Stock Pick of the Week: Foot Locker, Inc. (FL)

While it's true that retail businesses have had a rough time of late, certain businesses in growing markets are still thriving. This is exactly the case with this week's Stock Pick of the Week. With the rise of the "athleisure" style, companies selling athletic clothing and sneakers are positioned to profit in the coming year. This week, we've singled out one of the strongest retailers in this subsector: This week's stock pick of the week is Foot Locker, Inc. (FL).

What is Foot Locker?

Foot Locker is an athletic shoe and apparel retailer operating in two segments: Athletic Stores and Direct-to-Customers. The Athletic Stores segment refers to all of Foot Locker's physical store locations across the globe. At the end of January 2015, Foot Locker operated over 3,400 stores under names such as Foot Locker, Champs Sports, Lady Foot Locker, and Kids Food Locker. The Direct-to-Consumer segment is comprised of Foot Locker's stable of Internet websites selling even more athletic apparel and equipment. These websites consist of footlocker.com, eastbay.com, and final-score.com to name a few. In 2015, the Athletic Stores segment made up 88% of revenues with the Direct-to-Consumer comprising the remaining 12%.

Why Invest Now?

While FL is up 13% so far this year, we think the stock's run is far from over. Foot Locker's fiscal year 2015 results showed strength in its business that should only continue upon the growth of the athletic shoe and apparel market. As an athletic shoe and apparel retailer, Foot Locker is dependent upon the strength of the consumer. With the NPD Group reporting strong sneaker and active wear sales in 1Q15 across all consumer segments, men's, women's, and children's, Foot Locker could be in a great position to carry its strong fiscal 2015 into this year and beyond.

What About Foot Locker's Underlying Fundamentals?

In fiscal 2015, Foot Locker saw strong revenue growth and impressive after tax profit (NOPAT) growth. Revenues grew 10% over 2015 and NOPAT increased 17% year over year (YoY). This profit growth helped Foot Locker increase its return on invested capital (ROIC) to 10% in 2015. Foot Locker also generated over $409 million in free cash flow in 2015 and had a FCF yield of 4%.

Of particular interest in Foot Locker's 2015 10-K was the revenue growth from Foot Locker's online marketplaces. While representing a relatively small portion of Foot Locker's total revenue, the segment grew sales by 21% YoY in 2015 and 16% YoY in 2014. The growth in online sales is important to all retail companies and Foot Locker's growth within this segment while also growing its physical sales is impressive.

This strong 2015 was not just a one-time event. Over the past five years, Foot Locker has grown NOPAT by 29% compounded annually while increasing its ROIC to 10% from 4% in 2010. The ability to consistently generate greater returns on the capital being deployed into the business is a sign of quality management at Foot Locker and a positive going forward.

We Made These Adjustments to Foot Locker's Operating Profitability and Valuation

We make several key adjustments to the earnings and balance sheets of companies to uncover the recurring cash flows of each company's core business and the value left for shareholders. We made the following adjustments to Foot Locker's earnings in 2015:

- Removed $162 million in implied interest expense due to operating leases.
- Increased tax expense by $55 million due to the removal of non-operating expenses.

When considering Foot Locker's valuation, we also added $2.6 billion in off-balance sheet debt (93% of Foot Locker's debt) from operating leases to Foot Locker's total debt.

The Buying Opportunity is Now

As mentioned earlier, Foot Locker's stock has had a solid 2015 so far and is poised to go even higher. Buying now presents a great opportunity for upside. At its current price of $63/share, FL has a price to economic book value (PEBV) ratio of only 1.3. This ratio implies that the market expects Foot Locker's NOPAT to grow by 30% from current levels over the life of the business. This expectation, while optimistic, is still dwarfed by the fact that Foot Locker has grown NOPAT by almost 30% compounded annually since 2010. Given that the market in which Foot Locker operates is rapidly expanding, this expectation fails to recognize that Foot Locker is best positioned to capitalize on this growth with robust physical and online sales outlets.

If Foot Locker can grow NOPAT by just 9% compounded annually for the next seven years, the stock is worth $78/share today — a 24% upside.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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