Wedgewood Partners Comments on Coach

Dear Clients of Wedgewood Partners:

We attended Coach's Investor Day last week in New York. Over the course of the Company's four hour presentation we found ourselves nodding our head in agreement as the Company addressed mistakes and shortcomings in their current brand and marketing strategy. **We agree too that the Company's comprehensive remedies are welcome news for frustrated shareholders**. However, as we sat throughout the detailed presentations from all of the Company's top executives it became quite clear that the **"fix" at Coach will be very expensive, inducing a sharp decline in the Company's earnings power over the next 12-18 months - and the projected brand and earnings renewal won't be quick.** In fact, the fix will take a few years to fully complete in order for the Company to reclaim their once vaunted industry leading profitability.

The significance of the new Coach news - and Wall Street's swift reaction - was such that we did not want to wait until the next quarterly Client Letter to share our current thoughts on Coach.

<u>Benched by the Coach</u>

Our journey in our ownership in Coach thus far since July 2012 has been long...and wrong.

<u>Were did we go wrong on our initial timing?</u>

The first mistake in 2012 was our view that Company's lackluster North American sales slump was largely due to a pause in creative new product. **Thus, our initial investment in these shares came far too early in the Company's efforts to reinvigorate their iconic brand.**

Our second mistake by 2014 was **not recognizing the severity of the underinvestment in the brand. Competitors Michael Kors, Kate Spade and Tory Burch have all successfully copied key aspects of the high return on capital Coach playbook, and now the original progenitor of "accessible luxury" now finds itself at the crossroads of not only redefining and rebuilding its own brand, but fighting off it's well entrenched progeny.**

<u>Why do you still own it?</u>

We still think Coach has a sustainable competitive advantage, and we do not think that the competitive inroads of Coach's peer group are sustainable over the next 3 to 5 years.

First, we think competitors have expanded too quickly and will soon reach a point of saturation. For instance, Michael Kors reported roughly $400m in sales for its fiscal 2009; the Company recently guided to just above $4bn in sales for the period ending

June 2015 - a roughly ten-fold increase in just six years. For perspective, we look at well-known peers: Burberry - an iconic affordable luxury brand that is over 100 years old - eclipsed $400m in sales 2001. According to IBES estimates, the Company will surpass $4bn in March 2017. In other words, it has taken Burberry, roughly 16 years to go from $400m to $4bn in sales. But that's actually about normal: Ralph Lauren took at least 15 years. Coach: 16 years. Hermes: 22 years, and Tiffany's: 25 years.

All told, we think the exclusivity of the Kors value proposition is at risk, and therefore not sustainable.

Second, several months ago, **Coach embarked on an aggressive plan to reinvest in the brand and buttress its competitive positioning in North America**. We think this is very necessary after years of underinvestment. This reinvestment plan has included the hiring of a new head of creative, and repositioning the brand by curtailing dilutive impressions, particularly by closing underperforming stores and online "flash-sales" as well as elevating flagship full-price stores to dictate Coach's value proposition of modern luxury. While these investments have hurt sales growth over the past 6 months and will continue to do so for the next 12 months, we think it will lead to a healthier brand impression and a much higher, sustainable level of earnings power in 3 to 5 years.

Third, the Company's competitive positioning remains relatively unassailed in its international markets - especially in faster growing markets, such as Greater China. As the North American business remains challenged, we expect international will come to **represent 40% or more of revenues.**

Earnings power has been roughly cut in half since you bought, how is this growth?

We look at future earnings power, particularly over the next 3 to 5 years. While we underestimated the rate of competitive incursion and its effects on Coach's business in the near-term, we still think Coach has the ability to post earnings that are two to three times higher than trough earnings estimates, over the next 3 to 5 years. The Company's total addressable market is expanding at a robust mid to high-single digit rate and should be close to $50bn in 5 years. We expect that the negative leverage from the Company's aggressive reinvestment will subside over the next 12 to 18 months, and double-digit earnings growth will resume.

What's the downside from here and when do you sell?

Despite the planned sales declines and a dramatic increase in overhead (as a percent of revenues), Coach is still immensely profitable**. This speaks to the Company's financial strength and competitive positioning.** Currently, we estimate the market is assigning a $2.5bn value to the Company's North American business - we expect sales in North America to bottom around a similar level, leading to a price to sales multiple of just 1x. We believe that a 1x price/sales is much too low for a Company that has a profitability profile and growth opportunities similar to Coach.

That said, our valuation assumptions for North America are predicated on the continued success of Coach's international franchise. In addition, the Company remains dedicated to paying its current dividend, which is nearing a 4% yield. If Coach runs into difficulties overseas, there is a good chance we will move on, as the international business is the financial engine that will drive the near-term transformation in North America and support the Company's fortress balance sheet. Last, and as always, if we find a meaningfully more attractive risk-reward opportunity, we will sell Coach.

Any upside?

Philosophically, we expect stocks to track in-line with earnings growth, over a multi-year time horizon. We continue to think that the Company's aggressive reinvestment in the brand will yield earnings that are at least twice as high as today, particularly over the next 3 to 5 years.

Thank you for your continued confidence and support of Wedgewood Partners.

9909 Clayton Road, Suite 103, St. Louis, MO 63124
1.800.537.1252 | 314.567.6407

wedgewoodpartners.com

--

Coach Inc COH

Despite the short-term spending on the brand reset, Coach is still making strong economic profits.

by**Paul Swinand** Authors can be reached atAnalyst Feedback

Note 06/20/2014

Following Coach's analyst day, **we are lowering our fair value estimate to $50 from $54 after the company forecast that store closings, promotion reductions, and store renovations and repositionings would lead to a mid-20% comparable-store sales decline in North America, a low-double-digit total revenue decline in fiscal 2015, and a drop to high teens operating margins.** Investments in marketing and in-store experience during a major brand reset in fiscal 2015 are suggesting an increase in the SG&A ratio of around 600 basis points or more; the company is forecasting relatively stable

69%-70% gross margins. This would drop operating margins to the 19%-20% range, well below the already depressed 25%-26% range management previously forecast for fiscal 2014 (June ending).

Our narrow moat rating remains unchanged. Financial results are projected to get worse before they get better, and we acknowledge both fashion and execution risks. However, we continue to believe the luxury leather goods and accessories business is a high-returns, attractive industry where Coach can continue to play an important role because of its 75-year-old, iconic New York-born brand. We also believe the long-run outlook for global industry growth and Coach's potential market share internationally are being underappreciated. We are encouraged by the completeness and depth of the brand reset planned for the company, and note that Coach is fortunate to have a strong balance sheet and cash flow to be able to invest in this turnaround.

Although management is simultaneously projecting a return to "best in class" financial performance, including a 30% operating margin by fiscal 2019, we have modestly undershot this metric in our updated valuation model. We still believe the actions and strategies laid out can be successful, but conservatively are modeling that the firm only approaches the 30% operating margin figure by the end of our 10-year forecast period.

Investment Thesis 06/19/2014

Coach has developed a narrow economic moat through a brand that enables strong pricing, sourcing and distribution advantages, and capital efficiency. Despite the company's recent struggles, it is still creating excess economic profits, and at a level much greater than most retailers.

Attention to capital efficiency and consumers' strong brand loyalty have been key drivers of Coach's economic returns. We judge brand to be more important in bags and leather accessories than other soft goods categories as consumers tend to be more brand-loyal. Despite Coach's long-run plans to increase penetration in footwear and ready-to-wear, we believe accessories will remain the core of the business. The men's business also offers some upside, which currently comprises just over 13% of sales.

Additionally, Coach's international business is still underdeveloped and represents an opportunity if growth continues on its current trajectory. Although 2013 and 2014 struggles highlight Coach's market concentration in North America, using long-run success in Japan as a guide, we think there is plenty of room for Coach to take market share in other geographies. In Japan, Coach has had flat to low-single-digit growth rates for the past 10 years while competitors generally have experienced declines. The company only just entered Europe in 2012 through department store partnerships and is now penetrating further wholesale accounts and opening retail stores. We believe there is room for a brand

such as Coach offering uniquely American styles and high-quality products at lower price points. In China, Coach lags other luxury brands with respect to sales, but has greater growth potential. The company grew its China business to over $100 million in 2010 and projects that in fiscal 2014 it will attain $540 million in sales. Coach should also see higher operating margins in China as it expands because of lower operating costs and higher gross margins. In Europe, where Coach has just a small number of boutiques and dedicated shops in department stores, the company should leverage SG&A over time and now projects $100 million in revenue in fiscal year 2015.

Economic Moat 06/19/2014

While Coach might not have complete pricing power because of the price/value equation inherent at some level in consumers' decision to purchase its midtier luxury offerings, the company's ability to design, distribute, and source enable it to produce premium operating margins. Coach's gross margins, and gross margin return on investment (taking inventory value and turns into account) are among the best in our coverage list, lending evidence that it has some pricing power within the range where it competes. Thus, in our opinion, Coach has a defensible economic moat. Brand history and the extensive, directly operated, and wholesale distribution network also contribute to the defensibility of the position, in our thinking. Our viewpoint is supported by returns on capital that have averaged over 40% for the past five years, despite the recession. Operating margins have averaged above 30% in the past, and despite short-term declines in fiscal 2014 and 2015, can eventually approach those levels again, in our view.

Valuation 06/19/2014

We have lowered our fair value estimate to $50 per share, from $54, as lower operating margins and sales declines are forecast in fiscal 2015 based on financial plans released at the company's analyst day. Our fair value estimate implies 16 times forward fiscal June 2014 year-ending earnings per share and 27 times depressed fiscal 2015 earnings per share. On an enterprise value/EBITDA basis, our valuation implies 9 times June 2014 fiscal year estimates and 13 times 2015 fiscal year estimates. On a cash flow yield basis, our fair value estimate suggests approximately 4% cash flow yield for fiscal 2015, at the low end of a five-year historical range of 4%-6%. Fiscal 2015 metrics exclude any one-time charges for store closings and restructuring.

For fiscal 2014 (year ended June), we project a revenue decline of 7%, with negative same-store sales growth implied in North America. Gross margins are now forecast at about 70%, and although cost pressure worries have diminished, increased SG&A around the design changes should cause operating margins to dip near 26%. We are modeling roughly 300 basis points of gross margin decline, year over year, in fiscal 2014, as we remain concerned that some inventory clearing may still have to occur. In fiscal 2015 we model a revenue

decline of over 10%, operating margins below 20%, and capital spending of $400 million. This compares with our prior modeling assumptions of just under 26% operating margins and a sales decline of 2%-3% for the coming fiscal year. We have made no changes in the fiscal year ending June 2014, and are assuming prior guidance assumptions would have been updated at the analyst day had they materially changed.

Over our 10-year explicit forecast period, we model operating margins first dropping to just below 20% and eventually growing to just below 30%, with an average just under 27%. This is somewhat more conservative than company plans to return to 30% operating margins by fiscal 2019. Top-line growth to reach our cash flow-based valuation averages just below 7%, excluding the previously mentioned 11% decline forecast for fiscal 2015. Although we have increased our capital spending assumptions for fiscal 2015 through 2017, we model spending eventually returning to 4%-5% of sales.

Risk 06/19/2014

Remaining fashionable and extending the brand are constant risks at Coach, and as such we assign it a high uncertainty rating. If Coach extends the brand beyond what consumers understand it to be, the company could damage its core image. Coach has embarked on an ambitious plan to expand its product lines and become a full lifestyle brand, not unlike many older and more prestigious European luxury brands. It is also now undertaking a pullback on promotions and a repositioning of the store base, in the same year it will launch new product lines from a recently hired chief design officer, Stuart Vevers. Yet the strategies are not without risk. Footwear does leverage some competitive advantages in leather sourcing, but in our opinion is a different category from bags and accessories. Men's accessories have lower risk, in our opinion, and we agree that the men's leather goods market is underserved, but we cannot be sure that the extension will not dilute the women's business. The new fashion designs have met with very positive reviews in the fashion press, yet no amount of testing and publicity can assure success with consumers.

While Coach has established a niche in the fashion world, and customers are very brand-loyal in the handbag and accessories category, Coach runs the risk that changes in tastes and preferences will eventually lead consumers to believe it is a brand for a past era.

Coach also has been successful thus far extending the brand into new geographies, and a portion of our fair value estimate is based on that continued expansion. Today, sales growth prospects appear strong, but there is a risk that new entrants or other market forces could derail the international projects that today look promising for Coach.

Management 01/22/2014

Lew Frankfort was replaced by Victor Luis at the beginning of 2014. Luis, who was head of international operations, has been assembling a new team of designers and management, including a new creative director. His experience includes terms as CEO of Baccarat, running North America, and with other LVMH brands earlier in his career. We believe his international experience will be important to develop the future growth of the firm.

A majority of Coach's board is independent, and officers and directors own nearly 5% of the shares outstanding. We prefer to see the roles of chairman and CEO split, and agree with the new structure with Luis serving as chief executive and Frankfort remaining executive chairman. We believe management does a good job of providing transparency around the business. Overall, corporate governance is sound and aligned with shareholders, in our opinion, and we rate Coach's stewardship of shareholder capital as exemplary given its long record of above average returns and recent actions to return cash to shareholders. Finally, we note that in 2013 Frankfort bought Coach shares on the open market, despite having announced his diminishing role.

Overview

Profile:

Coach is a manufacturer, distributor, and retailer of handbags and accessories, and is expanding to broader product categories. Its products offer the quality of higher luxury brands but at more attractive price points. Although about 60% of sales come from its 543 North American retail stores, Coach also sells its products through department stores, international shops, the Internet, its catalog, and Coach stores in Japan and China. Coach recently started establishing European distribution, with 20 stores acquired in fiscal 2014.

S&P 500 index data: S&P 500 Copyright @ 2014

All data from Morningstar except U.S. intraday real-time exchange quotes, which are provided by BATS when available. End-of-day quotes for Nasdaq, NYSE, and Amex securities will appear 15 minutes after close. Graph times are Eastern Standard. @ Copyright 2014 Morningstar, Inc.

--

Coach Wants to Be Michael Kors, Will Consumers Buy It?

By Ben Levisohn June 23, 2014

Coach (COH) has plunged 27% this year after dropping 12% last week. Still, **Wedbush's Corinna Freedman** thinks now is a perfect time to downgrade the beaten-down luxury retailers shares. The reason: It's going to get worse before it gets better for Coach. She explains:

Bloomberg News

Following the comprehensive Analyst meeting held last week in New York City (COH's first in seven years,) we are downgrading our rating on share of COH to UNDERPERFORM from NEUTRAL as **we have incremental concerns about the company's turnaround plans and while we do find some incremental positives and while we continue to hold out hope that marketing plans will be compelling, we believe the shares are likely to remain under pressure for the balance of the year.** We believe it remains to be seen whether COH will be successful in changing brand perception and although its strategic initiatives touching product, marketing and stores are dramatic and bold, we are concerned about the lack of testing and ultimately customer acceptance in the near-term. We believe a more conservative stance for beyond fiscal 2015 (relative to management's long-term goals) is warranted and as such, **we believe valuation is likely to further compress. Though some may argue that the guidance is 'kitchen sinked,' and somewhat de-risked, we believe that beating very conservative guidance by any magnitude, still indicates a brand in decline as the difference between guidance of a -27 – 29% North American retail comp and reporting a -20% comp may not ultimately be relevant given the continued hemorrhaging of market share.** Though the timeline has been drastically extended and tangible results of the turnaround may not be evident until 2H15, a flat dividend (we do not expect any increase in FY15 or FY16) and declining in free cash flow may not be enough to satisfy longer-term holders.

Changing perception of Coach certainly won't be cheap. Freedman notes that Coach recently switched ad agencies, hiring **Michael Kors'** (KORS) Baron & Baron to head up its new campaign. Coach plans to spend about 3.4% of sales on advertising, Freedman notes, well above the 2% of sales **Michael Kors** spent in 2013.

Shares of Coach have dropped 2% to $34.02 at 1:41 p.m. today, while Michael Kors has dipped 0.2% to $88.43.