

## Foot Locker, Inc. (FL): Buy @ \$70.00

**Buy Thesis:** We maintain our Buy rating but lower our PT from \$85 to \$70 due to the deceleration in both sales and operating margin growth in the athletic store segment. Foot Locker experienced a significant slowdown in both total sales growth (+0.7% y/y) and comparable store sales (+0.5%) in 1Q17 as consumers shifted their buying habits from in-store purchase (85% of total sales) to online (15% of total sales). While management blamed softer sales on the delay of IRS tax refunds to consumers, it did not expect the strong growth in online purchases. Management is implementing a “Plan B” to tighten expense controls in 2H17 should sales growth continue to remain weak. We believe Foot Locker still maintains a dominant position in athletic footwear – a space that could still benefit from the athleisure trend as consumers look to casual lifestyle footwear to accessorize their casual office attire.

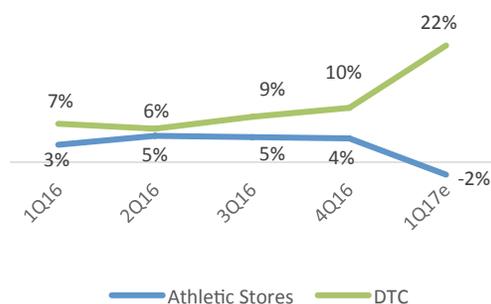
TABLE 1: Footlocker 1Q17 Results

1Q17 Results			2Q17 Guidance			1Q17 Results			2Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
1.36	1.38	miss	n/a	1.04	n/a	2.0B	2.0B	in-line	n/a	1.87B	n/a

Source: Foot Locker, Inc. and Estimize.com

### I. Softer Top-line Growth and Comp Store Sales due to Shift to Online Purchases

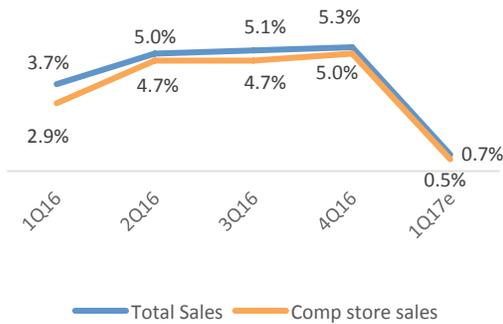
FIGURE 1: Sales Growth, Y/Y: Store vs. DTC



The shift in consumer buying pattern from in-store visits to online took an abrupt turn in 1Q17 as direct-to-consumer (DTC) sales grew to 22% y/y in 1Q17 from 10% y/y in the previous quarter. The shift to online caused store sales to drop by 2% y/y in 1Q17 from the FY2016 quarterly run-rate of 4% to 5% y/y (see Figure 1). While the cause for the shift was not explained, it caught management off guard and triggered the implementation of a “Plan B” for tighter controls on expense growth, just in case the slow-down in sales continued in 2H17.

Source: Foot Locker, Inc. and 1Q17 estimates from Viola Advisory, LLC

**FIGURE 2: Comp Store Sales vs. Total Sales Growth**



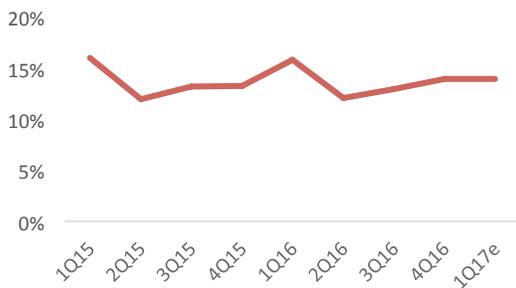
Source: Foot Locker, Inc. and 1Q17 estimates from Viola Advisory, LLC

We believe management has a distinct advantage when a customer walks in a store to purchase footwear and apparel items. Foot Locker has a deep understanding of their customers’ in-store buying habits and their sales associates do an outstanding job in selling premium sneakers and upselling accessories to increase average purchase size. However, lack of visibility in customer online purchasing habits could cause uncertainty in projecting comparable store sales and total sales growth.

Figure 2 shows the sudden drop in comp store sales and total sales growth from one quarter to the next. Both total sales and comp store sales were trending in the 5% range from 2Q16 to 4Q16 when they both dropped suddenly to less than 1% in 1Q17.

**II. Flat Operating Margin Growth**

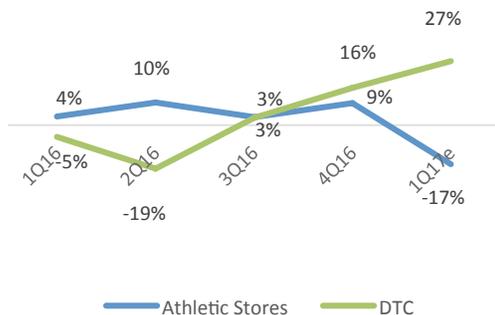
**FIGURE 3: Operating Margin Growth, Y/Y**



Source: Foot Locker, Inc. and 1Q17 estimates from Viola Advisory, LLC

Over the last two years, Foot Locker operating margin (OM) was stable and predictable – peaking at ~16% in 1Q, then dropping to ~12% in 2Q and steadily rising again to 16% in 1Q (see Figure 3). However, the shift in consumer purchase pattern in 1Q17 to increased online buying caused OM to flatten. Instead of hitting 16% in 1Q17, OM remained flat at 14% sequentially.

**FIGURE 4: Store OM Growth vs. DTC OM Growth**



Source: Foot Locker, Inc. and 1Q17 estimates from Viola Advisory, LLC

Quarterly store OMs usually run ~11-14% while OMs from DTC are ~1.5-2%. Operating margins in DTC grew rapidly from 3% y/y in 3Q16 to 27% y/y in 1Q17, while growth in store OMs fell from 3% y/y growth in 3Q16 to negative 17% y/y in 1Q17. It was the significant drop in store OM growth (store OM only reached a level of 11.5% in 1Q17 missing the minimum threshold of 14%) that caused total operating margin to remain sequentially flat in 1Q17, despite the rapid growth of DTC operating margin.

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