Investors' Chronicle | Alpha

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Alpha shares analysis

15 November 2024

Strong macro is not always well reflected

Both stocks this week operate in structural growth market backdrops, but both face issues that are bearing on their ratings. While caution on hardware player Calnex feels well supported, the valuation of JD Sports seems to be pricing too much risk and a re-rating, not necessarily imminent, is overdue.

- **Calnex Solutions (Aim:CLX)** – Calnex is a hardware and software business that allows network operators and applications providers to pre-test and monitor their internet-based traffic. Customers materially over-ordered new equipment in 2020/2021, leading to an order drought in 2022/2023. The resulting drop in revenues collided with higher operational costs and profits dropped to zero. Long-term demand for such network equipment is strong and multi-faceted, but is it hard to predict the pace and timing of improving demand for Calnex. However, when it does that, operational gearing swings back in its favour. When this occurs remains unclear and is made more difficult as Calnex has split from its leading distributor (Spirent) who drove 70 per cent of sales and Spirent itself has since been acquired by one of Calnex's rivals. Wait long enough and Calnex should see a geared rebound in EPS, but there are too many 'what ifs'.

- **JD Sports Fashion (JD)** – JD is a leading global player in the sports fashion or 'athleisure' retail markets. Having been one of the market's strongest performing stocks after the global financial crisis (GFC), the last five years have seen this ambitious and well run stock slump to a single-digit PE and negative total shareholder return (TSR) of almost 20 per cent. Investors might want to be cautious but solid market undertows in 'athleisure' clothing, strong internal drives for operational improvements, ample scope for further acquisitions (other than in the UK) and a solid drive for organic growth all argue against a rating that seems to indicate risk and disappointment. The current PE (less than 8x estimated earnings for the financial year ending January 2026) is close to half that of sector favourite **Next (NXT)**, half the level the stock traded on for much of the last 15 years and misaligned with forecast double-digit earnings per share (EPS) growth.

Analyst: **Robin Hardy**

Calnex Solutions (Aim: CLX) – cheap but many important 'what ifs'

Source: FactSet

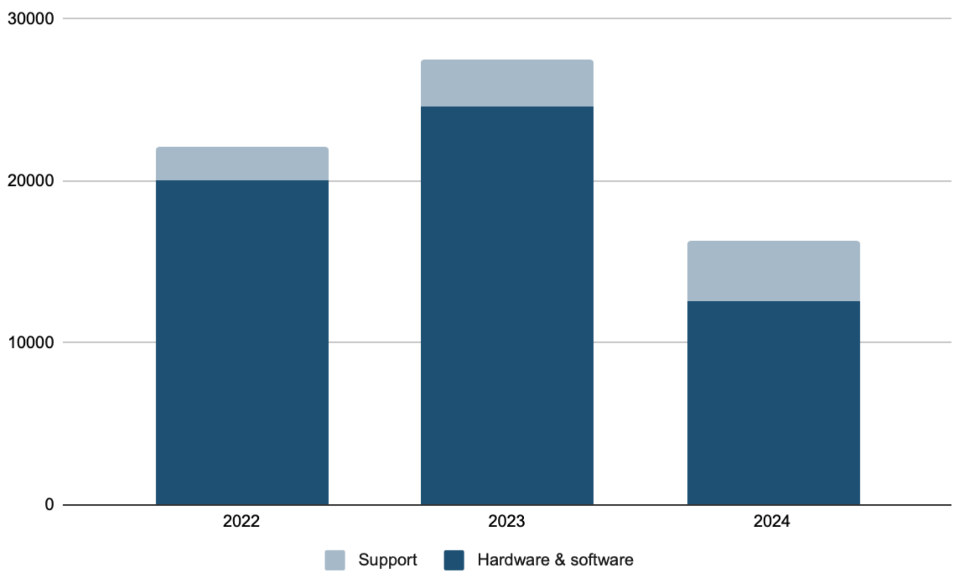
Calnex Solutions (Aim: CLX) is a £55mn market cap, Aim-traded telecoms testing equipment business that was floated towards the end of 2020. This is an electronics hardware business that builds standard and bespoked equipment for performance validation on fixed line and wireless communications systems. It boasts almost 700 customers, including network operators, full system equipment vendors, component suppliers, hyperscale enterprises and private cloud networks. Revenues had been in the high £20mn range, but in the last financial year (March 2024) this dropped to £16mn and earnings before interest and tax (EBIT) slipped to a small from being above £7mn previously to a small loss. Gross margins were stable in the mid-70s per cent – this margin level reflects very high gross margins for software (above 90 per cent) and a much lower level (estimated at 30-40 per cent) for hardware. The reason for the fall was the general slump in customers' capex spend on network and location equipment which also weighed on competitors such as Keysight, Spirent, Viavi, Nokia and Ericsson .

As the chart above shows, Calnex' share price performance has been weak in line with the tough trading environment, with the price dropping more than 75 per cent through 2023. After some recovery today the share price sits 30 per cent off the early 2023 all-time high. This leaves a five-year TSR of just 11 per cent or an annualised rate of just 2 per cent.

Trading recovery is forecast (albeit with just two analysts making forecasts) in a classically bullish V-shaped rebound that sees revenues up approximately 40 per cent from the 2024 baseline by

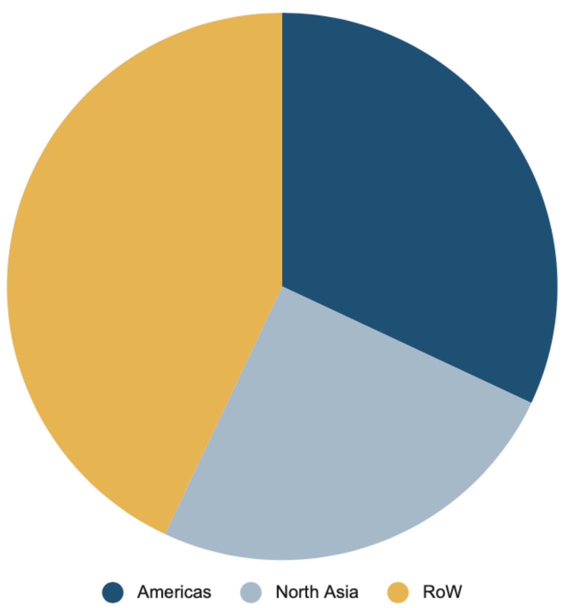
2027, with EBIT swinging around from negative £600,000 to positive £1.8mn. Last reported EPS were zero and for 2027 the single forecaster has 1.8p pencilled in. Despite the depressed level of EPS, a dividend of 1p is forecast. Even after heavy cash outflow last year, Calnex still held around £12mn of net cash.

Revenue by activity – £000



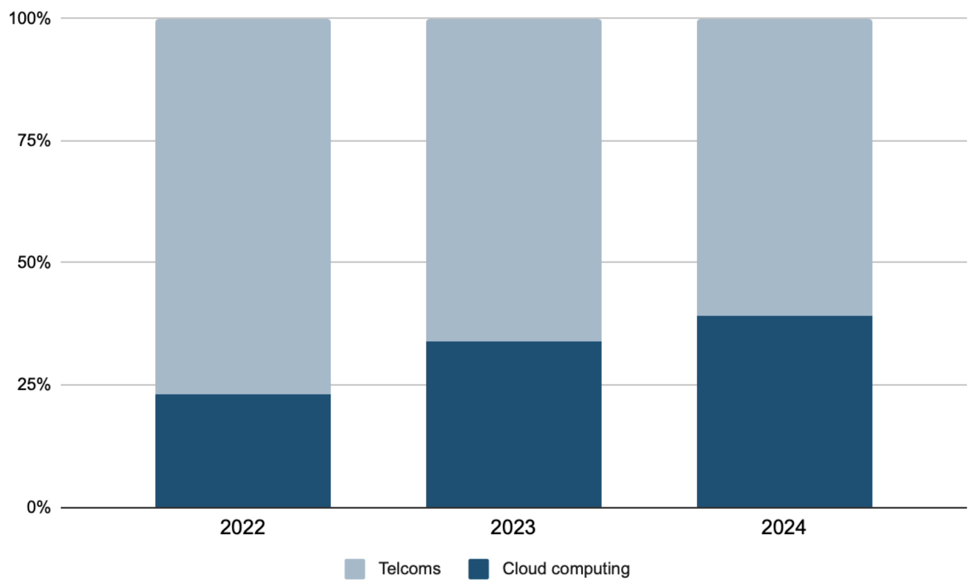
Source: Calnex

Geographic source of new orders – three-year average



Source: Calnex | North Asia = China, Japan, Mongolia, South Korea & parts of Russia

Orders by end market network type



Source: Calnex

Calnex delivers orders across four main product lines:

Lab Sync – network/field emulation equipment to allow lab testing of the timing synchronisation of packetised data streams. This line, under the Paragon brand, was the most heavily impacted by last year's spending cuts as new product and network rollouts by telcos and cloud operators were deferred. This test equipment allows installations to be certified compliant with the internationally recognised ITU-U and O-RAN standards and is not used in live networks.

Network Sync – this is testing equipment used in the field to check that all data is synchronised between endpoint devices to ensure that data sent is identical to data received. This can be data between an office and cloud-based Software as a Service (SaaS) or voice traffic across a mobile network. Data is not sent as a continuous stream (as in analogue networks), but is instead 'packetised' or chopped up and sent not always along the same path. The job of syncing systems is to reassemble correctly that which was chopped up. There are different systems for telco networks for data centres or cloud installations with mobile testing and rack-installed variants. This was more stable in 2024 benefiting from recurring licence fees, support revenues and upgrades/replacement in already operating installations.

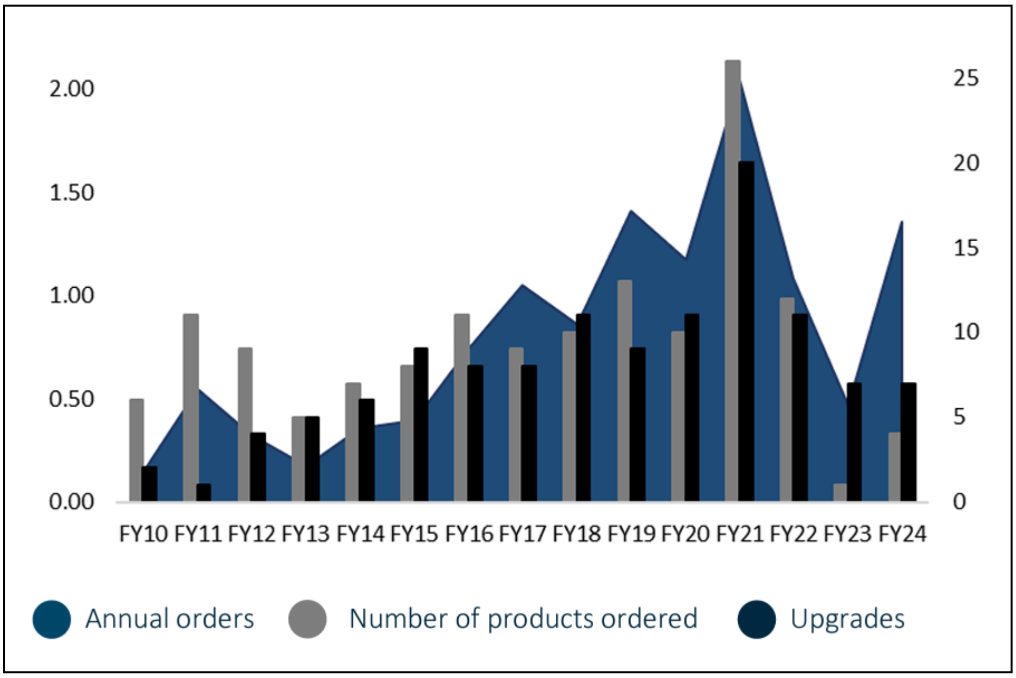
NAA or Network & Application Assurance (Infrastructure) – back into the lab and pre-testing environment, these are devices and software that emulate or synthesise network traffic across a wide range of protocols (e.g. 5G, Cloud, Broadcast & streamed video, online gaming, corporate data, cloud migrations, mobile voice or electrical grid monitoring) to test physical infrastructure. As with Lab Synch, lower network rollout and other capex saw orders fall away sharply, especially in the US which is the key market for this division.

NAA (Applications) – this allows networked or cloud-based software to be tested using synthesised traffic. This has been more robust recently as while physical network investment had run ahead of itself, development of online and/or cloud software has continued to expand. This was the only area in which revenues grew in 2024. Demand here is also supported by exposure to the robust defence and satellite communications sectors.

Analysis

Calnex had a tough year in FY2024 (mainly calendar 2023) following falling orders in calendar 2021 and 2022, although at the time the latter felt more like a normalisation after the investment excesses across the technology sector in 2020 and early 2021. FY2022 had looked like a return to trend growth with orders higher than they had been secured in FY2020, but it was actually the start of a sizable spending hiatus, especially in the US and China, that is still impacting today.

Example investment/ordering profile for a telco customer



Source: Calnex

Operational gearing

Calnex is a classic high operational gearing business, meaning its profits are highly sensitive to movements in revenue. Presently, it has a high gross but low net income with high and relatively fixed operating and other core costs (see table below). Analysts typically look at operationally geared businesses from a favourable bent with steep increases in profits arising from moderate top line growth. However, operational gearing works the same in reverse, with moderate revenue decline cascading through to significant profits drops as Calnex has exhibited.

While there was a collapse in net profits, it is significant that gross margins remained intact, showing that despite the fall in demand, Calnex did lean further into the slump by lowering its prices to attempt to defend sales – that is bad business because price cuts can prove hard to shift once demand returns.

Calnex's 2023 and 2024 income statements

	2024	2023	Delta
Revenue	16,274	27,449	-41%
Cost of sales	(4,327)	(6,977)	-38%
Gross Profit	11,947	20,472	-42%
Other income	797	751	6%
Administrative expenses	**(8,884)**	**(9,928)**	**-11%**
EBITDA	3,860	11,295	-66%
Amortisation of development costs	**(3,780)**	**(3,315)**	**14%**
Underlying EBITDA	80	7,980	-99%
Other depreciation & amortisation	**(697)**	**(746)**	**-7%**
Operating Profit	(617)	7,234	-109%
Finance expense	357	(26)	-1473%
Interest received	(124)	0	N/A
Profit before tax	(384)	7,208	-105%
Tax	424	(1,297)	-133%
Profit for the period	40	5,911	-99%
Stubborn costs	(13,361)	(13,989)	
As percentage of revenue	82.10%	50.96%	

Source: Calnex

Macro

Calnex's issues in 2023 and 2024 were pretty much all due to the macro environment. Network operators purchased too much kit and had little need to order again in 2022 or 2023. This was true for both investment in new installations and repair/upgrade spending.

This demand slump is a timing issue with a period of short, but intense excess followed by a hiatus before the reality that spending on network equipment will have to resume its long-term growth trend. This is because the key drivers of change in commerce, public sector and defence are all still very much present. There are a number of core areas that can be expected to restore demand for the type of equipment sold by Calnex.

AI and ML – while it's easy to become weary hearing about artificial intelligence (AI) and machine learning (ML), these are major developments in commercial systems that are set to take over many core, mundane and repetitive business processes.

There will need to be many more data centres, greater interconnection and interoperability of these installations and substantially greater communications speeds.

5G – today's 5G networks are a pale imitation of what is possible and likely going forwards for high speed wireless communications. Today, 5G is little more than a 4G+ offering and operator networks will need to make materially greater investment to unlock the true potential of 5G. For example, the average UK 5G connection today is 124Mbps down and 15Mbps up, whereas the nominal maximum across the 5G spectrum is 20Gbps or 20,000Mbps down and 10Gbps or 10,000Mbps up. This will drive demand for both infrastructures' and applications' testing to run at much higher speeds.

Digital transformation – businesses and public bodies globally are undertaking rapid digital transformation (DX), moving manual processes and storage to digital formats, often cloud-based. Spending on DX is growing at 16 per cent per annum and between 2022 and 2027 will double to almost $4tn globally. Testing and emulation are a key part of any DX process as no organisation can afford to fail in the public arena and all data movements need to be of an assured quality, especially with sensitive (e.g. medical) or financial data.

XaaS (Everything as a Service) – there are still many processes that run on locally installed, licenced, 'boxed' software. Increasingly holders of the IP in these tools are moving to cloud-based models and this space is expected to grow at a 22 per cent compound rate through to 2030. Before making the shift to an XaaS, exhaustive testing and emulation is a vital element.

IoT (Internet of Things) – it is estimated that today 18 billion internet connected devices (distinct from phones and computers) are in operation and will grow at 10 per cent compound. Often seen as inherently insecure, standards for security should harden over time and this will require higher levels of testing and conformity assurance.

Evolving network standards and conformity – network standards for fixed and wireless networks are constantly evolving – for example, a big shift today in wireless networks is to adopt the O-RAN or Open Radio Access Network. This moves operators to open rather closed or manufacturer specific hardware and software. This is a major rollout and requires exponentially more testing and emulation complexity than existing network configurations. Calnex's Lab Synch systems are focused on O-RAN.

Fast internet – today the great bulk of the internet 'backbone' runs on 100 gigabit ethernet, but upgrades are in hand to push this to 400 or 800 gigabit, with China testing 1,200 gigabit. This too will require substantial, additional testing and emulation for cloud providers, data centres, large enterprises, network hardware manufacturers and chipset producers.

Non-terrestrial – in addition to the long-standing terrestrial internet and wireless communication networks, rapid growth is expected in non-terrestrial networks. There is growing demand for better remote communications access using low earth orbit (LEO) satellites especially if autonomous cars are to ever become a reality. Also, more capacity is needed in Positioning, Navigation and Timing (PNT) networks and steep increases in the use of Unmanned Aerial Vehicles (UAV) for military and freight are expected. All of these will need robust testing and emulation.

While the spike and slump in new product orders may take a while to unwind, and the impact of the recent decision to drop Spirent as its main distributor after it agreed to be acquired by Calnex rival Keysight (Spirent is reckoned to have driven over 70 per cent of the group's sales) is yet to play out, the macro position long-term still looks pretty bullish. The drive for faster, more wireless and more cloud-based data access and use is only going to become more substantial and demanding on those providing the services.

While businesses like Calnex are one step back from the actual delivery of services, they are early-cycle players and are removed from the typically more arduous tasks of deploying and operating the new technologies. This gives Calnex something of a 'picks and shovels' business profile, making money from others actually playing the game whether they emerge as a winner or loser. Typically that is an attractive market spot to occupy.

Conclusions

This is a tough business to evaluate. It is pretty easy to see what kind of PE the stock might trade on, based on the valuation of the three players involved in the battle for **Spirent Communications (SPT)**. The bidders, **Keysight Technologies (US:KEYS)**and **Viavi Solutions (US:VIAV)**, are EACH trading on a PE of around 23-24x and Spirent is on a slightly higher multiple over 25x.

The problem in comparing Calnex is working out a meaningful figure for Calnex' earnings - the 'E' in PE - so that we can back out the target 'P'. Calnex is a business with much smaller revenues than Spirent, Viavi or Keysight (in the ball park of being 18x, 50x and 250x smaller, respectively). It also has less of a track record as a quoted business and has a smaller core of customers tied into replacement/upgrade cycles using its equipment. We cannot be sure how long the impact of the drop-in orders will last, whether those customers will come back to Calnex or might move to a competitor, and what the impact will be of breaking its distribution partnership with Spirent. (Spirent will doubtless be under pressure to sell more Keysight products). The macro environment has a strong outlook and it is highly likely that Calnex will see a rebound in orders, but when and to what extent is yet to be seen.

If we start with what level of revenue is needed to underpin the current 60p share price, based on a PE in the range 22-24x – that implies EPS of around 2.5p. Using the operational gearing now in a positive direction, we can estimate this level of EPS can be achieved with revenue running back up to £21.5mn (£16mn last year and £22mn in FY2023). So if we can see revenue re-building beyond that level, there would be higher EPS and support for a higher share price than today. If all of the stars align, revenues after 2025 could begin to advance in line with underlying market growth and climb well above this £21.5mn, but as you can see there are vast assumptions made.

It's not beyond the realms of possibility that investors in Calnex could make solid returns over time, but there are many more stocks where investors could do well without such a high degree of uncertainty. With Calnex there are just too many ifs and what ifs.

JD Sports Fashion (JD) – discounting too much risk

Source: FactSet

JD Sports (JD) is one of the world's largest sports/fashion apparel and equipment retailers generating around £10bn of revenues annually, historically split relatively evenly between the UK and Ireland, Europe and the United States. EBIT is around £1bn. The US is, through a series of foundational acquisitions, moving to the fore and in future will generate more than a 40 per cent share. Although the chart above may not suggest it, JD has delivered significant return for investors since the end of the global financial crisis (GFC), making a 27-fold return, although this was all pre-Covid. In the last five years total shareholder return (TSR) has been negative 20 per cent. The shares have almost halved since their all-time high at the end of 2021. The market cap is around £6.5bn, which on size leaves the shares ranked in the third quartile of the FTSE 100 index.

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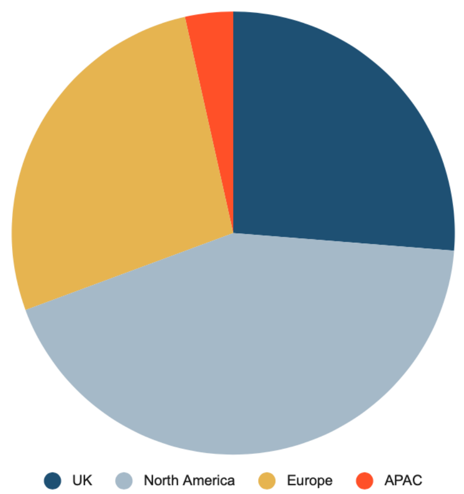
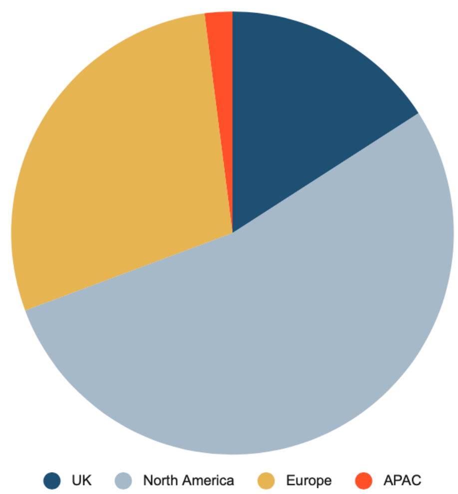
Operations
The business is best analysed in the three ways shown in the following pie charts:

Sales by geography

Revenues *	**Stores ***
	

Source: JD Sports | * Pro-forma for the July 2024 Hibbett acquisition

The geographic split has seen dramatic change with the US expanding rapidly by acquisition. Prior to 2018 the group had no presence in the US, but in that year it acquired the ailing Finish Line, many of whose 550 initial outlets have rebranded as JD. Then followed Shoe Palace in 2020 with 167 outlets, DTLR in 2021 with 240 outlets and most recently Hibbetts + City Gear in summer 2024, bringing in close to 1,700 outlets. From less than £1bn of sales in FY2019 (only a half-year's contribution from Finish Line) to today's pro-forma full-year sales of around £5bn.

The original core of the group was in the UK, but this is a pretty mature market and does not have quite the same new launch and shorter replace/renew cycle that is still a key factor in the US. In the UK, JD is also heavily constrained by its large market share of the 'sports–inspired casual footwear and apparel' sector (distinct from sports participations where SportsDirect dominates), which was evidenced by the competition authorities' decision to force JD to divest Footasylum (bought in 2019) in 2022. In addition to sports clothing or 'athleisure', the portmanteau by which the group's sector is known, JD owns Blacks, Millets and GoOutdoors, which sell clothing, footwear and equipment for active outdoor pursuits (camping, hiking, running, fishing, cycling, riding, climbing, skiing, swimming and aquasports). As with the US expansion, a greater part of the expansion in this home market was made through wholesale acquisitions of existing chains. Today there are around 430 JD outlets and 240 outdoor branded stores.

In Europe, JD operates in 25 countries, mostly by acquisitions starting in France in 2009, and now operates over 1,250 outlets. The largest operation is in Spain which accounts for a quarter of all sites, followed by Poland at approximately 22 per cent (until 2024 JD only controlled 60 per cent of this business) then France, Germany, Portugal, Greece and Italy. JD does not face the same overall competition issues as in the UK, but is getting closer to the size of market leader Decathlon, which runs around 1,700 outlets, and Intersport with a similar footprint. Retail hypermarkets also control a material share of this market and many US brands operate in larger cities across the continent. This means that JD has greater room to expand in America.

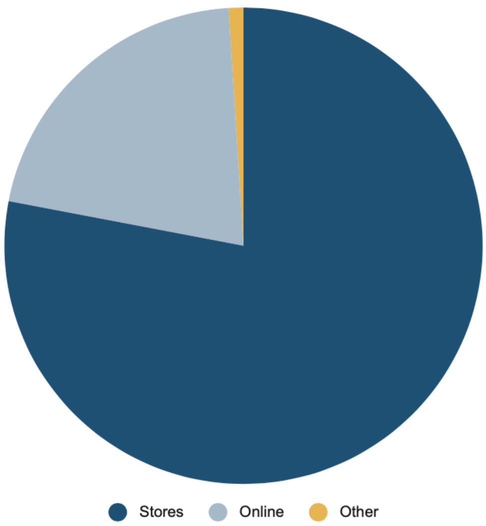
The Asia Pacific market is a small adjunct to the group with around 90-100 outlets in Australia, Singapore and Thailand, with Australia the primary focus. There are plans, across medium to long term, to quadruple the scale of this operation mostly by organic openings.

Analysis

JD has had a shaky two to three years with a series of market issues, supplier problems and setbacks:

- Being a business with a bias towards in-person sales, Covid wrought substantial damage to the sales base highlighting an under-invested online presence.
- The enlarged exposure to the US collided with the economic boost and then the slump brought about by stimulus checks after Covid.

Sales by channel



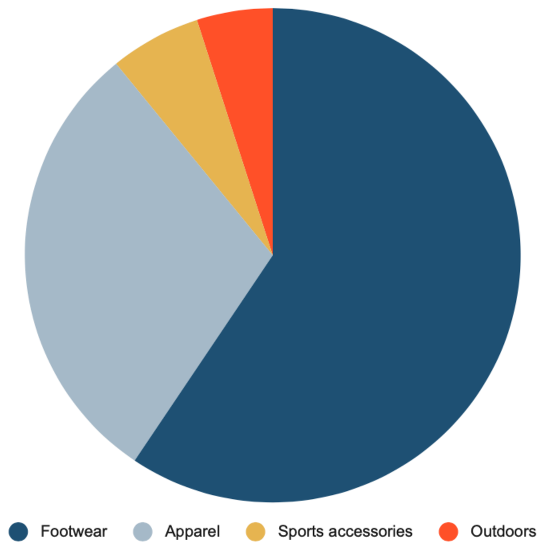
Source: JD Sports

- JD is proving a victim of global warming with the once well-established seasonal buying patterns increasingly thrown into chaos by both unseasonably hot and cold weather plus exceptionally wet weather in Europe in the last two years.
- There have been major supply chain issues first with Covid and then with the Red Sea route issues bringing finished products in from SE Asia.

- The group's high bias towards Nike products (c. 50 per cent globally and 70 per cent in the US) saw JD catch a cold when this manufacturer seemed to lose a lot of its mojo in 2023. Retailers saw new launches flagging and the long-standing stalwart 'Jordan' range started to mark time.

- In 2022 and 2023, Nike and other brands decided to increasingly cut out retailers and sell more products directly to their buyers. While this failed, and retailers (and especially JD) are back in the driving seat, there was a great deal of turbulence.

Sales by product category



Source: JD Sports

- The group's UK business was effectively cut off at the knees in 2022 by the Footasylum ruling that, in effect, banned it from making any further acquisitions in the sports/leisure segment.

- A strong pound (now reversing) especially against the US dollar was becoming a drag on translated earnings from the increasingly dominant US operations.

- Brands with which JD was less well positioned (Adidas and its 'terrace' or retro range, Hoka, OnCloud and New Balance) have been growing materially faster than JD's core partner Nike.

On top of these specifics came a nagging concern that the long run resilience of the sports leisure market and the wider 'athleisure' boom might succumb to the growing pressure on consumers' wallets. A profit warning in early 2024, arising from a weaker than hoped Christmas plus early discounting, not only saw actual profit guidance from the board lowered but concerns began to form that potentially JD had over-expanded in the US.

Tariff trauma?

That expansion in the US now potentially collides with what threatens to be a key plank of president-elect Trump's economic policy for the second term – tariffs. Almost all fashion and 'athleisure' items are made outside the US and a considerable amount comes from potential harsh-tariff targets Mexico and China, with much of the rest coming from regions where the surcharge could possibly be 10 to 20 per cent.

It is still about as unclear as it can be how US tariff policies will come into play or be enacted. If introduced, would they last once the true inflationary impact becomes apparent? We should at least be concerned about higher feed through costs but how much impact would there be at the till? JD's US gross margins are around 50 per cent meaning that the landed cost of an offshored $100 trainer or hoodie would be $50 and it is to this that the tariff is applied. The rest of the costs and the profits are generated within the US. So, a 20 per cent tariff becomes a 10 per cent price bump and so on. Still unhelpful but less of a bite.

The question then is how well would demand stand up to such an increase in price? Perhaps better than one might fear. Analysts believe that demand in the sport/leisure market is relatively inelastic and the basis for this is seemingly relentless pressure on costs (primarily raw materials and distribution costs) in the last five years have had relatively little impact on demand. To be fair, these have been gradual and tariff imposition would be more sudden, which would suggest a greater impact.

This is likely to be an issue that will overhang many US businesses or subsidiaries until the policies in this area are set (or not). For JD, the market seems more likely (for now) to take a glass half empty view and this keeps some downward pressure on the rating.

In practice, however, any impact on demand from tariffs might be hard to spot at JD. There is still an aggressive internal expansion and improvement programme across the group, benefits to be pulled through from better supply chain and warehousing, synergies to be extracted across the US from the large business network, stronger buying terms as the business grows and scope for either more substantial or infill acquisitions in the US, Europe and Asia-Pacific.

Tariff dilution

	Current	20% tariff
Wholesale	$50	$60
Overhead	$38	$38
Margin	$12	$12
Retail	$100	$110

Source: Investors' Chronicle

Triple double

Two years ago the then new management embarked on a new strategy known as the 'triple double'. This is a programme (still with three of five years to run) with three pillars. The first is to deliver a double-digit compound annual growth rate (CAGR) in revenues (today the underlying growth rate is close to 7 per cent before adjusting for external factors such as weather or FX headwinds). The second, is to push EBIT margins into double digits (they are now around 9-9.5 per cent). The third objective is to ensure a double-digit percentage market share in all regions (JD already has this in the UK, Ireland and Australia, is close in Spain and it is making progress in the US, climbing from 2 to 3.5 per cent of national store count after the Hibbett deal).

Running in the background

Driving the top line is always important, but it is equally important to work in the background to see that growth drop through to profit, and JD is busy working on its costs and efficiencies in often less visible ways.

There is a lot of work being done to improve distribution and warehousing. There was a major project for Europe in Holland and, with a large national footprint in the US now, too, there is ample scope for greater resource sharing and efficiency in stock management and stock movement. JD is also working hard (alone and with brands) on making better loyalty programmes across the network and is working to bring the 'JD Status' programme into its European operations (loyalty schemes can bump retailers' growth rates by 10-15 per cent). JD wants to improve its 'omnichannel' offering and is relaunching its e-commerce platform and the underlying IT platform (for stores and online).

There is also ongoing portfolio management with over 30 companies/brands sold off in the last two years (half to Frasers in a single deal) with the proceeds ploughed back into growing the core business. The focus, broadly, is to skew the offering more towards fashion with less focus on sport. This could, in time, mean getting rid of the Outdoors operations which are a sizable drag on returns – 5 per cent of sales but only 1-2 per cent of EBIT, although the aggressive US expansion has steadily de-emphasized this arm of the group.

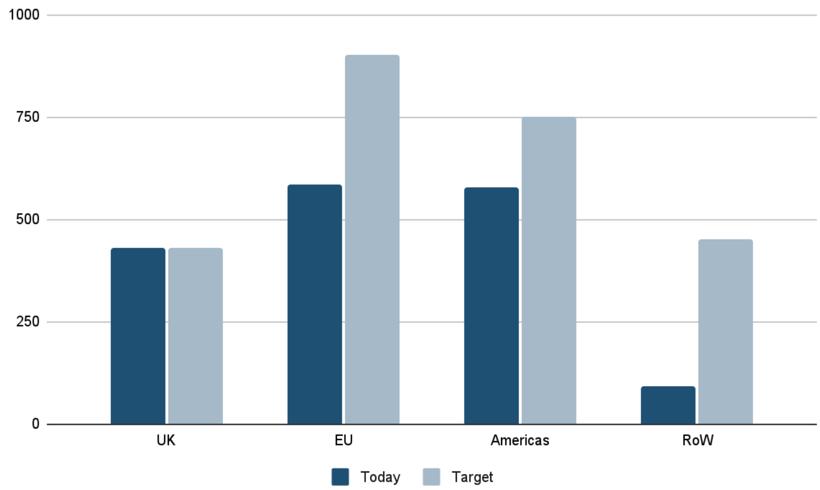
Still driving organic growth

While JD has a long and storied history of growing by acquisition, it does feel as if it will be harder to deliver this as well in future. The UK market is, in effect, closed; Europe would be hard work and in the US much of the low hanging fruit has now been picked. Does that mean much slower growth in future? No, because there is still a great deal of organic growth potential with JD still opening around 200-225 stores each year, and that is just in the JD branded stores. The company plans to grow its JD-branded estate by around 50 per cent and on the current trend, this could be possible in as little as five years. Beyond this, today there are many 'complementary concepts' or other brands in the portfolio where there is also scope for organic openings.

On top of totally new openings there is an ongoing programme of refresh, re-location and brand swapping. These tactics have long been proven to bring comfortably double digit sales improvements out of a tired location. This looks to have a lot of potential in Europe where margins are still lagging the rest of the group (approximately 4 per cent vs 9 per cent in the UK and 12 per cent USA), although a lot of the pressure in Europe is from aggressive pricing by the competition. However, this appears to be ameliorating.

All told, there looks still to be a great deal of organic growth potential across the business. That is still very well supported by a healthy underlying rate of market growth, albeit that's something some observers have begun to question.

Organic growth of JD branded stores



Source: JD Sports

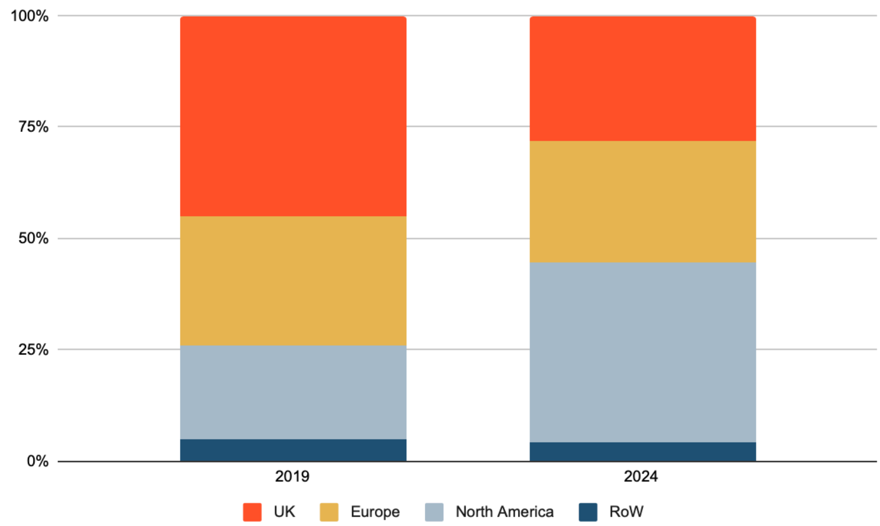
Athleisure undertow – still a growth market

There is always a fear that the sports fashion or 'athleisure' markets might prove to have been just a fad and could easily slip away – ask Dr Martens about their experience. JD argues that these markets are actually not fads but areas of structural growth, and that is significant. Market research agrees with JD's position and Grand View Research suggests that between 2023 and 2030 this market will grow globally at a compound annual rate of around 9.5 per cent. Factors such as good income growth for younger buyers, wider adoption of very casual clothing by older generations, working from home, greater emphasis on health/exercise, greater social acceptance of more casual clothing and harder work by brands to blur the edges between formal and informal clothing to make casual clothing more acceptable. That could be a recipe for structural growth.

US or Europe to give faster growth?

JD has taken a large bet on the US market in the last five years, but is this a sound decision? The US remains by far the largest single athleisure market accounting for an estimated 28 per cent of the global total, a little more than its share of global GDP. But is it the fastest growing market? Probably not with Europe around half the size of the US economy, but selling over 20 per cent of the leisure clothing sales achieved in the US. Europe is forecast to begin playing catch-up and is likely to grow faster than the US. Has JD made a bad call here? Not really as it has been able to buy large blocks of market share in only a few transactions which would have been much harder in the EU. Growth on paper might have been better with a European skew, but it would have been dramatically harder and slower to deliver. JD does have a large European footprint, so it is hardly going to miss out.

A big bet on the US



Source: JD Sports

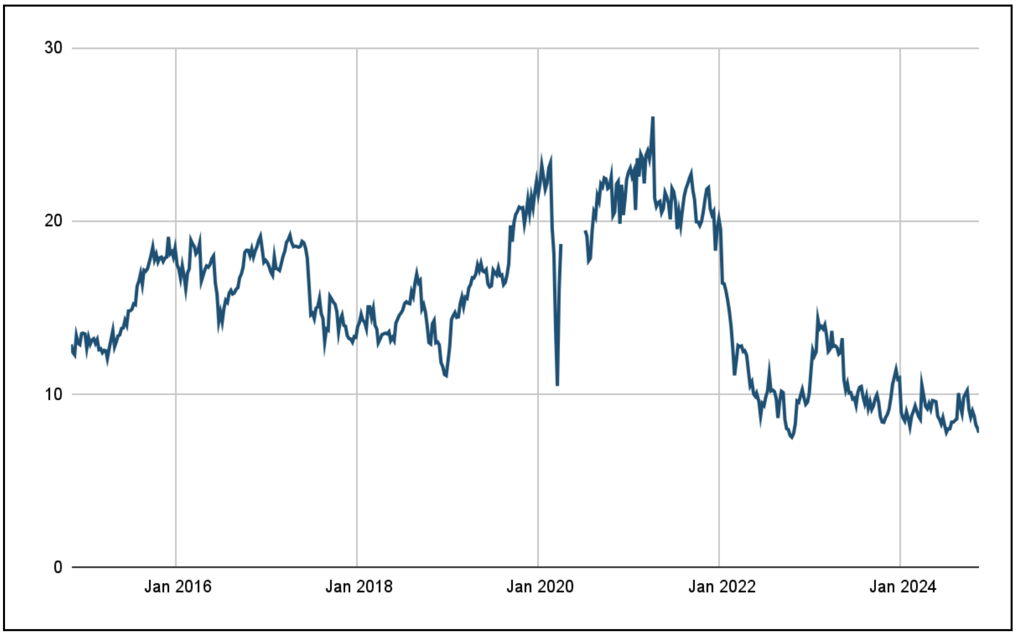
Conclusions

JD has been a rough ride for shareholders but has the de-rating been overdone? It is always hard when a stock market 'darling' suffers a misstep and that is really what was seen here. Coupled with perhaps some disquiet about UK growth flatlining with limited scope to acquire in this market, the near breakneck pace of the expansion into the US and potential effects of mooted tariffs. However, the main hits to the business in the last 12-18 months have been largely external, such as the weather or actions of a third party knocking JD a little sideways. These sorts of factors are not really structural and investors can 'look through' them and focus on what is happening with core growth. There JD continues to do well.

US expansion has been rapid but the businesses acquired have been better as time progressed and achieving a national footprint with more critical mass is likely to materially improve the quality of the US earnings. The future of tariffs is potentially an issue, but it is hard to see enough of a dent that would significantly lower growth, let alone make a sizable hole in the overall profits.

Growth looks good with the consensus suggesting EPS progress in the low teens percent range across the next three years, with a low start this year at around 8 per cent and then an average of 15 per cent for 2025 and 2026 calendar years (reported at FY2026 and FY2027 due to a January year-end). That does not really square fundamentally with a year 2 (FY2026) PE of less than 8x, and under 7x a year later. As the chart below shows, before Covid JD would trade at twice that level (although higher interest rates in the past two years have altered valuation assumptions).

JD Sports' Year 2 PE ratio – last 10 years



Source: FactSet

There is a great deal of risk being priced in, but objectively, the main possible problem areas are tariffs and more unfavourable externalities such as the weather. While JD has more strategy and execution risk than sector favourites such as **Next (NXT)** and **Marks and Spencer (MKS)**, the ratings gap for JD against these shares (particularly Next) is arguably too wide.

A very bullish view might be to argue that JD could restore its previous rating levels and trade a lot closer to Next thanks to superior growth. That is a little too much of a stretch for investors to swallow right now. However, a double-digit PE is plausible and even moving to a 10x Year 2 PE would spell potential upside of almost 30 per cent - going beyond that and matching Next's rating would mean JD close to doubling its share price.

JD is looking strategically and operationally robust and investors really need to look through factors which the group cannot control and value core growth driven by a solid and very achievable operating strategy. JD is looking substantially oversold and while the market is likely to wait to see how the winter and Christmas spending play out, there are strong grounds for a material re-rating over the next 12-18 months and room for a very comfortable double-digit total return.

ISSN 0261-3115.