Luxury goods

Luxury Goods team

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Sector structure

Luxury goods

Diversified groups or holdings
- LVMH
  - Louis Vuitton
  - Moët Hennessy
  - Sephora
  - DFS
  - Bulgari
  - Perfumes
- Christian Dior
  - 41% LVMH stake
  - Dior Couture brand
- PPR
  - Gucci
  - Puma
  - Retail assets
- Luxottica
  - Ray-Ban
  - Oakley
  - Eyewear licences
  - Lenscrafters
  - Sunglass Hut

'Hard luxury' companies
- Richemont
  - Cartier
  - Montblanc
  - IWC
  - Panerai
- Swatch Group
  - Omega
  - Breguet
  - Tissot
  - Swatch
- Tiffany
- Harry Winston

'Soft luxury' companies
- Coach
- Burberry
- Prada
- Ferragamo
- Tod's
- Hermès
- Hugo Boss

Source: HSBC
Sector valuation history (forward PE)

Source: Factset, HSBC
EBIT margin versus asset turnover (FY2012*)

* FY2012 figures for Burberry, Tiffany, Richemont and Prada are actuals, all other figures are HSBC estimates.
Source: HSBC estimates
Sector description

The luxury goods sector includes companies that develop, produce, market, distribute and sell high-end apparel, jewellery, watches, leather goods and accessories. Some luxury goods companies are also involved in other premium-priced categories, such as LVMH with its fragrances, and wines and spirits, or are vertically integrated; the Swatch Group, for example, has a watch-component division. Many listed companies are family-controlled, although some have a 100% free float, such as Burberry and Tiffany. The sector is characterised by high operating margins, substantial emerging-market exposure and strong cash generation. M&A has been a driver in the past, but with a few exceptions – Luxottica, for example – synergies are scarce, making it hard to return cash to investors in an efficient manner.

- **Diversified groups/holdings:** Some of the listed companies in the space have grown by acquisitions that gave them large, diversified brand portfolios. The proxy for the sector and the largest group is the French company LVMH, which now has more than 50 brands in five different product categories: fashion and leather, fragrance and cosmetics, wines and spirits, watches and jewellery, and selective distribution. Christian Dior is a listed holding company of LVMH. PPR is more of a conglomerate than a diversified luxury group, since it holds retail assets, a stake in sports brand Puma and a luxury portfolio. Richemont and the Swatch Group also have diversified portfolios, although they focus on so-called hard luxury.

- **Hard-luxury companies:** ‘Hard luxury’ describes products such as watches, jewellery and pens, although pens no longer contribute much to sales. Watches and jewellery are often considered together, but their distribution structures vary considerably. Watches are primarily wholesale-driven, because consumers want to compare designs, brands, prices and functionality. Jewellery is often retail-driven – companies sell their own jewellery in their own stores. The largest listed hard-luxury companies are Richemont, with its star brand Cartier, and the Swatch Group, with the star brand Omega. Monobrand companies include Tiffany and Harry Winston, which sells mostly jewellery.

- **Soft-luxury companies:** ‘Soft luxury’ describes high-end apparel and leather goods. Soft-luxury goods are mostly sold in directly operated stores. Monobrand listed companies include Burberry, Hermès, Prada, Ferragamo, Tod’s, Hugo Boss and Coach.

Key themes

Luxury goods stocks historically have shown strong growth, trading at a premium valuation to the market. The key concern is the sustainability of their growth, and the key question for the bigger brands like Louis Vuitton and Cartier is how close the brand is to being mature. It seems paradoxical to try to sell more of what theoretically should be exclusive, but the leaders of the industry have walked a fine line between selling in volume and holding on to their identity (and the consumer). Most of the key themes in the sector will revolve around image management, pricing power and the concept of maturity.

We believe that the key concerns and themes are:

- **High-end consumer behaviour:** Most investors consider luxury goods demand to be directly linked to GDP growth. To a certain extent, that has been the case in some countries. But consumption of luxury is driven by social, cultural and psychological factors as well as financial issues. Luxury boomed in Japan during one of the country’s deepest recessions. Similarly, consumer confidence was sluggish in many
developed markets in 2010 and 2011, but luxury demand soared as wealthy consumers loosened their belts after almost two years of austerity.

- **Pricing power**: Luxury brands do not really compete on price but rather on design and desirability. During the downturn, prices generally held up. In recovery phases, brands tend to launch higher-priced, higher-margin products, and raise prices again.

- **Trading up or down, more or less**: Linked to this pricing power and the social status that is associated with luxury, there is a big debate around the consumer behaviour of trading up or down, and trading more or less. In spirits, trading down is common; customers buy cheaper vodka in the US during a recession, for example. We think in luxury goods, high-end consumers tend to trade less when times get tough. A consumer interested in the latest Patek Philippe watch would probably postpone buying it during an economic crunch rather than trade down to a Casio or Swatch.

- **Market share/polarisation**: Trading less implies that some brands have a reference status and will both increase sales when times are good and expand their market share when times are tougher. Louis Vuitton is usually the reference in leather and accessories; Cartier in watches and jewellery.

- **Market maturity/saturation**: If Louis Vuitton, for example, increases sales by a high single-digit to low double-digit rate every year, how long can this last? When will its market be saturated? This is a theoretical debate that has gone on for years. Japan and possibly a few other countries may be treated as cash cows now, but we believe companies still have considerable capacity to recruit customers and persuade them to trade up.

- **Image control**: It is hard to get consumers to trade up if the distribution network is not up to speed in product assortment, merchandising and in-store service. Most brands try to control their image as much as they can. That often means taking back licences or transferring sales from wholesalers to directly operated stores, which is harder for wholesale-driven businesses such as watches or fragrances. And if the product category is a profitable diversification from the main business, but is a category in which the company does not have know-how or a production base, such as fragrances and eyewear at Burberry or Gucci, a licence makes sense. Another recurring subtheme here is counterfeit products in luxury.

### Sector drivers

Luxury goods have been driven by emerging-market exposure, both within developing countries and through customers from those countries buying goods in Europe. We expect entering and developing leadership positions in higher-growth countries, where margins are already higher than in the developed world outside Japan, will continue to be a key factor for the sector. Historically, currency and M&A have also had an impact on stock prices.

- **Currency**: Most European luxury goods manufacturers produce in euros (in France and Italy) or Swiss francs, and sell throughout the world. They have important exposure to the US dollar and dollar-linked currencies, such as the renminbi and the Hong Kong dollar, and to the yen. A weakening of the euro or/and the Swiss franc has a positive impact on earnings for French, Italian and Swiss luxury companies (which may have a time lag depending on hedging strategies).
M&A and cash management: There have been few deals since the LVMH buying spree in 1999-2000; LVMH’s acquisition of Bulgari in 2011 being one. But with cash piling up, there is recurring talk about deals, and cash generation could become an issue if buy-back programmes or dividend hikes do not occur. Beyond the scarcity of targets (many of which are privately held with no pressure to sell), the issue with acquisitions in the sector is that they do not produce many synergies – if LVMH were to acquire a leather goods brand, it would not be distributed in existing Louis Vuitton stores.

Geographic diversification: The US remains an underdeveloped market, in our view, and countries like India, Russia and Brazil could represent growth opportunities in the future. But the investment case for the sector now relies greatly on Asia outside Japan. Although there are theoretical risks when operating in China, we believe they are outweighed by the many reasons to remain excited by the country’s potential.

Valuation

Luxury goods companies tend to trade on forward-looking price/earnings ratios because they are usually not very capital/debt-intensive. Historically, the sector has traded at an average 50% premium to the market, with troughs during which the sector was trading in line (as it did following 9/11) and peaks when the sector was trading at a 100% premium (for example, during the 2000 bubble). In absolute terms, the sector traded in a forward PE range lying in the low to mid twenties in 2002-07. Since the 2008-09 downturn, it has traded more in the mid to high teens.

Luxury goods can be described as a ‘momentum sector’ since multiples tend to expand when earnings estimates are raised (and the reverse is also true).

One thing to bear in mind about investments and cost containment in the sector is that most of the companies are managed, and their equity held, by families. Consequently, management of brands, people and profits is done with the long term in mind, not necessarily the next quarter, which investors can sometimes find a difficult approach.

<table>
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<tr>
<th>Luxury goods: growth and profitability</th>
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<td></td>
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<tr>
<td>2008</td>
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<tr>
<td><strong>Growth</strong></td>
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<tr>
<td>Sales (organic)</td>
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<tr>
<td>EBITDA</td>
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<td>EBIT</td>
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<td>Net profit</td>
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<td><strong>Margins</strong></td>
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<td>EBIT</td>
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<tr>
<td>Net profit</td>
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<tr>
<td><strong>Productivity</strong></td>
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<tr>
<td>Capex/sales</td>
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<tr>
<td>Asset turnover (x)</td>
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<tr>
<td>Net debt/Equity</td>
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<tr>
<td>ROE</td>
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Note: based on all HSBC coverage of luxury
Source: company data, HSBC estimates
Sector snapshot

Key sector stats

MSCI Europe Textiles, Apparel and Luxury Goods Dollar Index

| MSCI Europe Textiles, Apparel and Luxury Goods Dollar Index | 2.26% of MSCI Europe US Dollar |

Trading data

5-yr ADTV (EURm) 599
Aggregated market cap (EURbn) 212
Performance since 1 Jan 2000
Absolute 106%
Relative to MSCI Europe US Dollar 127%
3 largest stocks LVMH, Hermes, Richemont
Correlation (5-year) with MSCI Europe US Dollar 0.58

Source: MSCI, Thomson Reuters Datastream, HSBC

Top 10 stocks: HSBC luxury goods coverage (weights are given for presence in relevant indices)

<table>
<thead>
<tr>
<th>Stock rank</th>
<th>Stocks</th>
<th>Index weight</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>LVMH</td>
<td><strong>44.9%</strong></td>
</tr>
<tr>
<td>2</td>
<td>Hermes International</td>
<td>#2.6%</td>
</tr>
<tr>
<td>3</td>
<td>Richemont</td>
<td>*17.0%</td>
</tr>
<tr>
<td>4</td>
<td>Christian Dior</td>
<td>*14.4%</td>
</tr>
<tr>
<td>5</td>
<td>PPR</td>
<td><strong>13.8%</strong></td>
</tr>
<tr>
<td>6</td>
<td>Coach</td>
<td>#0.1%</td>
</tr>
<tr>
<td>7</td>
<td>Prada</td>
<td>#0.2%</td>
</tr>
<tr>
<td>8</td>
<td>Luxottica</td>
<td>*8.4%</td>
</tr>
<tr>
<td>9</td>
<td>The Swatch Group 'B'</td>
<td>*6.9%</td>
</tr>
<tr>
<td>10</td>
<td>Burberry Group</td>
<td>*5.3%</td>
</tr>
</tbody>
</table>

* MSCI Europe Textiles, Apparel and Luxury Goods Dollar Index ** MSCI EU Retailing # SBF120 #S&P 500 * S&P Europe LM:$

Source: MSCI, Thomson Reuters Datastream, HSBC

Country breakdown: HSBC Luxury Goods coverage (by market capitalisation)

<table>
<thead>
<tr>
<th>Country</th>
<th>Weights (%)</th>
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<tbody>
<tr>
<td>France</td>
<td>56.5%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>15.1%</td>
</tr>
<tr>
<td>United States</td>
<td>9.1%</td>
</tr>
<tr>
<td>Italy</td>
<td>8.3%</td>
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<tr>
<td>Hong Kong</td>
<td>6.3%</td>
</tr>
<tr>
<td>UK</td>
<td>3.4%</td>
</tr>
<tr>
<td>Germany</td>
<td>1.3%</td>
</tr>
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Source: Thomson Reuters Datastream, HSBC

Core industry driver: international tourist arrivals and the world population, 1995-2010

Source: US Census Bureau, World Tourism Organization, HSBC

PE band chart: HSBC luxury coverage*

Source: Thomson Reuters Datastream, HSBC

PB vs. ROE: HSBC luxury coverage*

Source: Thomson Reuters Datastream, HSBC