



Michael Kors Holdings Ltd (KORS)

ACCUMMULATE RECOMMENDATION / COMPANY UPDATE

Rating:	OVERWEIGHT
Target Price (USD):	57.70
Price (28 Sep 2015, USD):	40.55
52-Week Price Range	36.63 - 79.70
Market Cap. (USD M)	7,843.26
Enterprise Value (USD M)	7,028.86

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Historical Price (3-Year)



Paving its Way to a Soft-Landing

Despite pessimistic outlooks on the slowing growth, brand remains strong

- Challenges ahead in North America:** In the past few years, the company saw an unprecedented high growth rate, where sales grew at ~53% CAGR. Market expectations, however, have remained rather pessimistic about KORS' future prospects, with this year's share price down 46% YTD. While the management's guidance notes that the company is on track to return to double-digit growth over the next few years, uncertainties regarding the extent of growth deceleration in NA market and higher margin pressures are hampering price recovery.
- An Established Brand Name Shunned Too Harshly:** Despite the negative expectations, we believe such a big discount for KORS is yet undeserved. Unlike its peers such as Coach Inc. (NYSE:COH), which is already experiencing substantial negative growth, KORS has already established itself as a trend-setting brand name to achieve at least a MSD growth in the NA market.
- Catalysts:** 1) Business expansion worldwide leads fruition – KORS has been dedicated to their global businesses. Given KORS' strengthening presence in the global market, we believe overseas businesses are ready for a significant contribution to its profitability. 2) Advent of E-commerce in North America – The Company's e-commerce contributed to 73% increase in 3Q15 online sales and saw 102% y/y growth in 4Q15; we presume that e-commerce has enough momentum to boost the business in the near future.
- Valuation:** Our **\$57.70** target price is based on a DCF analysis with our long-term FCF projections, a discount rate of 8.0%, and a Terminal FCF growth rate of -1.0%. We are modelling a 5-year revenue growth rate of 6.0% CAGR, and EBIT margin stabilizing at 25.4% by FY20. Given KORS' historical high growth and stable margins, we believe this is still quite conservative.

Financial and Valuation Metrics

Year	3/14A	3/15A	3/16E	3/17E	3/18E
EPS (USD)	3.42	4.55	4.57	4.95	5.12
P / E (x)	11.9 x	8.9 x	8.9 x	8.2 x	8.0 x
Revenue (USD M)	3,311	4,371	4,743	5,208	5,467
EBITDA (USD M)	1,089	1,396	1,423	1,541	1,596
EV / EBITDA (x)	7.2 x	5.6 x	5.5 x	5.1 x	4.9 x

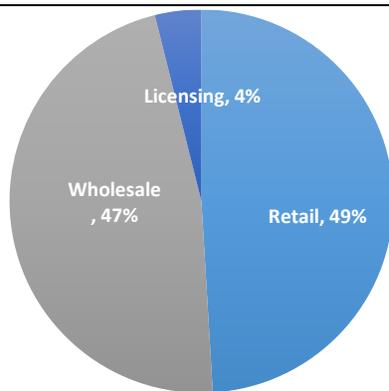
Company Background

Overview

- Michael Kors Holdings Limited is a global accessories, footwear, and apparel brand with a presence in 100 countries. The brand has since significantly increased its distribution from a primarily domestic wholesale business of women’s sportswear into a global accessories, footwear, and apparel company.
- The company is headquartered in New York City and London; as of the end of fiscal 2015, there were 343 North American full-price and outlet stores and 183 International full-price, outlet, and concession locations, a domestic e-commerce site, as well as a significant number of stores operated by license partners, among them ~100 stores in China.
- Currently ~98% of products are sourced in China and Europe with China accounting for more than 29% of finished goods.

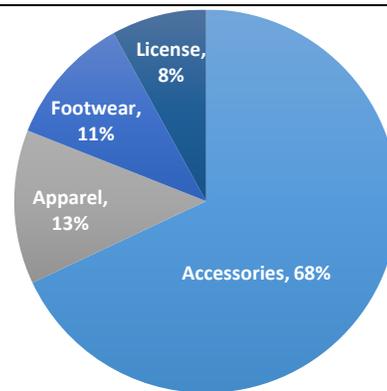
Revenue Composition

Figure 1 – KORS FY15 Revenue Mix



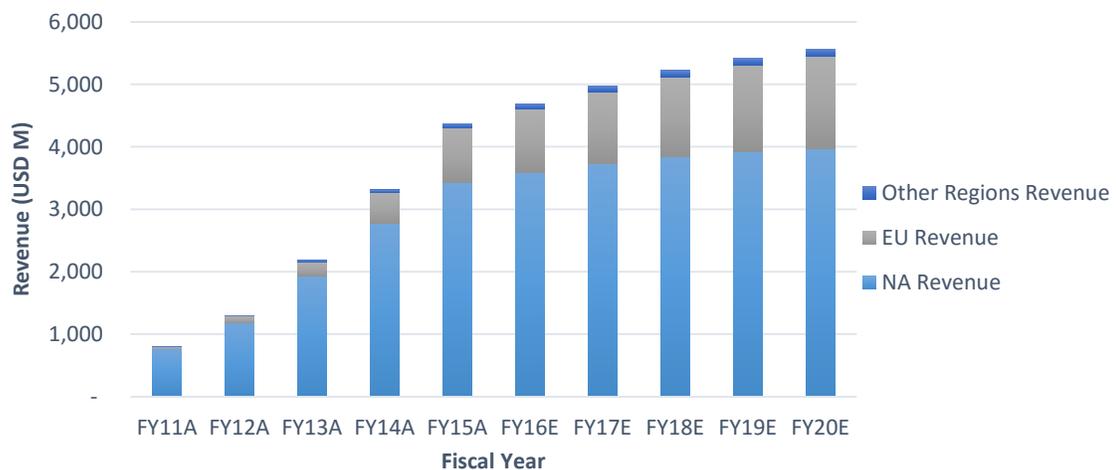
Source: Company data

Figure 2 – KORS FY15 Merchandise Mix



Source: Company data

Figure 3 – KORS Historical and Projected Revenue Mix by Geographical Segments

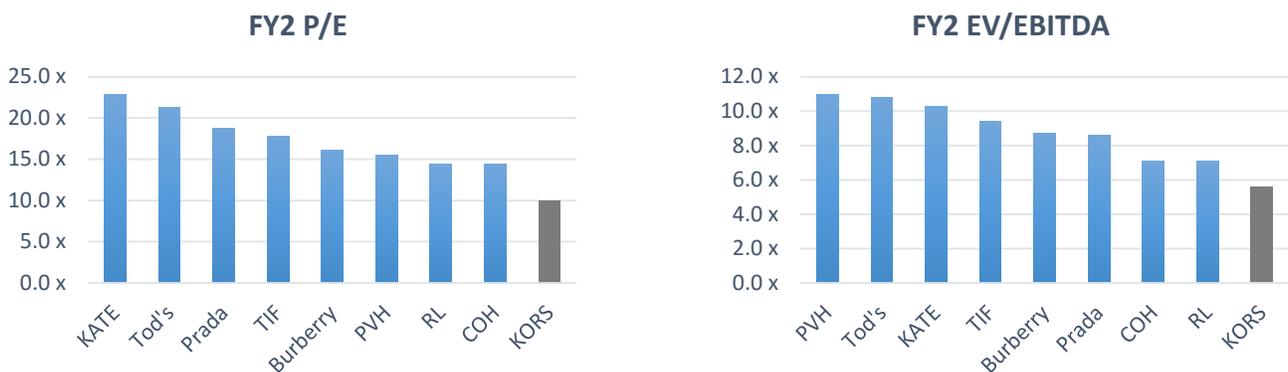


Source: Company data, KEIC estimates

Slowing Handbag Industry

- After years of high growth that significantly outpaced almost all other parts of retail, the handbag market is facing a different world, with more competition and limited growth opportunities. Euromonitor projects that market size growth for women's luxury handbags (which includes the accessible luxury category) will slow from +6% last year to just above +4% through 2019.
- As the fastest growing business in the handbag segment, KORS saw an unprecedented high growth rate in the past few years, where sales grew at ~53% CAGR. Recent market expectations, however, have been rather pessimistic about KORS' future prospects, with this year's share price down 46% YTD, primarily due to concerns regarding growth deceleration in NA market and higher margin pressures.

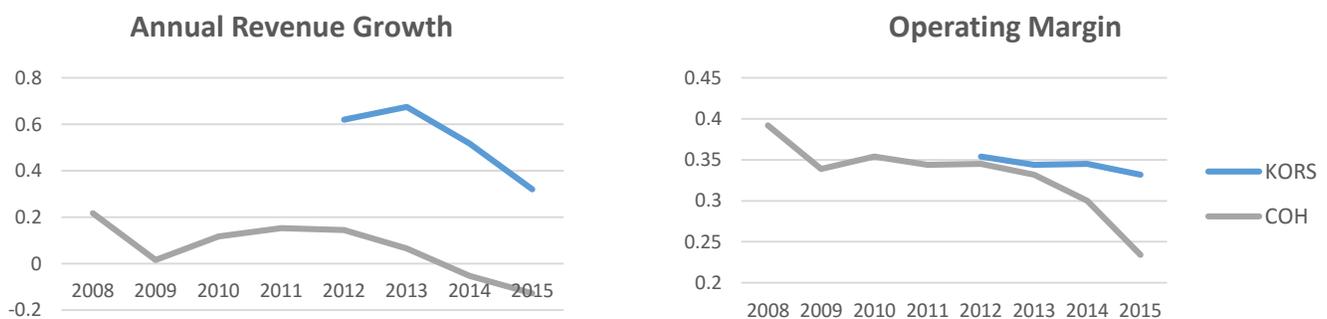
Figure 4 – Trading Below Global Peers



Source: RBC Capital Markets estimates, FactSet Consensus estimates for KATE, PVH and RL

- As a result, KORS has been trading at a significant discount to its global peers, as shown in Figure 4, at current P/E multiple of 9.6x. However, we believe such a big discount caused by negative market expectations for KORS is yet undeserved.

Figure 5 – Historical Growth and Op Margin Comparison with COH



Source: Company Data

- Unlike its closest peer, Coach Inc. (NYSE:COH), which is already experiencing substantial negative growth and pressures on operating margin, KORS' revenue growth seems healthy. Thus, we do not see enough justifications for COH (current P/E: 18.9x) to trade at such a large premium to KORS' P/E multiple of 9.6x.
- COH is also known to experience an erosion of brand power. We do not find KORS' current consumer perception of the brand to be deteriorating; in fact, we believe the KORS brand remains quite strong. We believe that KORS has established itself as a trend-setting brand name to achieve at least a sustainable MSD growth in the near future.

Valuation

DCF Analysis

Our base case Discounted Cash Flow (DCF) analysis, which assumes a 6% annual growth and operating margin stabilizing at 25.4% by FY20 (average of 26.2%), with a Discount Rate of 8.00% based on WACC derived from CAPM and a Terminal FCF Growth Rate of -1.0%, produced an implied share price of **\$57.70**.

- **Current Share Price:** At \$40.55, KORS appears substantially undervalued relative to its peer companies as well as to the implied intrinsic value from our discounted cash flow (DCF) analysis. As shown above, we believe a share price closer to \$60.00 would be more in-line with the P/E multiples from peers and the DCF output.
- **Other Cases:** If KORS can achieve revenue in-line with its guideline (double-digit growth), our target price is **\$65.00**; if the company delivers results that fall are close to market expectations, our target price is **\$49.00**. We focus on the “Base Case” numbers below, which imply a target price of **\$57.70**.

To project Free Cash Flow and complete the Discounted Cash Flow analysis, we relied upon our “Base Case” financial projections:

Figure 6 – KORS Projected Income Statement

Income Statement:	Units	Historical					Projected				
		FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
NA Revenue	\$ M	764	1,183	1,939	2,772	3,419	3,675	3,969	4,128	4,252	4,358
EU Revenue	\$ M	39	109	221	501	885	991	1,149	1,241	1,316	1,375
Other Regions Revenue	\$ M	1	10	22	39	68	77	89	97	106	116
Total Revenue	\$ M	803	1,302	2,182	3,311	4,371	4,743	5,208	5,467	5,674	5,849
Revenue Growth	%		62.1%	67.5%	51.8%	32.0%	8.5%	9.8%	5.0%	3.8%	3.1%
COGS	\$ M	357	549	875	1,295	1,724	1,947	2,138	2,245	2,330	2,402
Gross Profit	\$ M	446	753	1,307	2,016	2,648	2,795	3,069	3,222	3,344	3,447
Operating Expenses		305	499	676	1,007	1,390	1,488	1,634	1,715	1,780	1,835
Operating Income (EBIT)		141	254	631	1,009	1,258	1,281	1,385	1,432	1,464	1,486
Operating Margin	%	17.5%	19.5%	28.9%	30.5%	28.8%	27.0%	26.6%	26.2%	25.8%	25.4%
Less: Non-Operating (Income) Loss	\$ M	4	(1)	3	1	1	1	1	1	1	1
Less: Abnormal Losses (Gains)	\$ M	4	6	1	1	1	3	2	2	2	2
EBT (GAAP)		133	249	627	1,008	1,256	1,277	1,382	1,429	1,461	1,483
Less: Tax Expenses	\$ M	61	101	230	346	375	392	424	439	449	455
Net Income	\$ M	72	147	398	661	881	885	958	990	1,012	1,027
EPS	\$	0.37	0.76	2.06	3.42	4.55	4.57	4.95	5.12	5.23	5.31
EPS Growth			103.3%	169.9%	66.4%	33.2%	0.4%	8.3%	3.4%	2.2%	1.5%

Source: Company data, KEIC estimates

We then calculated Unlevered Free Cash Flow as follows:

Figure 7 – KORS Projection of Future Free Cash Flow

Unlevered Free Cash Flow Projections	Units	Historical					Projected				
		FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
Total Revenue	\$ M	803	1,302	2,182	3,311	4,371	4,743	5,208	5,467	5,674	5,849
Revenue Growth	%		62.1%	67.5%	51.8%	32.0%	8.5%	9.8%	5.0%	3.8%	3.1%
Operating Income (EBIT)	\$ M	141	254	631	1,009	1,258	1,281	1,385	1,432	1,464	1,486
Operating Margin	%	17.5%	19.5%	28.9%	30.5%	28.8%	27.0%	26.6%	26.2%	25.8%	25.4%
Less: Taxes	\$ M	(61)	(101)	(230)	(346)	(375)	(392)	(424)	(439)	(449)	(455)
NOPAT	\$ M	80	153	401	663	883	889	961	993	1,015	1,030
Total Adjustments for Non-Cash Charges	\$ M	56	39	(45)	59	165	163	178	187	194	197
Total Inc (Dec) in Operating Capital:	\$ M	(18)	(71)	3	(88)	(188)	(45)	(46)	(18)	(10)	(5)
Less: CapEx	\$ M	(57)	(88)	(121)	(185)	(356)	(332)	(354)	(361)	(363)	(363)
Annual Unlevered Free Cash Flow		60	32	239	450	504	675	739	802	836	860
Present Value of Free Cash Flow							665	689	692	668	636
EBITDA	\$ M	166	292	685	1,089	1,396	1,423	1,541	1,596	1,634	1,661

Source: Company data, KEIC estimates

Assumptions:

- **Discount Rate:** 8.00% based on WACC derived from CAPM (Rf: 2.104%, Risk Premium: 7.537%, Beta: 0.777). Since KORS is currently debtless, cost of debt was not considered.
- **Terminal Value:** Long-term Free Cash Flow Growth Rate of -1.0%, with an implied terminal EBITDA multiple of 5.9x.

With these assumptions and the Free Cash Flow projections above, the DCF produced the following output:

Figure 8 – KORS DCF Analysis Output

		Operating Margin								
		25.0%	25.5%	26.0%	26.5%	27.0%	27.5%	28.0%	28.5%	29.0%
Revenue Growth	2.0%	\$ 48.57	\$ 49.63	\$ 50.70	\$ 51.76	\$ 52.82	\$ 53.88	\$ 54.94	\$ 56.00	\$ 57.06
	3.0%	50.05	51.15	52.26	53.37	54.48	55.58	56.69	57.80	58.90
	4.0%	51.57	52.72	53.87	55.03	56.18	57.34	58.49	59.64	60.80
	5.0%	53.13	54.33	55.53	56.74	57.94	59.14	60.35	61.55	62.75
	6.0%	54.74	55.99	57.24	58.50	59.75	61.00	62.26	63.51	64.76
	7.0%	56.39	57.70	59.00	60.31	61.61	62.92	64.23	65.53	66.84
	8.0%	58.09	59.45	60.81	62.17	63.53	64.89	66.25	67.61	68.97
	9.0%	59.84	61.26	62.67	64.09	65.51	66.92	68.34	69.76	71.17
	10.0%	61.64	63.12	64.59	66.06	67.54	69.01	70.49	71.96	73.43
			WACC							
		4.0%	5.0%	6.0%	7.0%	8.0%	9.0%	10.0%	11.0%	12.0%
Terminal Growth Rate	(2.0%)	\$ 85.57	\$ 74.20	\$ 65.67	\$ 59.04	\$ 53.74	\$ 49.40	\$ 45.80	\$ 42.75	\$ 40.13
	(1.5%)	91.68	78.50	68.84	61.46	55.64	50.92	47.03	43.77	40.99
	(1.0%)	99.00	83.52	72.47	64.18	57.75	52.60	48.39	44.88	41.92
	(0.5%)	107.95	89.45	76.66	67.27	60.10	54.44	49.87	46.09	42.91
	-	119.14	96.58	81.54	70.80	62.76	56.50	51.50	47.40	44.00
	0.5%	133.52	105.28	87.31	74.88	65.76	58.79	53.29	48.85	45.17
	1.0%	152.70	116.16	94.24	79.63	69.20	61.38	55.29	50.43	46.45
	1.5%	179.55	130.14	102.70	85.25	73.16	64.30	57.53	52.18	47.86
	2.0%	219.82	148.79	113.29	91.99	77.79	67.65	60.04	54.13	49.40

Source: KEIC estimates

Investment Thesis, Catalysts and Risks

We believe that KORS is undervalued and that a price correction could occur within the next 12 months for the following reasons:

- **1) Business Expansion Worldwide Leads Fruition** – Many historical metrics over the past few years indicate how KORS has been dedicated to their global businesses. In 2013 and 2014, Michael Kors opened 101 and 121 new stores, respectively, bringing its total fleet to 550. Retail net sales increased 9.0% to \$523.3 million driven by 107 new store openings. Given the CEO's continued assertion that KORS would be expanding its size in the future, we believe it is fair to say that KORS has ample runway for global expansion.
- **2) Advent of E-commerce in North America** – The Company brought its e-commerce technology in-house last year and e-commerce had successfully contributed 73% increase in Q3 online sales in North America. Sales from e-commerce currently occupy 7% of net sales in the NA market. 102% y/y growth in the division was especially noteworthy; with the increasing number of online population and accessibility of technology, we presume that e-commerce could be considered as a good catalyst to boost the business in the near future.

Our targeted share prices are as follows:

- **Bull Case:** \$65.00, based on 10% annual revenue growth and 26.2% operating margin by FY20.
- **Base Case:** \$57.70, based on 6% annual revenue growth and 26.2% operating margin by FY20.
- **Bear Case:** \$49.00, based on 2% annual revenue growth and 25.0% operating margin by FY20.

Investment Risks

The followings represent the greatest risks to our investment thesis:

- **1) Projected Fed Rate Hike** – In September's FOMC meeting, the Fed has made it clearer that it would be rising its interest rate by the end of 2015. We note that KORS' operations are directly vulnerable to deterioration in consumer confidence caused by the Fed's interest rate hike, given its position as a global luxury lifestyle brand company.
- **2) Overexpansion May Lead to a Failure** – One of the factors that contributed to the company's profitability was its aggressive expansion, including the recent opening of 300+ retail stores in the past few years and transformation of inroad malls to outlet malls. However, we concern that this kind of rapid expansion may entail the possibility of overexposure, which can lead to a deterioration of brand value. Such a risk can pose greater challenges especially for KORS because it is a fairly young brand name in the industry. In addition, its main target customers are a relatively younger crowd, whose brand loyalty can be weak.
- Other risks to our price target include: further deterioration in NA sales, continued normalization of comps, further declines in FX rates, and increasing markdown pressure at both retail and wholesale channels.