Coach, Inc.

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Date:	17 October 2008
Symbol:	COH
Exchange(s):	NYSE
Price:	$18.10
Market Cap:	$6.0 billion
PE:	8.1x 2009 EPS
Avg. Daily Liquidity:	$148 million

Background

Coach Inc. is one of the most recognized fine accessories brands in the U.S. and in targeted international markets, selling handbags, women's and men's accessories, footwear, jewellery, business cases, watches, travel bags and fragrance. COH holds the number one position within the U.S. premium handbag and accessories market and the number two position within the Japanese imported luxury handbag and accessories market. The company operates 548 stores with nearly 1.5 million square feet of retail space globally.

Over 90% of the company's sales are generated by selling Handbags (62% of '08 revenue) and Accessories (29% of '08 revenue). Around 80% of Coach's 2008 sales were generated by selling directly to consumers, a channel that allows the company immediate, controlled access to consumer purchasing habits.

Business Strength

Defendable Competitive Position Driven by Customer Loyalty: Coach's business focuses on what customers really want: product and service quality, simplicity, convenience, reliability and perceived value for the money[1]. As a result, Coach has created a loyal customer base in its existing markets and successfully has laid the groundwork to introduce its brand in new markets.

Positioned for Global Growth: In May 2008, the company announced it will acquire the Coach retail businesses in Hong Kong, Macau and Mainland China from its current distributor, which should allow the company to raise brand awareness and grow market share with the Chinese consumer. The company intends to open at least 55 new stores in these markets over the next five years, growing the number of stores from about 25 locations today to about 80 in five years. This presents a significant opportunity for growth: Goldman Sachs predicts that by 2015, China will be first in world consumption of luxury goods, and by 2010 the Chinese middle-class will top 250 million people.

Enhancing the Online Customer Experience: Also during 2008, the company introduced in-store pick-up for goods purchased online, significantly increasing the buying experience for the nearly 55 million unique visitors who shop on Coach's website each year.

Financial Assessment

The company's return on invested capital has averaged 35% over the past five years. The company also is extremely productive, generating $1,730 in sales p/sq ft globally in 2008, which compares to $1,560 in sales p/sq ft during 2006 (and compares to Gap Stores' $330 p/sq ft, Neiman Marcus' $620 p/sq ft and Victoria Secret's $730 p/sq ft).

(in millions)	2007A	2008A	2009E	2010E	2011E
Net Sales	2,612	3,181	3,213	3,373	3,778
Sales Growth %	*28%*	*22%*	*1%*	*5%*	*12%*
Net Income	637	783	482	573	756
Net Margin	*24%*	*25%*	*15%*	*17%*	*20%*
Operating Cash Flow	781	923	554	660	869
Capital Expenditures	141	175	200	202	227

COH has funded expansion primarily using operating cash flow rather than using debt. As a result, the company currently has $2.6 million in long-term borrowings, or a debt-to-equity ratio of less than 1% (0.17%). However, COH carries operating leases off balance sheet. Therefore, capitalizing operating leases and adding the PV of minimum future rental payments, or $715 million, to the balance sheet implies a debt-to-equity ratio of 47%, which is higher but is reasonable given the company's balance sheet and operating cash flow. In the current credit environment balance sheet strength is paramount – the company currently holds $700 million in cash.

Risks and Mitigants

The greatest risk to the investment thesis is a prolonged global recession. Purchases of luxury items, such as Coach's products, tend to decline during weak economic environments, when disposable income is lower.

Valuation

At 8.1x expected 2009 EPS, COH trades at one of the lowest forward P/E multiples in the company's history, and is trading at a discount to the Bloomberg peer group multiple of 13.3x. DCF analysis implies a target share price of $23.50, based on bear case, base case and best case forecasts for sales growth and net margins.

Revenue Growth and Margins	2009E	2010E	2011E	2012E	2013E
Bear Case: Revenue Growth	-8.0%	-5.0%	5.0%	10.0%	15.0%
Bear Case: Net Income Margin	10.0%	15.0%	18.0%	20.0%	20.0%
Base Case: Revenue Growth	1.0%	5.0%	12.0%	15.0%	20.0%
Base Case: Net Income Margin	15.0%	17.0%	20.0%	20.0%	25.0%
Best Case: Revenue Growth	7.0%	8.0%	15.0%	18.0%	20.0%
Best Case: Net Income Margin	17.0%	20.0%	20.0%	22.0%	25.0%

Summary of 10-Year DCF Model	Bear Case	Base Case	Best Case
Sum of FCF, excl. Terminal Value	2,307	3,801	4,750
PV of Terminal Value	3,445	5,053	6,323
Equity Value	5,752	8,854	11,073
# Shares Outstanding	355.73	355.73	355.73
Equity Value per Share	16.17	24.89	31.13
Price Weighting (probability)	30%	50%	20%
Target Share Price		23.52	

Model assumptions: 10.6% discount rate (4.05% risk free, 4.45% equity risk premium, 1.48 beta); LT sustainable growth = 3%

Conclusion

An excellent brand hurt by fears of a prolonged recession, Coach is a well-managed company with a sound balance sheet that generates significant free cash flow. After assuming control of the company's Chinese operations, Coach is poised to experience growth by directly selling to what will be the world's largest luxury good market. With an intrinsic value of $23.50, the shares currently are undervalued relative to the company's prospects for growth.

[1] Customer preferences based on research by Patrick Barwise, Emeritus Professor of Management and Marketing at London Business School