A Perspective on Fossil Group

by Nathan Ritz, CFA

Fossil Group, Inc. (“FOSL”) is the fourth largest producer of watches and the largest licenser of brands for watches and jewelry globally. In 1984, founder and CEO, Kosta Kartsotis and his brother Tom Kartsotis saw an opportunity to offer high-quality, fashion oriented watches at an accessible price point. With the creation of the Fossil brand, they unlocked unmet demand for watches in the $50-$500 price range, between high-end Swiss luxury watches which sold in the thousands of dollars and low-end unbranded watches that sold for under $20.

In the coming decades, they leveraged this success by expanding their portfolio of owned brands with the acquisitions of Skagen and Michele, adding to their product categories through the addition of leather goods and jewelry and internalizing the manufacturing process for their quartz and Swiss Made mechanical time pieces. FOSL’s advantages in design, production and distribution opened the door for the company to produce watches and jewelry for third-party licensed brands. Their portfolio of licensed brands has grown to over 50% of company-wide sales and includes well-known brands such as Burberry, Michael Kors, Armani, Kate Spade, Marc Jacobs, Tory Burch and Adidas. The strength of their brand portfolio creates significant bargaining power with wholesalers, department stores and specialty retailers.

A Platform for Growth

Today, Fossil Group is the natural fit for fashion and luxury brands looking to add watch and jewelry assortments to their product mix. Fossil’s licensed business is over three times the size of their largest competitor, and with over 30,000 points of distribution in 150 countries, Fossil offers its partners immediate scale in quality locations. Over the past year, investor worry has grown as Fossil’s largest licensed brand, Michael Kors, has experienced decelerating growth and brand issues in North America. As Fossil’s other licensed brands have continued to grow, the risk of fashion misses and troubles at individual brands is reduced. In just the past two years the company has signed licensing agreements with Kate Spade, Tory Burch and Ralph Lauren’s Champs.

Fossil is the market leader in North America, which accounts for 50% of the company’s sales. However, many of the brands in FOSL’s portfolio are also well recognized internationally, particularly in Europe (which accounts for 25% of sales) and Asia Pacific (which accounts for 15% of sales). Fossil has low exposure to Asia Pacific compared with luxury watchmakers, which generate 50% of sales from Asia. FOSL’s under-penetration was due to a lack of distribution and an unbranded market at Fossil’s price point in Asia, where fashion brands only have a 15% market share compared to 50% in North America. Over the past 5+ years, management has invested heavily in international operations and the company now has the infrastructure and resources in place to grow their international business. Branded watches and jewelry are gaining market share internationally, and in our opinion have a long runway of share gains ahead.

Is the Watch Prehistoric?

As with previous watch cycles, the current watch slowdown has raised questions about the secular health of the traditional watch industry. These conversations have been heightened by the entrance of new competitors in the space with the advent of smartwatches and Apple’s entrance into the category. We believe investors are looking past FOSL’s growing capabilities in smartwatches through their partnerships with Google and Intel. More importantly, while many correctly identify that the number of consumers who wear watches for functional purposes has declined in recent decades, they miss the sustainable growth that has materialized in branded fashion and luxury watches. The purchase decision is no longer driven by function, but by design, fashion and craftsmanship. This plays well into Fossil’s strengths long-term as new fashion and luxury brands enter the category and as consumer wardrobe spending shifts from apparel to accessories, including watches and jewelry. Long term, we see substantial opportunity for Fossil as the upper middle class grows in markets with brand-centric cultures such as Greater China, the Middle East and Latin America.

Time to Cash In

Over the past decade, Fossil has widened their competitive moat by building out infrastructure and scale in manufacturing and distribution globally. They are now in a position to monetize this investment and use their growing free cash flow to invest in their brands and product innovation. While we wait for the market to realize FOSL's value, we welcome the continued allocation of free cash flow to share repurchase at what we deem to be a substantial discount to intrinsic value (management has repurchased 30% of the company's shares outstanding over the past 5 years).

In times of cyclical downturns, we value management teams who are willing to look long-term and invest opportunistically in their businesses. FOSL's management team has a successful track record in this regard, and their conservative balance sheet has put them in an attractive position once again. The probability of continued discipline is high as we are invested alongside CEO, Kosta Kartosis, who has a majority of his net worth in FOSL stock and owns over 10% of the company.

We think Fossil has enduring brands and defendable competitive advantages, which will allow returns on invested capital well in excess of their cost of capital in the future. We like the long-term attractiveness of the watch and jewelry categories and believe that at today's share price we have an attractive margin of safety to our $110 per share valuation for Fossil Group.

Weitz Investment Management is pleased to announce the promotion of Nathan Ritz to Research Analyst. Nathan has been an asset to the team since he joined the Firm as a Research Associate in 2011. His contributions and dedication are greatly appreciated. Please join us in congratulating Nathan! We look forward to his continued success.

Nathan Ritz, CFA, *joined Weitz in 2011. Nathan is a Research Analyst. He graduated from the University of Nebraska-Lincoln and became a CFA® charterholder in 2015. He previously completed an internship with Moody Aldrich Partners in Boston and worked as an analyst for West Gate Bank.*

As of June 30, 2015: Fossil Group represented 2.4%, 1.4%, 5.0% and 2.7% of the Partners Value, Partners III Opportunity, Research and Hickory Funds' net assets, respectively.