Investors' Chronicle | Alpha

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Alpha shares analysis

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Billion dollar question? Answer: triple, double!

JD Sports has unveiled a new operating strategy, dubbed the 'Triple Double' by its new CEO. The burning question ahead of the Capital Markets Day (CMD) was what the board intended to do with the more than £1.5bn that was sitting idle on the balance sheet. The answer is investment to drive faster growth: exactly what investors should crave.

Analyst: **Robin Hardy**

JD Sports Fashion (JD.) – the wheels seem reattached to the wagon

Source: FactSet

JD Sports Fashion (JD. Our original plan was simply to revisit our [analysis on JD from late 2021] to see if the concerns we then had about share price performance, primarily because of Covid and rising inflation, were overcome. While we expected to see cheaper buying opportunities ahead, we did not foresee the seas of woes that beset the stock and sector: major supply chain pressures, wholesale management change, war in Europe, acute personal spending pressures and far higher inflation. And we did not expect the shares to collapse by more than 60 per cent.

The wheels now seem to be very firmly re-attached to the wagon, new management is going down well with investors, recent trading statements show much stronger momentum and the decision to push harder for growth is another positive step. There are still a number of things not quite right with the existing business, but we now see the fixes that should bump up returns. The combination of higher growth and the addressing of the operating issues specific to JD argues robustly for a re-rating.

The story looks very positive and even though investors may have missed the very best opportunity to buy (87p in mid-October) there is still ample scope to solidly double-digit total shareholder return (TSR) from here, perhaps even as high as the returns JD delivered before Covid when TSR ran at more than 40 per cent per annum.

A lot happened in the months that followed our last report - both for JD itself and retailers more broadly. Our main concern at the end of 2021 was a fresh wave of Covid and the early signs of inflation and while widespread disruption from Covid did not really materialise, the retailers were instead dealt the rough end of the stick with a multiple hit of input cost inflation, a squeeze on consumer spending and a big dent in consumer confidence. JD managed to add a sizable slice of its own woes on top of the macro difficulties - primarily concerns about its management.

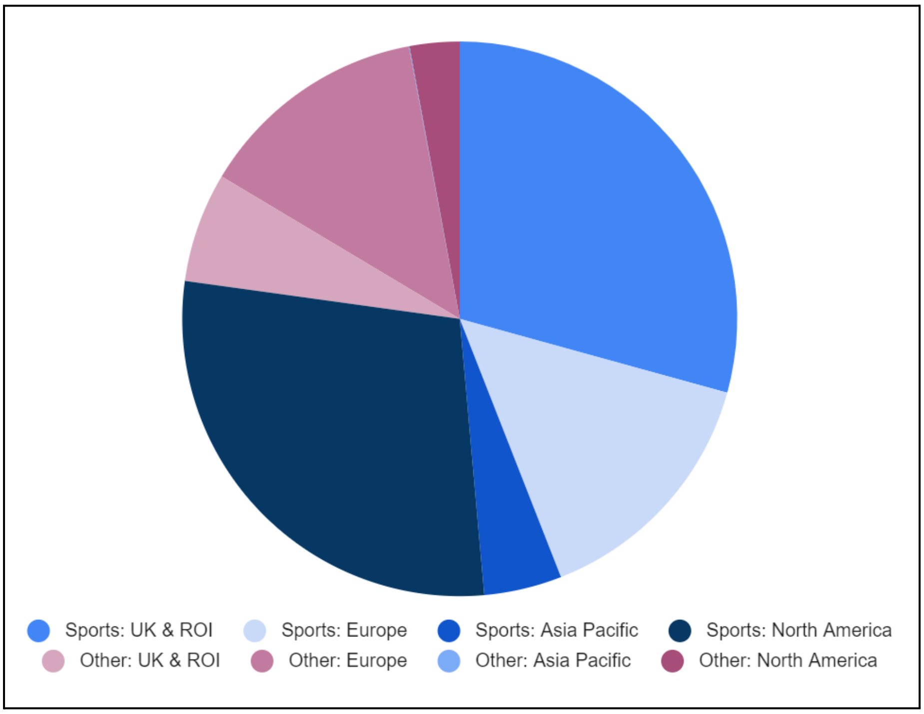
As the chart above shows, the share price fell more than 60 per cent and gave investors the first materially negative total return in more than a decade. Hitherto, JD had been a real stock market darling with the share price rising from an adjusted 2p at the end of the global financial crisis (GFC) in 2009 to 180p just before the start of Covid - an 8,000 per cent rise - in City-speak, an '80 bagger' - giving an average annual total return 44 per cent. That is why 2022 came as such a shock for JD's investors.

Snapshot

JD Sports is a leading retailer of sports footwear and apparel (aimed at the fashion rather than performance end). It's a FTSE 100 constituent with a market capitalisation of £8.5bn and operates a global network of more than 2,400 stores comprising more than 9 million sq.ft of retail space with revenues broadly split as in the chart (next page).

Around three-quarters of sales are in the sports fashion or 'athleisure' segment (including some non-sports brands) with the remainder primarily in outdoor wear and niche sportswear & equipment such as fishing and equestrian. Sports is more profitable, making close to double the margins of the other operations.

JD Sports revenue split - board guidance for FY2023



Source: JD Sports Fashion

JD has always been a highly acquisitive business and this has helped in the explosive growth seen in the last decade. From 2011 to 2021, revenues increased 8-fold and earnings before interest, tax, depreciation and amortisation (Ebitda) - the most helpful measure because there are considerable non-cash adjustments in the headline results (IAS 17 and FRS 16 for those interested in accounting standards' impact) - increased 12½ times. This was reflected in high and sustained total shareholder returns (TSR) which averaged more than40 per cent per annum across this period.

However, the good times came to a juddering halt at the end of 2021. Covid was one issue, but there were also management gyrations and interruptions in the supply chain from major manufacturers, especially in US branded footwear. Momentum does look to have been spun back to positive but growth rates have re-based with sales more recently only showing growth of mid single digit percentages.

A sea of troubles

2022 saw a number of issues for JD on top of wider macro issues and market concerns about the outlook for retailers:

> **Management** - One of the problems that JD had faced in recent years was growing investor dissatisfaction with the combined Chair and CEO, Peter Cowgill.

Eventually he was ousted (at end of May) and the two roles finally split in the middle of the year, ending a sizable drag on the valuation. The new CEO is Régis Schultz, hired from Dubai's Al-Futtaim Group, who comes with a wealth of retail experience, mostly on a global stage from France's Monoprix and the UK's Kingfisher and Castorama. The new Chair is Andy Higginson, latterly of Morrisons but also Woolworths, N Brown, Poundland, Tesco, Burtons, Laura Ashley and Unilever. This constitutes an immense uplift at the top of the group.

Footasylum - the decision by the UK competition authorities (CMA) to force JD to sell its acquired competitor Footasylum became something of a saga and another major drag. Citing too much loss of competition for consumers, the CMA forced the sale of the business acquired in 2019 for £90mn, with the buyer German asset management firm Aurelius Group, picking the business up for just £38mn at the end of July 2022.

Cartel - JD admitted in July to cartel activity along with manufacturer Elite Sports around the supply and pricing of Rangers' replica football shirts. It was fined £1.5mn. While there is no suggestion of anything similar elsewhere, suspicions will inevitably linger in some minds.

Supply chain - most of the world's leisure footwear is made in south-east Asia in the likes of Indonesia, Cambodia, Thailand and Vietnam. These nations suffered from especially draconian lock-down rules that largely prevented vital immigrant workers from re-entering the country. While mainly an issue in 2021, the interruption to the flow of stock hit the first half of 2022. As the market leader, JD took the worst hit especially in the USA where H1-on-H1 profits halved on stock shortages. This was only a temporary setback and had largely recovered by year end but did expose a vulnerability.

Brands' behaviour - Primarily Nike (although some other brands fell in behind) decided that they wanted more control of the downstream end of supply of their products. So, they began to push more of their supply through both their own in-house stores and through direct-to-customer (DTC) channels, primarily nike.com *et al*. This news really rattled the markets as retailers potentially faced a lack of supply from leading brands. Thankfully JD emerged okay from this owing to its very strong market position and the strength of its relationships, long evident through the early releases and exclusive products that Nike gives to JD.

Excess capital

JD is a highly cash generative business with last full year (FY Jan 2022) showing £675mn of free cash flow from around £950mn of pre-tax profit or £1,100mn of Ebitda. Cash on the balance sheet totalled £1.185bn. Profits for the year just ended are also guided to around £1bn but free cash is likely to be a little lower due to higher working capital investment (stock) and heavier capex (mainly stores). Nonetheless, the guided year end cash forecast is c.£1.6bn and before the revised strategy was announced consensus estimate saw this rising to £2.2bn and then £2.7bn.

This much cash sitting idle is unhealthy as it makes next to no return when investment in trading assets returns 8-10 per cent or buying back shares at cycle lows returns even more. Buying stock back at around 100p during Q4 of 2022 could have injected around 15 per cent or more permanently to growth, for example.

This issue has finally been addressed with the decision made to plough the excess cash back (over time) into the business and look to accelerate growth. This is probably the right decision as incremental returns should be in double digit territory and the opportunity to buy back shares is now less advantageous.

So, JD has around £1.5bn to £2bn that it can invest, as it is unlikely to want to take on a material debt position. If it followed the pattern of many other FTSE 100 businesses and took on net debt of 1.5 to 2x Ebitda, that would give the group another £2bn to invest. For what it aims to do (see below on the new strategy), it would struggle to spend £4bn internally and it feels unlikely that JD would be interested in augmenting internal investment with buy-backs just to push up the total capital invested.

There has been a lack of more substantial acquisitions recently (a longer term heavy use of cash), although JD did buy US retailer DTLR in the summer for £360mn, and there remain arguably too few businesses around that fit JD's acquisition criteria (lots of outlets, good locations but with a struggling business model - acquisitions tend to be about presence and the ability to massively improve the premium brand throughput). In any case, buying several businesses of this size and in short order would risk causing a lot of indigestion.

Overall, JD looks likely to retain a neutral to cash positive balance sheet in the near to medium term but with some scope for capital returns towards the later years of the new five-year growth strategy.

New strategy

The new management team has unveiled its new strategic plan for growth. The four pillars are:

1) Conceptually

JD brand first - this involves removing other brands from store fascias and changing more outlets to the pure JD name and branding. The board believes that the JD brand is a much stronger draw for sports fashion shopping than the often more local and regional brands that are more sport than fashion oriented. For example, the largest US business Finish Line has around 700 outlets and DTLR c.250, but pure JD Sports outlets there number less than 100. JD is a sports fashion brand and that is what its brand partners want it to be but most of the other stores' existing footprint feels still too sports oriented. JD feels it can generate more sales through fashion versus sports orientation and given that the big brands want to bring more of the pure sports sales back in-house, this is actually a necessary transition.

Complementary concepts - there are large parts of the core 'athleisure' market and other parts of fashion in which JD feels it can carve out more market share. Its main customers are still those aged 16-24 with a bias towards male shoppers. Without too much dilution or without straying too much towards specialist sports or outdoor wear, there should be decent incremental sales targeting slightly older customers and more women's fashion.

Beyond physical retail - JD already tags itself as an 'omni-channel' retailer, but believes that it can do things much better. It already sells in store and online, manages a lot of its own supply chain/logistics and uses social media as a buying trigger but feels more can be done. Targets include faster delivery (especially in the US), more use of click-and-collect 'kiosks' and the board also believes that brand loyalty can be improved. Buyers are loyal to the product brands, but feel less loyal to JD as their channel. So expect a new approach to build stronger attachment through initiatives like for example loyalty schemes.

JD is already a master of collecting and creating value from dat,a but again thinks that its analytics can be better. There is to be heavy additional investment in the group's operational IT 'engines', better analysis of the group's unstructured 'big data' along with more use of AI and machine learning.

People, partners and communities - a little more touchy-feely than the other areas of the strategy but in 2022 brands did show the retailers that relationships are worth their weight in gold and this allowed JD to stay very much on the right side of brands' channel reallocations. The plan is to put more mileage between JD and the competition.

2) Practically - the 'triple double'

Double-digit revenue growth - the target is to raise revenue growth to at least 10 per cent per annum against the current 6.5 per cent like-for-like (i.e. excluding large acquisitions). This is to be fed by the initiatives above.

Double-digit market share in key regions - JD only has more than 10 per cent market share in three markets: UK, Ireland and Australia. The dream would be to reach this level in the US but with around 36,000 sports outlets and $64bn of sector revenue in America that would be a major climb. In practice, this is going to come down to definitions - the 10 per cent share selectively in sports fashion rather than all sports sales and fashion brands only within that (i.e. you can buy New Balance running shoes but not Brooks or Hola or fashion-oriented jackets but not technical ones). That said, the target does seem to be to add 500-600 JD outlets (now around 140 from the total footprint of 1,200) in the US, but mostly by accelerating the conversion of Finish Line stores.

JD needs to work harder to put a larger gap between itself and the main competitor Foot Locker. In most other markets JD is by a large margin the preferred retail channel (in the company's own speak 'most loved') but in the US, it has been running neck-and-neck. However, Foot Locker did lose out in the drawing in of brands to their own channels, losing a lot of allocations.

Double-digit operating margin - this is already close and the consensus for FY Jan 2024 is already at 10.6 per cent earnings before interest and tax (EBIT) margin. However, there is likely to be some disruption as outlets convert to JD, as more stores are refurbished and as revenues grow in new markets. This level of margin is the end-game for the target £15-16bn of revenues by FY 2028.

Higher capex - this is where the bulk of the cash pile will be consumed with the ambition to spend £3bn by 2027/28. Capex of £500mn to £600mn per annum is the target, a large step up from the £247mn in FY 2022, and the c.£180mn in the last two years before Covid. Some 50 to 60 per cent will be focused on store expansion in underpenetrated markets with 250 to 350 new JD stores per annum plus re-brands and refurbishments. This is separate from future acquisitions.

Cash generation of £1bn per annum - this is another 'almost there' objective so is no great shakes, but still impressive as it means that the cash conversion is pushing up towards 100 per cent.

Grow lower penetration markets - the US sort of fits in here but really this refers to Europe with France, Spain, Italy and Germany the targets. There are 450 stores in these markets and the aim is to double this. In the rest of the world, the footprint of the JD brand is small with just 95 but a target nearer 500 using direct and franchised openings.

Minority buyouts - in recent years JD's strategy was to not buy 100 per cent of new businesses added to the group but to leave the vendors with some 'skin in the game'. This policy looks to have changed and JD now plans to buy out many of the minority stakes that remain. This could be tricky to calculate because in many cases business uplifts in value have been entirely through group actions rather than those taken by the minority owners.

Energise the UK network - the plans for the UK are modest with just 20-30 openings planned versus the current 400 stores; JD has little headroom in the UK as the enforced sales of Footasylum highlights. More significant than outlet numbers is likely to be scale, with plans to add floor space rather than store numbers.

Valuation and conclusions

The market seems to have warmed to the new strategy; the shares rose 10 per cent in the immediate aftermath of the outline of it being announced. Even after this rise, and the big surge since mid-October, the shares still do not look expensive. Looking at forward price to earnings ratios (share price divided by forward earnings per share estimates), the average Year 2 PE since the mid 2010s has been around 16-17x; at the low point in October this fell to just 7x and before the strategy was unveiled it had risen to 12.5x.

There are still a number of positive drivers for the share price:

1) Trusting that the slew of problems from 2022 are behind JD, the rating should at least return to long-run average. It is fair to assume that if new management had found additional concerns on their arrival they would have disclosed them - analysts refer to this as 'kitchen sinking', the process of ensuring that old management's issues are fully exposed, disclosed and dealt with.

2) If the new operating plans are able to deliver the higher rate of growth, then there are grounds for believing that the long-run average PE rating should be edged up - we suggested the exact same for Sage and Greggs in this week's other Alpha articles.

3) There is still a lot to be proven and there has been something of a shift in the balance of power in this industry with brands flexing the muscles more and that could still bite. Also there are overarching questions such as will the 'athleisure' boom sustain and with it the more premium pricing environment - while that appears to have strong momentum today, this is fashion industry and tides do run fast Also, expanding in less well-represented operating territories, especially at the planned pace we see here can easily create ripples that then cause a drag on performance.

So it would be wrong to just multiply everything through - 6 per cent revenue growth becomes 10 per cent, then margins perhaps 50-100 bps (a basis point is one hundredth of a percentage point) higher and more free cash flow that could easily see EPS boosted by share buy-backs a little further down the line. That could easily lead one to think that a fair value rating for JD is 35-40 per cent higher than it has been, but the more cautionary elements must also be accounted for. Overall, however, it is not difficult to argue that rather than the fair value being 16-17x year 2 PE, it could easily be 18-19x.

Consensus EPS for January 2025 today are 14.1p, but under the new strategy that could be nearer 15p. So, if we run those higher EPS through on a PE of 18-19x, a fair value for the stock of 275p could be supported. After the initial rally in reaction to the new strategy, JD ran up to 182p but, if we believe the re-rating and higher earnings we've mapped out here, there is potentially 50 per cent more upside in the stock; although this would likely take 18 months or more to play out.

Add to this scope for a better dividend from improved cash flows (yield today is nominal at around 0.3 per cent), an investor buying today could see returns climb back to those that JD made before 2019 with TSR north of 40 per cent per annum, although this is likely to be a shorter-term repricing correction rather than multi-year TSR at this level.

Overall, this stock feels well worth owning, even having rebounded so far already.

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