U.S. Stocks Fall 0.5%, Better News Abroad

By VITO J. RACANELLI | MORE ARTICLES BY AUTHOR

A sluggish U.S. economy and confusion from the Federal Reserve sent investors overseas this week. Plus: Why Kate Spade’s stock is as overpriced as its bags, and Coke’s new compensation package.

It was a good week to be out of U.S. stocks as broad market indexes here gave up ground. That was in marked contrast to major markets around the world, which posted solid rises. After American stocks smoked foreign equities last year, this was a rare week of role reversal.

In sympathy with overseas equities, the largest U.S. companies—which tend to get a good chunk of their sales from international sources—did better. Small-company stocks, typically more domestically focused, fell sharply. Among them, technology and biotech did especially poorly.
Don't mistake this for the return of the "risk off" trade, since even the MSCI Emerging Markets index—a beaten-down but riskier set of stocks—rose more than 3% last week. World equities, not including the U.S., were up 1.8%; German stocks rose nearly 3%, Japan was up 1.5%.

On these shores, the Standard & Poor's 500 index dropped nine points, or 0.5%, to 1857.62. The Nasdaq Composite index lost 121 points, or 2.8%, to 4155.76. The Russell 2000 small-company index dropped 42 points, or 3.5%, to 1151.81. Only the Dow Jones Industrial Average gained, up 0.1%, 20 points, to 16,323.06.

Investors were perhaps swayed to venture across borders by concerns about the Federal Reserve’s tapering of its bond-buying stimulus and by a U.S. economy that in the first quarter showed little sign of the acceleration many are expecting, says Jack Ablin, chief investment officer at BMO Private Bank.

More volatility could come from lower-than-expected first quarter earnings reports, out in April and May. Ablin notes analyst consensus first-quarter earnings-per-share growth projections for S&P 500 companies have dropped to 1% to 2% from 6% to 7% as the year began. The severe winter weather that gripped much of the U.S. in January and February may yet be seen again in many first-quarter reports.

With the quarter about to end, the S&P 500 is essentially flat, a far cry from the 10% rise in the same year-ago period. The bond market continues to confound. Though many have expected interest rates to rise since the Fed announced the tapering in mid-December, bond prices are higher and rates lower. The long end of the Treasury yield curve has
flattened a little bit, suggesting bond investors don't see much in the way of U.S. economic growth. Maybe that's why some have put their money to work overseas.

Some important data to be released this week could reignite stocks made in the USA, says Bill Stone, chief investment officer at PNC Wealth Management. March payroll numbers Friday will not be as weather-affected, and a number above the 200,000 forecast could be taken well, he says. Additionally, surveys done by the Institute for Supply Management on manufacturers and non-manufacturers, out Tuesday and Thursday, respectively, could shed more light on the waffling American economy.

**AT $200 TO $400 AND UP, Kate Spade's** (ticker: KATE) designer handbags are popular and expensive. At Friday's close of $37, the company's shares also appear popular, but more expensive still.

The stock has soared some 175% since 2012, outperforming a bull market 30% rise and a 90% jump at rival Michael Kors Holdings (KORS) shares over the same period. It sports a triple-digit 2014 price/earnings ratio worthy of highly-valued Internet or New Technology stocks, higher than Netflix (NFLX) and 3D printer 3D Systems (DDD). Moreover, its P/E tops peers' already rich valuations though Kate Spade's outlook doesn't appear to justify such a hefty premium. (See nearby table.)

The excitement derives from a nice turnaround since the disastrous years of 2007 through 2010, when the company—then known as Liz Claiborne—lost nearly $2 billion. Since then, it has shed lower-margin brands, such as Liz Claiborne in 2011 and Lucky Brands last year. This year it will wind down its Juicy Couture investment and turn 25 to 30 of those stores into higher-margin Kate Spade retail outlets, of which there are 212 around the world.

This has made the more-attractive Kate Spade brand—which has an earnings before interest, taxes, depreciation, and amortization (Ebitda) margin of 25%—the firm's most important one and a key focus of investor bullishness. In the fourth quarter, the brand recorded $64 million in Ebitda and $256 million in sales, or 60% of total quarterly sales. Even more impressive, that fourth-quarter Ebitda was nearly 50% higher than the same period in 2012.

As often happens with hot theme stocks, skepticism is in short supply. Investors are extrapolating that quarterly performance and projecting it too far into the future.

Kate Spade's improved annual results are less stellar than they look at first glance. In 2013, sales rose 21% to $1.26 billion, and income from continuing operations swung to $73 million or 61 cents per share from a loss of $74.5 million or 64 cents in 2012. But last year's turnaround includes an extraordinary $173 million net gain on the sale of Juicy Couture's intellectual property. Kate Spade's total per-share loss narrowed in 2013 to 15
cents from 31 cents. Results are getting better, but hardly deserving of a nosebleed-level P/E ratio.

Moreover, Kate Spade is much smaller than Michael Kors, which has $3 billion in sales, twice as many stores, and a much larger wholesale global distribution network. Kate Spade has a checkered long-term track record, while Michael Kors has shown annual revenue growth of 50% for five years, and its margins are more than 30%. Kate Spade doesn't have Kors' mojo, so why should it deserve a P/E five times higher?

The last time Kate Spade's shares were around their current level, in 2007, it was a much different company, with $4.5 billion in annual sales and $250 million in net income.

Indeed, the stock price appears to already bake in $5 billion in sales by 2018, well above the bullish consensus, and ignoring that such a huge jump in revenue would require investments in many more stores than the current level, according to Andrew Zamfotis. He's an analyst at EVA Dimensions, an independent research boutique that applies "economic value added" analysis to company stock prices. EVA basically values a stock on sales minus operating and financing costs, including the opportunity cost of equity, which isn't captured by standard earnings models.

There's a lot of hope in the stock price and a "lot of room for disappointment," Zamfotis adds. We concur. A spokesperson for Kate Spade declined to comment.

To justify the current stock price, the world will have to absorb a lot of Kate Spade handbags, clothes and other accessories in the next few years. A small setback will lead to a large stock-price drop.

A DEBATE OVER Coca-Cola's generous new executive compensation plan has emerged after David Winters of Wintergreen Advisors released a letter Thursday to Coke's board asking it to withdraw the plan. Winters, whose fund owns 2.5 million Coke (KO) shares, also wrote to Warren Buffett, a longtime large Coke shareholder, asking him to reject the compensation package at the annual meeting.

This plan, he says, proposes a transfer to management of a potential value of about 8% of Coke's outstanding 4.4 billion shares. And when those shares are added to the stock still grantable from Coke's earlier plans, the compensation represents a possible wealth transfer to managers of about a 16.6% Coke stake, or $28 billion dollars at the current share price, he says. At $39 per share, Coke's market value is $171.6 billion.

Winters calls that "excessive…and a staggeringly large transfer of wealth." He is particularly incensed that the plan's average annual dilution rises to 1.9% from a previous 1.3%. That's more significant than it seems when one considers that Coke's earnings-per-share growth has been a lackluster 5%, at most, in the last couple of years—and even that was helped by big share buybacks.

The plan hurts EPS growth and shareholder returns, and comes at "...a time when we believe company's results have been less than stellar," Winters says.
In a statement, Coke said Winters overstates the dilution, which will be "in the range" of the previous plans' "less than 1% per year." The new plan is closely in line with past plans and within industry norms, and links the interest of employees to shareholders, the company said.

Some 6,400 managers are eligible under the plan, and Winters' calculations assume all the options and share grants from the plans will be paid out, which might not happen. Executives can only cash in options, for example, if the stock trades above the grant price. There are also other significant restrictions and performance hurdles—though Winters says Coke needs to disclose more, like the hurdle rates for vesting.

This battle brings into sharp relief an underlying and important issue at the Atlanta-based firm. Apart from the suitability of the compensation on an absolute basis, for what level of share performance is Coke's management being rewarded?

Since Muhtar Kent became CEO in July of 2008, Coke shares have topped PepsiCo (PEP), 49% to 30%, and edged out the market's 44%. Yet in the last two years Coke's performance has been abysmal, up 5% to the market's 31% and Pepsi's 24%. Kent's pay fell by a third in 2013 to $20 million.

A company can't directly control its share price, and like Winters, this column sees Coke shares as undervalued. But it's up to management to perform and prove that. The weak stock rise over the past 24 months suggests investors believe management is underperforming. Yet a richer compensation plan is being introduced when the previous one still had a year to run.

**FIVE-DAY DOW COMPOSITE**

Bigger is Better: The Dow inched higher last week—as investors bet on international big caps and foreign stocks—bucking the down trend in the rest of the market.

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