EDISON

European luxury goods

Signs of life

Consumer

25 September 2017

The industry is seeing a patchy recovery in demand, but is unlikely to return to the stellar growth rates of 2010-14. Luxury goods companies will continue to be buffeted by macro-economic and geopolitical events and are more exposed than ever to consumer confidence trends and tourist flows. Chinese consumption (increasingly at home) remains a key driver. Recent positive top-line numbers have driven valuations back up to demanding levels so stock selection is paramount.

Slow return to top-line growth…

After two dire years for the sector (2015 and 2016) we have seen signs of an improvement this year with like for like sales figures starting to turn positive (though not in all cases). Confidence is returning slowly and industry observers now forecast a return to sustainable growth (the consultants Bain/Altagamma are predicting 2-4% annual industry growth between 2017 and 2020).

…but margins and ROCE are still under pressure

Beyond improving organic sales growth lurk many pressures. Most luxury brands have expanded their retail footprint substantially and the result is a much higher fixed cost base. Declining footfall and the continuing online shift effectively means underperforming stores that act as a drag on EBIT. Investing in digital (skills as well as technology) and in customer loyalty/engagement is essential for improved productivity and brand momentum, but it also means that returns on capital are likely to be under pressure and for some companies it may take longer than expected to reach previously attained profitability levels. Prada's recent results (8 September) are a case in point.

M&A likely to be peripheral

Despite two relatively large recent transactions (Michael Kors' purchase of Jimmy Choo for £896m and LVMH's consolidation of the Christian Dior brand, at an implied EV of €6.5bn), we are unlikely to see any transformational M&A in the sector in our view. Brands that would appeal as M&A targets (eg Ferragamo, Tod's) invariably have significant family ownership or blocking majority shareholders. The conglomerates (LVMH and Kering in particular) are likely to continue with bolt-on acquisitions and other mono brand companies are likely to continue buying back licences or buying out joint venture partners.

Valuation

There are currently no obvious places to seek value within the sector as in P/E terms it is trading above its historical average of 19x (currently 23.3x 2018e multiple even stripping out Hermes and Mulberry). Both Hugo Boss and Prada would seem to offer attractive dividend yields but neither company has yet convinced the market that its turnaround strategy is working. The conglomerates (particularly LVMH and Kering) offer a relatively defensive exposure to a sector that has typically seen sales growth outperform GDP growth by a multiple of 3x and may well do so again in the future.

Companies in this report

LVMH (MC FP)
Kering (KER FP)
Hermes (RMS FP)
Richemont (CFR VX)
Burberry (BRBY LN)
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Mulberry (MUL LN)
Ted Baker (TED LN)
Hugo Boss (BOSS GR)
Brunello Cucinelli (BC IM)

Analysts

Richard Lewis Jones +44 (020) 3077 5700
Paul Hickman +44 (020) 3681 2501
consumer@edisongroup.com

Note: All shares priced at 21 September 2017

Exhibit 1: A snapshot of European luxury goods companies

Company	Description	Key financials	Investment case
LVMH MC FP €229.45	Corporate overview LVMH was created by Bernard Arnault in 1987 bringing together several iconic luxury brands. It is now the largest of the luxury goods conglomerates and consists of over 70 luxury brands. It continues to invest in bolt-on acquisitions (eg recent purchase of luggage specialist Rimowa) as well as consolidating ownership where possible (eg Christian Dior). The Arnault family owns 47% of the group. Markets LVMH's brands have global reach. The geographical breakdown is: Asia 36%, Europe 27%, US 25%, other 12%. The company has five principal divisions: Fashion & Leather (35% of sales, 57% of EBIT), Wines & Spirits (11% of sales, 18% of EBIT), Selective Retailing (31% of sales, 11% of EBIT), Watches & Jewellery (9% of sales, 6% of EBIT) and Perfume & Cosmetics (13% of sales, 8% of EBIT). Catalysts: Q3 sales (October 2017)	2016 €m Mkt cap: 116,327 Net debt: 3,265 Revenue: 37,600 EBIT: 6,904 Net profit: 3,981	Bull ■ Well balanced in terms of product category and geographical exposure. ■ Best in class operating efficiency and margins at Louis Vuitton brand. ■ Recent move to bring all Dior brand activities in house presents opportunities. Bear ■ Louis Vuitton brand performance shields weaker brands in the Fashion & Leather portfolio (eg Marc Jacobs) and other underperforming businesses (eg Cognac). ■ Strong balance sheet but acquisitions likely to take precedence over share buy backs/increased dividends. ■ Decentralised structure/culture has benefits but also presents challenges, eg overall the group has been relatively slow to embrace digital.
Kering KER FP €331.95	Corporate overview Kering (formerly known as Pinault-Printemps-Redoute) is an international luxury group based in Paris. Its acquisition of Gucci in 1999 followed by several high-profile acquisitions have made it one of the key players in the luxury sector. Kering also has a Sport & Lifestyle division (which includes the Puma brand), but the group's focus is increasingly on luxury. The Pinault family owns 41% of the company through Artemis Group. Markets The Luxury division accounts for 69% of group sales and 94% of EBID. The luxury division sales break down as follows: Europe 33%, Asia 41%, North America 19%, other 7%. Gucci accounts for 52% of the luxury division's sales and 65% of its EBIT. Catalysts: Q3 sales (24 October 2017)	2016 €m Mkt cap: 41,918 Net debt: 4,371 Revenue: 12,385 EBIT: 1,886 Net profit: 1,282	Bull ■ Remarkable turnaround and outperformance at Gucci. ■ Several smaller brands could create significant value (eg Stella McCartney, Alexander McQueen). ■ Improving performance at Puma. Bear ■ Bottega Veneta underperformance continues. ■ Lack of clarity on Sport & Lifestyle division (will improved performance at Puma prompt Kering to sell?). ■ Relatively high leverage (38% gearing) compared with major sector peers.
Hermes RMS FP €421.3	Corporate overview Hermes was created in 1837 and has grown steadily to become one of the largest luxury brands ranked by sales (now over €5bn). The company retains a key focus on quality and craftsmanship and is the benchmark for all other luxury brands in the leather goods and accessories sector. Hermes rebuffed a takeover attempt by LVMH, which began by a stake building exercise in 2010, and remains majority owned by the founding family (77% of the voting rights). Markets Hermes operates globally through a network of directly owned stores and limited wholesale accounts. Revenue by geography breaks down as follows: Europe 32%, Asia 48%, Americas 18%, other 2%. Leather goods account for 50% of group revenue with the remainder split as follows: Fashion/Ready to Wear 21%, Silk & Textiles 10%, Perfume 5%, Watches 3%, other 11%. Catalysts: Q3 sales (October 2017)	2016 €m Mkt cap: 44,476 Net cash: 2,320 Revenue: 5,292 EBIT: 1,697 Net profit: 1,100	Bull ■ Brand desirability makes the company probably the most resilient in the sector. ■ Very high operating efficiency (32.6% EBIT margin is an all-time high). ■ Strong balance sheet enables investment in product development. Bear ■ Limited free float (24%) and demanding relative valuation. ■ Increasing scarcity of raw materials, particularly exotic skins. ■ Limited to organic growth as little prospect of acquisitions apart from to strengthen supply chain.
Richemont CFR VX CHF86.9	Corporate overview Richemont is a Swiss luxury goods conglomerate that owns several iconic brands such as Cartier, Van Cleef & Arpels and Dunhill. It is effectively controlled by the Rupert family (Johann Rupert is chairman) through unlisted B shares that have superior voting rights. Its management structure is unusual in that there is no longer a group CEO. Richemont now owns 49% of Net-a-Porter (25% of the voting rights) following the latter's merger with Yoox.com. Markets Richemont derives the bulk of its business from jewellery and watch brands and has limited exposure to "soft" luxury companies. Virtually all of its brands are global players – group sales break downs geographically as follows: Europe 29%, Asia 46%, Americas 17%, Middle East and Africa 8%. Catalysts: H1 results (10 November 2017)	March 2017 €m Mkt cap: CHF49,898m Net cash: 5,791 Revenue: 10,647 EBIT: 1,764 Net profit: 1,210	Bull ■ Jewellery is one of the fastest growing segments in luxury and Richemont is particularly well positioned. ■ 49% stake in Yoox/Net-a-Porter could generate value. ■ Strong balance sheet means the company can invest in struggling brands if it chooses not to sell them (cf Shanghai Tang sold in July 2017). Bear ■ Luxury watch market is still under pressure (excess inventory in Asia remains a problem). ■ Several non-jewellery brands are underperforming, particularly Dunhill. ■ Uncertainty over use of large cash resources.

Company	Description	Key financials	Investment case
Burberry BRBY LN 1,761p	Corporate overview Burberry Group plc was established in 1856 and has grown to be one of the largest single brand companies in the sector, specialising in outerwear but also increasingly active in accessories. Unusually for the luxury goods sector, the company has no family ownership and has a 100% free float. A new CEO and CFO were recently appointed but Christopher Bailey remains as president and chief creative officer. Markets Burberry operates through a network of directly operated stores and wholesale accounts. The company has focused on the retail channel in recent years (it is now 77% of sales) whereas both wholesale and licensing have declined to 22% and 1%, respectively. The company is well balanced geographically: Europe, the Middle East and Africa is 36% of sales, Asia-Pacific 39% and Americas 25%. Catalysts: Interim results (November 2017)	March 2017 £m Mkt cap: 7,543 Net cash: 809.2 Revenue: 2,766 EBIT: 458.7 PBT: 394.8	Bull ■ New management could be a catalyst for improved operational performance. ■ Strong balance sheet and increasingly attractive dividend payout ratio. ■ Digital expertise is hard to beat in the luxury sector. Bear ■ ROIC ex licensing has been in decline and the company has a cost saving challenge to return to previous levels. ■ Organic growth is lagging sector peers and comps will become difficult in H2. ■ New CEO/president structure is untested.
Moncler MONC IM €24.64	Corporate overview Moncler was founded in 1952 as a supplier of clothing for mountaineers and skiers. The brand became popular outside these niche markets and has become increasingly fashionable under the stewardship of Remo Ruffini, who bought the brand in 2003. The company was listed on the Milan stock exchange in 2013. Mr Ruffini is the majority shareholder in Ruffini Partecipazioni srl, which owns a 26% stake. Markets Moncler is an outerwear specialist (c 80% of sales) but the company is gradually diversifying into new categories and has pointed to knitwear and shoes as future growth areas. In terms of geography, sales break down as follows: Europe 43%, Asia and rest of world 40%, Americas 17%. Catalysts: Q3 results (24 October 2017)	2016 €m Mkt cap: 6,276 Net cash: 105.8 Revenue: 1,040.3 EBIT: 313.4 Net income: 196.3	Bull ■ Very strong track record of quality and product innovation. ■ Expansion in the Americas is an opportunity. ■ Strong balance sheet. Bear ■ Very dependent on outerwear; challenge will be to diversify into other categories and… ■ …reduce seasonality (heavily skewed to autumn/winter). ■ Increased competition from specialists (eg Canada Goose) and other luxury brands focusing on outerwear.
Tod's TOD IM €59.9	Corporate overview Tod's was founded in the early 1900s by the grandfather of executive Chairman Diego Della Valle. The company operates three other brands, namely Hogan, Fay and Roger Vivier, although the Tod's brand still accounts for the majority of the business (56%). The Della Valle family controls the company with a 62% stake. Markets Tod's operates globally through a combination of directly operated stores, franchise stores and wholesale accounts. The breakdown of sales by category is as follows: Shoes 79%, Leather Goods 14%, Apparel 7%. By geography: Europe 56%, Americas 10%, China 21%, rest of world 13%. Catalysts: Q3 results (6 November 2017)	2016 €m Mkt cap: 1,982 Net debt: 35.4 Revenue: 1,040 EBIT: 128.4 Net income: 85.8	Bull ■ Strategy is to refocus on heritage so there should be less fashion risk going forward. ■ Opportunity to expand further in the Americas and Asia (ex China). ■ Potential M&A target. Bear ■ Increased competition in the luxury shoe market. ■ Organic growth has been weak in recent quarters. ■ Considerable exposure to Italy (31% of sales).
Ferragamo SFER IM €22.88	Corporate overview Salvatore Ferragamo has its origins as a shoemaker in Florence dating back to 1927. It has gradually added other categories including leather accessories, ready to wear and perfume to become one of Italy's best-known luxury brands. Following the IPO in June 2011, the Ferragamo family still has a majority stake of 68%. Markets Shoes continue to be the mainstay of the brand, representing 43% of sales. Leather goods represent 37% and the remaining 20% is split pretty equally between apparel, fragrances and "soft" accessories. In terms of geography, sales are broken down as follows: Asia 45%, EMEA 25%, Americas 30%. Catalysts: Q3 results (November 2017)	2016 €m Mkt cap: 3,862 Net debt: 7.9 Revenue: 1,437.9 EBIT: 260.7 Net profit: 198.4	Bull ■ Brand's luxury positioning remains very strong. ■ Opportunity to grow apparel, which is under represented. ■ Would be an attractive asset for one of the conglomerates (although note family has control). Bear ■ Both CEO and CFO are relatively new and the market is yet to be convinced by their strategy. ■ Organic growth has been underperforming sector peers. ■ Relatively high wholesale exposure (36%).

Company	Description	Key financials	Investment case
Prada 1913 HK HK$26.25	Corporate overview Prada opened its first store in Milan in 1913 and the founder's granddaughter, Miuccia Prada, partnered with current Chairman Patrizio Bertelli in the 1970s to expand the business. Prada SPA is the holding company for Prada, Miu Miu, Car Shoe and Church's shoes. Prada brand represents 81% of group sales. The company was listed on the Hong Kong stock exchange in June 2011. Mr Bertelli and Miuccia Prada own 80% of the company between them. Markets Prada operates through a network of retail stores, which are mainly directly operated. Wholesale has been in decline and now represents only 16% of the business. In terms of geography, the breakdown of sales is as follows: Europe 38%, Americas 15%, Asia 44%, rest of world 3%. By category it is: Leather goods 57%, Shoes 22%, Apparel 19%, other 2%. Catalysts: Full year results (February 2018)	2016 Mkt cap: HK$67,169m Net cash: €23m Revenue: €3,184m EBIT: €431m Net income: €278m	Bull ■ Reiterated focus on innovation and quality. ■ Significant growth potential at Miu Miu and Church's. ■ Shareholders benefit from high dividend payout ratio (100% in 2016). Bear ■ Management has admitted that turnaround is taking longer than expected (recent H1 results showed continued weakness in like for like sales). ■ Has been slow to invest in digital, although the company is now embracing digital (both retail and wholesale). ■ Limited free float (20%).
Mulberry MUL LN 1,056p	Corporate overview Mulberry is a British company founded in 1971. Its success has been built on leather bags, which still account for nearly two-thirds of the business. The company is controlled by Singapore-based Christina Ong and her family, who own 56% of the shares. There are also two strategic shareholders, Banque Havilland SA and Tybourne Capital, leaving a very limited free float of less than 7%. Markets Mulberry still generates most of its revenue and profit from the UK, but is gradually expanding into international markets. The UK accounts for 73% of sales, Europe 14%, Asia-Pacific 7% and North America 6%. The company recently signed a joint venture with Challice Holdings to develop a retail presence in Greater China (the business was wholesale in that region). The breakdown of sales by category is Leather bags 73%, small leather goods 21%, Apparel 3%, Luggage 2%, Shoes 1%, other 1%. Catalysts: H1 results (December 2017)	March 2017 £m Mkt cap: 634 Net cash: 21.1 Revenue: 168.1 EBIT: 7.1 PBT: 8.6	Bull ■ New CEO and creative director have reset strategy and there are early signs of success. ■ Recently signed joint venture in Asia should drive growth in that region. ■ Opportunity to grow several categories, particularly shoes, apparel and jewellery. Bear ■ Limited resources to invest in a competitive real estate market. ■ Very exposed to the UK market (73% of sales). ■ Very small free float (6.6%).
Ted Baker TED LN 2,502p	Corporate overview Ted Baker was founded in 1988 as a shirt specialist in Glasgow. It has grown to be a successful lifestyle brand and although predominantly a premium positioned brand it is increasingly relevant to luxury customers. Founder and CEO Ray Kelvin owns 35% of the company. Ted Baker has been a constituent of the FTSE250 since January 2013. Markets Despite having started as a menswear specialist, womenswear now accounts for 57%, whereas menswear represents 43% of sales. The company is still largely dependent on the UK and European markets, which represent 69% of sales (North America is 28% and Asia 3%). The company has a good balance of channels with retail representing 73%, wholesale 24% and licensing 3%. Catalysts: H1 results (October 2017)	Jan 2017 £m Mkt cap: 1,109 Net debt: 37 Revenue: 549 EBIT: 67 PBT: 66	Bull ■ Clear brand strategy and positioning. ■ Healthy gross margin is not far below "true luxury" companies at 61% and could increase with further expansion into high-margin categories (eg accessories). ■ Digital is working well and is now 18% of the business. Bear ■ Fashion risk is relatively high due to significant contribution of men's and women's apparel. ■ The company may have to buy back territorial licences in the future. ■ Considerable exposure to the UK market (60% of sales) although this will decrease with international expansion.
Hugo Boss BOSS GR €72.85	Corporate overview Hugo Boss is a Germany-based manufacturer of premium and luxury men's and women's apparel. Historically the company has operated four different brands: Boss Black (predominantly formal wear), Boss Orange (casual wear), Boss Green (sportswear), and Hugo (avant-garde fashion). From 2018 the Green and Orange labels will be integrated into Boss Black. It also offers shoes and leather accessories, along with fragrances, watches and eyewear under licensing. Following the exit of private equity group Permira in 2015, 88% of the share capital is now free float –2% is treasury stock and the Marzotto family owns a 10% stake. Markets Hugo Boss has a global footprint and has gradually been shifting its business to retail, which now represents 62% of the business (wholesale 35%, licensing 3%). The breakdown of sales by geography is: Europe 61%, Americas 22%, Asia-Pacific 14%, other 3%. Catalysts: Q3 results (2 November 2017)	2016 €m Mkt cap: 5,129 Net debt: 113 Revenue: 2,693 EBIT: 263 Net income: 194	Bull ■ Rationalised label strategy should reinforce brand equity and simplify operations. ■ Management is focused on cost control and restructuring is already starting to bear fruit. ■ 60-80% dividend payout policy shows commitment to shareholder returns. Bear ■ Diverse brand awareness across regions. ■ Exposure to apparel (c 85% of sales) means relatively high fashion risk. ■ Little visibility on a return to sustainable like for like retail sales growth.

Company	Description	Key financials	Investment case
Brunello Cucinelli BC IM €26.22	Corporate overview Mr Cucinelli founded his eponymous brand near Perugia in 1978 and following the IPO in 2012 remains the principal shareholder, with a 57% stake. Originally a cashmere product specialist, the company now sells a wider selection of men's and women's apparel, which is virtually all made in Italy. The business is split equally between retail and wholesale. Markets The company has a more limited distribution than other luxury brands, but has plans to expand selectively, particularly in Asia. The current geographical breakdown of sales is: Europe 47%, North America 37%, Greater China 7%, rest of world 9%. Catalysts: Q3 results (November 2017)	2016 €m Mkt cap: 1,783 Net debt: 51 Revenue: 457 EBIT: 58 Net income: 39	Bull ■ Extremely high quality and craftsmanship means durable brand loyalty. ■ Less exposed to tourist fluctuations than many sector peers. ■ Well managed company with strong values. Bear ■ Relatively high valuation. ■ High exposure to Italy (17% of sales). ■ 15% of the free float is owned by two institutions (Fidelity FMR 10% and Oppenheimer 5%) so there is a risk that either may decide to sell down.

Source: Company reports, Bloomberg. Note: Prices as at 21 September 2017.

Valuation

Exhibit 2: Luxury goods peer group valuations

	Market cap (m)	P/E (x)			EV/EBITDA (x)			Yield (%)		
		2017e	2018e	2019e	2017e	2018e	2019e	2017e	2018e	2019e
LVMH	€116,327	23.9	21.6	19.9	12.1	11.1	10.4	2.0	2.2	2.4
Kering	€41,918	23.4	20.8	18.5	15.3	14.0	12.7	1.7	1.9	2.1
Hermes	€44,476	37.1	34.5	31.9	20.5	19.0	17.7	1.0	1.1	1.2
Richemont	CHF49,898	32.2	25.1	22.3	16.6	14.2	12.7	2.2	2.4	2.7
Burberry	£7,543	22.6	22.2	19.9	11.6	11.3	10.2	2.1	2.3	2.5
Moncler	€6,276	25.7	23.3	21.2	15.4	14.0	12.7	0.9	1.1	1.3
Tod's	€1,982	24.3	21.9	20.0	11.9	11.3	10.5	2.8	3.0	3.3
Ferragamo	€3,862	22.9	20.0	17.6	13.4	12.1	10.8	2.0	2.2	2.6
Prada	HK$67,169	24.5	26.1	22.4	11.0	11.9	10.6	3.2	5.4	5.3
Mulberry	£634	132.0	105.6	88.0	N/A	N/A	N/A	N/A	N/A	N/A
Hugo Boss	€5,129	20.2	18.8	17.3	10.6	10.1	9.5	3.8	4.0	4.4
Brunello Cucinelli	€1,783	39.9	36.4	32.5	21.4	19.3	17.3	0.9	0.9	1.1
Ted Baker	£1,109	22.2	19.7	17.4	13.9	12.1	10.8	2.2	2.4	2.8
Average (excl. Hermes and Mulberry)		25.6	23.3	20.8	13.9	12.9	11.7	2.2	2.5	2.8

Source: Bloomberg consensus. Note: Prices as at 21 September 2017.

Following a period of outperformance, the sector is now looking expensive both relative to the market and to historical sector averages – even stripping out outliers Mulberry and Hermes. A 2018e P/E of 23.3x compares with 14.6x for MSCI Europe and a historical average of 19.1x for the luxury goods sector.

Based on the table above we would note the following:

- LVMH is trading at a slight discount to the sector both on 2018 P/E and EV/EBITDA, which perhaps seems unwarranted given recent strong results and the relatively defensive nature of the group. Kering also looks attractive on a 2018 P/E basis.
- Ferragamo looks to be trading at a discount to the sector on a 2018 P/E basis, but this is probably warranted because of a lack of visibility on the company's recovery.
- Both Prada and Hugo Boss would appear to offer attractive dividend yields, but dividends could be at risk at both companies if their turnaround strategies do not lead to improving fundamentals.
- Although the sector has a history of growing on average three times faster than GDP, we believe that current valuations are rather demanding and imply a smooth return to superior growth.

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Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 12, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia