

Recommendation: BUY

Target Price until (03/31/2017): \$168

1. Reasons for the Recommendation

After careful analysis of Ralph Lauren Corporation (RL), we recommend the IAC purchase shares of Ralph Lauren stock. Ralph Laurens' sales revenue has increased in the prior four years; however, we forecast a minor contraction in sales growth offset by investment and restructuring initiatives which will drive core expenses down reducing the impact to earnings. SG&A expenses have decreased in the past two years due to restructuring and implementation of an enterprise resource planning system which will continue to improve the supply chain.

Ralph Lauren will continue their expansion in international markets over the next few years. In 2015 (RL's FY 2016), Ralph Lauren will expand their department stores to Japan and South Korea as well as expand the Chaps brand to certain international locations. They now have very strong gains in China and Europe, which are both huge markets for expansion. International revenue accounts for one third of their total revenue. Thus, their expansion of international markets, especially in Asia and Europe, will bring more opportunities and increased earnings in the next few years. Ralph Lauren will continue to make more investments in their e-commerce platform to better show the Ralph Lauren lifestyle to customers in the next few years. This investment will bring them sales revenue of a billion dollars according to their earnings call.

Additionally, the launch of Polo for women last fall has performed well; they will introduce Polo Sport for men's and boy's in fall 2015. Since this product has attracted many customers across the globe, and the sport apparel segment in the market is growing rapidly, we believe they will gain a significant market share for Polo in the next few years. Their launch of Polo brand, like new restaurants, will increase revenues and earnings growth.

Foreign exchange conditions will continue to threaten earnings due to a large portion of revenues coming from international markets. Because of the foreign currency translation, their operating margin will be affected. Since the global economic environment continues its struggle, Ralph Laurens' sales and profit margin could negatively be affected in 2015 and 2016. Unexpected weather conditions will also pose a threat in the selling season to Ralph Lauren as well as many other retailers.

Wholesale operations are highly dependent on department stores with ~50% of wholesale segment revenues, 12% of which come from Macy's. However, retail revenues are expected to outpace wholesale. The growth in e-commerce sales and availability internationally, and in the U.S., and the plans to build more retail locations internationally will be beneficial to Ralph Lauren.

The operating margin for fiscal year 2015 is expected to be 170 to 190 basis points lower than that in previous year. However, the main drivers of this decrease are investments in new stores in global markets and marketing. These investments will bring them more sales and high profit growth in the future.

2. Company Analysis

Ralph Lauren designs, markets, and distributes a range of lifestyle apparel including men's, women's, and children's clothing and accessories. Accessory offerings include footwear, eyewear, watches, fine jewelry, hats, belts, handbags and luggage. Through licensing agreements, the Ralph Lauren brand extends to home products including bedding, bath products, furniture, fabrics and wallpapers, lightings, paints, table-tops, and giftware, and fragrances. Ralph Laurens' segment operations include: wholesale, retail and licensing. Ralph Lauren's core premium lifestyle brands, multi-channel distribution, investment philosophy and an excellent management team resemble their core strengths.

47% of net revenue in 2014 comes from the wholesale segment, 51% from retail and approximately 2% of their revenues from the licensing segment. 36% of net revenues are from international markets focused in North America, Europe, and Asia.

Ralph Lauren has developed strong brand recognition among domestic and international consumers by encouraging participation in the Ralph Lauren lifestyle. Their products are much differentiated among other brands and emphasize on new and distinctive American styles, which is very innovative. Ralph Lauren's distinctive image advertising, across all brands, portrays a lifestyle which is very unique. To facilitate their global distribution, they have efficient distribution centers around the world to better facilitate the process control and inventory management. Besides, their point-of-sale registers, merchandising and financial systems together with software programs allow them efficient management.

Ralph Lauren still faces risk from international markets, like complying with foreign laws and regulations, new tariffs and adapting to local customs and culture. The fluctuating exchange rates might also cause them to suffer a loss.

Long-term strategic goals include expanding international markets, extending their direct-to-consumer reach, and expanding their product and accessory lines to meet consumer tastes at a variety of price points. Ralph Lauren has opportunities to make merger and acquisition activities to increase their resources in operating. And they can also expand more of their markets in foreign countries and make more initiatives on new products.

An unstable economic environment can affect Ralph Lauren's customers and suppliers. For instance, it can reduce the ability of customers and suppliers to access global capital markets and reduce the ability of manufacturers shipping their products; deterioration may affect their ability to access sources of liquidity. Besides, they face intense competition in the worldwide market. Many of the foreign fashion-oriented apparel producers are larger and more diversified and have better resources. The threat of competitors can result in their reduced market share and may adversely affect their business.

3. Industry Analysis

Ralph Lauren's retail operations consist of selling men's, women's, and children's clothing. They do not specialize in apparel sold based on gender or age groups. Key retail drivers include consumer disposable income, raw material costs, consumer confidence, population growth and demographic trends as well as consumer attitudes. The target demographic is individuals 20-65 years old. Women's clothing account for 61.1% of industry revenue with men's and children's accounting for 31.4% and 7.5% respectively. The supply chain begins with raw material (e.g. cotton, wool, leather) processed by textile mills into fabrics used by apparel manufacturers. Manufacturers then wholesale or retail finished goods to the consumer.

Competition in the industry is high. Price and location are the major basis for competition, style, comfort, and product range is also important. External competition comes from specialty stores and department stores as well as internet based retailers. The top four firms TJX (14.2%), Ross (10.7%), Gap (13.9%), and Abercrombie & Fitch Co (3.8%) account for 42.6% of industry revenue.

The industry is expected to perform strongly in the next five years due to increase in disposable income limited by the slowdown in target demographics. Sales are expected to trend towards luxury, high quality, prominent branded goods and premium children's wear. World price of cotton is expected to reverse an upward trend over the next 5 years decreasing input costs. Wages expected to trend up in the next five years will affect cost structure and profit margins negatively. Threats to the industry from specialty and internet retailers are expected to be steady.

Ralph Lauren's wholesale segment sells apparel to major department and specialty stores globally; there are two industries: Men's and Boys, and Women's and Children's. Apparel is purchased from manufacturers and resold to retailers. Wholesalers build relationships between manufacturers and retailers, and may advertise, market, store, and transport their apparel. Apparel ranges from casual, formal, sleep, seasonal, and work wear; along with accessories. Key drivers include consumer confidence index, per capita spending, department and clothing store demand, imports, and cotton prices.

The supply chain starts with manufacturers making goods and retailers buying those goods. Competition is very high since companies have built long lasting relationships with manufacturers and retailers; which has given way to maximized profits and increasing revenue. Internal competition includes price, range, and quality of products/services. External competition comes from vertically integrated manufacturers, specialty stores, etc. who cut out wholesalers and supply retailers directly.

In men's wholesaling, VF Corporation has 9.6% market share. PVH Corporation has 3.4% market share. Lastly, Ralph Lauren holds a 2.9% market share. In women's wholesaling, VF Corporation has 6.0% market share. Hanesbrands Inc. has 5.3% market share. Ralph Lauren has 3.8% market share and PVH Corporation has 3.5% market share. The wholesaling industry expects a 1.5% growth in 2016 and 1.4% each year thereafter through 2020.

Appendix: Inputs into valuation using multiples

Ralph Lauren Corporation	2009A	2010A	2011A	2012A	2013A	2014A	2015A	2016A	2017A
Stock Price (P/E Estimate)							158.93	162.29	167.97
Stock Price (P/S Estimate)							158.99	162.22	167.90
Actual Price (Avg)	54.16	70.54	97.41	144.24	157.11	169.69			
Basic EPS	4.09	4.85	5.91	7.35	8.21	8.55	8.49	8.70	9.00
Sales (\$Millions)	5,019.00	4,978.90	5,660.30	6,860.00	6,945.00	7,450.00	7599.00	7788.98	8061.59
Sales per share (basic)	50.70	50.34	58.96	74.00	76.07	82.14	83.78	85.88	88.88
P/E	13.24	14.54	16.48	19.62	19.14	19.85	18.73	18.66	18.66
P/S	1.07	1.40	1.65	1.95	2.07	2.07	1.90	1.89	1.89

* Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance. Industry analysis sourced from IBISWorld.