer consumers more affordable selection so sales are likely to increase.

Nike's plan to push its apparel line is also a good strategy to increase sales because athletic apparel is a good complementary to their shoes. Revenue growth will kick off with a good start but it's projected to fall slightly to a more sustainable growth rate. COGS, SG&A: As Nike's sales rate slowly declines in the next 10 years, their percentage of Cost of Goods Sold over Sales and Selling, General & Administrative percentage also decline. Nike plans to cut costs in the next 10 years. So as their costs decrease and sales increase, their percentage of COGS and SG&A to sales will decrease.

NWC: Next, we calculated Nike's change in net working capital. Net working capital is current assets minus current liabilities. To do this, we took the average of Nike's asset in percentage to sales and liabilities over sales for the last 4 years. (Refer to Exhibit A). We then take those numbers and multiply it by the projected revenue to get the project current assets and

current liabilities for the next 10 years. We took the difference to get the net working capital. The change in net working capital would be just the difference of one year to the next. Exhibit A. CAPEX, net Depr:

We calculated the Capital Expenditure and depreciation using a similar model. The 2001 Nike annual report gave us some guidance that CAPEX would not increase in 2002 from the previous year. Based on an increasing cost of depreciation we forecasted 2002 CAPEX net Depr. to be \$120 million. Using this projected 2002 value and the three years previous we calculated an average CAPEX net Depr. (See Exhibit B) We feel this average is the best way to estimate an unpredictable CAPEX number. We used this average in our forecasts through 2011. Exhibit B. Free Cash Flow: After we attain all the CAPEX and the change in NWC, we were able to do a cash flow by taking our net operating income after tax less CAPEX and NWC. For our terminal value, we used the Gordon growth model with a 3 percent growth rate. In our terminal value, we added back the CAPEX value because capital expenditure will eventually be zero in the future. We feel that it won't be accurate to have a negative value for CAPEX for our terminal value. After calculating the future cash flows for Nike, we were able to find the intrinsic value of the company. Using our WACC of 9.44 percent, we attained a NPV of \$15,963 million. During this time, Nike had a current debt balance of about \$1,047 million.

We subtracted the debt from the NPV to get an equity value for the company of about \$14,916 million. We took Nike's equity value and divided by their total number of shares outstanding of 273.3 for 2001 and got a price of \$54.58. Compared to the current market price of Nike's stock of only \$42.09, <https://assignbuster.com/nike-inc-case-study/>

Nike's stock is undervalued by almost 30 percent. Based on our new estimates of Nike's value, we think that these numbers reflect the company better than what the market says. We also did a sensitivity analysis of Nike's stock using various discount rates. We can see that even at a discount rate of 12 percent, Nike's stock would be \$44.7. This is still about \$2 more than what the market valued Nike. Conclusion: Knowing that our key to success has been a value investing approach to Large-Cap mutual funds, it is easy to see that we are recommending the investment in Nike, Inc. on the basis of the findings of our financial analysis, which reports the company as undervalued by over 29%. Essentially we are saying that according to our best analysis we believe that the company should be valued by the market at a price 29% higher than it currently is. In terms of stock price this is saying that although Nike is currently selling at \$42.9 we believe it should be priced at \$54.58. It is easy to figure out how this creates value for you as investors as long as Nike stays true to form and true to their word. We do not see the powers that be letting Nike die; they recommitted themselves and the company to excellence and have taken appropriate action to signify their sincerity. Their modifications to expenses in combination with their push of apparel and shoes, which despite its decline in market share is responsible for 30% of Nike's revenues, will bring Nike out of their current slump. They will ake this happen over time by slowly working down expenses, in particular cost of goods sold and selling and administration expense, while working to increase revenues. We feel very strongly on the accuracy of both our analytical and corporate analysis in part because despite increasing selling and administrative expenses and fluctuating revenues Nike has ended each fiscal year for the last few years with a positive economic value

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added result. Over the past three years Nike has ended with an average EVA of \$387 million, showing that they can go above and beyond market and investor expectations even while in a slump.