BUFFETTS BOOKS
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INTRINSIC VALUE ASSESSMENT OF

FOSSIL GROUP, INC. (FOSL)

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This article was written in collaboration with Christoph Wolf
from The Investor's Podcast and Christoph Wolf Value Investing

Introduction

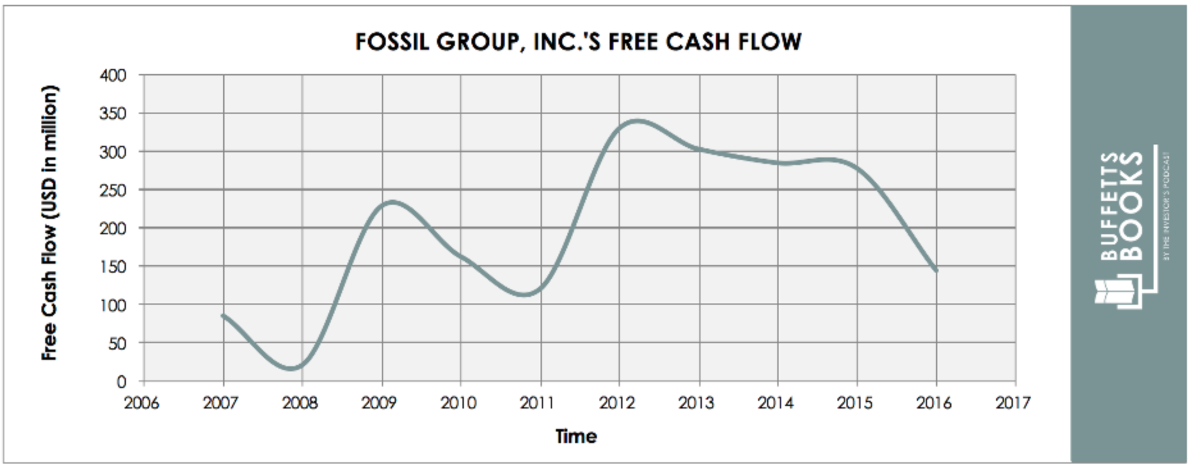
Fossil Group, Inc. designs, manufactures and distributes luxury watches, wearables, jewelry, as well as fashion articles like handbags or leather goods. Watches comprise the largest bulk of the company's revenue, and it sells its wares through two channels -- through its brands including Fossil, Misfit, Skagen, and Zodiac, and through licensed brands including Adidas, Emporio Armani, Karl Lagerfeld, Michael Kors, Burberry, and others. About half of the company's revenue comes from the Americas, while the rest is generated in Europe and Asia.

Due to multiple headwinds – a recent oversupply of luxury watches and a trend towards smartwatches – the stock has been punished brutally. From a stock price of $128 at the end of 2013, it traded for as low as $5.50 in November 2017. Because of recent earnings that vastly exceeded expectations, the stock has shot back to a current value of $15. Is Fossil Group, Inc. a value trap waiting to go bankrupt or is the stock still a promising investment?

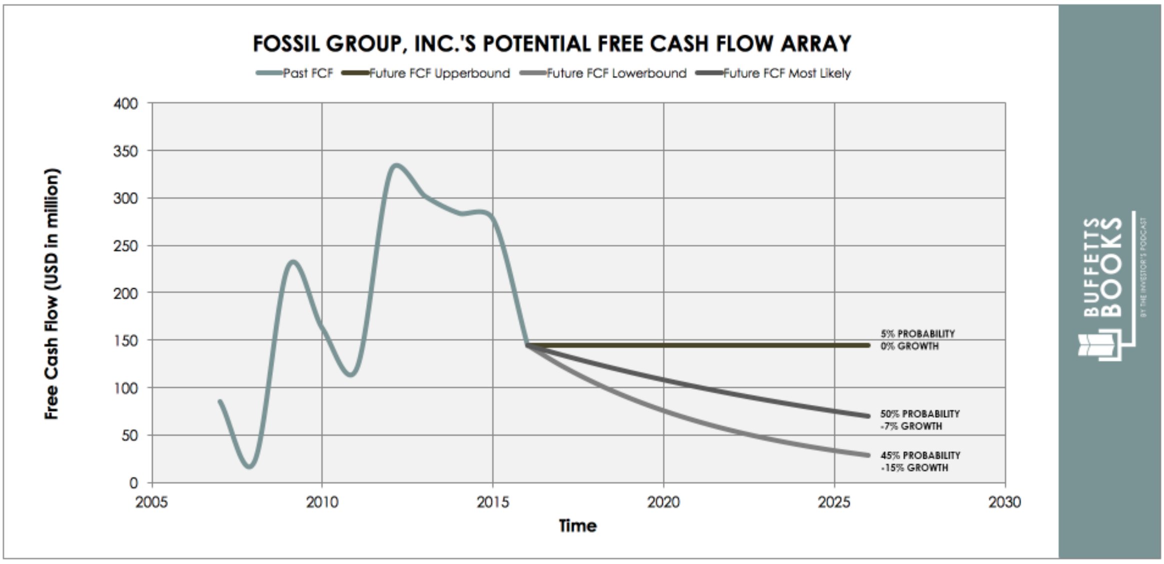
FOSSIL
GROUP

The Intrinsic Value of Fossil Group, Inc.

To determine the value of Fossil Group, Inc., let's start by looking at the company's history of free cash flow. The free cash flow is important because it represents the company's ability to retain earnings and grow the business. Most importantly, it demonstrates a return on the principal that might be invested into the ownership of equity of the business. Below is a chart of Fossil Group, Inc.'s free cash flow over the past ten years.



As one can see, the free cash flow is both volatile and has, in the last years, declined. Although results have improved lately (not shown in the chart), we will use a very conservative estimate of the future free cash flow. To build this estimate, we make use of an array of potential outcomes for future cash flows.



Each line in the above graph represents a certain probability for occurring. We assume a 5% chance for the upper growth rate of 0% per year, a 50% chance for a decline of 7% per year and a 45% chance for the worst-case scenario of -15% annual growth.

Assuming these conservative growth rates, Fossil Group, Inc. can be expected to yield a potential 10.2% annual return at the current price of $15. Now, let's discuss how and why those free cash flows could be achieved.

The Competitive Advantage of Fossil Group, Inc.

Before running into problems during the last years, the net profit margins were consistently above 10% until 2014. This is an indication that Fossil Group, Inc. possesses (or at least possessed) several unique advantages, which should enable it to thrive in the future. These include:

- **Quality Branding.** Fossil and its fellow owned brands are well-known and stand for luxury and quality. Add to this the who-is-who of licensed brands (Michael Kors, Adidas, Armani, etc.) through which it sells its wares, and it becomes clear, that Fossil Group, Inc. is highly visible and possesses a unique branding advantage.
- **Financial Strength.** Despite declining sales and losses due to impairment charges, the free cash flow has consistently remained positive. Also, the balance sheet is solid, and the current ratio is above 2.
- **Unique Management.** Long-term CEO Kosta Kartsotis refuses all forms of financial compensation for his work. Instead, he considers his sole compensation by aligning his interest with stockholder's interest – thereby increasing the value of his 12.4% ownership of Fossil Group, Inc. stock. In times of excessive management compensation, this behavior is unprecedented and creates trust.
- **Innovation.** Far from passively watching its traditional core business of luxury watches decline, Fossil Group, Inc. actively develops wearables like smartwatches, hybrid watches, and activity trackers. In 2017, the number of wearables exceeded 300. In fact, the rapid sales growth of these high-margin products was a major factor for the stock skyrocketing after the latest earnings announcement.

Risk Factors

The risks for Fossil Group, Inc. are definitively real, which can be seen in the recent disappointing numbers. The company has reported huge losses due to immense write-downs of goodwill and because of the effect of the U.S. tax reform.

These are the major risks:

- Competition by smartwatches, especially the Apple watch. As explained above, this risk is considered overblown. Fossil Group, Inc. is also a major player in the field of wearables so that the company could gain from rising demand in this field.
- An oversupply in luxury watches. This seems to be the real major threat for Fossil Group, Inc. While its wearable sales are rising rapidly, traditional watches remain the largest part of its business by far.
- Financial headwinds. Fossil Group, Inc. recently refinanced almost $500M of debt – but at a vastly higher interest rate than before. This poses an additional burden on the company and reduces its chances for a turnaround.

Opportunity Costs

When looking at various investing opportunities on the market today, let's compare the expected return of Fossil Group, Inc. to other ideas. First, one could invest in the ten-year treasury bond which is producing a 2.9% return. Considering the bond is completely impacted by inflation, the real return of this option is likely below 1%. Currently, the S&P 500 Shiller P/E ratio is 32. As a result, the U.S. stock market is priced at a 3.1% yield. If one were to invest in the S&P500, they might purchase a low-cost ETF to take advantage of this return.

Macro Factors

The luxury watch business, which constitutes the core business of Fossil Group, Inc., is currently experiencing a major disruption that is caused by two factors. Firstly, especially many young consumers consider a traditional watch that only shows time and date, as old-fashioned and switch to high-end technology products such as smartwatches.

This perception of a dying market of luxury watches because of a switch to smartwatches featured popular in the news and was a crucial factor for the market's pessimism towards Fossil Group, Inc. But high-end traditional watches should be more regarded as men's jewelry and therefore only compete marginally with smartwatches – after all, nobody wears a $10,000 Rolex because it so accurately shows the time.

Indeed, a second factor, which is only seldom discussed, is probably at least as challenging to the luxury watch market: An oversupply of fashion watches and a cannibalizing of the luxury label. By trying to gain market share, producers have saturated the market with luxury watches, leading to more competition and shrinking margins. It will be a painful and long transition to restore the feeling of scarcity and uniqueness in the minds of buyers.

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Summary

Fossil Group, Inc. is an intriguing stock – bringing about both euphoria and extreme pessimism which has been reflected in extraordinary volatility lately. Investing in small-cap stocks during a turnaround is not for the faint-hearted as Fossil Group, Inc.'s core business is struggling to adapt to shift in consumer preferences. For now, it is not yet clear if the change in focus to wearables can compensate for this loss of business in their more traditional product groups.

For the very same reason why, the potential reward of this turnaround is priced at such attractive levels indicating a potential 10.2% return.

This assessment was conducted from the tools provided in Preston and Stig's Intrinsic Value Online Training Course.