Research Update:

Academy Sports And Outdoor Inc. Upgraded To 'BB' On Better Competitive Prospects; Outlook Stable

October 5, 2022

Rating Action Overview

- U.S.-based outdoor and sports retailer Academy Sports & Outdoor Inc. recently reported better-than-expected performance, including S&P Ratings'-adjusted EBITDA margins of almost 19% over the last six quarters.
- We think this indicates an improved competitive position and expect continued good performance over the next 12 to 18 months.
- We therefore have raised our ratings on Academy, including our issuer-credit rating to 'BB' from 'BB-'.
- The stable outlook reflects our expectation for good performance over the next 12 to 18 months and S&P adjusted leverage at or near recent levels.

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Rating Action Rationale

Academy's recent performance trends, including improved EBITDA margins, indicate a better competitive position. Over the last year, Academy's operating performance, especially margin generation has been ahead of our forecast. Importantly, S&P Global Ratings'-adjusted EBITDA margins remain elevated compared with historic results and have meaningfully beat our forecast. For the trailing months through July 2022, Academy's S&P Global Ratings'-adjusted EBITDA margins were 18.2% compared with our prior projection of 15%. In addition, these margins were around 19% or more in the first half of this year. This is also better than our expectations, a forecast that assumed margin drag due to significant competition and promotions. While the economic environment remains uncertain, Academy has benefited from its market position as a value-oriented retailer, leading to elevated customer traffic and demand for sporting goods and outdoor equipment, along with demand from trade-down consumers. At the same time, adjusted EBITDA margins have improved versus the year ago period because of relatively lean inventory, cost-containment efforts, better promotional cadences, and operating initiatives over the last few years. While we believe economic and competitive risks will persist, we believe Academy's S&P Global Ratings'-adjusted EBITDA margins will remain around 18%.

That said, company sales were generally in line to slightly ahead of our projections, as revenue declined at a mid-single-digit rate for the first half of the year. We think this represents a modest normalization in the company's sales performance as it laps more than 20% growth in the prior period. We expect revenue declines to moderate in the second half of the year before expanding in the fiscal year in 2023. We believe changes in consumer habits, including more people working from home and continuing outdoor hobbies, will provide structural tailwinds to sporting goods demand. We also expect an acceleration in new store opening to boost sales over the next 12 to 18 months.

We believe management's operating initiatives will help Academy maintain good, long-term performance. Academy's management team has strategically employed operating initiatives that have helped the company maintain growth and sustain S&P Global Ratings'-adjusted EBITDA margins. This includes improved in-store customer service by increasing customer facing hours, modifying the store layout, enhancing the assortment, and increasing store localization efforts. Moreover, assortment and store layout updates, along with good vendor relations, have helped Academy maintain good inventory levels, up just 17% as of the second quarter ending July 2022 versus the 2021 period.

In addition, we believe implemented and planned omni-channel initiatives will help maintain and increase customer engagement. Technology management has increased and will likely continue to improve check-out speeds, improve in-store and online search capabilities, and expand payment options. This includes continual improvements of the company's website and enhancements to the mobile app.

We think these initiatives and others like data-driven markdown and merchandising optimization have allowed management to refocus on expansion strategies. We believe Academy will prudently and profitably expand its store base over the next few years, where we project around 10 to 15 new stores annually. We think operating initiatives enacted over the last few years will position Academy for good long-term growth and have accordingly revised our business risk assessment to fair from weak.

Academy remains a relatively smaller, but growing, competitor in the sporting goods retail industry. We continue to view Academy as a regional sports and outdoor retailer with physical stores, primarily in Texas and adjacent southern states. The company positions itself as an everyday-low-price value player and competes with significantly larger and better-capitalized competitors, companies that include a focus on the mass market or provide specialized sports products. This includes specialized retailers likes Dick's Sporting Goods Inc., (BBB/Stable/--) and Great Outdoors Group LLC (BB-/Positive/--), mass merchants like Walmart Inc. (AA/Stable/A-1+), and e-commerce competitors like Amazon (AA/Stable/A-1+). In addition, online penetration remains lower than some peers, comprising around 10% of total sales. We think this creates potentially long-term risks for Academy, as the industry remains prone to product promotions and competitive pricing along with evolving customer habits. We also believe sporting goods and related products remain a highly fragmented sector with increasing competition, including both physical retailers and pure-play e-commerce competitors.

Academy and the sports retailing industry may experience more volatile performance over the near term because of macroeconomic uncertainty. We project inflation will remain elevated well into 2023 and for an overall economic slowdown to persist through 2023. We acknowledge a degree of risk related to an unforeseen decline in Academy's performance that could arise from increased competition and heightened promotions. Moreover, increased competitor price promotions could also have a negative effect on near-term projections beyond what we already consider in our base-case forecast.

Outlook

The stable ratings outlook reflects our expectation for good performance over the next 12 months, including low- to mid-single-digit percent sales growth, S&P Global Ratings'-adjusted margins around 18%, and S&P Global Ratings'-adjusted leverage at or near recent levels.

Downside scenario

We could lower our rating on Academy if we expect leverage of 3x or more on a sustained basis. Such a scenario would likely include:

- A worsening macroeconomic environment or operational misstep that causes weaker performance compared with our base case; and
- A significant decline in sales and adjusted EBITDA margins that results in EBITDA declining more than 50% compared withour base-case projections.

Upside scenario

We could raise our ratings if:

- The company continues to successfully execute its operational strategies, resulting in better operating performance;
- Academy further expands its operational scale and significantly diversifies its operations beyond Texas and the southern U.S.; and
- The company maintains a conservative financial policy as indicated by adjusted leverage near recent levels and also publicly states a financial target.

Company Description

Academy operates as a full-line sporting goods and outdoor recreation products retailers in the U.S. with more than $6 billion of net sales. The company recently operated more than 260 Academy Sports & Outdoors retail locations in 17 states with approximately 18 million square feet of retail space, the majority of which are regionally concentrated in Texas and adjacent southern U.S. states.

Our Base-Case Scenario

Our performance projections for the company include the following assumptions:

- S&P Global economists forecast U.S. GDP growth of about 1.6% in 2022, decelerating to about flat in 2023.
- A short and shallow recession early next year but unemployment remains below 5% over the next 12 months.
- Projected 4% decline in sales in 2022, followed by 5% sales growth in 2023.

- Low- to mid-single digit decline in comparable sales in 2022 and low-single-digit increase in 2023.
- Ten new store openings over the next 12 months.
- Management's initiatives and inventory management will help maintain S&P Global Ratings'-adjusted margins around 18%.
- Annual capital spending between $140 million and $200 million, with investments on omnichannel initiatives, new store openings, and general maintenance.
- No meaningful debt reduction over the next 12 to 18 months; and
- $500 million in share buybacks over the next 12 months.

Based on our operating assumptions, we arrive at the following credit metric projections:

- S&P Global Ratings'-adjusted leverage around 1x over the next 12 to 18 months;
- Funds from operations (FFO) to debt more than 70% over the next 12 to 18 months;
- Adjusted interest coverage around 7x in 2022 and 2023; and
- Reported free operating cash flow generation approaching $600 million.

Academy has consistently reduced debt since its IPO in October 2020. This, in addition to ongoing operating performance growth, has resulted in an improvement in adjusted credit metrics, including S&P Global Ratings'-adjusted leverage of 1.6x as of July 2022, compared with the low-4x area prior to the IPO. Looking ahead, we expect the company will continue generating healthy cash flow, with meaningful reported free operating cash flow of more than $500 million. While we expect the company to use most of its excess cash flow for shareholder initiatives, we also expect Academy to fund operating initiatives and maintain leverage in the 1x range.

Liquidity

We assess Academy's liquidity as adequate and project it will have ample liquidity sources to satisfy its needs over the next 12 months. This reflects our qualitative analysis of the company's liquidity position. Specifically, we view Academy as having a limited ability to absorb high-impact, low-probability adversities without refinancing given its geographic scope along with highly competitive industry dynamics. In addition, we think Academy maintains a generally satisfactory standing in the credit markets. We also project Academy's liquidity sources will remain more than 2x its uses even if its EBITDA unexpectedly declines by 15%. Our quantitative liquidity forecast assumes:

Principal liquidity sources

- Balance sheet cash of nearly $400 million as of July 2022;
- FFO of about $850 million to $900 million annually;
- Estimated full availability under the $1 billion revolving credit facility due 2025; and
- Modest working capital cash flows over the next 12 months.

Principal liquidity uses

- Capital expenditures of about $140 million to $200 million over the next 12 months;

- Seasonal working capital needs of $150 million annually; and
- Modest contractual debt amortization and dividends to shareholders.

Covenants

The company's $1 billion asset-based loan (ABL) facility is subject to a fixed-charge coverage covenant if excess availability is less than the greater of either 10% of the line cap (lesser of the aggregate amount of the ABL commitments and the borrowing base) or $60 million. We do not expect the company's springing fixed-charge covenant will become applicable over the next 12 months because we forecast ample cash flow generation and no significant revolver borrowings.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-3, G-2

Social factors are a moderately negative consideration in our credit rating analysis of Academy. The company has substantial exposure to firearms and ammunition sales, which add volatility to the company's sales and profitability because of the significant unpredictability and meaningful fluctuations in demand, especially before national elections. In addition, regulators and lawmakers have looked to impose increased restrictions on firearm sales. While no new legislation has been enacted potential changes in the regulatory climate could increase future performance risks.

Issue Ratings - Recovery Analysis

Key analytical factors

- Our '3' recovery rating on Academy's senior secured debt reflects the value we attribute to the company in a simulated emergence following a default.
- We simulate a default occurring in 2027 because of lower consumer discretionary spending in a volatile economy along with a significant step up in competition. This leads to declining consumer spending on sporting goods and, consequently, lower sales and operating margins for Academy all leading to constrained liquidity.
- We believe the company's senior secured debt holders would maximize their recoveries if the company emerges from bankruptcy given its competitive position and the lack of significant owned assets.
- We accordingly estimated Academy's post emergence value by applying a 5x multiple to our forecasted emergence EBITDA. This multiple is in line with the multiples we use for its similar sporting good and other retail peers.
- After adjusting for the value we attribute to estimated administrative expenses and revolver-related claims, we forecast approximately $426 million in collateral value available to the secured debtholders.

Simulated default assumptions

- Year of default: 2027
- Emergence EBITDA: about $215 million
- Implied enterprise value (EV) multiple: 5.0x
- Estimated gross EV at emergence: About $1.07 billion
- A 60% draw on the ABL facility on the path to default

Simplified waterfall

- Net EV after 5% administrative costs: $1.02 billion
- Secured priority revolver claims: $594 million
- Remaining value after priority claims: $426 million
- Senior secured debt claims: $719 million
- --Recovery expectations: 50%-70%; rounded estimate: 55%

Note: All debts amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer credit rating: BB/Stable/--

Business risk: Fair

- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Fair

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

Anchor: bb+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)

- Financial policy: Neutral (no impact)
- Liquidity: Adequate (No impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: bb

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded; Outlook

	To	From
Academy Sports and Outdoor Inc.		
Academy Ltd.		
Issuer Credit Rating	BB/Stable/--	BB-/Stable/--
Ratings Upgraded; Recovery Rating Unchanged		
Academy Ltd.		
Senior Secured	**BB**	**BB-**
Recovery Rating	3(55%)	3(55%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.