Coach, Inc. COH

by Morningstar Equity Analysts

Analyst Note 08-03-2010

We are optimistic about the stability of high-end consumer purchases after Coach COH reported positive fiscal fourth-quarter and full-year results. Coach's announcement continued a string of optimistic financial results and comparable-store sales trends from other luxury makers and retailers during the first half of 2010. Management made positive comments about customers' willingness to spend based recent sales trends, and on a broad customer survey. Executives also mentioned that the brand would be building back inventory for the holidays. As with most consumer product makers, management made carefully worded comments about cost pressures in 2011, which are expected to impact gross margins slightly, offset by efforts in manufacturing and product mix. Trading at roughly 15 times our 2011 earnings per share estimate and yielding nearly 6% on a forward free cash flow basis, we view Coach as modestly undervalued relative to other luxury brands that we cover, many of which are currently trading at premiums to our fair value estimates. We will finalize our model after the company issues its 10-K, but we do not anticipate a material change to our fair value estimate.

Coach saw sales increase 13% after factoring in the effects of an extra week in the quarter compared to a year ago. Notably, comparable-store sales were up 6% in North America, with both factory outlet stores and full price stores increasing sales year-over-year. We were encouraged by positive comparable-store sales growth at mature, full price stores. This could signal that high-end consumers may be gradually returning to normalized spending patterns, and that the company is properly managing the brand impact of operating a multichannel distribution strategy. We also view the increases in net income, earnings per share, and cash flow, which were ahead of the sales growth rate, as positive signs that management is paying attention to profitability and shareholder value.

We believe Coach has ample growth opportunities over the long run, and will continue to grow sales and cash flows at an above-average rate beyond the short term. Despite only modest potential in its established markets, we agree with the company's strategy of investing in Asia--including its new China distribution center--and increasing its ownership of distribution in other Asian markets. We believe that China, despite investor fears of an impending economic bubble bursting at some point, will continue to drive significant growth and profitability for the next several years. Our model contemplates high single-digit average annual operating profit growth over the next five years, which could be a conservative forecast compared to the previous five-year average around 20%. Coach's excellent brand and high operating margins will,

Morningstar Rating
★★★

Stock Price
As of 08-03-2010
$37.10

Fair Value Estimate
$40.00

Consider Buying
$20.00

Consider Selling
$80.00

Fair Value Uncertainty
High

Economic Moat
Narrow

Stewardship Grade
B

Bulls Say

- Coach is positioned as a fashion-forward lifestyle brand. Its trendy, high-quality products continue to be popular with consumers seeking affordable luxury.
- Coach products are being well-received abroad, particularly in Japan. Given the popularity of the brand and Coach's buyout of its Japanese partner's stake in Coach Japan, expansion into new Japanese markets should fuel growth.
- With operating margins in the 30% range, Coach ranks as one of the best-performing specialty retailers.
- Coach continues to drive demand through its innovative handbag offering.
- Coach began paying a cash dividend to its shareholders in 2009 at an annual rate of $0.30 per share and has since increased it to $0.60 per share.

Bears Say

- Consumers remain selective in spending on discretionary items, which could lead to choppy near-term results.

in our view, allow it to consistently invest in growth, and still earn respectable returns on capital.

Thesis 07-12-2010

Coach is making a comeback as consumers' willingness to spend on premium discretionary goods has increased amid a more stable economic environment. A recovery in the United States (which accounts for around 70% of revenue) is likely to drive solid sales growth and margin expansion this year. Longer term, we think expansion abroad and continued product innovation will be key drivers of future success for this aspirational brand.

Coach has carved out a niche in the fast-growing premium accessories market with its accessible luxury handbags. The specialty retailer fills a void between moderate brands and designer labels with its high-quality, smartly priced goods. Coach has experienced phenomenal growth, with annual revenue increasing 20% on average during the past five years (including fiscal 2009 when sales grew an anemic 2%). Despite its fast ascent to more than $3 billion in sales, we think growth opportunities remain. While the company is slowing store growth in the near term in an effort to be prudent in this weak economic environment, the company still plans to expand its store base in North America from around 440 stores today to around 500 stores longer term.

We also think Coach has great potential in international markets. In fiscal 2009, around 22% of its sales were from Japan. While the Japanese luxury market remains weak and consumers have pulled in the reins on purchases of high-end goods, we believe Coach's affordable luxury positioning will pay off in the longer term. We think China is another key market for Coach down the road. The initial response to the brand has been positive, and the company is accelerating its expansion strategy with plans to open 15 stores in China in fiscal 2010. As Chinese consumers' disposable income increases and they become aware of the brand, we expect Coach to quickly increase its share of the Chinese accessories market.

Despite its long-term prospects, Coach recently downshifted in response to the difficult economic environment. The firm rebalanced its product offering providing a wider assortment of handbags in the $200-$300 range, a shift from its previous strategy of trying to broaden the assortment of handbags at higher price points, in the $300-$400 range. We recognize there is a risk to this aspirational brand given the downward shift in price, but we think Coach is compensating for that through product innovation. The retailer is seeing positive response to its recently launched Poppy line, which carries an average handbag price of $260. Ongoing product innovation will be key for Coach to maintain its brand cachet and drive demand for products as the economy recovers.

Valuation

Our fair value estimate of $40 per share implies forward fiscal-year price/earnings of 16 times, an enterprise value/EBITDA of 8.6 times, and a free cash flow yield of 6%. For fiscal 2010, we project that total sales will be up 10%, driven mainly by increased distribution abroad and improved sales in domestic locations. After 2010, we expect average annual sales growth in the mid- to high-single-digits, driven by new store openings both domestically and abroad and comparable-store sales growth averaging in the low-single-digits. While the company's strategy to lower prices 10%-15% in its handbag category should help drive sales and contribute to operating profit dollars, we think it is likely to result in

- Coach's growth strategy relies heavily on strong international markets, particularly Japan and China. Any change in demand or missed trend there will stifle growth.
- With the launch of a new brand under creative designer Reed Krakoff's name in the works, Coach risks taking its eye off its namesake line.
- Success is riding on Coach's ability to provide the latest trend. The firm faces greater exposure to trend-setting competitors that might steal share with the introduction of a more popular product.
- As Coach expands, it risks becoming ubiquitous, which could diminish the brand's cachet and limit this retailer's pricing power.

gross margins below historical highs. However, we expect some of the gross margin pressure to be offset by the company's cost-cutting initiatives, which are expected to result in $50 million in annual savings beginning in 2010. Longer term, we project operating margins to hover around 32%, slightly higher than our previous assumption of 30%. As the international business gains scale and becomes a more meaningful part of sales (we forecast that it will shift from around 30% of sales in 2009 to more than 40% of sales by 2019), we expect some margin improvement. This valuation assumes that Coach will succeed in its expansion efforts both domestically and internationally. A deviation from its build-out plans would cause us to reconsider Coach's long-term potential.

Risk

Relying on fashion trends to drive sales is one of the risks Coach faces. We attribute a large portion of Coach's recent success in hitting the latest trends to executive creative director Reed Krakoff. With Krakoff slated to launch a ready-to-wear line under his name in 2010, we think there is a risk that too much of his attention will be diverted away from the Coach brand.

Strategy

Coach continues to expand domestically and internationally, with plans to open around 20 stores in North America in 2010, as well as 10 locations in Japan, 15 in China, and an additional 30 wholesale locations in international markets. In addition to opening new stores, Coach continues to expand mature stores' square footage. The company has opened two Coach Legacy boutiques (a possible second concept), which feature products from its legacy line.

Management & Stewardship

Lew Frankfort has served as chairman and CEO since 1995, and helped lead the firm through its initial public offering in October 2000. He has more than 25 years of experience at Coach. In recent years, he has revitalized the Coach brand and assembled a topnotch management team to lead this effort. In 2009, his total compensation was $7.5 million. Although Frankfort's compensation is generous, particularly in terms of stock options, we think his 2.8% stake in the company helps align his interests with those of other shareholders. President and executive creative director Reed Krakoff's total compensation of $18 million in 2009 does strike us as excessive despite his unquestionable contribution to the company's success. He owns less than 1% of the shares outstanding, and we'd prefer to see him have a greater equity stake in the company. Despite the generous executive compensation, shareholder value has soared under Frankfort's leadership and Krakoff's creative skills, with the stock price up around 16 times the company's IPO price in 2000 (adjusted for splits). A majority of Coach's board is independent, and officers and directors own nearly 5% of the shares outstanding. Although we would prefer to see the roles of chairman and CEO split, we like that the company has appointed a lead director who can challenge the CEO if necessary. We believe management does a good job of providing transparency around the business. Overall, corporate governance is good, in our opinion.

Profile

Coach is a specialty retailer focused on providing premium everyday accessories in an assortment of styles and materials. Its products include handbags, wallets, watches, footwear, and other accessories. Although nearly 60% of sales come from its roughly 330 North American retail stores and more than 110 outlet stores, Coach also sells its products through department stores, international shops, the Internet, and its catalog.

Growth

Coach has chalked up average annual sales growth of 20% during the past five years, driven by new domestic stores and expansion into international markets. Improved productivity at mature stores has also contributed to Coach's growth spurt.

Profitability

Operating profits have skyrocketed during the past five years, increasing roughly 22% on average annually. This has been driven by better sourcing, an improved product mix, and growth in high-margin channels like Japan.

Financial Health

With little debt on the balance sheet and its ability to turn roughly 20% of sales into free cash flow, Coach is in excellent financial health and well-positioned to fund growth.

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