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GLOBAL IDEAS

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Dick's Sporting Goods - size counts $53.37

Investment thesis:

Dick's Sporting Goods (DKS:US) is the largest retailer of sporting goods and equipment in the US, with a 9% market share. Despite its market-leading position, the group has demonstrated an ability to continue growing ahead of the market through a fairly aggressive store roll-out programme over the past ten years– as with many retailers, scale can be an advantage in sustaining growth.

This company has ambitious plans for the future, with over 300 store openings planned over the next five years on a current base of ~530. The group believes it ultimately has scope for 1,100 stores across the US. Together with the group's targets of improved margins, we think the company remains well positioned to continue its long-term track record of delivering late-teen earnings growth.

Figure 1: Financial forecasts:

Dick's Sporting Goods Inc.				
January y/e	**FY12**	**FY13**	**FY14**	**FY15**
Diluted HEPS ($)	2.31	2.68	3.20	3.80
% growth		*16%*	*19%*	*19%*
DPS	2.50	0.64	0.76	0.92
P/E	23.1x	19.9x	16.7x	14.x
DY	4.7%	1.2%	1.4%	1.7%
Share price ($)	**53.37**			
12-mnth fwd P/E	17.6x			

Source: Company data, Anchor Capital

Note: in line with company convention, FY13 year-end refers to year ending 31 January 2014

Fundamentally, we believe this is a great business with superb return metrics: a typical new store costs $2.2mn to establish (capex + net working capital) and generates $1mn of operating cash flow within its second year of operations.

While the RoE of ~20% is a good figure, the group's balance sheet is conservative with net cash so returns on capital employed are much higher (~45% pre-tax RoCE). With these metrics, it is little wonder that the group appears intent on its organic store roll-out programme forming the core of its growth plans.

At a **forward 17.5x P/E multiple**, DKS is not the cheapest share in our investment universe, but also boasts an excellent long term track record which looks set to continue. We think the group's longer term financial targets are achievable and imply ~18% CAGR EPS growth from FY12-17. This leaves space for good returns from these levels, even if some de-rating is factored in. We rate the share a **BUY**.

Figure 2: DKS share price (left axis) and trailing P/E multiple (right axis):

Source: Bloomberg, Anchor Capital calculations

Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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Rolling out the model...

We love businesses that have fundamentally high returns **and** the ability to deploy more capital. Dick's Sporting Goods is a business that falls into that category, with significant store growth planned for the next few years.

To provide investors with a brief picture:

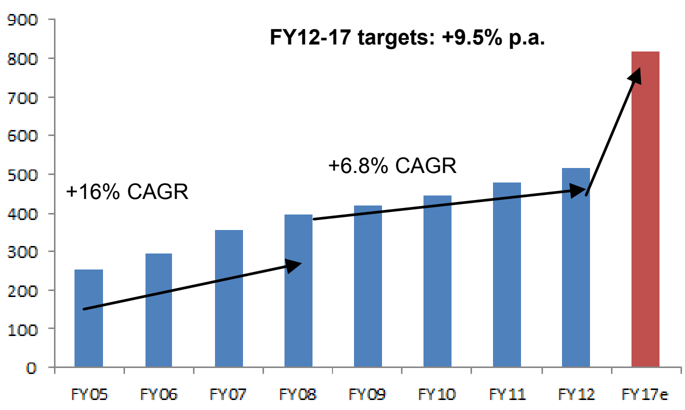
⇒ **The largest:** Dick's Sporting Goods is the largest retailer of sporting goods and apparel in the US, with annual sales of $5.8bn in FY12. This translates into 9% market share - to contextualise this, the next 5 biggest sporting goods retailers account for 23% of the US market.

⇒ **Gaining market share:** The US sporting goods industry has sustained growth of 2% per annum over the past decade, while Dick's has grown by 16% CAGR over the same period. This has resulted in its market share rising from 2.5% to 9%. Importantly, DKS's *same store* sales have grown faster than the industry which highlights good execution.

⇒ **Large format stores**: A typical Dick's store has traditionally come in two formats, a single-level 50,000 square feet (~4,650m2) store and a larger dual-level, 80,000 square feet store. More recently, the group has introduced smaller format stores to target smaller markets. To contextualise this for South African readers, a large format Dick's store is almost as large as a typical Makro store.

⇒ **High returns on capital**: What attracts us to this business, like many retailers, is the return profile on new stores. Our recent discussions with management indicate that a typical Dick's store costs $2.2mn to establish (roughly 50% capex and 50% net working capital) and should generate $1mn in operating cash flow within two years of operation. This is important in the context of the group's intention to roll-out another 300-odd stores in the next 5 years—**these stores would account for an incremental $300mn EBIT in today's dollars vs the current base of ~$525mn.**

Figure 3: Dick's Sporting Goods—store numbers:

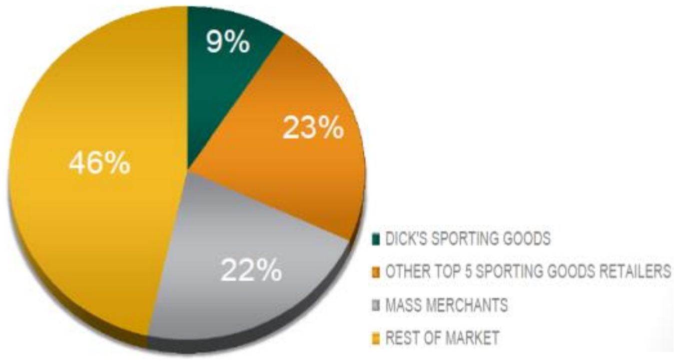


Source: Dick's Sporting Goods

Figure 4: Dick's geographic store locations and potential:

Source: Dicks Sporting Goods Goldman Sachs presentation

Figure 5: US sporting goods industry market share:

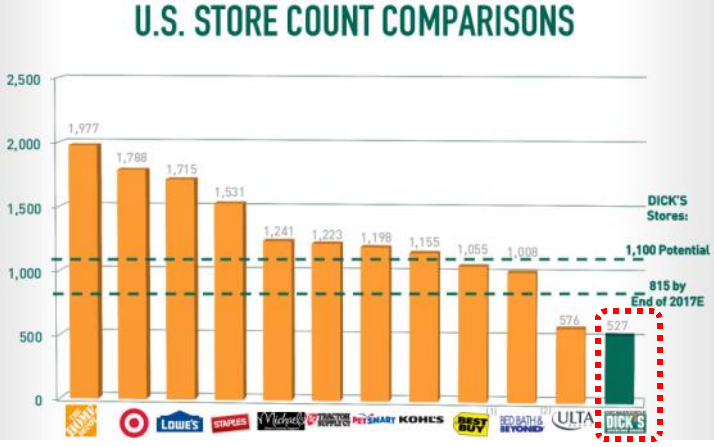


Source: Dick's Sporting Goods

While scale is no doubt a competitive advantage in retailing and DKS is larger than its specialty peers, it does compete with much larger retailers such as Wal-Mart which sell sporting goods. In this regard, DKS's key competitive advantage is its focus on offering unique product as well as high service levels:

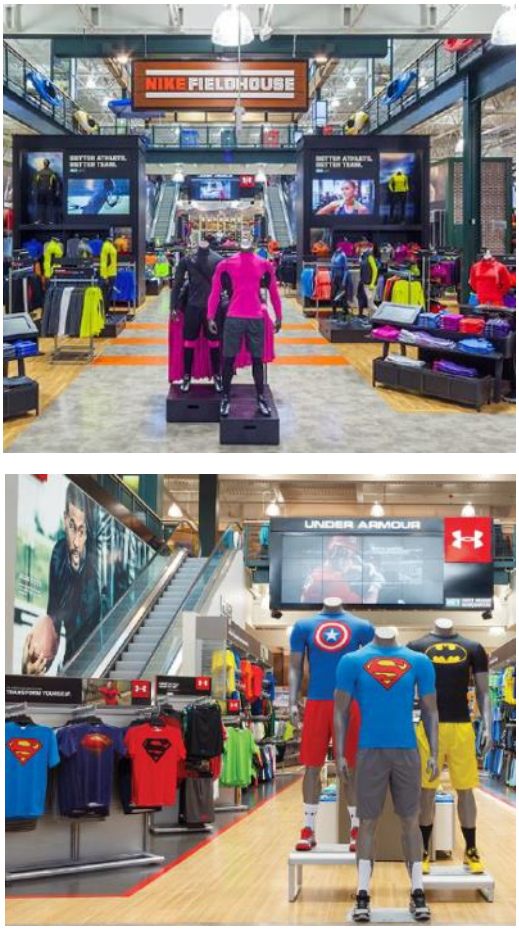
- **Service levels**: Dick's has category specialists which assist and advise prospective customers on product choice/fitment etc. For example, in FY12 the group employed 568 PGA and LPGA professionals in Dick's golf departments and Golf Galaxy Stores (stand-alone).
- **Brand partnerships:** Dick's has a number of arrangements with its key vendors (e.g.. Nike, Adidas) whereby the group establishes a branded "store-within-a-store" inside a Dick's outlet. This is intended to promote the respective brand, and importantly these principals **share in the capex to establish these stores** so they effectively have skin in the game. Allied to this, Dick's has access to exclusive product (e.g. certain garment colours/designs) which are only available in their stores. This protects margin.

Figure 6: Dick's store count—well below other large US retailers:



Source: Dick's Sporting Goods

Figure 7: Dicks Sporting Goods store-within-a-store concepts (Nike & Under Armour):

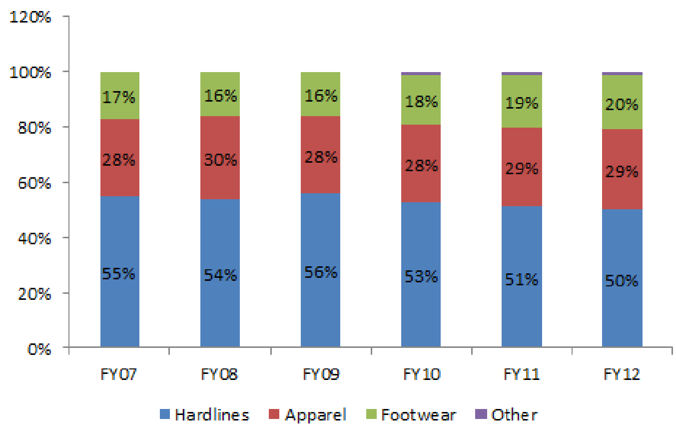


Source: Dicks Sporting Goods

Dick's has recently provided the market with fairly specific longer-term targets pertaining to store roll-out ability, top-line growth and margin trends. To summarise:

- Dick's believes it has the potential to roll-out 1,100 stores in the US ultimately, but plans to add 300 stores (on a current base of 527) over the next five years (i.e. From FY12-17).
- **Management is targeting $10bn revenue by FY17** - this implies CAGR growth of 11.5% between FY12-17 (FY12: $5.8bn), of which we estimate approximately 9.5% will comprise the impact of new stores. This implies ~2% same-store sales growth on an annual basis—we note that the group has averaged 2.5% same-store sales growth over the past ten years.
- **Management has guided to increasing EBIT margins from 9% in FY12 to 10.5% by FY17**. The company believes this will be achieved through a combination of gross margin expansion (60bpts) and leverage of sales, general and admin (SG&A) costs through an expanded store network as the group scales up. Part of the expansion of gross margins will be achieved through a higher-margin product mix, with some attributable to fixed lease cost leverage. We note that the group has been steadily increasing the apparel and footwear component of its sales mix in recent years, which tends to be higher-margin product. In addition to this, the company is driving a greater proportion of private label products (higher margin) but this needs to be carefully managed in order not to alienate the group's various brand partners.

Figure 8: DKS sales % - declining "hard-lines" mix:



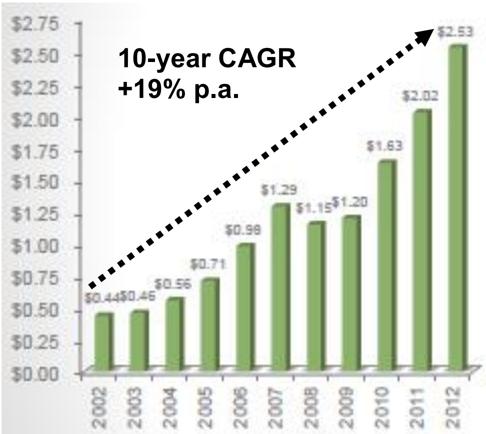
Source: Dick's Sporting Goods

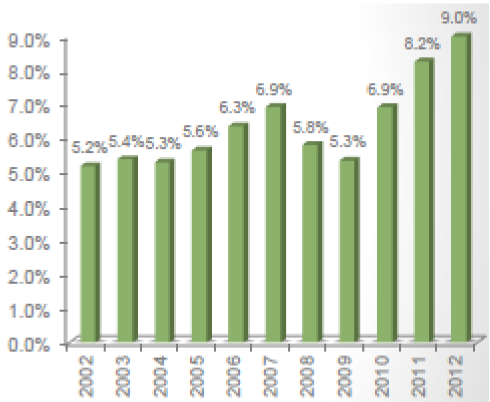
Strategically, the company recognises the need to have a competitive online offering and is investing behind building a meaningful e-commerce business. In FY12, the group derived $292mn (5%) revenue from e-commerce and is aiming to triple this by 2015.

- The company has **authorised a share buy-back of $1bn over a five-year period**; this equates to 15% of the group's current market cap. While some of this will be utilised to hedge share options, we still expect diluted shares in issue to decline by ~1.5%-2% per annum. Importantly, this buy-back programme, group capex and intended dividends will be funded out of operating cash flow so we don't expect to see an offsetting rise in interest charges. As a result, this reduction in shares in issue will represent a 1%-2% annual boost to EPS.

Taking into account the group's guidance (which we have discussed with management and regard as achievable), we estimate **DKS could deliver ~18% CAGR EPS growth from FY12-17 -** much in line with the group's track record.

Figure 9: DKS EPS track record and EBIT margins:





Source: Dick's Sporting Goods

Figure 10: Simplified income statement forecast implied by management targets:

$'m	FY12	FY17e	CAGR %
Net sales	5 836	10 000	11%
COGS	-3 999	-6 792	11%
Gross profit	1 837	3 208	12%
GP %	31.5%	32.1%	
Overheads	-1 313	-2 158	10%
EBIT	**524**	**1 050**	**15%**
margin %	9.0%	10.5%	

Source: Dick's Sporting Goods, Anchor Capital calculations

Note: Anchor EPS growth estimates of ~18% p.a. is higher than 15% EBIT growth due to impact of share buy-backs, tax rate etc.

It should be noted that the group's first two quarters of the current fiscal year (FY13) have been slow, with sales growth of only 5% and flat comparable sales growth. DKS has indicated that unusually wet weather has impacted negatively on sales in its golfing category. The group expects sales to pick up into the back-end of FY13 and has guided to full-year EPS of $2.60-$2.65; we suspect this guidance range could be conservative given that it implies only 0-3% EPS growth in 2H13.

Valuation & conclusion

DKS trades at a 12-month forward P/E multiple of 17.5x; this is much in line with the group's historical valuation range and we believe offers scope for 15-20% annual total returns from the current share price levels. We rate the share a **BUY**.

Sean Ashton

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