On November 12th, the Growth Fund, one of the four sub-funds of the Michael Price Student Investment Fund (MPSIF), purchased 450 shares of Nike Inc. at $44.67 per share. This edition features the research and analysis that led to the investment decision.

With increasingly volatile market conditions, Nike remains one of the few relatively defensive consumer discretionary stocks. Given its steady earnings and global exposure (approximately 2/3 international revenues in 2008), Nike offers a decent hedge against a prolonged U.S. recession. Nike’s solid free cash flow generation and share repurchase program should serve as a floor for the share price in the near term.

Nike continues to shift its focus from the soft U.S. market, and is investing heavily in emerging markets such as China, Brazil and Russia. The company looks to capitalize on its tremendous exposure at the Beijing Olympics to remain relevant to its global customer base in an increasingly sports-oriented marketplace.

Management also has several margin levers that it should be able to pull in the event that consumer weakness spills heavily into the athletic footwear and apparel market. The majority of its apparel and footwear is manufactured overseas, yet Nike has been able to effectively manage a lean manufacturing process which has steadily improved the expense side of gross margins for the past few years. Even in a difficult consumer environment, Nike has also been able to improve its pricing power by leveraging expertise in performance technology design and effectively marketing it to the consumer. Not only has improved product design allowed Nike to increase average selling prices (particularly in footwear), but it has also driven a mix shift toward higher margin performance apparel products. Such is the case both at its own retail stores as well as through independent retail channels.

With materials accounting for nearly a third of Nike’s production costs, the decline in oil and commodity prices should also have a positive effect on margins in the near term. Generally lower materials and input costs have a lagging effect on the bottom line as management re-negotiates contracts with suppliers; as such, gross margin improvement over the next few quarters should help offset any consumer weakness in a difficult environment.
Although the Nike brand clearly defines the company, the entire portfolio of brands should allow it to continue to take share in athletics while diversifying its customer base. Some of its other popular brands include: Converse, Umbro, Cole Haan, Hurley and Nike Golf. By diversifying into soccer, running and action sports, Nike is consistently targeting new growing segments of the market.

One example of how it leverages its position across the entire value chain is the recent launch of its Flywire running technology. Nike’s design team developed a shoe based on suspension bridge technology where strong threading across the body of the shoe supports the thin sole without adding significant weight. Weighing in at approximately 0.2 lbs per pair, Flywire shoes, such as the Nike Zoom Victory, were first adopted by the U.S. Olympic track team in Beijing and have since become popular with runners around the world. In addition to their light weight, the shoes are relatively inexpensive to produce as compared to other models. This is just a single example of Nike taking advantage of its core competencies in design, production and marketing to penetrate and capture share in a growing market (running shoes and equipment).

Nike's management team is one of the best in the industry, which is evident by the financial results over the past 2 decades. The company has systematically continued to grow earnings, maintain strong margins and generate significantly more free cash than its peers, which it is returning to shareholders. In addition to a dividend yield of more than 2% in FY 2008 which I expect could increase significantly in the coming years based on historical trends, Nike has already completed $2.5B of its $3.0B repurchase agreement from 2006. Management has said that it expects to complete the buyback this year, nearly 18 months ahead of schedule. The board also approved another $5B share repurchase agreement over the next four years, which indicates management is confident it will continue to generate significant free cash flow, beyond what is necessary for growth investments.

According to estimates, Nike has traded at an average forward P/E of approximately 18 over the last 5 years and is trading well below its 5-year trailing-twelve month P/E range. Based on my conservative estimate of $3.90 in earnings in 2009, well below consensus estimates of $4.00 per share, Nike was trading at only 11.7x forward. It would require forward P/E multiple contraction into the single digits and a significant full-year 2009 earnings miss for Nike to lose 15% of its market value, which I find unlikely. The limited downside risk and significant upside provide an outstanding investment opportunity.