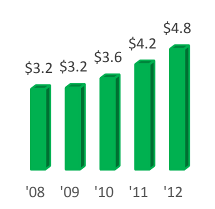
Coach Inc
February 21, 2013

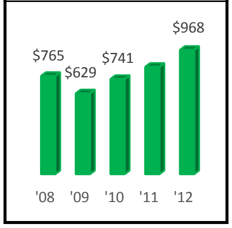
**General Overview**

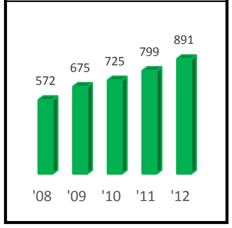
Coach Inc. was founded in 1941 as a family run workshop in a Manhattan loft and has since grown to be a leading New York design house focused on modern luxury accessories and lifestyle collections. Coach holds the number one or two position for brand recognition in several key regions including North America, Japan, and China. The powerful brand name has allowed Coach to maintain pricing power across all product lines with gross margins in excess of 70%.

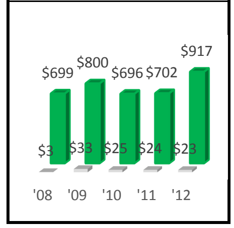
| Revenue | Gross Profit | Owner Earnings | Total Stores | Balance Sheet |
|---|---|---|---|---|
| $4,763,180,000 | $3,466,078,000 | $968,133,760 | 891 | Cash = $917 Million |
| 5-Year CAGR = 10.6% | 5-Year CAGR = 9.5% | 5-Year CAGR = 6.1% | 5-Year CAGR = 11.7% | Debt = $23 Million |








**Divisions**

Coach has grown from a family-run workshop in a Manhattan loft to a leading American marketer of fine accessories and gifts. Coach is one of the most recognized brands for luxury in the United States – specializing in the sale of hand bags for women.

**Problem & Solution**

Problem

Women have a lot of accessories and need to carry those. Also, there is a desire for 'prestige' by being identified with specific brands.

Solution

Coach makes hand bags to house accessories, but more importantly, is a brand that caters to women. Many women like carrying a Coach bag.

**How To Win**

Coach is a relatively simple business. The key to winning in this market place is having a desirable brand. The primary way to gauge the success of a company brand is by monitoring gross margins, changes in year-over-year revenue and same-store-sales.

*Gross Margins*

Gross margins are a direct measure of the premium people are willing to pay for your brand name. The larger the gross margin the higher price people are willing to pay to be associated with your brand. In this area it is evident that Coach has been dominant. There are very few businesses on the planet that sell tangible products with gross margins over 70%. The profitability of Coach is astounding.

**Gross Margins**

| Company | 2012 | 2011 | 2010 | 2009 |
|---|---|---|---|---|
| Coach | 73% | 73% | 73% | 72% |
| Michael Kors | 58% | 56% | 52% | 48% |
| Kate Spade | 57% | 54% | 49% | 44% |

However, gross margins are not the only factor that matters. Selling very little product at high prices would create a large gross margin, but that would indicate very few people are willing to pay such a high price for the brand. We'll see that this is not the case for Coach – lots of people love their products.

*Year-Over-Year Revenue*

Another indication of brand success is the revenue generated by the business. In 2012 Coach generated more than $4.7 billion in sales indicated that a tremendous portion of the population is willing to be a premium to be associated with the brand.

The year-over-year changes in revenue tell a story about how the perception of the brand is changing with time. In North America Coach has enjoyed an exceedingly dominant position for the past 10 years and has not had very significant changes in revenue year-over-year, but this is due to market dominance and not a lack of acceptance of Coach products. For the last 10 years Coach has had slightly more than 300 stores in North America and has not been able to open additional stores due to saturation of the market.

In the last five years there has been a shift in market share in North America – with the largest changes occurring in the last two years. Michael Kors, the leading competitor for Coach, went from a store base of less than 100 stores, to more than 300 today. Coach and Michael Kors have both reached a market saturating number of luxury handbag stores on the continent and the two will be forced to share the market. Prior to the success of the Michael Kors brand, Coach enjoyed a 30% market share. Their share of the market will likely decline to 20% - 25%.

However, internationally the story is very different. Coach has seen wild success opening stores in Asia that has more than offset competitive forces in North America. They are seeing particular success in China. Below is the overall year-over-year changes in revenue for the last 5 years. It is evident that Coach commands high prices and people are willing to pay.

**Year-Over-Year Revenue Changes**

| Company | 2012 | 2011 | 2010 | 2009 |
|---|---|---|---|---|
| Coach | 15% | 15% | 12% | 2% |
| Michael Kors | 62% | 58% | 28% | - |
| Kate Spade | -5% | -32% | -16% | -50% |

*Same-Store-Sales*

The same-store-sales shed light on changes in market share. Opening a lot of stores from a small base, like Michael Kors did, can paint a misleading picture about the success of a brand. Same-store-sales are a year-over-year comparison of how a single store has performed. This metric is very important to measure the strength of a brand. Imagine an existing Coach store that has $1.5 million in sales annually. If a Michael Kors opens up across the street and the Coach store maintains $1.5 million in sales it is evident that the new Michael Kors store has had little impact. However, if the sales drop to $1 million then it is evident that Michael Kors has stolen some market share.

While the shift in same-store-sales is a concern we believe that it has been overblown and the price of Coach declined too far. When competition is introduced to an existing market we'd expect to see rapid declines in year-over-year same-store-sales for the incumbents with rapidly rising same-store-sales for the new entrant.

Imagine a Walgreens that generates $400,000 in sales annually. A CVS opens up across the street. The first year the CVS sells $150,000 and the Walgreens $350,000. The following year CVS sells $250,000 and the Walgreens $250,000 and from that point forward they've reach a competitive equilibrium. This is essentially what is occurring between Coach and Michael Kors in North America, but we are in the middle of the transition so year-over-year comparison make Michael Kors seem more dominant than they are and Coach more vulnerable than reality. We believe that analysts are projecting very high growth rates for Michael Kors that will not materialize and projecting very rapid declines for Coach that are overly pessimistic. The two businesses will compete side-by-side in the future with changes in same-store-sales leveling out for both businesses.

Overall Coach scores very well on the critical metrics for competition in their industry.

**Products & Services**

Coach sells women's and men's bags, accessories, footwear, wearables, jewelry, travel bags, sunwear, watches and fragrance. The generate 58% of their sales from luxury handbags for women.

| | Fiscal Year Ended | | |
|---|---|---|---|
| | **June 30, 2012** | **July 2, 2011** | **July 3, 2010** |
| Men's & Women's Handbags | 65% | 66% | 65% |
| Accessories | 28 | 27 | 26 |
| All other products | 7 | 7 | 9 |
| Total | 100% | 100% | 100% |

The brand represents a blend of classic American style with a distinctive New York spirit. At Selective Wealth Management (SWM), when it comes to fashion we strongly prefer brands that position themselves as 'classic'. The reason we prefer this branding style is that it reduces the probability of a fashion being a fad. Classic brands tend to gain further acceptance as they age. Coach was established in 1941 and has competed against many fads throughout the years with great success. We believe their positioning as a classic American brand increases their staying power and reduces the risk as a business owner.

**Customers**

Their customers are predominantly women that want to own high quality accessories. Women have loved clothes and shopping since…the beginning of time. We believe this will continue and Coach will be a brand of choice for many of these shoppers seeking 'affordable luxury'.

**Sales & Marketing**

Coach sells their product through their retail stores, factory outlets, directly operating shop-in-shops, online and department and specialty stores. They perform sales and marketing by capturing customer information at the time of purchase, such as email and physical addresses, and add these customers to email and direct mail campaigns. These are the principal means of communication utilized in their marketing practices.

The company also runs national, regional, and local marketing campaigns to support it major selling seasons (like Christmas). A website has been launched in recent years that has added to their success.

As a brand they are very intentional about not marking down obsolete product to continue to product the image of the brand for the future. They have demonstrated exceptional skill in their sales and marketing for many decades and we believe this will continue.

**Revenue Creation**

Revenue is generated at the point-of-sale. When a customer enters a store they purchase their products, mostly handbags, for cash. It is a very simple business model.

Revenue is broken down geographically: 66% of sales occurring in North America and 34% occurring internationally. Below is a table of the store count in North America:

| | Fiscal Year Ended | | |
|---|---|---|---|
| | **June 30, 2012** | **July 2, 2011** | **July 3, 2010** |
| Retail stores | 354 | 345 | 342 |
| Net increase vs. prior year | 9 | 3 | 12 |
| Percentage increase vs. prior year | 2.6% | 0.9% | 3.6% |
| Retail square footage | 959,099 | 936,277 | 929,580 |
| Net increase vs. prior year | 22,822 | 6,697 | 36,543 |
| Percentage increase vs. prior year | 2.4% | 0.7% | 4.1% |
| Average square footage | 2,709 | 2,714 | 2,718 |

| | Fiscal Year Ended | | |
|---|---|---|---|
| | **June 30, 2012** | **July 2, 2011** | **July 3, 2010** |
| Factory stores | 169 | 143 | 121 |
| Net increase vs. prior year | 26 | 22 | 10 |
| Percentage increase vs. prior year | 18.2% | 18.2% | 9.0% |
| Factory square footage | 789,699 | 649,094 | 548,797 |
| Net increase vs. prior year | 140,605 | 100,297 | 71,073 |
| Percentage increase vs. prior year | 21.7% | 18.3% | 14.9% |
| Average square footage | 4,673 | 4,539 | 4,536 |

You can see from the above table that Coach has had a very stable store base in North America for many years. This has made the lack of revenue growth in the last two years less material than analysts suggest.

Coach also sells their products through 1,000 wholesale locations in the U.S. and Canada. The most significant wholesale customers are Macy's, Dillard's, Nordstrom, Saks Fifth Avenue, Lord & Taylor, The Bay, Bon Ton, Belk and Von Maur.

The international segment includes sales to consumers through Company-operated stores in Japan and mainland China, including the Internet, Hong Kong, Macau, Singapore, Taiwan, Malaysia and Korea. Below is a table of the international store count. You can see that they have been much more aggressive in their expansion internationally into these new markets. The stores have seen tremendous success with same-store-sales increasing at rates of more than 20% per year. We believe this international will continue as has a very long runway as the emerging middle class globally continues to seek affordable luxury products.

The number of stores for Coach China has nearly doubled in the last three years and they continue to see outstanding success in these markets with growth in excess of +20%.

Their revenue is seasonal with higher sales in their second quarter (October, November, & December). This is due to Christmas. The sales during this period are typically 40% higher than the other three quarters of the year.

**Expenses**

Coach spent approximately 2% of net sales on customer communications last year to help customer loyalty and to develop the brand. All of the products are manufactured by independent manufactures – meaning Coach does not own any equipment or facilities. They hire third parties to actually make their products and spend their efforts designing new products and cultivating the image of the brand.

The company qualifies raw material suppliers and maintains sourcing and quality control management offices in China, Hong Kong, Philippines, Vietnam, South Korea and India. These quality control offices work closely with the manufactures to ensure that product is being develop consistent with Coach standards. The company believes one of the major keys to its success is the rigorous selection of raw materials (high quality leathers).

Coach employ's approximately 18,000 people, including both full and part-time employees. Of those 18,000 employees roughly 14,200 were full or part-time employees in the retail field. Only 70 of their employees are covered by a collective bargaining agreement.

Overall the expenses for Coach are very low relative to their ability to generate revenue. The cost of goods sold are only 27% of their overall revenue; or to put another way, a handbag that costs $50 to manufacture is sold for nearly $200.

Coach has a large fixed cost from their lease agreements across the globe. They lease more than 2.5 million square feet of retail space for approximately $200 million per year. Their operating income covers their lease expense by a factor of nearly 8:1 (a typically retailer, like The Gap or Abercrombie and Fitch might have a ratio between 2:1 and 4:1). This gives them the ability to absorb substantial losses in market share and maintain profitability.

**Real Income**

The income for Coach is very straight forward – the reported figures are accurate. Their net income in 2012 was $970 million and the entire amount is available to the owners. No adjustments are required to reconcile this figure to economic reality.

**Growth**

Historically the business has grown between 7% and 15% per year for the last 5 years. The growth occurred due to flat income growth in North America and very strong growth internationally. The increased competition from Michael Kors in the United States will cause income declines in North America, but we believe these will be offset by strong gains internationally and the company's income will remain flat to slightly positive (+3%) for the foreseeable future.

Without income growth the purchase price we paid was still very attractive. Coach was purchased at roughly 11 times earnings, or 33% below the market average, and the income is entirely free cash flow.

**Competition**

The largest competitor for Coach is Michael Kors. They have grown at a very rapid pace in the last 5 years and stolen significant market share from Coach. The two businesses are of equivalent size, both experiencing strong international growth, and similar market shares in North America. However, Michael Kors established a 20% market share in North America by increasing their stake, whereas Coach has a 20% market share falling from 30%. The growth of Michael Kors and decline for Coach has caused these two nearly identical businesses to trade at very different valuations.

**Consolidated Balance Sheet**

Coach has a sensational balance sheet with $917 million in cash and equivalents and $23 million in debt. Their cash balance is large enough to cover six years of lease payments with no additional sales. They have one of the strongest balance sheets in the retail sector and can withstand a very difficult market for an extremely long period before there is need for concern. We believe they have at least 10 years of cash available for operations to weather any storms that may arise.

In addition to the $970 million in cash the company has access to a $1 billion dollar revolving credit facility. These two sources of liquidity combine to make Coach an extremely safe investment from a liquidity standpoint.

**Accounting Quality**

The accounting quality is very sound. Again, it is a very simple business model.

**Legal**

Coach has no material legal proceedings.

**Allocation of Capital**

Coach generates a substantial amount of free cash flow. Approximately 100% of their income has been removed from the business for shareholders for many years – while maintaining healthy growth. The cash is being allocated to share repurchases (60%) and dividend payments (25%).

**Risks**

The biggest risk for the business are changing fashion trends. It is very difficult to predict how fashion trends will change, but I believe that Coach's position in the market place is less prone to changes in taste. Due to the high uncertainty in changing fashion trends we will not allocate more than 5% of our assets to this position.

Coach also received 12% of their total units sold through a single independent manufacturer. If this manufacturer were to have a disruption in their process it could create temporary supply issues for Coach. The nature of the 12% of units is unknown – if these are expensive and high demand items it could impact the revenue and net income by significantly more than 12%.

**Moat**

The moat for Coach is their iconic brand and their positioning in the market place as a 'classic'. The position as a classic brand improves as time passes, whereas, trendy names tend to come and go. The older Coach gets, the more they embody this classic look and feel. The company is now over half a century old and an America icon for fashion. While this is not a very stable moat, we believe it is a superior market position than that of Michael Kors (trendy).

**Works Cited**

1) *COH Annual Report - SEC Filing 10-K.* EDGAR, 2012.

**Disclaimer**