# FLASH NOTE – FOOT LOCKER

JUNE 27TH, 2019

| Foot Locker Inc. | |
|---|---|
| Ticker Site BiG | FL |
| Ticker BiGlobal Trade | FL |
| Ticker BT24 | FL |
| Ticker BiG Power Trade | FL |
| P/E Ratio 2019E | 8,43 |
| P/BV Ratio | 1,84 |
| EV/EBITDA | 5,51 |

Source: Company´s data;

| Price and Performance (Values in USD) | |
|---|---|
| Price | 42,51 |
| 52 week high | 68,00 |
| 52 week low | 39,06 |
| YTD | -20,1% |
| Average daily volume (un) | 3.171.510 |
| Market Capitalization (mn) | 4.663 |
| Beta | 1,02 |
| Dividend | 1,38 |
| EPS | 4,68 |

Source: Company´s data;

| Analysts Consensus (last 3 months) | |
|---|---|
| Buy | 12 |
| Hold | 7 |
| Sell | 2 |

Source: Company´s data;

| Financial Data | |
|---|---|
| Sales (USD mn) | 7.939 |
| EBITDA (USD mn) | 877 |
| Number of Employees | 15.470 |
| ROA | 10,1% |
| ROE | 21,3% |
| D/E | 0,05 |
| Dividend Yield | 3,58% |

Source: Company´s data;

**Notes:**

All quotes were updated in Bloomberg at 15h12 of June 24th, 2019.

**Relevant Information:**

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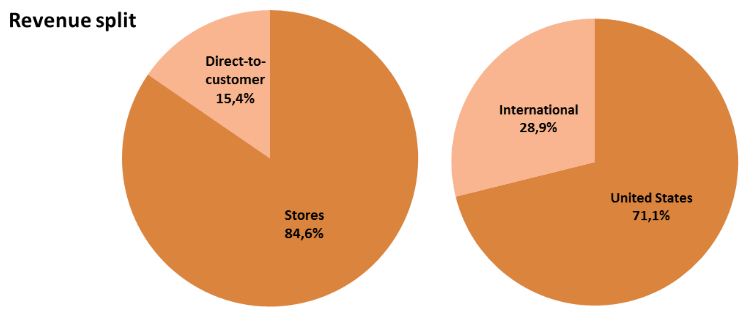
## Foot Locker (Ticker: FL)

### Description

Foot Locker Inc. is an American retailer, specialized in sport style footwear and apparel distribution of the own brands and well-known producers, such as Nike, Adidas, Puma and others. The company was launched in 1989 in New York, U.S., where it is currently headquartered. It has around 15.4 thousand full-time and 33.8 thousand part-time employees. Foot Locker Inc. operates in North America, Europe, Asia, Australia and New Zealand. The expansion of operation in Asia was initiated in 2018.




**Source**: Company´s data

### Investment Points

Foot Locker Inc. changed the strategy significantly in the last years after being penalized due to strong dependence to vendors. The company started investing in start-ups to have the most recent updates towards the customer preferences and at the same time to change the brand perception of being a discount shopping mall store.

The company has strong financial position in terms of liquidity, it increased dividend payments by 10% and announced about the continued share repurchase plan. However, recently the company was penalized by the market (share price plummeted by 20%) due to worse Q1 2019 results. Since May share price didn´t recover.

### Environmental, Social and Governance (ESG)

Foot Locker Inc. does not have an outstanding ESG performance. The company discloses very little or no data regarding the consumption, waste, or measures to decrease the footprint. Also, the company was involved in a significant litigation regarding the retirement plan, which proved to be disadvantageous to company´s employees. Nevertheless, Foot Locker has launched a college scholarship program to support athletes. For more information see *page 7*.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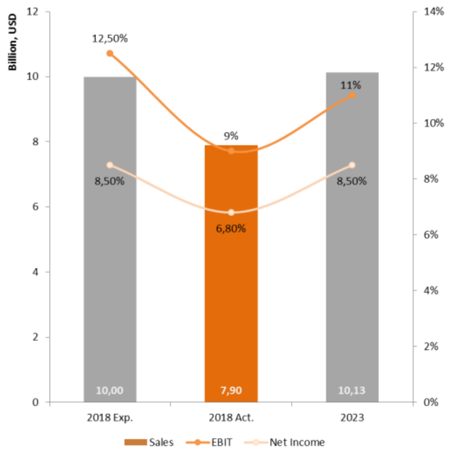
## Investment Case




**Source**: Company´s data

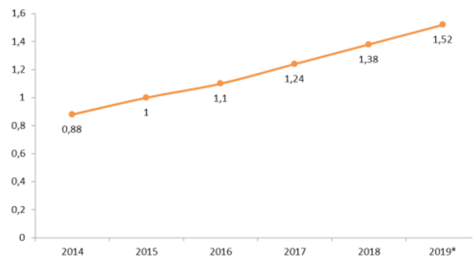
**Strategy.** The company is expecting to identify new customer trends faster by collaborating with the new vendors, but at the same time maintaining strong relationships with the main vendors, such as Nike Inc. For this purpose the company launched a Greenhouse – incubator, which will have several programs, through which the company will create partnerships with emerging vendors in their early stage, will help to develop new products. Greenhouse will include not only footwear-development programs: other initiatives include musical projects; Japanese brands introduction to U.S. and many others.

**Portfolio diversification**. In addition to Greenhouse project, in the beginning of 2019 Foot Locker Inc. started actively invest in various start-ups. Mainly the company focuses on the sports retail sector, however, two companies, selling children lifestyle products, have also joined the portfolio. On one side, Foot Locker is able to diversify the business and build a different brand than just a shopping mall re-seller. Also, the company may increase growth by collaborating with the different expertise in various sectors. On the other hand, company is investing in the early stage start-ups, which brings higher level of risk. The company invested $117.5 million in the first months of 2019.

**Growth.** In 2019 Foot Locker reviewed its long term strategy and set the new targets for 2023. The company is expecting to reach 5% revenue CAGR, which would result in sales of $10.1 billion. EBIT is expected to increase to 8.5% and net income increase by 10-12%. The company is expecting to achieve the targets by expanding activity in Asia: in 2018 it started increasing activity and by the end of the year Foot Locker Inc. had 5 stores in Singapore, Hong Kong and Malaysia, as well as digital platform in China. Foot Locker Inc. sees a potential in Asia, because the customers highly engage with brands, are digitalized and have increasing purchasing power. In addition, Foot Locker Inc. introduced a new concept of stores: Power store as a tool to move from malls (reduce by 10% to 70% by 2023) and change a perception being a discount store. Power stores combine most recent youth trends with the local ambience and ensure support and unique experience for customers. By the end of 2018 the company had 5 Power stores, in 5 years it is planning to have 200 Power stores worldwide.

**Retirement plan litigations.** In 2017 the U.S. Supreme Court confirmed that Foot Locker Inc. owes $290 million to its 16.000 employees as retirement plan benefits. Foot Locker Inc. was accused of changing the retirement plans of the employees and not disclosing the full information about the changes. Due to litigation the company had unexpected costs, which affected the margins and earnings negatively as well as company´s reputation.

**Dividends/share**




**Source**: Company´s data

**Financial position.** Foot Locker has a strong financial position. Even though the operational cash flow decreased by 3.9%, the company was able to invest in expansion, repurchase shares and pay dividends. Due to very low level of debt, the company has a good liquidity position. Also, the company increased the dividends by 10% for the year 2019 and initiated new share repurchase plan of $1.2 billion.

**Share performance**. Despite the strong financial position, the company disappointed investors with the first quarter of 2019 performance. Earnings and lfl sales figures were lower than expected, also, the company cut outlook for the full year: double-digit earnings growth reduced to high single-digit growth. The company blamed foreign currency exchange rates having the negative impact on results. However, after the outstanding performance of 2018, the poor first quarter results led to plummeting share price. On the announcement date share decreased by 11%, however, it didn´t recovered one month after: the share is down by 20%, at the lowest level since 2017 August. That is also reflected by the low P/E ratio of 8.4.

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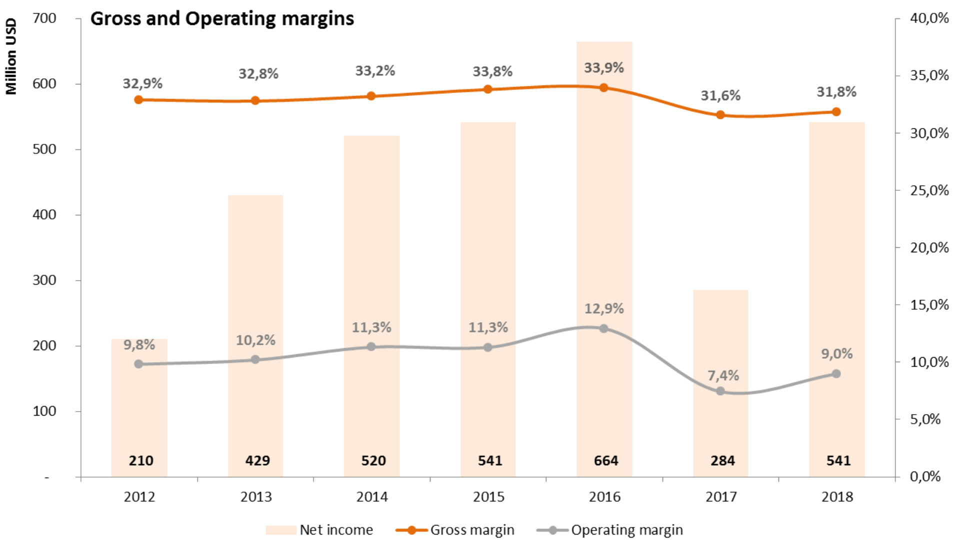
| Income Statement (USD millions) | 2018 | 2017 |
|---|---|---|
| Revenues | 7.939 | 7.782 |
| Other Revenue | 0 | 0 |
| COGS | (5.411) | (5.326) |
| Selling, General and Administrative costs | (1.614) | (1.501) |
| Depreciation and Amortization | (178) | (173) |
| Other Expenses/Income | (37) | (211) |
| Operating Expenses | (7.240) | (7.211) |
| EBIT | 699 | 571 |
| Net Interest | 9 | 2 |
| EBT | 708 | 573 |
| Taxes/benefits | (172) | (294) |
| Others | 5 | 5 |
| Net Income | 541 | 284 |
| Earnings per share | 4,7 | 2,2 |

**Source**: Company´s data

## Income Statement

In 2018 revenue increased by 2% driven by the segment growth: North America business grew at 2.1%, while International business grew at 1.9%, North America being the major market. COGS increased at a rate of 1.6%, which resulted in a slight increase in gross margin (31.8% in 2018; 31.6% in 2017). SG&A expenses increased by 0.4%, however due to lower litigation charges the operating margin increased to 9% (7.4% in 2017). Litigation charges in 2017 consisted mainly of pension litigation charges, which the company had to pay, due to false reporting and hidden benefits of the pension plans (more information in *page 2*). Also in 2017 the company recorded impairment of underperforming stores of SIX:02, Runners Point, and Sidestep stores of $20 million, which decreased to $4 million in 2018. Overall, company increased EBIT by 22% to $699 million.




**Source**: Company's data

| Free Cash Flow (USD millions) | 2018 | 2017 |
|---|---|---|
| Operational Cash Flow | 781 | 813 |
| Operating Profit | 541 | 284 |
| D&A, impairments | 197 | 193 |
| Taxes | 9 | 105 |
| Change Working Capital | 140 | 241 |
| Others | (106) | (10) |
| Investment Cash Flow | (274) | (289) |
| Capex | (187) | (274) |
| Acquisitions, partnerships | (87) | (15) |
| Financial Cash Flow | (527) | (616) |
| Debt change | 0 | 0 |
| Share buyback | (375) | (467) |
| Dividends | (158) | (157) |
| Others | 6 | 8 |
| Change in free cash flow | (20) | (92) |
| Other and forex | (30) | 50 |
| Cash and equivalents at end | 981 | 1.031 |

**Source**: Company´s data

## Free Cash Flow

Operational cash flow decreased by 3.9% in 2018 mainly due to litigation charges for the pension plans: part of it was accrued for 2018. Working capital decreased due to decreased inventory and significant change in payables. Investment cash flow slightly decreased by 5% in 2018, mainly due to lower investment in CAPEX. Capex primarily was attributed to renovation or relocation of 122 stores, as well as building of 45 new stores. Fool Locker is planning to spend $250 million in CAPEX for the next couple of years, which would result in 20 to 40 net new stores per year.

Also, the company made several minority investments total of $89 million in 2018, which is considerably higher as compared to $15 million minority investments in 2017. Financial cash flow decreased by 14% due to lower percentage of share buyback, which concluded $1.2 billion share repurchase program. In 2019 shareholders announced about a new three-years repurchase program of $1.2 billion. Also, shareholders approved a dividend increase of 10%. Cash at the end of the year decreased by 4.8% to $981 million. Nevertheless the cash flow is sufficient to cover financial obligations, invest in expansion and return funds to shareholders.

| Balance Sheet (USD millions) | 2018 | 2017 |
|---|---|---|
| Assets | 3.820 | 3.961 |
| Cash & Equivalents | 891 | 849 |
| Goodwill | 157 | 160 |
| Receivables | 87 | 106 |
| Inventories | 1.269 | 1.278 |
| Property Plant & Equipment | 836 | 866 |
| Intangible Assets | 24 | 46 |
| Other Assets | 556 | 656 |
| Liabilities | 1.314 | 1.442 |
| Short term Debt | - | - |
| Long term Debt | 124 | 125 |
| Payables | 387 | 258 |
| Accrued Expenses | 377 | 358 |
| Other liabilities | 426 | 701 |
| Total Shareowner's Equity | 2.506 | 2.519 |
| Total Equity and Liabilities | 3.820 | 3.961 |

**Source**: Company´s data

## Balance Sheet

Total assets decreased slightly by 3.6% in 2018 due to insignificant changes in different line items, namely decreased receivables and other assets. Total liabilities also contracted by 8.9% due to a significant decrease in other liabilities, which in 2017 represented pension litigation liability. In 2018 pension litigation liability was reclassified as pension obligation. Foot Locker Inc. has a very low amount of financial debt, which makes just

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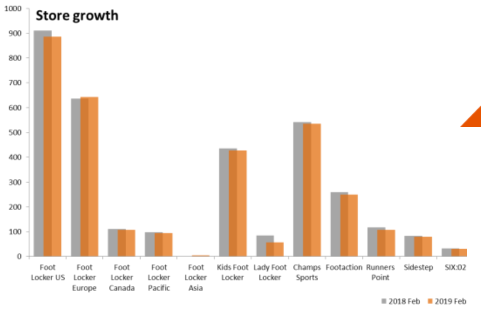


**Source**: Company´s data

16% of operational cash flow. There were no changes in debt during the last financial year.

## Guidance

For the Q1 2019 the sales grew by 2.6% (4.6% LFL) and gross margin increased to 33.2% as compared to 32.9% in 2018. Due to increased SG&A expenses, operating margin decreased to 10.9%, as compared to 11.1% in 2018. SG&A increased mainly due to investments in new stores and digitalization. During the first quarter Foot Locker Inc. opened 14 new stores, 13 stores were relocated, and 34 stores were closed, resulting in 3201 stores, a 0.6% decrease as compared to 2018 Feb. For the full year, Foot Locker Inc. expects to reach a mid-single digit revenue growth with the gross margin improvement of 0.2-0.4%. Even though the SG&A expenses are expected to increase in the second quarter by 0.8-1%, for the full year the company is planning to decrease the expenses by 0.4-0.6%. Due to slower share repurchasing activity, the company is expecting a high single-digit growth of EPS for the full year of 2019. However, after the Q1 results the company cut guidance for the full year.

Richard A. Johnson, CEO of Foot Locker Inc.

## Management

**Richard A. Johnson** is a Chairman of the Board and CEO of the company since 2016. Mr Johnson joined Foot Locker Inc. back in 2003 and since then went through various management positions, including CEO of Foot Locker Europe, CEO of Foot Locker Lady/Kids/Footaction and COO of the company before he was appointed to run CEO position. Before joining Foot Locker Inc. Johnson worked for Graebel Van Lines, General Motors, and Electronic Data Systems in various management roles. CEO holds a Bachelor Degree of Arts from the University of Wisconsin.

## Main Segments

The main segments of Foot Locker Inc. include banners, such as *Foot Locker, Kids Foot Locker, Lady Foot Locker, Champs Sports, Footaction, Runners Point, Sidestep, SIX: 02, Eastbay* and Franchise operations. Starting from 2018 the company changed its reporting structure, i.e. revenues are divided between **North America** business and **International** segment. North America business represents results of the following banners operating in the U.S. and Canada: *Foot Locker, Kids Foot Locker, Lady Foot Locker, Champs Sports, Footaction, and SIX:02*, including each of their related e-commerce businesses. International segment represents results of banners operating in Europe, Asia, Australia and New Zealand: *Foot Locker, Runners Point, Sidestep, and Kids Foot Locker*, including each of their related e-commerce businesses.

**Foot Locker** brand is designed to satisfy the preferences of youth, who are passionate about the sneakers. Even though it is focused on footwear, apparel is also distributed. The main brands being distributed are Nike, Adidas, Puma, Jordan, Vans and other smaller emerging brands. Foot Locker has 1734 stores.

**Kids Foot Locker** offers athletic footwear apparel and accessories of various brands for kids. Banner has 428 stores.

**Lady Foot Locker** distributes footwear, apparel and accessories designed for women. The banner is located just in U.S and Puerto Rico and has 57 stores.

**Champs Sports** distributes footwear, apparel and accessories and is the largest mall-based retailer in North America. The banner is located in U.S., Puerto Rico, U.S. Virgin Islands and Canada. In total it has 535 stores.

**Footaction** is based only in North America and distributes footwear, apparel and accessories. The merchandise combines sport and style, making the authentic and

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premium products. In 2017 the banner signed distribution agreement with UGG and Timberland. The banner has 250 stores.

**Runners Point** is focused on footwear, apparel and accessories specifically designed for runners. In addition to distribution of merchandise, the banner operates as a local advisor of training tips and access to local running events. It is based in Germany, Austria and Switzerland with the total of 107 stores.

**Sidestep** serves as a specifically athletic footwear banner. The stores are located in Germany, Austria, Netherlands and Switzerland with the total of 80 stores.

**SIX: 02** was specifically designed to distribute merchandise for women. However, it was decided to close the banner in early 2019 due to unprofitable activity. It had 30 stores in United States.

**Eastbay** is a direct marketer of sport goods operating in United States. The banner does not have a store presence: it operates digitally and through Team Sales field organization It provides athletic footwear, apparel, equipment and team licensed merchandise for high school and other athletes.

**Franchise operations**. The company has franchised Foot Locker stores in Middle East and Germany under the Runners Point banner. Also, in 2017 the company entered into the agreement with Fox-Wizel Ltd to franchise stores in Israel.

Direct-to-customers sales made 15.4% of total sales in 2018 and grew by 10.5%. The increase was mainly driven by the various e-commerce consumer enhancement projects. Store-sales made 84.6% of total sales in 2018 and grew by 0.6% (1.1% LFL). Both channels faced benefits of new assortment presented into the market.

In terms of geographical division, United States made 71.1% out of total sales and grew by 2.1% in 2018. The rest of the business, i.e. International sales made 28.9% of total revenues and increased at the rate of 1.9% in 2018.

## M&A

Foot Locker Inc. engages in minority investments into companies, especially startups, in order to expand the portfolio of the brands and change the brand awareness of being just a shopping-mall store. Company actively engaged in funding rounds in 2019, with the total investment of $117.5 million in the first months of the year.

**Carbon38** is a luxury active sportswear company for women, operating in U.S. Foot Locker Inc. invested in the company in the beginning of 2018 with the aim to develop and increase the growth of the own banner SIX:06. Foot Locker Inc. contributed to the investment round by $15 million.

**GOAT Group** provides authentic secondhand sneakers in U.S. through e-commerce and mobile app under GOAT and Flight Club brands. Foot Locker Inc. announced about the investment of $100 million in 2019 February. The strategic partnership is supposed to provide a physical presence of GOAT Group´s production in Foot Locker´s stores and digital presence of Foot Locker´s brands in GOAT Group´s platform. As of 2018 the approximate valuation of GOAT Group reached $250 million.

**PENSOLE Footwear Design Academy** offers educational programs to help designers to enter footwear industry. The courses cover entire footwear and apparel design process, manufacturing and branding. Foot Locker Inc. invested $2 million in 2019 February with the aim to develop new programs, which would collaborate to the new models creation for Foot Locker brand.

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**Rockets of Awesome** sells clothing for kids through online platform in U.S. Foot Locker Inc. Invested $12.5 million in 2019 February with the aim to differentiate the portfolio of the brands. While other investments served as an expansion in sportswear sector, this investment is completely different, knowing that investee operates only in kids clothing sector. Foot Locker Inc. will become the largest distributor of the Rockets of Awesome in U.S.

**Super Heroic** is a children lifestyle brand, operating in U.S. Foot Locker Inc. invested $3 million in 2019 January with the aim to expand company´s portfolio. Foot Locker Inc. will be the first retailer of Super Heroic production in stores in U.S.

## Relative Valuation

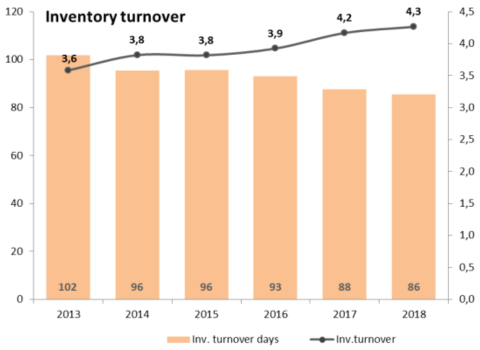
Foot Locker Inc. seems to be undervalued as compared to peers, i.e. the company has a P/E ratio of 8.4, while the industry average is 15.9. However, analyzing share performance it decreased by 20% since the beginning of year and it is reaching two-years lows. Foot Locker Inc. has a higher dividend yield than the market and EBITDA margin is significantly higher than the peer average: 19.3% as compared to peers 12.8%.

| Name | Country | Market Cap (mn) | Currency | P/E 2019E | P/E 2020E | EV/EBITDA | YTD | Div. Yield | 1 Yr. Price Δ | Margin EBITDA |
|---|---|---|---|---|---|---|---|---|---|---|
| DESIGNER BRANDS INC-CLASS A | UNITED STATES | 1.386 | USD | 9,7 | 8,5 | 14,8 | -25,4% | 5,4% | -28,6% | 6,0% |
| CALERES INC | UNITED STATES | 806 | USD | 7,9 | 7,2 | 9,9 | -31,4% | 1,5% | -46,5% | 8,5% |
| GENESCO INC | UNITED STATES | 740 | USD | 12,3 | 11,5 | 10,3 | 1,0% | NA | 5,8% | 5,9% |
| ABC-MART INC | JAPAN | 576.076 | JPY | 18,3 | 17,6 | 8,0 | 14,8% | 2,4% | 9,1% | 18,2% |
| CCC SA | POLAND | 6.743 | PLN | 23,8 | 17,7 | 12,0 | -15,3% | 1,4% | -27,3% | 19,9% |
| FORUS SA | CHILE | 423.476 | CLP | 15,8 | 14,9 | 8,1 | -13,8% | 2,4% | -18,9% | 20,5% |
| BOOT BARN HOLDINGS INC | UNITED STATES | 1.007 | USD | 23,4 | 19,3 | 12,0 | 108,5% | NA | 58,6% | 10,7% |
| FOOT LOCKER INC | UNITED STATES | 4.660 | USD | 8,4 | 7,8 | 5,5 | -20,1% | 3,3% | -22,2% | 19,3% |
| Average exc. Foot Locker | | | | 15,9 | 13,8 | 10,7 | 5,5% | 2,6% | -6,8% | 12,8% |

**Source**: Company´s data

## Risks

**Dependence on manufacturers.** Since Foot Locker Inc. is selling the merchandise of the other footwear manufacturing companies, it is highly dependent on the performance, reputation of the suppliers. 90% of production was purchased from top 5 suppliers. The biggest partner is Nike Inc., which makes around 66% of the total merchandise purchased from suppliers. Taking into consideration the new Nike Inc. strategy on focusing to direct-to-customer strategy and reducing distributors list, it creates a significant risk for Foot Locker Inc. Even though Foot Locker Inc. still remains among the biggest distributors of Nike Inc. production, in the future the partnership may be terminated depending on the Nike Inc. strategy changes.




**Source**: Company's data

**Competition**. Retail industry is very competitive and saturated with both smaller (<$5b in sales) and much bigger competitors (over $20b sales), which makes the total industry size of over $100 billion. Companies can easily enter the industry by offering slightly differentiated products and shape the customer preferences.

**Obsolete inventory.** In the last five years Foot Locker Inc. holds a significant amount of inventory, i.e. over $1 billion. Also, domestic inventories are accounted using LIFO method (66% of total inventories), which may result in obsolete merchandise which is a subject of impairment. It is also highly related to the consumer preferences and suppliers´ performance, meaning that suppliers´ failure to predict customer preferences, might result in increased amount of stock. However, the company every year is improving the inventory turnover ratios.

**Seasonality.** The company has noticed that sales are significantly lower in the second quarter, which accordingly results in the lower evolution of margins. Therefore the company has to precisely plan the cost structure, as well as accounts payable to be able

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to meet all the obligations and ensure the optimal working capital amount.

**Minority investments**. Foot Locker Inc. actively engaged in funding of the start-ups in the footwear and apparel sector in U.S. By the end of 2018 the company invested $104 million in various companies, while in the first months of 2019 Foot Locker Inc. increased the minority investments by $117.5 million. Due to the fact that company invests in very young (operating for two-tree years) companies, it increases the risk of having impairment losses, in case the funded companies face difficulties. However, Foot Locker Inc. invests small amounts (usually $10 to $15 million) in start-ups and has only minority interests.

**Macroeconomic environment**. Foot Locker Inc. might be negatively affected in case the U.S. imposes a significant increase in trade tariffs to China. Since the main supplier of merchandise is Nike Inc. (66% of the supplies), which highly depends on China, the trading issues directly affecting Nike Inc. will affect Foot Locker Inc. as well. Foot Locker Inc. was one of the sportswear retailers (among Adidas AG, Nike Inc., etc.), who signed the letter sent to U.S. government in May 2019, urging not to increase the trade tariffs as the U.S. companies might carry the biggest burden due to changed trading conditions.

## Environmental, Social and Governance (ESG)

**Environment.** Foot Locker Inc. does not disclose any ratios regarding the consumption or waste. Also, the company is not involved in any environment saving activity, as none of the details are disclosed in the reports of the company.

**Social**. The company launched a Foot Locker Foundation in 2001, which provides college scholarships of $20.000 for 20 athletes, who demonstrate excellence on the court and in the classroom, as well as possess leadership qualities. Company´s employees are also encouraged to participate in volunteering activities. Foot Locker has donated to some social organizations; however the amounts and conditions are not disclosed. In 2017 Foot Locker Inc. lost a litigation, which accused a company of hiding the newly adopted terms of Retirement plans. The company had to pay $290 million (for more details see section *Investment case; p. 2*). Foot Locker Inc. does not disclose any details regarding the employee turnover, unions or gender equality.

**Governance**. Foot Locker Inc. reports that 90% of directors are independent. Also, 4 out of 10 board members are women and the average age of the directors is 64.

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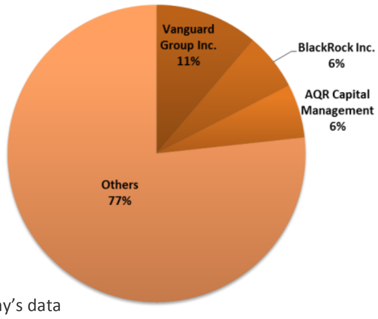
## Graph


**Source:** BiGlobal Trade (partner Saxo Bank); BiG Research

## Shareholders




**Source**: Company's data

## Calendar

**August 24th, 2019:** 2nd Quarter 2019 Results
**November 19th, 2019:** 3rd Quarter 2019 Results

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○ Buy, expected absolute return above 15%;
○ Accumulate, expected absolute return between +5% and +15%;
○ Keep/Neutral, expected absolute return between -5% and +5%;
○ Reduce, expected absolute return between -5% and -15%;
○ Sell, expected absolute return below -15%;
The investment framework aforementioned is merely indicative and not globally strict.

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• The update of the investment recommendations models and respective price-targets will occur, usually, in a period of 6 to 12 months.

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• The records of the investment recommendations of the Research Team are provided below. The detailed external consultation of the respective performances may be provided if so requested.

PSI20 Notes in the last 12 months as of 31st of December of 2018:

| | Number of Recomendations | % |
|---|---|---|
| Accumulate/Buy | 2 | 66,7% |
| Keep/Neutral | 1 | 33,3% |
| Reduce/Sell | 0 | 0,0% |
| Total | 3 | 100,0% |

Trading Ideas in the last 12 months as of 31st of December of 2018:

| | Number of Recomendations | % |
|---|---|---|
| Profit Taking | 9 | 56,3% |
| Stop Loss | 7 | 43,8% |
| In Place | 0 | 0,0% |
| Total | 16 | 100,0% |

Pair Trades in the last 12 months as of 31st of December of 2018:

| | Number of Recomendations | % |
|---|---|---|
| Profit Taking | 0 | 0% |
| Stop Loss | 0 | 0% |
| In Place | 0 | 0% |
| Total | 0 | 0% |

Source: BiG Research

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