WATCHLIST THE GLOBE AND MAIL

Why I bagged some shares in Coach

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Handbags. Handbags. Everywhere I go these days, I find myself staring at women's handbags. My recently acquired and admittedly bizarre obsession is due to my purchase of shares in Coach Inc. last month.

The fashion industry is one that I tend to avoid due to its fleeting nature. However, I perceive Coach to be a classic American brand that has staying power.

The company manufactures quality products, has international sourcing and distribution arrangements and 80 years of history to guide it. It has established itself as the market leader with a dominant 28 per cent share in the profitable $10.5-billion (U.S.) North American handbag and accessories market. (Louis Vuitton is a distant No. 2 with an 11 per cent share.)

Trendy competitors have stepped forward to challenge the company's dominance over the years, only to later fade away.

Women will continue to use handbags and a few men will, too. The only question is which brand they will choose to purchase.

Coach serves two distinct consumer groups. Its 650 upscale retail stores carry premium handbags that can cost anywhere from $400 to well into the thousands. For the aspirational consumer, Coach also has 235 factory outlets that offer lower priced products.

The company stands for quality products that are within reach of many consumers, unlike the ultra-rich offerings of LVMH, Hermès or Prada. Ten thousand dollars for a handbag? Really?

Financially speaking, Coach is an exceptional business. The company earns an unlevered return on equity in excess of 50 per cent, generates $1-billion plus of annual free cash flow, has raised its dividend in each of the past four years and carries around $836-million in net cash.

I recently asked a member of Coach's management what she thought about the idea of borrowing several billion dollars of cheap debt given the company's massive free cash flow. The company could then return the borrowed funds to shareholders through special dividends or share repurchases. The fact that she didn't like the idea brought a smile to my face. Coach has a conservative culture, which resonates with my risk-averse investment style.

The past five years have been difficult for retailers. Despite these headwinds, Coach has managed to grow its earnings per share at an annual rate in excess of 14 per cent.

Coach's success has drawn additional competitors to the market. Over the holiday shopping season, Coach saw its competitors discount products heavily. Coach chose not to, and ceded share in order to protect its brand.

Michael Kors is the hot brand (and stock) at the moment. Kors is gaining market share and growing quickly, while Coach is experiencing negative same-store sales. However, Kors' stock trades at 26 times earnings versus Coach's 12.

In a recent interview, Coach CEO Lew Frankfort referred to the recent poor holiday quarter as a "moment in time." In other words, this isn't the first challenge that we have faced in our 80-year history and we are up to the task.

The handbag category should continue to grow. Probably at a modest rate in North America, but more rapidly in emerging markets due to their expanding middle class. As a result, Coach's international segment should overtake North America in sales at some point in the next five years. If Coach can maintain its market share in North America and grow overseas through its planned store expansions, the stock will prove to be cheap at its current trading price around $50.30. If, on the other hand, competitors continue to steal market share and put pressure on its prices and margins, my investment in Coach will not be a good one.

I don't believe that will be the case. But with a spouse and two daughters who already own numerous Coach handbags, at least I will ensure my household's disposable income will be flowing into a company where I can enjoy some of the rewards.

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