FOOT LOCKER INC
Form 10-K
April 02, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934
For the fiscal year ended February 3, 2007
Commission file number 1-10299

FOOT LOCKER, INC.

(Exact name of Registrant as specified in its charter)

New York	**13-3513936**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
112 West 34th Street, New York, New York	**10120**
(Address of principal executive offices)	*(Zip Code)*

Registrant's telephone number, including area code:
(212) 720-3700

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrants knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act. Yes o No x

See pages 67 through 70 for Index of Exhibits.

Number of shares of Common Stock outstanding at March 27, 2007:	154,675,352
The aggregate market value of voting stock held by non-affiliates of the Registrant computed by reference to the closing price as of the last business day of the Registrant s most recently completed second fiscal quarter, July 29, 2006, was approximately:	$ 3,676,901,508*

* For purposes of this calculation only (a) all directors plus one executive officer and owners of five percent or more of the Registrant are deemed to be affiliates of the Registrant and (b) shares deemed to be held by such persons at July 29, 2006 include only outstanding shares of the Registrant s voting stock with respect to which such persons had, on such date, voting or investment power.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrants definitive Proxy Statement (the Proxy Statement) to be filed in connection with the Annual Meeting of Shareholders to be held on May 30, 2007: Parts III and IV.

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PART I

Item 1. Business

General

Foot Locker, Inc., incorporated under the laws of the State of New York in 1989, is a leading global retailer of athletic footwear and apparel, operating 3,942 primarily mall-based stores in the United States, Canada, Europe, Australia, and New Zealand as of February 3, 2007, Foot Locker, Inc. and its subsidiaries hereafter are referred to as the Registrant, Company or we. Information regarding the business is contained under the Business Overview section in Item 7. Managements Discussion and Analysis of Financial Condition and Results of Operations.

The Company maintains a website on the Internet at *www.footlocker-inc.com*. The Companys filings with the Securities and Exchange Commission, including its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports are available free of charge through this website as soon as reasonably practicable after they are filed with or furnished to the SEC by clicking on the SEC Filings link. The Corporate Governance section of the Companys corporate website contains the Companys Corporate Governance Guidelines, Committee Charters, and the Companys Code of Business Conduct for directors, officers and employees, including the Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer. Copies of these documents may also be obtained free of charge upon written request to the Companys Corporate Secretary at 112 West 34th Street, New York, NY 10120. The Company intends to disclose promptly amendments to the Code of Business Conduct and waivers of the Code for directors and executive officers on the corporate governance section of the Companys corporate website.

The Certification of the Chief Executive Officer required by Section 303A.12(a) of The New York Stock Exchange Listing Standards relating to the Companys compliance with The New York Stock Exchange Corporate Governance Listing Standards was submitted to The New York Stock Exchange on June 2, 2006.

Information Regarding Business Segments and Geographic Areas

The financial information concerning business segments, divisions and geographic areas is contained under the Business Overview and Segment Information sections in Item 7. Managements Discussion and Analysis of Financial Condition and Results of Operations. Information regarding sales, operating results and identifiable assets of the Company by business segment and by geographic area is contained under the Segment Information footnote in Item 8. Consolidated Financial Statements and Supplementary Data.

The service marks and trademarks appearing on this page and elsewhere in this report (except for ESPN, NBA, Nike, Amazon.com, Weekend Edition, The San Francisco Music Box Company, and USOC) are owned by Foot Locker, Inc. or its subsidiaries.

Employees

The Company and its consolidated subsidiaries had 16,806 full-time and 28,600 part-time employees at February 3, 2007. The Company considers employee relations to be satisfactory.

Competition

Financial information concerning competition is contained under the “Business Risk” section in the “Financial Instruments and Risk Management” footnote in “Item 8. Consolidated Financial Statements and Supplementary Data.”

Merchandise Purchases

Financial information concerning merchandise purchases is contained under the “Liquidity” section in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” and under the “Business Risk” section in the “Financial Instruments and Risk Management” footnote in “Item 8. Consolidated Financial Statements and Supplementary Data.”

Item 1A. Risk Factors

The statements contained in this Annual Report on Form 10-K and incorporated by reference (“Annual Report”) that are not historical facts, including, but not limited to, statements regarding our expected financial position, business and financing plans found in “Item 1. Business” and “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations,” constitute “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. The words “may,” “believes,” “expects,” “plans,” “intends,” “anticipates similar expressions identify forward-looking statements. The actual results of the future events described in these forward-looking statements could differ materially from those stated in the forward-looking statements.

Our actual results may differ materially due to the risks and uncertainties discussed in this Annual Report, including those discussed below. Additional risks and uncertainties that we do not presently know about or that we currently consider to be insignificant may also affect our business operations and financial performance. Accordingly, readers of the Annual Report should consider these risks and uncertainties in evaluating the information and are cautioned not to place undue reliance on the forward-looking statements contained herein. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

The industry in which we operate is dependent upon fashion trends, customer preferences and other fashion-related factors.

The athletic footwear and apparel industry is subject to changing fashion trends and customer preferences. We cannot guarantee that our merchandise selection will accurately reflect customer preferences when it is offered for sale or that we will be able to identify and respond quickly to fashion changes, particularly given the long lead times for ordering much of our merchandise from vendors. For example, we order athletic footwear four to six months prior to delivery to our stores. If we fail to anticipate accurately either the market for the merchandise in our stores or our customers’ purchasing habits, we may be forced to rely on markdowns or promotional sales to dispose of excess, slow moving inventory, which could have a material adverse effect on our business, financial condition, and results of operations.

A substantial portion of our highest margin sales are to young males (ages 12–25), many of whom we believe purchase athletic footwear and licensed apparel as a fashion statement and are frequent purchasers of athletic footwear. Any shift in fashion trends that would make athletic footwear or licensed apparel less attractive to these customers could have a material adverse effect on our business, financial condition, and results of operations.

The businesses in which we operate are highly competitive.

The retail athletic footwear and apparel business is highly competitive with relatively low barriers to entry. Our athletic footwear and apparel operations compete primarily with athletic footwear specialty stores, sporting goods stores and superstores, department stores, discount stores, traditional shoe stores, and mass merchandisers, many of which are units of national or regional chains that have significant financial and marketing resources. The principal competitive factors in our markets are price, quality, selection of merchandise, reputation, store location, advertising, and customer service. We cannot assure you that we will continue to be able to compete successfully against existing or future competitors. Our expansion into markets served by our competitors and entry of new competitors or expansion of existing competitors into our markets could have a material adverse effect on our business, financial condition, and results of operations.

Although we sell merchandise via the Internet, a significant shift in customer buying patterns to purchasing athletic footwear, athletic apparel, and sporting goods via the Internet could have a material adverse effect on our business results. In addition, some of our vendors distribute products directly through the Internet and others may follow. Some vendors operate retail stores and some have indicated that further retail stores will open. Should this continue to occur, and if our customers decide to purchase directly from our vendors, it could have a material adverse effect on our business, financial condition, and results of operations.

We depend on mall traffic and our ability to identify suitable store locations.

Our sales, particularly in the United States and Canada, are dependent in part on a high volume of mall traffic. Our stores are located primarily in enclosed regional and neighborhood malls. Mall traffic may be adversely affected by, among other things, economic downturns, the closing of anchor department stores or changes in customer preferences or acts of terrorism. A decline in the popularity of mall shopping among our target customers could have a material adverse effect on us.

To take advantage of customer traffic and the shopping preferences of our customers, we need to maintain or acquire stores in desirable locations such as in regional and neighborhood malls anchored by major department stores. We cannot be certain that desirable mall locations will continue to be available.

The effects of natural disasters, terrorism, acts of war and retail industry conditions may adversely affect our business.

Natural disasters, including hurricanes, floods, and tornados may affect store and distribution center operations. In addition, acts of terrorism, acts of war, and military action both in the United States and abroad can have a significant effect on economic conditions and may negatively affect our ability to purchase merchandise from vendors for sale to our customers. Any significant declines in general economic conditions, public safety concerns or uncertainties regarding future economic prospects that affect customer spending habits could have a material adverse effect on customer purchases of our products.

A change in the relationship with any of our key vendors or the unavailability of our key products at competitive prices could affect our financial health.

Our business is dependent to a significant degree upon our ability to purchase brand-name merchandise at competitive prices, including the receipt of volume discounts, cooperative advertising, and markdown allowances from our vendors. The Company purchased approximately 78 percent of its merchandise in 2006 from its top five vendors and expects to continue to obtain a significant percentage of its athletic product from these vendors in future periods. Approximately 50 percent was purchased from one vendor Nike, Inc. (Nike). Each of our operating divisions is highly dependent on Nike, they individually purchase 40 to 65 percent of their merchandise from Nike. We have no long-term supply contracts with any of our vendors. Our inability to obtain merchandise in a timely manner from major suppliers (particularly Nike) as a result of business decisions by our suppliers or any disruption in the supply chain could have a material adverse effect on our business, financial condition, and results of operations. Because of our strong dependence on Nike, any adverse development in Nikes financial condition and results of operations or the inability of Nike to develop and manufacture products that appeal to our target customers could also have an adverse effect on our business, financial condition, and results of operations. We cannot be certain that we will be able to acquire merchandise at competitive prices or on competitive terms in the future.

Merchandise that is high profile and in high demand is allocated by our vendors based upon their internal criteria. Although we have generally been able to purchase sufficient quantities of this merchandise in the past, we cannot be certain that our vendors will continue to allocate sufficient amounts of such merchandise to us in the future. In addition, our vendors provide support to us through cooperative advertising allowances and promotional events. We cannot be certain that such assistance from our vendors will continue in the future. These risks could have a material adverse effect on our business, financial condition, and results of operations.

We may experience fluctuations in and cyclicality of our comparable store sales results.

Our comparable-store sales have fluctuated significantly in the past, on both an annual and a quarterly basis, and we expect them to continue to fluctuate in the future. A variety of factors affect our comparable-store sales results, including, among others, fashion trends, the highly competitive retail store sales environment, economic conditions, timing of promotional events, changes in our merchandise mix, calendar shifts of holiday periods, and weather conditions.

Many of our products, particularly high-end athletic footwear and licensed apparel, represent discretionary purchases. Accordingly, customer demand for these products could decline in a recession or if our customers develop other priorities for their discretionary spending. These risks could have a material adverse effect on our business, financial condition, and results of operations.

Our operations may be adversely affected by economic or political conditions in other countries.

Approximately 24 percent of our sales and a significant portion of our operating profits for 2006 were attributable to our sales in Europe, Canada, New Zealand, and Australia. As a result, our business is subject to the risks associated with doing business outside of the United States, such as foreign governmental regulations, foreign customer preferences, political unrest, disruptions or delays in shipments, and changes in economic conditions in countries in which we operate. Although we enter into forward foreign exchange contracts and option contracts to reduce the effect of foreign currency exchange rate fluctuations, our operations may be adversely affected by significant changes in the value of the U.S. dollar as it relates to certain foreign currencies.

In addition, because we and our suppliers have a substantial amount of our products manufactured in foreign countries, our ability to obtain sufficient quantities of merchandise on favorable terms may be affected by governmental regulations, trade restrictions, and economic, labor, and other conditions in the countries from which our suppliers obtain their product.

Our business is subject to economic cycles and retail industry conditions. Purchases of discretionary athletic footwear, apparel, and related products, tend to decline during recessionary periods when disposable income is low and customers are hesitant to use available credit.

Complications in our distribution centers and other factors affecting the distribution of merchandise may affect our business.

We operate three distribution centers worldwide to support our athletic business. If complications arise with any facility or any facility is severely damaged or destroyed, the other distribution centers may not be able to support the resulting additional distribution demands. This may adversely affect our ability to deliver inventory on a timely basis. We depend upon UPS for shipment of a significant amount of merchandise. An interruption in service by UPS for any reason could cause temporary disruptions in our business, a loss of sales and profits, and other material adverse effects.

Our freight cost is affected by changes in fuel prices through surcharges. Increases in fuel prices and surcharges and other factors may increase freight costs and thereby increase our cost of sales.

A major failure of our information systems could harm our business.

We depend on information systems to process transactions, manage inventory, operate our website, purchase, sell and ship goods on a timely basis and maintain cost-efficient operations. Any material disruption or slowdown of our systems could cause information to be lost or delayed which could have a negative effect on our business. We may experience operational problems with our information systems as a result of system failures, viruses, computer "hackers" or other causes. We cannot be assured that our systems will be adequate to support future growth.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The properties of the Company and its consolidated subsidiaries consist of land, leased and owned stores, and administrative and distribution facilities. Gross operating square footage and total selling area for the Athletic Stores segment at the end of 2006 was approximately 14.55 and 8.74 million square feet, respectively. These properties are located in the United States, Canada, various European countries, Australia, and New Zealand.

The Company currently operates three distribution centers, of which one is owned and two are leased, occupying an aggregate of 2.12 million square feet. Two of the three distribution centers are located in the United States and one is in Europe.

Item 3. Legal Proceedings

Information regarding the Company's legal proceedings are contained in the "Legal Proceedings" footnote under "Item 8. Consolidated Financial Statements and Supplementary Data."

Item 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of security holders during the fourth quarter of the year ended February 3, 2007.

Executive Officers of the Company

Information with respect to Executive Officers of the Company, as of April 2, 2007, is set forth below:

Chairman of the Board, President and Chief Executive Officer	Matthew D. Serra
President and Chief Executive Officer - Foot Locker, Inc. – International	Ronald J. Halls
President and Chief Executive Officer - Foot Locker, Inc. – U.S.A.	Richard T. Mina
Senior Vice President, General Counsel and Secretary	Gary M. Bahler
Senior Vice President – Real Estate	Jeffrey L. Berk
Senior Vice President, Chief Information Officer and Investor Relations	Peter D. Brown
Senior Vice President and Chief Financial Officer	Robert W. McHugh
Senior Vice President – Strategic Planning	Lauren B. Peters
Senior Vice President – Human Resources	Laurie J. Petrucci
Vice President and Chief Accounting Officer	Giovanna Cipriano
Vice President and Treasurer	John A. Maurer

Matthew D. Serra, age 62, has served as Chairman of the Board since February 2004, President since April 2000 and Chief Executive Officer since March 2001. Mr. Serra served as Chief Operating Officer from February 2000 to March 2001 and as President and Chief Executive Officer of Foot Locker Worldwide from September 1998 to

February 2000.

Ronald J. Halls, age 53, has served as President and Chief Executive Officer of Foot Locker, Inc.- International since October 9, 2006. He served as President and Chief Executive Officer of Champs Sports, from February 2003 to October 8, 2006 and as Chief Operating Officer of Champs Sports from February 2000 to February 2003.

Richard T. Mina, age 50, has served as President and Chief Executive Officer of Foot Locker, Inc.- U.S.A. since February 2003. He served as President and Chief Executive Officer of Champs Sports, an operating division of the Company, from April 1999 to February 2003.

Gary M. Bahler, age 55, has served as Senior Vice President since August 1998, General Counsel since February 1993 and Secretary since February 1990.

Jeffrey L. Berk, age 51, has served as Senior Vice President Real Estate since February 2000.

Peter D. Brown, age 52, has served as Senior Vice President, Chief Information Officer and Investor Relations since September 2006. Mr. Brown served as Vice President Investor Relations and Treasurer from October 2001 to September 2006, served as Vice President Investor Relations and Corporate Development from April 2001 to October 2001 and as Assistant Treasurer Investor Relations and Corporate Development from August 2000 to April 2001.

Robert W. McHugh, age 48, has served as Senior Vice President and Chief Financial Officer since November 2005. He served as Vice President and Chief Accounting Officer from January 2000 to November 2005.

Lauren B. Peters, age 45, has served as Senior Vice President Strategic Planning since April 2002. Ms. Peters served as Vice President Planning from January 2000 to April 2002.

Laurie J. Petrucci, age 48, has served as Senior Vice President Human Resources since May 2001. Ms. Petrucci served as Senior Vice President Human Resources of the Foot Locker Worldwide division from March 2000 to May 2001.

Giovanna Cipriano, age 37, has served as Vice President and Chief Accounting Officer since November 2005. She served as Divisional Vice President, Financial Controller from June 2002 to November 2005 and as Financial Controller from April 1999 to June 2002.

John Maurer, age 47, has served as Vice President and Treasurer since September 12, 2006. Mr. Maurer served as Assistant Treasurer from April 2002 to September 11, 2006.

There are no family relationships among the executive officers or directors of the Company.

PART II

Item 5. Market for the Companys Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Information regarding the Companys market for stock exchange listings, common equity, quarterly high and low prices, and dividend policy are contained in the Shareholder Information and Market Prices footnote under Item 8. Consolidated Financial Statements and Supplementary Data.

There were no purchases of common stock during the fourth quarter of 2006. On February 15, 2006, the Company announced that its Board of Directors authorized a $150 million, three-year share repurchase plan program. During 2006, the Company repurchased 334,200 of common stock at a cost of approximately $8 million. On March 7, 2007, the Company announced that its Board of Directors authorized a new $300 million, three-year share repurchase program replacing the earlier $150 million program.

Performance Graph

The following graph compares the cumulative 5-year total return to shareholders on Foot Locker, Inc.s common stock relative to the total returns of the Russell 2000 Index and a selected peer group, which represents its peers as retailers in the athletic footwear and apparel industry. The peer group comprises:

- Dicks Sporting Goods, Inc.
- The Finish Line, Inc.
- Hibbett Sporting Goods, Inc., and
- Genesco, Inc., whose business includes operations outside of the athletic footwear and apparel retailing.

In 2005, the peer group also included The Sports Authority, Inc. On January 23, 2006, The Sports Authority, Inc. announced it had agreed to go private through an acquisition by Leonard Green & Partners LP and certain members of its senior management and, therefore, it was not included in this year's performance graph.

Indexed Share Price Performance

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Item 6. Selected Financial Data

Selected financial data is included as the Five Year Summary of Selected Financial Data footnote in Item 8. Consolidated Financial Statements and Supplementary Data.

Item 7. Managements Discussion and Analysis of Financial Condition and Results of Operations

Business Overview

Foot Locker, Inc., through its subsidiaries, operates in two reportable segments Athletic Stores and Direct-to-Customers. The Athletic Stores segment is one of the largest athletic footwear and apparel retailers in the world, whose formats include Foot Locker, Lady Foot Locker, Kids Foot Locker, Champs Sports, and Footaction (beginning May 2004). The Direct-to-Customers segment reflects Footlocker.com, Inc., which sells, through its affiliates, including Eastbay, Inc., to customers through catalogs and Internet websites.

The Foot Locker brand is one of the most widely recognized names in the market segments in which the Company operates, epitomizing high quality for the active lifestyle customer. This brand equity has aided the Companys ability to successfully develop and increase its portfolio of complementary retail store formats, specifically Lady Foot Locker and Kids Foot Locker, as well as Footlocker.com, Inc., its direct-to-customers business. Through various marketing channels, including television campaigns and sponsorships of various sporting events, Foot Locker, Inc. reinforces its image with a consistent message; namely, that it is the destination store for athletic footwear and apparel with a wide selection of merchandise in a full-service environment.

<u>*Athletic Stores*</u>

The Company operates 3,942 stores in the Athletic Stores segment. The following is a brief description of the Athletic Stores segments operating businesses:

Foot Locker Foot Locker is a leading athletic footwear and apparel retailer. Its stores offer the latest in athletic-inspired performance products, manufactured primarily by the leading athletic brands. Foot Locker offers products for a wide variety of activities including running, basketball, hiking, tennis, aerobics, fitness, baseball, football, and soccer. Its 2,101 stores are located in 20 countries including 1,368 in the United States, Puerto Rico, the U. S. Virgin Islands, and Guam, 132 in Canada, 509 in Europe and a combined 92 in Australia and New Zealand. The domestic stores have an average of 2,100 selling square feet and the international stores have an average of

1,500 selling square feet.

Champs Sports Champs Sports is one of the largest mall-based specialty athletic footwear and apparel retailers in the United States. Its product categories include athletic footwear, apparel and accessories, and a focused assortment of equipment. This combination allows Champs Sports to differentiate itself from other mall-based stores by presenting complete product assortments in a select number of sporting activities. Its 576 stores are located throughout the United States, Canada, and the U.S. Virgin Islands. The Champs Sports stores have an average of 3,700 selling square feet.

Footaction Footaction is a national athletic footwear and apparel retailer. The primary customers are young urban males that seek street-inspired fashion styles. Its 373 stores are located throughout the United States and Puerto Rico and focus on marquee allocated footwear and branded apparel. The Footaction stores have an average of 2,900 selling square feet.

Lady Foot Locker Lady Foot Locker is a leading U.S. retailer of athletic footwear, apparel and accessories for women. Its stores carry major athletic footwear and apparel brands, as well as casual wear and an assortment of proprietary merchandise designed for a variety of activities, including running, basketball, walking, and fitness. Its 557 stores are located in the United States, Puerto Rico, the U. S. Virgin Islands, and Guam and have an average of 1,300 selling square feet.

Kids Foot Locker Kids Foot Locker is a national childrens athletic retailer that offers the largest selection of brand-name athletic footwear, apparel and accessories for children. Its stores feature an environment geared to appeal to both parents and children. Its 335 stores are located in the United States, Puerto Rico, and the U.S. Virgin Islands and have an average of 1,400 selling square feet.

Store Profile

	At January 28, 2006	Opened	Closed	At February 3, 2007
Foot Locker	2,121	57	77	2,101
Champs Sports	556	27	7	576
Footaction	363	17	7	373
Lady Foot Locker	554	22	19	557
Kids Foot Locker	327	23	15	335
Total Athletic Stores	3,921	146	125	3,942

Direct-to-Customers

Footlocker.com Footlocker.com, Inc., sells, through its affiliates, directly to customers through catalogs and its Internet websites. Eastbay, Inc., one of its affiliates, is one of the largest direct marketers of athletic footwear, apparel, equipment, team licensed and private-label merchandise in the United States and provides the Companys eight full-service e-commerce sites access to an integrated fulfillment and distribution system. The Company has a strategic alliance to offer footwear and apparel on the Amazon.com website and the Foot Locker brands are featured in the Amazon.com specialty stores for apparel and accessories and sporting goods. In addition, the Company has a marketing agreement with the U.S. Olympic Committee (USOC) providing the Company with the exclusive rights to sell USOC licensed products through catalogs and via an e-commerce site. The Company has an agreement with ESPN for ESPN Shop an ESPN-branded direct mail catalog and e-commerce site linked to *www.ESPNshop.com*, where consumers can purchase athletic footwear, apparel and equipment which will be managed by Footlocker.com. Both the catalog and the e-commerce site feature a variety of ESPN-branded and non-ESPN-branded athletically inspired merchandise.

Franchise Operations

In March of 2006, the Company entered into a ten-year area development agreement with the Alshaya Trading Co. W.L.L., in which the Company agreed to enter into separate license agreements for the operation of a minimum of 75 Foot Locker stores, subject to certain restrictions, located within the Middle East. Three of these franchised stores were operational at February 3, 2007. Revenue from the three franchised stores was not significant for the year-ended February 3, 2007. These stores are not included in the Company’s operating store count above.

Overview of Consolidated Results

2006 was a challenging year for the Company due to the continued highly competitive retail environment both in the United States and abroad. The 2006 results represent the 53 weeks ended February 3, 2007 as compared with the 52 weeks in the 2005 and 2004 reporting years. Income from continuing operations in 2006, after-tax, was $247 million, or $1.58 per diluted share, as compared with $263 million or $1.67 per diluted share in 2005. The following were the financial highlights of 2006:

- Contributed $68 million to its U.S. and Canadian qualified pension plans. The U.S. payment was made in advance of ERISA requirements.
- Repaid $50 million of its 5-year term loan, in advance of the regularly scheduled payment dates of May 2007 and May 2008.
- Purchased and retired $38 million of the $200 million 8.50 percent debentures payable in 2022 at a $2 million discount from face value, bringing the outstanding amount to $134 million as of February 3, 2007.
- Declared and paid dividends totaling $61 million. In the fourth quarter the Company increased its quarterly dividend per share by 39 percent.
- Repurchased $8 million of common stock.

Additionally, the following were the key factors affecting the Company’s performance during 2006:

- The 53rd week increased sales by $95 million and increased net income by $18 million or $0.11 per diluted share.
- Included in 2006 is a non-cash impairment charge of $17 million ($12 million after-tax), or $0.08 per diluted share, recorded to write-down the value of long-lived assets of underperforming stores in the Company’s European operations. This was necessitated by the continued declines in sales and division profit, principally as the result of a fashion shift from higher priced marquee footwear to lower priced low-profile footwear and a continued highly competitive environment, particularly for the sale of low-profile footwear styles.
- During the first quarter of 2006, the Company adopted SFAS No. 123(R), “Share-Based Payment.” The Company has recorded an incremental $6 million of share-based compensation in 2006. Additionally, the Company recorded a cumulative effect of a change in accounting of $1 million to reflect estimated forfeitures for prior periods related to the Company’s nonvested restricted stock awards.

The following table represents a summary of sales and operating profit, reconciled to income from continuing operations.

	2006	**2005 (in millions)**	**2004**
Sales			
Athletic Stores	$ 5,370	$ 5,272	$ 4,989

Direct-to-Customers	380	381	366
	$ 5,750	$ 5,653	$ 5,355
Operating Result			
Athletic Stores	$ 405	$ 419	$ 420
Direct-to-Customers	45	48	45
Division profit	450	467	465
Restructuring charges (1)	(1)	—	(2)
Total division profit	449	467	463
Corporate expense	(68)	(58)	(74)
Total operating profit	381	409	389
Other income	14	6	—
Interest expense, net	3	10	15
Income from continuing operations before income taxes	$ 392	$ 405	$ 374

(1) The restructuring charge in 2006 represents a revision to the original estimate of the lease liability associated with the guarantee of The San Francisco Music Box distribution center. During 2004, the Company recorded a restructuring charge of $2 million related to the dispositions of non-core businesses. These charges were classified within selling, general and administrative expenses in the Consolidated Statements of Operations.

Sales

All references to comparable-store sales for a given period relate to sales from stores that are open at the period-end, that have been open for more than one year, and exclude the effect of foreign currency fluctuations. Accordingly, stores opened and closed during the period are not included. Sales from the Direct-to-Customer segment are included in the calculation of comparable-store sales for all periods presented. Sales from acquired businesses that include the purchase of inventory are included in the computation of comparable-store sales after 15 months of operations. Accordingly, Footaction sales have been included in the computation of comparable-store sales since August 2005.

Sales increased to $5,750 million, or by 1.7 percent as compared with 2005. Excluding the effect of foreign currency fluctuations and the 53rd week, sales declined 0.7 percent as compared with 2005. Comparable-store sales decreased by 1.2 percent, which is primarily a result of the decline in our European operations.

Sales of $5,653 million in 2005 increased by 5.6 percent from sales of $5,355 million in 2004. The effect of foreign currency fluctuations on sales was not significant. This increase was primarily related to increased sales in the Company's Footaction and Champs Sports formats. Comparable-store sales increased by 2.7 percent.

Gross Margin

Gross margin as a percentage of sales was 30.2 percent in 2006; excluding the effect of the 53rd week, gross margin declined 20 basis points as compared with 2005. This reflects increased promotional activity, offset, in part, by the effect of increased vendor allowances. The effect of these vendor allowances was an improvement in gross margin in 2006, as a percentage of sales, of 20 basis points as compared with 2005. Additionally, gross margin was negatively affected by lower sales, which resulted in increased occupancy costs, as a percentage of sales.

Gross margin as a percentage of sales was 30.2 percent in 2005, decreasing by 30 basis points from 30.5 percent in 2004. This decline was primarily the result of increased markdowns recorded by the European operation. The effect of vendor allowances on gross margin, as a percentage of sales, as compared with the corresponding prior year period was not significant.

Corporate Expense

Corporate expense consists of unallocated general and administrative expenses, as well as depreciation and amortization related to the Company's corporate headquarters, centrally managed departments, unallocated insurance and benefit programs, certain foreign exchange transaction gains and losses and other items.

The increase in corporate expense in 2006 as compared with 2005 of $10 million reflects the adoption of SFAS No. 123(R) that resulted in incremental compensation expense of $6 million and a charge of $4 million for anticipated settlements of certain legal matters. The effect of the 53rd week on corporate expense was not significant. Depreciation and amortization included in corporate expense amounted to $22 million in 2006, $24 million in 2005, and $23 million in 2004.

The decrease in corporate expense in 2005 as compared with 2004 primarily included decreased incentive bonuses of $14 million; a $3 million decrease in costs associated with the Company's loyalty program, as 2004 represented the initial costs to launch the program; and decreased restricted stock expense of $2 million. In addition, 2004 included $5 million for the integration of the Footaction stores. Included in 2005 was also a settlement of $3 million pursuant to a class action settlement with Visa and MasterCard related to past overcharges for certain debit card transactions. These decreases were offset, in part, by a charge of $4 million due to the potential insolvency of one of the Company's insurance carriers and legal and settlement costs of $5 million.

Other Income

During 2006, the Company terminated two of its leases for approximately $5 million, which resulted in a net gain of $4 million. In addition, the Company finalized its insurance claims related to Hurricane Katrina, which resulted in a gain of $8 million, which represents amounts in excess of losses. Also during 2006, the Company purchased and retired $38 million of long-term debt at a discount from face value of $2 million. The 2005 amounts represent $3 million related to the insurance recoveries associated with Hurricane Katrina, as well as $3 million of a net gain on foreign currency option contracts that were entered into by the Company to mitigate the effect of fluctuating foreign exchange rates on the reporting of euro-denominated earnings.

Selling, General and Administrative Expenses

Selling, general and administrative ("SG&A") expenses increased by $34 million to $1,163 million in 2006, or by 3.0 percent, as compared with 2005. SG&A as a percentage of sales increased to 20.2 percent as compared with 20.0 percent in 2005. Excluding the effect of foreign currency fluctuations and the 53rd week, SG&A would have increased by 1.4 percent. This increase is primarily the result of incremental share-based compensation included in corporate expense, associated with the adoption of SFAS No. 123(R) of $6 million. Additionally, the net benefit cost for the Company's pension and postretirement plans reflected a reduction of $5 million, primarily as a result of additional contributions and improved pension fund asset performance.

SG&A increased by $41 million to $1,129 million in 2005, or by 3.8 percent, as compared with 2004. SG&A as a percentage of sales decreased to 20.0 percent as compared with 20.3 percent in 2004. The increase in SG&A is primarily related to an increase in payroll and related costs. The effect of including Footaction for the full fiscal year is an incremental $21 million, excluding the integration costs. During 2005, the Company donated 82,500 pairs of athletic footwear with a cost of $2 million to Save the Children Foundation. This donation benefited the tsunami victims in Banda Aceh, Indonesia, and Save the Children programs in the United States.

Depreciation and Amortization

Depreciation and amortization of $175 million increased by 2.3 percent in 2006 from $171 million in 2005. This increase primarily reflects additional depreciation and amortization for the Athletic Stores segment due to capital spending and the effect of foreign currency fluctuations of approximately $1 million.

Depreciation and amortization of $171 million increased by 11.0 percent in 2005 from $154 million in 2004. This increase primarily reflects additional depreciation and amortization for the Athletic Stores segment due to capital spending and adjustments to depreciable lives of certain fixed assets. Additionally, depreciation and amortization for the Footaction format increased by $6 million as compared with 2004, primarily due to increased capital expenditures related to store improvements and point-of-sale equipment.

Interest Expense, Net

	2006	2005 (in millions)	2004
Interest expense	$ 23	$ 23	$ 22
Interest income	(20)	(13)	(7)
Interest expense, net	$ 3	$ 10	$ 15
Weighted-average interest rate (excluding facility fees):			
Short-term debt	—%	—%	—%
Long-term debt	7.8%	6.2%	5.2%
Total debt	7.8%	6.2%	5.2%
Short-term debt outstanding during the year:			
High	$ —	$ —	$ —
Weighted-average	$ —	$ —	$ —

Interest expense of $23 million remained unchanged from 2005. Interest rate swap agreements did not significantly affect interest expense in 2006.

Interest income is generated through the investment of cash equivalents, short-term investments, the accretion of the Northern Group note to its face value and accrual of interest on the outstanding principal, as well as interest on income tax refunds. The increase in interest income of $7 million in 2006 was primarily related to increased interest income earned on cash, cash equivalents, and short-term investments. Interest income related to cash, cash equivalents and short-term investments was $14 million in 2006 and $11 million in 2005. Interest income on the Northern Group note amounted to $2 million in both 2006 and 2005. Also included in interest income is the effect of the Company’s cross currency swaps, which totaled $3 million in 2006 and was not significant in 2005.

Interest expense of $23 million increased by 4.5 percent in 2005 from $22 million in 2004 primarily attributable to higher interest rates. Interest rate swap agreements reduced interest expense by approximately $1 million and $3 million in 2005 and 2004, respectively.

The increase in interest income of $6 million in 2005 as compared with 2004 was primarily related to increased interest income earned on short-term investments due to higher interest rates and increased short-term investment balances. Interest income related to cash equivalents and short-term investments was $11 million in 2005 and $5 million in 2004. Additionally, interest income on the Northern Group note amounted to $2 million in both 2005 and 2004.

Income Taxes

The effective tax rate for 2006 was 36.9 percent as compared with 35.0 percent in the prior year. The increase in the rate is primarily due to the change in the mix of U.S. and international profits and the $17 million impairment charge relating to the Company’s European operations, as well as a $6 million valuation allowance adjustment recorded in 2005.

The effective tax rate for 2005 was 35.0 percent as compared with 31.7 percent in 2004. The increase was attributable to less benefit from non-recurring items than in 2004 and a higher percentage of the Company’s income earned in the United States, rather than from lower-taxed international operations. During 2005, the Company restructured its Canadian continuing business, which resulted in a $6 million reduction to its income tax valuation allowance related to Canadian tax loss carry-forwards and unclaimed tax depreciation. Additionally, the Company recorded an income tax benefit of $3 million in discontinued operations related to its former Canadian operations. During 2004, the Company settled foreign and domestic income tax examinations and reviews that resulted in reductions of its income tax provision for continuing operations by $14 million and discontinued operations by $37 million.

Segment Information

The Company evaluates performance based on several factors, the primary financial measure of which is division profit. Division profit reflects income from continuing operations before income taxes, corporate expense, non-operating income, and net interest expense.

Athletic Stores

	2006	2005	2004
		(in millions)	
Sales	$5,370	$5,272	$4,989
Division profit	$ 405	$ 419	$ 420
Sales as a percentage of consolidated total	93%	93%	93%
Division profit margin	7.5%	7.9%	8.4%
Number of stores at year end	3,942	3,921	3,967
Selling square footage (in millions)	8.74	8.71	8.89
Gross square footage (in millions)	14.55	14.48	14.78

2006 compared with 2005

Athletic Stores sales of $5,370 million increased 1.9 percent in 2006, as compared with $5,272 million in 2005. Excluding the effect of foreign currency fluctuations, primarily related to the euro, and the effect of the 53rd week, sales from athletic store formats decreased by 0.6 percent in 2006. Footaction and Champs Sports significantly increased sales, primarily from the sales of marquee basketball and running footwear. This was offset primarily by decreased sales in Foot Locker Europe. Foot Locker Europe's sales declined due to the continued difficult athletic retail environment, particularly in France, the U.K and Italy. Comparable-store sales decreased by 1.1 percent in 2006.

Division profit from Athletic Stores decreased by 3.3 percent to $405 million in 2006 from $419 million in 2005. Division profit as a percentage of sales decreased to 7.5 percent. The decrease in division profit is primarily attributable to the Foot Locker Europe division due to the fashion shift from higher priced marquee footwear to lower priced low-profile footwear styles and a highly competitive retail environment, particularly for the sale of low-profile footwear styles. Included in the Athletic Stores division profit for 2006 is an impairment charge of $17 million related to the Company's European operations, consistent with the Company's recoverability of long-lived assets policy. The charge was comprised primarily of stores located in the U.K. and France. As previously disclosed in 2005, the Company was monitoring the progress of the European operations and the possible analysis of recoverability of store long-lived assets pursuant to SFAS No. 144. Excluding the impairment charge, Athletic Stores division profit increased by 0.7 percent as compared with the corresponding prior-year period. The decline in Foot Locker Europe were offset by increases in all other divisions.

2005 compared with 2004

Athletic Stores sales of $5,272 million increased 5.7 percent in 2005, as compared with $4,989 million in 2004. Excluding the effect of foreign currency fluctuations, primarily related to the euro, sales from athletic store formats increased 5.5 percent in 2005. Comparable-store sales increased by 2.6 percent in 2005. These increases were primarily driven by sales related to the Footaction division, which was acquired in May 2004. Approximately $126 million of the increase in Footaction represented the inclusion of their operations for the full year in 2005. Champs Sports experienced a strong increase in sales during 2005, as this format benefited from higher quantities of marquee athletic footwear and private-label apparel. Foot Locker Canada also experienced increased sales. Excluding the effect of foreign currency fluctuations, Foot Locker Europe's sales were essentially flat as compared with the corresponding prior-year period.

Division profit from Athletic Stores decreased by 0.2 percent to $419 million in 2005 from $420 million in 2004. Division profit as a percentage of sales decreased to 7.9 percent in 2005 from 8.4 percent in 2004. This decline is primarily a result of the decreased profit from the European operations as compared with the prior year. The continued weak economy, the increased competitive environment and a fashion shift from higher priced marquee footwear to lower priced low-profile footwear negatively affected Europe's operating results. In addition during 2005, Foot Locker Europe recorded significantly higher markdowns as a result of the continued promotional environment, particularly in the U.K. and France, and to clear excess inventory. Despite these factors, in 2005 Foot Locker Europe achieved a double-digit division profit margin. The decline in Europe was partially offset by the improved results at the Footaction, Champs Sports and Canadian divisions. The increase in Footaction is primarily a result of the inclusion of its results for the full year as compared with a partial year during 2004.

Direct-to-Customers

	2006	**2005**	**2004**
		(in millions)	
Sales	$ 380	$ 381	$ 366
Division profit	$		