VIOLA ADVISORY

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Mariano R. Viola, PhD
Consumer & E-commerce Analysis
(917) 751-3733
mariano@violaadvisory.com
www.violaadvisory.com

Foot Locker, Inc. (FL): Buy @ $80.00

Buy Thesis: We believe Foot Locker will be the prime beneficiary of the casualization of dressing styles around the world and the ongoing adoption of healthier, more active lifestyles, both of which support the steady growth of sales in athletic footwear and apparel. The resurgence in mall visitations and foot traffic also bodes well especially at the onset of the year-end Holiday season. There is also more room for growing operating margins as Foot Locker aims to raise store productivity by steadily growing its sales per square footage metric.

TABLE 1: Footlocker 3Q16 Results

3Q16 Results			4Q16 Guidance			3Q16 Results			4Q16 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
1.13	1.11	beat	n/a	1.32	n/a	1.89B	1.89B	in-line	n/a	2.12B	n/a

Source: Foot Locker, Inc. and Estimize.com

3Q16 Highlights

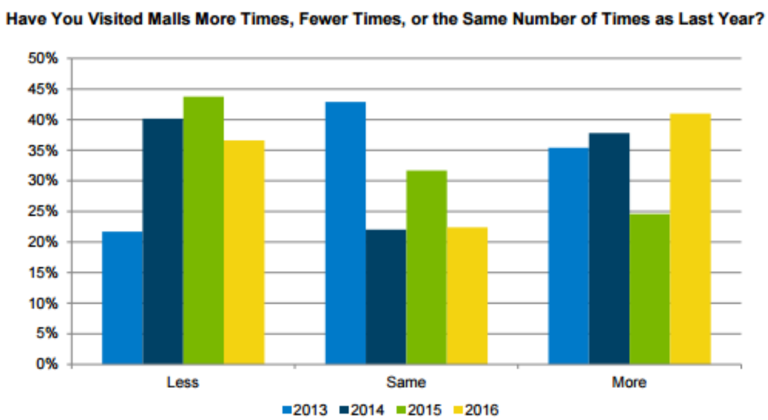
- Revenue of $1.89B, up 5% y/y, in-line with consensus forecast of $1.89B
- Non-GAAP EPS of $1.13, up 13% y/y, beats estimate of $1.11
- Comparable store sales increased 4.7% and total sales increased 5.1% to $1.886B vs. $1.794B in 3Q15
- Gross margin improved to 33.9% of sales from 33.8% a year ago; SG&A expense rate improved 20 bps. to 19.4% of sales
- Merchandise inventories were $1.361B, 1.9% higher than at the end of 3Q15
- Cash totaled $865M, while the debt on its balance sheet was $128M
- Spent $76.3M to repurchase 1.15M shares during the quarter and paid a quarterly dividend of $0.275
- Year-to-date, returned $463M to shareholders between stock repurchase program and dividends, spending $352M to repurchase 5.9M shares, and paying $111M in dividends
- YTD invested $193M in store fleet, websites, and infrastructure, tracking to ~$290M for the full year
- Opened 21 new stores, remodeled or relocated 40 stores, and closed 28 stores
- As of 10/29/16, operated 3,394 stores in 23 countries in North America, Europe, Australia, and New Zealand; in addition, 56 franchised Foot Locker stores were operating in the Middle East and South Korea, as well as 15 franchised Runners Point stores in Germany

I. Mall Traffic is Alive and Well

Visits to shopping malls have seen a positive reversal this year compared to prior years. According to a survey of teens and young adults by *William Blair,* teens are visiting malls more in 2016 than they were in 2015. 41% of respondents have visited malls more frequently in 2016, while only 37% report visiting malls less frequently (see Figure 1). This year's results mark the first uptick in teen mall visitation since 2013.

This is a strong positive data point for Foot Locker, since the company's strategy is to locate their stores in shopping malls and in high-traffic streets. Moreover, Foot Locker targets teens and young adults as an important customer demographic.

FIGURE 1: 2016 Teen Survey by *William Blair*

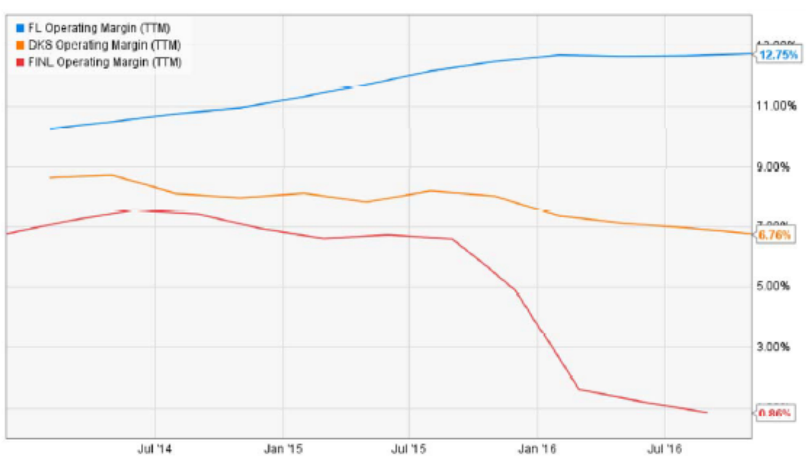


Source: lab42, Survey Monkey and William Blair

Also encouraging is that teens indicated that the mall (24%) was the most popular place for them to meet with friends, beating out movie theaters (21%), restaurants (21%) and sports clubs/extracurricular activities (10%). This suggests that malls' efforts to increase relevancy through more experiential brands and the addition of attractive entertainment and dining options are starting to pay off.

II. <u>*Growth in Sales per Square Foot Could Drive Operating Margins Higher*</u>

FIGURE 2: 3Q16 Operating Margins: Foot Locker (FL), Dick's Sporting Goods (DKS) and Finish Line (FINL)

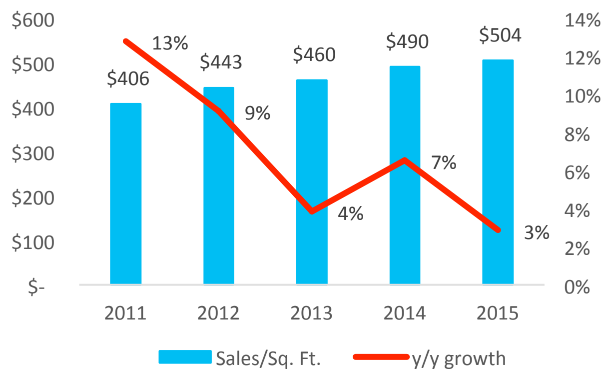


Source: YCharts

Relative to its peers, Foot Locker has always had higher operating margins. In 3Q16, Foot Locker's operating margins were at 12.75% vs. Dick's Sporting Goods at 6.76% and Finish Line at 0.86% (see Figure 2). However, operating margins for FY16 seem to have flattened out prompting investors to ask if Foot Locker's operating margins have peaked.

We believe Foot Locker can increase both its top-line and operating margins by growing its sales per gross square foot. Increasing sales/sq. ft. not only involves opening new stores each year, but it also means shutting down unproductive stores. Foot Locker's sales/sq. ft. has grown steadily over the last 5 years, but momentum seems to have slowed down last year at a 3% y/y growth rate (see Figure 3). This may explain why operating margins have flattened out this year.

FIGURE 3: Sales per Gross Square Foot and Y/Y Growth



Source: Foot Locker, Inc.

At the 3Q16 earnings call, management announced plans for managing its retail store profile which currently numbers ~3,400 stores worldwide. While the ratio of net store openings to closing will largely be a wash this year, the plan for next year is to be a few doors bigger. This means that as existing stores are closed or re-modeled, new stores will be opened or relocated to take on more square footage.

So, even with door closures, there will still be growth in square footage, which has been the consistent trend over the past few years and will be expected to continue. We believe this strategy makes sense since bigger stores increase operating capacity (more shelf space, bigger storage backrooms) which in turn increases allocation of premium brand sneakers from Adidas, Nike, etc. leading to higher productivity for each store as measured by their sales per gross square foot.

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