Foot Locker (FL)

Updated August 26th, 2018 by Josh Arnold

Key Metrics

Current Price:	$48	**5 Year CAGR Estimate:**	15.8%	**Volatility Percentile:**	95.4%
Fair Value Price:	$66	**5 Year Growth Estimate:**	6.5%	**Momentum Percentile:**	85.6%
% Fair Value:	74%	**5 Year Valuation Multiple Estimate:**	6.4%	**Valuation Percentile:**	94.9%
Dividend Yield:	2.9%	**5 Year Price Target**	$90	**Total Return Percentile:**	93.8%

Overview & Current Events

Foot Locker was founded in 1974 as part of the FW Woolworth Company, and became independent in 1988. The company has outlived its former parent. This athletic apparel retailer now has $7.8 billion in annual sales and a $5.7 billion market capitalization. Foot Locker has almost 3,300 stores in 24 countries under various brand names.

Foot Locker reported Q2 earnings on 8/24/18 and results sent shares lower by 9%. Total sales were up 4.8% as foreign exchange translation helped, while comparable sales rose 0.5%. Gross margins also rose slightly from 29.6% to 30.2%, but that was more than offset by higher SG&A costs, which rose from 19.9% to 21.3%. The company's focus on inventory management is working in terms of boosting gross margins, but additional labor costs are increasing SG&A expenses, so operating margins are suffering. Indeed, inventory was down nearly 3% year-over-year despite sales increasing 5%, which is a terrific result. We have maintained our estimate of $4.50 in earnings-per-share for this year as Foot Locker's Q2 report was largely in line with our expectations.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$0.67	$0.54	$1.10	$1.80	$2.58	$2.89	$3.61	$3.84	$4.82	$3.99	***$4.50***	***$6.15***
DPS	$0.60	$0.60	$0.60	$0.66	$0.71	$0.78	$0.88	$1.00	$1.10	$1.24	***$1.38***	***$2.00***
Shares	155	157	155	152	150	146	140	137	132	120	***115***	***108***

Earnings-per-share has grown quite steadily in the past decade as the company has managed to grow its store count as well as its direct-to-consumer business. Damage done during the Great Recession was actually quite light and Foot Locker basically picked up where it left off in terms of earnings growth. It has since seen its earnings-per-share quadruple from 2010 levels, representing extraordinary growth for what is a very mature business.

We see earnings growth continuing at a mid-single digit rate going forward, adding 6.5% annually over the next five years. Management guided for flat to low single digit comparable sales for this year as well as a gradual recovery in gross margins, both of which should lead to upside for operating margins. The weak dollar should help as well as it is a truly global business and until the dollar enters another long-term rally, Foot Locker will benefit in the low single digit range annually, as we saw again in Q2. In addition, it buys back a small amount of stock but improving prospects for earnings should afford it more purchasing power, should it choose to do so. Overall, the growth outlook for Foot Locker is fairly robust as management is confident it is past the recent issues with sales and in particular, margins. Higher comparable sales and revenue should help leverage operating costs down, and mid-single digit earnings growth should be achievable, with the only caveat being that investors pay close attention to SG&A costs, as they rose sharply in Q2.

We see the dividend growing at about the same rate as earnings and in five years, we have the payout reaching $2 per share. Foot Locker has always made the dividend a priority and we do not see that changing moving forward.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	18.4	19.6	13.7	12.1	12.6	12.3	14.0	16.9	13.4	13.0	***10.7***	***14.6***
Avg. Yld.	4.9%	5.7%	4.0%	3.0%	2.2%	2.2%	1.7%	1.5%	1.7%	2.4%	***2.9%***	***2.2%***

Foot Locker's price-to-earnings multiple has suffered greatly in the recent past as it is still near a historically low level. The current multiple of 10.7 is much lower than its historical average in the mid-teens, and as a result, we see a significant 6.4% tailwind to total returns going forward from the higher multiple. This will lead to a lower yield over time, but its total return prospects are bolstered meaningfully by its very low valuation, which has inflated the yield.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	27.1%	30.1%	26.4%	27.0%	29.1%	31.3%	29.8%	32.0%	32.3%	33.9%	***34.0%***	***34.5%***
Debt/A	30%	33%	31%	30%	31%	29%	28%	30%	32%	29%	***29%***	***30%***
Int. Cov.	57	23	9	30	75	124	135	164	212	508	***550***	***600***
Payout	89%	111%	54%	36%	27%	28%	24%	26%	23%	31%	***31%***	***33%***
Std. Dev.	64.7%	41.3%	36.3%	31.5%	21.9%	20.2%	23.8%	21.5%	23.1%	59.6%	***30.0%***	***34.0%***

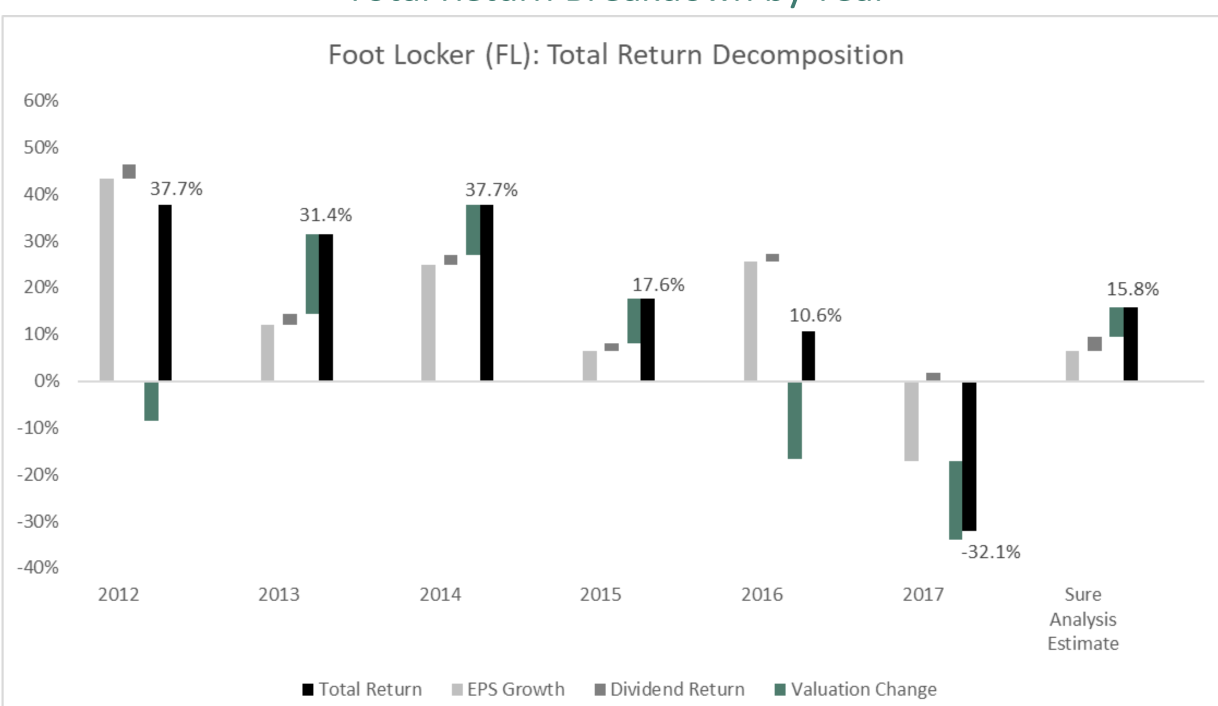
Foot Locker's quality metrics have not moved much in the past decade with the exception of gross margins, and it has been for the better. Q2 results showed strong gross margin expansion, something we think will continue. We therefore see a gradual improvement in gross margins going forward, contributing to earnings growth. Foot Locker is extremely conservatively financed at less than one-third of its assets encumbered by liabilities and as a result, its diminutive interest expense is covered hundreds of times over by its earnings power. The dividend is around one-third of earnings and we see that remaining as such going forward barring a strategic shift.

Foot Locker's competitive advantage is in its valuable brand names, its decades of experience in athletic apparel retailing and its enormous scale. This affords Foot Locker the financial stability others crave during a recession but that does not make it immune to such an event, and earnings will likely suffer materially during the next downturn.

Final Thoughts & Recommendation

Overall, we see Foot Locker as a stock with a nice current yield, moderate growth prospects and a very cheap valuation, creating an attractive stock. We forecast total annual returns of 15.8%, consisting of the current 2.9% yield, 6.5% earnings growth and a 6.4% tailwind from a rising valuation. Investors have punished Foot Locker for what appear to be temporary issues and as a result, it looks favorable for growth, value and income investors alike. It isn't without its risks, but the stock appears to be pricing in those risks and then some, and we therefore rate Foot Locker as a buy.

Total Return Breakdown by Year



Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.