

NIKE, INC.: COST OF CAPITAL

On July 5, 2001, Kimi Ford, a portfolio manager at NorthPoint Group, a mutual fund management firm, pored over analyst write-ups of Nike, Inc., the athletic shoe manufacturer. Nike's share price had declined significantly from the start of the year. Kimi was considering buying some shares for the fund she managed, the NorthPoint Large-Cap Fund, which invested mostly in Fortune 500 companies with an emphasis on value investing. Its top holdings included ExxonMobil, General Motors, McDonald's, 3M and other large-cap, generally old-economy stocks. While the stock market declined over the last 18 months, NorthPoint Large-Cap had performed extremely well. In 2000, the fund earned a return of 20.7 percent even as the S&P 500 fell 10.1 percent. The fund's year-to-date returns at the end of June, 2001 stood at 6.4 percent versus the S&P 500's minus 7.3 percent.

Only a week ago, on June 28, 2001, Nike held an analysts' meeting to disclose its fiscal year 2001 results¹. However, the meeting had another purpose: Nike management wanted to communicate a strategy for revitalizing the company. Since 1997, Nike's revenues had plateaued at around \$9 billion, while net income had fallen from almost \$800 million to \$580 million (see **Exhibit 1**). Nike's market share in U.S. athletic shoes had fallen from 48 percent in 1997 to 42 percent in 2000.² In addition, recent supply-chain issues and the adverse effect of a strong dollar had negatively affected revenue.

At the meeting, management revealed plans to address both top-line growth and operating performance. To boost revenue, the company would develop more athletic shoe products in the mid-priced segment³—a segment that it had overlooked in recent years. Nike also planned to push its apparel line, which, under the recent leadership of industry veteran Mindy Grossman⁴ had performed extremely well. On the cost side, Nike would exert more

¹ Nike's fiscal year ended in May.

² Robson, Douglas, "Just Do...Something: Nike's insularity and foot-dragging have it running in place", *Business Week*, July 2, 2001

³ Sneakers in this segment sold for \$70-\$90 a pair.

⁴ Mindy Grossman joined Nike in September 2000. She was the former president and chief executive of Jones Apparel Group's Polo Jeans division.

effort on expense control. Finally, company executives reiterated their long-term revenue growth targets of 8-10 percent, and earnings growth targets of above 15 percent.

Analyst reactions were mixed. Some thought the financial targets to be too aggressive; others saw significant growth opportunities in apparel and in Nike's international businesses.

Kimi Ford read all the analyst reports that she could find about the June 28 meeting, but the reports gave her no clear guidance: a Lehman Brothers report recommended a 'Strong Buy' while UBS Warburg and CSFB analysts expressed misgivings about the company and recommended a 'Hold'. Kimi decided instead to develop her own discounted-cash-flow forecast to come to a clearer conclusion.

Her forecast showed that at a discount rate of 12 percent, Nike was overvalued at its current share price of \$42.09 (see **Exhibit 2**). However, she had done a quick sensitivity analysis that revealed Nike was *undervalued* at discount rates below 11.2 percent. Since she was about to go into a meeting, she requested her new assistant, Joanna Cohen, to estimate Nike's cost of capital.

Joanna immediately gathered all the data she thought she might need (**Exhibits 1 through 4**) and set out to work on her analysis. At the end of the day, she submitted her cost of capital estimate and a memo (**Exhibit 5**) explaining her assumptions to Ms. Ford.

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Exhibit 1

NIKE, INC.: COST OF CAPITAL

Consolidated Income Statements

| Year Ended May 31 (In millions except per share data) | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|--|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Revenues | 4,760.8 | 6,470.6 | 9,186.5 | 9,553.1 | 8,776.9 | 8,995.1 | 9,488.8 |
| Cost of goods sold | 2,865.3 | 3,906.7 | 5,503.0 | 6,065.5 | 5,493.5 | 5,403.8 | 5,784.9 |
| Gross profit | 1,895.6 | 2,563.9 | 3,683.5 | 3,487.6 | 3,283.4 | 3,591.3 | 3,703.9 |
| Selling and administrative | 1,209.8 | 1,588.6 | 2,303.7 | 2,623.8 | 2,426.6 | 2,606.4 | 2,689.7 |
| Operating income | 685.8 | 975.3 | 1,379.8 | 863.8 | 856.8 | 984.9 | 1,014.2 |
| Interest expense | 24.2 | 39.5 | 52.3 | 60.0 | 44.1 | 45.0 | 58.7 |
| Other expense, net | 11.7 | 36.7 | 32.3 | 20.9 | 21.5 | 23.2 | 34.1 |
| Restructuring charge, net | - | - | - | 129.9 | 45.1 | (2.5) | - |
| Income before income taxes | 649.9 | 899.1 | 1,295.2 | 653.0 | 746.1 | 919.2 | 921.4 |
| Income taxes | 250.2 | 345.9 | 499.4 | 253.4 | 294.7 | 340.1 | 331.7 |
| Net income | 399.7 | 553.2 | 795.8 | 399.6 | 451.4 | 579.1 | 589.7 |
| Diluted earnings per common share | 1.36 | 1.88 | 2.68 | 1.35 | 1.57 | 2.07 | 2.16 |
| Average shares outstanding (diluted) | 294.0 | 293.6 | 297.0 | 296.0 | 287.5 | 279.8 | 273.3 |
| Growth (%) | | | | | | | |
| Revenue | | 35.9 | 42.0 | 4.0 | (8.1) | 2.5 | 5.5 |
| Operating income | | 42.2 | 41.5 | (37.4) | (0.8) | 15.0 | 3.0 |
| Net income | | 38.4 | 43.9 | (49.8) | 13.0 | 28.3 | 1.8 |
| Margins (%) | | | | | | | |
| Gross margin | | 39.6 | 40.1 | 36.5 | 37.4 | 39.9 | 39.0 |
| Operating margin | | 15.1 | 15.0 | 9.0 | 9.8 | 10.9 | 10.7 |
| Net margin | | 8.5 | 8.7 | 4.2 | 5.1 | 6.4 | 6.2 |
| Effective tax rate (%)* | | 38.5 | 38.6 | 38.8 | 39.5 | 37.0 | 36.0 |

*The U.S. statutory tax rate was 35%. The state tax varied yearly from 2.5% to 3.5%.

Source: Company's 10-K SEC filing, UBS Warburg

Exhibit 2

NIKE, INC.: COST OF CAPITAL

Discounted Cash Flow Analysis

| | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>2011</u> |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Assumptions: | | | | | | | | | | |
| Revenue growth (%) | 7.0 | 6.5 | 6.5 | 6.5 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 |
| COGS/Sales (%) | 60.0 | 60.0 | 59.5 | 59.5 | 59.0 | 59.0 | 58.5 | 58.5 | 58.0 | 58.0 |
| S&A/Sales (%) | 28.0 | 27.5 | 27.0 | 26.5 | 26.0 | 25.5 | 25.0 | 25.0 | 25.0 | 25.0 |
| Tax rate (%) | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 |
| Current assets/Sales (%) | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 | 38.0 |
| Current liabilities/Sales (%) | 11.5 | 11.5 | 11.5 | 11.5 | 11.5 | 11.5 | 11.5 | 11.5 | 11.5 | 11.5 |
| Yearly depreciation and capex equal each other. | | | | | | | | | | |
| Cost of capital (%) | 12.0 | | | | | | | | | |
| Terminal value growth rate (%) | 3.0 | | | | | | | | | |

| | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>2011</u> |
|-----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Discounted Cash Flow | | | | | | | | | | |
| Operating income | 1,218.4 | 1,351.6 | 1,554.6 | 1,717.0 | 1,950.0 | 2,135.9 | 2,410.2 | 2,554.8 | 2,790.1 | 2,957.5 |
| Taxes | 463.0 | 513.6 | 590.8 | 652.5 | 741.0 | 811.7 | 925.9 | 970.8 | 1,060.2 | 1,123.9 |
| NOPAT | 755.4 | 838.0 | 963.9 | 1,064.5 | 1,209.0 | 1,324.3 | 1,494.3 | 1,584.0 | 1,729.9 | 1,833.7 |
| Capex, net of depreciation | - | - | - | - | - | - | - | - | - | - |
| Change in NWC | 8.8 | (174.9) | (186.3) | (198.4) | (195.0) | (206.7) | (219.1) | (232.3) | (246.2) | (261.0) |
| Free cash flow | 764.1 | 663.1 | 777.6 | 866.2 | 1,014.0 | 1,117.6 | 1,275.2 | 1,351.7 | 1,483.7 | 1,572.7 |
| Terminal value | - | - | - | - | - | - | - | - | - | 17,998.7 |
| Total flows | 764.1 | 663.1 | 777.6 | 866.2 | 1,014.0 | 1,117.6 | 1,275.2 | 1,351.7 | 1,483.7 | 19,571.5 |
| Present value of flows | 682.3 | 528.6 | 553.5 | 550.5 | 575.4 | 566.2 | 576.8 | 545.9 | 535.0 | 6,301.5 |

| | |
|--------------------------------|-----------------|
| Enterprise value | 11,415.7 |
| Less: current outstanding debt | 1,296.6 |
| Equity value | 10,119.1 |
| Current shares outstanding | 271.5 |
| Equity value per share at 12% | \$ 37.27 |
| Current share price: | \$ 42.09 |

| Sensitivity of equity value to discount rate: | |
|--|--------------|
| Discount rate | Equity value |
| 8.00% | \$ 75.80 |
| 8.50% | 67.85 |
| 9.00% | 61.25 |
| 9.50% | 55.68 |
| 10.00% | 50.92 |
| 10.50% | 46.81 |
| 11.00% | 43.22 |
| 11.17% | 42.09 |
| 11.50% | 40.07 |
| 12.00% | 37.27 |

Note: Terminal value is estimated using the constant growth model:

$$TV = FCF_{10} * (1 + \text{Terminal value growth rate}) / (WACC - g)$$

$$TV = \$1,572.7 * (1.03) / (12\% - 3\%)$$

Exhibit 3

NIKE, INC.: COST OF CAPITAL

Consolidated Balance Sheets

| As of (In millions) | May 31, <u>2000</u> | <u>2001</u> |
|---|--------------------------|--------------------------|
| Assets | | |
| Current Assets: | | |
| Cash and equivalents | \$ 254.3 | \$ 304.0 |
| Accounts receivable | 1,569.4 | 1,621.4 |
| Inventories | 1,446.0 | 1,424.1 |
| Deferred income taxes | 111.5 | 113.3 |
| Prepaid expenses | 215.2 | 162.5 |
| Total current assets | <u>3,596.4</u> | <u>3,625.3</u> |
| Property, plant and equipment, net | 1,583.4 | 1,618.8 |
| Identifiable intangible assets and goodwill, net | 410.9 | 397.3 |
| Deferred income taxes and other assets | 266.2 | 178.2 |
| Total assets | <u>\$ 5,856.9</u> | <u>\$ 5,819.6</u> |
| Liabilities and shareholders' equity | | |
| Current Liabilities: | | |
| Current portion of long-term debt | \$ 50.1 | \$ 5.4 |
| Notes payable | 924.2 | 855.3 |
| Accounts payable | 543.8 | 432.0 |
| Accrued liabilities | 621.9 | 472.1 |
| Income taxes payable | - | 21.9 |
| Total current liabilities | <u>2,140.0</u> | <u>1,786.7</u> |
| Long-term debt | 470.3 | 435.9 |
| Deferred income taxes and other liabilities | 110.3 | 102.2 |
| Redeemable preferred stock | 0.3 | 0.3 |
| Shareholders' equity: | | |
| Common stock, par | 2.8 | 2.8 |
| Capital in excess of stated value | 369.0 | 459.4 |
| Unearned stock compensation | (11.7) | (9.9) |
| Accumulated other comprehensive income | (111.1) | (152.1) |
| Retained earnings | 2,887.0 | 3,194.3 |
| Total shareholders' equity | <u>3,136.0</u> | <u>3,494.5</u> |
| Total liabilities and shareholders' equity | <u>\$ 5,856.9</u> | <u>\$ 5,819.6</u> |

Source: Company 10-K SEC filing.

Exhibit 4

NIKE, INC.: COST OF CAPITAL

**Capital Market and Financial Information
On or Around July 5, 2001**

Current yields on U.S. Treasuries

| | |
|---------|-------|
| 3-month | 3.59% |
| 6-month | 3.59% |
| 1-year | 3.59% |
| 5-year | 4.88% |
| 10-year | 5.39% |
| 20-year | 5.74% |

Historical Equity Risk Premiums (1926-1999)

| | |
|-----------------|-------|
| Geometric mean | 5.90% |
| Arithmetic mean | 7.50% |

Current Yield on Publicly Traded Nike Debt*

| | |
|---------------|--------------------------|
| Coupon | 6.75% paid semi-annually |
| Issued | 07/15/96 |
| Maturity | 07/15/21 |
| Current Price | \$ 95.60 |

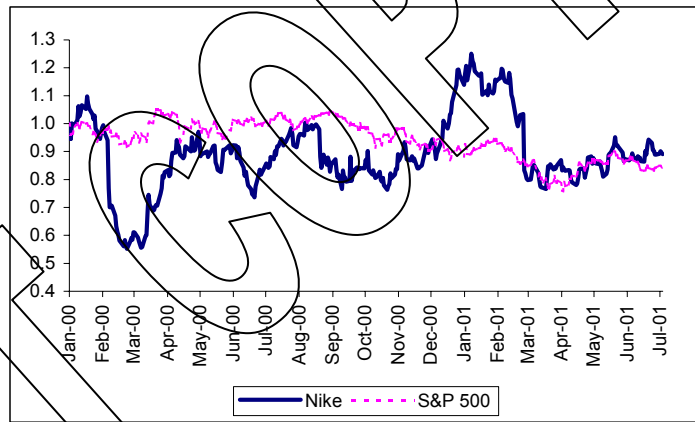
Nike Historic Betas

| | |
|--------------|------|
| 1996 | 0.98 |
| 1997 | 0.84 |
| 1998 | 0.84 |
| 1999 | 0.63 |
| 2000 | 0.83 |
| YTD 06/30/00 | 0.69 |
| Average | 0.80 |

Consensus EPS estimates:

| | |
|---------|---------|
| FY 2002 | FY 2003 |
| \$ 2.32 | \$ 2.67 |

Nike Share Price Performance Relative to S&P500:
January 2000 to July 5, 2001



Nike share price on July 5, 2001: \$ 42.09

Dividend History and Forecasts

| Paymt Dates | 31-Mar | 30-Jun | 30-Sep | 31-Dec | Total |
|-------------|--------|--------|--------|--------|-------|
| 1997 | 0.10 | 0.10 | 0.10 | 0.10 | 0.40 |
| 1998 | 0.12 | 0.12 | 0.12 | 0.12 | 0.48 |
| 1999 | 0.12 | 0.12 | 0.12 | 0.12 | 0.48 |
| 2000 | 0.12 | 0.12 | 0.12 | 0.12 | 0.48 |
| 2001 | 0.12 | 0.12 | | | |

Value Line Forecast of Dividend Growth from '98-00 to '04-'06:
5.50%

* Data have been modified for teaching purposes.

Sources of data: Bloomberg Financial Services, Ibbotson Associates Yearbook 1999, Value Line Investment Survey, IBES

Exhibit 5

NIKE, INC.: COST OF CAPITAL

Joanna's Analysis

TO: Kimi Ford
FROM: Joanna Cohen
DATE: July 6, 2001
SUBJECT: Nike's Cost of Capital

Based on the following assumptions, my estimate of Nike's cost of capital is 8.4 percent:

I. Single or Multiple Costs of Capital?

The first question I considered was whether to use single or multiple costs of capital given that Nike has multiple business segments. Aside from footwear, which makes up 62 percent of revenue, Nike also sells apparel (30 percent of revenue) that complement its footwear products. In addition, Nike sells sport balls, timepieces, eyewear, skates, bats, and other equipment designed for sports activities. Equipment products account for 3.6 percent of revenue. Finally, Nike also sells some non-Nike branded products such as Cole-Haan dress and casual footwear, and ice skates, skate blades, hockey sticks, hockey jerseys and other products under the Bauer trademark. Non-Nike brands account for 4.5 percent of revenue.

I asked myself whether Nike's business segments had different enough risks from each other to warrant different costs of capital. Were their profiles really different? I concluded that it was only the Cole-Haan line that was somewhat different; the rest were all sports-related businesses. However, since Cole-Haan makes up only a tiny fraction of revenues, I did not think it necessary to compute a separate cost of capital. As for the apparel and footwear lines, they are sold through the same marketing and distribution channels and are often marketed in "collections" of similar design. I believe they face the same risk factors, as such, I decided to compute only one cost of capital for the whole company.

Methodology for Calculating the Cost of Capital: WACC

Since Nike is funded with both debt and equity, I used the Weighted Average Cost of Capital (WACC) method. Based on the latest available balance sheet, debt as a proportion of total capital makes up 27.0 percent and equity accounts for 73.0 percent:

Exhibit 5 (continued)

| | Capital sources | Book Values | |
|--------|-----------------------------------|--------------|-------------------------------------|
| Debt | | | |
| | Current portion of long-term debt | \$ 5.4 | |
| | Notes payable | 855.3 | |
| | Long-term debt | <u>435.9</u> | |
| | | | \$ 1,296.6 → 27.0% of total capital |
| Equity | | \$3,494.5 | → 73.0% of total capital |

Cost of Debt

My estimate of Nike's cost of debt is 4.3 percent. I arrived at this estimate by taking total interest expense for the year 2001 and dividing it by the company's average debt balance.¹ The rate is lower than Treasury yields but that is because Nike raised a portion of its funding needs through Japanese yen notes, which carry rates between 2.0 percent to 4.3 percent.

After adjusting for tax, the cost of debt comes out to 2.7 percent. I used a tax rate of 38 percent, which I obtained by adding state taxes of 3 percent to the U.S. statutory tax rate. Historically, Nike's state taxes have ranged from 2.5 percent to 3.5 percent.

Cost of Equity

I estimated the cost of equity using the Capital Asset Pricing Model (CAPM). Other methods such as the Dividend Discount Model (DDM) and the Earnings Capitalization Ratio can be used to estimate the cost of equity. However, in my opinion, CAPM is the superior method.

My estimate of Nike's cost of equity is 10.5 percent. I used the current yield on 20-year Treasury bonds as my risk-free rate, and the compound average premium of the market over Treasury bonds (5.9 percent) as my risk premium. For beta I took the average of Nike's beta from 1996 to the present.

Putting it All Together

Inputting all my assumptions into the WACC formula, my estimate of Nike's cost of capital is 8.4 percent.

$$\begin{aligned}
 \text{WACC} &= K_d (1-t) * D/(D+E) + K_e * E/(D+E) \\
 &= 2.7\% * 27.0\% + 10.5\% * 73.0\% \\
 &= 8.4\%
 \end{aligned}$$

¹ Debt balances as of May 31, 2000 and 2001 were \$1,444.6 and \$1,296.6 respectively.