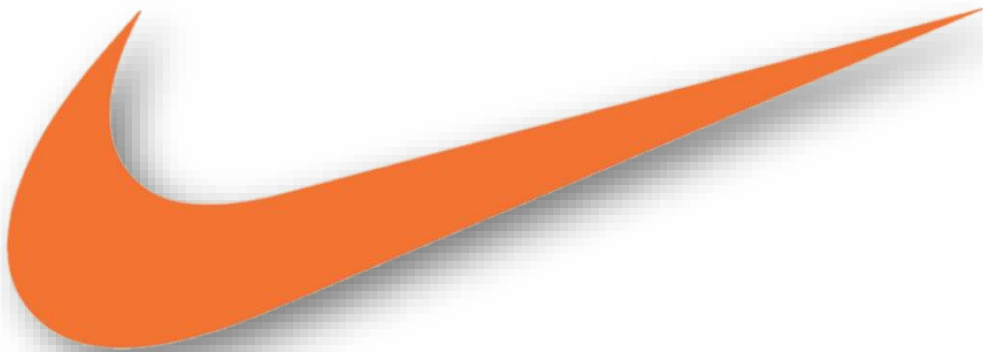


FINANCIAL MANAGEMENT

LCMB7002

ASSESMENT 1

CASE STUDY REPORT



PART 1

NIKE Inc.

**ANALYSIS OF THE FINANCIAL PERFORMANCE OF THE COMPANY AND
COMPETITION BENCHMARKING**

PART 2

EVALUATION OF INVESTMENT PROJECT

Alexander Yosifov – ID 1913375

Lecturer: Jia Miao

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PART 1

Abstract: This report aims to provide a critical review of Nike Inc.'s financial performance over the past 5 years. The trends in the company's performance will be analysed, as well as a comparison will be made with the main competitor Adidas AG. Evaluation tools such as liquidity ratios, gearing ratios, profitability ratios, asset efficiency ratios and investment efficiency ratios will be applied to critically appraise the performance of Nike Inc. for the period from 2015 to 2019 and will be compared with those of the main competitor Adidas AG for 2019. Main source of data are the annual reports and financial statements of the companies for the respective periods.

1. Introduction

Nike, Inc., formerly (1964–78) Blue Ribbon Sports, American sportswear company headquartered in Beaverton, Oregon. It was founded in 1964 as Blue Ribbon Sports by Bill Bowerman, a track-and-field coach at the University of Oregon, and his former student Phil Knight. They opened their first retail outlet in 1966 and launched the Nike brand shoe in 1972. The company was renamed Nike, Inc., in 1978 and went public two years later. By the early 21st century, Nike had retail outlets and distributors in more than 170 countries, and its logo—a curved check mark called the “swoosh”—was recognized throughout the world (Encyclopædia Britannica 2019).

Nike's core business activities are concentrated in the design, development, marketing and sales of athletic footwear, apparel and equipment, as well as accessories and services. The company is currently the largest retailer of athletic footwear and apparel in the world with market share of 27 % and revenue of \$ 39.117 bln, which is about 50% more than the closest rival Adidas. The company's products are offered in its own 1152 retail stores and through digital platforms, as well as through independent distributors, licensees and sales representatives in virtually every country in the world. Production is carried out at 446 factories of independent contractors, all of which are located outside the United States with the exception of some equipment manufacturers. The company owns three subsidiary brands, namely Jordan Brand, Converse and Hurley (Nike Inc. 2019). Main competitors include Adidas, Anta, ASICS, Li Ning, Puma, Under Armour and others. For the purposes of this report Nike will be benchmarked against Adidas for the fiscal year 2019, since Adidas is the closest rival of the company.

Over the years, Nike has been associated with various controversial practices or scandals that have more or less affected the company's image. Poor working conditions for factory staff in Asia, child labour, tax evasion. In 2017, the company was mentioned in the so-called Paradise Papers along with other global giants such as Apple, Facebook and others (Staudenmaier 2017). According to the investigation, the mentioned companies have avoided paying taxes for billions of dollars through offshore companies and thus have increased their financial results. Another factor that affected Nike's profits in 2018 was the enactment of the Tax Cuts and Jobs Act at the end of 2017. The act provides for serious changes in taxation from the beginning of 2018, especially for multinational companies, with the aim of ending tax evasion through offshore companies or other international financial transactions.

2. Ratio analysis

As stated before, a critical review of the company's financial performance will be carried out in this section. The key financial ratios will be calculated for a 5-year period to compare the performance of the company and to identify trends, as well as to make a comparison with one of its main competitors Adidas.

Financial ratios are a convenient and understandable form of synthesized presentation of various indicators from the financial statements of companies Through them we can assess the financial health of the company, as well as make a comparison between companies of different scales. Several groups of indicators

will be used to analyse Nike Inc. Several categories of ratios will be considered, namely liquidity ratios, leverage ratios, profitability ratios, efficiency ratios and return on investment ratios.

2.1. Liquidity ratios

Liquidity ratios are used to try to assess how well the business manages its working capital (McLaney 2011).

The current ratio reflects the amount of current assets per \$1 of current liabilities, or what is the balance between the two components of the working capital. It is accepted that this ratio should be above 1 in order to prevent difficulties in obtaining short term credits. In reality it varies depending on the industrial sector. In the case of Nike, the values range between 2.1 and 2.9 with an upward trend until 2018, when a downward movement begins to reach 2.1 in 2019. The values range between 2.1 and 2.9 with an upward trend until 2018, when it starts to move down to 2.1 in 2019. The reason is the sharp decline in short-term investments after 2017, from 2371 million to 197 million in 2019, as well as the increase of accrued liabilities for the period from about 3000 million to 5000 million in 2019 (Nike Inc. 2019). Generally, the figures are about the typical for the industry and much higher than those of Adidas.

Quick ratio is very similar to current ratio but less the inventory part of the assets, as the quick liquidity of this asset is questionable. This assesses the ability to repay short-term liabilities if they are demanded by the creditor immediately. This ratio is generally better to be about or above 1. Here the trend is similar to that of the current ratio, with values well above 1. Adidas has almost twice lower quick liquidity with a value of 0.78 mainly due to the higher relative value of the liabilities (Adidas 2019).

Cash ratio is the most stringent liquidity ratio, where only the cash is compared to the current liabilities. Again, trend follows same pattern and the downward decline after 2017 is primarily due to increase of the liabilities as the cash amount is relatively constant or even increasing. Adidas with much lower cash ratio compared to Nike, which is not a positive signal for the creditors.

Generally, Nike Inc has very good liquidity hence better opportunities if short term financing required, especially when compared to the competition.

Table 1 Liquidity Ratios of Nike Inc (2015-2019) and Adidas 2019

Ratio/Year	Nike					Adidas
	2015	2016	2017	2018	2019	2019
Current ratio	2.46	2.80	2.93	2.51	2.10	1.25
Quick ratio	1.78	1.90	2.01	1.64	1.39	0.78
Cash ratio	0.94	1.02	1.13	0.87	0.59	0.29

2.2. Leverage (Gearing) Ratios

Leverage ratios are the relationship between the contribution to financing the business, made by the owners of the business, and the amount contributed by others, in the form of loans (Atrill, McLaney 2016), or the extent to which the business uses borrowings. These ratios are quite important as they reflect the risk associated with a business and play significant part in the financing decision making process.

Debt to equity ratio reflects the ability of the shareholders' equity to cover all outstanding debts in the event of a business downturn.

Looking at Nike's debt to equity (Tab. 2) there is a clear trend upward through the period. It starts very low, at about 10% but it is sharply declining to reach about 39% in 2018 and keeps the level in 2019. This is due to the increase of the long-term debt about 3.5 times from 2015 to 2017. This can be explained with the company's policy of global expansion, which needs to be financed, as a steady growth in inventory and PPE is also evident for the period (Nike Inc. 2019, Nike Inc. 2016).

The above statement can also be confirmed by the debt-to-capital ratio, which will show what fraction of the firm is financed by debt. Here the pattern is exactly the same as above, sharp decline up from 2016 on, to reach 28% in 2018 and 2019 (Tab. 2). These figures however are still way below the industry's median values of about 60% and about half of those of the rival Adidas.

Table 2 Leverage Ratios of Nike Inc (2015-2019) and Adidas 2019

Ratio/Year	Nike					Adidas
	2015	2016	2017	2018	2019	2019
Debt-to-Equity, %	10	17	31	39	38	70
Debt-to-Capital, %	9	14	23	28	28	41

2.3. Profitability ratios

Businesses generally exist with the primary purpose of creating wealth for their owners (Atrill, McLaney 2016). Profitability ratios are concerned with the effectiveness of the business in generating profit. A very popular means of assessing a business is to assess the amount of wealth generated for the amount of wealth invested (McLaney 2011).

Gross profit ratio shows how much an organisation earns for one dollar of sales after making the goods available to the customer.

The gross margin of the company (Tab. 3) is within the average for the industry and is almost constant within the considered period, slightly decreasing after 2016 (most visible in 2018), but still strong. Revenues for the period with upward trend and growth of about 28%. Adidas, however scoring better here with 52% compared to 44.7% of Nike for 2019.

Operating margin shows what is left of sales revenue after all of the expenses of running the business for the period have been met (McLaney 2011). It follows the trend of the gross margin, with slight downward direction after 2016, but still above the average for the industry and showing better efficiency for Nike by one point compared to Adidas for 2019.

Net profit margin is the fraction of each dollar in revenues that is available to equity holders after the firm pays interest and taxes. A slightly different situation can be observed with this ratio. Here the trend is up first three years of the period, when a sudden drop with more than 50% compared to the previous year appears in 2018. On December 22, 2017, the U.S. enacted the Tax Cuts and Jobs Act (the "Tax Act"), which includes a number of significant changes to previous U.S. tax laws that impact the company. Implementation of the Tax Act required us to record incremental provisional tax expense in fiscal 2018, which increased our effective tax rate in fiscal 2018 (Nike Inc. 2019). In connection with the provisions of this law, the company paid nearly four times higher tax in 2018 (Nike Inc. 2019). The situation normalized in 2019, when we see a net margin corresponding to the trend before 2018 (Tab 3). When compared to Adidas in 2019, we can note a two-point difference in favour of Nike, which again shows its better efficiency.

Table 3 Profitability Ratios of Nike Inc (2015-2019) and Adidas 2019

Ratio/Year	Nike					Adidas
	2015	2016	2017	2018	2019	2019
Gross Profit Margin, %	46.0	46.2	44.6	43.8	44.7	52.0
Operating Profit Margin, %	13.6	13.9	13.8	12.2	12.2	11.3
Net Profit Margin, %	10.7	11.6	12.3	5.3	10.3	8.1

2.4. Efficiency Ratios

Efficiency ratios assess the effectiveness of a business in using its assets (McLaney 2011).

Asset turnover (Tab. 4) is used to show how effectively the assets are used to generate sales. Higher figures mean better efficiency. The figures show high efficiency, above average for industry, with upward trend, and the comparison with the competition shows a difference of about 50% better efficiency of Nike.

The fixed asset turnover gives a view of the assets efficiency that are directly involved in generating sales. Very high figures again for Nike, although the trend is to decrease, the efficiency of the fixed assets is excellent. Adidas with good ratio as well, but about 50% lower than Nike (Tab. 4).

Table 4 Asset Efficiency Ratio of Nike Inc (2015-2019) and Adidas 2019

Ratio/Year	Nike					Adidas
	2015	2016	2017	2018	2019	2019
Asset Turnover	1.42	1.51	1.48	1.62	1.65	1.1
Fixed Asset Turnover	10.2	9.2	8.6	8.2	8.2	4.5

2.5. Investment Returns

These ratios look at how the investments generate income from the perspective of shareholders or investors who are not involved in the management.

Return on equity (ROE) measures the management's ability to generate income from the equity available. The figures in the table (Tab. 5) show high returns with a strong upward trend and five percent points average increase every year for the period. One exclusion is 2018 when returns shrink from 34% previous year to 19%. This is attributed again to the new Tax Act and the related tax expense of 2.4 bn (Nike Inc. 2019). In 2019 the ROE jumps back to 44.6%, which is about one third more than the ROE of Adidas for that year and above the industry average.

Return on assets (ROA) helps investors measure how management is using its assets or resources to generate more income. Nike's return on asset ratio follows the pattern of the return on equity ratio steady increase

over the period with values above average, meaning very good utilisation of the assets to generate income. The abnormal value for 2018 is again related to the very high tax expense reducing significantly the net income. Adidas with much lower value here, but generally good ratio (Tab. 5).

Table 5 Investment Returns of Nike Inc (2015-2019) and Adidas 2019

Ratio/Year	Nike					Adidas
	2015	2016	2017	2018	2019	2019
Return on Equity (ROE), %	25.8	30.7	34.2	19.7	44.6	29.1
Return on Assets (ROA), %	15.2	17.6	18.2	8.6	17.0	9.6

In conclusion, the results can be summarized and it can be said that both companies have very good indicators. Nike shows better values in all indicators and trends to improve the ratio. A company with high liquidity and high efficiency and return on investment. Attractive for investors. It should be noted, however, that the factors forming the ratios are also influenced by the size of the companies, the tax legislation in the individual countries, the accounting policies, the difference in the dates of the end of the financial year, as well as other external factors. As recommendations, it can be noted in connection with the high liquidity that large cash availability can be used to finance the expansion of the company. An appropriate time can be used to refinance long-term loans with more favorable interest rates.

PART 2

EVALUATION OF INVESTMENT PROJECT

3. Project details

Assume that the company you chose in part a) has been researching the prospects for a range of new investment opportunities. The cash flow details of two promising projects (which are mutually exclusive) are given below:

Year Projected Cash Flows (£m)

	A	B
0	-85	-90
1	10	40
2	20	35
3	25	7
4	65	40

Assume that the company's cost of capital is currently at 10.25 per cent.

Assume that all cash flows arise at year ends and straight-line depreciation is used over the life of the project with zero scrap value. Ignore taxation and inflation.

4. Investment appraisal methods.

The essential feature of investment decisions is time. Investment involves making an outlay of something of economic value, usually cash, at one point in time, which is expected to yield economic benefits to the investor at some other point in time. Given the importance of investment decisions, it is essential that there is proper screening of investment proposals. An important part of this screening process is to ensure that the business uses appropriate methods of evaluation (Atrill, McLaney 2016). Capital investment appraisal techniques are used to aid decisions concerning the investment of a large amount of capital in a long-term project. For the purpose of the evaluation several investment appraisal methods will be used: Payback Period (PBP), Accounting Rate of Return (ARR), Internal Rate of Return (IRR) and Net Present Value (NPV).

4.1. Payback Period (PBP)

This is the length of time it takes for an initial investment to be repaid out of the net cash inflows from a project (Atrill, McLaney 2016). The project that ensures the fastest return on investment should be selected.

For the payback period calculations show as follows:

Project A: 3.5 years

Project B: 3.2 years

Project B has faster investment return, hence is the preferred project according to PBP method.

The advantage of the PBP is that it is easy to calculate and communicate to others, good for small firms or firms with cash flow issues.

Disadvantages: ignores time value of money, ignores cash flow after payback period, does not take into account all risks (inflation).

4.2. Account Rate of Return (ARR)

This method takes the average accounting operating profit that the investment will generate and expresses it as a percentage of the average investment made over the life of the project. The selection of the preferred project with this method is based on the required target value of the return rate. Whichever project with equal or greater ARR is the winner. If projects are mutually exclusive the one with higher ARR has to be chosen.

The calculation for the ARR provided following results:

Project A: ARR=20.6%

Project B: ARR=17.8%

In this case the winning project is Project A

Advantages of the method: gives result in terms of percentage, which is familiar and easy to understand, can be compared with primary accounting ratio ROCE, not as complicated as NPV and IRR, can compare mutually exclusive projects.

Disadvantages: uses accounting profit rather than cash, which gives room for errors as profit could be manipulated, profit is not directly linked to the primary objective of shareholders – maximum wealth, ignores the time factor, ignores size of the initial investment, ignores time value of money.

4.3. Net Present Value (NPV)

Net present value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows over a period of time. Selection criteria is all projects with positive NPV are acceptable. For mutually exclusive projects – the one with highest NPV is selected.

The results from calculations are as follows:

Project A: NPV=3.17

Project B: NPV=7.37

The project that has to be selected here is the one with higher NPV, or Project B.

Advantages of the method are: takes into account the time value of money, uses cash flow, not accounting profit, takes into account all relevant cash flow throughout the project life, takes account of unconventional cash flow and changes in the discount rate, gives absolute measure of project value, the only method to address the wealth of the owners – positive NPVs enhance wealth.

Disadvantages: could be difficult to find the cost of capital, it is likely the cost of capital to change over the project life rather to be constant, could be difficult to estimate project cash flows.

4.4. Internal Rate of Return (IRR)

IRR is quite closely related to the NPV method in that, like NPV, it also involves discounting future cash flows. The internal rate of return (IRR) of a particular investment is the discount rate that, when applied to its future cash flows, will produce an NPV of precisely zero. In essence, it represents the yield from an investment opportunity (Atrill, McLaney 2016).

Results of calculation:

Project A: IRR=11.56%

Project B: IRR=14.25%

In this case, similarly to NPV, the chosen project is Project B.

Some of the disadvantages of IRR compared with NPV: in projects with unconventional cash flows could be found multiple IRRs, where NPV gives the right solution; IRR ignores changes in discount rate, ignores the scale of investment.

In conclusion NPV can be considered as the Gold Standard of financial decision making as it has no major flaws. IRR could be an alternative but taking into account its limitations. ARR and PBP could be applied as initial screening methods.

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