Coach, Inc.
(NYSE: COH)

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Executive Summary

Coach is a classic compounder, not to be confused with certain pyramid schemes, selling magic weight loss potions and masquerading as growth stories. From 2002 to 2012, the company's sales increased at a compound annual rate of 21.1%, while earnings per share grew 31.1%. However, in the past year, shares have slid 35.4% while the S&P 500 has generated a 13.4% total return, providing investors with a rare opportunity to own a high quality business at a significant discount to intrinsic value. Coach currently trades at 8.3x EBIT, 13.0x current and 11.7x forward earnings. In other words, the stock is priced as if Coach's growth is long in its past. At its peak in 2001, shares fetched 32 times earnings. If we assume that Coach ultimately trades back towards its average forward multiple of 15x over the next three years, we estimate the stock is worth $76.60 in our base case, which represents more than 50% upside potential. In our bull case, upside is significantly greater.

Investors have been quick to punish Coach for any temporary dip in profitability, highlighting the risk in owning luxury brands amidst an uncertain macroeconomic environment. But we view the company as more of a consumer staple, with the growth trajectory of a young, specialty retailer. We agree that $300 handbags are not exactly a basic necessity, but the resiliency of Coach's business during the most recent downturn speaks for itself. When the recession hit, sales nudged higher in 2009, while profit dipped single digits. Meanwhile, competitors all had to take markdowns - the rest of the Luxury index saw sales fall mid-single digits and earnings slashed by a third. Even during the recession, Coach's fundamentals were excellent, with three-year historical operating margins above 30% and returns on capital around 40%. While management did adjust price and mix to offer more value to its core customer base, we think the brand is more bulletproof than the bears might suggest. This year, Coach's operating profit will be more than 30% higher than at the 2008 peak.

Free cash flow generation is stellar, historically greater than 20% of revenue. We believe that management's focus on capital efficiency and the company's strong brand loyalty have been the key drivers of financial results. The key to profitability is the diversity of the business model and what distinguishes Coach from other high-end businesses is the factory outlet channel, where it generates almost three times the sales per square foot as full-price stores and remains the most profitable segment domestically.

China, along with the expansion of its US men's business and entry into Europe, gives Coach several early-stage growth stories to complement its dominant, more mature domestic operations. So all together, we expect high single digit top-line growth and share buybacks to drive double digit earnings growth for the foreseeable future. Furthermore, we believe the company's industry-leading return on capital and strong free cash flow generation give management plenty of room to return more cash to shareholders through a significant increase in the dividend after doubling the payout over the past three years.

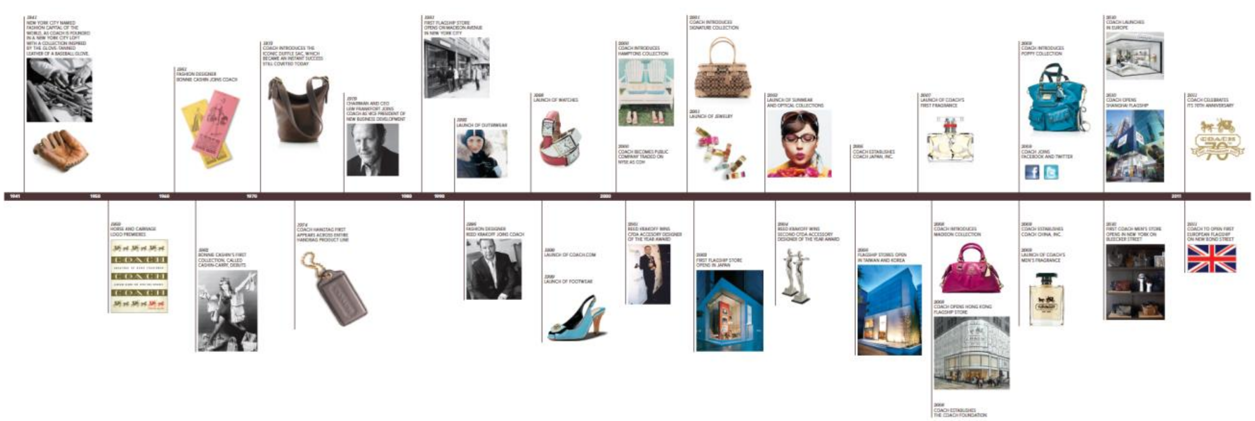
A Rich Heritage Defining Classic American Style

Coach Inc. (COH) was founded in 1941 as Gail Leather Products in a New York City loft as a family owned workshop. Six artisans handcrafted leather wallets and billfolds using top quality materials until the company was steered into women's leather handbags by Lillian Cahn almost 10 years later. The company was bought out from the original owners in 1961 by Lillian and Miles Cahn and the name was changed to Coach Leatherware.

In the years that followed, Coach products quickly became renowned for their distinctive design, quality, function and durability. In 1985, the company was sold to Sara Lee for $30 million as the Cahn's wanted to focus on their goat farm and cheese production business. We have not studied the economics of goat farming, but we'd venture to say that, in hindsight, this was not an optimal financial decision given the overwhelming success of Coach which followed. Nevertheless, Sara Lee sold 19.5% of their shares of Coach at the IPO in October of 2000. This was followed in April 2001 with the distribution of their remaining shares to Sara Lee's stockholders through an exchange offer. Shareholders have been very well rewarded over time as the stock has compounded at a 25% annual rate since the company's IPO, while the S&P 500 has gained about 4% annually.

During the last decade, Coach has emerged as America's preeminent designer, producer, and marketer of fine accessories and gifts for women and men. Continued development of new categories has further established the signature style and distinctive identity of the Coach brand. The company's headquarters remain in mid-town Manhattan on 34th Street, in the location of its former factory lofts. A full size timeline is available by clicking on the graphic below.

Coach Timeline: 70 Years of American Style



Business Overview

Coach offers its merchandise for sale through the following methods of distribution: (1) Coach stores, (2) Coach factory stores, (3) authorized department stores, (4) authorized specialty stores and catalogs, (5) limited duty free locations, and (6) coach.com. Coach does not have individual distributors and is not available through house parties or "nutrition" clubs. The direct-to-consumer segment represents 41% of total locations which consist of 833 Coach operated stores generating 89% of total sales and 75% of operating income. The indirect segment represents the wholesale channel where Coach products are purchased at department stores and authorized resellers. Each segment is discussed further below.

	Direct-to-Consumer	Indirect	Corporate Unallocated	Total
Fiscal 2012				
Net sales	$4,231,698	$531,482	$ —	$4,763,180
Operating income (loss)	1,733,612	298,593	(520,216)	1,511,989
Income (loss) before provision for income taxes	1,733,612	298,593	(527,302)	1,505,663
Depreciation and amortization expense	90,733	9,049	33,127	132,909
Total assets	1,546,225	107,135	1,450,961	3,104,321
Additions to long-lived assets	121,426	7,085	69,776	198,287

Direct to Consumer Segment

North America

At the end of fiscal year 2012 Coach operated 354 North American full price retail stores with square footage of 959,099. North American stores represent over half of their total base and 63% of total sales. Management believes the brand can support about 500 full-prices stores, so there is a long runway for expansion domestically. Retail segment stores are located in shopping centers and free standing buildings in highly-dense populations. Additionally, Coach distribution benefits from 169 North American factory stores, with square footage of 789,699. Factory stores sell product exclusive to this store base as well as irregular and discontinued inventory, and represents the most profitable segment for the company domestically. Finally, Coach online received 76 million unique visits in fiscal year 2012 and is expected to grow in importance over time.

International

At year end fiscal 2012, the US represented approximately 68% of net sales, Japan represented 18% and other International, which reflects retail sales in China and Canada as well as shipments to third-party distributors primarily in East Asia, represented about 14%. Currently, China generates 6% of total sales, but is on target to surpass Japan on store count within 3 years as management expects to open 30 stores annually for the foreseeable future. On top of store growth in China, Coach is positioned to capitalize on meaningful growth opportunities in Asia by taking ownership of its existing distributors in this region.

Indirect Segment

The Indirect segment is comprised of US and International operations. The US Wholesale segment is conducted through 990 department stores with significant customers including Macy's, Dillard's, Nordstrom, Lord & Taylor, Carson's, the Bay and Saks Fifth Avenue. The international business is mostly driven by travel retail (airports), but management is driving growth through relationships with department stores and freestanding retail locations. Coach is currently refocusing its efforts on the segment in light of increasing competition, reimaging indirect stores to create a more welcoming and focused experience.

	United States	Japan	Other International[1]	Total
Fiscal 2012				
Net sales	$3,243,710	$844,863	$674,607	$4,763,180
Long-lived assets	631,979	74,324	108,334	814,637
Fiscal 2011				
Net sales	$2,895,029	$757,744	$505,734	$4,158,507
Long-lived assets	574,285	76,804	76,473	727,562
Fiscal 2010				
Net sales	$2,534,372	$720,860	$352,404	$3,607,636
Long-lived assets	567,380	76,514	42,466	686,360

The company also segments out their revenue by product type. As of fiscal 2012, Coach sales mix is as follows: Handbags accounted for approximately 65%; accessories including women's small leather goods (money pieces, wristlets and cosmetic cases), men's small leather goods (wallets and card cases) and novelty accessories including electronic, time management, pet accessories, key fobs and charms represent approximately 28%. The remaining 7% included footwear, outerwear, sunglasses, watches, travel bags, jewelry and fragrance.

Manufacturing and Distribution

All of Coach's products are produced by independent manufacturers with one vendor supplying 16% of total units. Management still controls the supply chain process from design to manufacture which includes sourcing of quality raw materials (leather and hardware) for their products. This affords Coach a flexible cost structure and allows them to bring products to market faster and more efficiently. For example, during fiscal year 2012, 71% of total sales were generated from newly introduced products. We view management's sourcing and distribution capabilities as one of the company's competitive advantages. Although some aspects of this can be mimicked in the near term, others, such as being one of the largest high-quality leather buyers on the planet, are more permanent.

Coach also licenses out their brand for certain products providing exposure to product lines that are not core to their manufacturing or distribution capabilities, but help to extend the company's brand and reach. These partners pay royalties to Coach on their net sales and contracts give Coach the right to terminate the agreement if specified sales targets are not met.

Investment Thesis

Coach is due for a change. Its products have become outmoded and stodgy and its stores look too heavy, dark and masculine. Meanwhile, rival designers are moving into its turf with more fashionable styles. At least, that's what reports suggested at the turn of the century. Ironically, the bears believe share loss will ultimately result in gross margin compression as the company struggles to hold onto market share today. It's a similar story, and as a result, short interest is up 200% over the past twelve months as the stock has lost more than a third of its market capitalization. **We believe that this short term shift in sentiment has provided long term investors with a rare opportunity to own a premium brand at a discounted price. History suggests that this is not the first time Coach has faced such challenges. In fact, management has done an amazing job reinventing itself over the years.**

Over a decade ago, Coach's top and bottom lines took a hit as its styles missed the mark. Sales slowed in the mid-to-late 1990's as both high-end designers and lower-end rivals muscled onto its turf. But in 1996, Lew Frankfort hired Reed Krakoff from Tommy Hilfiger, and what followed is history as the two refocused the company, bringing in new styles, collections and fabrics. Coach decided it was time for a change and started thinking like a consumer-products company, relentlessly testing the market to see what holes it could fill. In late 2000, Krakoff came up with the "wristlet" and rolled out 25 styles over the following 10 months. A few years later, Coach was selling over one million wristlets in 75 styles, and luring younger women who had not previously been customers. Meanwhile, the company's market research suggested that women were increasingly interested in a less expensive, more casual brand so Krakoff came up with the idea of the "weekend bag" for the Hamptons. And after noticing women mixing evening fashion with casual clothes, Krakoff saw an opportunity for the "Madison" collection, which remains one of Coach's bestsellers today.

Today, Coach is America's leading premium handbag and accessory brand with a market leading position in its core market, and a significant opportunity for brand expansion at home and abroad. Our investment thesis is grounded in three key pillars driving growth going forward: the ascent of affordable luxury, continued brand extension and ongoing international expansion.

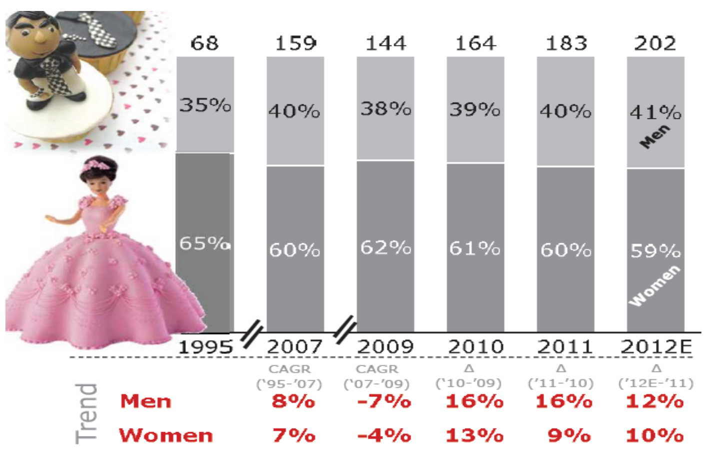
Affordable Luxury

American consumers are on a budget, but they still like to buy the best of what they can afford. We think manufactures and retailers that can provide consumers with an accessible luxury brand that they can identify with are best positioned in the current macroeconomic environment. Coach is the embodiment of affordable luxury – a coveted brand at prices a third lower than high end peers. Its strategy is simple: the company creates and markets new styles to fill "usage voids" in various activities and prices bags lower than luxury designers, but high enough for women to buy as a special treat. For generations, "established fashion wisdom" called for American women to buy about two purses a year. But in recent years, Coach has successfully made handbags the shoes of women's wardrobes. "American women, it seems, are finally learning what Parisian women have known for decades: Accessories make the outfit," Frankfort says, and he helped to guide the way. Coach's American products set it apart from higher priced European rivals. For a luxury brand, the stores have a more casual, approachable feel which appeals to a broader customer base and attract brand-conscious shoppers who have become increasingly sensitive to value.

Rise of The Murse

The company's expansion toward a true "lifestyle brand" is a natural and logical progression allowing for an easier cross-sell and greater brand awareness for both men and women. The launch of the Legacy Lifestyle Collection, which incorporates outerwear, jewelry, small accessories, footwear, watches and scarves, is the latest example of this trend. The line is expressed as the "new modern classic" holding true to the classical look of Coach with a modern touch. The proposition remains simple: a distinctive brand that is innovative and consumer-centric.

Importantly, the male market is increasing the overall size of the lifestyle brand, and represents a significant opportunity for expansion at Coach, which is pushing hard into the estimated $5 billion market. Fashion conscious men in countries such as China, Korea, France and the UK are where growth is strongest. In contrast, the US male population is less accustomed to a fashionable dress code, but it's a trend that has been reversing. While we have yet to see a broad uptake of "murses" in Lenoir, North Carolina, today, men make 41% of luxury purchases, up from 35% in 1995. The male market is expected to expand at a low double-digit pace for several years ahead, and Coach believes its men's sales could hit $1 billion in the next few years.



Coach continues to expand their men's line through enhancements and additions to clothing, accessories and bags. Exposure is being driven by dual gender stores that are being rolled out with store upgrades and to new stores with a third of their domestic stores outfitted as such. Reach is also been aided by a targeted marketing campaign in the US, China and Japan. Management expects revenues in Men's to reach $600 million this year, 50% growth from prior year, representing 10% of total revenues.

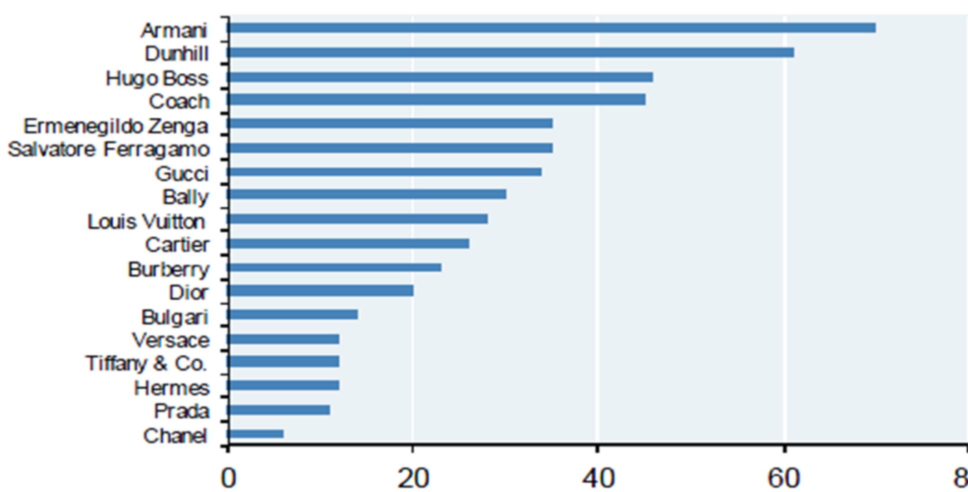
International Expansion

Barron's ranks Frankfort one of The World's Best CEO's noting the transition from a maker of stodgy briefcases and handbags into a red-hot international fashion icon. We believe this transition is in its infancy. While Coach continues to be one of the best recognized accessories brands in North America, its long-term strategic plan is to increase international distribution and target international consumers, with an emphasis on the Asian consumer. Through the company's directly operated businesses in Japan, China, Singapore, Taiwan, Malaysia and South Korea, Coach is leveraging a significant growth opportunity in this important region.

Many investors view Coach as a firm dependent on the fortunes of the American consumer as the company's international business is still underdeveloped relative to global peers. We see this as a massive platform for growth and believe Coach's distribution footprint can be greatly expanded without brand dilution. Looking to Japan as a guide, where market share has grown from 2% - 3% in the 1990's to 17% today, there is plenty of room for Coach to take share of the global luxury goods market. We see obvious parallels to the company's opportunity in China today, with current market share estimated at 5% and growing. But as we began our research, we were quite shocked to learn that the company only just entered Europe last year. Again, conventional wisdom assumes that Coach will never compete with European bag makers on their home turf, but our research suggests that the company's great American heritage brand should be well received by increasingly price conscious European consumers.

While the potential in Europe is significant, particularly relative to consensus expectations, the greatest geographic growth opportunity for the company today is in Greater China where management plans to open 30 stores annually for the foreseeable future and projects $500 million in sales next year. Since 2008, the company has expanded its footprint to 117 stores. Last year, sales in China grew 64% to over $300 million annually.

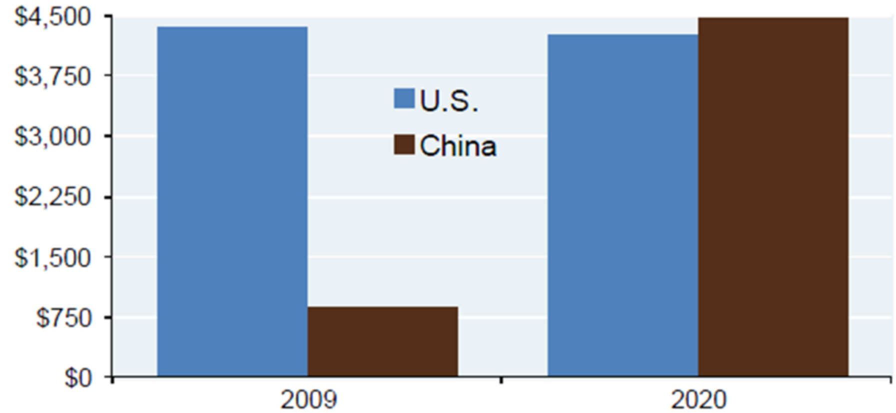
NEW STORES OPENED SINCE 2008



Source: *"2011 China Luxury Market Study"*, Bain & Company, Dec. 2011.

JP Morgan estimates that, "By 2015, for the first time in 300 years, the number of middle class consumers in Asia is projected to be the same as in Europe and North America. The driver of this transition is China. Over the next few years, Chinese middle class consumption is expected to surpass the US, a function of a growing middle class and a modestly growing propensity to spend." While we have our doubts about the true potential of the "Chinese Growth Miracle" we are comfortable with the basic assumption that Chinese consumption is headed higher over time and should serve as a long term catalyst for affordable luxuries provided by American icons like Coach.

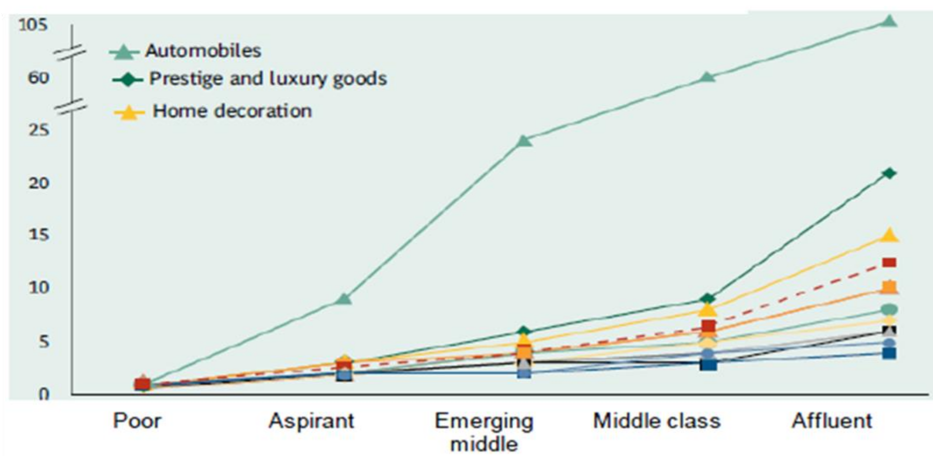
TOTAL MIDDLE CLASS CONSUMPTION (USD BILLIONS)



Source: Wolfeson Center for Development at Brookings.

A recent study by Bain & Company shows Chinese consumers are expected to account for 35% of total global luxury goods consumption over time. And the chart below shows that as Chinese consumers become wealthier, consumption of luxury goods accelerates quite rapidly. Granted, we don't suggest extrapolating recent growth rates into the future, as Chinese growth has been driven largely by unsustainable surges in money and credit, but the fact remains that this region is the world's largest market for emerging middle class consumers. We think these consumers are likely to develop a growing taste for "Riding Coach."

CHINESE CONSUMPTION INDEX: WHAT WE BUY AS WE GET WEALTHIER



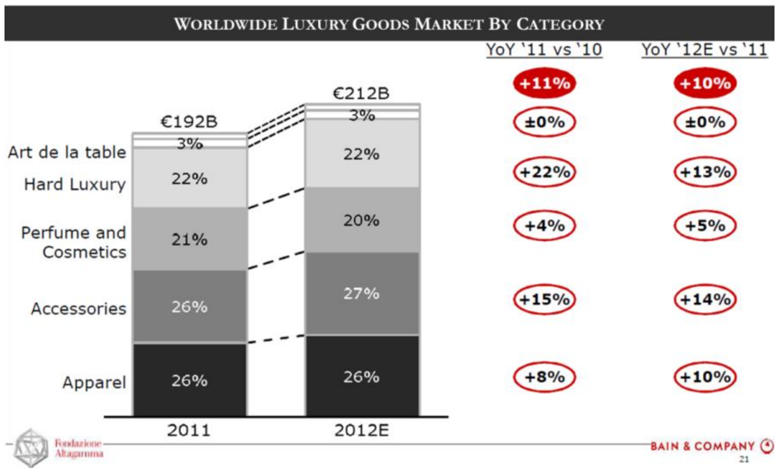
Source: Boston Consulting Group, March 2010.

The premium handbag and accessories market in Asia is estimated at $12 billion (compared to $10 billion in the U.S.), and excluding Japan, the market is growing at a double-digit rate, led by Mainland China, Hong Kong, Korea, and Southeast Asia. The men's business also has more potential in Asia, as men give leather goods as gifts and tend to have more personal leather accessories compared to domestic markets.

Industry & Competitive Analysis

Industry Dynamics

In total, the worldwide luxury goods market was estimated to be €212 billion in 2012 and the market is expected to continue to generate strong growth in 2013. We believe that Coach's strong manufacturing and distribution model, pristine balance sheet and top class management team are well positioned to capitalize on this growing global opportunity set.



The total worldwide luxury goods market is expected to compound 4% to 6% annually reaching sales of $327 billion through 2015. Slightly over half of this spend is estimated to be within soft luxury (leather goods) and apparel with hard luxury (i.e. watches, bracelets) close behind. Leather goods showed strong growth in 2012 estimated at 16% y/y to over $70 billion. Sales of accessories are estimated to be $58 billion, or 22% of total industry sales. Growth is largely driven by China, expansion into men's categories and greater online distribution and sales.

The handbag and accessory market is highly competitive. Coach's competitors range from premium luxury makers such as Hermes, Gucci, Burberry and Louis Vuitton to mid-tier producers including Michael Kors (KORS), Kate Spade and Tory Birch. Even then, Coach remains dominant in the US with approximately 30% market share, and has captured the second largest share of the Japanese market from a standing start years ago. On a regional basis, Europe continues to command the greatest spending across the globe at 35% of industry sales. With Europe being a tourist destination, countries such as France and Italy are capturing a significant amount of "external" spending from the Asian consumer.

Online presence has become increasingly important for brand exposure and continues to drive growth in luxury goods. E-commerce sales in the industry have been growing at 25% annually and represent an estimated $10 billion of total sales in 2012. Compete.com, a provider of online traffic data, shows Coach still ranks first in the US, amongst a strong peer group including brands like Gucci, Louis Vuitton, Chanel, etc. Additionally, Coach recently launched an e-commerce site in China, which should help increase brand awareness and sales growth in the region.

Competitive Positioning

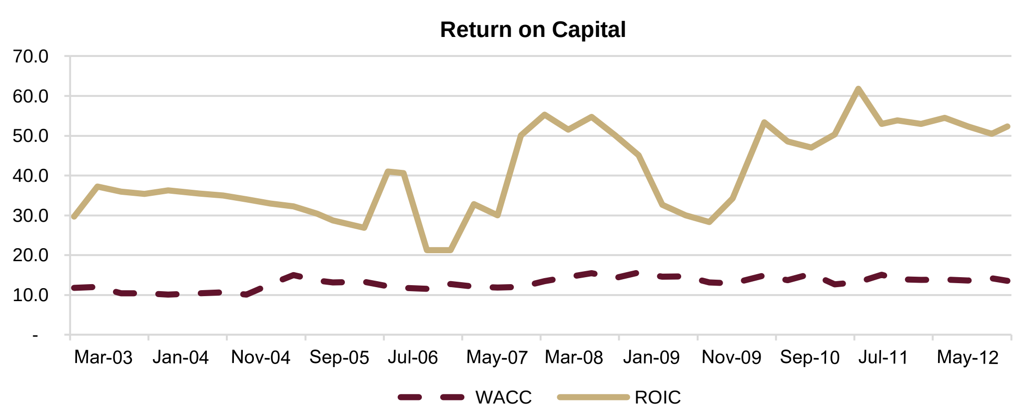
The most important component of any industry analysis is the assessment of the existence of a sustainable competitive advantage. We ask two basic questions to make such an assessment:

- **Does the incumbent firm maintain market share over time?** The key indicator of this is the history of the dominant firm in the segment. If the leading firm has maintained its position over a period of many years, that fact strongly suggests the existence of competitive advantage.

- **Is the business exceptionally profitable over a substantial period?** If the companies in a market maintain returns on capital that are substantially above what they have to pay to attract capital, the chances are strong that they benefit from competitive advantages. After-tax returns on invested capital averaging more than 15-25% over a decade or more are clear evidence of the presence of competitive advantages.

In 1959, Coach introduced their classic logo, a symbol of the company's heritage of fine leather goods and American culture. Since then, Coach's market-positioning, and brand loyalty have provided the company with the ability to price at competitive levels where consumers see exceptional value. This position has been difficult for competitors to replicate and has resulted in high and stable market share, as well as exceptional returns on capital. <u>Despite recent investor concerns, Coach has increased its domestic market share ten points, from 18% to 28%, in the past five years, and we see ample room for share growth abroad looking to Japan as a model for expansion</u>.

Management's exemplary track record of capital allocation and operating efficiency has been the historical driver of Coach's strong financial results. Return on Capital has been stellar and far outpaces the current industry average of 16.5% as well as the company's own cost of capital. Since 2003, Coach's ROIC has averaged 40% and even during the 2008-2009 recession management was still able to return close to 30% on capital deployed. To help put these numbers in perspective, consider that we typically look for return on capital of 20% or greater as evidence of a strong competitive advantage. This is a rate of return that very few managers can achieve over long periods of time. <u>Coach is currently generating over 50% ROIC. The opportunity to own a share of such a high quality business that can compound capital at such a high rate has the potential to build significant wealth over time</u>.



Management, Ownership & Incentive Structure

Executive Leadership

When Lew Frankfort joined Coach, Inc. in 1979 as Vice President of New Business Development, the company's sales were just $6 million. He quickly decided that reaching consumers without retail middlemen would allow the company to enhance the brand experience. "I looked at this brand called Louis Vuitton that controlled its distribution fully," Frankfort says. "They only sold product through their own stores. And therefore it was able to control the retail presentation, the assortment, the service, the imagery, and so forth, and I thought there was an opportunity for me to create a democratized version of this European brand that would be appropriate for an egalitarian society like the U.S., where anyone could be anyone."

Over the last 30 years, Frankfort, now Chairman and Chief Executive Officer, has literally transformed Coach from a cottage-industry manufacturer of leather goods into the premier American accessories brand. In his three decades at the company, he has continued to build upon Coach's strong customer franchise by broadening product offerings, modernizing stores, accelerating retail expansion, improving operational efficiency and growing the brand's international presence. Coach recently announced that Frankfort will transition to an executive chairman role over the next year, with Victor Luis, the current president of the international group, becoming CEO in January 2014. While disappointing to see this visionary step down, this was a planned transition as part of the board's succession plan. We also think the promotion confirms the company's focus on international growth as the primary driver of returns over the long run. And while Frankfort has been at the helm of the company for decades, his management team is among the best in the business, providing us with relative comfort around the transition.

Importantly, Reed Krakoff, President and Executive Creative Director, remains as the architect of the brand today. He leads design, store concept, marketing, and worldwide positioning. Since his arrival in 1996, he has led the creative renaissance that successfully strengthened an already formidable brand image and contributed to increased sales of Coach products throughout the world. The actions of the board clearly demonstrate his importance as the compensation committee has historically allocated 60% - 70% higher compensation to Krakoff than CEO Frankfort.

Michael Tucci, President, North American Group, brings over 20 years of experience in the retailing and merchandising fields to Coach. Tucci joined the company in January 2003 and previously served as Executive Vice President of Gap, Inc. where he held senior leadership positions in retailing and merchandising from 1994 through 2002. There is some risk that Tucci, could depart having been passed over for the CEO post, but considering that he received long-term stock awards of $4.5 million last year and total compensation of more than $9 million, he has good reason to stick around.

Company Ownership

The majority of Coach's board is independent, and officers and directors own almost 5% of the outstanding shares so interests are well aligned with shareholders. Frankfort is the largest shareholder with a 1.7% stake or roughly 4.9 million shares. Krakoff is the second largest owner with 655,000 shares. Recently named CEO, Luis, was not a top holder, but will be required to increase his level of ownership, per the board's ownership requirements for all Vice Presidents and above. Currently, the CEO is required to have the lesser of five times current salary or 250,000 shares. The COO, Creative Director and President of North America are required to have the lower of 100,000 shares and three times base salary, while the CFO is required to have 50,000 shares and two times base salary. Overall governance is solid and management has proved to be an admirable steward of capital.

Incentive Structure

Frankfort has been a strong believer in meritocracy since first reading John Stuart Mill in college. "Decisions should be based on measured results, and people should get ahead based on their ability to perform against measured results," he says. His board has taken on a similar stance.

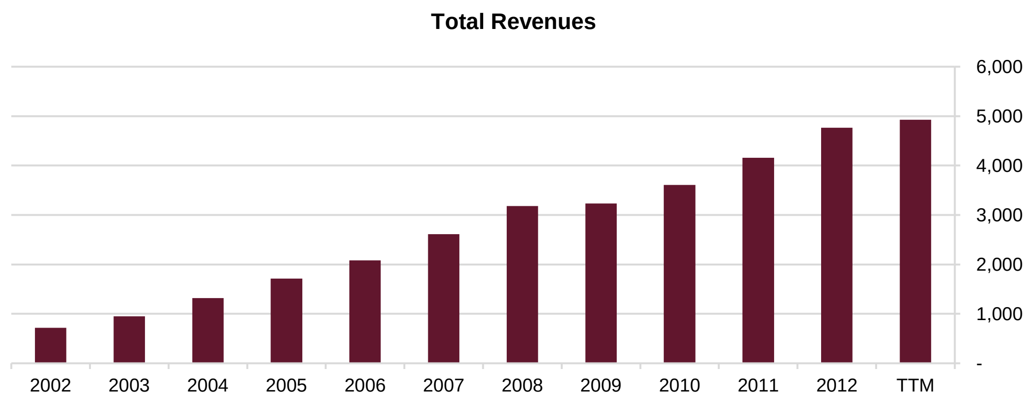
Although incentive compensation is generous, it is largely based on operating metrics (i.e. sales, operating income, diluted EPS) with a heavy weight on performance. In FY 2012, 77% of the Frankfort's total compensation was performance based. The table below details fiscal year 2012 targets versus actuals:

Measure of Coach, Inc. Performance	Weight	Prior Year Results(1)	Needed to Achieve Threshold Award	Needed to Achieve Target Award	Needed to Achieve Maximum Award	Fiscal Year 2012 Results(1)	Payout as a % of Target Incentive(2)	Payout as a % of Maximum Incentive(2)
Operating income (millions)	40%	$ 1,330.6	$ 1,163.9	$ 1,456.0 +9% vs. prior year	$ 1,487.1	$1,512.0 +14% vs. prior year	133.33%	100.0%
Diluted earnings per share	25%	$ 2.92	$ 2.67	$3.34 +14%	$ 3.41	$3.51 +20 %	133.33%	100.0%
Free cash flow (millions)	25%	$ 885.5	$ 696.4	$871.2 -2 %	$ 889.8	$1,037.4 +17 %	133.33%	100.0%
Net sales (millions)	10%	$ 4,158.5	$ 3,793.3	$4,745.2 +14 %	$ 4,846.5	$4,763.2 +15%	105.9%	79.4%
Weighted average percentage payout:							130.6%	97.9%

Financials

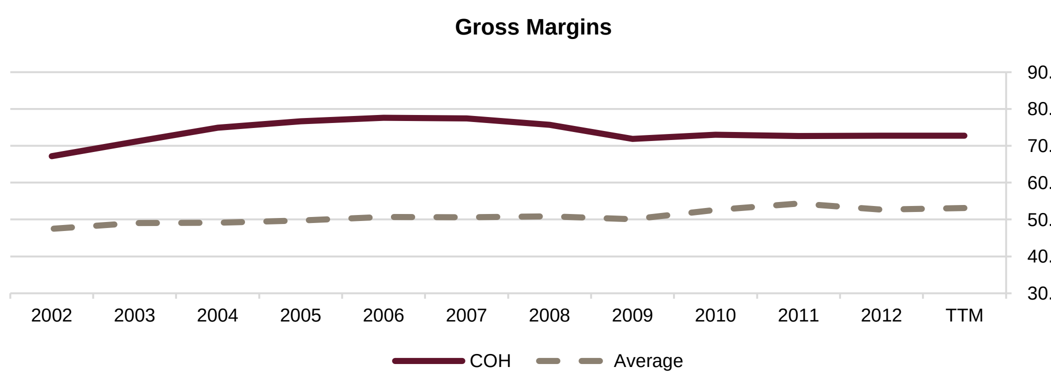
Sales

Coach is a well-run company that has demonstrated consistent top line growth over the years. From 2002 to 2012, the company's sales increased at a compound annual rate of 21.1%, while earnings per share grew 31.1%. Total sales stand near $5 billion today, almost three decades after the Kahn's cashed out to Sara Less for $30 million to spend more time on the goat farm. Since then, Coach has increased sales through good times and bad. For example, during the last recession, the company's top line actually grew by 1.6%, while most luxury retailers watched sales fall mid-single digits. Store growth and wholesale distribution has led to continual revenue growth, while the Men's category is expected to sell over $600 million this year - an increase of 50% from the prior year. Emerging markets should also fuel growth as Coach expands their store base and distribution across major cities. China grew 40% last year to $300 million. These trends should continue for the foreseeable future as management executes on their strategy in the US and across the globe.

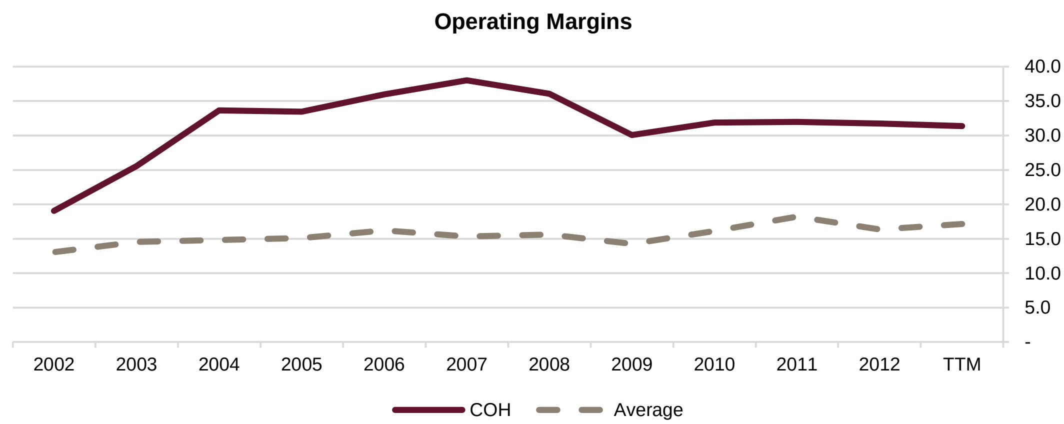


Margins

Coach boasts the highest gross margins in the industry. As seen below, average industry gross margins have hovered around 50%, with Coach consistently above its peer group. We believe that by forgoing revenue for growth's sake in the most recent quarter, management showed good discipline in pricing resulting in consistent high profitability. The burden of proof is on the bears, who believe that gross margins will eventually revert toward the peer group, a low probability bet in our opinion, but something we will consider shortly in our valuation work.



Operating margins are currently under pressure as management is investing heavily in the business amidst softer sales, but it is still not a stretch for Coach to generate $1 billion in free cash flow on industry leading margins. We expect that increased D&A and overhead from the impact of recent acquisitions and new store rollouts will result in near term margin compression. But over time, these additional costs will roll off as stores gain traction and mature, ultimately resulting in long term upside in operating leverage. Management is guiding to 31% operating margins, a level we think is achievable over the next three to five years, and one we are quite happy with as shareholders. Even still, we forecast further margin compression in our model, discussed shortly.



Balance Sheet & Financial Health

Coach has little debt on the balance sheet and $835.9 million of net cash on hand, or roughly $3 per share, leaving the company in a formidable position to fund future investment. Growth in receivables and inventory has historically risen in line with sales, but as the company expands its footprint and product offerings, we expect inventory growth to increase further. This is something we are monitoring.

Operating cash flow has been positive every year for the past decade. As the company turns roughly 20% of sales into cash annually, free cash flow has been equally strong and the stock boasts a current free cash flow yield of 8.2% on an enterprise basis. In our experience, it is extremely rare to find such a high quality brand trading near double-digit free cash flow yields. We judge the quality of earnings at Coach to be quite strong as free cash flow has been equal to or greater than net income since 2003. Looking ahead, capital expenditures are expected to rise to $250 million in FY 2013, a 36% increase from the prior year due to store base expansion, but management maintains plenty of financial flexibility within the business model.

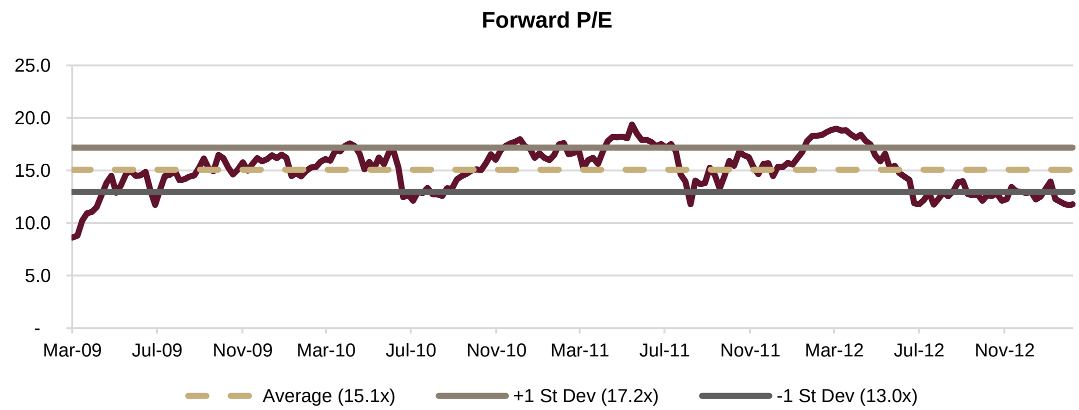
Coach has doubled its dividend payout in the past three years. While the stock already yields 2.5% at recent prices, we see potential to raise the dividend to 3% or greater given the strength of the balance sheet. The current $1.4 billion share repurchase program in place represents roughly 8.9% of the company's outstanding shares, in addition to the $800 million used in 2012 and $1.0 billion in 2011. As we discuss in the following section, we hope to see management aggressively retiring shares at current levels. The more quickly they are able to retire shares, the more rapidly we increase our percentage interest in this wonderful business.

Valuation

Currently Depressed

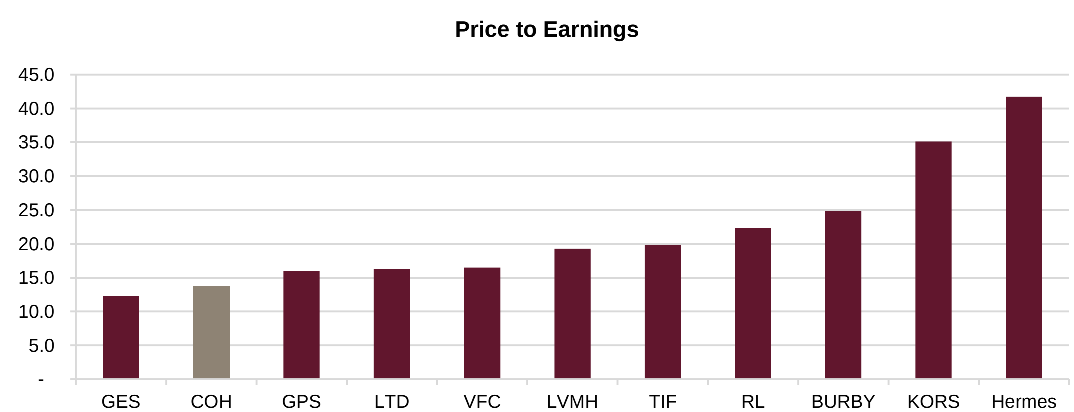
Coach currently trades at 8.3x EBIT, 13.0x current and 11.7x forward earnings. In other words, the stock is priced as if Coach's growth is long in its past. At its peak in 2001, shares fetched 32 times earnings. **Today, the company can be purchased at an 8.2% free cash flow yield, as Mr. Market has again extrapolated short term competitive threats far into the future, despite the fact that Coach has successfully fended off new entrants for decades.**

If we assume that Coach ultimately trades back towards its average forward multiple of 15x over the next three years, we estimate upside in the stock to $76.60 in our base case, which represents 51.9% potential appreciation. **Given recent rumors that the company is exploring a sale, shareholder returns may be more front-end loaded. As a point of reference, note that Coach's peer group trades at 20x forward earnings today.**



Optimistic Peer Group

A quick look at the group on a price-to-trailing earnings basis shows that Coach currently trades near the bottom of the pack. We feel this discount is unwarranted for such a unique American brand generating returns on capital well above its peer group. But the question remains, what is the right price?



Assumptions

Coach has increased sales at a 21.1% annual growth rate over the past decade. In the past five years, top line has swelled 13.0% annually, which includes the company's performance during the financial crisis. We think this is a conservative starting place for thinking about forward revenue growth as it encompasses a complete business cycle. Accordingly, we assume 12.5% annual top line growth in our *bull* case. Our base case for the stock assumes sales grow below current consensus estimates, at a 7.5% pace over the next three years. Realistically, we think this leaves a lot of room for upside surprises.

Gross margins at Coach have averaged 74.4% over the last decade and 73.2% in the past five years. Consistency in gross profits has driven a 32.8% ten year average operating margin. The five year record is roughly 40 bps lower. For our part, we assume continued margin compression in each of our three scenarios. Our bull case assumes management achieves their targets and operating margins hold steady at 31% while our base case prices in an additional 100 basis point decline in profitability. Our bear case punishes margins by 100 basis points *annually* for the next three years, bringing profits toward levels of lower quality peers.

What's It Worth?

Mr. Market tends to get his panties in a bunch pretty often over relatively small blips in quarterly earnings. At the same time, most of "the street" tends to value stocks based off of next year's earnings. Others still, prefer the time-tested dartboard. I suppose it's all a matter of personal preference, but we feel more comfortable looking at a company's normalized earnings power three to five years out.

Based on this discipline, we think Coach has upside to $76.60 over the next three years, applying the stock's average forward multiple to our base case earnings estimates. Assuming the dividend stays constant over this period, which we think is a stretch, the stock offers about 60% upside. Our bull case assumes sales grow at about half the historic average rate, margins decline by 100 basis points, and the stock trades back up to the top of its trading range at 17x earnings. This, still conservative scenario, would generate 120% upside for investors. Even in our worst case scenario, we find it difficult to lose money buying Coach at today's price. Assuming top line grows in line with inflation, margins decline 100 basis points annually, and the stock continues to trade at the bottom end of the peer group, we think the stock is worth about where it trades today in three years' time. But recognizing that this probably won't satisfy the bears, we assume the stock trades back down to 10x earnings, representing about 20% downside. **Bottom line, we see 120% upside potential relative to 20% downside risk in one of the highest quality brands in America today.**

The matrix below illustrates the potential cumulative return to investors over three years, under various scenarios for revenue growth and operating margins. The one constant assumption here is that shares trade back to their average of 15x forward earnings. Obviously, if performance were to deteriorate below our expectations, investors should consider the impact of additional multiple compression in the bear case, as we laid out in the previous paragraph. Conversely, if the management continues to execute and meets the high end of our assumptions, we believe shares would warrant a greater than average multiple. In any event, we believe visualizing the company's potential in this perspective is helpful so we have shared it below. The highlighted cells represent the range of outcomes we considered for revenue growth as well as the margin compression we modeled in our bear case relative to recent performance. The return potential is based on a multiple of 15x forward earnings and represents our potential cumulative return over three years.

	Annual Revenue Growth							
Operating Margins	**-2.5%**	**0.0%**	**2.5%**	**5.0%**	**7.5%**	**10.0%**	**12.5%**	**15.0%**
25.0%	-7.2%	1.9%	11.8%	22.4%	33.7%	45.9%	59.0%	72.9%
25.5%	-5.5%	3.8%	13.9%	24.7%	36.3%	48.7%	62.0%	76.3%
26.0%	-3.8%	5.7%	16.0%	27.0%	38.8%	51.5%	65.1%	79.6%
26.5%	-2.1%	7.6%	18.1%	29.3%	41.3%	54.3%	68.1%	82.9%
27.0%	-0.3%	9.5%	20.1%	31.6%	43.9%	57.0%	71.1%	86.2%
27.5%	1.4%	11.4%	22.2%	33.9%	46.4%	59.8%	74.2%	89.5%
28.0%	3.1%	13.3%	24.3%	36.2%	48.9%	62.6%	77.2%	92.8%
28.5%	4.8%	15.2%	26.4%	38.5%	51.5%	65.4%	80.2%	96.1%
29.0%	6.5%	17.1%	28.5%	40.8%	54.0%	68.1%	83.3%	99.5%
29.5%	8.2%	19.0%	30.6%	43.1%	56.5%	70.9%	86.3%	102.8%
30.0%	9.9%	20.9%	32.7%	45.4%	59.1%	73.7%	89.4%	106.1%
30.5%	11.7%	22.8%	34.8%	47.7%	61.6%	76.5%	92.4%	109.4%
31.0%	13.4%	24.7%	36.9%	50.0%	64.1%	79.2%	95.4%	112.7%
31.5%	15.1%	26.6%	39.0%	52.3%	66.7%	82.0%	98.5%	116.0%
32.0%	16.8%	28.5%	41.1%	54.6%	69.2%	84.8%	101.5%	119.4%
32.5%	18.5%	30.4%	43.2%	56.9%	71.7%	87.6%	104.5%	122.7%
33.0%	20.2%	32.3%	45.3%	59.2%	74.2%	90.3%	107.6%	126.0%

Risks

International Expansion

Coach's long-term growth potential hinges on management's international expansion strategy. Significant resources and capital are being used to drive European and Asian growth, regions currently dominated by entrenched competitors. Prospects appear strong today, but if international plans are slow to materialize or demand slows, performance may fall below our expectations.

The Chinese Consumer

Our concerns around China are well documented and we believe we have taken conservative assumptions into consideration. However, if Chinese growth slows more significantly than even our pessimistic projections, new store growth is likely to disappoint. That said, most investors will have much bigger concerns than owning Coach at an 8.2% free cash flow yield in this scenario.

Margin Compression

Coach continues to expands into clothing and outwear such as coats, shoes and scarves, increasing the potential for margin compression. As the company's products are generally priced lower than higher-end peers, customers tend to be more sensitive to the economy. However, we view the company's pricing as a competitive advantage in an uncertain macroeconomic climate.

Brand Dilution

Coach is expanding into new categories outside of their core base of leather goods. This transformation could prove difficult for Coach if not executed properly. If management reaches too far, they risk diluting their brand and damaging the core business. Given the company's consistent track record, we feel history is on our side.

Competition

Coach benefits from unparalleled brand loyalty, but new entrants are attacking the incumbent's niche every day. Management has done a tremendous job reinventing itself over the decades and it will have to continue to do so to maintain leadership in the industry. We think the burden of proof lies with the bears.

Bottom Line

"Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understood business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards – so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so too will the portfolio's market value."

- Warren Buffett

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