

Coach, Inc.

Sector: Retail

Ticker: COH

Recommendation: BUY

Analyst: Bulldog Investor

Current Price: \$55.65

Target Price: \$71.25

Date: January 9, 2014

Recommendation Summary

Coach, Inc. (COH) is well positioned to continue double digit growth by seizing global opportunities, adding to its current product line, and emphasizing a focus on men's products. The company is currently trading below its intrinsic value, creating an opportunity for investors to purchase a steadily growing company with a wide moat and margin of safety. My 1-year price target for COH is \$71.25, a 28% upside over its current trading price of \$55.65.

Company Overview

COH is a leading designer of luxury accessories, primarily leather goods and most notably handbags. It operates in North America (69% of 2013 Sales) and internationally (31% of 2013 Sales). Design is done in-house, independent manufacturers produce products, and merchandise is sold via retail stores, wholesalers, and the internet.

Investment Thesis

International Expansion and Factory Stores to Fuel Growth: COH is becoming a global brand and potential still exists to grow domestically. International sales increased 9.9% in fiscal year 2013 and this is a trend expected to continue. First quarter currency neutral international sales were also up 9.3% in fiscal year 2014. COH opened 30 new locations in China and 11 new locations in Japan in the 2013 fiscal year. While same store sales have been flat in North American retail stores, comparable store sales in Japan have seen double digit growth. Management believes that North America can support 500 retail stores and currently only 350 exist. The strategy continues to be to close the underperforming retail stores while growing the number of lower end factory stores. Management's is yet to act on the remaining capacity for retail stores in North America. COH has successfully used joint ventures with established companies as a catalyst for the proliferation of its brand in other countries. This method has produced positive results in Japan and China and the company plans to implement the same strategy in Latin America in 2014.

Key Statistics

Market Cap.	15.7B
Total Debt	985K
52-Week	\$45.87
Range	\$61.94
3m Avg. Vol.	4M
Beta	1.17
Dividend Yld	2.4%
ROA Q1-14 TTM	29.5%
ROE Q1-14 TTM	47.2%
P/E Q1-14 TTM	15.48
EV/EBITDA Q1-14 TTM	8.59
Last Reported Quarter	2014 Q1
Consensus	.76
Actual	.77

COH currently is a market leader in North America and is the number one accessory importer to Japan by units sold.

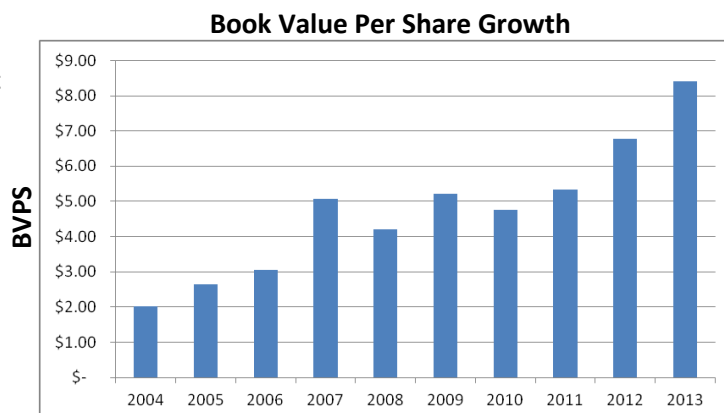
Launching new factory stores has helped to overcome recent flat North American retail store sales. Coach closed three retail stores and opened 24 new factory stores including 10 Men's, bringing the total number of retail and factory stores to 351 and 193, respectively, at the end of fiscal year 2013. The growth of factory stores has stolen some sales from higher margin retail stores but remains an attractive investment for the company, which has grown sales every year for the last 10 years and boasts industry leading margins.

Strong Moat Will Insulate Earnings for years to come: COH's competitive advantage comes from the emotional attachment consumers have to the brand. COH has become synonymous with quality. This can be seen by surveying almost any American consumer. The accessory and handbag market is growing and has many new entrants and fierce competition amongst competitors. Despite those facts, COH continues to grow year after year. This can be illustrated by an average earnings growth between 15.8% and 18.5% over the last 10 years.

5 Year Multi-Year Performance										
	2008-2012	2009-2013	2008-2011	2009-2012	2010-2013	2008-2010	2009-2011	2010-2012	2011-2013	Median
Tang Shareholder Equity	6.9%	9.2%	1.9%	5.6%	17.1%	-0.7%	-2.5%	15.2%	22.4%	6.9%
Free Cash Flow	8.5%	19.8%	5.8%	22.2%	8.8%	10.2%	24.8%	6.8%	15.1%	10.2%
CROIC	66.6%	70.0%	66.3%	68.4%	70.3%	66.6%	66.1%	70.6%	70.0%	68.4%
FCF/Sales	21.8%	21.8%	22.4%	21.5%	22.4%	23.5%	21.3%	21.8%	21.8%	21.8%
ROA	33.4%	29.8%	31.6%	31.6%	31.6%	29.8%	29.8%	33.4%	33.4%	31.6%
ROE	51.7%	48.8%	50.2%	50.5%	50.5%	48.8%	48.8%	52.1%	52.1%	50.5%
Gross Margin	72.8%	72.8%	72.9%	72.7%	72.8%	73.0%	72.7%	72.8%	72.8%	72.8%
Operating Margin	31.7%	31.4%	31.6%	31.6%	31.6%	31.9%	31.4%	31.7%	31.4%	31.6%
Net Margin	21.2%	20.4%	20.8%	20.8%	20.8%	20.4%	20.4%	21.2%	21.2%	20.8%
Revenue Growth	10.6%	12.0%	9.3%	13.8%	12.1%	6.5%	13.5%	14.9%	10.5%	12.0%
Earnings Growth	12.9%	17.2%	10.4%	22.7%	15.8%	3.5%	23.5%	23.2%	11.2%	15.8%
Cash from Ops Growth	7.2%	15.0%	3.8%	14.7%	12.6%	3.6%	13.0%	11.0%	17.0%	12.6%

10 Year Multi-Year Performance										
	2004-2011	2005-2012	2006-2013	2004-2009	2005-2010	2006-2011	2007-2012	2008-2013	2004-2013	Median
Tang Shareholder Equity	11.3%	14.2%	10.7%	17.3%	13.8%	6.4%	0.9%	9.6%	13.6%	11.3%
Free Cash Flow	12.8%	12.7%	14.2%	8.4%	15.1%	13.9%	10.2%	9.4%	13.3%	12.8%
CROIC	66.3%	66.3%	68.3%	65.5%	65.5%	66.3%	68.6%	68.3%	70.0%	66.3%
FCF/Sales	24.0%	22.7%	22.5%	24.0%	24.0%	22.7%	22.7%	22.4%	23.3%	22.7%
ROA	29.3%	30.1%	30.1%	28.0%	29.3%	30.1%	31.6%	31.6%	29.5%	30.1%
ROE	39.6%	45.2%	45.9%	37.2%	39.6%	45.2%	50.2%	50.2%	42.3%	45.2%
Gross Margin	75.3%	74.3%	72.9%	76.2%	76.2%	74.3%	72.9%	72.8%	74.0%	74.3%
Operating Margin	34.9%	34.0%	31.8%	36.1%	36.1%	34.0%	31.8%	31.6%	32.8%	34.0%
Net Margin	22.0%	22.3%	21.5%	23.1%	23.1%	22.3%	21.5%	20.8%	21.5%	22.0%
Revenue Growth	17.8%	15.8%	13.3%	19.6%	16.1%	14.5%	12.8%	9.8%	16.1%	15.8%
Earnings Growth	23.2%	19.8%	16.1%	23.0%	18.5%	18.1%	15.0%	10.7%	20.4%	18.5%
Cash from Ops Growth	12.7%	12.2%	13.1%	12.5%	12.7%	11.6%	9.4%	8.9%	13.6%	12.5%

Warren Buffet's measure of growth in intrinsic value and the existence of a strong moat is growth in book value per share (BVPS). COH's BVPS has increased by more than 4x in the last ten years.



Comparables

COH is trading at a P/E below most of its competitors while having better margins and returns. COH traded at an average P/E of 28x in the four years before the credit crisis, between 2004 and 2007. It now trades at 15.4x, below many of its peers. Because of the company's effective business model, using independent manufacturers, and carrying little debt it has been able to boast industry leading profit margins. Below is a chart including the publicly traded companies that COH considers peers. The green color marks leaders while red marks laggards in respective categories. COH is a laggard in P/S because of its high margins.

Company	Coach, Inc.	Gap Inc.	Guess' Inc.	Ralph Lauren Corporation	L Brands, Inc.	PVH Corp.	Tiffany & Co.	V.F. Corporation	Williams-Sonoma Inc.
Sector	Consumer Goods	Services	Services	Consumer Goods	Services	Consumer Goods	Services	Consumer Goods	Services
Price	\$55.65	\$39.42	\$29.37	\$172.88	\$57.75	\$133.02	\$92.01	\$62.29	\$58.08
Market Cap	\$15,661.75	\$18,251.46	\$2,471.46	\$15,628.35	\$16,747.50	\$10,819.45	\$11,777.65	\$6,823.56	\$5,543.91
P/E	15.42	14.08	15.79	22.02	20.70	44.94	25.42	5.88	20.74
Forward P/E	14.52	13.13	14.30	17.54	16.15	16.37	21.59	20.17	18.13
PEG	1.57	1.04	3.67	2.27	1.88	4.02	2.12	0.51	1.51
P/S	3.09	1.12	0.94	2.21	1.55	1.51	2.97	0.61	1.28
P/B	6.59	6.18	2.23	3.92	0.00	2.67	4.19	1.21	4.74
P/Cash	18.32	18.32	6.86	11.08	39.41	17.20	22.60	21.61	43.04
P/Free Cash Flow	19.68	26.96	40.12	37.82	0.00	61.72	87.70	7.73	49.28
Dividend Yield	2.43%	2.03%	2.72%	1.04%	2.08%	0.11%	1.48%	1.69%	2.13%
Payout Ratio	34.90%	19.40%	40.20%	19.90%	40.50%	6.20%	36.10%	32.40%	40.50%
Return on Assets	30.40%	17.30%	9.80%	12.90%	13.50%	2.20%	9.80%	12.00%	13.00%
Return on Equity	45.20%	42.50%	15.30%	19.00%	-89.30%	5.90%	17.20%	22.40%	22.40%
Return on Investment	43.10%	29.40%	16.00%	19.30%	30.20%	9.90%	13.20%	16.80%	19.50%
Gross Margin	72.70%	39.70%	38.50%	58.90%	41.70%	52.10%	57.60%	47.80%	39.00%
Operating Margin	29.90%	13.60%	9.60%	15.20%	16.40%	7.40%	19.20%	14.30%	10.30%
Profit Margin	20.40%	8.10%	6.30%	10.30%	7.60%	3.00%	11.70%	10.50%	6.40%

Positive Earnings Notes

While first fiscal quarter earnings met median analyst estimates, earnings were depressed by currency fluctuations of the yen. This temporary problem deterred investors.

COH continues to team with other brands to license products such as shoes and fragrances for sale under the company's name. These products create upside as COH establishes its global brand as a lifestyle company.

Plans to target the underserved male market have been successful. COH has seen men's products go from 5% of sales in 2011 to 11% in fiscal year 2013.

Investors are slow to purchase shares because of the stepping down of designer and creative director Reed Krakoff, making the stock cheap for those who believe in COH's strong moat and effective business model.

Risks

Keeping up with consumer preferences by creating new and desirable products is a major risk. In fiscal year 2013, 69% of sales came from new products that had \$0 of sales in the same quarter the previous year. To add to the risk in 2013 President and executive creative director Reed Krakoff stepped down to start his own brand.

An economic downturn could drastically impact sales.

COH is expanding in Asia, Europe and Latin America, which poses risks related to new consumer preferences and price points that could erode margins.

Competition remains fierce and COH could lose share to its closest competitor, privately held Michael Kors, or to new market entrants.

Valuation

I valued COH with a multi-stage DCF model based on FCF. I added back restructuring costs in 2013 to arrive at a base FCF and I made assumptions on growth rate, discount rate, growth decay rate, and terminal growth to arrive at 3 scenarios for stock price. I then used a sensitivity matrix to see how sensitive those stock prices are to varying discount rates and growth. Growth rates were based on the above mentioned graph of last 5 year and last 10 year performance.

Base Case Scenario: 1-year price target of \$71.25, 28% upside. This forecast assumes that COH continues to grow at the average of its 5 year and 10 year performance. It further assumes that growth begins to decay by 10% per year in year 4, and by 10% more in year 8. I used a discount rate of 11.5% slightly higher than the current beta dictates.

Bull Case Scenario: 1-year price target of \$85.66, 54% upside. This forecast assumes that COH grows at slightly below its average rate over the last 3 fiscal years, 14%. We will be slightly conservative and assume again that growth begins to decay by 10% per year in year 4, and by 10% more in year 8 as COH begins to saturate the North American market. I used a discount rate of 11%.

Bear Case Scenario: 1-year price target of \$54.65. Under my most pessimistic scenario my value reflects that the market has accurately priced COH. This forecast assumes that COH grows at below its slowest rate of growth over the most recent 10 year period, 8%. Because COH has so many opportunities for growth, for this scenario to occur Kors would have to steal market share, new entrants would have to come into the space, and international expansion would have to begin to fail. I also assumed that growth began to decay by 20% per year in year 4, and by 15% more in year 8. I used a discount rate of 12%, higher than the current beta dictates.

Base Case Model: \$71.25*

Projection of future Free Cash Flow

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Yearly Growth Input Field										
12%	\$1,366.77	\$1,523.95	\$1,699.20	\$1,875.07	\$2,069.14	\$2,283.29	\$2,519.61	\$2,754.31	\$3,010.88	\$3,291.34
Terminal Growth	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
3%	\$ 3,390.08	\$ 3,491.78	\$ 3,596.54	\$ 3,704.43	\$ 3,815.57	\$ 3,930.03	\$ 4,047.93	\$ 4,169.37	\$ 4,294.45	\$ 4,423.29

Calculation

Total Cash	\$ 854.75
MAX(0,Current Liabilities-Current	\$ -
Excess Cash	\$ 854.75
Adding some Intangibles	\$ -
Interest Bearing Debt	\$0.76
Present Value	\$ 20,053.28
Shares Outstanding	281.43
Per Share Value	\$ 71.25
Desired Margin of Safety	25%
Purchase Price	\$ 53.44
Current Price	\$ 55.65
Margin of Safety	22%

Stock Price Sensitivity Matrix: Growth vs Discount Rate

		Discount Rates				
		9.5%	10.5%	11.5%	12.5%	13.5%
Growth Rates	8.5%	\$ 66.13	\$ 61.22	\$ 56.85	\$ 52.97	\$ 49.50
	9.5%	\$ 74.38	\$ 68.67	\$ 63.61	\$ 59.11	\$ 55.09
	11.5%	\$ 83.75	\$ 77.12	\$ 71.25	\$ 66.05	\$ 61.41
	13.5%	\$ 94.37	\$ 86.70	\$ 79.91	\$ 73.89	\$ 68.54
	15.5%	\$ 106.42	\$ 97.54	\$ 89.70	\$ 82.75	\$ 76.58

Bull Case Model: \$85.66*

Projection of future Free Cash Flow

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Yearly Growth Input Field										
14%	\$1,397.41	\$1,593.05	\$1,816.08	\$2,044.90	\$2,302.56	\$2,592.68	\$2,919.36	\$3,250.42	\$3,619.01	\$4,029.41
Terminal Growth	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
3%	\$ 4,150.29	\$ 4,274.80	\$ 4,403.04	\$ 4,535.14	\$ 4,671.19	\$ 4,811.33	\$ 4,955.67	\$ 5,104.34	\$ 5,257.47	\$ 5,415.19

Calculation

Total Cash	\$ 854.75
MAX(0,Current Liabilities-Current	\$ -
Excess Cash	\$ 854.75
Adding some Intangibles	\$ -
Interest Bearing Debt	\$0.76
Present Value	\$ 24,106.99
Shares Outstanding	281.43
Per Share Value	\$ 85.66
Desired Margin of Safety	25%
Purchase Price	\$ 64.24
Current Price	\$ 55.65
Margin of Safety	35%

Stock Price Sensitivity Matrix: Growth vs Discount Rate

		Discount Rates				
		9%	10%	11%	12%	13%
Growth Rates	10%	\$ 79.86	\$ 73.56	\$ 67.98	\$ 63.03	\$ 58.62
	12%	\$ 90.05	\$ 82.74	\$ 76.27	\$ 70.54	\$ 65.45
	14%	\$ 101.62	\$ 93.14	\$ 85.66	\$ 79.03	\$ 73.15
	16%	\$ 114.73	\$ 104.93	\$ 96.28	\$ 88.63	\$ 81.85
	18%	\$ 129.59	\$ 118.27	\$ 108.29	\$ 99.47	\$ 91.66

Bear Case Model: \$54.65*

Projection of future Free Cash Flow

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Yearly Growth Input Field										
8%	\$1,323.86	\$1,429.77	\$1,544.15	\$1,642.98	\$1,748.13	\$1,860.01	\$1,979.05	\$2,086.71	\$2,200.23	\$2,319.92
Terminal Growth	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
3%	\$ 2,389.52	\$ 2,461.21	\$ 2,535.04	\$ 2,611.09	\$ 2,689.43	\$ 2,770.11	\$ 2,853.21	\$ 2,938.81	\$ 3,026.97	\$ 3,117.78

Calculation

Total Cash	\$ 854.75
MAX(0,Current Liabilities-Current	\$ -
Excess Cash	\$ 854.75
Adding some Intangibles	\$ -
Interest Bearing Debt	\$0.76
Present Value	\$ 15,381.22
Shares Outstanding	281.43
Per Share Value	\$ 54.65
Desired Margin of Safety	25%
Purchase Price	\$ 40.99
Current Price	\$ 55.65
Margin of Safety	0%

Stock Price Sensitivity Matrix: Growth vs Discount Rate

		Discount Rates				
		10.0%	11.0%	12.0%	13.0%	14.0%
Growth Rates	8.5%	\$ 51.25	\$ 47.78	\$ 44.69	\$ 41.92	\$ 39.45
	6.0%	\$ 56.93	\$ 52.94	\$ 49.39	\$ 46.22	\$ 43.38
	8.0%	\$ 63.30	\$ 58.72	\$ 54.65	\$ 51.02	\$ 47.78
	10.0%	\$ 70.46	\$ 65.21	\$ 60.55	\$ 56.40	\$ 52.69
	12.0%	\$ 78.49	\$ 72.48	\$ 67.14	\$ 62.40	\$ 58.16

*Analyzed using Old School Value stock analyzer software, oldschoolvalue.com.

Conclusion

COH's potential for price appreciation is high based on growth prospects and its strong moat around earnings. The company is currently priced below intrinsic value in my base and bull case financial models and priced accurately in my bear case model. If the company continues to grow anywhere near the pace it has averaged year-over-year for the last 10 years then an investor could purchase its stock today with a 22% margin of safety (MOS). To further insure you are insulated, I would wait till the price reached around \$53.44, a 25% MOS, to make a purchase. COH is a strong steady grower to add to a portfolio but probably not a 10-bagger. I originally identified COH after using Joel Greenblatt's magic investing formula to screen stocks. The formula ranks stocks based on return on capital and P/E ratio, respectively, then combines the rankings to give each stock one score. This method produced average annual returns of 30.8% for 17 years between 1988 and 2004.