

## Growth on Kors

Fossil Group Inc (NDAQ: FOSL)	
Rating	BUY
Last close	108.28
TP (1-yr)	135
Upside	+23.5%
Mkt cap	5.875bn
3-month avg value	107.6m
P/E (TTM)	16.5x
P/B	5.6x
ROE	35.2%
EV/EBITDA	10.5
5Y sales growth	15.5%
52-week low/high	92.44 / 134.99
Shares outstanding	53.8m
Free float	44.1m
Insti. hldgs	93.72%

### Initiate coverage on Fossil Group with BUY, TP \$135.

- **FOSL is a designer and manufacturer of watches, jewelry and leather products, with its \$2.5bn of watch sales an estimated 4% by revenue of the \$62bn watch industry.**
- FOSL is a **luxury sector play with exposure** to consumer darling KORS. Its **best-in-class portfolio of luxury brands range from well-established names such as Armani and Burberry, to the hottest and fastest-growing accessible luxury names – Michael Kors, Marc Jacobs and Tory Burch.** We note Michael Kors, 22.4% of FOSL sales, grew at a 44% CAGR from FY09-13 and is trading at 31x P/E.
- **Luxury industry: FY13-18 6% CAGR, faster than GDP. The \$300bn luxury industry is set to grow at 6% from FY13-18 according to Euromonitor, supported by social and economic trends such as continued GDP growth, urbanisation of emerging markets, and widening income inequality.**
- FOSL's unparalleled distribution network with 30,000 points of sale through specialized retail, department and duty free store, and a talented team of in-house designers which created the iconic Michael Kors Runway chronograph watch are key to its expansion.
- Continued growth in its licensed brands, as they expand into Asia supported by Fossil's distribution network, will drive FY14-15 bottom-line growth of 14% annually. Our TP is 18x FY14F earnings, supported by a FCF valuation of 143. We expect operating margins to expand 20bps in FY14 as higher margin licensed products grow as a proportion of sales.
- Further upside is possible from better-than-forecast performance from the new Tory Burch license, the growth of the \$1.2bn Fossil brand in Asia, and better-than-expected performances from Michael Kors, Armani and Marc Jacobs in China.
- Potential catalysts include Android Wear as well as the revival of FOSL's heritage brands Zodiac and Michele.

### Company overview

**Fashion watch specialist.** Fossil Group (FOSL) is a Texas-based consumer fashion accessories specialist. It designs, manufactures and sells over 30m watches annually for its five proprietary brands and ten licensed brands, accounting for 77% of its net sales. Also in FOSL's product mix is leather goods (13%) and jewelry (7%). The vast majority of FOSL's products are priced affordably at \$100-500, although it offers select Swiss-made Michele and Burberry watches at over \$4,000 retail. Licensed products account for 51% or \$1.6bn of sales, overtaking proprietary products (46% or \$1.5bn of sales) for the first time in FY13. We attribute this to the explosive growth of the Michael Kors license, which accounts for 22% or \$730m of FOSL's net sales and we estimate grew at a 44% CAGR from FY09-13. It is FOSL's second largest brand, with the namesake brand at an estimated \$1.2bn of sales split between \$800m in watches and \$400m in leather goods.

**Business segments and geographic sales.** FOSL's wholesale channel accounts for 75% of revenues and has a 27% operating margin. However, its APAC wholesale division (12% of sales) has a much higher 33% operating margin, due to concession store agreements, where FOSL operates a shop-in-shop in its customer's department store, controlling the merchandising, inventory and branding decisions and capturing the full retail margins on its products. In return, it pays a commission on the sales generated. Its direct-to-consumer segment is 25% of sales, with operating margins at a relatively low 11%.

### Industry analysis

**Single digit market share, but leader in fashion watches.** Fossil is fourth by market share in the watch industry with an estimated 4% of revenue share, behind leaders Swatch (13%), Richemont (6%), and Rolex (7%). It also dominates in North America, where it has a 26% market share, up from 23% in 2011, while it has much smaller shares of the EMEA (9%) and Asian (2%) markets. However, we note FOSL is the market leader in the sub-category of watches under \$1,000 ("fashion watches") according to Euromonitor, ahead of competitors Movado, Swatch, and private competitors such as Timex Group. Brands that fall under this segment include Fossil, Michael Kors, Marc by Marc Jacobs, Burberry, Armani Exchange and Tory Burch. It also competes in the fine premium watch segment (\$1,000-\$4,000) with its Burberry, Armani, Fossil Swiss, Michele and Zodiac lines.

**Watch industry expected to grow.** Euromonitor estimates a 5.9% 2013-2018 CAGR and \$82bn market size for the global watch industry, up from 5% from 2008-2013. Of this, it estimates the fastest growth in Asia at 9.6%, while Europe and America are forecast to grow at 3.3% and 5% respectively.

**Luxury industry 6% FY13-18 growth supported by social and economic trends.** Favourably for FOSL's portfolio of luxury brands, expert consensus expects the \$300bn luxury industry to continue its expansion, supported by continued GDP growth, income inequality, and the urbanisation and increase in disposable income of emerging economies. Euromonitor forecasts a 6% growth in the luxury goods industry, bringing it to \$425bn by 2018 from \$320bn in 2013. Similarly, Bain/Altagamma expect the luxury goods industry to grow in the range of 3-6% til 2016. This outpaces GDP growth, which the IMF expects at 3.7% in 2014 and 3.9% in 2015.

## Competitive positioning

**Market leader in sub-\$1,000 fashion watches.** FOSL's closest listed peers are Movado and Swatch, and the private companies Timex Group and Montaine. As the watch industry is fragmented by price, FOSL does not compete directly against lower-end competitors such as Casio, nor against ultra-high-end competitors such as Rolex. This section compares FOSL against its listed peers only as data is not readily available for private competitors.

Company	Points of sale	Vertical integration	Pricing	FY13 watch sales	Fashion brands	FY13 license revenues
<b>Fossil</b>	30,000	Partially integrated	50 - 4,999	\$2.5bn	Burberry, Armani, Marc by Marc Jacobs, Tory Burch, Michael Kors, Karl Lagerfeld, DKNY, Diesel	\$1.6bn
<b>Movado</b>	8,000	Outsourced	100 - 9,999	\$570m	Hugo Boss, Coach, Lacoste, Tommy Hilfiger	\$250m
<b>Swatch</b>	16,000	Integrated	10 - 20,000	\$7.5bn	Calvin Klein	\$120m

**Largest portfolio, strongest brands.** Compared to its competitors, FOSL dominates with the largest stable of fashion brands – both the fastest growing, and the best top-of-mind. Armani and Burberry were among the top-10 brands for gifting in Hurun's 2014 Chinese Luxury Consumer Survey, while Michael Kors was the most searched-for US luxury brand in 2012 according to the Digital Luxury Group with 20% of total searches in 35 countries. In the same survey, Marc Jacobs came in second, beating out Ralph Lauren and Calvin Klein, while Tory Burch came in sixth. Michael Kors has also grown rapidly, with a 44% FY09-13 CAGR, while we estimate Tory Burch has had a similar performance (34% FY09-13 CAGR). In contrast, Coach sales in the most recent quarter fell 6%, with a 14% decline in its core North American market.

**Unparalleled distribution network of over 30,000 doors...** We note FOSL sells its products in over 30,000 doors worldwide, far ahead of even larger competitor Swatch's 16,000. As it currently only has 543 stores, 447 of which are Fossil-branded, this is largely through its relationships with distributors such as specialty retailers, duty free and departmental stores, which have been built over its 30-year operating history. Licensors benefit from this wide distribution network, even as they grow their own stores.

**...growing alongside licensors particularly in Asia.** With Euromonitor expecting the Asia luxury goods market to grow 72% by 2018, we like how FOSL is both growing through and alongside its licensors in Asia. For instance, Michael Kors is expanding aggressively, having opened 133 stores in the past 3 quarters, and plans to open another 100 by 2015. It currently has 94 stores in Asia, opening 7 stores in the most recent quarter – but is still a ways away from its long-term target of 200. Both it and Burberry opened new Shanghai flagship stores in March 2014. As for the Fossil brand, management has guided the opening of 75 stores for FY14, a 14% increase in store count; the new Macau flagship store had highest per square foot sales globally in FY13.

**Designer advantage.** FOSL's in-house team of over 100 designers has a long history of success – for instance, creating the iconic Michael Kors Runway chronograph watch. FOSL has successfully renewed all licenses since signing its first agreement with Armani in 1997, and has even expanded into jewelry for major brands Armani and Michael Kors. FOSL's relationship with licensors is symbiotic, with FOSL's designers working closely with the licensors' team on designs and marketing collateral. In contrast, the license agreement between competitor Swatch and jeweler Tiffany was abruptly ended over a dispute in 2011 and the lawsuit was recently settled for \$400m.

**Best of both worlds: partially integrated supply chain.** FOSL outsources the production of its all its leather goods, sunglasses, clothing, and watch parts, while jewelry manufacture and watch assembly is done partially in-house – 60% in FY13, with the rest through third-party factories. This allows FOSL the flexibility to scale production up or down depending on demand, while keeping costs under control. In contrast, Swatch is fully vertically integrated while Movado fully outsources production – and we note cost inflation negatively affected Movado's gross margins for their most recent financial year.

**Moving up the value chain: Swiss-made, heritage brands.** FOSL recently debuted Swiss-made Emporio Armani and Zodiac designs at Baselworld 2014, a year after the Burberry Brit and Fossil SWISS models were launched. The Zodiac Sea Wolf, Sea Dragon and Astrographic models were particularly well-received among watch enthusiasts – the brand has a cult following among watch collectors. Although we estimate Zodiac's sales at less than \$100m annually, we think this is a significant first step for FOSL's move up the value chain, supported by its recently-acquired Swiss movement manufacture, Swiss Technology Production.

**Potential catalyst Android Wear comes after 2003 Fossil Wrist PDA.** We note FOSL is the only watchmaker to announce an upcoming Android Wear device, alongside tech groups Motorola and LG. Smartwatch Group estimates a 2013 market size of \$700m for smartwatches, with Samsung's Galaxy Gear commanding a 33% market share, and expects the market to grow rapidly to \$2.5bn by 2016. We like how FOSL's long history of innovation produced the 2003 Fossil Wrist PDA, and note that ex-FOSL engineers recently announced a smartwatch, Meta. As FOSL has not released details of their partnership with Google, we have not included this in our valuation, but regard this as a significant opportunity, and should mitigate investor fears that smartwatches will replace FOSL's fashion watches.

## Financial analysis

**Consistent growth and margin expansion.** FOSL has expanded gross margins by 250bp and net margins by 260bp from FY09-13 on 1) product mix shift to higher margin licensed watches and jewelry, and 2) increasing sales in Asia. Since FY09 it has opened new stores at a CAGR of 11% - the bulk internationally (189 vs 69 new US stores), excluding concessions which have grown at a 29% CAGR to 309 now. We conservatively estimate 20-30bps of gross margin improvement in FY14-15, which flow through to net margins even at an increased 32% tax rate.

**Debt increased for share buybacks, acquisitions.** Historically, FOSL has generated free cash flow in excess of its capex needs, except for FY12 when it acquired Swiss Technology Production and Skagen. We note that management has taken on significant debt in FY13, which it has used for \$582m of a share buyback programme. FY11-13 capex also increased due to the purchase and integration of distributorships e.g. in Spain, and we expect FOSL to continue consolidating its distribution, improving margins.

Summary table	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014F	FY2015F	FY2016F	FY2017F	FY2018F
EPS	2.07	3.77	4.61	5.59	6.56	7.51	8.38	9.48	10.27	10.67
<i>vs consensus</i>						4.20%	2.57%	0.29%	-7.26%	-
ROE	14.4%	24.3%	26.4%	27.7%	35.2%	29.3%	24.6%	21.8%	19.1%	16.6%
Sales growth	28.3%	31.2%	26.4%	11.3%	14.1%	15.5%	12.8%	9.2%	6.9%	4.7%
EBITDA growth	3.0%	67.6%	22.7%	5.5%	16.0%	18.7%	12.7%	11.1%	8.6%	4.9%
EBIT growth	2.8%	77.9%	25.4%	3.6%	14.9%	17.9%	11.8%	13.0%	8.2%	4.2%
EPS growth	2.0%	82.1%	22.3%	21.3%	17.4%	14.4%	11.6%	13.1%	8.3%	4.0%
Gross margin	54.6%	56.9%	56.1%	56.2%	57.1%	57.3%	57.5%	57.8%	58.0%	58.0%
EBITDA margin	16.1%	20.6%	20.0%	18.9%	19.2%	19.8%	19.7%	20.1%	20.4%	20.4%
Operating margin	13.7%	18.5%	18.4%	17.1%	17.2%	17.6%	17.4%	18.0%	18.3%	18.2%
Net margin	9.0%	12.6%	11.5%	12.0%	11.6%	11.8%	11.7%	12.1%	12.3%	12.2%
Operating cashflow	-0.6%	-16.4%	16.1%	68.5%	-3.9%	2.1%	14.1%	18.5%	12.1%	8.5%
Debt/equity	0.84%	0.93%	1.37%	6.28%	47.25%	32.91%	24.80%	19.39%	15.69%	13.09%
Debt/assets	0.64%	0.67%	0.93%	4.23%	22.78%	18.41%	15.34%	12.95%	11.11%	9.70%
Interest coverage (x)	936	343	189	95	59	104	83	94	102	83
Inventory turnover (x)	6.30	5.46	5.25	5.64	5.71	5.62	5.62	5.62	5.62	5.62
Free cash flow to the firm	237.55	166.28	123.92	50.45	245.67	289.17	336.24	420.70	485.09	536.26
Capital expenditure	-38.0	-46.4	-110.1	-351.9	-123.6	-122.0	-137.7	-150.4	-160.8	-168.4
Net borrowings	-1.9	0.9	4.0	56.2	430.6	0.0	0.0	0.0	0.0	0.0
Share buybacks	0.0	-199.2	-270.9	-271.3	-582.3	0.0	0.0	0.0	0.0	0.0

## Peer comparison

**We think FOSL is unfairly valued below its peers** – which should include its licensor brands and luxury names as well as other watchmakers. FOSL has historically grown alongside its luxury brand licensors such as Michael Kors and Burberry, and we expect this relationship to persist. FOSL currently trades at a discounted 16.5x P/E compared to the luxury sector average (excluding KATE) of 20.5 times. In particular, we note the average P/E for aspirational brands is currently at 23.2 times earnings – with KORS at a lofty 31.8x on expectations of further growth in Asia and Europe.

**Highest 5-year sales growth, ROE among watch competitors.** FOSL has grown FY09-13 sales at a 15.5% CAGR. In contrast, Movado and Swatch have grown more slowly, with Movado reporting FY10-11 losses as its brands fell out of favour.

Name	Type	P/E	P/B	EV/EBIT DA	5-year sales CAGR	EBIT margin	Net margin	Debt/equity	ROE	Market cap (USDm)
Fossil	Watches	16.5	5.6	10.5	15.5	17.2	11.6	47.3	33.2	5,884.3
Movado	Watches	20.8	2.3	9.6	4.4	11.9	8.9	Net cash	13.6	1,075.7
Swatch	Watches	16.1	3.2	11.7	8.3	27.4	22.7	0.6	17.6	34,941.9
Michael Kors	Aspirational	31.8	11.7	15.8	47.5	30.7	20.1	Net cash	45.7	19,006.0
Burberry	Aspirational	22.3	6.2	10.7	15.0	24.7	13.1	12.3	30.0	10,721.7
Coach	Aspirational	13.9	5.7	9.2	9.8	28.6	19.6	0.0	37.3	13,745.8
Mulberry	Aspirational	24.9	5.1	19.0	26.4	13.4	9.9	Net cash	-	702.8
Kate Spade	Aspirational	388	-	418.4	-20.5	-3.1	4.5	Net cash	-142	4,311.7
Ralph Lauren	Lifestyle	19.0	3.4	10.8	7.3	15.2	10.4	7.0	19.6	13,990.1
Hermes	Soft luxury	33.6	9.5	19.7	16.3	32.0	21.0	2.0	27.6	37,289.5
Kering	Soft luxury	21.6	1.8	11.4	-10.7	18.0	0.5	43.5	11.1	26,154.2

Name	Type	P/E	P/B	EV/EBIT DA	5-year sales CAGR	EBIT margin	Net margin	Debt/equity	ROE	Market cap (USDm)
Dior	Soft luxury	17.9	2.4	6.6	10.8	20.4	4.7	30.5	9.8	37,477.7
Prada	Soft luxury	23.6	5.5	11.9	16.9	26.2	17.5	10.0	24.0	20,463.5
LVMH	Soft luxury	20.7	2.7	9.9	11.1	20.7	11.8	31.9	13.4	100,305.6
Tiffany	Hard luxury	23.6	4.2	11.7	7.2	19.5	4.5	36.7	18.3	11,356.4
Pandora	Hard luxury	20.7	7.0	12.7	40.3	29.8	24.6	0.8	43.8	8,578.8
Richemont	Hard luxury	18.9	3.4	12.3	13.9	23.4	20.4	19.0	19.2	57,354.9

## Scenario analysis, assumptions and valuation

Our base case assumes

- the Michael Kors license will grow at a 15% CAGR for FY14-17 and slow down to 5% by FY18;
- the Fossil license will grow in line with store expansion (10% FY14-17) and slow down to 5% by FY18;
- Asia will account for 30% of sales by FY18, up from 15% in FY13, driving FY14-15 margin expansion of 20-30bps;
- Beta of 1.668, risk free rate of 2.62% and a market risk premium of 7.01% to derive a WACC of 8.38%, with a terminal growth rate of 2%.

	Bull Case	Bear Case
Assumptions	<ul style="list-style-type: none"> <li>Michael Kors 35% growth rate for FY14</li> <li>Fossil brand takes off in Asia and recovers elsewhere: 20% growth</li> <li>Margin expansion of 100bps</li> </ul>	<ul style="list-style-type: none"> <li>2014 recession: sales growth of -1%, similar to 2009</li> <li>Increased operating expenditures due to store expansion: margin contraction of 200bps</li> <li>P/E derates to 2009 average of 14</li> </ul>
FY14F EPS	8.10	5.35
P/E-based TP	18x: 145.8	14x: 74.9
Up/down	Upside: +34.5% (+8% vs TP)	Downside: -30.8% (-44% vs TP)
Probability	30%	10%

**Us vs consensus: in line.** The consensus 12-month target price is 130.33, 20.4% above the last close price, with the consensus recommendation a hold. Our FY14 EPS is a mere 4.2% above consensus and our FY14 TP only 3.5%. We think the bull case is far more likely at an 30% probability versus the bear case, and we ascribe a 60% probability for our base case. A weighted average target price of the three scenarios gives us a valuation of \$133, slightly lower than our P/E valuation and much lower than our FCFF valuation.

Coverage	Buys	Holds	Sells	Avg 12m tgt px	Upside
19	7 (36.8%)	9 (52.9%)	3 (15.7%)	130.33	20.4%

**A history of quarterly surprises going back to 2004.** We note FOSL has reported positive earnings surprises for the past 4 quarters, averaging 15.2% over consensus EPS. Stretching the analysis further back, FOSL has beat the street at an average of 19.4% for the past 40 quarters – significant because it began its policy of share buybacks only in 2010. We think the street continues to undervalue FOSL, and consider our base case FCFF valuation assumptions very conservative, given we forecast growth rates to be below FOSL's 5-year average growth sales of 15.5%.

**Share buyback policy icing on cake, hedges downside risk.** FOSL has spent a significant portion of its free cash flow to repurchase shares from FY10-13. For FY13, FOSL spent \$574.8 million to repurchase 5.3 million shares of its common stock at an average share price of \$109, and has \$494 million remaining on its share repurchase authorization. Management has guided that they will not be able to match FY13 share repurchases in FY14, but we think this should provide a hedge against downside risk of a general economic slowdown on the share price. At the last close price of \$108.28, FOSL can repurchase up to 4.6m shares, 8.5% of its current shares outstanding.

**Key risk factors. Like other consumer discretionary companies,** FOSL is most threatened by a slowdown in the global economy, which would hurt discretionary spending and therefore consumer purchases of its products. Also, if its products should prove unfashionable, FOSL could have several unprofitable quarters like Movado in FY10-11. FOSL is exposed to the risk of license loss, or poor performance of a licensor e.g. Coach and Juicy Couture. FOSL is also affected by the general performance of the luxury industry, and a slowdown in the industry will affect it, although we think the risk is small given KORS' continued outperformance vs big luxury names e.g. LVMH. Finally, FOSL is subject to currency risk from its multinational operations.