Coach Inc. (COH)

Strong Buy

We recommend Coach Inc (COH) as a Strong Buy based on strong financial position, stable revenue and EPS and recent stock price sell-off. Our Fair Value Price for Coach is $65 per share.

RECOMMENDATION

We are reiterating our Strong Buy rating on Coach and decreasing our Fair Value share price from $68 to $65.Coach'smarket price is trading at a 23% discount to our estimated fair value. We expect to see the company generate earnings per share of $3.77 in 2014 and to increase EPS by 12.5% annually from FY 2013 to FY 2017.

COMPANY OVERVIEW

Coach is a leading U.S. marketer of premium handbag and accessories. The company sells products globally through both direct and indirect channels. By building a business model that emphasizes on "accessible luxury", Coach is able to reach a larger demographic than many of its higher-priced competitors. With superior margins and consistent double-digit annual revenue growth, Coach is a highly profitable business that generates strong cash flows with virtually no debt.

Coach offers a number of key differentiating elements that set it apart from the competition, including:

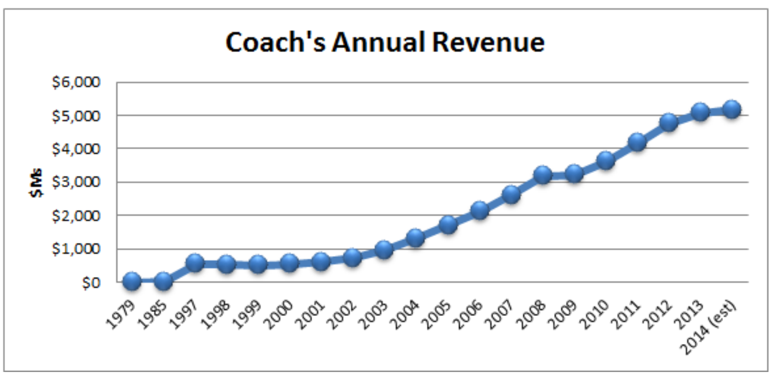
A Distinctive Brand — Coach offers distinctive, easily recognizable, accessible luxury products that are relevant, extremely well made and provide excellent value.

A Market Leadership Position with Growing Share — Coach is America's leading premium handbag and accessories brand and each year, as its market share increases, its leadership position strengthens. In Japan, Coach is the leading imported luxury handbag and accessories brand by units sold.

Loyal and Involved Consumers — Coach consumers have a specific emotional connection with the brand. Part of the company's everyday mission is to cultivate consumer relationships by strengthening this emotional connection.

Multi-Channel International Distribution — This allows Coach to maintain a critical balance as results do not depend solely on the performance of a single channel or geographic area. The Direct-to-Consumer channel provides us with immediate, controlled access to consumers through Coach-operated stores in North America, Japan, Hong Kong, Macau, mainland China, Taiwan, Singapore and the Internet. Beginning with the first quarter of fiscal 2013, this channel also includes Coach-operated stores in Malaysia and Korea. The indirect channel provides Coach with access to consumers via wholesale department store and specialty store locations in over 20 countries.

Management: Lew Frankfort is the longtime CEO and Chairman of Coach. He joined Coach in 1979 as Vice President of New Business Development, six years before Sara Lee acquired it in 1985. Mr. Frankfort led Coach's transition from a subsidiary of Sara Lee to an independent publicly traded company on the NYSE. He has contributions to the rapid sales growth of Coach (from $6M in 1979 to an estimated $5B in 2013). Barron's recognized Mr. Frankfort from 2005 to 2008 as one of its 30 Most Respected CEOs and Institutional Investor voted him as the top CEO in his sector from 2004 to 2009. In 2014, he will hand off the CEO duties to Coach's President & Chief Commercial Officer Victor Luis while remaining Executive Chairman of Coach.



Source: Coach's Profile on Lew Frankfort and FactSet

Victor Luis is the President and Chief Commercial Officer of Coach as well as the CEO-in-waiting. Mr. Luis has been a member of Coach's senior leadership team since 2006 and has served in a variety of key international leadership roles. Prior to serving as President and CCO of Coach, Mr. Luis served as President Coach's international division from 2012 to 2013 and had oversight for all of Coach's operations outside of North America. Mr. Luis served as President for Coach Retail International from 2010 to 2012, where he oversaw the company's directly operated businesses in China (Hong Kong, Macau and Mainland China), Japan, Singapore, and Taiwan, and President and CEO, Coach China (2008-2010) and Coach Japan (2006-2010). Mr. Luis originally joined Coach in June 2006 as President and CEO of Coach Japan.

Prior to joining Coach, from 2002 to 2006, Mr. Luis was the President and Chief Executive Officer for Baccarat, Inc., running the North American operation of the French luxury brand. Earlier in his career, Mr. Luis held marketing and sales positions within the Moët-Hennessy Louis Vuitton (LVMH) Group. We also like that he attended college at Holy Cross in Worcester, MA.

Reed Krakoff was Coach's Executive Creative Director but left Coach in order to focus on his Reed Krakoff branded products. Coach recently sold the Reed Krakoff product line to Mr. Krakoff. Stuart Vevers is Coach's new Executive Creative Director and recently joined Coach from Loewe.

Francine Della Badia, who was Coach's Executive Vice President in charge of North America Retail Merchandising, Planning and Allocation as well as Coach Inc's Global Men's and Factory merchandising, succeeded Michael Tucci as head of Coach's North American operations

David Duplantis previously served as Digital Marketing EVP before taking on a new role as the Global Digital and Customer Experience President.

Javan Bunch, recently assumed the expanded role of Senior Vice President and President, North America Wholesale and Licensed Categories, reporting into Todd Kahn, General Counsel in his expanded role as Corporate Affairs EVP.

Ian Bickley previously served as Coach International's President and recently expanded his role to take on responsibility to include all international direct retail businesses.

Stephanie Stahl previously served as Strategy and Consumer Insights SVP and recently took on an expanded role as Marketing and Strategy EVP.

Ownership: The directors and executive officers as a group beneficially held 7.05M ordinary shares, representing approximately 2.47% of the outstanding shares as of June 30, 2012. This figure includes 5.1M shares beneficially owned by Coach's CEO Lew Frankfort and 730K by former Executive Creative Director Reed Krakoff. Notable institutional investors in Coach based on the most recently filed 13-F reports include Artisan Partners (1.57%) and Harding Loevner (1.77%). Morgan Stanley Investment Management also purchased 5.8M shares of Coach in H2

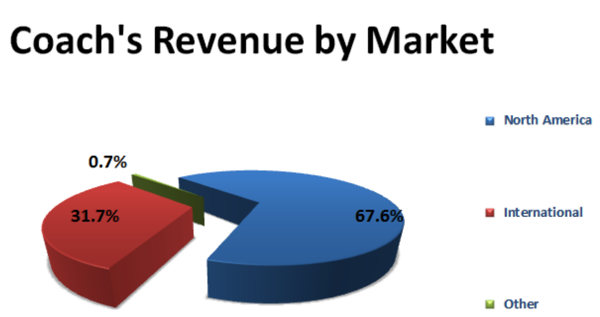
2012 and has 4.6M shares (1.63%) as of CQ2 2013 after selling off 1.8M shares in CQ1 2013 and buying 636K shares in CQ2 2013.

SUMMARY OF OBSERVATIONS

Although Coach's growth has come down in 2013 and 2014 versus the 2000 to 2012 period, Coach is still expected to generate solid single digit growth in the future. While Coach may have been an overvalued company last year at $80/share, we believe Coach's $50 share price is at a 23% discount to its fair intrinsic value of $65/share. We like the fact that the firm has been able to maintain solid gross margins that exceeded 70% over the last 10 years, which shows that Coach has strong brand recognition and pricing power.

Coach increased its revenue from $953M in 2003 to $5.1B for 2013 (CAGR 18.25%) and its EPS from $0.41 to $3.61 (CAGR 24.3%) during the same period. Coach achieved this primarily through organic growth as well as the 2005 acquisition of the 50% minority interest in Coach Japan from Sumitomo Corporation. Coach changed its reportable segments in FY 2013 to a geographic focus, recognizing the expansion and growth of sales through its international markets. This is consistent with organizational changes implemented during FY 2012.

Prior to this change, the company reported its results based on directly operated and indirect business units. The company has recently experienced substantial growth in its international business, while at the same time has converted formerly wholesale businesses in several key markets such as China, Taiwan and Korea to company-operated businesses. Reflecting this growth and corresponding declines in indirect businesses relative to company-operated, the company implemented a realignment of its business units based on geography, aligning with the organizational changes.



Source: Coach's Q120148-K Report

Although Coach is one of the most respected companies in the consumer products, luxury brands and accessories industry, it has seen some recent competitive headwinds due to the emergence of Michael Kors (KORS). Coach's management believes that it can achieve 5%-10% growth in handbags and maintain its handbag market share. Coach is in the midst of implementing a multi-year, transformative set of strategies to transform the Coach brand into more of a lifestyle brand.

RECENT QUARTER (Q1 2014)

Coach's most recent fiscal quarterly period (Q1 2014) continues to generate soft financial performance. Below are highlights for the quarter ending September 30, 2013:

- Net sales totaled $1.15B, down 1% from prior year period.
- Diluted EPS totaled $0.77, which was flat versus prior year period.
- Gross margin was 71.8% and declined by 1%.
- Operating margin declined 61bp to 27.95%.
- North America sales decreased 76bp to $778M. However, comparable store sales declined by 6.8%.
- International sales decreased 55bp to $365M, driven by 35% gain in sales in China and partially offset by 22% decrease in Japan sales (2% decrease in constant currency).

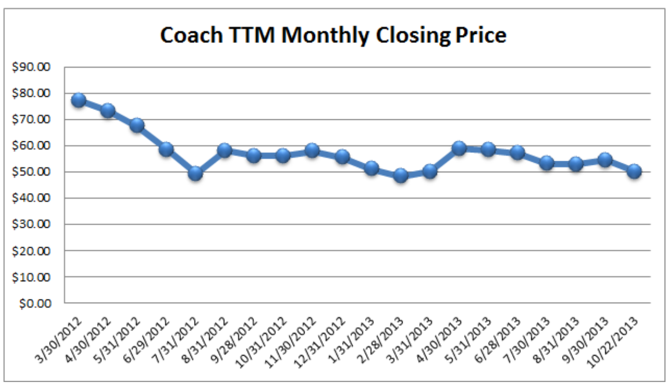
North American direct sales declined 1% for the quarter with comparable store sales down 6.8%. At POS, sales in North American department stores were slightly below prior year while shipments into this channel declined slightly as well. Coach still has to deal with the emerging popularity of trendy brands such as Michael Kors and Tory Burch. Coach tried to acquire Tory Burch last year but was not able to consummate a deal. International sales decreased 55bp to $365M from $367M last year's comparable quarter but grew 9% on a constant currency basis.

China results continued very strong, with total sales growing 35% and comparable store sales rising at a double-digit rate. Shipments into international wholesale accounts declined due to timing of a Chinese holiday versus the prior year, while underlying POS sales trends eked out growth. In Japan, sales declined by 2% on a constant-currency basis, while dollar sales declined 22% due the weaker yen. Coach purchased its partner's 50% interest in Coach Europe in Q1 2014. Coach will transition Coach Europe from a 50% joint venture into a directly owned operating subsidiary. Coach bought back $175M of its shares in Q1 2014 and has $1.2B remaining on its share repurchase authorization.

VALUATION ANDPROJECTIONS

Our $65 per share FV is based on applying a 16 times price to earnings multiple to estimated 2017 earnings per share of $5.55 and discounting the terminal value back to October 2013 at a cost of capital of 11%. We believe the PE of 16X reported EPS is justified due to Coach's superior consumer products franchise and strong brand recognition. In addition, we believe that the multiple used is justified considering that the firm has grown faster than its industry and its price had declined by 38% from its 2012 highs.

We believe that the company will continue to grow its businesses, particularly its handbag products segment. We also see potential in its efforts to expand its non-handbag product offerings. We like that Coach has declined by 38% versus its two year high. We expect that the company will take steps to mitigate the competitive headwinds it is facing thanks to Michael Kors. Coach is a high quality company and its FY 2014 PE ratio is less than the PE of the S&P 500 Index even though Coach is a higher quality business than many of the index's members.

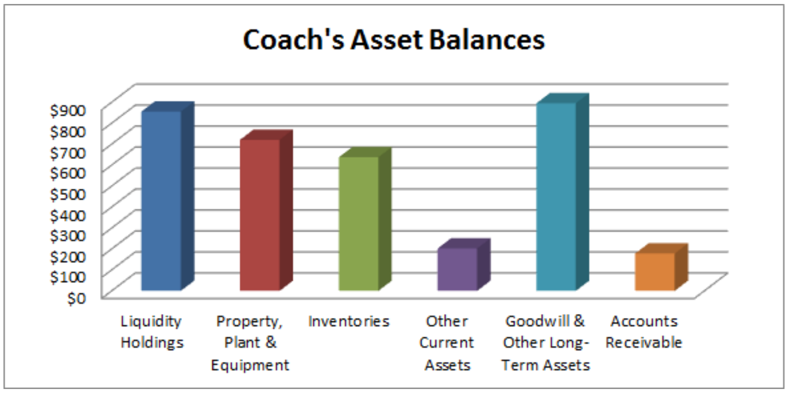


Source: Morningstar Direct

KEYS TO INVESTMENT THESIS

We like the new management changes. We believe that Coach's recent management changes will help the company resume its solid growth momentum and better compete with Michael Kors.

We love that it generates strong free cash flows. Coach has seen its operating cash flows increase from $222M in 2003 to $1.4B in 2013. We like that Coach's business model does not require much in the way of CapEx as CapEx has only increased from $57M in 2003 to $241M in 2013. This also enables Coach to have a liquid balance sheet as its $855M in cash and marketable securities is more than its net Property, Plant & Equipment ($721M). We also like that its liquidity holdings exceed all of its other separately stated asset categories.



Source: Morningstar Direct

The firm has been able to grow its dividend every year since 2009 while many of its larger competitors had to cut or freeze dividends.

We believe the price to earnings ratio is still very low (especially in relation to the market). Coach's adjusted PE based on projected FY 2014EPS of $3.77 is 13.3X projected 2014 EPS. This is still less than the S&P 500 (15.5X projected 2014 EPS) even though Coach has a better business model than the average S&P 500 component.

We love Coach's balance sheet. Coach has only $985K worth of debt and $855M worth of cash and marketable securities. Coach's liquidity assets represent 24.5% of its balance sheet assets and it has a conservative capital position ($2.4B in stockholders equity versus $985K in debt).

We are optimistic about its estimated future growth projections. Although the company is not growing at the same level it achieved from 2000 to 2012, we are expecting that it will be able to grow its revenues and profits at the same level as the industry. Although Coach is facing competitive headwinds now, we expect Coach will be able to meet the competitive challenge that Michael Kors has posed to it.

RISKS TO ACHIEVING $65 FAIR VALUE TARGET PRICE

- Failure of investment community to recognize Coach's competitive advantages, resulting in a stagnant or declining price/earnings ratio.
- New stores fail to generate traffic levels that are comparable to existing stores.

- Turnover of key staff, particularly to other firms.
- Production quality risks (potential product recalls, regulatory action taken against the firm and shortages of key product inputs).
- Competitive legal risks stemming from potential intellectual property infringement or if firms try to pirate Coach's products.
- Failure to develop and commercialize new products.
- Consumer fashion tastes and other competitors offering the next hot handbag.
- Currency fluctuations may result in a gain or drag upon conversion to US Dollars.
- The EuroZone debt crisis providing headwinds to growth, particularly in heavily indebted markets like Greece, Portugal, Spain, Ireland and Italy.
- Decelerating growth in emerging markets.

APPAREL, ACCESSORIES & LUXURY GOODS INDUSTRY OUTLOOK

We have a neutral outlook for the industry at large. We believe that the US economy will see economic headwinds due to the expiration of the payroll tax holiday and we expect that political gridlock will serve as a major macroeconomic headwind in the US. We are also concerned that the European economy will continue to flail about due to the sovereign debt crisis and even potential headwinds in the formerly fast-growing emerging market countries

According to international management consulting firm Bain & Co., worldwide sales of personal luxury goods grew an estimated 10% in 2012, to 212B euros, led by an estimated 16% increase in the leather goods category. By region, sales rose an estimated 18% in Asia-Pacific, 13% in the Americas, 8% in Japan, and 5% in Europe. Bain projects worldwide luxury goods sales to reach between 240B and 250B euros by 2015, supported by 4% to 6% annual growth. Bain projects underlying demand for luxury goods will support growth in the U.S., Europe and Japan, and growing luxury demographics in Asia-Pacific, particularly China, and emerging markets.

Apparel brands are increasing their investments in company-owned retail, outlet, and online stores, which provide higher-margin growth opportunities than the highly competitive and promotional department store channel. This strategy enables apparel brands to showcase their entire merchandise assortment, enhance consumer brand awareness, and test new products.

Apparel companies are also pursuing growth through development of new product lines specifically for discounters and mass merchandisers, as well as international expansion. Finally, we expect lower cotton prices and supply chain improvements to support gross margin expansion for apparel and accessories brands in 2013. We also look for companies to maintain discipline in inventory and expense management in support of earnings growth. We believe companies with strong brands, differentiated products, and attractive price-value propositions are likely to outperform their peers.

Overall, we feel the industry is fairly valued, however we would use declines in the market to add to positions in high quality firms like Coach and gains in the market to sell weaker firms.

VALUATION ANALYSIS

DCF/NPV Model Summary

Fiscal Year	2010A	2011A	2012A	2013A	2014E	2015E	2016E	2017E	Assumptions
Revenue	$3,608	$4,159	$4,763	$5,075	$5,177	$5,591	$6,038	$6,521	8% Growth Rate
Cost of Goods Sold	$974	$1,135	$1,297	$1,377	$1,424	$1,538	$1,661	$1,793	27.5% of Revenues
Gross Profit	$2,634	$3,024	$3,466	$3,698	$3,753	$4,054	$4,378	$4,728	72.5% of Revenues
SG&A Exp	$1,484	$1,719	$1,954	$2,174	$2,217	$2,394	$2,586	$2,793	8% Growth Rate
Net Operating Profit (EBIT)	$1,150	$1,305	$1,512	$1,525	$1,536	$1,659	$1,792	$1,935	8% Growth Rate
Financial Expense (Income)	-$8	$4	$6	$4	$4	$4	$4	$4	N/M
Pre-Tax Income	$1,158	$1,301	$1,506	$1,521	$1,532	$1,655	$1,788	$1,931	N/M
Income Tax Expense	$423	$420	$467	$486	$506	$546	$590	$637	33% of Pre-Tax Income
Net Income	$735	$881	$1,039	$1,034	$1,027	$1,109	$1,198	$1,294	
Diluted EPS	$2.33	$2.92	$3.53	$3.61	$3.77	$4.29	$4.88	$5.55	12.5% EPS Growth
DVD/Share	$0.38	$0.68	$0.98	$1.23	$1.38	$1.55	$1.74	$1.96	12.5% DVD Growth
Weighted Average Share Count	316	302	294	286	272	258	245	233	5% Share Reduction
PV of Dividend Stream	N/A	N/A	N/A	N/A	$1.24	$1.26	$1.28	$1.29	$5
			PE	P/TB	2017 Stock Price				
Terminal Value of Stock			16		$89				$60
Cumulative PV of Stock & DVD									$65
Current Price									$50
Net Present Value									$15
Discount to Estimated Intrinsic Value									23%
Estimated Total Return									19%
Discount Rate/Cost of Capital									11%

Source: Saibus Research forecasts

DISCLOSURES

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Disclosure: Analyst covering this company does not own its stock.

RECOMMENDATION SCALE

INVESTMENT RATING	DEFINITION
STRONG BUY	Stocks expected to be 20% underpriced relative to its intrinsic value and whose total return is expected to significantly exceed the market index benchmarks.
ACCUMULATE	Stocks expected to be at least 10% underpriced relative to its intrinsic value and whose total return is expect to exceed the market index benchmarks.
NEUTRAL	Stocks expected to be fairly priced relative to its intrinsic value and whose total return is expected to closely track the market index benchmarks.
AVOID	Stocks expected to be slightly overpriced and to either potentially see a small, incremental decline in its price to converge with its intrinsic value or expected to appreciate at a slower pace relative to the market index benchmarks.
STRONG SELL	Stocks expected to be strongly overpriced and to potentially see a rapid decline in price to converge with its intrinsic value or expected to significantly underperform relative to the market index benchmarks.

Relevant benchmarks: In North America, the relevant benchmark is the S&P 500 Index