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Coach — China expansion and Men's division provide bullish outlook

Investment thesis

- US luxury goods manufacturer, Coach (COH) promotes itself as selling "accessible luxury" and is considered a bellwether for the higher and upper middle-income shoppers (the prices of the company's handbags can range from $298-$6,000), which means that the company's products should reach a larger consumer demographic than some of its high-priced competitors (Louis Vuitton, Gucci, Prada etc.) which focus only on the very wealthy.
- For 2Q13 Coach released disappointing results reporting only a 4% YoY increase in sales to $1.5bn vs $1.4bn in 2Q12, as a subdued economic environment and increased competition in the US, together with the European recession impacted sales. Earnings came in at $1.23/share (vs $1.18/share in 2Q12 and $0.77/share in 1Q13) and below Wall Street expectations of $1.26/share. Fortunately the group's international operations performed much better with sales in China recording stellar 40% growth with significant upside potential going forward.
- Although the company reported results that disappointed the market in 2Q13, we see potential for sales growth to increase exponentially on the back of its global expansion strategy (especially in China) and in Coach's Men's division (currently only around 12% of the overall business). The group is also undertaking a transformation strategy to move it from an accessories brand into a global lifestyle brand.
- Since the release of its results the company's share price has declined 17.7% and at a 12M fwd P/E of 12.8x (far below the luxury retailers) we believe the share is trading in extreme value territory.

Coach vs luxury peer group:

	12M trailing P/E	12M forward P/E
Coach	13.8	12.8
Hermes	37.1	32.8
LVMH	18.9	16.6
Michael Kors Holdings	33.1	22.7
Prada	28.9	22.4

Source: Bloomberg, Anchor Capital

Coach's metrics are as follows:

Spot ($)	49.93
Mkt Cap $bn	14.0
12M trailing P/E	13.8
12M fwd P/E	12.8
10-year average P/E	19.1
FYE	30-Jun
P/Book ratio	6.7
12M trailing DY	2.4
12M fwd DY	2.5

Source: Bloomberg, Anchor Capital

What it does

Coach, Inc. is a US luxury leather goods manufacturer and retailer, founded in 1941. The company designs, produces and markets mainly leather goods including handbags, business cases, travel accessories, leather outerwear and gloves. Through its licencing partners Jimlar (footwear),

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Luxottica (eyewear), Movado (watches) and Estee Lauder (fragrance) it also offers a variety of other products. Coach products are sold globally through Coach stores, select department and specialty stores, and through its website. The group currently has over 500 stores in the US and Canada, along with more than 300 locations in China, Japan, Singapore and Taiwan. Coach is listed on the New York Stock Exchange and its Hong Kong Depositary Receipts are traded on The Stock Exchange of Hong Kong Limited under the symbol 6388.

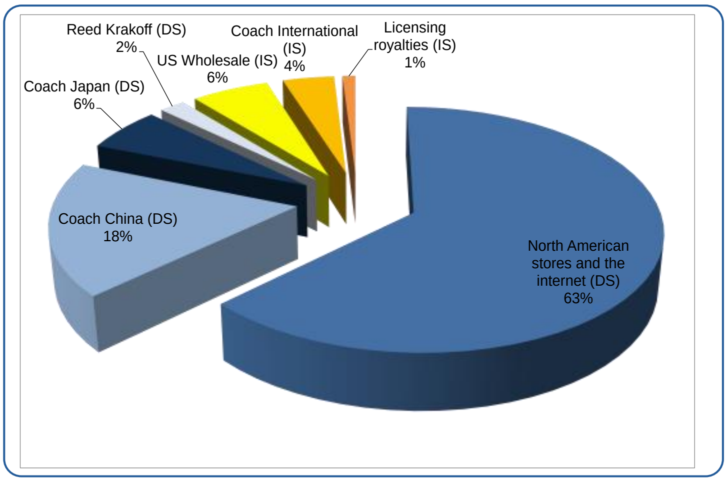
Coach operates two segments: Direct-to-Consumer and an Indirect segment.

The **Direct-to-Consumer segment** provides the company with channels that allow immediate, controlled access to consumers. It represented c. 89% of Coach's total net sales in FY12. This segment includes North American retail and factory stores, the coach website, Coach Japan, Coach China, Coach Singapore and Taiwan as well as the Reed Krakoff brand. Reed Krakoff, known primarily for handbags, accessories and ready-to-wear items was launched in 2010 and introduced through specialty retailers in early FY11. Designer Reed Krakoff was hired in 1996 by CEO Lewis Frankfort and is credited with Coach's success from 1996 with his designs transforming the company into a global brand.

The **Indirect segment** represented c. 11% of Coach's total net sales in FY12 and consists of US Wholesale, Coach International and the royalties earned on licenced products. Coach's products are sold in around 990 wholesale locations in the US and Canada with its most significant US wholesale customers being Macy's (including Bloomingdale's), Dillard's, Nordstrom, Lord & Taylor, Carson's, the Bay and Saks Fifth Avenue. Also in this segment is Coach International which includes sales to international wholesale distributors and authorised retailers with travel retail representing the biggest portion of its sales. Coach's international distributors serve South Korea, the US and its territories, Taiwan, Malaysia, Hong Kong, Mexico, Saudi Arabia, Thailand, Japan, Australia, Singapore, UAE, France, China, Macau, Indonesia, Kuwait, Bahamas, Aruba, Vietnam, New Zealand, Bahrain, India and Brazil. Its most significant international wholesale customers are the DFS Group, Shinsegae International, Tasa Meng Corp, Lotte Group and Shilla Group. Coach assumed direct control of its domestic retail businesses in Malaysia and Korea in July and August 2012, respectively.

Although Coach maintains control of the supply-chain process from the design through to the manufacture, all the company's products are made by independent manufacturers. Coach qualifies its raw-material suppliers by maintaining sourcing and product development offices in China, Hong Kong, Vietnam, South Korea and India. These offices work closely with the company's independent manufacturers. According to Coach its broad-based, global manufacturing strategy is designed to optimise the mix of cost, lead times and construction capabilities.

FY12 net sales by segment



Source: Company reports, Anchor Capital

**Note DS=Direct Segment and IS=Indirect Segment*

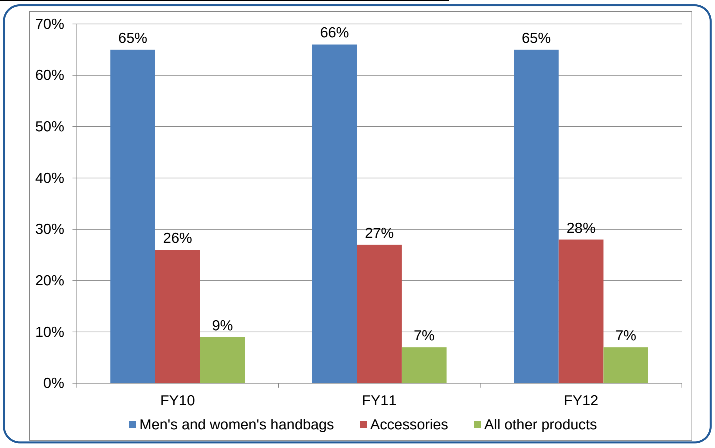
A global presence

At FY12, Coach had 354 retail and 169 factory stores in North America while Coach Japan, Coach China, Coach Singapore and Coach Taiwan operate department store shop-in-shop locations and freestanding flagship, retail and factory stores (as well as an e-commerce website in the case of Japan). Flagship stores, offering the broadest assortment of products, are located in select shopping districts throughout Japan, Hong Kong and mainland China. At FY12 the number of Coach Japan locations stood at 180 (6.5% higher than in FY11), Coach China had 96 locations (up 45.5% YoY) and Coach Singapore and Taiwan had 34 locations (up 25.9% YoY). International free-standing stores totalled 77 at FY12, while international department stores and other international locations stood at 87 and 41, respectively. The company has said that its expansion plans for FY13 includes further forays into Latin America through distributor partners to customers in Venezuela, Colombia, Panama and Peru

2Q13 results

After achieving average YoY sales growth of 13.4% in the past four quarters, Coach's 2Q13 results, which were released in January, disappointed the market. The results were pulled down by the company's women's division where its handbag business saw comparable store-sales decline 2%. Despite the fact that the usually busy Christmas holiday season fell in the quarter, Coach reported only a 4% YoY increase in sales to $1.5bn vs $1.4bn in 2Q12 (North American sales were up only 1% to $1.08bn vs $1.07bn in 2Q12), while the group's net margin decreased 50 bpts p.a. to 23.5% as a subdued economic environment in the US and the European recession impacted consumer spending. Net income was $352.7mn vs $347.5mn in 2Q12 while EPS came in at $1.23/share (vs $1.18/share in 2Q12). Although the company did acknowledge that price-cutting and stiffer competition (especially from Michael Kors Holdings) further impacted its bottom line, it mainly blamed macroeconomic factors such as the impact of Hurricane Sandy and uncertainty surrounding the fiscal cliff as playing a role in the weaker results.

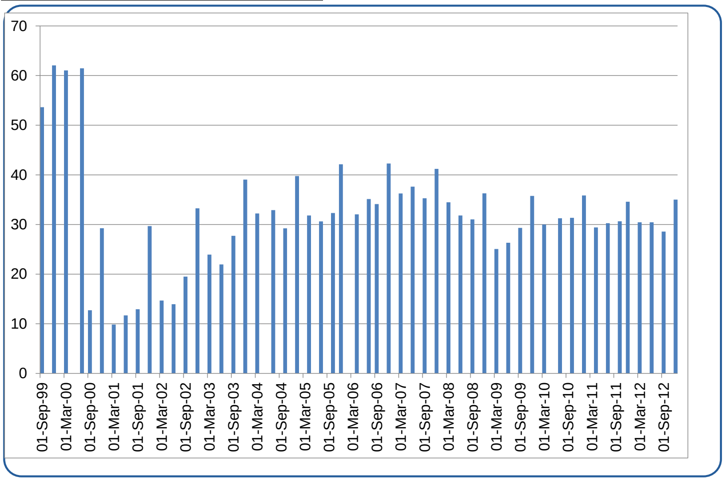
FY12 net sales by product category



Source: Company reports, Anchor Capital

Another major part of the comparable sales decline in its factory channels was in effect self-inflicted as Coach discontinued its in-store coupon programme in its factory stores. The company made this move to improve its Average Unit Rates (AUR) in factory stores, but the move backfired and Coach's factory store customers (accustomed to in-store coupons) started distancing themselves once in-store couponing was discontinued. At the same time Coach's competitors increased the scale of their promotions, effectively taking away a significant number of Coach's customers. Coach realised this and restarted in-store couponing within a few weeks but unfortunately by then it was too late and the damage had been done.

Coach operating margins



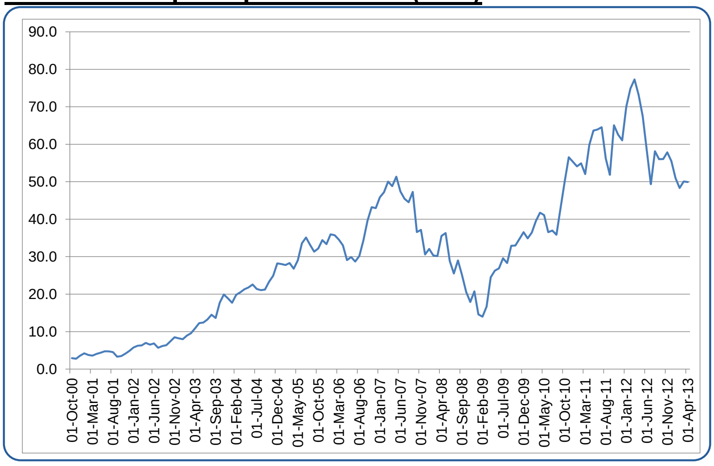
Source: Bloomberg, Anchor Capital

On the more positive side the company posted strong international results which were buoyed by its men's business (the company has noted that its men's business was on track to generate sales of over $600mn globally [up 50% YoY]). International sales were up 12% to $411mn (vs $368mn in 2Q12) with China driving growth as total sales in that country increased by 40% and a measure considered an important indicator of a retailer's health, revenue at stores opened at least a year, saw a double-digit increase. Coach also reported strong growth in other Asian markets, including Singapore, Taiwan, Malaysia and Korea. However, sales in Japan declined 2%.

Handbags, which represent the company's most dominant product category (accounting for c. 65% of revenue), saw increasing competition particularly from Michael Kors Holdings. The women's handbag category particularly was under pressure on the back of this increased competition and while Coach was reticent to offer promotions there was intense promotional activity from most of its competitors. This contributed to revenue at stores opened at least a year, falling by 2%. Belts, wallets, wristlets and other small leather goods represent the company's second-largest category (c. 28% of sales), while other products including apparel, travel bags, jewellery & fragrance, footwear, etc. account for c. 7% of sales. Coach's gross margins held steady at over 72% and its operating margins rose to 35% (36% excluding special tax related charitable donations). The group also bought back 4mn shares at $56 during the quarter.

Following the release of the 2Q13 results Coach's share price fell over 16.4% to $50.75. Ytd the share price is down 10.1%,

Coach share price performance (USc)



*Source: **TimBukOne**, Anchor Capital*

Looking ahead the company said that its strategy is four-fold:

- Growing its Women's business in North America by developing the accessories market and increasing its distribution.
- Raising its brand awareness and market share in under-penetrated Asian markets.
- Increasing its Men's business (especially in North America and Asia); and
- Maximizing e-commerce sales.

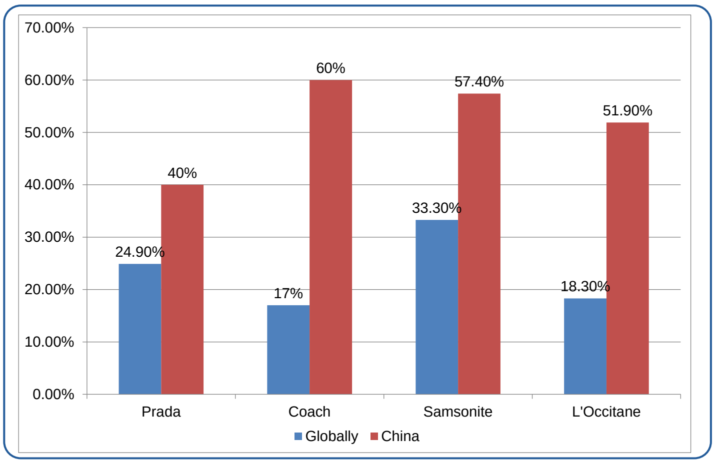
Key drivers:

The following are what we believe will be the key growth drivers for the company going forward:

- **China:** Because of its rapid economic growth, the fact that there remains tremendous growth potential and the rising standard of living, the consumption of luxury goods in China has seen double-digit growth. The Chinese market is expected to become the largest luxury goods market by 2014, accounting for c. 23% of the global market. *China International Capital Corporation Ltd. (CICC)* estimates that by 2020 China will be buying

- ***China continued...***$7trn worth of consumer goods while **World Bank** data shows that from 2001-2010, China's average annual consumption of goods grew by 13.5% vs 4% for the US and 2% for Japan. Thus the rising incomes and a relatively strong Chinese economy is expected to support consumer spending in China. As evidence by its 2Q13 results and the increasing contribution of the Chinese tourist to Coach's global sales the Chinese consumer has embraced the Coach product and brand and there is significant potential for further growth. Coach plans on opening 30 new locations in China in FY13, with the majority based in mainland China.

3Q12 Sales growth of four luxury brands in China



Source: ***Company reports***

- **Asia –** According to *Bloomberg* the Asian luxury goods market (including China) makes up 50% of all luxury good sales. Besides expansion into China there is also huge potential for Coach to further expand into other Asian markets.
- **International expansion and diversification**: The company's current growth strategy includes plans to also expand in a number of emerging markets in Asia, Europe and Latin America where there is increasing demand for luxury goods items. Besides new stores in China the group has entered into strategic agreements with various partners to increase its operations in Europe. In addition, in 2012 Coach took control of certain retail operations in the Asia-Pacific region, including Taiwan, Malaysia and South Korea. This geographic diversification on the part of Coach will help the company to reduce its exposure to risks in one country and should be seen as a positive development.
- **The Men's business** continued to grow at a rapid pace in the last quarter and Coach claims that it is on track to achieve 50% growth (to $600mn) in its men's business in 2013. It continues to open more dedicated men's stores in addition to dual-gender stores to tap into a growing men's market in Asia and North America. The company said that it is experiencing success in Men's across all concepts and store types and across all geographies and channels, while in North America, Men's is driving productivity in existing stores and also represents a substantial new distribution opportunity for the company. With Men's currently accounting for only around 12% of total sales we expect the upward momentum in this business to be one of the primary growth drivers for the company going forward.
- **Internet and mobile**: As internet usage globally, and especially in emerging markets, grows and with the ever-increasing adoption of smartphones, Coach is focusing on further developing its internet and mobile platforms to drive growth. The company's online sales channel did well in 2Q13 and in November last year, Coach also opened an e-commerce website in China. Coach also recorded a higher percentage of sales from its mobile channel in its last results and plans to leverage this growth on its the mobile platform.
- **Product innovation:** According to the company it is planning to expand further into the footwear market by re-launching shoes in around 170 stores with a diverse range of innovate styles. Product innovation should go far towards helping Coach build its global lifestyle brand strategy and should positively impact revenue. The company has also cited a new pricing strategy as a way to broaden its appeal to encapsulate both the high-end and the value customers.
- **Coach offers a fully integrated supply-chain** which includes sourcing and distribution of its products in those countries and geographies where it has a presence. With its long-term strategic plan to increase international distribution and target international consumers, with an emphasis on the Asian consumer, through directly operated businesses in Japan, China, Singapore, Taiwan, Malaysia and South Korea, the company is leveraging a significant growth opportunity in a very important region. Its ownership structure provides Coach with complete control of its distribution channels in these key Asian markets.

Risks:

Expansion into other territories and regions is not without its risks while the uncertain global economic climate can also impact a company's bottom line. Below we look at the possible risk factors that Coach faces:

- **Luxury goods demand is directly correlated with economic growth.** Economic circumstances can materially affect a luxury-goods company's sales, if disposable income is under pressure it will impact the purchase of discretionary luxury goods items. The recession in Europe and the continued lacklustre economic situation in the US as well as uncertain economic conditions globally have the potential to negatively impact Coach's sales.
- **Competitive industry:** There is significant competition in the luxury goods space. In North America, Coach is facing intense competition from Michael Kors (as well as Kate Spade and Tory Burch) in the handbags and accessories categories. As evidenced by Coach's 2Q13 results Michael Kors Holdings has emerged as a very significant threat to Coach's market share. Continued intense competition in the future, will negatively impact sales.

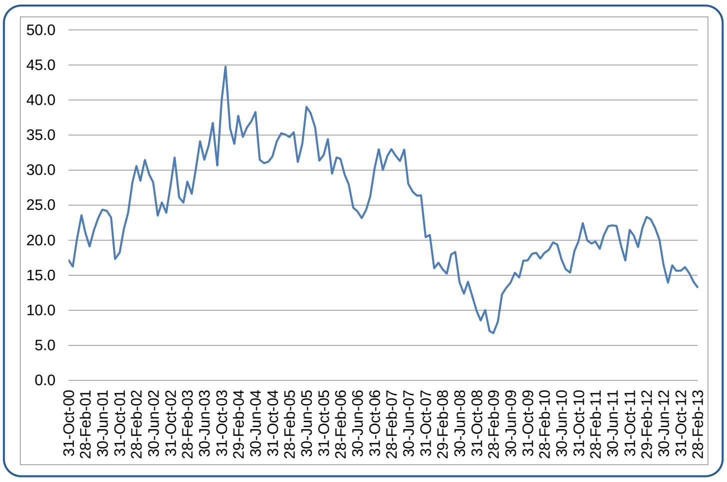
- **Operating in international markets.** Although its entrance into international markets has thus far served it well it should be noted that Coach faces established competitors in many international geographies, while at the same time these countries have different operational characteristics related to employment and labour, transportation, logistics, real estate and local reporting or legal requirements.
- **Consumer behaviour in new markets:** Following on from the point made above, consumer demand and behaviour, as well as tastes and purchasing trends in new untapped markets may also differ depending on the geography. What sells in the US may not necessarily sell in other countries or the margins on those sales may not be in line with the company's expectations.
- **Upfront investment costs:** New markets require upfront short-term investment costs that may not be accompanied by sufficient revenue to achieve the expected operational and financial performance. Therefore it could be dilutive to Coach in the short-term.
- **Currency fluctuations:** Coach operates globally, with c. 32% of net sales coming from operations outside the US and sales to its international wholesale customers being US dollar denominated. Dollar weakness could have an impact on Coach's results as fluctuations in exchange rates for foreign currencies can adversely affect the retail prices of its products. This in turn can result in decreased international consumer demand (if prices go up significantly consumers may not buy Coach's products).
- **Counterfeit merchandise:** As the company expands into more emerging markets the increased sale and prevalence of counterfeit product could impact Coach's sales.
- **Other:** Political or economic instability, natural disasters and changes in regulatory requirements can also have a detrimental impact on the group's profitability.

Conclusion

Although Coach's domestic business has been struggling recently due to challenges from competitors, its global expansion strategy and the company's intention to transform into a global lifestyle brand, coupled with current growth as well as future growth potential in the Asia-Pacific region should drive sales significantly going forward. As China spends more than $2bn p.a. on luxury products, the country is becoming an increasingly important market for luxury retailers with an up-and-coming Chinese middle class providing an increase in potential customers. We think the company's international business, especially China, and its Men's category, remain key growth segments for the business. With international sales currently contributing only around one-third (North America equals two-thirds) to Coach's total sales, there is significant scope for increasing this contribution especially from the high-growth Asian market such as China and thus being less reliant on the North American segment of its business. There also seems to be a consumer shift to more affordable luxury brands which have held up quite solidly in times of trying market conditions (unlike premium luxury brands such as Louis Vuitton and Hermes which have reported slowing sales).

On the negative side it does seem that Coach needs to better respond to its competitors in the US in order to curb losses especially in its women's division. Increasing competition in this category particularly from Michael Kors Holdings was one of the primary reasons behind the decline in its 2Q13 results and Coach would need to come up with a viable strategy to stem further losses in that segment of its business.

Coach historic P/E (x)



Source: Bloomberg, Anchor Capital

Coach's P/E has fallen significantly from its 45x levels of ten years ago and the share is currently trading at just 13.5x the $3.70/share Bloomberg consensus estimates are projecting the company will earn in FY13. On a 12M trailing and fwd P/E basis the company is much cheaper than its high-end luxury goods counterparts (Hermes, LVMH, Prada) and also significantly cheaper than its main US competitor, Michael Kors Holdings which is trading at a 12M fwd P/E of 22.7x vs Coach's 12.3x.

Coach forecasts

Coach				
June y/e	2012	2013F	2014F	2015F
EPS ($)	3.60	3.70	4.14	4.78
% growth		3%	12%	15%
DPS ($)	0.98	1.23	1.30	1.43
P/E	13.9x	13.5x	12.1x	10.4x
DY		2.5%	2.6%	2.9%
Share price ($)	49.93			
12M Fwd P/E	12.3x			

Source: Bloomberg estimates, Anchor Capital

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Although Coach has only been paying dividends to its shareholders since 2009 (when it initiated a cash dividend at an annual rate of $0.30/share), it has raised its dividend three times since then and, in 2012, it increased its cash dividend 33% to $1.20/share. Because of its falling stock price over the past few months the share now has a dividend yield of around 2.5%.

The fact that, over the past five years or so Coach has also been an aggressive buyer of its own shares can also be seen as an indication that management regard the company's stock as a good investment. With the share price correction overdone and the market overreacting, in our view, after the company released its 2Q13 results the share is now firmly in value territory and we would recommend Coach as a good, long-term investment.

Marco de Matos

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