



# Foot Locker Inc. (FL)

Updated September 2<sup>nd</sup>, 2019 by Josh Arnold

## Key Metrics

<b>Current Price:</b>	\$36	<b>5 Year CAGR Estimate:</b>	11.5%	<b>Volatility Percentile:</b>	97.3%
<b>Fair Value Price:</b>	\$44	<b>5 Year Growth Estimate:</b>	4.0%	<b>Momentum Percentile:</b>	21.4%
<b>% Fair Value:</b>	83%	<b>5 Year Valuation Multiple Estimate:</b>	3.8%	<b>Growth Percentile:</b>	27.1%
<b>Dividend Yield:</b>	4.2%	<b>5 Year Price Target</b>	\$53	<b>Valuation Percentile:</b>	70.3%
<b>Dividend Risk Score:</b>	B	<b>Retirement Suitability Score:</b>	A	<b>Total Return Percentile:</b>	57.7%

## Overview & Current Events

Foot Locker was established in 1974 as part of the FW Woolworth Company, and became independent in 1988. The company has outlived its former parent, which closed in 1997. The athletic apparel retailer, known for its namesake Foot Locker brand, operates more than 3,200 stores in 27 countries. Foot Locker is a \$4 billion market capitalization company that should generate more than \$8 billion in revenue this year.

Foot Locker reported Q2 earnings on 8/23/19 and results were weak, missing expectations and sending the stock down double digits. Comparable sales came to +0.8% in Q2, but that was well short of estimates for more than 3%. Total sales were down 0.4% during the quarter to \$1.77 billion. Excluding currency exchange rate fluctuations, total sales would have risen 0.8%. Foot Locker continues to struggle to build upon the years of growth it has seen in the top line, and investors are clearly worried about its future growth. We are as well, having reduced our growth estimate after Q2.

Gross margins declined fractionally to 30.1%, while SG&A costs rose 90bps to 22.2%, causing operating margins to deteriorate. The company continues to make heavy investments in its digital capabilities and technology infrastructure to build for the future, but those investments are coming at a time when gross margins are under pressure from the tariffs that are resulting from the trade war with China.

Adjusted earnings-per-share came to \$0.66 in Q2, down from \$0.75 in the year-ago period. We've reduced our estimate of earnings-per-share to \$4.85 for this year from \$5.10 prior following the Q2 report.

## Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
<b>EPS</b>	\$0.54	\$1.10	\$1.80	\$2.58	\$2.89	\$3.61	\$3.84	\$4.82	\$3.99	\$4.71	<b>\$4.85</b>	<b>\$5.90</b>
<b>DPS</b>	\$0.60	\$0.60	\$0.66	\$0.71	\$0.78	\$0.88	\$1.00	\$1.10	\$1.24	\$1.38	<b>\$1.52</b>	<b>\$2.08</b>
<b>Shares<sup>1</sup></b>	157	155	152	150	146	140	137	132	120	113	<b>113</b>	<b>95</b>

During the last recession, Foot Locker's earnings dipped ~20%, but since then they have sharply rebounded. Indeed, from 2008 through 2018 the company was able to increase earnings-per-share by over 20% annually. However, this was during a time when Foot Locker's net profit margin improved from ~2% to ~7% and the share count was reduced by 25%. Moving forward we are more cautious, albeit still optimistic, on the firm's growth prospects.

Share repurchases ought to continue to aid in bottom line growth, but we do not believe margins will expand at a rate anywhere near what was accomplished in the last decade. This was supported again by Q2 results and indeed, 2019 guidance, as management believes a lower share count will be responsible for the majority (or all) of projected earnings-per-share growth this year.

We've reduced our growth estimate once more to 4% annually from 6% as tariffs continue to weigh on shoe and apparel retailers. Foot Locker, buying the vast majority of its inventory from China, is quite exposed to these tariffs. Until the trade war with China is resolved, we think Foot Locker's margins may suffer.

The current yield is outstanding at 4.2% following protracted weakness in the stock.

<sup>1</sup> Share count in millions

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## Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
<b>Avg. P/E</b>	19.6	13.7	12.1	12.6	12.3	14.0	16.9	13.4	13.0	11.3	<b>7.5</b>	<b>9.0</b>
<b>Avg. Yld.</b>	5.7%	4.0%	3.0%	2.2%	2.2%	1.7%	1.5%	1.7%	2.4%	2.6%	<b>4.2%</b>	<b>3.9%</b>

Over the past decade, shares of Foot Locker have traded hands with an average P/E ratio of about 14 times earnings. Given the reaction of investors to the Q2 report, we've lowered our fair value estimate from 13 times earnings to 9 but that still represents sizable upside to the current trough valuation of just 7.5 times this year's earnings. As such, we see a solid ~4% tailwind to total returns from a higher valuation in the coming years. Retailers in general are seeing lower valuations, and given the trade war, we think investors will be reticent to pay more than 9 times earnings for Foot Locker for the near-term. Foot Locker is exceptionally exposed to the trade war and its resulting tariffs, and the stock is reflecting this concern. We don't see this as easily resolved or as a transitory headwind at this point.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
<b>Payout</b>	111%	54%	36%	27%	28%	24%	26%	23%	31%	29%	<b>31%</b>	<b>35%</b>

Foot Locker's competitive advantage is in its valuable brand names, its decades of experience in athletic apparel retailing and its enormous scale. Moreover, Foot Locker's balance sheet affords the company financial stability that others crave during a recession.

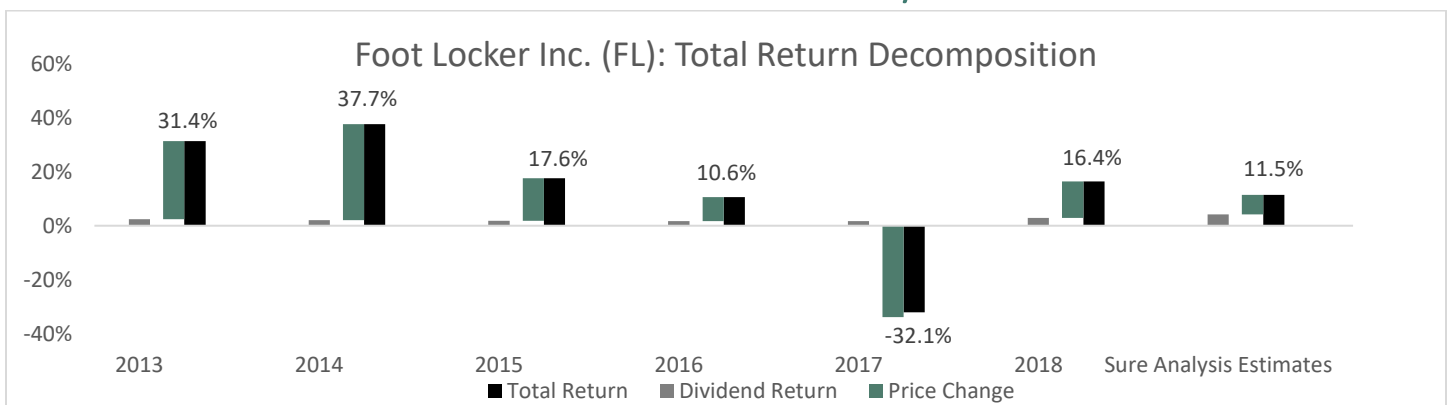
This does not mean that earnings power will not deteriorate in tougher times. During the last recession, Foot Locker posted earnings-per-share of \$0.67, \$0.54 and \$1.10 through the 2008 to 2010 stretch, while the dividend was held steady. However, it does give a fair indication of the company's ability to withstand tougher times and bounce back.

The company's payout ratio has been reduced significantly since the last recession and stands at less than a third of earnings. This sets up well for faster dividend growth, a robust share repurchase program, or both in the years to come.

## Final Thoughts & Recommendation

After a declining share price since our last update, and despite meaningfully reduced valuation and growth estimates, Foot Locker continues to offer very high projected returns. We are forecasting 11.5% annual returns as the high yield, moderate growth, and very low valuation make Foot Locker attractive. As such, we see the security as suitable for value investors, those seeking a safe yield for income, and those looking for moderate rates of growth. We think Foot Locker has issues to work through after Q2, but still find the stock to be worthy of a buy rating at present.

## Total Return Breakdown by Year



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## Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	5237	4854	5049	5623	6182	6505	7151	7412	7766	7782
Gross Profit	1460	1332	1516	1796	2034	2133	2374	2505	2636	2456
Gross Margin	27.9%	27.4%	30.0%	31.9%	32.9%	32.8%	33.2%	33.8%	33.9%	31.6%
SG&A Exp.	1174	1099	1138	1244	1294	1334	1426	1415	1472	1501
D&A Exp.	130	112	106	110	118	133	139	148	158	173
Operating Profit	156	121	272	442	622	666	809	942	1006	782
Operating Margin	3.0%	2.5%	5.4%	7.9%	10.1%	10.2%	11.3%	12.7%	13.0%	10.0%
Net Profit	-80	48	169	278	397	429	520	541	664	284
Net Margin	-1.5%	1.0%	3.3%	4.9%	6.4%	6.6%	7.3%	7.3%	8.6%	3.6%
Free Cash Flow	237	257	229	345	253	324	522	563	578	539
Income Tax	-21	26	88	157	210	234	289	296	340	294

## Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	2877	2816	2896	3050	3367	3487	3577	3775	3840	3961
Cash & Equivalents	385	582	696	851	880	858	967	1021	1046	849
Accounts Receivable	53	N/A	41	49	68	99	78	94	101	106
Inventories	1120	1037	1059	1069	1167	1220	1250	1285	1307	1278
Goodwill & Int. Ass.	257	244	217	198	185	230	206	201	197	206
Total Liabilities	953	868	871	940	990	991	1081	1222	1130	1442
Accounts Payable	187	215	223	240	298	263	301	279	249	258
Long-Term Debt	142	138	137	135	133	136	132	129	127	125
Shareholder's Equity	1924	1948	2025	2110	2377	2496	2496	2553	2710	2519
D/E Ratio	0.07	0.07	0.07	0.06	0.06	0.05	0.05	0.05	0.05	0.05

## Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	-2.6%	1.7%	5.9%	9.4%	12.4%	12.5%	14.7%	14.7%	17.4%	7.3%
Return on Equity	-3.8%	2.5%	8.5%	13.4%	17.7%	17.6%	20.8%	21.4%	25.2%	10.9%
ROIC	-3.5%	2.3%	8.0%	12.6%	16.7%	16.7%	19.8%	20.4%	24.1%	10.4%
Shares Out.	157	155	152	150	146	140	137	132	120	116
Revenue/Share	34.01	31.06	32.22	36.42	40.14	43.22	48.98	52.64	57.48	60.84
FCF/Share	1.54	1.64	1.46	2.23	1.64	2.15	3.58	4.00	4.28	4.21

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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