Reebok International: Strategic Asset Allocation

The Situation

In early January of 1996, Reebok Division’s Chief Executive Officer, Robert Meers, sat in his office in Stoughton, Massachusetts pondering an important decision. Meers had to decide whether or not to support the launch of a new Reebok basketball shoe. A single new product decision would not normally take up the time of the CEO, but in this case, it had strategic implications. The shoe, aptly named “The Question”, was to be endorsed by the 76er’s point guard Allen Iverson. However, Meers had begun to doubt the potential success of the project. In the past six years, Reebok, once the largest manufacturer of athletic shoes in the world, had fallen further behind Nike, the company with the current number one position. Meers wondered how he could compete against this giant in the basketball arena. After all, a total of two hundred sixty-four NBA players endorsed Nike basketball sneakers, as compared with only one hundred thirty-five players for all other shoe companies combined, including Reebok.\(^1\) Also, the past year saw decreased earnings, a decline in stock price and a loss of U.S. market share. In 1994, Reebok’s market share had been 21.6%, but early estimates for 1996 indicated a share of around 16% of the $18 billion dollar athletic shoe and apparel industry.\(^2\) The company had promised its stockholders it would regain its competitive position with more innovative products such as the “The Question”. However, Meers knew the company had done a poor job of anticipating consumer preferences in recent years. He questioned if this project would be any different. Furthermore, the industry trend was towards hiking and walking sneakers. In fact, industry sales for basketball shoes had consistently declined overall. The decision to abandon or launch “The Question” was one that could have a major effect on the overall standing of the company. Meers did not have much time to decide as “The Question” was currently slated for a December 1996 introduction.

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\(^1\) Sports Illustrated, December 22, 1997, p.22.
“The Question”

Reebok would choose Allen Iverson, the 6-foot 165 pound Philadelphia 76ers point guard and number one draft pick for 1996, over other rising athletes, on the basis of his positive perceptions in focus groups and his high scores in name-recognition surveys. Iverson’s endorsement would hopefully improve Reebok’s position in the 12 to 18 year old male segment. This is the group willing to pay the $100 retail price of the shoe. The shoe would be named “The Question” in reference to Iverson’s nickname and tattoo, “The Answer”.

Although Iverson's endorsement of "The Question" is felt to be vital to the shoe’s success, the endorsement would not be cheap. For example, Reebok agreed to pay Iverson $50 million over 5 years. In addition, Reebok would have to invest in a new advertising and promotion campaign, a new factory and equipment to produce the shoe, inventory, and additional selling and administrative expenses. Furthermore, "The Question" is expected to reduce sales of other Reebok shoes, and the life of the shoe is expected to be only 6 years.

Reebok's CFO, Kenneth Watchmaker, had compiled the following information surrounding "The Question" project:
1. The life of the project is 6 years.
2. The retail price of the shoe is estimated to be in the $130-$150 range; Reebok’s wholesale selling price will be $100.00
3. The athletic shoe market is projected to reach $18 billion during Year 1 and is growing at a rate of 3% per year. The market share projections for Reebok’s “The Question” are: Year 1, 1.70%; Year 2, 1.75%; Year 3, 1.60%; Year 4, 1.45%; Year 5, 1.35%; and Year 6, 1.25%.
4. In order to produce the shoe, Reebok will need to build a factory in New Delhi, India. This will require an immediate outlay of $150 million, which will be depreciated on a 39 year MACRS basis. The depreciation percentages for the first six years, respectively, are: 2.6%, 5%, 4.7%, 4.5%, 4.3%, and 4.0%. Reebok analysts estimate that the building will be sold for $102.35 million at the project's termination. Note that this “salvage value” is not taken into consideration when computing the annual depreciation charges here3.
5. Reebok must also immediately purchase equipment costing $15 million. Freight and installation of the equipment will cost $5 million. The equipment and freight/installation costs will be depreciated on a 5-year MACRS basis. The depreciation percentages for the six years, respectively, are: 20%, 32%, 19%, 12%, 11%, and 6%. It is believed that the equipment can be sold for $3 million at the project's termination.
6. In order to manufacture "The Question,” two of Reebok's working capital accounts are expected to increase immediately. The inventory balance is expected to increase by $60 million and the accounts payable account is expected to increase by $15 million. These balances will be maintained until the final year of the project, at which time they will be recovered.

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3 Including salvage value in depreciation computations is done for financial reporting purposes. Here, we are concerned with the cash flow impacts of taxes; for tax purposes, it is not necessary for firms to incorporate salvage value.
7. Sales of "The Question" are expected to reduce sales of other Reebok basketball sneakers. Specifically, Reebok’s other sneaker sales are expected to decrease by $170 million during each year of the project. Assume these lost sales have the same margins as The Question.

8. Variable costs of producing the shoe are expected to be 31% of the shoe’s sales.

9. Selling, General and Administrative Expenses are expected to be $7 million per year for the project.

10. Reebok would agree to pay Iverson $10 million dollars annually for five years.

11. Other advertising and promotion costs are expected to be $20 million per year.

12. Reebok has already spent $2 million in Research & Development on "The Question".

13. Reebok will finance the project using a combination of equity and debt. The interest costs on the debt are expected to be approximately $1.2 million per year.

14. The company's federal plus state marginal tax rate is 40%.

Meers was also worried about the marketing approach (i.e., going after 12 to 18 year old males) for “The Question” for several reasons. Firstly, women’s sports were on the rise and doing well, especially with the recent introduction and promotion of the WNBA. Secondly, demographic studies show the average age of athletic footwear purchasers to be 26.7, up from 24.6 three years ago. This trend is expected to continue as the US population becomes older. Lastly, Meers was concerned about selling $100 sneakers to inner-city youths and the public relations impression that this may make, especially in the wake of the previous year’s uproar over the use of child labor in Reebok’s overseas facilities.

"Persistence"

Robert Meers was still contemplating "The Question" project when Janet McCutchins, the Vice President of New Products Development, came into Meers' office anxious to meet with him. McCutchins was excited about a proposal she had developed for a new Reebok hiking shoe. The hiking shoe would be named "Persistence". The hiking sector is one of the fastest growing areas of the footwear industry -- and one that Reebok had not yet entered. Furthermore, Reebok's strategic plans were to enter into new areas of the athletic shoe industry with high anticipated growth, such as hiking and walking shoes. McCutchins was confident that hiking shoes would be the largest footwear trend in the next decade and suggested that, at the project’s end, Reebok follow-up with another hiking shoe. In fact, she urged Reebok to investigate introducing an entire hiking shoe product line in the future. The target market for this shoe would be men and women in the 25 to 40 year old age category.

McCutchins needs to produce a projected capital budgeting cash flow statement for "Persistence," and after some preliminary analysis, decides on the following:

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4 Research Alert, 9/6/96, v.14, n.17, p.5
5 www.reebok.com/company/student.html.
6 The “hiking and walking” category was the third largest in the athletic footwear industry (9%), as well as the fastest growing category. Source: Research Alert, 9/6/96, v.14, n.17, p.5.
1. The life of the project would be only 3 years, given the steep technological learning curve for this new product line.

2. The manufacturer's selling price of the shoe will be $90.00

3. This segment of the athletic shoe market is projected to reach $350 million during Year 1 and is growing at a rate of 15% per year. The segment market share projections for "Persistence" are: Year 1, 10%; Year 2, 16%; and Year 3, 19%.

4. Reebok will be able to use an idle section of one of its factories to produce the hiking shoe. A cost accountant has estimated that, according to the square footage in the factory, this section’s overhead allocation would amount to $1.8 million per year. Note that Reebok would still incur these costs if the product is not undertaken. In addition, this section would remain idle for the life of the project if the “Persistence” project is not undertaken.

5. Reebok must purchase manufacturing equipment costing $10 million. The equipment falls into the five year MACRS depreciation category. As such, the depreciation percentages for the first three years, respectively, are: 20%, 32%, and 19%. The cash outlay will be today, at year 0, and depreciation will start in year 1. Reebok analysts estimate that the equipment can be sold for book value at the end of the project’s life.

6. Inventory and accounts receivable accounts will increase by $25 million at year 0 and will be recovered at the end of the project (year 3). The firm’s accounts payable balance is projected to increase by $10 million at year 0 and will also be recovered at the end of the project.

7. Because Reebok has not yet entered the hiking shoe market, the introduction of this product is not expected to have an impact on sales of Reebok’s other shoe lines.

8. Variable costs of producing the shoe are expected to be 17% of the shoe's sales.

9. General and Administrative Expenses for “Persistence” will be 20% of revenues per year.

10. The product will not have a celebrity endorser, but advertising and promotion costs are expected to be $3 million per year, beginning in year 1.

11. The company's federal plus state marginal tax rate is 40%.

12. In order to begin immediate production of “Persistence”, the design technology and manufacturing specifications for a simple hiking shoe will be purchased from an outside source for $50 million before taxes. It is assumed this outlay takes place immediately and will be expensed immediately for tax purposes.

13. Annual interest costs on the debt for this project will be $600,000.

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**The Decision**

Meers has asked for your assistance with his decision. Reebok only has the resources to undertake *either* “The Question” or “Persistence,” but not both.

Two main factors were guiding Meers' decision-making process: the profitability of the project and its alignment to the company’s strategy. Should Meers authorize the launch of “The Question” or “Persistence?” Use the following questions to assist you in your recommendation. Assume that Reebok’s cost of capital (discount rate) is 11% for “The Question” and 14% for “Persistence”.


Study Questions

1. Should the following be included in “The Question” project’s capital budgeting cash flow statement? Why or why not?
   - Building a factory and purchase/installation of the equipment.
   - Research and development costs.
   - Cannibalization of the other Reebok sneaker sales.
   - Interest costs.
   - Changes in current asset/current liabilities accounts.
   - Taxes
   - Variable costs
   - Advertising and promotion expenses
   - Depreciation charges

2. Produce projected capital budgeting cash flow statements for “The Question” and "Persistence" projects, by answering the following:
   - What is the project’s initial (year 0) investment outlay?
   - What are the project’s annual (years 1 through 6) net operating cash flows?
   - What is the project’s terminal (year 6) non-operating net cash flow?
   - How does this statement differ from the company’s published annual financial statements?

3. Is the cost of the idle portion of the factory where "Persistence" would be manufactured captured on the cash flow statement? Why or why not?

4. Calculate and interpret the payback period, Net Present Value (NPV), and Internal Rate of Return (IRR) for each of the projects.

5. Based on your results in 4), which project do you feel is better for Reebok’s shareholders? Why?

6. Should Meers be more or less critical of the cash flow forecasts for “Persistence” than the cash flow forecasts for "The Question?", and why?

7. What are the qualitative advantages and disadvantages of each project?

8. Which project do you think is more risky? How do you think you should incorporate differences in risk into your analysis?

9. What is your recommendation to Meers?