Snapshot
Quote
Analyst Research
Morningstar Rating
Options
Data Interpreter
Valuation Ratios
Financial Statements
Key Ratios
Charts
Dividends & Returns
Company Filings new
Insider Trading
Formatted Report
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Coach, Inc. COH

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by Kimberly Picciola

Analyst Note 08-04-2009

After reviewing Coach's COH fourth-quarter and full-year results, we are modestly increasing our fair value estimate to reflect the benefit we think the company will receive from its cost-cutting initiatives as well as the cash generated by the business. We believe the company has done a nice job of navigating a difficult environment by slowing store growth, cutting expenses, and rebalancing its product assortment to include more items at lower prices. The retailer continues to invest in the brand through new product launches and expanded distribution in emerging markets like China (where it is seeing double-digit growth in comparable-store sales). For fiscal 2010, we project a modest increase in sales due mainly to increased distribution. We anticipate more margin contraction in the coming year as the retail environment remains promotional.

The retailer reported total quarterly sales of $778 million, a 1% decrease from the prior-year quarter. Direct-to-consumer sales were $683 million, up 3% from the year-ago quarter, driven by sales from new stores, with domestic same-store sales declining 6.1%. We think the company’s move to broaden its assortment in the $200-$300 price range in addition to its launch of the more youthful Poppy line could provide a lift to sales at its full-price stores over the next few quarters. Indirect sales were $95 million, down 21% from the prior-year period, driven by reduced shipments to domestic department stores. We anticipate sales through the department store channel will remain weak in the near term as department stores continue their efforts to keep inventory levels in line with soft consumer demand.

The weak sales continue to weigh on Coach's bottom line with quarterly operating profit down 22% (excluding unusual items). This resulted in an operating margin of 28.2% versus 35.9% in last year's fourth quarter. The big driver of the margin contraction was deterioration in the gross margin rate to 70.4% versus 75.9% in the year-ago period due mostly to increased promotional activity in the factory channel. Additionally, the company's selling, general, and administrative expenses (excluding unusual items) were up 4.9% over the prior-year period pressuring profitability. We believe profit margins will remain under pressure in the near term as sales stay soft.

While Coach has demonstrated time and time again its commitment to its brand, we are concerned about the launch of a new brand under head designer Reed Krakoff's name slated for 2010. We think that Krakoff's innovative product designs have been key to Coach's success and that his focus is likely to shift to his own line over the coming months as he builds out the new brand. Although we think the recent weakness in the retailer's performance is more a function of the challenging times than a sign of a weakening brand, we will continue to closely assess the health of the Coach brand.

Morningstar Rating
★★★

Stock Price
As of 08-04-2009
$29.31

Fair Value Estimate
$31.00

Consider Buying
$15.50

Consider Selling
$62.00

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 30s, 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.

Bears Say

- Consumers are cutting back on discretionary items, which is likely to pressure Coach's sales and profit margins over the next few quarters.

Thesis 08-04-2009

Despite a strong brand, Coach isn't immune to the challenging environment. Same-store sales (sales from stores open at least a year) have been negative in recent quarters as demand for handbags and accessories has taken a dive. Although we believe unfavorable economic fundamentals will pressure near-term sales and profitability, we think expansion abroad and continued product innovation will be key drivers of future long-term success for this aspirational brand.

Coach has carved out a niche in the fast-growing premium accessory 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 over the long term, with a target of around 500 stores.

We also think Coach has great potential in international markets. In fiscal 2009, around 22% of its sales were from Japan. While the Japanese economy has weakened in recent months and we are seeing consumers pull 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 a 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 2010. As Chinese consumers' disposable income increases and they become aware of the brand, we expect Coach to increase its share of the Chinese accessories market.

Despite its long-term prospects, Coach is downshifting in light of the difficult economic environment. Coach has rebalanced its product offering with a wider assortment of handbags in the $200-$300 range, a shift from its previous strategy of trying to broaden its 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 its products in this challenging retail environment.

Valuation

We are increasing our fair value estimate to $31 per share from $28 to account for cash generated during the year as well as the company's cost-cutting efforts. For fiscal 2010, we project total sales will be up modestly, driven mainly by increased distribution abroad as sales in domestic locations remain weak, particularly through the back half of 2009. After 2010, we expect average annual sales growth of around 5%, 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 operating margin and profit contraction in the near term as gross margins remain under pressure. In 2010, we expect the company to benefit from its recent cost-cutting initiatives with an expected savings of $50

- 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.

million. We project the direct segment, which includes U.S. retail stores, factory stores, the Internet, and the catalog, will continue to make up the majority of Coach's revenue, but we expect international sales will increase as a percentage of total revenue over the next 10 years as the company ramps up its expansion into China. This valuation assumes that Coach will succeed in its expansion efforts both domestically and internationally. A deviation from its expansion plans would cause us to reconsider Coach's long-term potential.

Risk

Consumers are cutting back on discretionary goods in light of a challenging macroeconomic environment, which is likely to pressure near-term sales and profitability for Coach. 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 2008, his total compensation was $9.6 million. Although Frankfort's compensation is generous, particularly in terms of stock options, we think his 2.6% stake in the company helps align his interests with other shareholders'. President and executive creative director Reed Krakoff's total compensation of $22 million in 2008 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 10 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 4% 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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