

Foot Locker, Inc. (FL): Buy @ \$74.00

Buy Thesis: We are Bullish on Foot Locker heading into 2H16 given what we believe will be a Strong 3Q Back-to-school and 4Q Holiday Shopping Season. We believe the Sneaker Culture in the U.S. will be driven by Gen Z and their Millennial parents who have a great affinity and loyalty to sneakers and athletic brands. The U.S. sneaker market has shifted from Performance-driven to a more casual athletic with Ladies Sportswear Apparel also gaining in popularity. We believe Foot Locker is nimble enough to navigate the shifting market trends and remain the “Go-to” Destination for premium and “cool” athletic footwear and sportswear apparel.

TABLE 1: Footlocker 2Q16 Results

2Q16 Results			3Q16 Guidance			2Q16 Results			3Q16 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
0.94	0.91	beat	n/a	1.13	n/a	1.78B	1.76B	beat	n/a	1.89B	n/a

Source: Foot Locker, Inc. and Estimize.com

Foot Locker reported 2Q16 results surprising the market with a strong EPS beat of 94 cents (up 12% y/y) vs. consensus estimate of 91 cents and total sales of \$1.78B (up 5% y/y) slightly ahead of \$1.76B consensus estimate. It also delivered a 2Q comparable store sales increase of 4.7% and gross margin also improved to 33.0% from 32.6% a year ago. SG&A was steady at 19.7% of sales vs. 19.5% a year ago.

2Q16 Highlights

- Inventory was \$1.34B, up 1.7% y/y
- Cash totaled at \$945M with debt at \$129M
- Spent \$188M to repurchase 3.35M shares during 2Q16
- Paid a quarterly dividend of \$0.275 spending \$37M
- During 2Q16, opened 23 new stores, remodeled or relocated 64 stores and closed 18 stores; as of 7/30/16, Foot Locker operated 3,401 stores in 23 countries in North America, Europe, Australia and New Zealand; in addition, 54 franchised FL stores were operating in the Middle East and South Korea, as well as 15 franchised Runners Point stores in Germany

I. Classic Retros are a Big Hit while Performance Category Remains Weak

According to the *NPD Group*, the biggest growth driver in sneaker sales was the Classics (or Retro) category which drove 30% of sales in 2015 (see Figure 1 below). The largest branch in the Classics category is retro basketball, driven by Brand *Jordan*. Retro tennis also outperformed with Adidas’ *Stan Smith* franchise. Retro running also showed a healthy increase. *NPD Group* expects the retro trend to last for some time.

FIGURE 1: Footwear Category Sales Growth for FY2015

Source: NPD Group, Retail Tracking, 2015

Performance sneakers, both in basketball and running has shown some softness in 2015, but more so in the first four months of 2016 (see Table 2). Retailers have been citing softness in performance basketball with ASPs for 2016 seeing a decline. Of the major brands, only Under Armour has shown some growth in this category. *NPD* believes that declines will moderate in 2H16 due to easier comps. However, expect performance basketball to remain challenged for the rest of 2016.

TABLE 2: U.S. Athletic Footwear Category Sales Growth (2Q16 vs. 2015)

Category	2015	Jan.- Apr. 2016
Classics	30%	25%
Hiking	15%	3%
Walking	9%	declining
Cross Training	6%	
Running	4%	
- Performance		-8%
- Lifestyle		40%
Basketball	4%	weak
Casual Athletic	-5%	5%

Source: NPD Group, Retail Tracking, Jan.-Apr. 2016 & FY15

Performance running (comprising 80% of the running category) was also down in the high-single digits from January to April 2016 while lifestyle running grew more than 40% in the same period. Most brands in performance running have struggled with Adidas being the exception. *NPD* expects lifestyle running to continue to expand.

Casual athletic saw a turnaround in 2016. While the category was down 5% in 2015, it grew in the mid-single digits by April 2016 mostly from Converse Casual and robust growth from Adidas' *Neo* collection (see Table 2). *NPD* has stated that the U.S. footwear industry is in a major non-performance cycle at this time.

Foot Locker 2Q16 Category Results: Footwear sales had gains in mid- to high-single digits. Both basketball and running were up mid-single digits while court classic and casual styles saw stronger growth with high-single digit gains.

Foot Locker 2Q16 ASP Results: Continuing the trend of previous quarters, both ASPs and unit sales were up in footwear, while in apparel, ASPs were up and unit sales were down, reflecting the shift to more premium apparel assortments. Men's apparel (the largest category) was up mid-single digits and Kids' apparel up by double digits. Women's apparel was down by double digits. Lifestyle apparel performed well but Foot Locker did not keep pace with the rapid shift out of performance styles by female customers.

II. Transitioning to 2H16 Back-to-school (BTS) and Holiday Season

TABLE 3: 2Q16 U.S. Athletic Footwear Sales – Y/Y Growth by Category

Category	Sales	% Change
Men	\$2.1B	3%
Women	\$1.0B	4%
Children	\$824.3M	10%
Total	\$3.9B	5%

Source: NPD Group, 8/15/16

2Q16 is generally a transition period for the U.S. athletic footwear industry as retailers begin to turn their attention towards the biggest seasons for the industry: Back-to-school (BTS) and the holiday shopping season. According to *NPD*, both dollar and unit sales grew by 5% in 2Q16 setting a healthy pace for 2H16 (see Table 3).

Key Data Points for 3Q16 Back-to-school and 4Q16 Holiday Season

- Children's athletic footwear experienced the highest uptick in sales, and was the only wearer segment to see an increase in ASP. This has to do with the fact that athletic fashion is now the wardrobe of choice for many adults, translating to consumers seeking the same for their children.
- Like their Millennial parents, Gen Z has an affinity and loyalty to sneakers and athletic brands. The growth in categories that carry higher price points, particularly the Classics category, and the popularity of teen girls buying boys-sized shoes is driving much of the positive performance. Expect the results to further improve for children's footwear as the BTS season goes into high gear.
- Classics should continue to outperform as a growth story, but brands must monitor their supply and demand closely. It is very easy for fashion products to get oversupplied, which can really hurt a market.
- Expect performance basketball to be challenged, but less severely as the downtrend that started during BTS last year.
- Running category is seeing an uptick in sales as some new performance running products are currently being introduced. The trend of "performance running as fashion" could make a comeback this season.

What to Expect from Foot Locker for the Remainder of 2016

- Foot Locker's strategy of growing the Kids business continues to be a major revenue contributor. Kids Foot Locker grew in the low-single digit in 2Q16 underperforming the national average growth of 10% y/y (see Table 3). Expect the company to push this segment especially during BTS.
- Lady Foot Locker/SIX:02 comped down low in the mid singles for 2Q16, breaking two straight years of comp gains. Apparel was also down by double digits. Foot Locker is aiming to grow the Ladies business by focusing on the SIX:02 franchise via online (see six02.com) and by opening new brick-and-mortar stores. A new SIX:02 store is scheduled to open in Midtown Manhattan by end of August.
- Eastbay (Foot Locker's performance-oriented business) continues to struggle with sales declining in the high single digits. Expect this downtrend to continue as consumers shift their purchases away from performance and more towards casual athletic.

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Analyst Certification

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