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Foot Locker, Inc. (FL): Buy @ $85.00

Buy Thesis: We maintain our Buy rating and raise our PT from $80 to $85.00. Foot Locker remains the dominant retail store in the Athletic Footwear Apparel space. While the retail environment was especially difficult with Mall Traffic down and a heavy promotional environment, Foot Locker bucked the trend, posting low-single digit growth in U.S. foot traffic, an increase in ASPs and a solid 5% comparable store sales growth in 4Q16. While we believe the secular growth in Retro Lifestyle Footwear/Apparel is still Strong, we see Foot Locker's Top-line as limited to mid-single digit growth, mostly due to the Slowdown in Direct-to-Consumer (DTC) sales growth and the steady pace of Store Re-models taking place this year.

TABLE 1: Footlocker 4Q16 Results

4Q16 Results			1Q17 Guidance			4Q16 Results			1Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
1.37	1.31	beat	n/a	1.52	n/a	2.11B	2.11B	in-line	n/a	2.08B	n/a

Source: Foot Locker, Inc. and Estimize.com

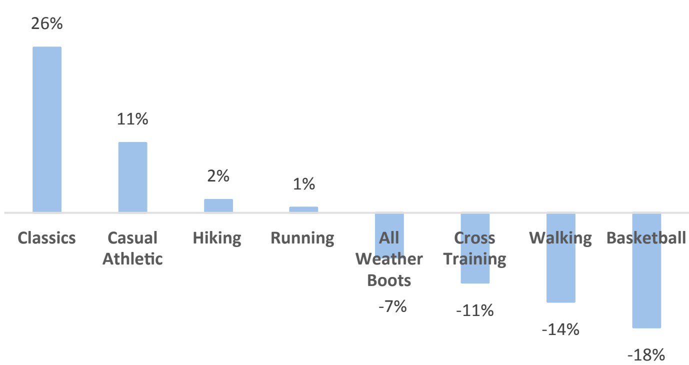
I. U.S. Consumer Preference Shifts from Performance to Casual Athletic

The NPD Group reported that the U.S. athletic footwear industry grew by 3% in 2016, generating $17.5B. Unit sales also grew by 3% and average selling price remained flat at $60.81. The industry grew in each of the first three quarters of 2016, slowing down slightly in 4Q16. Moreover, during the 4Q holiday season, slower traffic caused significant promotional activities earlier, deeper and broader than expected by the retail sector.

Furthermore, the bankruptcies of *The Sports Authority* and *Sport Chalet* was a net positive for Foot Locker, but it did cause disruptions in the supply chain with the greatest impact occurring during 4Q16 when both retailers were shutting down. *The NPD Group* projects that the supply chain dislocation will likely continue through 1Q17, but after that the drag should be over and the trend should return to normal.

In terms of category performance, the Classics category drove the industry, with sales increasing by 26% in 2016 (see Figure 1). *NPD* data shows the category growing sales by $1.7B over the past three years as trends shifted away from performance-driven categories to more retro styles. For example, Foot Locker reported in its 4Q16 call that solid 5% comp store sales growth was fueled by double-digit gains in both footwear and apparel led by lifestyle offerings from PUMA, Adidas and Nike. It also mentioned that comparable sales at its *Runners Point* and *Sidestep* stores continued to decline double digits as both banners continued to face a difficult retail climate in Germany, including significant declines in store traffic. This is reflected in both the 1% growth and the minus 11% decline in the running and cross-training categories, respectively (see Figure 1).

FIGURE 1: U.S. Athletic Footwear Growth by Category



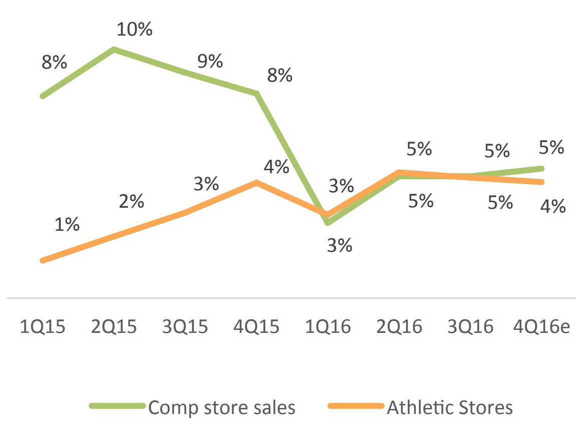
Source: NPD Group Retail Tracking Service

NPD believes that Retro/Lifestyle will remain the dominant fashion trend in the near-term, but success will not be easy as competition will intensify and brands must constantly update their styles. Moreover, to further distinguish themselves and stay ahead of the competition, brands should focus their innovation on the manufacturing side, emphasizing speed and sustainability, as this impact will be long-lasting, regardless of where the fashion trends move the market.

II. ***Slowing DTC Growth Limits Top-line Growth to Mid-single Digit***

Foot Locker's top-line growth trajectory grew from just 3.6% y/y in 2015 to 4.8% y/y in 2016. Considering the difficult retail environment in 4Q16, where mall traffic slowed down considerably and heavy promotional pricing was the norm, a 5% comparable store sales growth was a solid number (see Figure 2). On a quarterly basis, comp store growth grew much faster in 2015. This changed drastically in 1Q16 when comp store growth fell to just 3% y/y. Through 2016, comp store growth and total store growth were roughly equal (see Figure 2).

FIGURE 2: Sales Growth (Y/Y): Comparable Store Sales vs. Athletic Store Sales



Source: Foot Locker, Inc.

The biggest driver of comp store sales growth is the increase in Direct-to-Consumer (DTC, or "on-line") sales, which grew 8.2% y/y in 2016, double the growth of athletic store sales (4.3% y/y in 2016). But, since DTC only comprises ~15% of total sales, it only contributed around an extra 50-100 bps growth to overall sales. Furthermore, DTC growth has slowed down from 9.3% y/y in 2015 to 8% y/y in 2016. The slowdown by 130 bps caused comp store sales to fall from an average 9% y/y growth in 2015 to an average 4% y/y growth in 2016 (see Figure 2). Going forward, we are projecting comp store sales growth to closely mirror the average growth rate of brick-and-mortar stores, which will be ~5% y/y in 2017.

Disclosure Information

Analyst Certification

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