Fossil's high margins: A relic from the past?

By Ernest SIM

Fossil Group Inc., which houses a variety of portfolio brands such as Tory Burch and Kate Spade New York alongside its namesake Fossil brand, is a specialty retailer with a global presence through its omni-channelization strategy. By leveraging on its diverse portfolio brands and its expansive global footprint, the American traditional watchmaker has posted a robust growth in margins over several years. However, in recent quarters, Fossil Group Inc. has seen weaker earnings as mounting challenges have suppressed its bottom line growth. Currency headwinds faced by Fossil since the latter half of 2015 did not favor Fossil as foreign consumers held back purchases of products due to a stronger US dollar.

The strong US dollar compounded by a gloomy global business sentiment at the onset of 2016, saw the watchmaker's same store sales dip into negative territory for the 3rd quarter of 2015 and the first half of 2016. Same store sales, which is an indicator of the performance of a retail chain's sales by comparing quarterly sales of established stores on a year-on-year basis, was -0.6% in Q3 2015 and slid further to -3.0% in Q1 and Q2 2016 (see left panel of figure 1). While Fossil posted positive same store sales in Q4 2015, the trailing 12 months EBITDA (earnings before interest, taxes, depreciation and amortization) margin, had been on a decline. This suggests that the positive same store sales in Q4 2015 could potentially be driven by temporal heightened demand, doing little to boost growth of Fossil's ailing margins (see left panel of figure 1). Profitability plummeted with trailing 12 months profit margin falling between Q2 2015 and Q2 2016 (see left panel of figure 1).

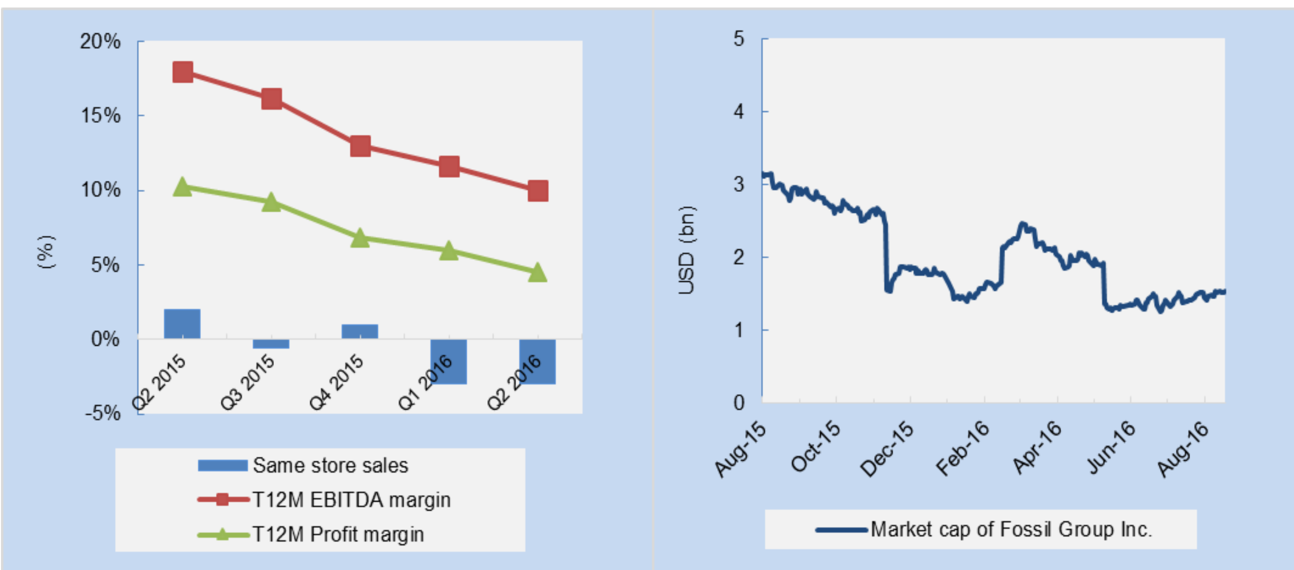

Figure 1: Same store sales growth rate (in %), T12M EBITDA margin, T12M profit margin (left panel) and market cap of Fossil Group Inc. (right panel). *Source: Bloomberg*

Besides the harsh macroeconomic conditions, Fossil has had to contend with heightened competition. The Apple watch was released on April 24, 2015 while Fitbit posted astounding revenue growth in 2015, maintaining its lead in the wearable device market. The advent of new wearable technology, which includes smart watches and fitness trackers, has caused demand for traditional watches to wane, further shaving off the top line of Fossil. With watches forming 75.5% of Fossil's revenue, the faltering demand would create a significant dent in Fossil's sales. In response to the shifting consumer preferences, Fossil acquired Misfit Inc., a private firm that produces fitness trackers and wearable technology, gaining entry to the smartwatch market. In addition, to re-establish its footing in the entire watch market, Fossil has also capitalized on Misfit's technological specialization, integrating Misfit's technology into its watches. With new capabilities in smartwatch technology, plans to flush out competition is in the pipeline through the launch of 100 smartwatch models.

While Fossil's acquisition of Misfit could present opportunities for Fossil to boost its margins in the future, difficulties in meeting its debt obligations could emerge following the prolonged shrinkage of margins and the increased debt to fund the acquisition. Fossil had already experienced a plunge in its EBIT (earnings before interest, taxes) to interest expense; a marked decrease when compared YoY, from 14.05% in Q2 2015 to 2.41% in Q2 2016 (see table 1). Furthermore, Fossil's total debt to trailing 12 months EBITDA had also climbed steadily from a multiple of 1.17X in Q2 2015 to 2.55X Q2 1016 (see table 1).

3 months ending	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016
EBIT to interest expense (%)	14.05	14.84	15.60	2.4	2.41
Total debt/T12M EBITDA (X)	1.17	1.58	2.13	2.42	2.55

Table 1: Credit metrics for Fossil Group Inc. *Source: Bloomberg*

The RMI-CRI 1-year Probability of Default (PD) for Fossil Group Inc., reflecting the challenging business environment Fossil has been operating in, exhibits a general upwards trend, rising from under 10bps at the end of 2015 to a peak of above 100 bps at the end of June 2016 (see figure 2). Correspondingly, the firm's market capitalization declined significantly during the period; Fossil's market capitalization fell by more than half its value from above USD 3bn on Aug 3, 2015 to USD 1.5bn on Aug 18, 2016 (see right panel of figure 1).

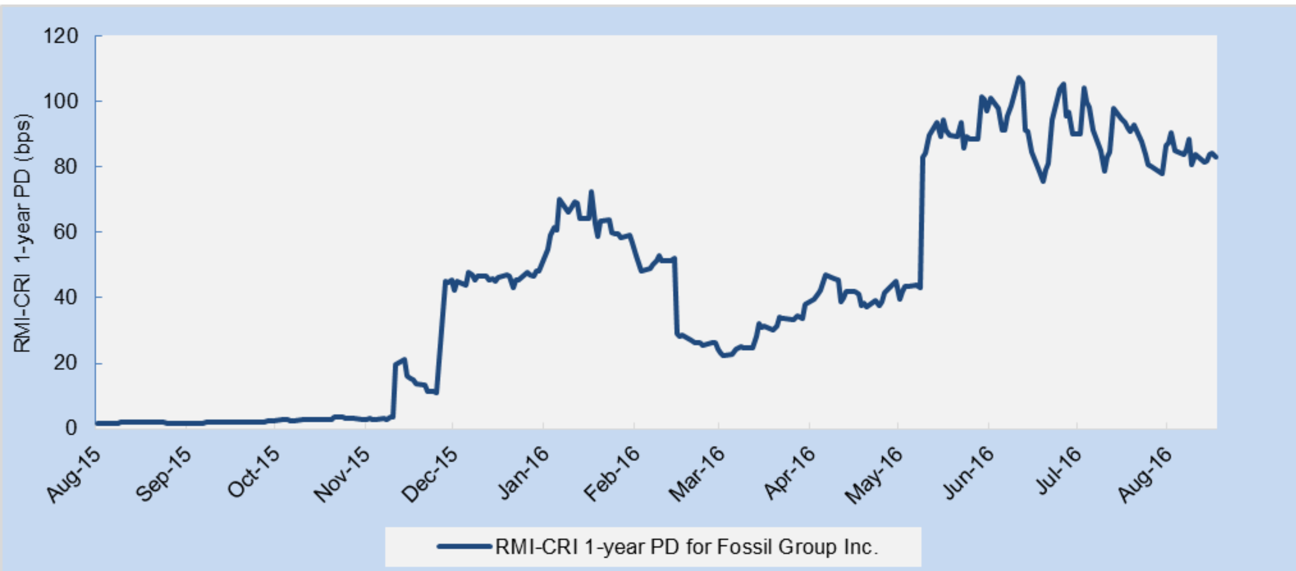

Figure 2: RMI-CRI 1-year PD for Fossil Group Inc. *Source: RMI-CRI*

Given the current headwinds due to increasing competition in the watch segment and the Federal Reserve Vice Chairman Stanley Fischer's suggestion of a probable rate hike, Fossil's ability to expand margins is uncertain. Furthermore, in light of its deteriorating margins, Fossil's acquisition of Misfit is a gamble, either boosting Fossil's future margins or hurting the creditworthiness of Fossil.

Credit News

Singapore defaults boost calls for aid as oil firms falter

Aug 19. According to EY, Singapore firms struggling to meet debt obligations due to the oil price slump may get more support from the government if the economy deteriorates any further. The government had launched a loan assistance program to help ease cash strains at smaller businesses in March this year. However, the situation has since worsened, as the oil-services providers Swiber Holding defaulted and the two oil rig builders Keppel and Sembcorp Marine slashed numerous jobs. As the oil related industries might have limited funding access to the bond market and bank loans, they are highly likely to call on the government's help once again. (Bloomberg)

Caesars bankruptcy cards closer to being revealed

Aug 19. The long-lasting dispute over Caesars bankruptcy has recently narrowed to two main counterparties. One is the Caesars Entertainment holding company, controlled by a group of private equity firms; the other is a group of hedge funds that own big stakes in Caesars junior bonds. Because the creditors are arguing against some asset stripping and financing decisions by private equity owners, the court-appointed mediation between both parties had been fruitless so far. However, the mediator said confidently that a consensual debt restructuring could be reached before January, as the Las Vegas gaming industry has been recovering and a prolonged legal fight would be very costly. (FT)

Premier Oil lifts output estimate as talks with lenders continue

Aug 18. Premier Oil Plc increased its production forecast to 68,000 to 73,000 barrels a day in 2016 amid ongoing negotiations with its lenders for debt refinancing for maturity extension and an increment in the maximum leverage ratio for its loan covenants. The negotiations are expected to complete by the end of the year. Chief executive, Tony Durrant said that both the increased production and debt refinancing are expected to address the challenge in a low commodity price scenario. The firm's production level has averaged 61,000 barrels a day, particularly driven by the North Sea's Huntington field. Together with the second Solan field, analyst Mark Wilson expects an over 100,000 barrels production rate per day if the second field "comes on as planned". (Bloomberg)

UK's big lenders would lose GBP 12bn in commercial property stress scenario

Aug 17. According to Moody's, a hypothetical stress test scenario including a sharp drop in commercial property prices could cost UK banks GBP 12bn of losses over two years. Banks remain heavily exposed to the commercial property market even though they have reduced their portfolios by 40% since 2009. Results from Moody's stress tests reveal that RBS and Lloyds Banking Group would be the hardest hit banks with expected loses of GBP 4.1bn and GBP 3bn, respectively. Banks are likely to be hit post-Brexit referendum as weak investment sentiment has decreased the appetite for syndicated property loans. These loans are usually underwritten based on the values of UK commercial properties, which posted their largest price decline since March 2009 in July. (FT)

BHP makes record loss after commodity rout and Brazil disaster

Aug 16. BHP Billiton, the world's biggest miner recorded a USD 6.4bn loss following a fatal dam disaster in Brazil, the commodity price slump and a bet on fracking in the United States. The chief executive, Andrew Mackenzie, said that the past one year had been challenging and commodity prices were likely to be volatile despite a robust long-term demand. BHP Billiton's loss was a result of a USD 4.9bn charge as value reduction for its US shale operation and a USD 2.2bn charge for the Samarco dam disaster which killed 19 people, polluted a river valley and devastated communities in Brazil's Minas Gerais state. The company was also expected not to gain reopening approval as a result of the dam incident. (The Guardian)

IMF loan arrangement earns B3 credit rating for Egypt (The National)

Sinosteel to try debt-to-equity swap to restructure loans (SCMP)

Rand Logistics in default on two credit agreements (Marine Log)

Regulatory Updates

Bank tied to 'Panama Papers' firm to be investigated in Taiwan

Aug 22. Taiwanese regulators have started investigations on Mega Financial, one of its largest banks, after the lender was fined USD 180mn for breaching international anti-money laundering laws. The Department of Financial Services in New York uncovered illegal transactions between the bank's US unit and subsidiaries in Panama, and discovered a number of customers that were linked to Mossack Fonseca, the law firm at the heart of the "Panama Papers" scandal. To address concerns by the New York government, Mega-Financial and Taiwan's regulators have agreed to consult a third party firm to strengthen internal controls and enhance anti-money laundering procedures within the bank. On Aug 22, the bank announced that the USD 180mn penalty would affect earnings in 2016, but the amount is not significantly large. (Bloomberg)

Shadow ratings investigation pits banks in Nordics against ESMA

Aug 17. European financial institutions warned that ESMA's plan to ban shadow ratings could increase systemic risk and hurt the liquidity of the corporate bond market in the Nordic region. These shadow ratings play an important role by providing investors with market information, especially on small Nordic issuers who are unable to obtain credit ratings from large rating agencies. Swedbank and Nordea Bank AB deliver shadow ratings for free, as a complementary service to clients who use the banks for raising capital. Investors and issuers trust these shadow ratings and often rely on them to make investment decisions. ESMA said that only registered rating companies are allowed to issue credit ratings, but the banks would likely create a solution to work around the new rule. (The Business Times)

Hong Kong Exchange to start stock volatility control system (Bloomberg)

Israeli regulator considering steps to boost bank profitability (Bloomberg)

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