SINGULAR DILIGENCE

Fossil

(NASDAQ: FOSL)

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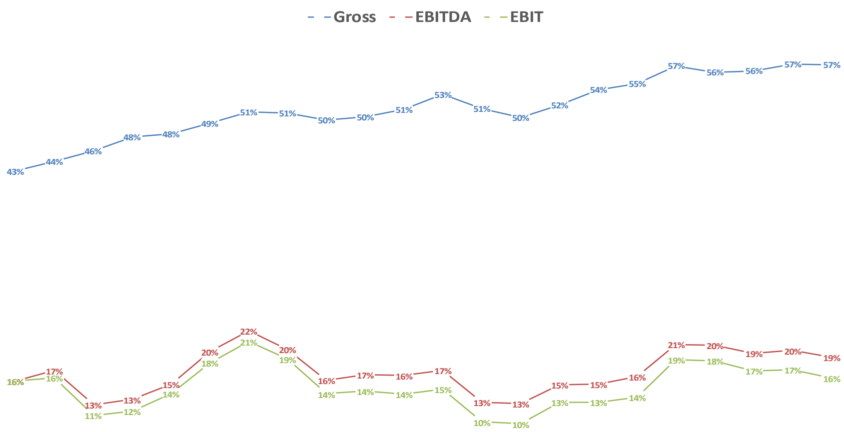
Stock Price: $30.69



	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Guess	0.50	1.40	5.82	9.62	9.62
Movado	0.82	1.55	5.73	6.73	6.73
PVH	1.18	2.25	11.24	15.66	15.66
Michael Kors	1.72	2.85	5.40	6.00	6.00
Luxottica	3.99	6.02	19.83	26.40	26.40
Minimum	0.50	1.40	5.40	6.00	6.00
Maximum	3.99	6.02	19.83	26.40	26.40
Median	1.18	2.25	5.82	9.62	9.62
Mean	1.64	2.81	9.60	12.88	12.88
Standard	1.39	1.88	6.21	8.46	8.46
Variation	85%	67%	65%	66%	66%
Fossil	0.77	1.34	4.06	4.75	5.95

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014		Minimum	Maximum	Median	Mean	Standard Deviation	Variation
Sales	105	162	181	206	245	305	419	504	546	663	781	960	1,043	1,214	1,433	1,583	1,548	2,031	2,567	2,858	3,260	3,510		105	3,510	871	1,187	1,053	89%
Gross Profit	45	72	83	98	118	151	213	256	272	333	400	510	535	609	742	851	845	1,155	1,439	1,607	1,862	2,001		45	2,001	455	645	606	94%
EBITDA	17	28	23	27	38	60	93	100	86	110	129	165	135	155	219	243	253	417	524	554	644	662		17	662	132	213	209	98%
EBIT	17	26	20	24	35	55	87	94	77	96	110	141	109	123	186	206	212	376	472	489	562	567		17	567	109	186	183	98%
Receivables				28	32	38	47	57	68	80	103	138	148	148	191	217	208	237	283	333	409	443		28	443	148	169	127	75%
Inventory				46	51	54	60	72	92	113	124	153	210	235	238	270	269	309	430	498	539	584		46	584	210	229	174	76%
PP&E				16	19	22	26	35	66	97	110	119	135	159	179	197	210	215	250	309	346	351		16	351	135	150	110	73%
Working Liabilities				16	19	26	31	35	42	51	74	104	122	129	164	180	171	208	262	285	310	315		16	315	122	134	103	77%
Net Tangible Assets				74	82	89	102	129	185	238	263	306	371	413	445	504	515	553	701	854	983	1,063		74	1,063	371	414	306	74%
MARGINS																													
Gross	43%	44%	46%	48%	48%	49%	51%	51%	50%	50%	51%	53%	51%	50%	52%	54%	55%	57%	56%	56%	57%	57%		43%	57%	51%	51%	4%	0.08
EBITDA	16%	17%	13%	13%	15%	20%	22%	20%	16%	17%	16%	17%	13%	13%	15%	15%	16%	21%	20%	19%	20%	19%		13%	22%	17%	17%	3%	0.16
EBIT	16%	16%	11%	12%	14%	18%	21%	19%	14%	14%	14%	15%	10%	10%	13%	13%	14%	19%	18%	17%	17%	16%		10%	21%	15%	15%	3%	0.19
TURNS																													
Sales/Receivables				7.46	7.59	7.93	8.91	8.83	7.97	8.27	7.58	6.98	7.04	8.19	7.49	7.31	7.45	8.59	9.08	8.58	7.97	7.93		6.98	9.08	7.93	7.95	0.63	8%
Sales/Inventories				4.46	4.84	5.61	6.96	7.00	5.90	5.88	6.28	6.28	4.97	5.17	6.01	5.86	5.76	6.58	5.96	5.74	6.05	6.01		4.46	7.00	5.90	5.86	0.66	11%
Sales/PPE				12.80	12.95	13.79	16.19	14.23	8.25	6.87	7.13	8.04	7.72	7.62	8.02	8.05	7.38	9.45	10.28	9.26	9.43	10.01		6.87	16.19	9.26	9.87	2.77	28%
Sales/NTA				2.78	2.97	3.43	4.12	3.90	2.95	2.79	2.97	3.14	2.81	2.94	3.22	3.14	3.00	3.67	3.66	3.34	3.32	3.30		2.78	4.12	3.14	3.23	0.38	12%
RETURNS																													
Gross Profit/NTA				132%	142%	169%	209%	198%	147%	140%	152%	167%	144%	147%	167%	169%	164%	209%	205%	188%	189%	188%		132%	209%	167%	170%	25%	0.15
EBITDA/NTA				37%	46%	67%	92%	77%	47%	46%	49%	54%	37%	38%	49%	48%	49%	75%	75%	65%	65%	62%		37%	92%	49%	57%	16%	0.27
EBIT/NTA				33%	42%	62%	86%	73%	41%	40%	42%	46%	29%	30%	42%	41%	41%	68%	67%	57%	57%	53%		29%	86%	42%	50%	16%	0.31
GROWTH																													
Sales		54%	12%	14%	19%	24%	37%	20%	8%	22%	18%	23%	9%	16%	18%	10%	-2%	31%	26%	11%	14%	8%		-2%	54%	18%	19%	12%	0.64
Gross Profit		59%	15%	18%	20%	28%	41%	20%	6%	22%	20%	28%	5%	14%	22%	15%	-1%	37%	25%	12%	16%	7%		-1%	59%	20%	20%	13%	0.65
EBITDA		67%	-17%	20%	37%	59%	56%	7%	-14%	27%	17%	28%	-18%	15%	41%	11%	4%	65%	26%	6%	16%	3%		-18%	67%	17%	22%	25%	1.17
EBIT		58%	-22%	19%	42%	60%	58%	7%	-18%	25%	14%	29%	-23%	13%	51%	10%	3%	78%	25%	4%	15%	1%		-23%	78%	15%	21%	28%	1.31
Receivables				21%	13%	24%	21%	22%	18%	17%	39%	30%	-9%	10%	47%	-9%	2%	25%	15%	20%	25%	-5%		-9%	47%	20%	17%	15%	0.87
Inventories				17%	3%	12%	10%	29%	28%	18%	4%	41%	35%	-5%	9%	18%	-16%	51%	31%	4%	13%	5%		-16%	51%	13%	16%	17%	1.03
PP&E				8%	26%	10%	24%	48%	113%	15%	13%	6%	20%	16%	8%	11%	2%	2%	30%	19%	6%	-3%		-3%	113%	13%	20%	25%	1.29
Working Liabilities				24%	20%	48%	2%	23%	15%	30%	54%	32%	7%	4%	49%	-16%	9%	32%	21%	-1%	19%	-13%		-16%	54%	20%	19%	20%	1.04
Net Tangible Assets				15%	8%	7%	21%	32%	51%	14%	8%	24%	19%	5%	10%	16%	-10%	26%	28%	17%	13%	3%		-10%	51%	15%	16%	13%	0.80

SINGULAR DILIGENCE

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Fossil (NASDAQ: FOSL) is a Watchmaker with a Focus on Licensed Fashion Watches

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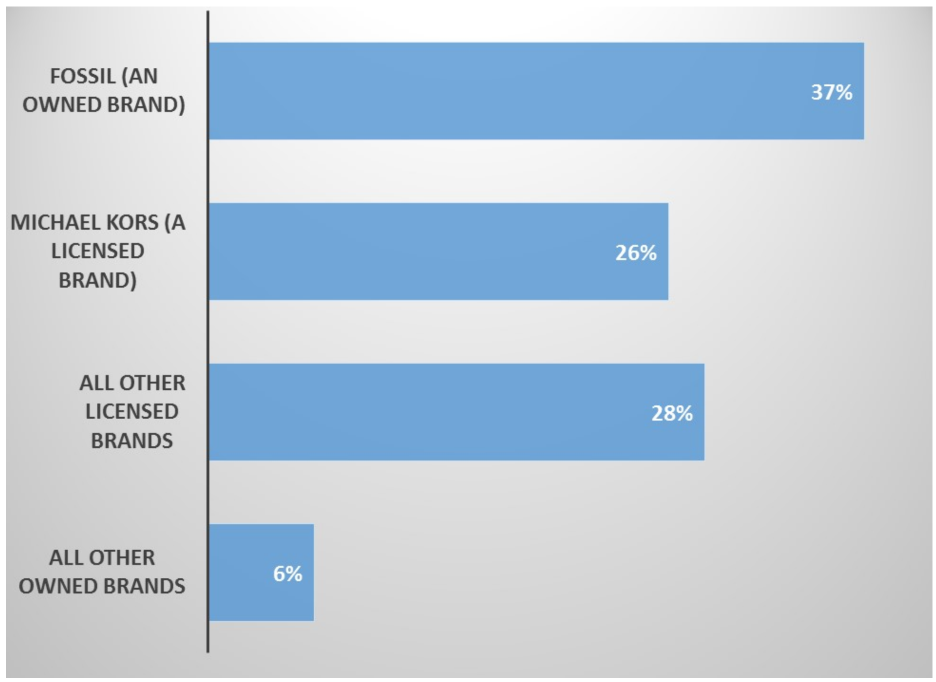
OVERVIEW

Fossil sells watches and accessories. The company gets about 55% of sales from brands it pays royalties to license and about 45% from brands the company owns. Licensed brands include Emporio Armani, DKNY, Diesel, Burberry, Michael Kors, Adidas, Marc Jacobs, Karl Lagerfeld, Tory Burch, and Kate Spade. Company owned brands include Fossil and Skagen. Fossil is a large brand (about $2 billion in sales at retail and $1.3 billion in revenue booked by the company). Skagen is a small brand. Fossil gets most of its sales and profits from two brands: the Fossil brand (which it owns) and the Michael Kors brand (which it licenses). Last year, Fossil the company got 37% of its sales from Fossil the brand. Another 26% of sales came from Michael Kors. So, the entire company gets just under two-thirds of its sales from those two brands combined.



Fossil gets 54% of sales from licensed brands (26% from Michael Kors and 28% from all other licenses)

Fossil was founded by the Kartsotis brothers. In the 1980s, Kosta Kartsotis worked in merchandising at the Dallas department store Sanger Harris. His younger brother, Tom Kartsotis, was making money selling tickets to Dallas Cowboys games and other events. Kosta told Tom about the big profit margins in importing retail goods made in East Asia and selling them in U.S. department stores. At this point, the Swatch brand of watches were being sold in the U.S. as a fashion watch fad. So, Tom went to Hong Kong. He investigated the possibility of importing something from Asia to the U.S. – stuffed animals, toys, etc. – but eventually settled on his brother's original idea: fashion watches. Tom hired a designer (who he'd later marry) and placed an order for 1,500 watches with a Hong Kong factory. He then marketed these 1,500 watches to department stores and boutiques in Dallas. Tom repeated this process through the 1980s. His brother Kosta (the one who had given Tom the original idea) joined Fossil in 1988. Kosta's presence probably helped Fossil get into department stores throughout the entire U.S. From 1987 to 1989, Fossil's sales increased tenfold from $2 million to $20 million. The company settled on a nostalgic American image. By 1989, it was packaging its watches in tin containers that promoted the Fossil brand name. Fossil went public in 1993. After the IPO, Tom Kartsotis owned 41% of the company and Kosta Kartsotis owned 19% of the company. Years later, Tom Kartsotis sold his shares of Fossil and left the company. He later founded Shinola. Shinola makes watches, accessories, and some other products (like bicycles) in Detroit. As of this issue, Tom Kartsotis runs Shinola – which is a private company that has nothing to do with Fossil – and his brother Kosta runs Fossil. Kosta is Chairman & CEO of Fossil. He still owns 12% of the stock. And he works for free.

Swatch – a huge Swiss watchmaker – had a strong fashion brand called "Swatch" that sold well in the U.S. throughout the 1990s. Swatch – both the company and its namesake brand – started losing its market position in the U.S. by the early 1990s. There are several reasons for this. We did an issue on Swatch. And you can go back and read that issue for more detail on Swatch. But, basically, Swatch is a Swiss luxury watchmaker. It is not a U.S. company. As people in emerging markets – especially China – got richer, Swatch focused more on the true luxury segment in those markets. It paid less and less attention to the U.S. Watches are sold differently in the U.S. than they are elsewhere in the world. And Swatch's strategy shifted away from the kind of marketing that would work best in the U.S. This left an opening in the U.S. watch market. It has since been captured mainly by two companies: Fossil and Movado. This might not be obvious to you if you simply walked into a U.S. department store (a Macy's, a Belk, a Nordstrom's, etc.) without knowing which companies have the licenses to which brands. But we did an issue on Movado so you can get background on that company's brands by reading that issue. We just mentioned Fossil's licenses. It's worth repeating them: Emporio Armani, DKNY, Diesel, Burberry, Michael Kors, Marc Jacobs, Karl Lagerfeld, Tory Burch, and Kate Spade. The biggest fashion watch brand that neither Fossil nor Movado has is Guess. Fossil tried to get this license years ago, but they were hit with an anti-trust lawsuit. Almost all the brands of watches you see at a department store's watch counter in the U.S. are actually produced under a license controlled by Fossil or Movado. So, like the cereal aisle of your grocery store, there may appear to be a lot of variety in a department store's watch counter – but the diversity of styles and brands and prices is really provided by two watchmakers: Fossil and Movado. This description applies to the U.S. only. It's not true in the rest of the world. Swatch has big market share worldwide. But its position in the U.S. is weak. Other watchmakers like Swatch (which owns brands like Omega) and Rolex are sold through independent jewelry stores and boutiques that use the luxury watch brand's own name. They don't get a lot of sales in the U.S. through the mass market channels of department stores like Fossil and Movado do.

Fossil is the biggest company in the fashion watch industry. It has over 1,000 employees working in "creative" roles like design, packaging, and marketing. The company has over 300 employees in its design team alone. Fossil also owns some of its own manufacturing. Other companies – like Movado – do not own manufacturing in East Asia. They contract for all of it. Fossil's Asian manufacturing base allows it to switch designs quicker. It has a much shorter time to market than Movado. Fossil also uses it marketing power in a couple ways that Movado doesn't. Fossil now has 100 Watch Station stores. These sell watches from different brands in one place. The company has over 450 Fossil branded stores. These stores dedicate about one-third of their space to watches and about two-thirds to leather goods, jewelry, and other accessories like sunglasses. There are about 225 of these stores in the U.S. and another 225 stores abroad. Many of the U.S. stores are in shopping malls. The rent expense on such locations is high. So, Fossil has higher fixed charges than Movado.

Fossil is a fashion brand not a luxury brand. Fossil watches might sell for $100 at retail. Wallets for between $30 and $50. A woman's clutch could be $60 to $80. And women's cross bodies, satchels, etc. from $125 to $250. These are not high prices for the kinds of goods we are talking about. Even Fossil's licensed brands tend to be in the $85 to $500 range for watches. There is definitely overlap and direct competition between Movado and Fossil's licensed watch brands. There is somewhat less direct competition with Fossil and Movado's company owned brands. Generally, Fossil is much larger in terms of volume and is somewhat lower in terms of price. Movado's owned brands – like the Movado brand – start at affordable luxury and move up. The Fossil brands really start at fashion watch price levels with some of the watches bumping up against the bottom of the luxury range. But, Fossil is basically a fashion watch company. Sales are about 75% wholesale and 25% direct to consumer.

The stock is extraordinarily cheap. It is much, much cheaper than either Swatch or Movado. As I write this, Fossil is priced at about 5 times last year's EBIT and maybe 6 times normal EBIT. This is equivalent to a high single-digit P/E after-tax. It's not an exaggeration to say that Fossil trades for about half the price of a "normal" stock in "normal" times.

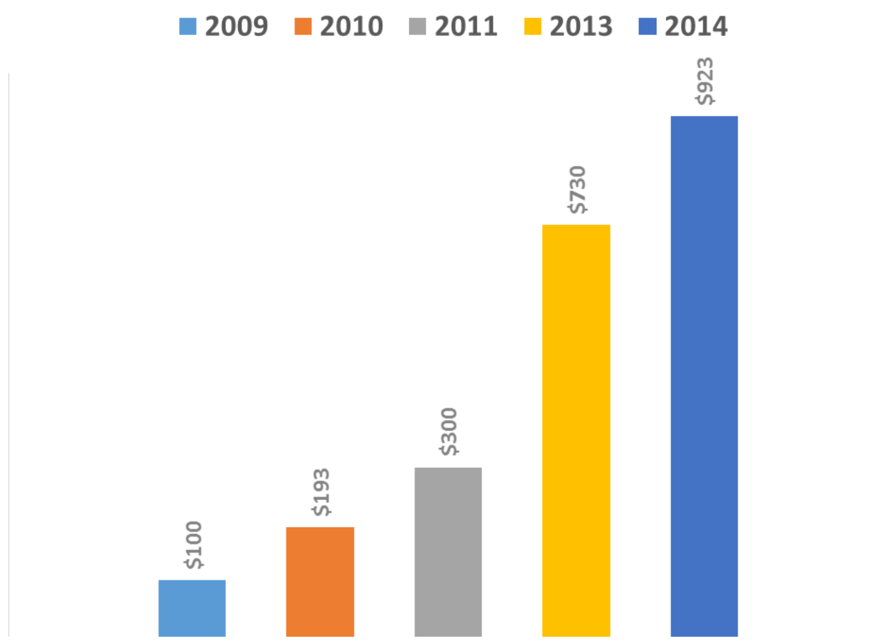
DURABILITY

Michael Kors is a Fad: Fossil's Sales and Earnings Will Decline Along with the Popularity of the Michael Kors Brand

Fossil's durability can be divided into 3 parts: 1) The Fossil brand (about 37% of sales), 2) Licensed Brands other than Michael Kors (which are about 37% of sales), and 3) Michael Kors (which is 26% of sales). Company owned brands include Fossil and Skagen. These are 43% of the company's total revenue. Skagen is maybe a $150 million brand right now. It's a Danish brand Fossil bought. The company hopes to one day grow it into another Fossil type brand. The company owned brands get a lot of their sales from company owned stores. So, the revenue split here is about 55% wholesale and 45% direct to consumer. That's different from the licensed brands. That revenue tends to be wholesale. So, the amount of Michael Kors inventory on hand at a retailer does matter. If a department store is now oversupplied with Michael Kors watches it'll buy a lot fewer of those watches next quarter and the quarter after that.

Company owned brands include Fossil, Skagen, and Michele. Skagen is Danish but otherwise similar to Fossil. Michele is a fashion luxury watch brand sold at higher end department stores like Bloomingdales, Neiman Marcus, Nordstrom, and Saks. Michele is maybe a $100 million brand. Skagen maybe a $150 million brand. While Fossil is more like a $1.3 billion brand in terms of revenue reported by Fossil. The actual brand would be more like $2 billion in sales at retail. Fossil is a big brand. So, we'll just focus on the Fossil brand and set aside Skagen and Michele. The Fossil brand's product mix might look something like 50% watches, 30% leather goods, 15% jewelry, and 5% other ("other" is accessories like sunglasses). A lot of the Fossil brand's sales are driven by its own Fossil-branded stores. Retail provides 45% of revenue for the company owned brands. Company owned retail has very high operating leverage. Roughly speaking, the business model looks like this: Fossil makes a 30% profit margin before rent. Fossil pays 20% of its sales in rent. So, Fossil's retail stores have a 10% after-tax (and before corporate expenses) profit margin. The risk here is the high operating leverage combined with overexpansion. Fossil grew the stores in its chain from 183 Fossil stores in 2008 to 469 stores in 2014. However, leather sales were flat at $428 million in 2011 to $419 million in 2014. They had jumped from 2008 to 2011. But from 2011 till today they haven't grown at all. The opening of many stores selling handbags in the same malls and areas where Fossil stores are obviously hurt. It is not difficult to find a wide assortment of leather goods at the department stores Fossil sells to and in Michael Kors and Coach and so on stores in the same malls that these department stores anchor.

Fossil is a fashion brand. It sometimes



Fossil's revenue from the Michael Kors brand surged more than 55% a year from less than $100 million in 2009 to more than $900 million in 2014

falls out of favor. In the fourth quarter of 2005, Fossil's U.S. watch sales dropped 19%. The company increased its price, changed the design of the watches, added details, and made other fashion oriented changes. The brand recovered. This sort of thing will happen again in the future. Fossil is not a luxury watch brand. It's a fashion watch brand. It employs a design team of 300 people. It has a lead time of 75 days. Movado has a lead time of 180 days. Fossil is trendier. It has the ability to be trendier. But this also means it can rise and fall with customer whims. Many customers purchase multiple fashion watches per year. They may own 3-4 different fashion watches and alternate them based on whether they are at work, on a date, or even what outfit they are wearing. Some of Fossil's licensed brands – like Michael Kors – appeal much more to women than to men. So, there are big differences between a watchmaker like Fossil and a watchmaker like Swatch. In fact, while we think of Fossil and Movado as being comparable – we don't consider Swatch to have any of the same risks Fossil does. Fossil has fashion risk. Swatch has China risk and luxury risk.

The durability of Fossil's licenses is probably very good. Generally, fashion labels don't switch who they license their brand to for the manufacture of watches. Fossil and Movado don't lose watch licenses.

Fossil's licenses for Adidas, Burberry, and Karl Lagerfeld expire at the end of 2017. Tory Burch expires at the end of 2018. DKNY expires at the end of 2019. Marc Jacobs at the end of 2020. Michael Kors in 2021, Armani in 2023, and Kate Spade in 2025. So, none of the licenses expire until about 2 years from today. And Michael Kors – which is the most important brand – doesn't expire for another 6 years (it was recently renewed). Even when a license expires, the odds are it will be renewed. So, taking the time till expiration and the odds of a non-renewal together – there's really not much risk presented by license expiration in terms of probabilistic damage to the net present value of the stock.

The real risk to durability is that Michael Kors tanks. Michael Kors may be a fad. It's a huge watch brand. In 2014, Fossil's sales from the Michael Kors brand was $923 million. This is many, many times the size of the average licensed watch brand.

Here is Fossil's Chief Marketing Officer talking about who buys these watches: "…let's call it the fashionable or the fashionista. That is a predominantly female segment. Think Michael Kors, Tory Burch consumer. They buy 2 to 5 watches (a) year, they have a large collection of watches, they rotate based on their outfit and whether they're going to work, whether they're going to a club, or whether they're going to dinner."

The last risk to durability is technology. Some investors believe smart watches pose a threat to companies like Swatch, Movado, and Fossil. Quan and I don't. People don't wear watches to tell time. Everyone who wears a watch also carries a cellphone that tells the time. People may want to wear activity trackers, smart watches, etc. It's unclear if they will wear them instead of watches. And it's unclear if there's much overlap between people who wear quartz and mechanical watches and people who wear smart watches. Many people who wear an Apple Watch like Apple products – they don't like watches. Quan and I aren't worried about watch companies like Swatch, Movado, and Fossil going away because people buy smart watches from companies like Apple. We are worried that watchmakers like Swatch, Movado, and Fossil may acquire companies and invest money in trying to develop their own smart watches and then fail to sell these watches.

We'll have more discussion of this topic in capital allocation. Fossil recently bought a company that makes wearables. And Fossil will sell both non-watch wearables (like activity trackers) and smart watches. There is a difference with some of the smart watches made by a watch company like Fossil or Movado and those made by a tech company. A smart watch made by Fossil tends to look like a low-tech fashion or even luxury watch. It then just has some added high-tech features. Pretty soon, all watchmakers will sell this kind of watch. Fashion watches and luxury watches may add some high-tech features. That's not our concern. Our concern is whether low-tech watchmakers will lose focus and allocate capital poorly by spending time and money chasing the smart watch market. That is more of a capital allocation risk than a durability risk though. We're not worried that people will stop buying watches made by companies like Swatch, Movado, and Fossil because they are instead buying smart watches made by tech companies. That may be a concern some investors have. Fossil is a heavily shorted stock. And the threat of smart watches could be one of the reasons why people short the stock. It's not a concern Quan and I have. So, it's not something we'll be talking much about in this issue.

MOAT

Fossil Has a Wide Moat in U.S. Fashion Watches

A watchmaker's moat comes from its distribution power. Production costs are not an important part of watchmaking. Getting good licenses is important. And getting into the right department stores, jewelry stores, etc. is important. The gross margin at which a watchmaker can sell its products is also important. This is determined by the bargaining power of the seller and the buyer. In the U.S., the buyer of watches is often a department store chain. In Europe, the buyer is often a mom and pop jewelry store. In Asia, it is likely the watches will be sold directly to the people who will wear them through concessions in a shopping mall that are manned by employees of the watchmaking company. This means a watchmaker's market power will always be lowest in the U.S. where retailers are best organized and most powerful. Fossil is stronger in the U.S. than Swatch. It is weaker in Europe and especially Asia than Swatch. However, Fossil is strong in licensed brands. This is an area that companies like Swatch and Richemont – who focus on company owned luxury watch brands – do not pursue. That leaves Fossil and Movado with most of the good licensed watch brands. Fossil's licensed watch business is seven times the size of Movado's.

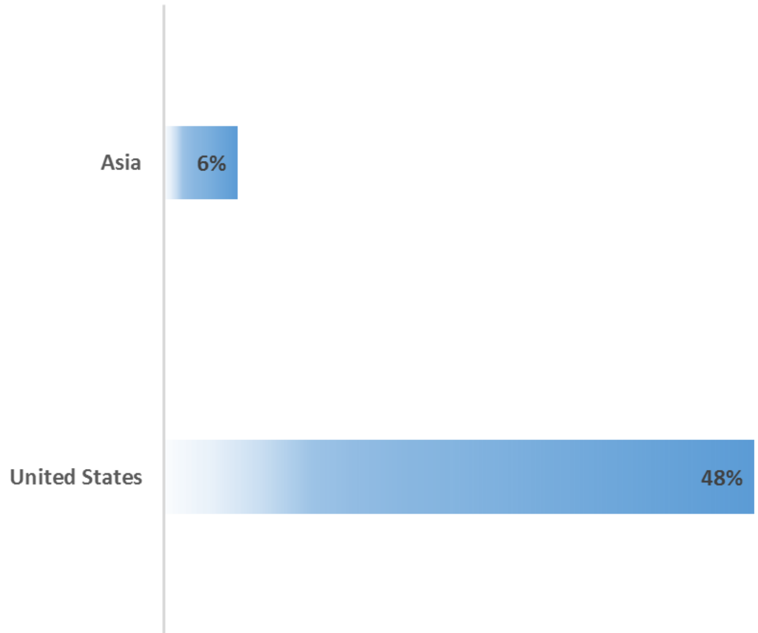
Fossil has about half of the U.S. market for watches that retail below $1,000. This means the company has large scale. For example, it sells maybe 30 million watches a year. That sounds impressive. But economies of scale in producing are not important in the watch industry. Watches are not sold on the basis of cost. Even cheap watches have high gross margins. Customers are willing to pay far, far more than a watch costs to make. And simply making the cheapest possible watches in huge quantities and then undercutting the competition on price isn't a viable strategy. Why not? Because the key to getting watches in places people want to buy them is producing enough gross profit for the retailer who displays the watch. A department store chooses to carry a watch brand because it generates a sufficient amount of sales per square foot for the store. If another watch brand could sell more in dollars while taking up less space in square feet – the retailer would buy that watch instead.

So, watches are sold based on brand name, design, and features rather than on price. In fact, it is best for a watchmaker to have a range of high and low priced watches to offer a department store. A watchmaker that had only the lowest cost watches to sell would not get into department stores because a department store wants a range of watches to offer its customers at different prices. And a department store doesn't want to sell the greatest unit volume of watches. It wants to generate the most gross profit per square foot for the store. The way to do this is to buy a wide assortment of watches from a few companies that offer a variety of different licensed brands at a variety of different prices. That's what American department stores do. They buy mostly from Fossil and Movado.

Fossil has a lot of advantages over Movado in licensed watches. Fossil has its own retail presence. Movado closed its boutiques after they lost money for years. Fossil has Fossil branded stores. And Fossil also has Watch Station stores. Fossil also sells accessories like leather goods. Movado doesn't. Movado's lead time is about 6 months. Fossil's lead time is about 10 weeks. So, Fossil can get its designs to market more than twice as fast as Movado.

The real question when looking at moat is how much another company could hurt the company we're looking at. In other words, how much damage could Movado do to Fossil? How much damage could Swatch do to Fossil? How much damage could a new entrant like Apple do to Fossil? The answer is probably very, very little. In that sense, Fossil has a wide moat. Competitors can't do much harm to Fossil. Instead, Fossil's success and failure as a business has to do with its own decisions, its own brands, its own designs, and also the bargaining power of retailers. In fact, the cap on Fossil's margins comes more from the power of department stores to negotiate for good prices rather than the threat of Movado or another watchmaker taking a lot of space in the display case, or forcing Fossil to lower prices to compete, or winning a license from Fossil.

Fossil has been very successful in winning new licenses. In fact, Guess wanted to switch to Fossil but stayed with Timex after Timex sued Fossil claiming there would be an anti-trust problem if a license as big as Guess went to the already dominant licensed watch company. Movado and Fossil don't tend to lose licenses. It's possible Michael Kors was able to negotiate for better royalties from Fossil. However, no licensed watch brand has ever been remotely as big as Michael Kors. So, this is a one-time occurrence. And Michael Kors may not be popular enough in 5 years – when the license is up for renewal again – to demand a better than normal royalty structure.



For watches priced below $1,000 USD, Fossil is the market share leader in the U.S. (with 48% market share) but a very distant also ran in Asia (where Fossil has just a 6% market share)

Licensed brands tend to stick with the same watchmaker. And while watchmakers do want to win more business – they aren't especially aggressive in going after other competitor's licensed brands.

Competition for licenses exists. But it's a lot like competition for ad agency clients. Competition is oligopolistic. If you have a fashion brand you want to license for use on watches – you go to Fossil or Movado or you seek out another company like Timex or maybe Swatch or one of the Japanese watchmakers. By far, your most likely choices are Fossil or Movado. The other watchmakers have a much smaller stable of licenses. And they seem much less interested in winning any new licenses. When you pick a watchmaker, you sign an agreement giving them the license to make watches using your fashion brand for the next 5 to 10 years. As a fashion brand owner, the quality and style and the kind of lifestyle associated with your watches is important. The financial benefit is probably less important. To illustrate, Michael Kors branded watches generated revenue of more than $900 million last year. That's an anomaly. Few watch brands sell more than $100 million. Movado says it really only wants brands that can make $40 million to $50 million. It's reasonable to think a good fashion brand licensed to the right watchmaker could – with a lot of time and effort – generate sales of say $100 million plus or minus $50 million. So, maybe your fashion brand could sell $50 million to $150 million worth of watches. The licensing agreement you would sign with Fossil or Movado – or some other watchmaker – would only provide for royalties in the 10% to 20% range. Realistically, even a very successful watch brand license isn't going to make you – the brand owner – more than say $5 million to $30 million a year. And it's probably going to be much closer to $5 million than $30 million. Look at the names on licensed watches. They are companies like Guess (made by Timex), Calvin Klein (made by Swatch), Polo Ralph Lauren (made by Richemont), Hugo Boss (made by Movado), and Michael Kors (made by Fossil). These are huge fashion brands with large amounts of EBIT each year from their other operations. Guess had $125 million in EBIT last year. Michael Kors had $1.2 billion in EBIT. Can a fashion brand get 10% of its profit from licensing its name for use on watches? Yes. It can maybe get 10% of profit from licensed watch sales if it is one of the most successful licensed watch brands in the world. For all of these fashion companies, this is a sideline. Getting a slightly better royalty rate by switching from Fossil to Movado or vice versa would be very tricky. The disruption from switching is high. Historically, companies have renewed their licenses when they've expired. There are few examples of big, successful brands even wanting to switch. Guess is the best example. And it was a license that wanted to switch to Fossil not away from it. It seems that competition for watch licenses can be like competition for ad agency clients. The biggest, most successful licenses are often the happiest. Small and unsuccessful licenses may switch multiple times. For example, Ferrari has granted its license to a few different watchmakers. They were all smaller. And Ferrari was eager for changes. Overall, licensed watchmakers have wide moats because they have a high retention rate for licensed brands and they rarely compete by offering higher royalty rates to keep a license. Over time, this is one area that could become a problem. It's possible that the renewal of key licenses like Michael Kors can be done at higher and higher royalty rates. The two biggest risks to Fossil's moat are pressure from department stores and pressure from the licensors rather than rivalry between watchmakers to win licenses. As is typical in a duopoly, the presence of Movado helps both department stores and licensors play Fossil against Movado and Movado against Fossil in a way that would be impossible if there was a monopoly. Fossil will always be in a duopoly at best and an oligopoly at worst. It's never going to gain monopoly power in licensed watches. It is in the interests of both department stores and licensors to keep an alternate choice – even if it is a much, much smaller alternate choice like Movado – alive to prevent Fossil from ever exercising monopoly power in licensed watches. Both department stores and licensors benefit from dealing with a company that has tremendous scale. So, a consolidated licensed watch market is good for them. But, a monopoly licensed watch market would be bad for them.

QUALITY

Fossil Can Earn a 30% After-Tax Return on Equity Without the Use of Debt

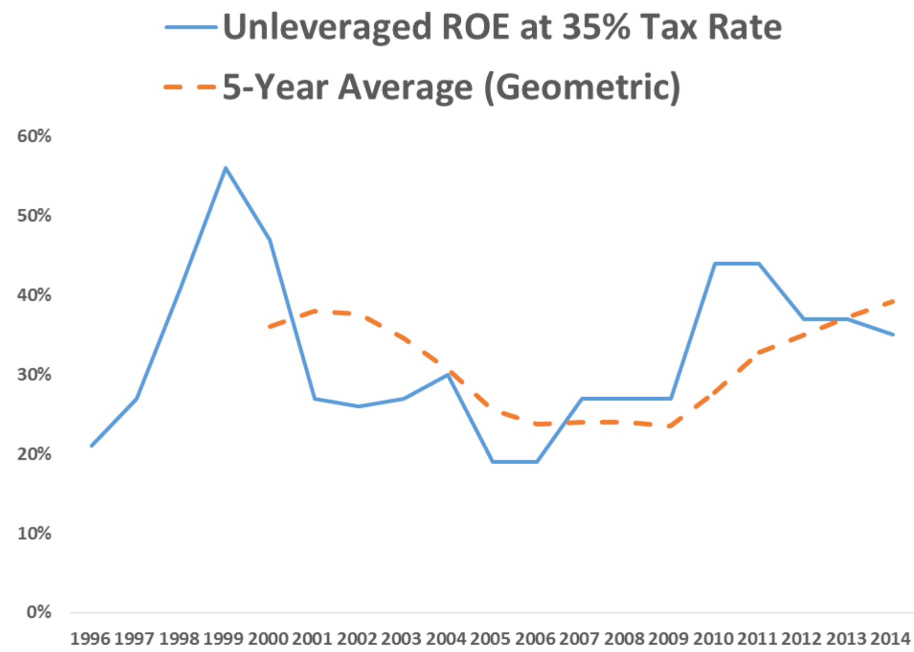
Fossil's business quality is high. The company is capable of earning a 30% after-tax return on equity. Fossil's gross profitability is very high. The company's cost of goods sold divided by average finished inventory (its inventory "turns") is 3. Movado's is 2. Richemont's is 1.4. Fossil's gross margin in the U.S. is 50% to 55%. That's a very high level of gross profitability. Outside the U.S., Fossil's gross margin would be higher. However, inventory turns could be lower in places like Asia. Generally, luxury watchmakers and companies that sell a lot in Asia – like Swatch and Richemont – can have higher gross margins but lower asset turns. It's possible for Fossil to achieve returns on equity as high as a luxury watchmaker even while having a lower gross margin. This is because of high inventory turns. Fashion watches sell quicker than luxury watches.

The quality of Fossil's retail operations is difficult to judge. From 2006 to 2014, the retail segment had an EBIT margin in the 10% to 14% range with two exceptions. In 2007, the margin was just 9%. In 2008, it plunged to 4%. That margin is before corporate expenses. Once you allocate the retail segment's share of corporate expenses to those stores – it's possible they lost money or at least didn't really turn a meaningful profit for Fossil in 2008. However, 2008 was the worst year for retail in a long time. Fossil's retail business is – compared to other watchmakers – skewed toward the U.S. So, the performance in 2007 and 2008 wasn't bad considering the performance of other sellers of watches in the U.S. in those same years. The difficulty in judging the retail segment's quality comes more from what has happened since The Great Recession. Fossil had 188 stores in 2006, 231 in 2007, 311 in 2008, 349 in 2009, 360 in 2010, 398 in 2011, 473 in 2012, 543 in 2013, and 593 in 2014. From 2009 through 2014, we are in a period of recovery for retailers of fashion watches and accessories. And it wasn't a bad period for the Fossil brand. It's possible that Fossil's sales growth was due to expansion of the number of stores. And it's possible that this was an entirely benign period for the Fossil brand. Other retailers have periods in their history where the brand fell out of favor. Having a record of such lean times helps judge the quality of the retailer over a full fashion cycle of being in and out of favor and of good and bad economic times. We have financial results for the tough economic times in 2007 and 2008 for Fossil's stores. But, that's about it.

A lot of fashion retailers have EBIT margins in the neighborhood of 10%. But, the way they achieve these margins can be very, very lumpy. For example, over the last 10 years, Abercrombie & Fitch has had EBIT margins as low as 1% and as high as 20%. American Eagle has had margins as low as 5% and as high as 21%. Even Gap – which has multiple brands that wouldn't all be in or out of favor at the same time – has ranged from a low of 7% to a high of 13%. Fashion retail is more cyclical than the results we see from luxury watchmakers. Fossil has some fashion risk simply being a maker of fashion watches. But it also sells some watches and accessories itself. A retailer has additional risks that a maker of the product does not have. This is because retail has extremely high fixed costs. For example, a fashion retailer with a 10% operating margin may actually have a 30% margin before rent expense and then pay 20% of sales in rent. This is the situation Fossil's retail business is in. If we take Fossil's total rent expense (not just for stores, but for corporate offices as well) it can be as high as 20% of the retail segment's sales. As a company, Fossil's long-term financial record suggests that pre-tax results as high as a 50% return on capital and a 30% after-tax return on equity are achievable. However, it's important to remember that a fashion retailer always has excellent returns on capital except in those few disastrous years for the brand where it makes little or nothing after rent expense.

Fossil's market power is strong. The company's relative size in the U.S. is good. Department stores are big in the U.S. But Fossil has 50% market share in watches from $100 to $1,000. No department store sells anywhere near 50% of the watches in the U.S. So, Fossil is relatively bigger in watches than any one of its customers. In Europe, the retailers Fossil sells to are smaller. And Fossil can charge them 5% to 10% more than it does U.S. department stores. All watchmakers charge the relatively weaker mom and pop stores in Europe more than the big U.S. department store chains. Fossil is seven times the size of Movado in licensed watches. Fossil's size relative to competitors in both licensed watches and watches below $1,000 (so not luxury – but fashion watches, affordable watches for the masses, etc.) is huge. Fossil is relatively huge compared to other companies selling non-luxury watches in the U.S. The next closest competitor is Movado.

Fossil's quality depends on its market power in the sense of bargaining power with department stores and with licensors. A big part of what Fossil does is act as the middleman that hooks up the world's best fashion brands with America's best department stores. It brings these brands and these stores together. Shoppers at these department stores wouldn't want unbranded watches. They want watches with the best known names in fashion on them. And these fashion brand companies can't sell their watches directly. They will get the most profit selling them in the right environment – a department store display case. Fossil's profitability depends on how much assets it ties up in production, distribution, etc. – basically how quickly it can turn its



Over the last 20 years, Fossil has tended to earn a 20% to 40% after-tax return on equity

physical products – combined with how low a royalty rate it can give licensors and how high a price it can charge department stores. Competition based purely on those numbers may not be as great as you think. A lot of licensors are probably getting the same royalty rate. And a lot of fashion watches are probably sold to department stores at the same mark up. What matters then is getting the shelf space. There is a limited amount of space that a department store is going to dedicate to watches. So, Fossil needs to get as much real estate as possible. The way to do this is to have a whole collection of different watches to sell at different prices. The other way to sell more watches is to have company owned brands and company owned stores and to sell these watches in locations with other accessories. So, Fossil's quality can come from the ability to sell Michael Kors watches next to Burberry and DKNY and Fossil and Skagen watches. Movado can offer something similar. Movado can offer a department store the possibility of a Coach watch next to a Tommy Hilfiger watch next to a Movado watch. These two are really the only companies that do this. Fossil is seven times the size of Movado in this area. But, the biggest difference is in the other channel it can sell through. Fossil owns Watch Station stores that can sell watches from different brands in the same place – and outside of department stores. And it also has Fossil stores where it can sell watches next to leather goods and sunglasses. It can also sell Skagen products next to Fossil products. This is the one area where Movado has really failed. Movado was unable to get the critical mass necessary in retailing to sell much of anything outside of department stores in the U.S. It had Movado boutiques. And the Movado brand is a very strong accessible luxury brand in the U.S. But, it's basically a luxury watch brand. They couldn't move into jewelry or support the Movado brand with selling other brands in the same store or selling accessories beyond just watches. This is something Fossil has had success doing over the last 10 years. It's hard to judge how important this difference between Movado and Fossil is. But, I'd say it has the potential to be very important. Fossil can sell a lot of leather goods. And Fossil can potentially grow Skagen into another big brand. Movado was never able to do this. Fossil is more diversified than Movado. It has more market power. Fossil is the wider moat company.

CAPITAL ALLOCATION

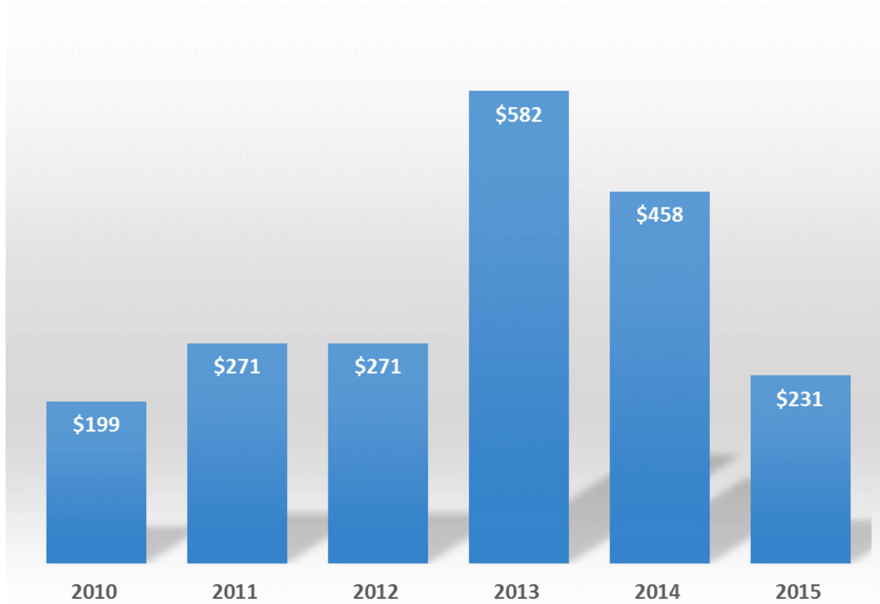
Since 2010, Fossil has Borrowed Money, Bought Back Stock, and Acquired Skagen and Misfit

Historically, Fossil did not use debt. However, Fossil now has about $760 million in net debt.

Fossil's main use of cash in recent years has been buying back its own stock. From 2010 through 2015, Fossil spent about $2 billion on share buybacks. The company spent $199 million in 2010, $271 million in 2011, $271 million again in 2012, $582 million in 2013, $438 million in 2014, and then $231 million last year. Buying back stock makes sense given the way the CEO is compensated. Kosta Kartsotis does not get any pay from Fossil. He owns a little over 12% of the company.

From 1992 to 2012, Fossil paid out almost nothing to shareholders. Sales compounded at 24% a year. The company started with $74 million in sales in 1992. By 2004, sales hit $960 million. So, the return to shareholders was excellent – but achieved purely through growth. Not through dividends or stock buybacks. EBIT growth mirrored sales growth during this period.

Capital allocation was very different from 2004 through 2014. Fossil spent $2 billion on stock buybacks. However, it generated over $200 million from different forms of stock issuance to employees (stock options, etc.) that should be excluded. The company had to spend $200 million just to offset the dilution that would be caused by granting options to employees. Fossil also borrowed $519 million. So, this was not cash generated from operations either. The company's actual cash generated from operations and then paid out to shareholders – through stock buybacks – was about $1.26 billion over the years 2004 through 2014. Sales and EBIT grew by about 15% a year during this time.



Over the last 6 years, Fossil has spent more than $2 billion on share repurchases

Fossil doesn't pay dividends. It does buyback stock. The company doesn't seem to try to time stock buybacks. This can be a problem. For example, Fossil may simply buy back stock when it has the free cash flow to do so – which may tend to happen when the stock is expensive. When free cash flow declines, the company may stop buying back stock. Or it may spend less on share buybacks. This means it might do worse than an investor who simply averages into Fossil stock by buying the same dollar amount each week, month, year, etc. That tends to be what happens to companies that buy back their own stock without regard to timing or price. For example, Fossil bought back stock in every year from 2003 through 2015 with the exception of 2009. This can show that Fossil won't buy back stock as much during a crisis or immediately following a crisis. That is often the best time to buy stock. So, Fossil may not do a good job timing stock buybacks. Doing a bad job of timing stock buybacks doesn't mean the buybacks will be worth less than if they were paid out as dividends. It could mean that. But, if the underlying stock performs well enough – as Fossil shares did for much of the 2000s – that wouldn't be the case. For example, if a company grows its sales and EBIT by close to 15% a year – it can buy back stock at an average price that is rather high in relation to earnings, and still get a decent return on the stock it buys back.

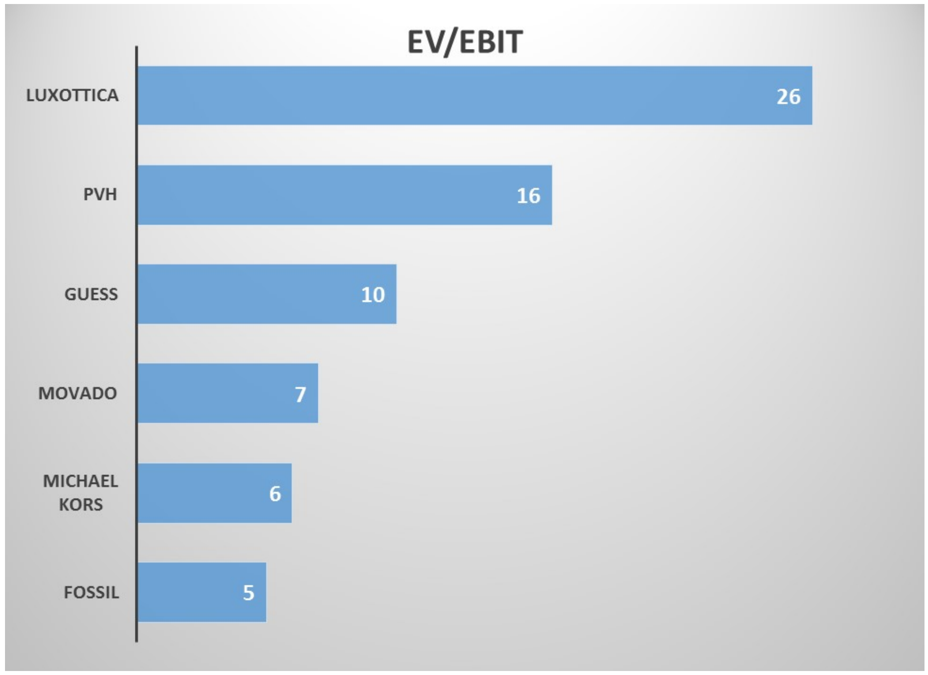
Fossil has also used some cash to make acquisitions. In 2012, Fossil bought the Skagen brand. Fossil paid $230 million for a company with $120 million in sales. Skagen's EBIT margin was 17%. So, Fossil paid a little over 11 times pre-tax profit. This is only an okay price if Fossil doesn't get much growth or synergies out of owning Skagen. However, it's a very reasonable price to pay for a brand if that brand will perform better once part of Fossil. In fact, today many publicly traded companies go for 11 times EBIT – or even higher. So, this is not very different from the price a pure financial buyer would pay. There's no sign in the Skagen acquisition that Fossil is an overly aggressive acquirer. The brand is a very close fit. It was already profitable. And the purchase price both in terms of price-to-sales and price-to-earnings was reasonable. Skagen is a Danish brand with products that are very, very similar to those that Fossil sells. The acquisition was a natural fit. And the price paid was an acceptable one. By 2014, Skagen's revenue had grown to $150 million. This deal can work out fine for Fossil.

The Misfit acquisition is more worrying. Misfit makes an activity tracking bracelet. Fossil paid $260 million for a company with just $30 million in sales. Fossil said it was making this acquisition for Misfit's battery technology and its app. Fossil has always preferred vertical integration. Fossil didn't want to outsource the software part – the app and the cloud services – of the activity tracker product. Fossil wanted to enter "wearables" and this acquisition gives it technology it can use to do so.

However, there are several problems with this deal. It's unclear if smart watches and wearables will be a big market anytime soon and if they are whether they will be profitable for watchmakers like Fossil. The price-to-sales paid here was astronomical. The deal also adds $260 million in debt when Fossil has too much debt. Historically, Fossil kept debt to basically nothing. Now it has net debt that is over 1.3 times EBIT. Michael Kors sales are declining. If Fossil's EBIT declines further it will be carrying a debt load that is 2 to 3 times its EBIT. This is a lot for a watchmaker. Companies like Movado and Swatch have often had net cash. Even Fossil rarely used debt. Now, it has spent over $2 billion on stock buybacks in about 6 years while also making its most transformational acquisition yet. It's possible that Fossil has made a smart move because it would've spent more than $260 million developing hardware and software technology on its own to enter this market. But, it's not clear that activity trackers are an area worth entering. And, even if they are – now might not be a good time for Fossil to take on this much integration risk and financial risk. Fossil stock is riskier today because the company chose to acquire Misfit. It's a risk Fossil didn't need to take.

VALUE

Fossil's Valuation Relative to its Fashion and Watch Peers Makes No Sense – The Stock is Clearly Too Cheap



Fossil is trading at a 20% discount relative to its biggest licensor (Michael Kors) and a 30% discount relative to its closest peer (Movado)

Fossil is an extraordinarily cheap stock. Right now, it trades for about 5 times EBIT. Michael Kors goes for 6 times EBIT. Movado for 7 times EBIT. Fossil is a safer stock than Michael Kors. And it has a stronger competitive position than Movado. One way of thinking of Fossil's cheapness is to compare it with these two companies. Michael Kors is Fossil's biggest license. And the biggest risk to Fossil – other than the financial risk of Fossil's almost $750 million in net debt – is the risk of a big decline in sales of Michael Kors watches. This would happen because the Michael Kors brand falls out of favor. That's obviously a bigger risk to Michael Kors the company than it is to Fossil – which gets somewhere between two-thirds and three -quarters of its profits from things that have nothing to do with the Michael Kors brand. Michael Kors stock is 100% exposed to the Michael Kors brand. Fossil is less than 30% exposed to the Michael Kors brand. About 74% of Fossil has nothing to do with Michael Kors. So, it's silly for Fossil stock to be cheaper than Michael Kors stock if the biggest risk to Fossil is Michael Kors. I think the biggest risk to Fossil is Michael Kors. But, it's worth mentioning two other risks that can affect the value of Fossil's stock. One is the debt. Fossil has about $300 million in cash and $1.06 billion in debt. That second number is a problem. It would be better if Fossil didn't use debt. Now is a particularly bad time for the company to have debt. The stock prices of watchmakers like Fossil and Movado are cheap. It would be terribly expensive for them to ever have to raise cash by issuing stock. It would be terribly expensive for them to acquire anything using their own – very undervalued – shares as currency. And it would be great if Fossil could be buying back its own stock right now since it is so cheap. But, that's not a good idea when a company has so much debt. In theory, the debt load Fossil has is manageable. But the timing of having this much debt when the stock market has such a pessimistic view of the company is bad. So, Fossil's timing turned out to be awful. This can happen when you buy back stock without regard to the price you are buying back at or trying to time your purchases when the market is pessimistic.

Fossil's enterprise value is about $2.5 billion right now. In 2014, the company had EBIT of $567 million. So, the company sells for less than 5 times its peak pre-tax profits. The company's tax rate is a blend of U.S. taxes (about 35%) and taxes in the rest of the world (almost always lower) that works out to an average tax rate around 30%. An EV to EBIT of 5 works out to a P/E of 7. That's obviously a very, very cheap stock. However, that was a peak EBIT number. It was based on very good sales out of Michael Kors. We estimate that Michael Kors sales were less than $100 million in 2009, then $193 million in 2010, $300 million in 2011, $730 million in 2013, and an incredibly high $923 million in 2014.

It's possible that Fossil's sales might have been as much as $500 million higher in 2014 than they would be in "normal" times for Michael Kors. Michael Kors is the biggest licensed watch brand around. And not by a small amount. Armani watches bring in about $300 million in sales. Fossil's other established watch licenses average maybe $130 million each. Michael Kors had $923 million in sales in 2014. If Michael Kors declined to the level of an Armani it would mean Fossil would lose $623 million in sales. If it declined to the level of a typical Fossil license, it would mean Fossil would lose about $800 million in sales. How likely is that?

It's hard to say. Michael Kors is a huge brand. It's a very big watch brand in relation to the brands overall sales of other products. But Michael Kors is a big brand that could continue to be the biggest – or one of the biggest – watch licenses for many years. Fossil also has the license to Michael Kors for about 6 full years till expiration (the license was just renewed).

So, how much is Fossil's "normal" EBIT? Well, Fossil made $472 million in EBIT in 2011. Michael Kors was "only" a $300 million watch brand back then. It's a $923 million brand now. A drop of $623 million in Michael Kors sales would obviously cause big declines in EBIT as Fossil adjusted to lower sales, as inventory was sold off, etc. But, eventually, Fossil's "normal" EBIT if Michael Kors again sold at 2011 type levels would be an EBIT of more than $400 million. That's a very safe assumption if we know that in 2011 Michael Kors had only $300 million in revenue and Fossil made $472 million in EBIT. So, let's take $400 million as a conservative EBIT figure for Fossil once the Michael Kors brand has cooled. Think of it this way. If Fossil's EBIT declines to $400 million, then the stock would trade at the equivalent of a P/E of 10 when it had an EV of $2.8 billion ($2.8 billion divided by $400 million in EBIT equals an EV/EBIT ratio of 7. At a tax rate of 30%, an EV/EBIT of 7 is equivalent to a P/E of 10). A P/E of 10 is low for even a slow or no-growth stock. Fossil is a high ROE stock with a history of good growth. It has net debt of about $750 million. It has 48 million shares outstanding. It would still be cheap at an enterprise value of $2.8 billion. That means it would still be a cheap stock when it trades at a price of $42 or less per share. This would be like having a debt free P/E of 10 once Michael Kors has cooled as a watch brand. As I write this, Fossil's stock price is $29 a share. The stock could rise about 50% and still be cheap. In fact, it might need to double just to get to "fair value" in "normal times". There are risks. Michael Kors could be a fad that doesn't just fall to Armani like levels of $300 million in sales but all the way to almost nothing. Fossil is a heavily shorted stock. Those shorts obviously expect some very bad things to happen. And there is some financial risk in the stock and a lot of fashion risk. But, Fossil is a definite value stock. The stock would need to rise nearly 50% just to get from "very cheap" to plain "cheap". It is cheaper than Michael Kors, cheaper than Movado (which is an inferior peer), and cheaper than Guess (which has similar fashion risk to the Fossil brand). Fossil seems mispriced compared to all peers. It's extraordinarily cheap both as a stock generally and as a fashion watchmaker specifically. It's cheap versus other watchmakers. And it's cheap versus other fashion companies.

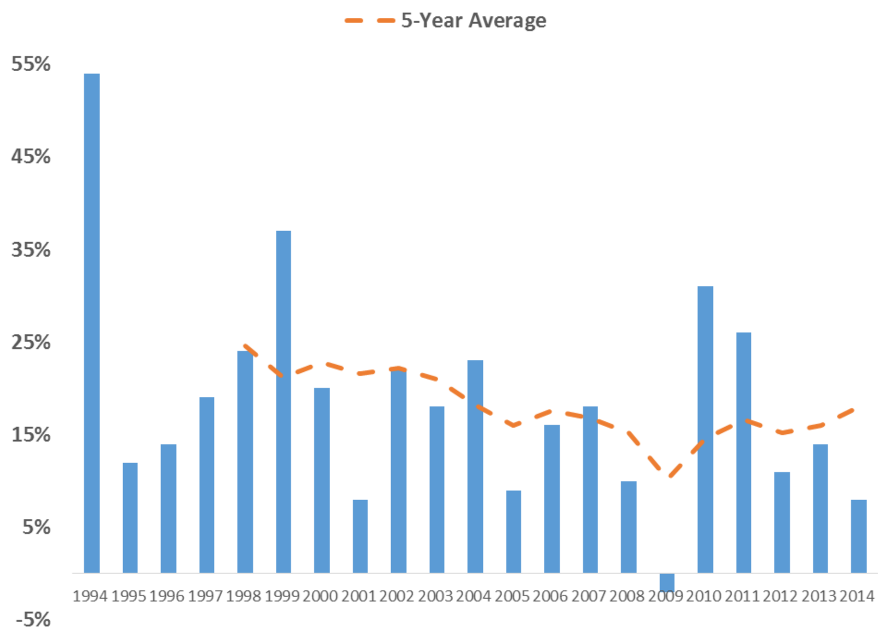
GROWTH

Fossil Has Been a Growth Stock for Over 20 Years

Fossil is a high growth stock. It has historically grown its sales, earnings, etc. at a very rapid annual rate. The company also has several possible avenues for future growth. One, Fossil could sell more leather goods. Leather is just 12% of Fossil's total revenue. And the leather goods market as a whole is actually bigger than the watch market. Two, Fossil could grow jewelry sales. Jewelry is just 8% of Fossil's total sales. Jewelry is a huge market. However, the market for branded jewelry is only about 20% of the total jewelry market. Branded jewelry was just 10% of total jewelry sales in 2003. So, the market share of branded jewelry has more than doubled since the turn of the millennium. McKinsey expects branded jewelry will be 30% to 40% of the total jewelry market in the 2020s. That means the branded jewelry market could double again over the next decade or so even if overall sales of jewelry don't grow fast at all. Fossil sells just $280 million worth of jewelry. So, this is a big area where the company could grow. It has a retail presence through Fossil branded stores. The company may be able to sell some leather goods and jewelry over time using the popularity of the Fossil name as a fashion watch brand. In the recent past, leather goods have not been fast growing product lines for Fossil. In fact, the company's leather goods sales have been relatively flat since the financial crisis. The story is different with jewelry. Fossil sells its jewelry through the same channels as its watches. The company's jewelry brands include Fossil (an owned brand), Skagen (also an owned brand), and then Diesel, DKNY, Emporio Armani, and Michael Kors – all of which are licensed brands. Fossil's jewelry sales have grown 11% a year over the last 6 years. They basically doubled from the financial crisis to today. The third avenue for growth is the Skagen brand. Fossil's management believes Skagen can be the next Fossil. Fossil is a $2 billion brand at retail. In theory, a brand like Skagen could one day be ten times the size it is now. It could also stay the same size it is now forever. The brands growth will depend on both the public's taste and Fossil's own efforts to push Skagen through the channels it sells its Fossil products and its licensed products. Fossil has a strong platform in the U.S. for pushing the Skagen brand. And you can now see Skagen watches next to Fossil watches in the display cases of U.S. department stores like Macy's.

One long-term source of growth for Fossil is international sales. Fossil is more like Movado than like Swatch and Richemont when it comes to geographic distribution of sales. Fossil get 45% of its revenue from the U.S. Europe brings in another 34% of revenue. By far the biggest country in Europe for Fossil is Germany. Fossil gets a full 17% of its worldwide sales from Germany. In fact, all the rest of Europe combined doesn't quite equal Fossil's sales in Germany. So, the U.S. is a huge market for Fossil. And then Germany is a really big market. The rest of Europe is a big market with another 17% of revenue. Asia brings in 16% of sales.

Fossil's market share probably has a lot to do with how watches are sold in each region. In the U.S., department stores are powerful. Fossil controls both the Fossil and Skagen brands and licenses for many other fashion brands. Department stores in the U.S. rely heavily on Fossil and to a much lesser extent Movado. Fashion watches are a very big part of the U.S. watch market. In the U.S., watches are bought more for fashion and less for craftsmanship. There are many reasons why this may be. The strength of department stores can be part of it. The huge size of the U.S. "middle class" can be another reason. Mid-tier watches are considered to be watches below $1,000. In the U.S., there are many millions of people who could afford multiple watch purchases in this price range each year. In other countries, this may be far less true. In the U.S., fashion



Over the last two decades, Fossil compounded its revenue at 18% a year

watches account for 53% of all watches priced below $1,000. In Asia, fashion watches are only 18% of all watches priced below $1,000. That means Fossil has a huge theoretical growth opportunity in Asia. Fossil could benefit enormously from the growth of a middle class of consumers in places like China, India, and Vietnam. This growth may be harder for Fossil to capture than you'd think though.

Companies like Swatch and Richemont are strong in Asia specifically and emerging markets generally. They are weaker in the markets where Fossil is strongest. For example, Fossil is very strong in licensed watches, sales to department stores, and sales in the U.S. Swatch is weak in those areas. Fossil is weakest in sales of high end watches, sales in Asia, and sales through concessions and mom and pop type retailers – Swatch is strong in those areas. To grow in Asia, Fossil had to open concession stores. These are locations in malls run by Fossil's own employees. Fossil had to do this because of the lack of privately owned department stores with nationwide reach in China. In the U.S., there are for profit department store chains throughout the country as a whole or with many stores in one region. You simply need to convince buyers at Macy's, Nordstrom, Saks, Belk, J.C. Penney, etc. that your watches will generate more gross profit per square foot than another product – a competitor's watch or any other product that can take up floor space. In China, it probably doesn't work that way. Department stores are usually not part of chains with national reach. Many department stores have just one location. Some are owned by local governments. The foreign watch companies that get space seem to be the ones who have been in those countries the longest. There is also probably more government involvement, bribery, and other non-purely capitalistic incentives at work. We can't prove that. But it can be a continual hindrance in places like China, India, and Vietnam. Obviously, some watches do get sold into countries even where Fossil has a weak retail presence. For example, you can see licensed watches like Marc Jacobs and Michael Kors in Vietnam even though there's no dealer selling those watches in the country. People buy the watches online via Amazon. This shows an appetite for fashion watches and for licensed brands. But, it also shows the difficulty of getting retail space in Asia. There are probably a lot of people in China, India, and Vietnam who would be buying Fossil watches if the company had the kind of retail presence it has in the U.S. But, Fossil may never be able to get the kind of retail presence it has in the U.S. in other countries. Certainly, companies like Swatch are more determined to compete for space in these markets than they are in the U.S.

Fossil's sales in Asia had been growing strongly after the financial crisis. Sales were up 46% in 2010, 34% in 2011, 25% in 2012, 12% in 2013, and 12% again in 2014. However, Fossil's Asian sales plunged 10% in constant currency last quarter. Fossil blamed macroeconomic factors in Asia. That's likely. However, the decline in popularity of the Michael Kors brand may be another factor.

Historically, Fossil was a very high growth stock. See the datasheet at the beginning of this issue for details from the 1990s through today. Double-digit sales growth was common in most years. It's hard to know how much Fossil will grow in the future. It can grow by opening new Fossil stores, opening new watch station stores, selling more leather goods, selling more branded jewelry, growing the Skagen brand, gaining new fashion watch licenses, and improving its retail presence in Asia. The global watch market is predicted to grow 6% a year over the next 5-10 years. If Fossil grew its sales at 6% a year, it could still pay out 75% to 80% of its earnings in dividends and stock buybacks. It could also use those earnings to pay down debt or make acquisitions. Fossil has a 30% after-tax return on capital. So, at a "normal" mature company growth rate of 5% or 6% a year it would have a lot of free cash flow. Fossil needs to retain very little of its earnings to grow at a nominal GDP type growth rate. This makes whatever growth Fossil does achieve very valuable.

MISJUDGMENT

Fossil Has More Debt Now Than It Has Ever Had in the Past

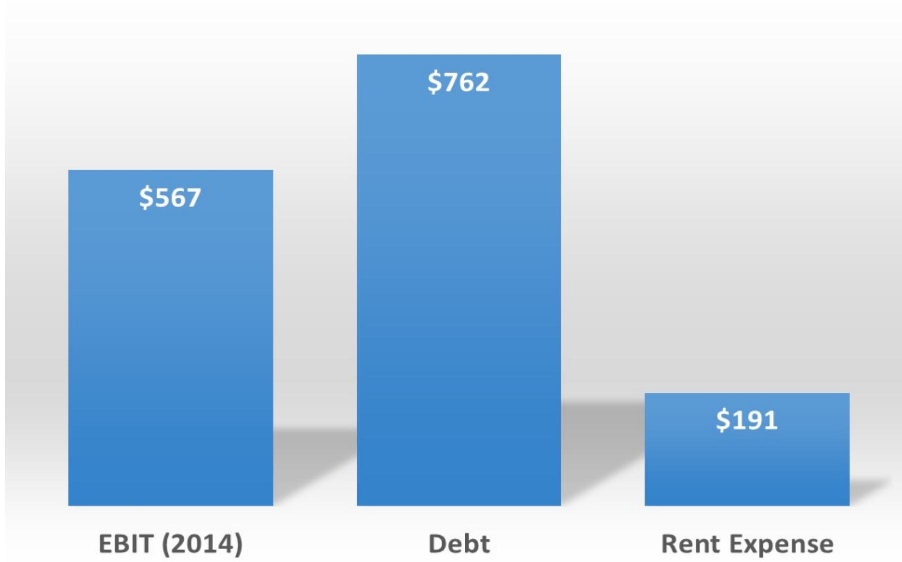
Fossil stock is very cheap right now. But Fossil is also at its riskiest right now. The company faces several risks. The low stock price more than makes up for these risks. It's an incredibly low price for any stock. But, Fossil had historically been a safer and more predictable business than it is today. Fossil is a relatively highly shorted stock. It's possible that some people shorting the stock are concerned about Apple Watch and other smart watches. Quan and I aren't worried about that. So, we won't discuss a risk we don't take seriously. We will discuss the risks that we see as real.

The realest of all risks is obviously Fossil's debt load. Many watchmakers specifically and fashion companies generally carry no debt. Some have excess cash. Movado has excess cash. Movado is safer than Fossil right now for that very reason. Fossil has $762 million in net debt. The company's 2014 EBIT was $567 million. So, debt is only about 1.3 times EBIT. That doesn't sound too bad. But, a fashion company's EBIT can decline with the popularity of the brands it controls. The Michael Kors brand – which Fossil licenses from Michael Kors – is declining in popularity. The decline in Michael Kors's popularity could reduce Fossil's EBIT by hundreds of millions of dollars. Fossil's EBIT would have to fall by over 50% from its 2014 levels to bring the company's debt to EBIT into a range of 3 or more. Many companies are considered safe while borrowing 3 times their EBIT. It's important not to overstate the financial risk at Fossil. The company's debt load is very manageable by conventional metrics. But a fashion company may not be the best borrower. Many of Fossil's competitors don't carry any debt. And Fossil didn't have any debt through most of its history as a public company. So, there is no denying that Fossil faces financial risks today that it did not in the past and that its closest peer (Movado) does not face today.

Fossil has an extra risk that Movado does not. Fossil has a retail business. Retail is a very high fixed cost business. At the worst part of a macroeconomic cycle – or a fashion cycle – a retailer of fashionable accessories like the watches, leather goods, and jewelry that Fossil sells in its stores can have a very low operating margin. This is because the stores tend to have high earnings before rent and then very high rent charges for the prime shopping real estate they control in order to display their brands. A typical Fossil retail store's profit and loss statement might look something like this: 30% margin before rent and corporate expenses. Then subtract as much as 20% in rent charges. And then subtract whatever corporate overhead is really needed to support the retail operation. That's the real profit contribution from the store to the shareholder. The rent doesn't show up as debt. But the lease is a fixed charge that needs to be paid. Without any rent payments, the amount of debt Fossil is carrying (1 or 2 times EBIT – certainly less than three) might be perfectly safe. But, now you have a combination of debt and operating leases. That's a lot of financial risk in the business. Something like Movado has essentially none of that. It really doesn't run meaningful amounts of retail on its own (there are some Movado outlet stores) and it has net cash.

A lot of fashion brands also don't make acquisitions. Movado has rarely bought anything. Fossil had – until recently – rarely bought anything. It bought Skagen a few years back. That is a perfectly reasonable acquisition to make. It's a great fit with Fossil. And the price was reasonable both in terms of price-to-sales and price-to-earnings. Skagen also had positive earnings at its current size.

The Misfit acquisition is different. Fossil paid a very high price-to-sales ratio for Misfit. As a one-time deal this isn't much of a problem. Whether Fossil chooses to use any one slug of $250 million of cash to buy back stock, pay a dividend, pay down debt, or acquire something is not that important to a long-term shareholder. Fossil can generate more than $250 million in free cash flow for shareholders every year. So, even the worst misuse of $250 million is no more than wasting a year's earnings on an experiment that proved worthless. That's not the concern here. There are three concerns about Misfit. One, the acquisition can demonstrate that Fossil – unlike Quan and I – is worried that smart watches and activity trackers will do a lot of damage to traditional quartz fashion watches and Fossil needed to quickly spend a lot of money to try to catch up to a societal wave and protect its core business. Like I said earlier, Quan and I don't think Fossil's core business is threatened by changes in the public's preference for wearing high tech fashion accessories instead of low tech. So, I can't really do this argument justice. If you think it's a valid argument, it's something you should consider before buying Fossil. But, it's not something I can quantify for you – because it's not a risk I believe is real. However, it's possible the Misfit acquisition is a sign Fossil believes the risk of a huge societal shift toward technologically more advanced fashion accessories is real. If that's true – it's a really bad sign. There's another way the Misfit acquisition can be a cause for concern. And it's sort of the opposite of what I just explained. It may be that smart watches aren't a real threat – but Fossil is really, really determined to spend a lot of time and effort on this unproven area. If that's true, Fossil could blow a lot of free cash flow from its traditional business trying to break into and gain a dominant market share in this unproven business. This is what Barnes & Noble did with the Nook. It took the free cash flow from its stores and plowed it into the Nook business. The Nook wasn't profitable. And as a result, shareholders never got to drink the free cash flow "milked" from the still profitable bookstores as they declined. That cash went to funding a



Fossil's $567 million in EBIT is only 3 times its annual rent expense. While Fossil's net debt of $762 million is more than the company's highest ever EBIT

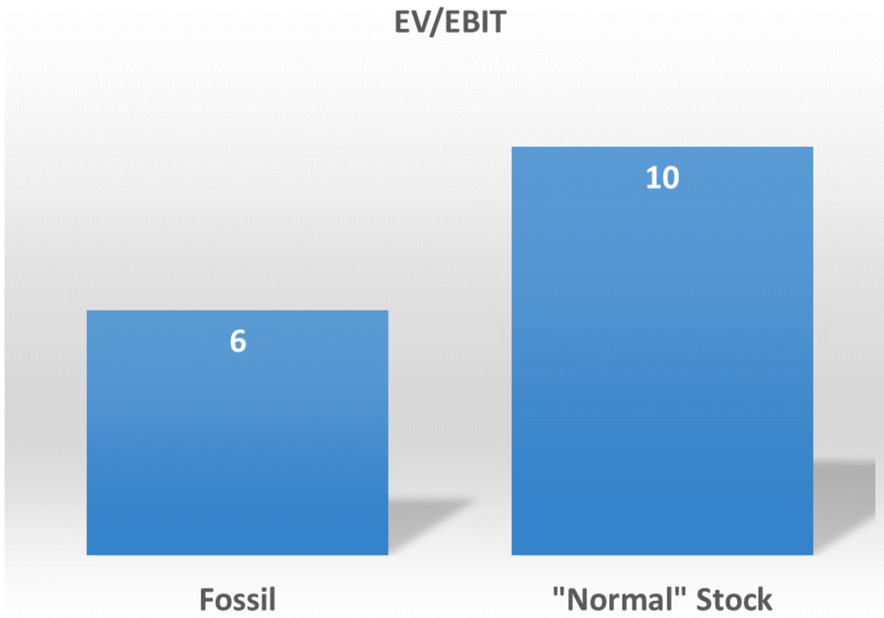
new business that – while it did turn out to be the future for consumers – never offered a profitable future for the company. Fossil's management – especially if influenced by stock analysts and the media – could focus on the risk of smart fashion accessories to such an extent that it launches many different designs that all fail miserably. This is a real risk. And the question is just how costly the experiment would be for Fossil. Finally, the Misfit acquisition could be a cause for concern because as Fossil's growth slows it will generate huge amounts of free cash flow. Fossil has high returns on capital. With an after-tax return on capital of say 30%, you'd need to find a use for about 75% to 80% of your company's earnings if you grow as fast as nominal GDP in the U.S. and the world tends to grow. So, a fully mature Fossil would need to find something to do with almost 80 cents of each dollar of earnings. Management has never shown an ability – or even a real interest – in timing stock buybacks. The stock hasn't paid a dividend. So, what will it do? Will it make purchases like Misfit? Will it use all the cash to buy back stock regardless of the share price? We don't really know. Capital allocation at Fossil is not especially strong. The incentives are right. The CEO gets no pay. And he owns a lot of Fossil stock. But having the right incentives does not mean you will make the right decisions. Someone who is good at growing a fashion brand and a watchmaking business over decades – and remember, Fossil has been a growth stock for its entire history – is not necessarily good at milking a more mature company for its free cash flow. Bad financial decisions are a risk at Fossil. The company only has debt now because it bought back a lot of stock in the past. And it isn't very skilled at buying back stock. So, there is no need to have the debt it has. And there is no guarantee the company will pay down debt quickly to make the stock especially safe for shareholders. Nor is there any guarantee management will focus on maximizing shareholder value instead of growing the business. Fossil has been a good investment long-term because it's always been a growth company. At today's price, the stock should turn out to be a great investment even if Fossil is never again a growth stock. But, it's unclear if capital allocation at Fossil will be good when the business is no longer growing quickly. To be fair, it's entirely possible Fossil can grow quickly in the future. There is no reason to believe Fossil has reached the limit of its time as a growth stock.

CONCLUSION

Fossil's Unbelievably Low Stock Price More Than Makes Up for its Very Real Financial and Fashion Risks

Fossil seems to have several risks. But, the price more than justifies these risks. For example, investors may avoid Fossil because they are concerned about smart watches. Quan and I don't believe this is a real risk. So, we discard that one. Second, investors may avoid buying Fossil because of the company's dependence on Michael Kors. This is a perfectly valid point. It just isn't valid given Fossil's low stock price. You can model whatever decline you want into Michael Kors sales. No matter how big a decline you expect in Michael Kors – the decline from Michael Kors alone is not going to erode Fossil's EBIT to the point where the stock is too expensive for a value investor to buy. Fossil's EV/EBIT is 4.7 times its peak. Quan and I would put "normal" EBIT lower. So, Fossil is trading at about 6 times "normal" EBIT. The average stock during a period of average P/E multiples might trade at 10 times EBIT. So, Fossil is trading at a 40% discount to an average stock. Fossil's history of growth and its return on capital are both much, much better than the average stock. So, you'd assume the upside potential in Fossil for the future should be greater than at the average company.

What are the real risks at Fossil? Michael Kors will decline. But, that's not a risk. That's just a bad thing that's going to happen. You can quantify how deep the decline might be and then decide for yourself whether you want to buy the stock or not after that decline. For example, if Michael Kors declined to the point where Fossil made about $250 million in EBIT instead of the $567 million in EBIT it made last year – the stock would then be at about an average price for an average stock. And yet it would be a business with a history of double-digit revenue growth and 30% after-tax returns on capital. So, it'd be a pretty good looking deal after a 50% decline in EBIT. We wouldn't say it's a perfect stock at that price. We wouldn't even say it's a value stock. But, it would certainly be a high quality stock at a reasonable enough price. And it'd potentially be a high growth stock at a normal price for a normal stock. That's after something like a 50% decline from what it earned in 2014. My point is not that Michael Kors won't decline. Nor is it that the decline in Michael Kors won't hurt Fossil's earnings a lot. Michael Kors will decline. And Fossil's earnings will decline along with Michael Kors. But that will not be a surprise to the market. The market has already priced in a tremendous decline in Fossil's EBIT.



Fossil is a high ROE and high growth business trading at a 40% discount to a typical stock

Debt is a real risk. Fossil has $750 million in net debt. If it has lower EBIT in the future, it'll take the company years to pay down that debt. Fossil is a heavily shorted stock. It's a high beta stock. Watchmakers and fashion companies are surprisingly high beta stocks. When you plot the consistency in their margins against the inconsistency in their stock prices – you see a problem. It's not a good idea for fashion companies to rely on public markets for financing. Their stock prices are not stable. Say Fossil wanted to issue equity to reduce debt. It shouldn't do that now. Because doing so would destroy a lot of value. Why? Because the stock is so cheap. For a normal stock in normal times, issuing equity to replace debt is somewhat costly. But, that cost is actually pretty low because the value of a public company's stock tends to be pretty high. A company that sometimes trades at 5 times EBIT can't rely on issuing common stock when it needs to raise some money. The destruction of shareholder value would be too great. The same is true of debt. Debt is likely to be most expensive for a company like Fossil when it is most needed. If people are concerned about Fossil as a stock and Michael Kors as a brand they are likely to demand higher rates and stricter terms when lending to Fossil. In theory, the market for Fossil equity or Fossil debt shouldn't matter to long-term shareholders. And it wouldn't if Fossil never needed to tap those markets. But Fossil is now carrying debt. This is why it's hard to recommend buying Fossil shares instead of Movado shares without a bit of hesitation. Fossil is a better business than Movado. Fossil has a clearer competitive position. Fossil has better growth prospects. And Fossil shares are cheaper than Movado shares. But is Fossil safer than Movado?

Financial risk is the one real risk at Fossil. The company has $750 million in net debt and about $200 million a year in rent expense. If you think about the payments that would need to be made on the debt – or conversely, you capitalized the rent expense – you'd see that the rent is a bigger risk than the debt. When you have almost $200 million in annual rent payments – do you really want to have any debt at all?

We don't know if the Fossil brand will decline. And the Fossil brand is what most of the rent expense is associated with. Fossil runs Fossil stores and Watch Station stores. As long as their sales are strong, it'll be able to make its rent payments each year from the profits those stores earn.

Fossil is the ultimate "magic formula" stock. It is one of the cheapest stocks we've featured in Singular Diligence. And it has a very high return on capital. If it grows, that growth will be very valuable. Fossil has huge upside. But, it's also potentially a risky stock for a few reasons. One, it's a high beta stock. And people do short the stock. So, unless you know you will be buying the stock to stick with it forever – it's very easy to lose money in Fossil shares through bad timing of your purchase and sale. You can be scared out of the stock.

The other risk is financial. If Michael Kors completely implodes as a fad – Fossil will have relatively little EBIT before rent compared to its rent expenses and its debt load. This is the part of Fossil that worries me the most. However, the business is undeniably high quality. The competitive position is solid. It's a leader in its industry. And it's a very, very cheap stock. Fossil is clearly an excellent speculation. It's also a good investment in a portfolio of 10 or 20 equal sized positions. But, Fossil is not a good choice for a portfolio of 4 or 5 equal sized positions. This is a stock that is best bought as part of a diversified portfolio – perhaps along with Movado – and best held for several years. Quan and I think Fossil is best bought along with Movado (in probably equal measure). And it is certainly a stock to be bought and held for 5 years rather than speculated on for 5 months. Above all, expect owning Fossil to be a very bumpy ride. This is a very high quality business at a very low price. The stock should perform well. But it will not perform smoothly.

Fossil (NASDAQ: FOSL)

Appraisal: $82.73

Price/Appraisal Value: 57%

Fossil Owner Earnings	(in millions)
Wholesale Normal EBIT	
Wholesale Normal Revenue	$2,085
* EBIT margin	25%
= Normal EBIT	$521
Pre-tax Owner Earnings	
Wholesale Normal EBIT	$521
+ Direct-to-consumer EBIT	$115
- Corporate Expenses	$184
= Pre-tax Owner Earnings	$452

Business Value

Fossil's business value is $4,746 million.

- Pre-tax owner earnings are $452 million
- Fair multiple = 10.5x pre-tax owner earnings
- $452 million * 10.5 = $4,746 million

Fair Multiple

Fossil's business is worth 10.5x pre-tax owner earnings

Fossil is worth 15x after-tax owner earnings

- Fossil's proprietary brands deserves 10x after-tax earnings
    - Fossil's licensing business deserves 20x after-tax earnings
    - These two businesses are equal contributors to Fossil's profit
    - 10.5x pre-tax owner earnings is equivalent to 15x after-tax owner earnings
- Effective tax rate is 30%

Share Value

Fossil's stock is worth $82.73 a share

- Business value is $4,746 million
- Cash: $302 million
- Debt: $1,067 million
- Equity value is $23,133 million
- $4,746 million + $302 million - $1,067 million = $3,981 million
- Equity Value = $82.73/share
    - 48.12 million outstanding shares
    - $3,981 million / 48.12 million = $82.73

Margin of Safety

Fossil is trading at 57% of its value.

- Business Value = $4,746 million
- Enterprise Value = $2,691 million
- $2,691 million / $4,746 million = 57%

	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBIT	EV/Owner Earnings
Guess	0.50	1.40	5.82	9.62	9.62
Movado	0.82	1.55	5.73	6.73	6.73
PVH	1.18	2.25	11.24	15.66	15.66
Michael Kors	1.72	2.85	5.40	6.00	6.00
Luxottica	3.99	6.02	19.83	26.40	26.40
Minimum	0.50	1.40	5.40	6.00	6.00
Maximum	3.99	6.02	19.83	26.40	26.40
Median	1.18	2.25	5.82	9.62	9.62
Mean	1.64	2.81	9.60	12.88	12.88
Standard Deviation	1.39	1.88	6.21	8.46	8.46
Variation	85%	67%	65%	66%	66%
Fossil (Market Price)	0.77	1.34	4.06	4.75	5.95
Fossil (Appraisal Value)	1.36	2.36	7.15	8.37	10.50

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).

SINGULAR DILIGENCE

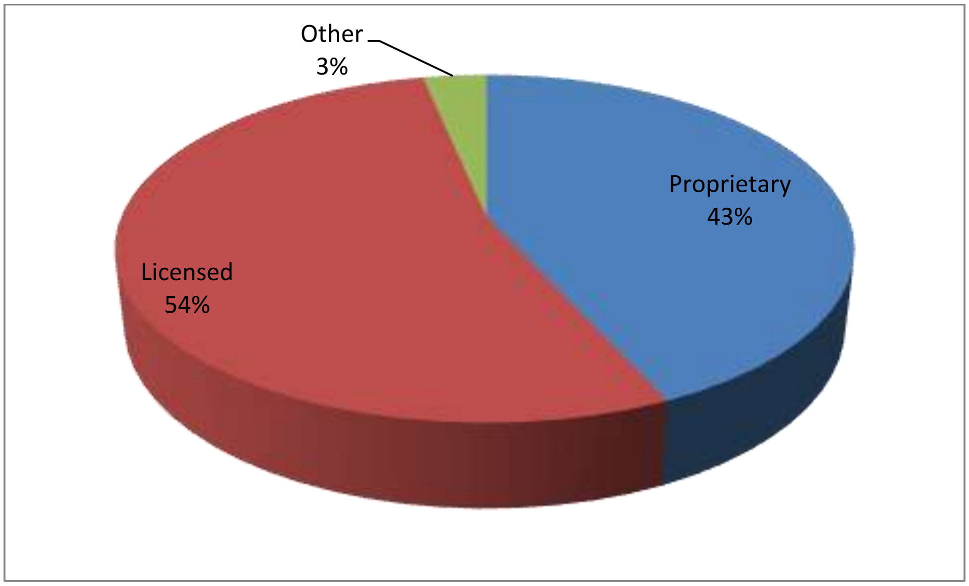
NOTES

Fossil

(NASDAQ: FOSL)

Overview

Fossil Has a Portfolio of Its Proprietary Brands and Licensed brands



Fossil gets 54% of its revenue from licensed brands

- Tom Kartsotis was college drop-out
    - He hawked hard-to-get tickets for sporting events and concerts
        - In the early 1980s
    - By 1984, he became wearied of hawking Dallas Cowboys tickets
        - He was 24 years old
        - His company had a substantial share of a market that wasn't growing
        - He didn't want to be a 30-year-old ticket scalper
    - => he looked for something else to do
- His older brother is Kosta Kartsotis
    - Kosta was a merchandise executive at Sanger Harris
        - A big Dallas department store chain
    - Kosta told Tom about the fat profit margins in importing retail goods made in the Far East
        - Especially the growing trend in moderately priced fashion watches
            - Pioneered by Swatch
    - Tom went to Hong Kong
        - Considered a number of items

            - Stuffed animals
            - Toys
            - Etc.
    - Then Tom followed his brother advice[1]
        - Settled on watches
- Tom hired a friend as his first designer
    - Lynne Stafford
        - Lynne Stafford later became Tom's wife
- Tom put up $200,000 in to the business
    - From his savings, and
    - The sale of the scalping business
- He enlisted a Hong Kong manufacturer
    - Produced 1,500 watches
    - Sold to local department stores and boutiques
- He came up with the retro theme to attract more attention
    - In 1989, Fossil began packaging the watches in elaborately crafted tin containers
        - Played up the nostalgia angle
- Kosta helped push the line into department stores across the country
    - He joined Fossil in 1988
- Inspiration for new designs came largely from ads in the pages of old magazine
    - Life, Look and Time
- Sales jumped from $2 million to $20 million
    - Between 1987 and 1989
- Fossil went public
    - In June, 1993
    - Sold 20% of its equity
        - For $19 million
            - Half went to pay down debt
                - Mostly notes to shareholders
            - The rest went into working capital
    - Tom retained 40.5% control[2]
    - Kosta retained 18.8% control
        - **Notice:**
            - Tom sold his shares of Fossil
                - And left Fossil

            - Kosta is now CEO and chairman of Fossil
                - Kosta receives no compensation from Fossil
                - He currently owns 12.3% of Fossil
- In early 1990s, Swatch has slipped from the number one spot in the U.S.
    - Guess and Fossil was battling for the lead
- Fossil diversified the business[3]
    - Began designing and selling a line of leather goods
        - In 1990
        - Handbags
        - Belts
        - Wallets
    - Started a second, less expensive watch brand
        - Relic
        - Sell in stores like Sears and J.C. Penney
- Fossil started making licensed watch
    - In 1997
        - Emporio Armani
    - In 1999
        - DKNY
        - Diesel
    - In 2001
        - Burberry
    - In 2004
        - Michael Kors
    - In 2005
        - Adidas
        - Marc Jacobs
    - In 2006
        - Marc by Marc Jacobs
    - In 2009
        - Armani Exchange
    - In 2011
        - Karl Lagerfeld
    - In 2013
        - Tory Burch
    - In 2015
        - Kate Spate

            - Chaps
- Having many brands gave Fossil scale to invest in
    - Design
        - Over 1,100 employees working in creative process
    - Manufacturing
        - Set up assembly facilities for
            - Consistent quality
            - Faster supply chains
    - Distribution
        - Deal directly with retailers
            - Gain shelf space
        - Open multi-brand watch stores
            - Now has 99 stores
- Fossil also opened Fossil store to increase brand awareness
    - 461 stores
        - ½ in the U.S.
            - Tend to be in class A shopping mall
    - Watches occupy less than 1/3 of Fossil's store space
        - The rest include
            - Leather goods
            - Jewelry
            - Other accessories like sunglasses
- Fossil business today include
    - Proprietary brands: **43%** of revenue
        - **$1,517 million**
            - Fossil brand: about $1.3 billion
                - An American vintage-inspired lifestyle brand[4]
                    - Inspired by looks from the 1940s and 1950s
                - Watch: around $100
                - Leather goods
                    - Men's wallet: $30-50
                    - Women's clutch: $60-80
                    - Women's crossbody bag: $128-178
                    - Women's satchel: $158-$248
                    - Leather products are made of genuine leather
                        - Fossil's leather products are known for
                            - Solid quality

                - Affordable price
            - Emphasizes classic style
        - Jewelry: $30-50
    - Licensed revenue: **53%** of revenue
        - Total revenue: $1,877 million
        - Licensed watch revenue: **$1.7 billion**
            - Each brand has a different price range
            - The majority of collections are focused on the $85-500 price range
    - Others: **4%**
        - $116 million
- Revenue mix by channel
    - Wholesale: **74%**
        - $2,585 million
    - Direct-to-consumer: **26%**
        - $925 million
            - Proprietary: $689 million
            - License: $225 million
- EBIT by channel
    - (before unallocated expenses)
    - Wholesale: 85%
    - Direct-to-consumer: 15%
- Fossil is currently heavily shorted
    - Short interest: 22%
    - Two main reasons
        - Concern about smart watches
        - Sales declined
            - Last quarter: sales decreased 14%
                - (8% in constant currency)
                - Fossil brand decreased 6%
                    - But increased 2% in constant currency
                - Skagen brand increased 1%
                    - But increased 10% in constant currency
                - Multi-brand global watch portfolio decreased 17%
                    - Decreased 11% in constant currency
                    - Excluding the Michael Kors brand

        - Fossil's watch business was flat in constant currency
- The market seems to overreact
    - Fossil is now very cheap at $40 per share
        - 4.75x EBIT
        - 5.95x normal EBIT

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[1] Source: _Selling Nostalgia and Whimsy_, William Barrett, Forbes Magazine, 08 November 1993

[2] Source: Fossil History, Funding Universe

[3] "Did the public buy in at the peak? Quite possibly. It's a tough business. **Swatch, which invented the moderately priced fashion watch category ten years ago, appears to have slipped from the number one spot in the U.S. market, with Guess (made under license from the jeansmaker by Timex) and Fossil now battling for the lead.**

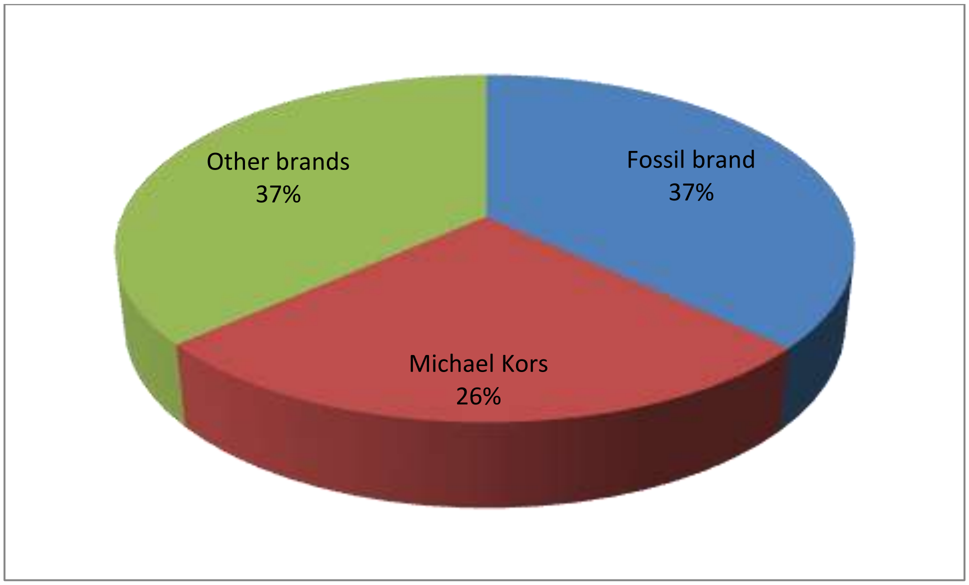
To insure against the almost inevitable drying up of profitability in the fashion watch business, Fossil is hedging its bets**. In 1990 Kartsotis began designing and selling a line of leather goods, which now includes handbags, belts and wallets. He has started a second, less expensive, watch brand – Relic – to sell in stores like Sears and J.C. Penney**. The company is also looking to expand into the European market.

But it's clear that whatever it does, competition will see to it that Fossil doesn't continue making these astounding returns on capital. So for all his success, Kartsotis tells FORBES: "work, work, work. That's what I do these day"" – _Selling Nostalgia and Whimsy_, William Barrett, Forbes Magazine, 08 November 1993

[4] Fossil's website introduces: "**Fossil is an American watch and lifestyle company, creatively rooted in authentic vintage and classic design**. We strive to create high-quality watches, bags and more that **preserve the best of the past while updating it for today. When the clean lines of the mid-century meet the modern looks of today**, the result is key items that represent the best of what we stand for: bags that pair portability with streamlined design, traditional watches created in fresh hues and materials, and timeless clothes and accessories that accompany you wherever you are traveling."

Durability

Fossil's Durability Is Threatened by Its Reliance on the Fossil and Michael Kors Brand



Fossil brand and Michael Kors account for about 63% of total revenue

- **Biggest Negative**:
  - The future of Fossil brand is unpredictable
- Durability of Fossil's proprietary brands is unclear
  - Proprietary revenue: $1,517 million
    - **43%** of total revenue
    - Wholesale: **55%** of proprietary revenue
    - Direct-to-consumer: **45%** of proprietary revenue
  - Proprietary brands include
    - Fossil:
      - Revenue captured within the company: **$1.3 billion**
        - Revenue is $2 billion at retail
      - Fossil is an American vintage-inspired lifestyle brand[1]
        - Inspired by looks from the 1940s and 1950s
    - Skagen:
      - Revenue is about **$150 million**
      - A Danish lifestyle brand
      - Fossil is trying to build Skagen similarly to Fossil brand
    - Michele:

            - Revenue is **about $100 million**
            - A fashion luxury watch brand
            - Sold at
                - High-end department stores like
                    - Bloomingdales
                    - Neiman Marcus
                    - Nordstrom
                    - Saks Fifth Avenue
                - Watch specialty store
                - Jewelry stores
        - And some less important brands
    - It's difficult to judge the durability of the Fossil brand
        - Fossil brand's target customers are
            - 25-35 years old
            - Younger attitude
            - More aspirational
            - More vintage inspired
            - Very creative
        - Fossil brand's revenue mix (estimated)
            - Watch: 50%
            - Leather goods: 30%
                - Wallet
                - Belt
                - Handbag
                - Etc.
            - Jewelry: 15%
            - Other: 5%
                - Sunglasses, etc.
        - Fossil brand's price range
            - Watch: around $100
            - Leather goods
                - Men's wallet: $30-50
                - Women's clutch: $60-80
                - Women's crossbody bag: $128-178
                - Women's satchel: $158-$248
                - Most leather products are made of genuine leather
                    - Fossil's leather products are known for

                - Solid quality
                - Affordable price
            - Emphasizes classic style
    - Jewelry: $30-50
- Fossil relies on retailing to build its brand awareness
    - Has about **469** Fossil-branded stores
        - About ½ is in the U.S.
    - Watches occupy less than 1/3 of Fossil's store space
    - Retail contributes **45%** of proprietary revenue
        - Proprietary revenue: $1,517 million
        - Proprietary direct-to-consumer revenue: $689 million
    - Direct-to-consumer revenue has about **10%** EBIT margin
        - (Before corporate expenses)
        - High operating leverage
        - Rent is expensive
            - About 20% of sales
            - Tend to be in class A shopping mall
- It's impossible to predict Fossil brand's future
    - It can grow
        - Or it can decline
    - Proprietary revenue has grown a lot since 2004
        - 2004: $637 million
        - 2014: $1,517 million
        - Mainly driven by new stores
            - Wholesale proprietary revenue:
                - 2004: $510 million
                - 2014: $828 million
            - Retail proprietary revenue:
                - 2004: **$127 million**
                - 2014: **$689 million**
            - The number of Fossil stores almost **tripled**
                - 2008: 183
                - 2014: 469
        - Retail operation has high risk
            - High operating leverage
                - Rent expense is 20% of sales
            - Depends on the brand's popularity

    - We don’t know whether Fossil brand has over-expanded
  - Leather goods weren’t Fossil brand’s biggest growth driver
    - There was no boom in Fossil-branded leather goods
    - Fossil has been in this business for a long time
      - Entered in the 1990s
      - It was one of the top 4 brands in handbags[2]
        - In the U.S.
        - In early 2000s
    - Leather sales was flat over the last 4 years
      - 2008: $278 million
      - 2009: $298 million
      - 2010: $340 million
      - 2011: $428 million
      - 2012: $436 million
      - 2013: $436 million
      - 2014: $419 million
  - Fossil-branded watches are fashion-oriented
    - Taste changes sometimes
      - In 2005
        - Fossil watch’s U.S. sales declined by 19%
          - Q4
        - Fashion watch was weak in the U.S.[3] [4]
          - Due to lack of newness
        - Fossil made some changes[5]
          - Add more details to the watches
            - Improve quality
          - Raise price from $55 to $95
          - Target 25-35 year-old customer
          - => more consistent with what it had in Europe
    - There’re cycles in demand for fashion watch[6]
      - It can be driven by customer’s attention
        - Move from one category to another
          - Clothes
          - Handbag
          - Watch
          - Etc.

            - It can be driven by new trends in the category
                - Watch style preference can change
                - In early 1990s, people preferred leather strap[7]
                - Then the trend changed to stainless steel
                - Then to other materials
        - Fossil has great relative strength in fashion watches
            - Most big watch companies don't really focus on fashion watches
                - Luxury watches have classic designs
                    - Richemont
                    - Swatch
                    - Movado
            - Only Swatch brand focuses on fashion watches
                - It's not as strong as it used to be
                - Fossil is perhaps stronger
                    - Has synergy with its licensing business
                    - It's definitely bigger in terms of revenue
                        - $2.5 billion revenue from fashion watches
            - Fossil runs retail stores
                - And sell directly to retailers
                    - Competitors rely on distributors
                - => Fossil can read new trends quickly
            - Fossil has a design team of over 300 designers
            - Its lead time is just 75 days
                - Compared to Movado's 6 months
- Fossil's licensed watch business is very durable
    - Licensed brands include
        - Diesel
            - Expiration: 31 December 2015
        - Adidas
            - Expiration: 31 December 2017
        - Burberry
            - Expiration: 31 December 2017
        - Karl Lagerfeld
            - Expiration: 31 December 2017
        - Tory Burch

            - Expiration: 31 December 2018
        - DKNY
            - Expiration: 31 December 2019
        - Marc by Marc Jacobs
            - Expiration: 31 December 2020
        - Michael Kors
            - Expiration: 31 December 2021
        - Armani Exchange
            - Expiration: 31 December 2023
        - Emporio Armani
            - Expiration: 31 December 2023
        - Kate Spade
            - Expiration: 31 December 2025
        - Chaps
            - Expiration: no information
    - There's little risk of losing licenses
        - Fossil is the partner of choice for licensors
            - (See the Moat section)
    - Michael Kors is a short-term problem
        - Michael Kors watch's revenue: $923 million in 2014
        - Started declining this year
        - Fossil may have excess inventories
            - Liquidating excess inventories will hurt gross margin
        - And it may take some time to adjust cost structure
            - (below Gross profit)
    - Long-term prospect of the licensing business is great
        - Fossil has got many new licenses recently
            - Karl Lagerfeld: in 2011
            - Tory Burch: In 2013
            - Kate Spade: in 2015
            - Chaps: in 2015
        - Smart watch isn't a big threat
            - The market is different
            - People who buy smart watch care about functions
            - People who buy fashion watches care about
                - Design

            - Brand
        - Fashion watch consumers tend to buy 2 to 5 watches a year[8]
            - They have a collection of watches
            - They rotate based on their outfit
        - Even if there's overlap in customers
            - Customers don't necessarily wear smart watches all the time
            - They may wear different watches for different occasions
        - It's difficult to marry tech with fashion
            - 90% of watches have circular face[9]
                - It's driven by preference
                - Sell better
                - Easier to be water resistant
                    - Corners are bad for water
                    - Create tension
                    - Can break crystals
            - Circular faces are harder for tech companies to make
                - Have to fit so much into such a tiny space
            - Consumer electronics companies tend to have a one-size-fit-all design
            - Example: Apple watch
                - Rectangular face
                - Models differ only in band color and materials
        - Fashion watch consumers may like some functions
            - Activity trackers
            - Message/phone call notification
        - It's easy to put these functions into a watch
            - Movado Motion
            - Fossil Q Grant
- E-commerce won't disrupt the fashion market
    - Fashion consumers tend to use the Internet as a research tool
        - Each brand's website in the virtual world is like a boutique in a mall
            - It's a place for fans to browse

        - It'll support physical stores
            - Engage consumers
            - Check in-store availability
            - Click and collect
            - Online-purchase, in-store returns
            - Etc.
    - Amazon isn't a risk
        - It just provides a huge selection
        - Customers still have to search through themselves
    - => it's safe to license a bunch of recognizable brands

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[1] Fossil's website introduces: "**Fossil is an American watch and lifestyle company, creatively rooted in authentic vintage and classic design**. We strive to create high-quality watches, bags and more that **preserve the best of the past while updating it for today. When the clean lines of the mid-century meet the modern looks of today**, the result is key items that represent the best of what we stand for: bags that pair portability with streamlined design, traditional watches created in fresh hues and materials, and timeless clothes and accessories that accompany you wherever you are traveling."

[2] "Well, there is just a lot of interest in the category for one thing, and stores are giving it more open to buy and more space, and we are actually in a very good position that **we are one of the top three or four brands in handbags and we may be the largest or second-largest branded company in leather handbags which is obviously at a higher price**. So our positioning in handbags is actually somewhat better than the department stores at a slightly higher price, and we're benefiting from this whole trend of consumers wanting to spend a little bit more money for an item. And an our trend is actually very positive relative to the stores (inaudible) our momentum and our market share is increasing, and we show the increases in the fourth quarter. And we think that is going to continue and we will gain a bigger position and more space in the stores and continue to have growth. It is a big opportunity, but as I said earlier, the handbag business is several times the size of the watch business, so we are benefiting quite a bit from that." – Kosta Kartosis, Fossil's CEO, 2004 Q4 Earnings Call Transcript

[3] "While we can't predict the future, **we know that in our almost 13 years as a publicly-traded company, we have experienced negative watch cycles in the past which have lasted between 18 months and two years**. In the meantime, it is our goal to successfully improve our business regardless of the cycle. We offer some of the world's most premier brands which drove market

share gains in 2005. We also possess a highly talented team that is motivated and eager to deliver a better performance. **By working harder, smarter, and more creatively that our competitors, we expect to rejuvenate our FOSSIL fashion watch business, our largest and most mature brand**, which will assist us in returning to a more normalized growth level." – Tom Kartsotis, Fossil's former Chairman, 2005 Q4 Earnings Call Transcript

[4] "**The U.S. FOSSIL watch performance again was disappointing, down almost 19%. The fashion watch market is in a state of disruption, and research shows that consumers are generally less interested in watches for whatever reason**. It is our job to reverse this trend by coming up with innovative, differentiated products that reverse the trend, and that is exactly what we are focused on.

…

We do know that the total watch business in the United States in the fashion watches was down, so that impacted it [Fossil's sales decline]. But of course, we're the largest part of that, so you could say that we accelerated it by not having the right assortment and styling and newness. So I'd say since we are a bigger part of it, then it's really up to us to change that trend. And that's exactly what we're doing. We think that we have a lot of new ideas and a lot of platforms in there. **We're really focusing on changing the whole way it looks and feels, and it's going to be a bit more upscale and the branding is a bit more aspirational, more derivative sort of of luxury watches, rather than more fashion trendy watches**. We think we've got some good ideas in there that can change the trend, **but I would say it's a combination of just less interest in watches because of lack of newness, and that's really our responsibility. So we're doing everything we can to change that.**" – Kosta kartsotis, Fossil's CEO, 2005 Q4 Earnings Call Transcript

[5] "John Rouleau, Analyst, Wachovia Securities: Hey, guys. A couple of questions. Kosta, when you look at the assortment, specifically I guess in the Fossil watches over in Europe and what is selling over there, and maybe what is not selling here in the U.S., is the assortment that much different? Are you doing anything different in Europe from a styling or pricing perspective? I guess I'm really trying to get at is it really just a U.S. chain phenomena that we're dealing with here on the Fossil side or are you seeing anything else?

Kosta Kartsotis, Fossil's CEO: **Well, I think the European assortment is a little bit different, and that customers, as you know, are somewhat older**. So it tends to be -- although it is mostly the same assortment, there tends to be **less frivolous kind of younger fashion in Europe than there is here. And as**

we've said before, the part of the business in the United States that is weak is that younger, more frivolous fashion business.

So as we said last time, I think **our strategy really to, in the United States, increase the quality and the detail in watches, averaging in retails are higher. They are really more a luxury derivative, a bit more aspirational. Some of the watches we're selling right now in the U.S. are $95 instead of $55**. So the direction we're going in is really more consistent with what we've had in Europe for a long time.

So we think it's -- actually the markets are coming together. **In the United States now, we are targeting with Fossil at 25 to 35-year-olds, which is more consistent with Europe**. So on a global branding situation, it's going to be more consistent and the assortments will be so as well." – Fossil 2006 Q1 Earnings Call Transcript

[6] "Neely Tamminga, Analyst, Piper Jaffray: Good morning and congratulations, you guys. I was wondering if Kosta could help frame up qualitatively or quantitatively his comments about how **we are early in on the watch cycle**. It has been probably one of the more difficult things for us to assess here on the sell side but yet **we continue to see strength and adoption of some of the key watch styles that really came onto the scene last year**. So just wondering if you can either help us frame up what you mean by early and what signs you are looking for that momentum to continue to build? That would be really helpful. Thanks.

Kosta Kartsotis, Fossil's CEO: **Obviously we've seen these cycles before, as we've said. And it's hard to say how long it will last** except what we are seeing is very broad based and consistent sell-through metrics across all our brands in the United States especially and we are now starting to see that going into Europe and we had some meetings last week in New York with some of our European retailers and they are starting to see this percolation as well.

A lot of this in the past and it looks like right now has been driven by a major shift in the trend. So if you go back the last time this happened to us, which was **over 10 years ago, almost every watch we made was a leather strap watch, and then the trend changed to stainless steel bracelets. So we changed our line, put it out in the market and we went through a several year trend of pretty significant growth**. And this has happened to us before going back 18, 19 years ago when the fashion watch business really first exploded.

So there is a lot of moving parts to it, and it is not just one new material. It is across a lot of different materials across all our brands. Part of what you might say is **in the last five years, the watch business has been relatively flat**, somewhat of an assortment business. **There has been a huge amount of interest in handbags and discussions about the "it" handbag and people were buying handbags every week**.

There is now a thought process that it is now about the "it" watch and everybody wants to own a watch and they are important in the fashion world. And it seems to be gaining momentum.

One additional thing I would add is this is being driven by mix materials, new materials, things that look different. There is a reason to buy a watch, and it is not about telling time. And I think it is going to be accelerated increasingly by all the Swiss guys that are putting new products in the market especially during this holiday season and these are all typically what they are showing for -- new for holiday is all mixed material also. So I think the momentum is just going to continue to proceed." – Fossil 2010 Q3 Earnings Call Transcript

[7] "Until recently, investors maintained a stony attitude toward Fossil. One reason: **Management was slow to react in 1995 when consumer tastes turned toward watches with metal rather than leather bands. At the time, leather-banded timepieces accounted for 90% of Fossil's watches**.

Sales plummeted, and the company produced a series of earnings disappointments. The stock fell to $7 in December 1995 from $29.50 in October 1994.

What has changed since the shares tanked? For one thing, Fossil flip-flopped its product mix -- 90% of its watches, which come in about 350 styles, now have metal bands. Led by new product lines -- including a collection of chronograph watches with multiple dials, a Fossil Blue sport line and Fossil Steel stainless-steel-banded watches -- domestic watch sales jumped 19% to $22 million in the recent second quarter from a year earlier." – Solid Growth Potential May Make Fossil a Stock Worth Watching, Jonathan Weil, Wall Street Journal, 17 September 1997

[8] "So if you think from a consumer point of view and then how the watch market segments -- I think it's three segments. **The first is the -- let's call it the status**

seeker. The watch aficionado. So Swiss made, high price point -- let's say $800,000. You can -- all the brands that play in that space including us. There may be some early adopters, **I don't think you are going to get many techs switching from [varied] brands to a tech-branded smart watch**. That's the first segment.

The second segment, let's call it the fashionable or the fashionista. That is a predominantly female segment. Think Michael Kors, Tory Burch consumer. They buy 2 to 5 watches year, they have a large collection of watches, they rotate based on their outfit and whether they're going to work, whether they're going to a club or whether they're going to dinner.

That status and style that they look for in those product lines -- again, that's a pretty big leap from taking a tech-branded product and replacing the behavior in a way that they engage with the category today.

On the flipside -- right, and that's our core segment today, that gives us tremendous opportunity as we look at ways that we can take technology and I would say it's a much broader strategy. It's more wearable technology than it is Smart watches, but taking technology, figuring out how to infuse it into our business model in a way to reach those consumers -- serve those consumers with brands they love, products they love, but with technology and some function comes with that.

Third segment is just consumers that either dabble in the cate -- are in the watch category, but it's more functional driven today or consumers that just aren't even in the watch category. Huge number of consumers that aren't in the first two segments that we believe if we can bring a more functional tech-enabled product to market, would still fit the status and the style desires of some of those customers but that -- we have the opportunity to bring new consumers into the category.

So that's how we think about it. So as we see it developing, there will be some early adopters but we see our ability to bring, apply technology to our brands and our products as that's a huge upside for us over time." – Greg McKelvey, Fossil's Chief Strategy & Marketing Officer, said at Piper Jaffray 2014 Consumer Conference

[9] “If you walk into a jewelry or department store and visit the watch section, you'll notice about **90% of the faces are circular. That's not an accident; the design is driven by preference**, Moxcey said.

"We also know that form factor of devices changes over time. There were flip phones until someone decided otherwise. **We mostly make round watches because they sell better, but we have to be responsive**.”

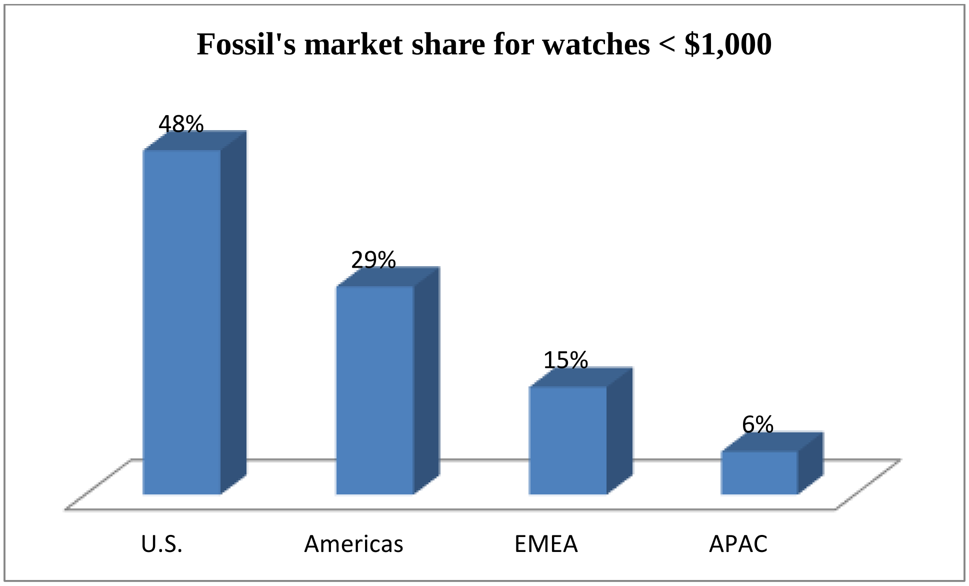
However, the majority of smartwatches on the market today are square-shaped, including the much-anticipated Apple Watch rumored to launch in March.

"**Circular smartwatches are harder for technology companies to make because they need to fit so much into such a tiny space**," he said. "**If you go back to traditional watch making, the design was round because it was easier for it to be water resistant. Corners are bad for water, create tension and can break crystals.**”

That said, it’s clear to see why watches ended up with a circular face. **Whether or not the tech industry will keep the look square for smartwatches has yet to be seen, but Fossil said it’s more inclined to push for circular out of the gate**.”

Moat

Fossil Has Wide Moat in the Licensed Watch Business



Fossil has 48% market share for watches less than $1,000 in the U.S.

- **Biggest Negative**:
    - Fossil brand has no moat
- **Michael Porter Questions for the Fossil brand**
    - (-) means low
    - (=) means medium
    - (+) means high
    - **For the industry**
        - Is the threat of new entrants high or low?
            - **(+)** Many leather brands can open accessory stores
        - Is the bargaining power of buyers high or low?
            - **(=)** Department stores have bargaining power
                - mom-and-pop stores in Europe don't have bargaining power
        - Is the threat of substitutes high or low?
            - **(=)** Customers may buy other accessories
        - Is the bargaining power of suppliers high or low?
            - **(-)** Components are widely available
        - Is the rivalry within the industry high or low?
            - **(=)** Competition between watch brands is based on design

        - Not price
      - Licensees don’t try to get licensors by offering high royalty rates
  - **For the company**
    - Is the threat of new entrant different for this company specifically?
      - **(+)** same as the industry
    - Is the bargaining power of buyers different for this company specifically?
      - **(-)** bargaining power of buyers is lower for Fossil
        - Fossil is a significant supplier of watches for department stores
    - Is the threat of substitutes different for this company specifically?
      - **(=)** same as the industry
    - Is the bargaining power of suppliers different for this company specifically?
      - **(-)** bargaining power of suppliers is lower for Fossil
        - Fossil is a big customer
          - Sell 20-30 million watches a year
    - Is the rivalry within the industry different for this company specifically?
      - **(=)** same as the industry
- **Michael Porter Questions for the licensing business**
  - (-) means low
  - (=) means medium
  - (+) means high
  - **For the industry**
    - Is the threat of new entrants high or low?
      - **(-)** Strong brands want to work with established licensees
    - Is the bargaining power of buyers high or low?
      - **(=)** Department stores have bargaining power
        - mom-and-pop stores in Europe don’t have bargaining power
    - Is the threat of substitutes high or low?
      - **(-)** Licensors prefer licensing to doing in-house
    - Is the bargaining power of suppliers high or low?
      - **(-)** Royalty rate is standard
    - Is the rivalry within the industry high or low?

        - **(=)** Competition is based on design
            - Not price
- **For the company**
    - Is the threat of new entrant different for this company specifically?
        - **(-)** same as the industry
    - Is the bargaining power of buyers different for this company specifically?
        - **(-)** bargaining power of buyers is lower for Fossil
            - Fossil is a significant supplier of watches for department stores
    - Is the threat of substitutes different for this company specifically?
        - **(-)** same as the industry
    - Is the bargaining power of suppliers different for this company specifically?
        - **(-)** same as the industry
            - Michael Kors was an exception
                - It may get a higher royalty rate
    - Is the rivalry within the industry different for this company specifically?
        - **(=)** same as the industry

Fossil brand

- Customer retention: **Weak**
    - Fossil brand targets young, fashion customers
        - 25-35 years old
    - Fashion customers tend to be fickle
        - Customers can be loyal for a while
        - But churn is probably high
- Customer acquisition: **Not unique**
    - Fossil brand isn't unique
        - Competes with many brands
    - Its retail strategy isn't unique
        - Many leather brands open boutique stores
            - Competes with Fossil's "accessory stores"
    - Its leather goods face a lot of competition
        - Fossil proposition:
            - Solid quality

            - Most leather products are made of genuine leather
            - Emphasizes classic style
        - Affordable price
            - Men’s wallet: $30-50
            - Women’s clutch: $60-80
            - Women’s crossbody bag: $128-178
            - Women’s satchel: $158-$248
                - Fossil’s leather products are known for
                    - Solid quality
                    - Affordable price
    - Fossil’s strength in customer acquisition may come from its design
        - Fossil has great relative strength in fashion watches
        - Most big watch companies don’t really focus on fashion watches
            - Luxury watches have classic designs
                - Richemont
                - Swatch
                - Movado
        - Only Swatch brand focuses on fashion watches
            - It’s not as strong as it used to be
            - Fossil is perhaps stronger
                - Has synergy with its licensing business
                - It’s definitely bigger in terms of revenue
                    - $2.5 billion revenue from fashion watches
        - Fossil runs retail stores
            - And sell directly to retailers
                - Competitors tend to sell to distributors
            - => Fossil can read new trends quickly
        - Fossil has a design team of over 300 designers
        - Its lead time is just 75 days
            - Compared to Movado’s 6 months
- Margin protection: **not clear**
    - Fossil may have low cost thanks to volume
        - It sells about 30 million watches a year
    - But production cost isn’t significant in this business
    - Customer’s willingness to pay is high
        - Competition won’t hurt margin
    - Volume depends on the brand’s popularity

        - Competition can hurt volume
- => Fossil brand's moat is weak

Licensed watch business

- Customer retention: strong
    - Long-term contracts
        - 5 or 10 years
    - Fossil has never lost a license
    - Brands rarely change licensees
        - Financial benefit might not be high
            - Few brands make much more than $100 million revenue
            - Movado wants brands that can make $40-50 million revenue
            - => licensing revenue is just $4-10 million
        - Perhaps maximizing revenue isn't the primary goal
            - Other concerns can be keeping the product consistent with the brand
        - There's a lot of transition issues when switching licensees[1]
            - It may take several years
- Customer acquisition: strong
    - Licensors
        - Fossil has the best platform for licensed brands[2]
            - 30,000 doors
            - 90 countries
            - 300 employees in design department
        - Fossil sell through different distribution channels[3]
            - U.S: Department stores
            - Europe: Mom-and-pop watch and jewelry stores
            - Asia: Concessions stores[4]
        - Having many licensed brands leads to synergies in[5]
            - Back office
            - Supply chain
                - Sourcing
                - Same distribution company in a country/region
            - Local advertising

- Fossil's licensing business is 7 times larger than the nearest competitor[6]
  - Fossil's licensed revenue: $1,877 million in 2014
  - Movado's licensed watch revenue: $274 million in 2014
- Success with Michael Kors made Fossil the partner of choice
  - $923 million revenue from Michael Kors watch and jewelry
    - In 2014
    - Mostly from Michael Kors watches
  - Some big brands recently gave licenses to Fossil
    - Karl Lagerfeld
      - In 2011
    - Tory Burch
      - In 2013
    - Kate Spade
      - In 2015
    - Chaps
      - In 2015
- Guess wanted to switch to Fossil
  - Guess watch was the largest licensing business in 2005[7]
    - About $150 million annually[8]
  - Guess had had over 20 years of relationship with Callanen International
    - A subsidiary of Timex
  - Guess and Fossil discussed about a new contract
    - Utilize Fossil's network to further expand sales of Guess watches
  - Callanen sued Fossil
    - The contract would violate the Federal antitrust laws
      - Fossil already had 40% market share
  - Callanen eventually renewed the contract with Guess

- Retailers
  - Brand power may help Fossil attract retailers
    - Brand power results in high gross profit per square foot
  - Fossil has distribution clout
    - By owning a portfolio of strong brands
    - Fossil can sell more brands to retailers
- Fossil is likely to have

            - More licenses overtime
            - More store shelf-space over time
- Margin protection: strong
    - Fossil has cost advantage in its distribution
        - Different brands can share
            - Back office
            - Supply chain
                - Sourcing
                - Same distribution company in a country/region
            - Local advertising
        - Competitors rely on distributors
    - Customer's willingness to pay is high
        - Customers choose watches within their price range
        - => competition isn't on price
            - But on
                - Brand
                - Styles
                - Quality
                - Etc.
    - Fossil has great relative size
        - U.S:
            - Sells to big department store
            - Fossil has **50%** market share in the US
                - For watches between $100 and $1,000
            - Gross margin is 50-55%[9]
                - Mass brands like Relic has 40-45% margin
        - Europe
            - Sells to mom-and-pop watch and jewelry stores
            - Fossil makes better margin outside the U.S.[10]
                - Sells at a higher price
                - 5-10% higher margin outside the U.S.
    - Volume of individual brand may fluctuate
        - But volume of the whole portfolio can be strong
- The licensing business has strong moat
    - Barrier to entry is low
        - It's easy to establish a new watch brand
            - (Or get license of a new brand)

            - Department stores always shelf-space to test new brands
  - Potential damage of new entrants is small[11]
    - Many competitors come and go
      - Don't get shelf space
    - Cannibalization isn't very high in watches
      - Michael Kors' growth didn't hurt other brands much
        - Its fall didn't benefit other brands much either
    - New entrants might not be able to build up on its early success
      - Taste changes
      - It's difficult for a new brand to stay relevant
        - Must diversify into other product categories, or
        - Build a portfolio of brands
          - It's difficult to get licenses of strong brands
  - Rivalry among licensees isn't based on price
    - Licensees don't try to get licensors by offering high royalty rates
  - Rivalry among brands isn't based on price
    - But on designs
    - Competitors are
      - Swatch
        - Has Calvin Klein license
        - Isn't interested in getting new licenses
          - Focused on luxury Swiss watches
      - Richemont
        - Has Polo Ralph Lauren license
        - Isn't interested in getting new licenses
          - Focuses on luxury Swiss watches
      - Movado
        - Has license contracts with
          - Coach
          - Hugo Boss
          - Tommy Hilfiger
          - Lacoste
          - Ferrari
          - Juicy Couture
      - Timex
        - Its subsidiary Callanen International has license contracts with

        - Salvatore Ferragamo
        - Guess?
            - A big fashion watch brand
        - Versace
        - Versus
        - Nautica
    - Seiko
        - Kenneth Cole
        - Ted Baker
        - Asics
    - Other companies are tiny
- => having a growing portfolio of strong brands help Fossil gain market share overtime

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[1] "**As far as Adidas, basically 2007 was a pretty flat year for Adidas. We saw a lot of transition issues. It was a lot slower and more difficult to launch a brand that had been in the marketplace under a difference licensee on a global basis than I anticipated**, quite frankly.

So last year was kind of a transitional year. We do have a lot of opportunity, I believe, this year in 2008 to resume the growth of the brand and move away from the flat performance that we had last year. So we think that we have got some pretty good product position now." – Mike Barnes, Fossil's former CEO, 2007 Q4 Earnings Call Transcript

[2] "**And probably our biggest advantage is our global distribution. We sell about 30,000 doors globally**. That is very diverse whether you're in the United States or Europe or in Asia.

In the US we sell largely department stores and specialty stores. In Europe it's largely a lot of mom-and-pop jewelry stores and some jewelry chains. In Asia it's largely department stores and concessions.

We have a diverse set of infrastructures around the world to distribute to these 30,000 doors. Our objective is to put additional markets in those doors. Not all of those doors carry all our brands or have as large a presence as we would like so **the process we're in is continuing to develop each of those doors and adding additional products to it and as we add additional brands we'll have**

additional opportunity." – Kosta Kartsotis, Fossil's CEO, ICR Conference, 13 January 2014

[3] "And, of course, on distribution channel, we sell in different distribution channels around the world. **The United States is mostly department stores and that's pretty robust business. In Europe, we largely sell mom and pop watch and jewelry stores which is a huge network of them over there.**

In Asia, it's very different. In China, it's mostly concessions that are one at a time and somewhat complex. In India, we're actually making progress, opening our own stores. So it's a very complex global situation but the fact that we have our own people on the ground in all these markets, we have automated warehouses in the wherewithal to go-to-market in different ways in different markets.

And the other thing is that we've largely built infrastructure already for all these markets. So as we mentioned in our calls that we think we are in a position where we continue to leverage, and we'll talk about that when we talk about our fuel for growth." – Kosta Kartsotis, Fossil's CEO, Investor Day 2015

[4] "Well, as we discussed earlier**, we're actually moving our Watch Station operation over there**. We actually have a new store design and we actually changed name slightly, so it's called WSI. And the new store design, which we're opening -- we've opened a couple of them in the last month or so -- look very good.

They're a little more Asia-focused, more branded, and look a little more luxury. They have the opportunity to really communicate the brands and the storytelling better, so it's really much more attuned to that market, which we think is very helpful.

And if you look at our distribution over there, especially in China, there's not a lot of places where we can just automatically go and sell. We have to build concessions, our own distribution, our own stores, et cetera, so having Watch Station as a catalyst for that over there, whether it's an actual store on the street, or it's a concession in a mall or in a department store, it all fits together and it enables us to do exactly what you said.

When we first go into a market, typically the brands that are in our portfolio are much more well known than Fossil. **So Armani is an extremely powerful brand**

throughout Asia, and especially in China. So it's a door opener, enables us to get locations, and we add the other brands, and we bring our own brands, along so FOSSIL and SKAGEN and we will get the benefit of getting distribution in those locations.

So as you said, **with Watch Station, we're able to put our whole portfolio in there, tell the stories we want to tell, tell a Swiss story, and be able to scale that over, across Asia, long-term is a very significant opportunity for us because it's largely pioneering a category that doesn't exist at this point**. There's a huge amount of interest in luxury brands and a huge amount of interest in watches and there is a huge amount of interest in Swiss. We're bringing all that to life in one place under the WSI banner, which should be very successful for us." – Kosta Kartsotis, Fossil's CEO, 2014 Q2 Earnings Call Transcript

[5] "Global distribution started -- one other thing I would say about the Company is we've always been very investment-oriented. We started very early on selling watches to distributors around the world.

And again, in this idea of long-term runways, sustainable growth, we started acquiring those distributors. So we now have -- we do over 50% of our business outside the United States, 85% of it, the business outside the US is actually done through our wholly-owned subsidiaries.

There are 26 subsidiaries around the world. We have complete control over them. If you go into a concession in Korea in the department store, the person standing behind the counter is a Fossil employee.

Having that kind of control and efficiency and also the information, we know real-time what's selling in those markets, so our inventory is much more productive and more competitive than our competitors.

We also have a global support structure. Over the many years of again, **investment in our business in the long-term future have put in technologies such as SAP we install 10 years ago**.

If you see our growth over the last seven years, we never would have been able to grow as fast as we did if we had not put SAP in place for example.

Automated warehouses around the world, we also have a global repair facilities network all over the world, so obviously, we have warranties on our watches you can get in one of our product mix anywhere in the world.

That operation alone, very complicated and sophisticated with 10s of 1,000s of spare parts and the ability to fix multiple styles is very complicated. We have a very strong network of that. **We spend significant amount of money, about $20 million a year just on the repair network**, significant barrier to entry but a huge competitive advantage for us.

And, of course, our global management, we have over the last couple of years actually globalized the Company. We have companies broken into three regions, the Americas based here, of course, Asia which is based in Hong Kong office. **Asia, right now, is about $600 million business, very significant**.

Our European business based in Basel, a $1.2 billion business, very significant infrastructure there with people, merchants, retail organizations. Our mission as a global organization is to empower the regions to grow with guidance and really have them be closer to customer and grow faster. We think it's a great unlock for us in the future.

We also have a couple of other competitive advantages, just in fact that we have vertical and horizontal advantage. **Obviously, we're vertically integrated from design all the way to point-of-sale**.

And also we're horizontally advantaged in terms of taking those brands. **So our opportunity over the future is really to take additional brands and leveraging them across our infrastructure in a vertical way as well as horizontal**.

So we operate and the way we look at the Company is **we have three distinct businesses, using shared services globally. And we learned a long time ago, it's very difficult to grow one brand globally. We started by trying to sell Fossil, you never get enough critical mass. We were using distributors, you never were important, you couldn't tell your story**.

It wasn't until we really developed the idea of the portfolio in addition to Fossil, going into a market, having -- being able to adapt to a market, get critical mass and helps us invest, makes the business more profitable. It's really been a big unlock for us, so the idea of having these three businesses using shared services globally.

Part of the reason why we had an early-mover advantage in going global is because of the fact that watches and accessories cross borders easily.

The other reason is because **we were able to invest and there's a portfolio approach in the market rather than just putting one brand in the markets, very, very complicated**. That was one of the reasons we move so fast, still big advantage for us." – Kosta Kartsotis, Fossil's CEO, Investor Day 2015

[6] "While we certainly admire those who we compete within our space, our licensing business is roughly seven times larger than our nearest competitor. That makes us the natural partner, the licensee of choice for the best brands in the world today and, we believe, in the future. And that's how we look at our brand portfolio." – Dennis Secor, Fossil's CFO, Fossil 2015 Investor Day

[7] "T**he public dispute between Callanen and Fossil began Aug. 26, when Fossil and Guess announced they were in "advanced negotiations" for a 10-year global license agreement, which was to become effective Jan. 1, 2007**. The agreement called for Fossil to establish a separate company to make and distribute Guess and Guess Collection watches.

Kosta Kartsotis, Fossil's president and chief executive officer, said at the time that the company was very excited about the proposed long-term partnership with Guess and expected the agreement to be finalized in a week.

Marciano said at the time that the proposed partnership would be "a strong one and contribute to the further expansion [of Guess watches] domestically and internationally."

On Aug. 31, however, Callanen sued Fossil, but not Guess, asking the federal court in Los Angeles to stop the proposed pact, claiming it violated federal antitrust and state unfair competition laws, "interfered with Callanen's contractual relationship" with Guess, and **would give Fossil a monopoly of the fashion watch market, which it already dominates with a 40 percent share.**" – *New Callanen-Guess License Ends Dispute with Fossil*, William George Shuster, JCK Magazine, November 2005

[8] "Guess said its watch sales total about $150 million a year.
…
Richardson, Texas-based Fossil said it would form a separate company for the Guess business and would rely on its worldwide network to expand

sales beyond the $150 million global business it is now." – *Fossil to Make Watches for Guess*, Jennifer Waters, MarketWatch, 26 August 2005

[9] "As we've always talked about, our most profitable business, both from an operating margin and a gross margin perspective, are our international operations, primarily due to gross margins being higher due to the fact that we are, obviously, able to price our products at amounts slightly higher than the U.S. equivalent wholesales and retail. And in a number of those countries we're doing business with smaller mom-and-pop boutiques that, obviously, allow us to be a little more focused on driving margin.

If you look at the domestic businesses, **our accessories business is generally a 40 to 45% type of margin producer. And that depends somewhat within that range on the mix of FOSSIL versus RELIC.** RELIC is a little bit lower margin than that, obviously, because we're selling to J.C. Penney's and Kohl's, and we allow those guys be promotional with the RELIC product, whereas with the FOSSIL product it's primarily done at full price.

As it relates to the domestic watch business, our FOSSIL watch business, which is the largest piece of that, is obviously a significant contributor as far as margins, **probably 50 to 55% range**. **But what we have seen domestically is some of the gains we've seen from the increase in the MICHELE business and some of the other luxury brands have been offset by growth in the mass-market channel as well that, as we've talked about before, performs at a much lower level than our typical fashion or luxury watch business**.

And then **the retail stores on average** are going to be a little bit better than our domestic watch business, simply because we have the opportunity to sell at retail in those stores, and on a full price basis, **drive margins near the 75% level**. **But due to the mix of our outlet stores, which obviously sell at much lower margins than that, our retail business is probably coming in in the 55%-plus range as well.**" – Mike Kovar, Fossil's former CFO, 2005 Q4 Earnings Call Transcript

[10] "As it relates to international versus domestic, **our international margins are higher than our U.S. margins on the wholesale side, primarily due to the fact that we are afforded the luxury of selling at higher prices**. **We don't have the same competitive landscape** in the watch business in most of the markets internationally as we find here in the U.S., and therefore, the -- we can price much more sharply. **Our gross margin sort of generally anywhere from**

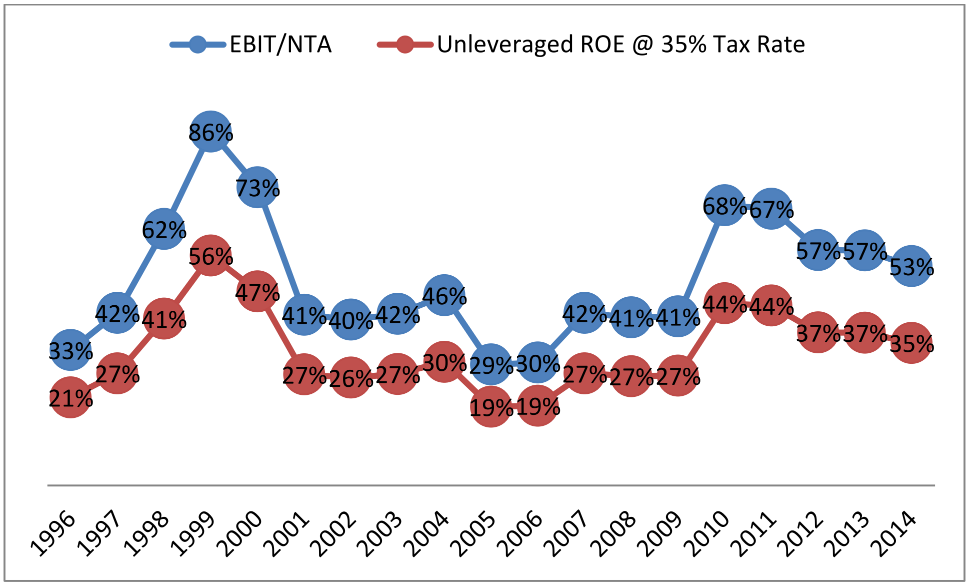
probably 5 to 10% higher in the international wholesale segment than they are in the U.S. segment on a like-per-like product perspective." – Mike Kovar, Fossil's former CFO, 2008 Q2 Earnings Call Transcript

[11] "**I think there've always been a lot of new brands entering the market, especially in the last five to six years or so. And some of those have not lasted very long as you can tell**. There's been a number of them that came in for a short while and then left pretty quickly and I think that process still continues. **Everybody that's in any kind of merchandising business wants to be in the watch business and they're always pursuing it and they sometimes put it in there and it's in there a short amount of time, they don't get much space and they leave**.

But I think that probably has not abated, there's probably still a lot of people trying to do that." – Kosta Kartsotis, Fossil's CEO, 2006 Q2 Earnings Call Transcript

Quality

Fossil Is a Platform to Gain Market Share in a Great Industry



Fossil can makes more than 30% after-tax ROE

- **Biggest Negative**:
  - The retail business has high operating leverage
- **Michael Porter Questions**
  - (-) means low
  - (=) means medium
  - (+) means high
  - **For the industry**
    - Can the industry charge a high price?
      - (+) industry can make 50% gross margin
    - Does the industry have low costs?
      - (-) Inputs are commodity
    - Does the industry have low need for assets?
      - (=) assets are mostly inventories
  - **For the company**
    - Can the company charge a higher or lower price than the industry?
      - (+) Stronger brands can charge higher price
    - Does the company have higher or lower cost than the industry?
      - (-) Fossil's brands can share the same supply chain

        - Does the company have more or less need for NTA than the industry?
            - (-) Fossil has higher inventory turnover than peers
- Fashion watches seem less sensitive to the economy than luxury watches
    - Movado
        - From January 2008 to January 2010
            - Revenue of Concord and Ebel declined by 55%
                - From $84 million to $38 million
            - Revenue of Movado and ESQ declined by 50%
                - From $224 million to $114 million
            - Revenue of licensed brands increased slightly
                - From $140 million to $144 million
                    - Declined only to $138 million in 2009
    - Fossil
        - Constant-current revenue growth was
            - 2008
                - Europe wholesale: 6.8%
                - Other international wholesale: 14%
                - U.S. wholesale: 2.6%
                    - Fossil declined 6.1%[1]
                        - Representative of the deteriorating economic condition in the U.S.
                - Direct to consumer: 22.3%
                    - Comparable store sales increased 2.3%
            - 2009
                - Europe wholesale: **-9.5%**[2]
                    - Fossil brand watch volume: declined 6.7%
                    - Licensed watch volume: declined 9.3%
                    - Jewelry sales volume: declined 16.1%
                - Other international wholesale: **-10.1%**
                - U.S. wholesale: **-0.3%**[3]
                    - Fossil watches declined 20.4%
                        - Fossil is the most mature brand
                        - Retailers managed their inventories
                - Direct to consumer: 22.7%
                    - Comparable store sales increased **7.8%**
    - Fashion watch benefited from increased penetration in 2008-2009

        - It may decline 20% in the next economic downturn
            - Like Fossil brand did
            - Retailers stop purchasing during economic downturns
- Watch is a much more simple business than apparel[4] [5]
    - 2,400 SKUs
        - Many of those have been around for a number of years
    - Don't depend on
        - Size
        - Weather
        - Month
- Fashion watches have shorter shelf life than luxury watches
- Fossil reduces the risk by speed
    - Over 550 employees working in creative process
    - Short lead time
        - Has assembly facilities near component suppliers
            - Better flow of communication
            - Consistent quality
            - Improve supply chain speed
        - Fossil's lead time is 75 days in Asia
        - Movado's lead time is 6 months or longer
            - Luxury watches have longer lead time
    - High inventory turn[6]
        - Able to make short runs and test
            - Before producing large quantities
            - => much faster inventory turns than peers
        - Fashion watches inherently turns faster than luxury watches
        - Cost of goods sold/Average finished inventory
            - Fossil: 3x
            - Movado: 2x
            - Richemont: 1.4x
- Gross margin is high
    - Has 50-55% gross margin in the U.S. [7]
        - Mass brands like Relic has 40-45% gross margin
            - Sell at lower price point
    - Gross margin is 5-10% higher in international markets[8]
        - Sells to mom-and-pop watch and jewelry stores
    - Customers don't buy on price

        - They don't know what a watch costs
        - They can only tell the fair price based on
            - The store
            - The brand
            - The list price
        - Customers tend to decide a price range for the watch they buy
            - Then select the one they like most
    - => brands compete for volume
- Fossil has both wholesale and retail operations
    - Wholesale: 74% of revenue
    - Retail: 26% of revenue
        - Including ecommerce
- There's chance for margin expansion in the wholesale business
    - Fossil has largely built infrastructure already for all markets[9]
    - Sales growth can leverage[10]
        - Infrastructure
        - POS systems
        - SAP
        - Etc.
    - Wholesale EBIT margin expanded overtime
        - (before 5% unallocated corporate expense)
        - 2006: 16.3%
        - 2010: 27.5%
            - Operating expense/sales declined
                - 2006: 33.0%
                - 2010: 26.3%
        - EBIT margin has declined since 2010
            - 2010: 27.5%
            - 2011: 27.1%
            - 2012: 25.6%
            - 2013: 26.8%
            - 2014: 24.6%
        - Mainly due to investment in
            - Asia
            - Some new brands
                - Karl Lagerfeld
                - Tory Burch

- It's hard to estimate Fossil's normal retail EBIT margin
    - Retail revenue: $925 million
        - Proprietary brands: $689 million
        - Licensed brands: $235 million
            - Fossil runs 99 watch station stores
                - Sell all of its brands
    - The retail business is risky
        - High operating leverage
        - Rent expense is 20% of revenue
        - A Fossil store in a mall is like a designer collection in a department stores
            - But it has broader line
            - Can attract repeat loyal customers that department stores don't
        - A Fossil store is less flexible than department stores
            - Department stores may change brands when sales per square foot decline
            - A Fossil store is stuck with its own products
        - => EBIT margin depends on store volume
    - Fossil's retail EBIT margin was within 10-14% since 2006
        - (before 5% unallocated corporate expense)
        - Exceptions
            - 2007: 9%
            - 2008: 4%
    - Fossil's store count grew very fast over the period
        - EBIT margin was low when store count growth was high
        - 2006: 188
            - Growth:
            - EBIT margin: 11.4%
        - 2007: 231
            - Growth: 23%
            - EBIT margin: 8.5%
        - 2008: 311
            - Growth: 35%
            - EBIT margin: 4.2%
        - 2009: 349
            - Growth: 12%

            - EBIT margin: 10.4%
        - 2010: 360
            - Growth: 3%
            - EBIT margin: 13.7%
        - 2011: 398
            - Growth: 11%
            - EBIT margin: 14.4%
        - 2012: 473
            - Growth: 19%
            - EBIT margin: 13.8%
        - 2013: 543
            - Growth: 15%
            - EBIT margin: 10.8%
        - 2014: 593
            - Growth: 9%
            - EBIT margin: 12.4%
    - The retail business may make 15% normal EBIT margin
        - 10% after corporate expenses
        - Department stores make 10-11% EBIT margin
        - EBIT margin of other fashion retailers over the last 10 years
            - Abercrombie & Fitch:
                - High: 20%
                - Low: 1%
            - American Eagle Outfitter:
                - High: 21%
                - Low: 5%
            - Gap:
                - High: 13%
                - Low: 7%
        - => fashion retailers makes about 10% margin over a cycle like department stores
            - But fashion retailers have much more volatile margin
                - Because they sell only their brand
            - Fossil is less volatile than these fashion retailers
                - But won't be as stable as department stores
- Fossil can make over 15% average margin
    - Wholesale: 27%

- Retail: 15%
- => weighted pre-corporate margin: 23.6%
  - = 27% * 76% + 15% * 24%
- Corporate expense: 5%
- => potential margin: 18.6%
  - Fossil achieved 18.5% margin in 2010
- 22-year median margin: 15%
- 22-year median Sales/NTA: 3.2
  - 3.3 in 2014
- => average ROIC is about 48%
  - Over 30% after-tax ROIC

- 8 dimensions of quality
  - Relative size
    - In North America
      - Department stores are big buyers
      - But Fossil has 50% market share in watches between $100 and $1,000
    - In Europe: tiny buyers
      - Sells to mom-and-pop watch and jewelry stores
  - Focus
    - Not as focused as Movado
    - But Fossil's products are related
      - Watch, leather goods, jewelries are all accessories
      - Similar economics
    - Fossil has 2 main businesses
      - Proprietary brands
        - Fossil and Skagen
      - Licensed brands
        - for watches and other accessories
  - Customer engagement
    - Low
  - Cross-selling
    - Consumers may buy different Fossil-branded products
  - Retention
    - Low
  - Words of mouth
    - Low

- Reinvestment rate
    - Total advertising expense since 2000: $1.6 billion
- Stock's popularity
    - Float: 38 million shares
    - Short % of float: 24%
    - Share turnover: 1,084%
    - Number of analysts covering the stock: 14
    - Concentrated owners
        - Vulcan Value Partners: 6% of portfolio
        - Weitz Partner Value Investors: 2.5% of portfolio

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[1] "During fiscal year 2008, the increase in wholesale watch shipments in the U.S. was primarily the result of sales volume growth in licensed brand and MICHELE watches, partially offset by a sales volume decrease in FOSSIL watches. Licensed brand watch sales included a 108.4% increase from MICHAEL KORS and a 33.9% increase from EMPORIO ARMANI. We attribute the increases for both of these businesses to further penetration of the lines in the department store channel and new doors being added for MICHAEL KORS. These increases were partially offset by DKNY watches, which experienced a 25.3% net sales volume decline. The decrease in our DKNY watch business was for similar reasons as explained above for our European wholesale segment. MICHELE watch sales volume rose 20.8% during fiscal year 2008, primarily as a result of a significant reduction in the level of returns experienced during the year as compared to the prior fiscal year. The increased level of returns in fiscal 2007 was primarily driven by an accommodation made to ship more new styles and by the manner in which product was shipped. Watch heads and straps were shipped assembled together as a complete watch rather than being shipped separately. As a result, end of season fashion watches had to be returned to change the straps to current fashion colors**. During fiscal 2008, the FOSSIL watch business represented the highest penetration level of our fashion watch brands within the moderate department store environment. As a result, its growth was mostly predicated on the overall performance of the moderate department store channel. We believe the 6.1% net sales decline in FOSSIL watches to be representative of the deteriorating economic conditions in the U.S. throughout 2008**, which resulted in lower traffic levels in department stores and an overall decline in department store sales during 2008." – Fossil 2009 10K

[2] "The following discussion excludes the impact on sales attributable to foreign currency rate changes as noted in the above table. **The net sales decline in our European wholesale segment during fiscal year 2009 was primarily the**

result of sales volume declines in our core watch and jewelry businesses of 9.4% and 16.1%, respectively. We believe that weakening economies, and the resulting decrease in discretionary spending was the primary reason for our sales volume decreases in this segment. **The declines had a bigger impact on our larger, more penetrated businesses. The decrease in our watch business was principally the result of FOSSIL and licensed brand watch sales volumes declining 6.7% and 9.3%, respectively, while the reduction in our jewelry sales volume was primarily led by a 21.1% decrease in Fossil jewelry**. However, for brands and businesses recently introduced into our European wholesale segment and for those brands and businesses less penetrated, and thus continuing to expand into new doors, we experienced sales growth. For example, our recently introduced FOSSIL leathers business increased 18.5% during fiscal year 2009, with solid growth in both the women's and men's categories. We believe the expansion of our leathers business is partly attributable to the growth of our FOSSIL accessory store concept in this region, which is continuing to improve the brand awareness across all FOSSIL categories. **Additionally, MICHAEL KORS_ and BURBERRY_ watch sales volumes rose 17.7% and 8.7%, respectively, primarily as a result of an increase in the penetration level with existing customers and new door growth**. During fiscal year 2009, net sales were also favorably impacted by the introduction of DKNY_ jewelry, launched during the third quarter of fiscal 2008. Although we believe the current economic environment in Europe will negatively impact our ability to substantially grow our sales in the near-term, we believe we have maintained, if not increased, our market share and have positioned the Company to grow as the economic environment and discretionary spending improves." – Fossil 2009 10K

[3] "**Domestic wholesale shipments of FOSSIL watches declined 20.4% during fiscal 2009, which we believe resulted from retailers managing their inventories conservatively**. FOSSIL is the most penetrated watch business within our portfolio in the U.S. wholesale segment and thereby more significantly impacted by comparable stores sales within the department store channel." – Fossil 2009 10K

[4] "One of the things we mentioned in here is that we have a lot of initiatives in the Company to look at all the SG&A in the Company from top to bottom. And we think we can glean out of that additional capital invested in growth.

One of the ideas behind this is reducing the SKU count. We've gone through this process before. **SKU is kind of growing and we have to bring them back with -- as we mentioned in the remarks, we have 2,400 active SKUs that are doing $2.7 billion. And those styles that we change very often, a lot of**

those styles are actually been around for a number of years. A lot of them are on quick response, automatic reorder with a lot of stores.

So, **this is probably what makes our business very simple for us to operate much more simple than an apparel business center, which has sizes and weather and it changes every month**. I mean, it's a much more simple business. But this process is tightening the SKUs even more. **We think it will give us additional sales per SKU to make it even simpler for us to operate. And it will reduce a lot of cost in terms of inventory obsolescence, product development, sampling**. It's a big initiative for us in our scope. It can save us a lot of money and make us more effective at the point of sale, so we think it's a big idea." – Dennis Secor, Fossil's CFO, Investor Day 2015

[5] "Robin Murchison, Analyst: Right, no, honestly, when I look out there, a lot of different retail websites and then the wholesale websites obviously on back order. I am wondering how much in sales you are missing because you just don't have enough of these popular styles to satisfy demand?

Kosta Kartsotis, Fossil's CEO: Well, the one thing that is interesting about that is we had -- obviously Michael Kors grew very quickly last year as well and we have identified a number of key styles there that we have got pretty large quantities that has been rolling. And I think we tripled the business in the first quarter, right, Mike?

Mike Kovar, Fossil's CFO:: Right.

Kosta Kartsotis, Fossil's CEO: Obviously, you're going to run out of some styles, but on balance, if you look at, not just Michael Kors, but how much we grew our watch business last quarter, part of this is due to our operating model. **We have relatively short lead times on reorders. So as we said in the notes, we saw very strong trends in watches in December and what we are shipping over the last couple of months is things that we saw in December sell-in and we aggressively bought back into them**.

One of the benefits we have in our business model is **the watch business does not change as fast as other businesses. It is not seasonally driven and we don't have a lot of seasonal products. The stuff that sold really well in December is exactly the same thing that is selling right now.** And we are seeing things that have changed slightly and suddenly in the last six, eight weeks and those things are going to sell 90 days from now when we get reorders back in.

So part of the reason we are so optimistic on the watch business is we are seeing -- it has been broad-based, consistent. It has been happening for several months; it is happening in all brands. There is a lot more interest in watches generally and we are getting additional resources from the stores that are putting more inventory in and they are putting in more salespeople, giving it more space. I mean we are seeing a very positive future for watches over the last several months." – Fossil 2010 Q1 Earnings Call Transcript

[6] "The creativity really prospers in this building. **There's 1,100 people in this building. About half of them are working on the creative process**, whether it's merchandize design, marketing, product development. Very much of a creative engine.

And product is the most important thing we do and everything we say today or on -- in the future, all starts with product innovation, brand building, design and the customer experience.

This is our strength and this is what we do first and foremost.

We also have, you know, over the many, many years, the reason the Company's grown so fast is because **in addition to the creative part of the Company, we're very scientific. Fast inventory turns, test and react, really scientific operations globally and especially against our competitors, in a large way, we have not only exported watches around the world, but retail science around the world**.

And we're going to talk about today, we're going to even accelerate that even more and get more scientific as we feel like we have a much bigger opportunity.

The other important thing in the Company that we talk about is the fact that **we're operating in accessories and watches**, these categories are the best you could possibly operate in globally, **they cross borders easily, we sell the same watches and accessories around the world that at the same time we have relatively small number of SKUs**.

In fact in the Company right now we have 2,400 active watch SKUs that do about $2.7 billion. You can imagine the impact that has on our operations. It's just a much simpler business to operate.

The business is much more inherently profitable. Our margins are higher. The stores that we sell to, their margins are higher. Lead times are shorter. In our manufacturing base, we're actually able to make relatively short runs and test before we produce large quantities.

Our inventory turns are much faster because of that. We also air-freight watches around the world because it doesn't cost much to do it. And the time it saves us is much more important than the cost to doing it, so huge amount of advantages." – Kosta Kartsotis, Fossil's CEO, Investor Day 2015

[7] "As we've always talked about, our most profitable business, both from an operating margin and a gross margin perspective, are our international operations, primarily due to gross margins being higher due to the fact that we are, obviously, able to price our products at amounts slightly higher than the U.S. equivalent wholesales and retail. And in a number of those countries we're doing business with smaller mom-and-pop boutiques that, obviously, allow us to be a little more focused on driving margin.

If you look at the domestic businesses, **our accessories business is generally a 40 to 45% type of margin producer. And that depends somewhat within that range on the mix of FOSSIL versus RELIC.** RELIC is a little bit lower margin than that, obviously, because we're selling to J.C. Penney's and Kohl's, and we allow those guys be promotional with the RELIC product, whereas with the FOSSIL product it's primarily done at full price.

As it relates to the domestic watch business, our FOSSIL watch business, which is the largest piece of that, is obviously a significant contributor as far as margins, **probably 50 to 55% range**. **But what we have seen domestically is some of the gains we've seen from the increase in the MICHELE business and some of the other luxury brands have been offset by growth in the mass-market channel as well that, as we've talked about before, performs at a much lower level than our typical fashion or luxury watch business**.

And then **the retail stores on average** are going to be a little bit better than our domestic watch business, simply because we have the opportunity to sell at retail in those stores, and on a full price basis, **drive margins near the 75% level**. **But due to the mix of our outlet stores, which obviously sell at much lower margins than that, our retail business is probably coming in in the 55%-plus range as well.**" – Mike Kovar, Fossil's former CFO, 2005 Q4 Earnings Call Transcript

[8] “As it relates to international versus domestic, **our international margins are higher than our U.S. margins on the wholesale side, primarily due to the fact that we are afforded the luxury of selling at higher prices**. **We don't have the same competitive landscape** in the watch business in most of the markets internationally as we find here in the U.S., and therefore, the -- we can price much more sharply. **Our gross margin sort of generally anywhere from probably 5 to 10% higher in the international wholesale segment than they are in the U.S. segment on a like-per-like product perspective**.” – Mike Kovar, Fossil’s former CFO, 2008 Q2 Earnings Call Transcript

[9] “And, of course, on distribution channel, we sell in different distribution channels around the world. The United States is mostly department stores and that's pretty robust business. In Europe, we largely sell mom and pop watch and jewelry stores which is a huge network of them over there.

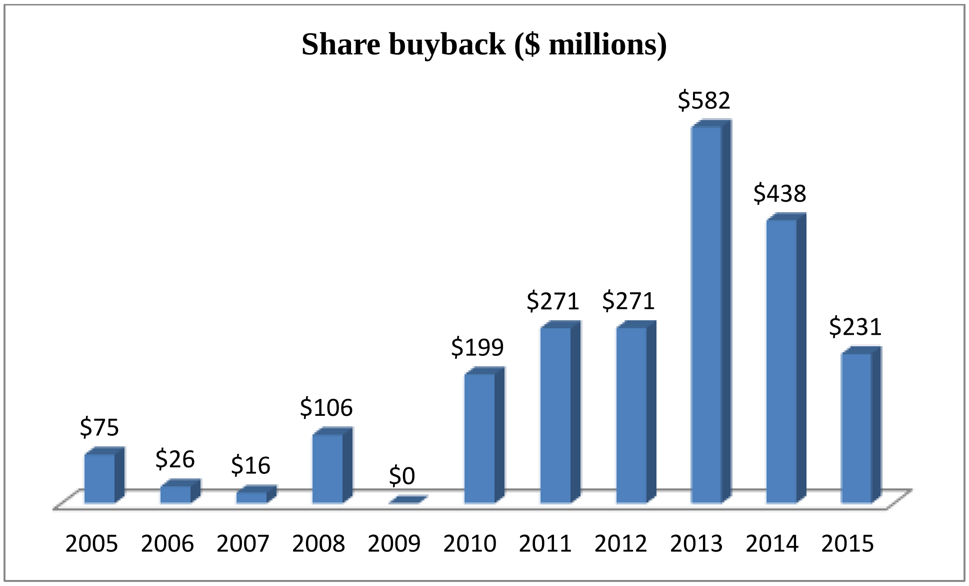
In Asia, it's very different. In China, it's mostly concessions that are one at a time and somewhat complex. In India, we're actually making progress, opening our own stores. So it's a very complex global situation but the fact that we have our own people on the ground in all these markets, we have automated warehouses in the wherewithal to go-to-market in different ways in different markets.

And the other thing is that we've largely built infrastructure already for all these markets. So as we mentioned in our calls that we think we are in a position where we continue to leverage, and we'll talk about that when we talk about our fuel for growth.” – Kosta Kartsotis, Fossil’s CEO, Investor Day 2015

[10] “As far as the operating income percent, **we've always targeted that 16.9% or 17%. We think that, as we continue to leverage investments we have made around the world in infrastructure, POS systems, SAP, etc**., the margins on these categories are very high. We think, as we get larger, that we can move towards that 16.9% or 17% and we are focused on that. **We do look at other companies and look at what the operating margin potentials are in retail and distribution categories similar to ours. And we think that 16.9% is very doable**.” – Kosta Kartsotis, Fossil’s CEO, 2010 Q1 Earnings Call Transcript

Capital Allocation

Kosta Kartsotis's Only Compensation Is from Share Price Growth



Fossil has spent more than $2.2 billion in share buyback since 2005

- **Biggest Negative**:
  - Fossil currently has $502 million net debt
- Management interests are aligned with shareholders'
  - The CEO receives no compensation[1]
    - His primary compensation is met by stock price growth
    - Kosta Kartsotis currently owns 12.3% of Fossil
      - He's the biggest shareholder
  - Compensation for other named executive officers include
    - Base salary
    - Short-tern annual cash incentive
    - Long-term equity incentive
  - Short-term annual cash incentive and retention awards
    - Performance rating percentage is based on annual performance
      - 0-100% of base salary
        - "needs improvement" performance: 0%
        - "outstanding performance: 100%
    - => determine the bonus target
    - Bonus payout percentage is based on EBIT targets achieved
      - Ranges from 10% to 150%

        - Bonus = base salary * Bonus Payout Percentage * Performance rating percentage
    - Long-term retention and incentive equity awards
        - Grants
            - Stock options
            - RSUs
            - Stock appreciation rights
        - Value is equal to a % of total cash compensation
            - The % depends on performance
                - 18%: meets expectations
                - 35%: exceeds expectation
                - 43%: outstanding
    - Total compensation isn't high
        - 3-year average of total compensation is
            - Dennis Secor, CFO: $1.7 million
            - Darren Hart, Executive VP, HR: $1.7 million
            - Jennifer Pritchard, President, Skagen: $1.9 million
            - John White, COO: $1.4 million
- Annual dilution: **0.6%**
    - Fossil issued 8,091 thousand shares over the last 10 years
        - Related to
            - Stock options
            - Stock appreciation rights
            - Restricted stock units
    - The dilution was offset by $205 million share repurchase
        - $205 million was the total of
            - Non-cash stock-based compensation expense
            - Proceeds from exercises of stock options
        - => bought back about 3,872 thousand shares
    - => net shares issued: 4,219 million
        - = 8,091 – 3,872
    - Fossil had 71 million shares at the end of 2004
    - => 6% dilution over the period
    - => Less than 0.6% annual dilution
        - Dilution was more significant when EBIT growth was high
            - EBIT is a big part of Fossil's compensation
            - In 2007

            - Share issued: 2,330 thousand
            - Dilution: 3.6%
            - EBIT growth: 51%
        - In 2010
            - Shares issued: 1,545 thousand
            - Dilution: 2.3%
            - EBIT growth: 78%
- Kartsotis is an aggressive value builder
    - Fossil expanded horizontally and vertically[2]
        - Horizontal expansion[3]
            - Start out as a single brand
            - Add brands and products
                - Add licensed brands
                - Expand to related products
                    - Leather goods
                    - Jewelry
            - Attempt to own the shelf
            - Horizontal expansion gives Fossil scale to
                - Expand vertically
                - Grow globally
        - Vertical expansion
            - Invest in manufacturing facilities
                - (assembly operations)
                - In China[4]
                - In Switzerland
                    - To make watches for brands like
                        - Fossil
                        - Emporio Armani
                        - Burberry
                        - Tory Burch
                    - Fossil makes Swiss watches to grow in Asia
                - Having assembly operations allows for
                    - Better flow of operations
                    - Consistent quality
                    - Product design protection
                    - Faster supply chains speed
            - Invest in distribution capabilities

        - Own distribution companies in most markets[5]
            - Most competitors sell to distributors
        - Sell directly to mom-and-pop retailers in Europe
        - Invested a lot in Asia
            - A big reason for lower EBIT margin recently
            - Built structure to do concession-based business in Asia[6] [7] [8]
                - Hire senior management people in Asia
                - Add people to manage concessions
                    - Open concessions
                    - Do visual presentations
    - Invested in retail operations
        - Open Watch Station International stores
            - 99 stores
            - **$225 million** revenue
            - Sells watches from all of Fossil's brands
        - Open Fossil stores
            - 469 stores
            - **$689 million** revenue
            - Help raise brand recognition
            - But also raise the risk profile of the business
                - High operating leverage
        - Has over 330 concessions in Asia
            - Asia is now a $566 million business
            - This business is good[9]
                - Operates in department stores
                    - Fossil concession store
                    - Multi-brand watch concession store
                - Pay a % of sales
                    - Instead of fixed rent expenses
- Fossil's reinvestment has produced great result
    - In the 1992-2004 period
        - Fossil returned almost no cash to shareholders
        - Annual sales growth: 24%
            - 1992: $74 million
            - 2004: $960 million

        - EBIT annual growth: 24%
            - 1992: $11 million
            - 2004: $141 million
    - In the 2004-2014 period
        - Fossil spent **$1,985 million** in share repurchase
            - Including
                - $205 million was from
                    - Non-cash stock-based compensation expense
                    - Proceeds from exercises of stock options
                - $519 million from debts
            - True cash return was **$1,261 million**
                - = $1,985 million – $205 million – $519 million
        - Total earnings was **$2,202 million**
        - => Fossil distributed almost **60%** of earnings
            - = $1,261 million / $2,202 million
        - Annual sales growth was **14%**
            - 2004: $960 million
            - 2014: $3,510 million
        - Annual EBIT growth was **15%**
            - 2004: $141 million
            - 2014: $567 million
    - => implies over 30% after-tax ROIC
- Fossil doesn't pay dividend
    - This is strange when the CEO receives no compensation
    - Fossil repurchased shares every years since 2003
        - Except for 2009
    - Fossil doesn't time share buyback
- Fossil makes few acquisitions
    - Only 2 significant acquisitions
    - Skagen
        - In 2012
        - Paid $230 million
        - Skagen revenue was $120 million
            - EBIT margin: 17%
        - => Fossil paid 11.3x EBIT
        - Fossil wants to grow Skagen similarly to the Fossil brand
            - A Danish lifestyle brand

        - Skagen's revenue has grown to $150 million in 2014
    - Misfit
        - A maker of activity tracking bracelet
        - Fossil agreed to pay $260 million
        - Misfit revenue is only $30 million
        - Fossil acquired Misfit for
            - Its battery technology
            - The app platform[10] [11]
                - Believes that apps and cloud services are part of product
                    - And extension of brands
                - => Too important to outsource
        - The acquisition is consistent with Fossil's preference for vertical integration
            - It's unclear how much more Fossil will invest in this area
            - It can be a mistake
- Fossil's current debt level is pretty high
    - Fossil historically avoided debt
    - Only started having positive net debt in the last 3 years
        - Spent **$1,251 million** in share buyback since 2013
        - Reduced share count by 19%
    - Fossil currently has $502 million net debt
        - Adding pending $260 million acquisition of Mistfit
        - => $762 million net debt
            - 1.34x 2014 EBIT ($567 million)
            - If EBIT declines to $300 million
                - Net Debt/EBIT is 2.54x
        - Fossil won't repurchase shares
            - It'll focus on reducing leverage

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[1] "For fiscal 2014, **Mr. Kartsotis, our CEO, continued to refuse all forms of compensation, expressing his belief that, given his level of stock ownership, his primary compensation is met by continuing to drive stock price growth, thereby aligning his interests with stockholders' interests**. As a result, the following references to Named Executive Officers in this Compensation Discussion and Analysis do not include Mr. Kartsotis." – Fossil 2015 Proxy

[2] "So what are the big picture implications of these two macro trends in the convergence? As Kosta mentioned in our opening, **there are two ways the Company has competed for decades in a very simplistic way of looking at this**.

The first is horizontal advantage where you may start out as a single brand in the product company but you add brands and products as you search for growth and as you attempt to own the shelf, it's horizontal advantage.

And by virtue of starting with Fossil as a single humble brand in watches and adding a portfolio brands, that's exactly the course that we took and adds a horizontal advantage as part of our business model **whereas for vertical advantage, you compete with better, relative scope or scale in one or more areas of your value chain**. This is true for all categories. We see the dynamics as ways of competing from automobiles to electronics and also is the case in fashion accessories in our business.

At Fossil Group, we're fortunate to have a business model **where we've been able to bring product and brand diversity at scale, at scale in design, at scale in manufacturing, at scale in global distribution and multi-channel retail.**" – Greg Mckelvey, Fossil's Chief Strategy and Digital Officer, Investor Day 2015

[3] "And also we're horizontally advantaged in terms of taking those brands**. So our opportunity over the future is really to take additional brands and leveraging them across our infrastructure in a vertical way as well as horizontal.**

So we operate and the way we look at the Company is we have three distinct businesses, using shared services globally. **And we learned a long time ago, it's very difficult to grow one brand globally. We started by trying to sell Fossil, you never get enough critical mass. We were using distributors, you never were important, you couldn't tell your story**.

It wasn't until we really developed the idea of the portfolio in addition to Fossil, going into a market, having -- being able to adapt to a market, get critical mass and helps us invest, makes the business more profitable. It's really been a big unlock for us, so the idea of having these three businesses using shared services globally.

Part of **the reason why we had an early-mover advantage in going global** is because of the fact that watches and accessories cross borders easily.

The other reason **is because we were able to invest and there's a portfolio approach in the market rather than just putting one brand in the markets**, very, very complicated. That was one of the reasons we move so fast, still big advantage for us." – Kosta Kartsotis, Fossil's CEO, Investor Day 2015

[4] "Manufacturing and sourcing, our factories that we make our watches in, as you know, **we make most of our watches ourselves, huge competitive advantage. It's really the secret weapon in the Company**.

The amount of innovation, design, the quality, the quickness, the sheer volume that they can produce and every single day, they come in and say, "How can we get better more innovative?" Their -- that operation in China largely drives the Company. They can almost do anything and it's amazing what they do and they drive innovation for us and really inspire all of us." – Kosta Kartsotis, Fossil's CEO, Investor Day 2015

[5] "Global distribution started -- one other thing I would say about the Company is we've always been very investment-oriented. We started very early on selling watches to distributors around the world.

And again, in this idea of long-term runways, sustainable growth, we started acquiring those distributors. **So we now have -- we do over 50% of our business outside the United States, 85% of it, the business outside the US is actually done through our wholly-owned subsidiaries.**

There are 26 subsidiaries around the world. We have complete control over them. If you go into a concession in Korea in the department store, the person standing behind the counter is a Fossil employee.

Having that kind of control and efficiency and also the information, we know real-time what's selling in those markets, so our inventory is much more productive and more competitive than our competitors.

We also have a global support structure. Over the many years of again, investment in our business in the long-term future have put in technologies such as SAP we install 10 years ago.

If you see our growth over the last seven years, we never would have been able to grow as fast as we did if we had not put SAP in place for example.

Automated warehouses around the world, we also have a global repair facilities network all over the world, so obviously, we have warranties on our watches you can get in one of our product mix anywhere in the world.

That operation alone, very complicated and sophisticated with 10s of 1,000s of spare parts and the ability to fix multiple styles is very complicated. We have a very strong network of that. **We spend significant amount of money, about $20 million a year just on the repair network, significant barrier to entry but a huge competitive advantage for us**.

And, of course, our global management, we have over the last couple of years actually globalized the Company. **We have companies broken into three regions, the Americas based here, of course, Asia which is based in Hong Kong office. Asia, right now, is about $600 million business, very significant**.

Our European business based in Basel, a $1.2 billion business, very significant infrastructure there with people, merchants, retail organizations. Our mission as a global organization is to empower the regions to grow with guidance and really have them be closer to customer and grow faster. We think it's a great unlock for us in the future." – Kosta Kartsotis, Fossil's CEO, Investor Day 2015

[6] "**Obviously in our Multi-brand Watch business, it's pretty large long-term opportunity for us to continue to build out the infrastructure, especially in Asia. If you look at the hundreds of millions of new people joining the middle class in Asia**, that's basically our Fossil customer and our multi-brand watch customer, so we think there's a very large opportunity out there that we're building in to. **If you look at those two businesses and they use shared services around the world, to us it's a very compelling business model, and we think that long term it will help us penetrate those new markets in Asia**, even more efficiently than you might if you just had one brand." – Kosta Kartsotis, Fossil's CEO, 2012 Q1 Earnings Call Transcript

[7] "In China, we are actually studying several different methodologies. The one thing **I would say about Asia that appears to us at this point like we have seen in Korea that a lot of it is going to be concessions**, which they can tend to grow much faster because they are cashing full retail instead of wholesale.

The operating model is very good also in terms of profitability for us and it also enables us to control a lot of the process, the (inaudible) presentation assortments, the sales process, etc. **So we feel like Asia and China will be largely concessions, which part of the infrastructure we are putting over there is really enabling us to implement a broader concession-based business throughout Asia**. And I think that is what is going to accelerate the growth." – Kosta Kartsotis, Fossil's CEO, 2010 Q4 Earnings Call Transcript

[8] "So as to say how long it will take us to get to a third, it's very difficult because we're focused on growing the entire world, and at the same time we're putting significant resources in Asia to capture that market.

So as to the expenditures we're making there, we have a whole re-organization, a huge work chart that we've been hiring into. **We've hired a number of key players throughout the region, including some senior management people**. And as I said on the comments earlier, we have sent a number of ex-pats there to really accelerate the learning. **So we've sent people over there to help train and get people up to speed on our operating model, et cetera**.

And there's a number of other investments that we are making throughout the region to **add management and people to manage concessions, open concessions, do visual presentations, do construction and facilitation of fixturing**. There's a number of large initiatives that they're focused on over there and we are supporting them as much as possible. And we are really very, very active in the market right now." – Kosta Kartsotis, Fossil's CEO, 2011 Q1 Earnings Call Transcript

[9] "<u>Scott Krasik, Analyst</u>: Thanks, Kosta. And when you talk about having concessions, are these mono-brand concessions? Are you doing the multi-brand concept yet? And how many concessions are you at and how many can you get to?

<u>Kosta Kartsotis, Fossil's CEO</u>: So if you look at our business model, we have basically two core businesses -- the FOSSIL brands and then the multi-brand watch business. So in Asia, for example, we're developing a group of people that will build the FOSSIL brand, so there will be stores, websites, and concessions -- FOSSIL stores inside of department stores.

We also have a multi-brand watch business in those markets where there will be concessions and potentially Watch Station Stores in those markets as well. **So in some of the stores throughout Asia, we will have a FOSSIL store inside a**

department store. And in that same store we will have a multi-brand watch concession. And this all ties back in with our long-term Watch Station strategy to really study closely how we are as a direct vertical retailer of the watch category in really an effort to gain market share, and to communicate the whole idea of fashion watches around the world and the brands that we carry. So we think the Watch Station idea globally kind of dovetails in with our concessions strategy, especially in Asia, as we move forward. So it's a big, long-term strategy on both the FOSSIL brand and on the multi-brand watch business.
…
Barbara Wyckoff, Analyst: Hi, everyone. Can you talk about how many concessions do you have now by country in Asia? And can you talk about the mechanics of how they run? Are they different -- China, Japan, Korea? Or they have different sort of -- are they all pretty much the same? And then can you talk about the four-wall margins in your own stores? And is there a difference between the legacy versus the new stores?

Kosta Kartsotis, Fossil's CEO: On the concessions, we don't have the numbers by country, but the way it works is basically, **we go in and pay a percentage of sales; we own the inventory; and these are our sales people**.

The great thing about the concessions and probably the reason for Korea's growing so fast is we capture full retail. **And the operating margin on those operations is very, very strong. So it's a great way to grow and also the capture of bigger part of the retail picture and also to control our own destiny**.

The number one thing is to have our own people and our own visual presentation, presented the way we want to with the right amount of inventory flowing correctly, and really drive significant sales if it's done correctly, which is what we're focused on." – Fossil's 2011 Q1 Earnings Call Transcript

[10] "**The Misfit acquisition is really about owning the cloud on the app platform, given how integral it is now to product and brand and customer experience. So, we'll own that part of the customer experience through the app and cloud**, but we will continue to partner with the leading technology companies across the world to continue to build the right ecosystem of partners to compete in this space. So, we'll – the best hardware providers, the best contract manufacturer, the right ecosystem, cloud partners, whether that's music or fitness or what have you. So, it still takes an entire ecosystem. **This is just about us owning the cloud and app platform that's now part of product and**

brand." – Gregory McKelvey, Fossil's Chief Strategy and Digital Officer, 2015 Q3 Earnings Call Transcript

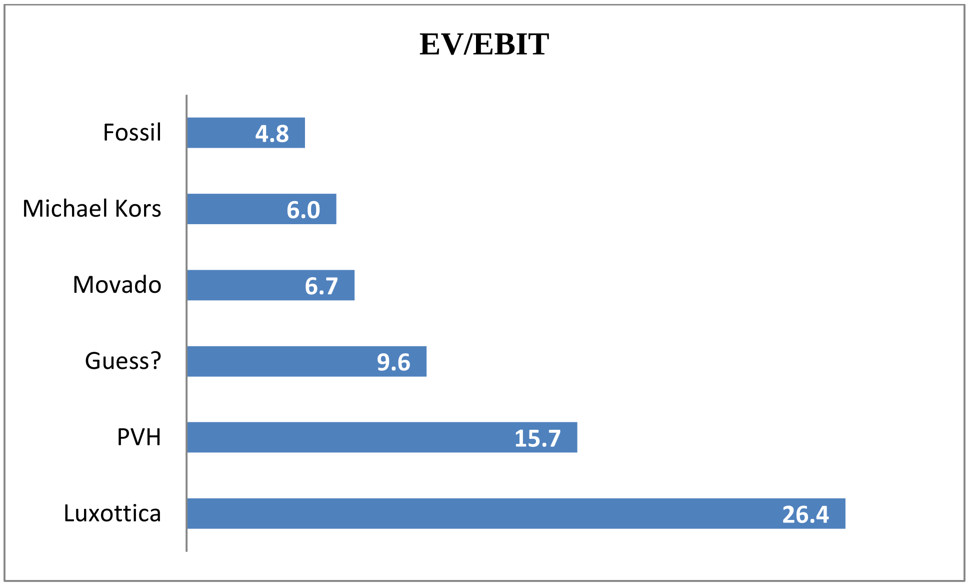
[11] "Yeah, in terms of the confidence in the size of the category, it's – I think the first is, we're seeing the market develop, where it's increasingly clear to us that wearable technology is and will be a large growing category. There's projections out there that are putting it about $45 billion in the next four years or five years with roughly two-thirds of that being wrist wearing, that would put the size of that market at roughly the same size of the under $1,000 global watch market. And we believe that, **all three categories that make up that market, which would be activity trackers, smartwatches with display, and then the third being smarter watches, so integrating technology similar to what you'd find in activity tracker into the same type of watches we sell today**, all three of those are viable products that are – that we see actually are Fossil Q launch being very successful with. So we're going – part of that we see the market is developing and we have a position to play in it.

With Misfit, it's – we've learned a lot in the last couple years in developing products and bringing to market Fossil Q. **We believe that we're now in a connected age where apps and cloud services are effectively now a part of product and an extension of brand**, and that needs to support and mirror our business model of today, so meaning multi-brand, fashion and design-driven, and globally-scalable. And **it's so integral now to product and brand development that it's really too important to outsource that to somebody else. So we need – we want to own that customer experience, own the platform, be able to have – be get to market much more quickly. And then as we scale it across the breadth of our portfolio of brands** in 20 languages in 115 countries, just a pure economics of scaling our product size, breadth, number of brands across the fixed cost of the development of that platform makes for a much more attractive margins, ultimately, than we'd get if we fully outsourced it.

And then – sorry, I'd just add one other thing. In Misfit, specifically, **they've got a very talented team that spent the last four years solving some of the hardest problems in wearables, including battery life. And their platform has already – because they've got – is already supporting multiple brands given their partnerships with Swarovski and Victoria's Secret and others**. They're global especially with strengths in the U.S. and in Asia, which is important to us. They've got an 18-month pipeline of products and innovation that we're going to be able to extend not only into the Misfit brand, but into the full breadth of our product portfolio and brand portfolio. And then, it's a digitally native brand as we discussed on the call as well that allows us to get into consumer electronics and healthcare and enterprise and other channels we're not in today. So, a significant opportunity to expand our addressable market.” – Gregory McKelvey, Fossil’s Chief Strategy and Digital Officer, 2015 Q3 Earnings Call Transcript

Value

Relative Valuation of Fossil and Peers Makes No Sense



Fossil is trading at 20% discount to its biggest licensor (Michael Kors) and 28% discount to its direct peer (Movado)

- **Biggest Negative**: Normal earnings of Fossil brand is unpredictable
- Key inputs
  - Number of shares: 48.12 million
  - Share price: $40
  - Cash: $302 million
  - Debt: $1,067 million
    - Including potential debt to pay for the acquisition of Misfit
      - $260 million
  - EV: $2,691 million
  - Normal EBIT: $452 million
  - EV/Normal EBIT: **5.95x**
  - Effective tax rate: 30%
- Fossil can make **$452 million** normal EBIT
  - 2014 EBIT was $567 million
  - But Michael Kors revenue was abnormal
    - Estimated Michael Kors revenue:
    - 2009: less than $100 million
    - 2010: $193.4 million

        - 2011: $300 million
        - 2013: $730 million
        - 2014: $923 million
    - Normal revenue might be $3 billion
        - Armani makes over $300 million
        - Other brands average about $130 million per brand
        - Fossil has added
            - Karl Lagerfeld
            - Tory Burch
            - Kate Spade
            - Chaps
        - Potential decline in sales is less than $500 million
            - It's very safe to assume $423 million revenue from
                - Michael Kors
                - Karl Lagerfeld
                - Tory Burch
                - Kate Spade
                - Chaps
    - 2014 sales included
        - Wholesale: $2,585 million
        - Direct to consumer: $925 million
    - Most of the $500 million potential decline will be in wholesale
        - Resulting in
            - Wholesale: $2,085 million
            - Direct to consumer: $925 million
    - Wholesale can have 25% EBIT margin
        - Was 25% in 2014
        - Averaged 27% in 2010-2013
        - => $521 million EBIT
            - = $2,085 million * 25%
    - Direct-to-consumer EBIT was $115 million
    - Corporate expense was $184 million
    - => **$452 million** normal EBIT
    - $452 million isn't aggressive compared to historical profits
        - Implies 15% EBIT margin
            - Similar to 23-year median margin
        - Fossil made **$472 million** EBIT in 2011

        - Michael Kors made $300 million in that year
            - Less than the assumed future revenue from
                - Michael Kors
                - Karl Lagerfeld
                - Tory Burch
                - Kate Spade
                - Chaps
        - Total revenue in 2011 was $2,567 million
            - Less than the assumed normal revenue of $3 billion
    - Short-term EBIT may be lower than $452 million in the short run
        - It may take some time for Fossil to reduce expenses
- Peers include
    - Luxottica (LUX)
        - The world's largest manufacturer of sunglasses
            - and prescription eyewear
        - Luxottica owns famous brands such as
            - Oakley
            - Ray-ban
            - Oliver Peoples
        - Luxottica is the partner of choice of licensing brands
            - Designer-licensed brands include
                - Prada
                - Chanel
                - Ralph Lauren
                - Burberry
                - Tiffany
                - Coach
                - Armani
                - Kors
        - Revenue mix
            - Proprietary brands: 69%
            - Designer brands: 31%
        - Luxottica is the most similar peer to Fossil
            - Strong advantage in
                - Design
                - Distribution
            - Stronger than Fossil in manufacturing

            - Luxottica dominates the eyewear market
                - Own over 80% of the high-end eyewear market
        - Luxottica's EBIT margin is similar
            - About 15%
        - Luxottica's past growth was weaker than Fossil
            - Sales grew 8.4% annually since 2005
                - 2005: $5,145 million
                - 2014: $10,616 million
            - Sales grew 10% annually since 2000
                - 2000: $3,357 million
                - 2014: $10,616 million
        - Morningstar predicts 7-8% annual growth for the next 10 years
        - Luxottica's current valuation
            - Share price: EUR 61 (= $67.1)
            - Market cap: EUR 29,513 million (= $32,464 million)
            - EV: EUR 30,563 million (= $33,619 million)
            - EV/S: 3.99
            - EV/EBIT: 26.40
    - PVH Corp (PVH)
        - One of the largest branded apparel companies in the world
        - Owned brands are
            - Calvin Klein
            - Tommy Hilfiger
            - Van Heusen
            - IZOD
            - ARROW
            - Warner's
            - Olga
            - Eagle
        - Licensed brands are
            - Kenneth Cole New York
            - Kenneth Cole Reaction
            - MICHAEL Michael Kors
            - Michael Kors Collection
            - DKNY
            - Nautica

    - Ted Baker
    - Etc.
  - PVH has strong unit market share in the U.S.
    - Neckwear topping: 50%
    - Dress shirts: 41%
    - Woven shirts: 17%
    - Knit shirts: 11%
  - PVH's revenue isn't as diversified as Fossil
    - Calvin Klein and Tommy Hilfiger generate over 75% of revenue
  - PVH has lower margin than Fossil
    - 25-year median EBIT margin: 6.8%
    - 25-year max EBIT margin: 12.7%
    - 25-year min EBIT margin: 0%
    - Currently: 7.4%
  - Morningstar expects
    - Calvin Klein: 4-8% revenue growth
    - Tommy Hilfiger: 4-8% revenue growth
  - PVH's current valuation
    - Share price: $82.84
    - Market cap: $6,838 million
    - EV: $9,753 million
    - EV/S: 1.18
    - EV/EBIT: 15.66
- Michael Kors (KORS)
  - KORS is Fossil's licensed watch brand
    - 26% of Fossil's revenue
  - There was a boom in KORS's business
    - Revenue was
      - 2009: $397 million
      - 2014: $4,371 million
  - It's impossible to estimate KORS's normal EBIT
  - KORS' share price declined 45% year-to-date
  - KORS' current valuation
    - Share price: $42.70
    - Market cap: $7,859 million

            - EV: $7,540 million
            - EV/S: 1.72
            - EV/EBIT: 6.00
    - Guess? (GES)
        - A lifestyle brand
        - Its revenue and margin was cyclical
            - Follow the brand's popularity
            - Its heyday was in 1980s
                - Known best for its denim collection
                - Has an iconic, sexy, youthful heritage
            - Average EBIT margin was
                - 1994-1999: 16%
                - 2000-2005: 5%
                - 2006-2011: 17%
                - 2012-2014: 8%
                    - 2012: 10%
                    - 2013: 9%
                    - 2014: 5%
        - GES's current valuation
            - Share price: $19.18
            - Market cap: $1,607 million
            - EV: $1,211 million
            - EV/S: 0.50
            - EV/EBIT: 9.62
    - Movado (MOV)
        - Movado is a direct peer
        - Movado's current valuation
            - Share price: $27.01
            - Market cap: $622 million
            - EV: $481 million
            - EV/S: 0.82
            - EV/EBIT: 6.73
- We can divide peers into 3 group
    - Portfolio of brands: Luxottica and PVH
        - Very expensive peer
        - Similar to Fossil's licensing business

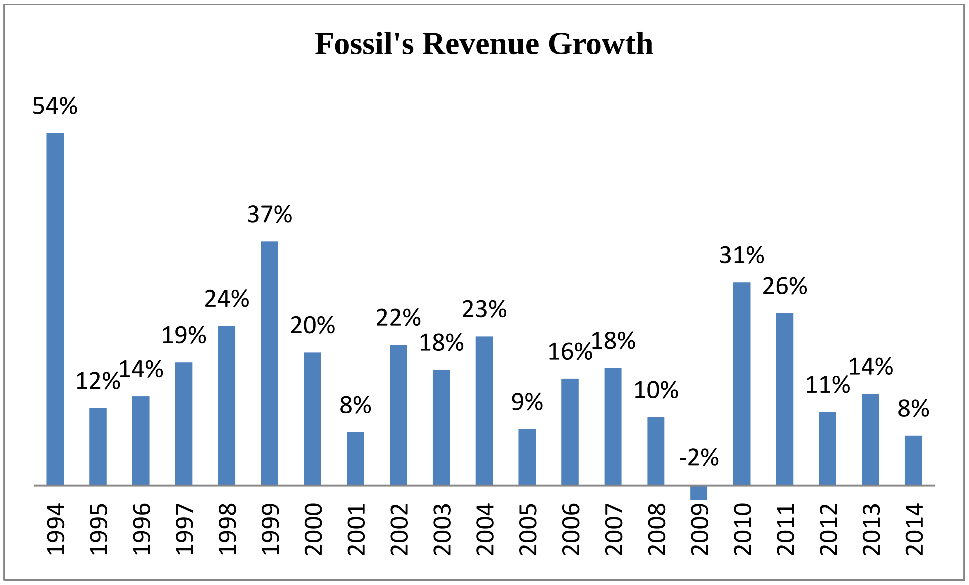
- Single brand: Michael Kors and Guess
  - Very difficult to estimate normal earnings
  - GES's historical multiple followed business performance
    - High when the business was good
      - About 30x P/E in 2005-2008
      - About 10x P/E in 2011-2012
      - Currently 15x P/E
        - 10-year low earnings
  - KORS and Guess may indicate volatility in Fossil brand
- Direct peer: Movado
  - Movado is a weaker peer
  - But Movado is more expensive than Fossil
  - Fossil's EV/normal EBIT: 5.95
  - Movado's EV/normal EBIT: 6.73

- Fossil's valuation is more like "single brand" than "portfolio of brands"
  - It's very cheap
  - Fossil is trading at 4.75x 2014 EBIT
    - Its peak EBIT
    - KORS is trading at 6.00x 2015 EBIT
      - Its peak EBIT
    - KORS was a very hot single brand
    - its business may decline much more than Fossil
      - it's riskier than Fossil
  - Assuming Fossil brand shrinks to a $500 million brands
    - => total sales decline to $2.2 billion
    - Current EV is 1.22x sales in this draconian scenario
      - => just need 12% margin to justify the price
      - This is what a smaller-scale Movado can make
    - Fossil actually made $376 million EBIT in 2010
      - On $2,031 million sales
      - Current EV is just 7.16x 2010 EBIT
- Fossil deserves more than 10x EBIT
  - Fossil's proprietary business deserves **7x EV/EBIT**
    - It's hard to estimate normal EBIT of Fossil's proprietary business
      - Fossil and Skagen are still growing
      - But Fossil is now a big brand
        - It may decline

        - KORS trades at 10x its peak after-tax earnings
            - The business is deteriorating
        - Fossil has 30% effective tax rate
        - **7x EV/EBIT** is equivalent to 10x after-tax earnings
    - Fossil's licensing business deserves 14x EV/EBIT
        - This is a great business
        - Deserves 20x after-tax earnings
            - Deserves **14x EBIT**
    - Proprietary makes up 50% of normal revenue
        - Possibly 50% of EBIT
    - => Fossil deserves 10.5x EBIT
        - (14 + 7)/2 = 10.5

Growth

New Products, Brands, and Markets Give Fossil a Lot of Growth Opportunities



Fossil grew revenue by about 18% annually over the last 21 years

- **Biggest Negative**:
  - Michael Kors will decline in the short run
  - Fossil brand's growth is unpredictable
- New products
  - Leather goods and jewelry represent a tiny portion of revenue
    - Leather: 12% of revenue
      - $419 million
    - Jewelry: 8% of revenue
      - $279 million
  - The market size of leather goods is several times that of the watch market
  - Jewelry is a huge market
    - Branded items account for 60% of sales in the watch market
      - Only 20% of sales in the jewelry market[1]
        - Has increased from 10% in 2003
        - Expect to increase to 30-40% in 2020
    - Fossil's jewelry brands include
      - Fossil

                - Skagen
                - Diesel
                - DKNY
                - Emporio Armani
                - Michael Kors
            - Jewelries are sold through the same channel as watches[2] [3]
            - Fossil's jewelry revenue is growing pretty fast
                - Grew 11% annually over the last 6 years
                    - 2008: $150 million revenue
                    - 2014: $279 million
- New brands
    - Fossil has become the partner of choice for licensors
    - The number of licenses increased by 50% since 2011
        - Had only 8 licenses in 2011
        - Added
            - Karl Lagerfeld
                - In 2011
            - Tory Burch
                - In 2013
            - Kate Spade
                - In 2015
            - Chaps
                - In 2015
        - It takes several years for a new brand to ramp up revenue
    - Fossil will possibly have get more brands in the future
- Skagen can be an opportunity[4]
    - Fossil brand makes $2 billion at retail
        - Contributes $1.3 billion revenue
    - Skagen's revenue is just $150 million
    - Fossil wants to build Skagen into a Danish lifestyle brand
        - Fossil believes that Skagen can be the next Fossil
    - Skagen's president was the highest paid officers over the last 3 years
        - 3-year average of total compensation is
            - Dennis Secor, CFO: $1.7 million
            - Darren Hart, Executive VP, HR: $1.7 million
            - Jennifer Pritchard, President, Skagen: $1.9 million
            - John White, COO: $1.4 million

- New market
  - Fossil’s revenue mix by geography
    - U.S.: $1,589 million
      - **45%** of revenue
    - Europe: $1,196 million
      - **34%** of revenue
      - Germany: $613 million
        - **17%** of total revenue
        - **51%** of total revenue in Europe
    - Asia: $566 million
      - **16%** of total revenue
    - Others: $159 million
      - **5%** of total revenue
  - Fossil’s market share in mid-tier watches[5]
    - (watches below $1,000)
    - U.S.: 48%
    - Americas: 29%
    - EMEA: 15%
    - APAC: 6%
  - Fashion watches have low penetration of the watch market in Asia
    - U.S. mid-tier watch market: $2.9 billion at wholesale
      - Fashion watches: 53%
    - Asia mid-tier watch market: $7.9 billion at wholesale
      - Fashion watches: 18%
  - Asia is a huge long-term opportunity
  - Fossil didn’t enjoy great success in Asia because of
    - Distribution
      - Fossil has to open concession stores to grow in Asia[6]
    - Another potential reason is income gap
      - Some rich people have money to buy luxury goods
      - But middle class in Asia isn’t really strong
  - Fossil’s brand portfolio gave it scale to invest in retail operations in Asia
    - Invested in manufacturing facility in Switzerland
      - To make Swiss watches for brands like
        - Fossil
        - Emporio Armani
        - Burberry

- Tory Burch
- Swiss watch is the key to grow in Asia
- Built structure to do concession-based business in Asia[7] [8] [9]
  - Hire senior management people in Asia
  - Add people to manage concessions
    - Open concessions
    - Do visual presentations
- Has over 330 concessions in Asia[10]
  - Operates in department stores
    - Fossil concession store
    - Multi-brand watch concession store
- The process is very long
  - It's not scalable in China[11]
    - No department store group that owns many stores
    - A lot of them are individual stores
      - owned by local governments
    - It takes more time
    - There's more processes involved to get things installed and up and running
- There can be great demand for fashion watches in Asia
  - Swiss luxury brands must increase prices to maintain exclusivity
    - Led to a huge white space below Swiss watch price point[12]
  - Quan's scuttlebutt:
    - A very big % of professionals in Vietnam wear watches
    - Managers may wear Swiss watches
      - Tissot and above
    - Employees at lower positions will wear cheaper watches
      - People with some money wear fashion watches
        - Mango
        - Zara
        - Michael Kors
        - Marc Jacobs
        - Etc.
        - They buy online from Amazon
          - There's no dealer selling these watches in Vietnam
      - Others wear even cheaper watches

- Revenue growth in Asia was
  - 2009: 0%
  - 2010: 46%
  - 2011: 34%
  - 2012: 25%
  - 2013: 12%
  - 2014: 12%
  - 2015: -11% (in the first 9 months)
    - Declined 2% in constant currency
    - For Q3: sales declined **19%**
      - **10%** in constant currency
    - Fossil blamed macroeconomic factors for the decline
    - Michael Kors might account for a big part of the decline

- The global watch market is expected to grow 6% annually
  - (Euromonitor)
  - 2014: $64.1 billion
  - 2020: $87.3 billion
- It's hard to predict Fossil's growth
- 3-5% sales growth seems easy
  - (Excluding short-term decline of Michael Kors)
- Fossil's growth will be very profitable
  - Margin may expand
    - Has largely built infrastructure for all markets
  - After-tax ROIC is about 30%
  - => retains only **17%** of earnings for **5%** growth

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[1] The Jewelry Industry in 2020, McKinsey

[2] "In addition to that, **we do think long-term, jewelry and lifestyle brand jewelry is an opportunity. And we kind of look at part of our watch business, because it's same characteristic in terms of lead time, it's branded, it goes to the same stores, it leverages our global infrastructure**. So we think it's an add-on and has the potential to eventually make the size of the Company larger. **Of course, especially when you look at Asia, the categories that consumers over there are most interested are watches, jewelry and accessories. And that's our zone, and we think we are in the right place**." – Kosta Kartsotis , Fossil's CEO, 2012 Q4 Earnings Call Transcript

[3] "**You know, the whole idea right now is that jewelry is a much larger business globally than watches but the portion of it is branded, it's relatively small, but that's the fastest growing part of it**. So there's a huge tear globally over the next 10 years.

The category of jewelry will get increasingly globally branded. And this fits right into our wheelhouse. As we mentioned before, **jewelry is very similar to the watch business, same characteristics we sell to the same stores, huge follow-on opportunity for the Company.**" – Kosta Kartsotis , Fossil's CEO, Investor Day 2015

[4] "We also a couple of years ago acquired Skagen brand. The way we look at Skagen is, you know, we have an opportunity as a company to own a larger share of our business rather than just being licenses. Fossil is the big part of that.

The idea for Skagen is to take a concept, Danish design, and make a lifestyle brand and accessories concept out of it as a follow-on to Fossil, so following in the footsteps of Fossil, how we built it, with great product, the lovely good, watches, jewelry and stores, Web.

And Skagen especially, we've spent a lot of time building in an early stage as a digital brand, so we're going to talk about that in a bit, but huge, long-term opportunity. And also in the future, we want to continue to acquire brands like Skagen, put them in this roadmap, to continue the build the business that way." – Kosta Kartsotis, Fossil's CEO, 2015 Investor Day

[5] Source: Fossil's 2015 Investor Day Presentation

[6] "**And if you look at our distribution over there [Quan: Asia], especially in China, there's not a lot of places where we can just automatically go and sell. We have to build concessions, our own distribution, our own stores, et cetera**, so having Watch Station as a catalyst for that over there, whether it's an actual store on the street, or it's a concession in a mall or in a department store, it all fits together and it enables us to do exactly what you said.

When we first go into a market, typically the brands that are in our portfolio are much more well known than Fossil. So Armani is an extremely powerful brand throughout Asia, and especially in China. So it's a door opener, enables us to get locations, and we add the other brands, and we bring our own brands, along so FOSSIL and SKAGEN and we will get the benefit of getting distribution in those locations." – Kosta Kartsotis, Fossil's CEO, 2014 Q2 Earnings Call Transcript

[7] “**Obviously in our Multi-brand Watch business, it's pretty large long-term opportunity for us to continue to build out the infrastructure, especially in Asia. If you look at the hundreds of millions of new people joining the middle class in Asia**, that's basically our Fossil customer and our multi-brand watch customer, so we think there's a very large opportunity out there that we're building in to. **If you look at those two businesses and they use shared services around the world, to us it's a very compelling business model, and we think that long term it will help us penetrate those new markets in Asia**, even more efficiently than you might if you just had one brand.” – Kosta Kartsotis, Fossil’s CEO, 2012 Q1 Earnings Call Transcript

[8] “In China, we are actually studying several different methodologies. The one thing **I would say about Asia that appears to us at this point like we have seen in Korea that a lot of it is going to be concessions**, which they can tend to grow much faster because they are cashing full retail instead of wholesale.

The operating model is very good also in terms of profitability for us and it also enables us to control a lot of the process, the (inaudible) presentation assortments, the sales process, etc. **So we feel like Asia and China will be largely concessions, which part of the infrastructure we are putting over there is really enabling us to implement a broader concession-based business throughout Asia**. And I think that is what is going to accelerate the growth.” – Kosta Kartsotis, Fossil’s CEO, 2010 Q4 Earnings Call Transcript

[9] “So as to say how long it will take us to get to a third, it's very difficult because we're focused on growing the entire world, and at the same time we're putting significant resources in Asia to capture that market.

So as to the expenditures we're making there, we have a whole re-organization, a huge work chart that we've been hiring into. **We've hired a number of key players throughout the region, including some senior management people**. And as I said on the comments earlier, we have sent a number of ex-pats there to really accelerate the learning. **So we've sent people over there to help train and get people up to speed on our operating model, et cetera**.

And there's a number of other investments that we are making throughout the region to **add management and people to manage concessions, open concessions, do visual presentations, do construction and facilitation of fixturing**. There's a number of large initiatives that they're focused on over there and we are supporting them as much as possible. And we are really very, very active in the market right now." – Kosta Kartsotis, Fossil's CEO, 2011 Q1 Earnings Call Transcript

[10] "Scott Krasik, Analyst: Thanks, Kosta. And when you talk about having concessions, are these mono-brand concessions? Are you doing the multi-brand concept yet? And how many concessions are you at and how many can you get to?

Kosta Kartsotis, Fossil's CEO: So if you look at our business model, we have basically two core businesses -- the FOSSIL brands and then the multi-brand watch business. So in Asia, for example, we're developing a group of people that will build the FOSSIL brand, so there will be stores, websites, and concessions -- FOSSIL stores inside of department stores.

We also have a multi-brand watch business in those markets where there will be concessions and potentially Watch Station Stores in those markets as well. **So in some of the stores throughout Asia, we will have a FOSSIL store inside a department store. And in that same store we will have a multi-brand watch concession**. And this all ties back in with our long-term Watch Station strategy to really study closely how we are as a direct vertical retailer of the watch category in really an effort to gain market share, and to communicate the whole idea of fashion watches around the world and the brands that we carry. So we think the Watch Station idea globally kind of dovetails in with our concessions strategy, especially in Asia, as we move forward. So it's a big, long-term strategy on both the FOSSIL brand and on the multi-brand watch business.

…

Barbara Wyckoff, Analyst: Hi, everyone. Can you talk about how many concessions do you have now by country in Asia? And can you talk about the mechanics of how they run? Are they different -- China, Japan, Korea? Or they have different sort of -- are they all pretty much the same? And then can you talk about the four-wall margins in your own stores? And is there a difference between the legacy versus the new stores?

Kosta Kartsotis, Fossil's CEO: On the concessions, we don't have the numbers by country, but the way it works is basically, **we go in and pay a percentage of sales; we own the inventory; and these are our sales people**.

The great thing about the concessions and probably the reason for Korea's growing so fast is we capture full retail. **And the operating margin on those operations is very, very strong. So it's a great way to grow and also the**

capture of bigger part of the retail picture and also to control our own destiny.

The number one thing is to have our own people and our own visual presentation, presented the way we want to with the right amount of inventory flowing correctly, and really drive significant sales if it's done correctly, which is what we're focused on." – Fossil's 2011 Q1 Earnings Call Transcript

[11] "Barbara Wickoff, Analyst: Right, thanks. So, for Kosta, could you talk about Asia a little more? What is the biggest country? Is it Korea then followed by Japan and China? And then how do you see that growth potential by country? And then, can you talk about any obstacles outside of, I guess the diverse store base in China to accelerating growth in China?

Kosta Kartsotis, Fossil's CEO: Well, the three markets we are focused on are Japan, Korea and China. As you know, **in Korea, the last several years we have converted from a distributor situation where we were selling to a distributor to our own concessions. So, there's about 70 big huge department stores in Korea**.

The concessions that go in there are a pretty identified group of stores that are relatively easy to get to. And they are doing extremely well, and we have an opportunity to grow inside of those doors. **We also are looking at a similar situation in Japan where we have a number of concessions there that are doing well and we think they can expand**. Again, each of these department stores in those two markets, the idea is to **have a multibrand watch concession and a Fossil store inside of those**. So we are working on that.

We also have just recently -- we have opened a number of stores in Japan that present the brand really well that will help us get those Fossil concessions open, and **we just opened a flagship store in Seoul, Korea**, that we do the same. So, the idea is to take our experience in Korea, and those concessions that are extremely profitable and growing very quickly, to take our experience in Korea and expand that to China.

And China is more difficult, just because it is not as scalable. There's not a department store group that owns very many stores. A lot of them are individuals stores owned by local governments, et cetera. So it is just a more fragmented market, **it just takes more people, time. There's more processes**

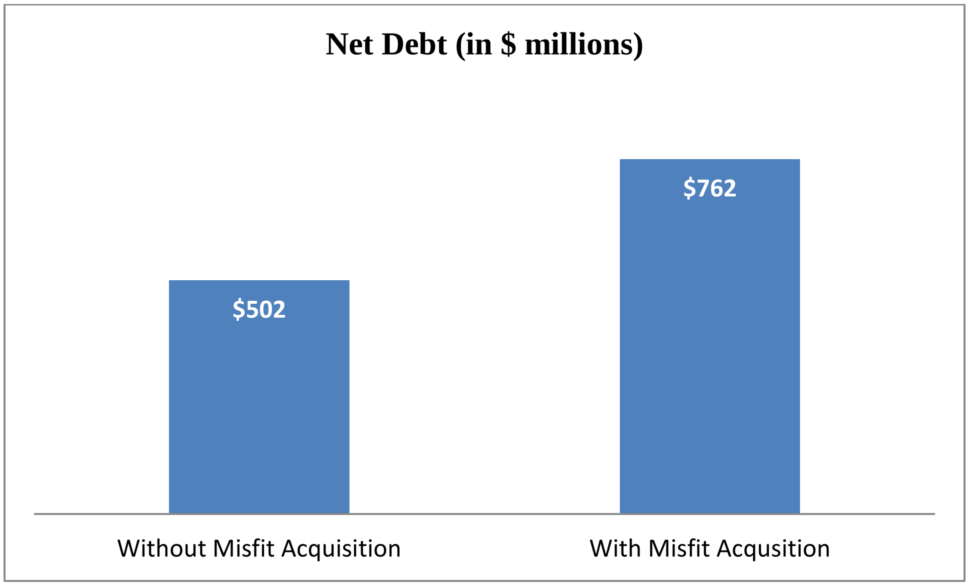
involved to really get those installed and up and running, and that is the process we are working on now.

But we do expect that over time we will be able to have an operation in China that is significant, and we'll have an experience similar to what is going on in Korea. We have enough sell-through information from existing concessions there to know that this multibrand watch thing is going to work very well once we get -- all get it in place." – Fossil 2011 Q4 Earnings Call Transcript

[12] "As we said, the Swiss watch market has been very, very successful in Asia, especially in China and even China travelers buying Swiss watches around the world. **And the prices of those products have gone up dramatically and so has scarcity. It's I think given us an additional white space opportunity for us to put Swiss made products in the Asian markets**" – Kosta Kartsotis, Fossil's CEO, 2012 Q2 Earnings Call Transcript

Misjudgment

Will Fossil Fail Because of Debt and Uncertainties?



After closing the acquisition of Misfit, Fossil would have $762 million net debt

- **Biggest Negative**: Fossil has the highest leverage in is history
- What's the impact of smart watches on fashion watches?
  - The market is different
  - People who buy smart watch care about functions
  - People who buy fashion watches care about
    - Design
    - Brand
  - Even if there's overlap in customers
    - Customers don't necessarily wear smart watches all the time
    - They may wear different watches for different occasions
  - There are currently 3 approaches
    - Tech companies: put a computer on consumer's wrists
    - Fitbit: focuses on activity trackers
      - And apps that promote health and wellness
    - Watch companies:
      - Add some smart features into watches
        - Activity tracking
        - Phone notification
      - Retain traditional watch designs

- Watch companies will possibly retain their core customers
- How much will Fossil invest in smart watches?
  - Fossil recently introduced Fossil Q
    - Fossil Q Dreamer and Q Reveler
      - An activity tracking bracelet
      - Price: $125
    - Fossil Q Grant
      - A watch with smart features
        - Activity tracking
        - Filtered notification from favorite contacts
      - Price: $175 and $195
    - Fossil Q Founder
      - A watch with touchscreen functionality
        - Maintain classic good looks
  - Fossil initially followed a conservative approach
    - Partner with Google and Intel
  - But Fossil recently acquired Misfit
    - Fossil acquired Misfit for
      - Its battery technology
      - The app platform[1] [2]
        - Believes that apps and cloud services are part of product
          - And extension of brands
        - => Too important to outsource
  - This acquisition is consistent with Fossil's strategy
    - Prefer vertical integration
    - Fossil is usually "quicker" than other watch companies
      - Partnered with Microsoft
        - In 2003
        - Made smart watches with instant access to Web information and services
          - News
          - Weather
          - Sports
          - Stock quotes
          - Instant messaging
          - Etc.

        - But discontinued because
          - The chip was big
          - Battery was weak
  - We don't know whether the acquisition is necessary
  - We don't know how much Fossil will invest further into smart watches
- Will Fossil brand decline?
  - Fossil is now a $2 billion brand
  - We don't have much financial information about Fossil brand
    - Little information about revenue
    - No information about profit
  - It did grow overtime
    - It's much more successful than Swatch brand
      - Both started as fashion watch brand
      - Fossil managed to maintain its popularity in the U.S.
        - Swatch is more popular China
      - Fossil evolved into a lifestyle brand
        - Swatch company focuses on watch and jewelry
  - Fossil brand may decline like other fashion brands
  - But it may prove more durable than people expect
    - People question its durability all the time since it started
- Will Skagen brand be another Fossil?
  - Skagen is growing fast
    - Now makes $150 million revenue for Fossil
  - Fossil pays a lot of attention to Skagen
    - Wants to build Skagen into a Danish lifestyle brand
      - Fossil believes that Skagen can be the next Fossil
    - Skagen's president was the highest paid officers
      - 3-year average of total compensation is
        - Dennis Secor, CFO: $1.7 million
        - Darren Hart, Executive VP, HR: $1.7 million
        - Jennifer Pritchard, President, Skagen: **$1.9 million**
        - John White, COO: $1.4 million
- Fossil has the highest leverage level in its history
  - Fossil historically avoided debt
  - Only started having positive net debt in the last 3 years
    - Spent **$1,251 million** in share buyback since 2013
    - Reduced share count by 19%

- Fossil currently has $502 million net debt
  - Adding pending $260 million acquisition of Mistfit
  - => $762 million net debt
    - 1.34x 2014 EBIT ($567 million)
    - If EBIT declines to $300 million
      - Net Debt/EBIT is 2.54x
- Yet Fossil's business risk is highest ever
  - Its retail business is now 26% of total revenue
    - Highest ever
  - Its rent expense is now $191 million
    - Highest ever
    - (although stay around 20% of retail revenue)
  - Its Fossil brands is now $2 billion
    - Highest ever
      - meaning potential decline is highest ever
  - It's just made the biggest acquisition in its history ($260 million)

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[1] "**The Misfit acquisition is really about owning the cloud on the app platform, given how integral it is now to product and brand and customer experience. So, we'll own that part of the customer experience through the app and cloud**, but we will continue to partner with the leading technology companies across the world to continue to build the right ecosystem of partners to compete in this space. So, we'll – the best hardware providers, the best contract manufacturer, the right ecosystem, cloud partners, whether that's music or fitness or what have you. So, it still takes an entire ecosystem. **This is just about us owning the cloud and app platform that's now part of product and brand**." – Gregory McKelvey, Fossil's Chief Strategy and Digital Officer, 2015 Q3 Earnings Call Transcript

[2] "Yeah, in terms of the confidence in the size of the category, it's – I think the first is, we're seeing the market develop, where it's increasingly clear to us that wearable technology is and will be a large growing category. There's projections out there that are putting it about $45 billion in the next four years or five years with roughly two-thirds of that being wrist wearing, that would put the size of that market at roughly the same size of the under $1,000 global watch market. And we believe that, **all three categories that make up that market, which would be activity trackers, smartwatches with display, and then the third being smarter watches, so integrating technology similar to what you'd find in activity tracker into the same type of watches we sell today**, all three of

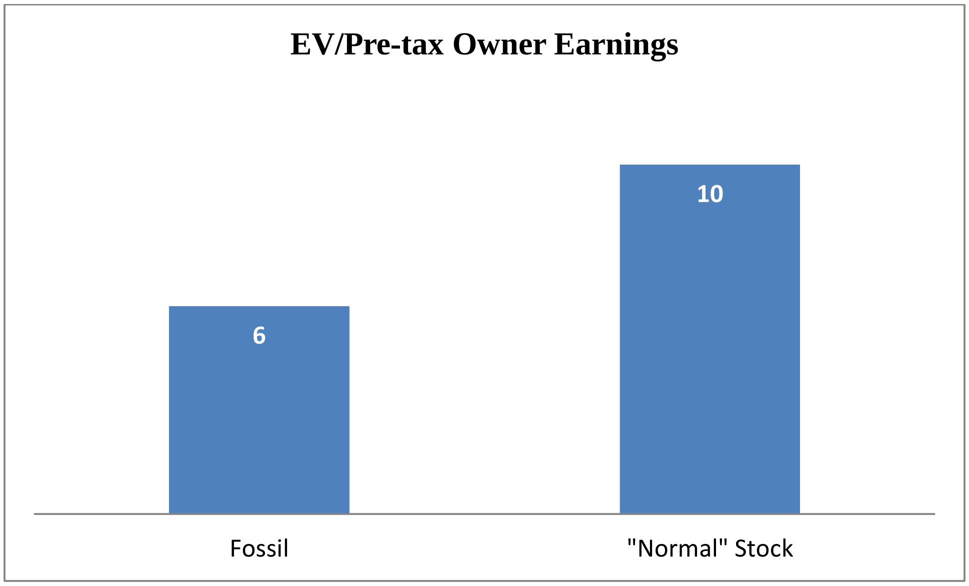
those are viable products that are – that we see actually are Fossil Q launch being very successful with. So we're going – part of that we see the market is developing and we have a position to play in it.

With Misfit, it's – we've learned a lot in the last couple years in developing products and bringing to market Fossil Q. **We believe that we're now in a connected age where apps and cloud services are effectively now a part of product and an extension of brand**, and that needs to support and mirror our business model of today, so meaning multi-brand, fashion and design-driven, and globally-scalable. And **it's so integral now to product and brand development that it's really too important to outsource that to somebody else. So we need – we want to own that customer experience, own the platform, be able to have – be get to market much more quickly. And then as we scale it across the breadth of our portfolio of brands** in 20 languages in 115 countries, just a pure economics of scaling our product size, breadth, number of brands across the fixed cost of the development of that platform makes for a much more attractive margins, ultimately, than we'd get if we fully outsourced it.

And then – sorry, I'd just add one other thing. In Misfit, specifically, **they've got a very talented team that spent the last four years solving some of the hardest problems in wearables, including battery life. And their platform has already – because they've got – is already supporting multiple brands given their partnerships with Swarovski and Victoria's Secret and others**. They're global especially with strengths in the U.S. and in Asia, which is important to us. They've got an 18-month pipeline of products and innovation that we're going to be able to extend not only into the Misfit brand, but into the full breadth of our product portfolio and brand portfolio. And then, it's a digitally native brand as we discussed on the call as well that allows us to get into consumer electronics and healthcare and enterprise and other channels we're not in today. So, a significant opportunity to expand our addressable market." – Gregory McKelvey, Fossil's Chief Strategy and Digital Officer, 2015 Q3 Earnings Call Transcript

Conclusions

Fossil Is a Good Stock for a 10-Stock Portfolio



Fossil's is trading at 40% discount to a typical stock with 15 P/E and no debt

- Why not to buy Fossil?
    - Uncertainty about smart watches
    - Dependence on Michael Kors
    - Uncertainty about Fossil brand
- The first reason is irrational
- The second reason isn't justified by current share price
- The third reason doesn't seem to be in investor's mind now
    - Herd mentality is strong when it comes to investing in fashion brands
    - But Fossil brand is doing well now
- The third reason is a real concern for long-term investors
    - This is the only uncertainty about Fossil's long-term prospects
        - Michael Kors is a short-term issue
        - Smart watches aren't a problem
- Fossil is a high-upside big-downside stock
    - The price is incredibly cheap
        - Trading at
            - 4.75x 2014 EBIT
            - 5.95x normal EBIT
            - 57% of fair value

    - There's also big potential downside
        - Fossil brand is a $2 billion brand
            - Contributes $1.3 billion revenue
            - => (in theory) potential decline is big
        - Its retail business has high leverage
            - $925 million revenue
                - Single-brand stores: $689 million
                - Multi-brand stores: $225 million
            - Rent expenses: $191 million
- Fossil is a high-beta stock
    - Beta: 1.94
    - Most fashion brands have high beta
    - Mr. Market tends to overreact to short-term results
        - Wholesale business adds to volatilities
            - Retailers stop replenishing inventories in bad times
- Who should buy Fossil?
    - Only long-term investors
        - Business result in near term will definitely decline
    - Fossil isn't suitable for concentrated investors
        - Its licensing business is great
        - But its Fossil brands has too much uncertainty for a concentrated investors
    - Fossil can be a good stock for a 10-stock portfolio
        - But not a 4-stock portfolio