BERNSTEINRESEARCH

# LVMH: King of the Luxury Jungle

**SEPTEMBER 2009**

*Profit from temporary W&S woes to bag the stock at discount prices*

LVMH is the strongest player in the luxury goods industry, a giant in an industry where fixed costs make scale paramount; the only "two-legged" balanced player, leading with mega-brands in both Leather Goods and Wines & Spirits; enjoying stable group EBIT margins as a consequence

Champagne consumer demand weakness, de-stocking and oversupply in 2010 are well understood; W&S concerns have depressed the stock close to 20-year trough multiples and in the same range of smaller and more volatile hard luxury players and other peers; an opportunity in our view

On top of LVMH's unrivaled industry position, markets seem to under-appreciate cost-saving opportunities, brand-portfolio rationalization, higher FCF from lower W&S inventory investment, above-average mega-brands' results or support from first-mover EM inroads

In a medium-term growth environment, LVMH has the chance to be a key consolidator in the luxury goods industry: a mega-merger with CFR would be a strategic master stroke, placing it ahead of any M&A counter move by competitors

# Portfolio Manager's Summary

We have few doubts about the opportunity of investing in LVMH for the medium to long term. We expect "winners will continue to win" in the luxury industry. LVMH with its material scale advantage, leading brand portfolio, balanced category and geographic exposure is set to dominate over competitors in the long term.

LVMH's mega-brands and scale advantage is particularly relevant in fashion and leather goods. We expect this area to continue to provide material top-line and earnings growth. In fact: (1) mega-brands like Louis Vuitton secure aspirational and emerging markets demand, leading to faster growth and superior margins; (2) scale provides cost advantage in SG&A (e.g., advertising expenditure, store rental costs, etc.), a key advantage for LVMH as the largest player in the industry; and (3) mega-brands and scale also allow first-mover advantage in emerging markets, where LVMH can push its other brands ahead of the competition. In this context, LVMH clearly emerges as a long-term winner and a potential consolidator of the luxury industry.

We expect Wines & Spirits to provide operating profit upside, as the champagne sector faces capacity constraints medium term. We see higher-than-average upstream integration at LVMH as a positive in the current capacity situation, causing lower COGS inflation. We expect highly positioned LVMH brands to continue to have pricing power medium term. Strong international distribution is another positive, enhancing margin. Short term, W&S is going to be pressured, as the recession prompts trade-down and higher promotion intensity. Retail de-stocking is likely to exacerbate this trend in FY 2009.

We expect more profitable growth in Watches & Jewelry as well as in Selective Retailing. We expect LVMH to grow its relative share in Watches & Jewelry through focused acquisitions (e.g., Hublot), reducing its scale disadvantage to UHR and CFR and producing — over time — improved operating profit from manufacturing and distribution scale. In the meantime, though, we expect Watches & Jewelry will probably be one of the most pressured LVMH divisions, as consumers — and retailers alike — focus purchases on the leading brands, where LVMH is still a runner-up at best.

We see Sephora as one of the most promising businesses in the LVMH portfolio, with a long-term opportunity to increase returns and grow IC. Increasing success at Sephora, with growing LFL and space, should push ROIC ahead in this area — closing the gap to group average. Fragrances & Cosmetics looks set to provide further growth support; LVMH lags sector leaders in this area, but should continue to produce higher-than-group average ROIC returns from the strength of its brands and the relatively modest invested capital requirements. We expect ROIC for P&C to stay above 30%, and Selective Retailing to approach group average, as space maturity and LFL growth continues.

The key controversy on luxury investment is the short term; specifically, the impact of the current macro slowdown. Calling the macro picture and its timing at this point seems exceedingly difficult. We see current depressed luxury stocks valuations as an opportunity to buy quality stocks on the cheap, but this may work in the medium term and does point to short-term risks — the risk we see is more in the shape of sideways trading than in downside terms, given the material recent correction. We rate LVMH outperform with a price target of €79.

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# Table of Contents

**Exhibit 1 Financial Overview**

| | PPR PP.FP (€) | LVMH MC.FP (€) | Richemont CFR.VX (CHF/€) | Swatch UHR.VX (CHF) | Burberry BRBY.LN (£/p) | Inditex ITX.SM (€) | H&M HMB.SS (SEK) | Next NXT.LN (£/p) | M&S MKS.LN (£/p) | Kingfisher KGF.LN (£/p) | DSGI DSGI.LN (£/p) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Recent Price (08/09/09) | 83.90 | 67.60 | 30.02 | 236.80 | 508.00 | 37.23 | 393.50 | 1,746.00 | 366.40 | 218.00 | 29.29 |
| Rating | O | O | M | M | M | O | M | M | O | O | M |
| 52-Week High | 83.90 | 71.72 | 34.37 | 269.75 | 508.00 | 38.46 | 431.00 | 1,746.00 | 366.40 | 218.00 | 50.91 |
| 52-Week Low | 31.54 | 39.20 | 14.23 | 120.40 | 160.00 | 23.69 | 250.00 | 858.00 | 200.00 | 98.90 | 7.00 |
| | | | | | | | | | | | |
| **YTD Performance** | 80.0% | 41.5% | 48.0% | 62.4% | 129.1% | 18.8% | 28.8% | 61.5% | 70.6% | 61.5% | 126.8% |
| YTD Relative Performance | 65.0% | 26.4% | 32.9% | 47.3% | 114.0% | 3.7% | 3.7% | 46.4% | 55.5% | 46.4% | 111.7% |
| Market Cap (million) | 9,850 | 30,943 | 15,946 | 10,822 | 2,106 | 22,675 | 323,139 | 3,511 | 5,466 | 4,965 | 1,047 |
| | | | | | | | | | | | |
| **Earnings per Share** | | | | | | | | | | | |
| FY2008 | 6.72 | 4.26 | 1.34 | 15.51 | 32.00 | 2.02 | 18.48 | 155.7 | 28.0 | 27.4 | 0.7 |
| FY2009E | 5.78 | 3.82 | 0.81 | 10.79 | 25.59 | 1.90 | 19.74 | 150.9 | 25.2 | 12.8 | 1.0 |
| FY2010E | 6.24 | 4.38 | 0.77 | 10.68 | 29.86 | 2.15 | 22.49 | 157.7 | 29.0 | 14.8 | 1.8 |
| FY2011E | 7.06 | 4.92 | 0.86 | 11.72 | 33.61 | 2.71 | 25.22 | 173.5 | 32.4 | 20.1 | 2.2 |
| | | | | | | | | | | | |
| **P/E Ratio** | | | | | | | | | | | |
| FY2008 | 12.5x | 15.9x | 14.7x | 15.3x | 15.9x | 18.5x | 21.3x | 11.2x | 13.1x | 8.0x | 41.8x |
| FY2009E | 14.5x | 17.7x | 24.3x | 21.9x | 19.9x | 19.6x | 19.9x | 11.6x | 14.5x | 17.0x | 29.3x |
| FY2010E | 13.4x | 15.4x | 25.8x | 22.2x | 17.0x | 17.3x | 17.5x | 11.1x | 12.6x | 14.7x | 16.3x |
| FY2011E | 11.9x | 13.7x | 22.9x | 20.2x | 15.1x | 13.7x | 15.6x | 10.1x | 11.3x | 10.9x | 13.2x |

**Note:** 2008A PPR and Kingfisher EPS pre-exceptionals.

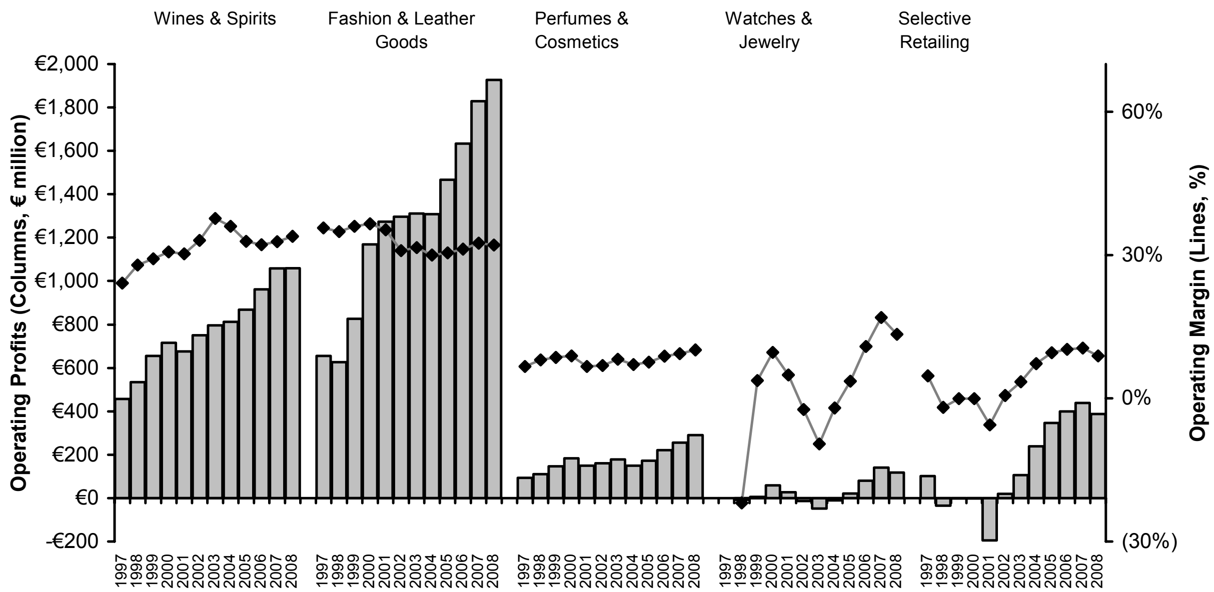
Source: Corporate reports and Bernstein analysis.

# Significant Research Conclusions

**LVMH Is the Only Luxury Goods Player With Two Strong Category "Legs"**

LVMH is the only luxury goods player with two strong category "legs": a very strong position in Leather Goods with Louis Vuitton, and an equally strong position in premium Wines & Spirits, with a vast portfolio of major brands, including Dom Pérignon, Moët et Chandon, Veuve Clicquot and Hennessy. These two divisions provide around 80% of group operating profit and about 95% of net cash (see Exhibit 2).

**Exhibit 2** **Operating Profit and Margin by Division (1997-2008)**




Source: Corporate reports and Bernstein analysis and estimates.

**Leather Goods Is Driven by the Dominance of Louis Vuitton**

Leather Goods are a particularly important category for LVMH, given the global dominance in this area by Louis Vuitton — the largest luxury goods brand in the world. Louis Vuitton brings a vital contribution to the broader LVMH group. Leather Goods generated around 80% of total net cash for LVMH in FY 2008, and we estimate that over 100% of this has come from Louis Vuitton. We expect leather goods and handbags to continue being a key category within luxury goods in the future, and we expect dominance of brands like Louis Vuitton to continue.

Handbags have been one of the fastest-developing categories in the luxury market in the past 10 years. Over the 1998-2008E period, leather goods — of which handbags is the most important product category — have shown a CAGR of around +10% per annum. This is materially above that of women's apparel, which has risen +4.5% per annum and the broader luxury goods market, which has posted a CAGR of 6% per annum.

Handbags serve as "image anchors" to consumers and are largely immune from "mix and match". In fact, women can use them to "make a statement" and claim a certain status with their peers. Because of their prominence in a woman's attire, and their recognizable shape and logos, they are rarely lost on the onlooker. As a category, in fact, handbags also offer brands a unique opportunity to differentiate themselves from competitors. This can be done in a number of ways, some more subtle than others: shape, texture, logo and metal components.

We expect handbags to continue to remain a key product category for "mega-brands" and for luxury players in years to come. Based on our historical correlation of luxury market growth to OECD real GDP growth, we anticipate that handbags will grow at a CAGR (2008-13E) of around 10% versus around 4% for women's apparel and some 6% for the broader luxury goods market. Handbags will be crucial to penetrate different constituencies of luxury consumers:

Handbags are one the fastest-growing product categories in emerging markets, making them a powerful way for top brands to establish themselves with emerging consumers. Using Italian and French exports as a proxy, we calculate that handbags sales posted CAGR (1998-2007) of about 22% for Russia, 26% for China and 46% for India.

Handbags are key to penetrate aspirational consumers. Demand from "aspirational" consumers has been a key driver of luxury and fashion market growth. In the past 15 years, growth of aspirational luxury has outstripped growth of elitist luxury across all product categories — and has been some 80% higher in leather accessories. This has been originated by two factors: mega luxury brands like Louis Vuitton and Gucci "pushing the envelope" with lower absolute entry point prices (e.g., fabric-based handbags, "mini" handbags) and the buoyant growth of "aspirational specialists" such as Coach.

We also see an opportunity at the very high end of the market. High-end sophisticated consumers have been eager to embrace high-end niche brands that provide differentiation from the luxury "mainstream" mega-brands. However, high-end incumbents like Hermes and Chanel have provided little innovation on their iconic products. Hence, this space has opened up to new high-end champions: in our view, the best of these has been Bottega Veneta. We see further opportunity in this area, as consumers across markets continue to mature.

In principle, it makes sense for leading luxury players to have a portfolio of niche brands to complement mega-brands. Mega-brands are perfect to satisfy the "need to belong" of emerging markets and aspirational consumers. Niche brands could instead serve the smaller audience of sophisticated luxury consumers and their "need to differentiate" — all the more so, as mega-brands continue to expand and to thrive both in developed markets and abroad.

In practice, though, the complementary play of mega-brands and niche brands is working in only a handful of cases. The acquisition spree of the late 1990s has provided only isolated success stories, and created a "long tail" of underperforming brands.

We don't expect major value-creation opportunities in the case of DKNY, Kenzo, Pucci or Givenchy. The most important lesson from the late 1990s is that designer and fashion brands struggle to become profitable niche champions. For starters, re-launching designer brands and putting them back to center stage has proven close to impossible. We think this depends on their more modest staying power and limited perceived intrinsic value. On top, running a designer brand is inherently more expensive, as it requires larger stores, more costly product-development budgets, fashion shows, higher end-of-season clearance costs, etc.

We expect that accessories brands could provide much better value. We see Fendi in the top position, but value-creation is not necessarily going to be a simple matter. The second most important lesson from the late 1990s is that "*everything is not possible*", even when dealing with specialist brands: (1) mid-level brands are very hard to move upward (this may not be a problem in the LVMH portfolio); (2) tentative marketing execution and brand positioning backfire (Celine?); (3) questionable product and design content fails to put brands on the map (Loewe?); and (4) last, but not least, developing a luxury brand takes time and cannot be achieved overnight and according to formulaic procedures.

### Champagne Is in the Doldrums But the Fizz Is Likely to Return

Wines & Spirits is the "second leg" of LVMH, where the group has global dominance in champagne and cognac. The champagne industry is dominated by LVMH's Moët et Chandon. LVMH's champagne division Moët et Chandon is the clear leader in champagne, commanding more than 18% of the market in volume terms, three times larger than the runner-up, Boizel. In value terms, LVMH is even more dominant, making up 22% of the industry.

As a very crude segmentation the leading champagne houses fall into four categories. (1) Moët et Chandon is the big kahuna. As well as the eponymous brand, the group also produces Dom Pérignon and owns Veuve Clicquot, Mercier, Ruinart and Krug, giving it a range of brands which runs from lower mass-market (Mercier) to ultra-premium (Krug). (2) Tier 2 global branded, encompassing Pernod (Mumm and Perrier-Jouët) and Rémy Cointreau (Piper Heidsieck and Charles Heidsieck). (3) 'Niche' premium — Roederer, Bollinger, Taittinger, Laurent Perrier (especially Rosé & Grand Siècle). (4) Predominantly mass-market: Vranken (Pommery), Boizel (Lanson), CVC (Nicholas Feuillate) and Thiénot (Canard Duchêne), though each of these houses has their own premium cuvées.

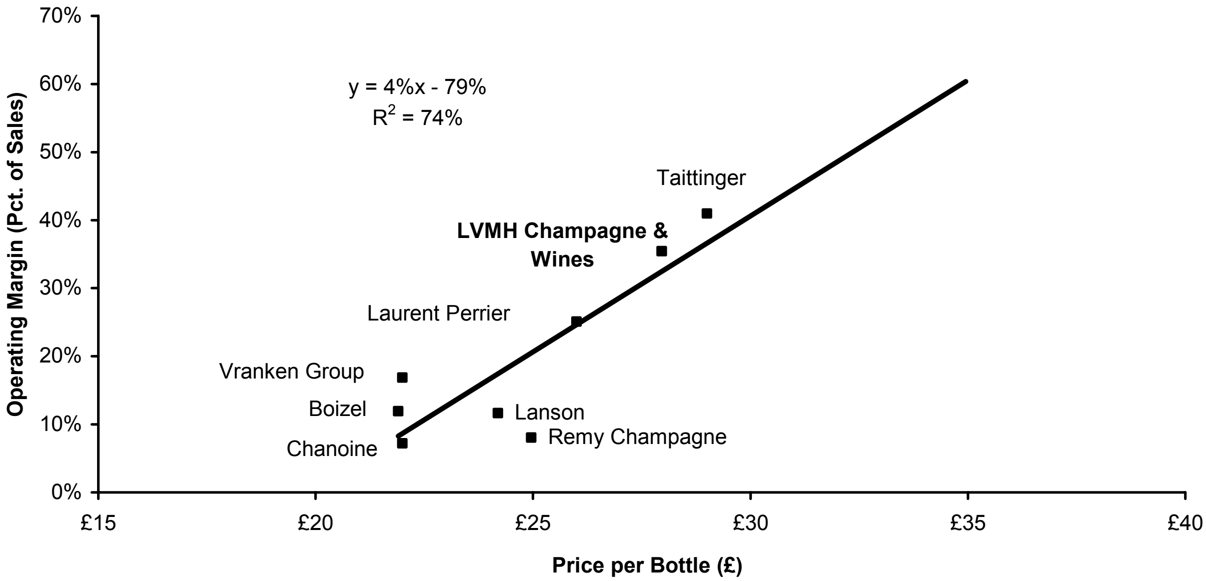
Key drivers of profitability include: (1) strong brands that guarantee higher gross margins; (2) strong international distribution that opens markets with lower price pressures; and (3) higher upstream integration that guarantees efficient sourcing.

We found a strong correlation between operating margins and average retail price per bottle. This would indicate a similar operating cost structure between players in this category. One of the reasons for the success of the Moët et Chandon group is that it covers an extraordinary range of price points, from the global benchmark core brand to eye-wateringly expensive single vineyard champagnes from Krug, including the recently launched Clos d'Ambonnay at over £2,000 per bottle. As well as benefiting from premiumization as consumers trade up this scale, Moët et Chandon, and indeed the broader champagne industry, have benefited from increased demand for premium-priced rosé champagne (see Exhibit 3).

Strong international distribution allows LVMH to have materially higher market share abroad — e.g., more than 50% in the United States, and about 80% in Asia — than in France, as international markets are growing faster and are less price competitive. This produces higher margins as champagne and wine sales in France are primarily channeled through supermarkets, which have significant purchasing power. Conversely, champagne and wine products are sold at full prices in international markets with a higher proportion of on-trade (see Exhibit 4).

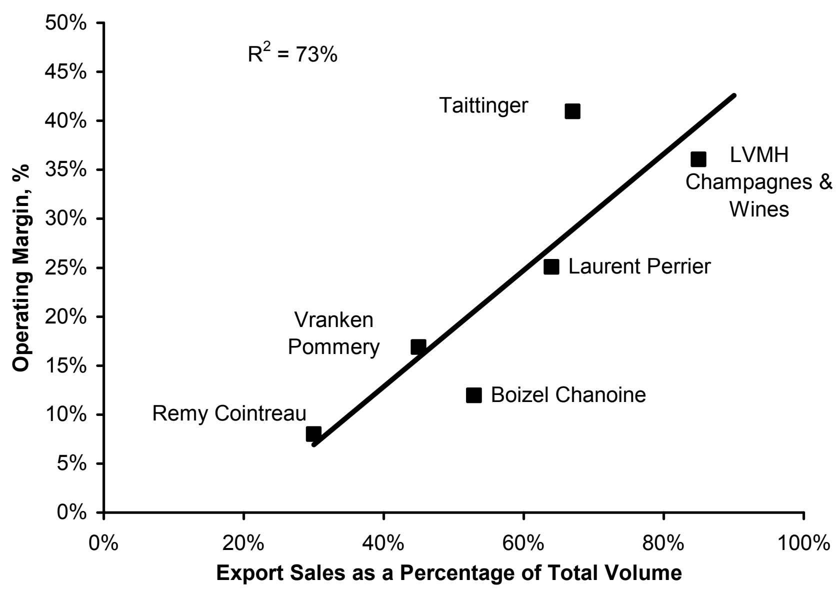
A high degree of upstream integration seems to correlate positively to operating margins, as production is close to maximum. The boundary for the Champagne area was set in 1927. The theoretical maximum area that can be planted in Champagne is approximately 35,000 hectares. At the end of the 1970s only 20,000-25,000 hectares was under vine. This has steadily increased to 30,000 hectares at the end of the 1990s, and today stands at 32,700 hectares. An expansion of the vineyard area is planned but will not bring new supply to the market before 2020 at the earliest (see Exhibit 5).

**Exhibit 3** **Operating Margin vs. Average Price — Champagnes**



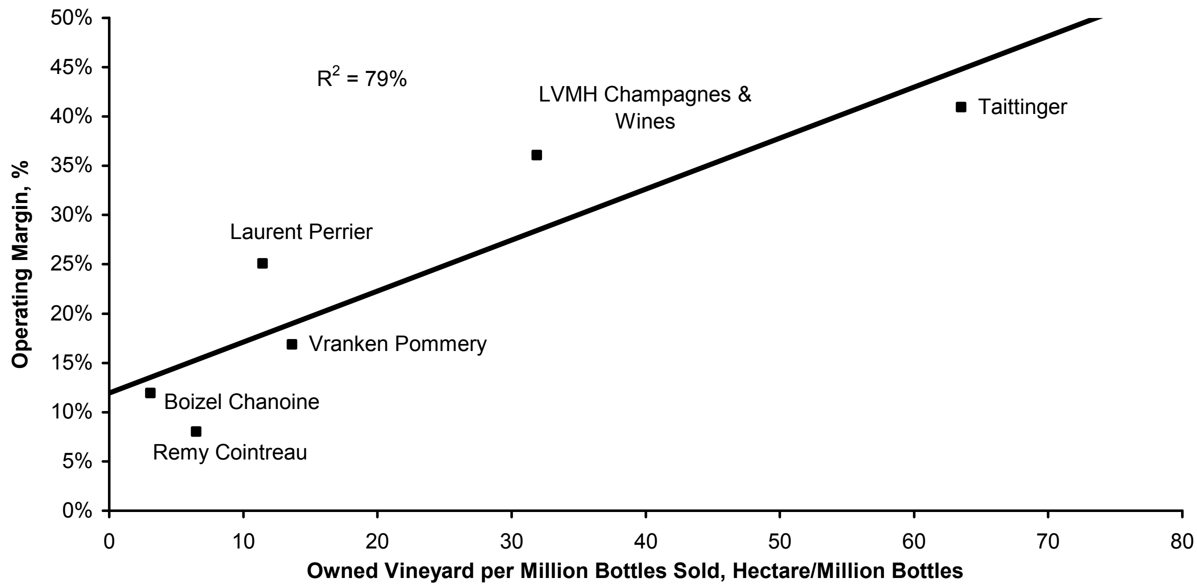

Source: *Wine Searcher*, corporate reports and Bernstein analysis and estimates.

**Exhibit 4** **Operating Margin vs. Percentage of Export Sales**




Source: *Just-Drinks*, corporate reports and Bernstein analysis and estimates.

**Exhibit 5** **Operating Margin vs. Level of Vertical Integration — Champagnes**




Source: *Just-Drinks*, corporate reports and Bernstein analysis and estimates.

The current recession is affecting the champagne industry and LVMH. A remarkable turnaround in 2008 has been seen in the fortunes of the champagne industry. During the course of 2007, pricing accelerated, partly reflecting approximately a 7.5% increase in grape costs. At the same time the dollar was weak against the euro. But global volume growth remained robust; so the major houses pushed through 5-10% price increases. Indeed, the champagne industry seems to have an unerring ability to jack up prices just as the world is about to enter an economic slowdown (e.g., 1989/1990, 1999/2000) and then suffer the consequences in a sharp fall in volume. Once again, consumers are voting with their wallets. HMRC data on shipments of sparkling wine show a rapid deceleration over the course of 2008. In 3Q:08 the sector declined 10% in volume terms versus 3Q:07. In the United States, AC Nielsen data indicate a similar negative trend.

Our best guess is that 2008/2009 will look more like 1990/1991 than 1999/2000. The sharp fall in demand will likely continue into 2009-10**.** Despite the protestations of some houses, we also expect some unwinding of the price increases that have been pushed through perhaps in the form of off-invoice rebates, or currency adjustments in order to preserve face. Although, a strong dollar should take the pressure off the U.S. market without the houses having to take a big hit in the euro price. Pressure on gross margins will be reflected in negotiations on grape prices which will at best be flat next year and may fall depending on the intensity of the pricing pressure. And net margins will fall due to reduced operating leverage. In the longer term, we expect that champagne will recover, as it always has. The product remains very attractive and the cachet unrivalled. Ultimately, the fizz will return but it may take three to five years.

**Cognac Shipments Are Also Experiencing a Setback But China Exposure Should Support Future Growth**

Historically, Cognac experienced remarkably steady growth post-war up to 1990, interrupted only by the oil crisis of 1973 (following which growth continued through the 1980s, driven primarily by Japan). The 1990s saw a turning point in the fortunes of the industry, with a decade of steady decline, driven once again primarily by Japan. However, global growth took off again in 2000, led by the United States and China. China accounted for 70% of total volume growth and roughly 85% of value growth for the 2004-07 period. Superior qualities (≥VSOP) have grown faster than VS Cognac in the "naughties" due to (1) trading up in key developed markets, such as the United States; and (2) the disproportionate weight of China, which is a predominantly higher-quality market.

Shipment numbers exaggerate comparable declines in demand because of de-stocking. 1H:09 volumes for the four major houses are down around 15%, with consumer off-take probably down mid-high single digits, and it seems that we are through the worst of the channel destocking.

We believe that the key investment controversy for the next few years is: will industry volumes fall for a decade (like Japan in the 90s) or bounce back (as in the 70s)? We are in the latter camp. We are cautious on the prospects for the United States because we expect U.S. consumption to grow slowly for next three years and it is unclear if cognac will be equally fashionable when the recovery does kick in. But we are positive on the prospects for China and the propensity for affluent Chinese consumers to drink cognac.

**LVMH Watches & Jewelry Remain the Follower in the Hard Luxury Competitive Landscape**

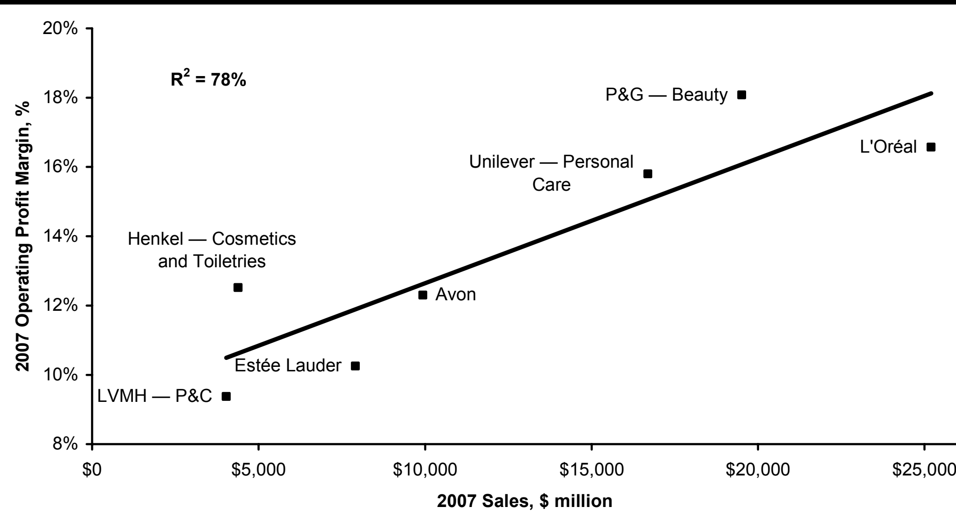
LVMH is a follower in the Watches & Jewelry industry. With sales of €879 million in FY 2008, LVMH is between one-third and one-quarter the size of Richemont and Swatch, as well as materially smaller than privately held Rolex. The LVMH W&J brands are smaller and — for the most part — "middle of the road" in terms of price point, product content, consumer recognition and distribution network. As a follower in the Watches & Jewelry industry, we expect LVMH to be hit more than the industry leaders by the slowdown. In fact, as in other luxury goods categories, we expect both consumers and retailers to become increasingly conservative in their brand choices against the recession, and to focus their purchases on the most prominent brands, disproportionately penalizing others.

LVMH has the option to continue with its small/medium-sized acquisitions, in order to strengthen its Watches & Jewelry business. As a blue-sky alternative, LVMH may consider a mega-merger with one of the major Swiss hard luxury players. This would create a unique "three-legged" luxury behemoth, but it would have to deal with some of the major egos in the industry.

**The Cosmetics & Fragrances Business Is Led by Larger, Scale-Advantaged Players**

Cosmetics & Fragrances businesses operate on high fixed costs. Hence, market leaders that dominate their categories and enjoy scale advantages are capable of generating higher margins, and grow more profitably than their smaller peers (see Exhibit 6).

**Exhibit 6** **Scale Allows Companies to Generate Structurally Higher Margins**




Source: *Capital IQ*, corporate reports and Bernstein analysis.

Category and brand dominance tend to go hand-in-hand and amplify the benefits of scale advantage. Category leaders derive a significant proportion of their sales from "top 10" brands: this is the case for P&G in hair care, where three "top 10" brands — Pantene, Head & Shoulders and Herbal Essences — account for just short of 90% of P&G haircare category sales. Brand dominance allows cosmetics and fragrances businesses to leverage their fixed cost base, by consolidating brand-related costs — and more specifically communication costs — into a small number of blockbusters. Additionally, category leaders tend to enjoy greater brand share gains over time than non-category leaders in most cases.

Downstream retail integration creates potential future business opportunities for cosmetics and fragrances brands — especially in the premium segment. Premium cosmetics and fragrances distribution is still largely in the hands of traditional retailers — like department stores and independent perfumeries. Innovative self-service retail formats like Sephora, offering a deep range in an attractive environment, have proven to be highly effective in gaining share and consumer favor. However, contrary to other luxury product categories — e.g., leather goods and fashion — we expect self-standing mono-brand stores to be less attractive to Cosmetics & Fragrances brands. Indeed, while high-profile flagship stores contribute to affirm and confirm the Fashion & Leather Goods' brand status in consumers' minds, Cosmetics & Fragrances consumers shop for range rather than brand. In this light, we believe pursuing a multi-brand strategy like Sephora is appropriate.

Cosmetics & Fragrances is a borderline business — with some of the allure and brand dynamics of quintessentially luxury categories — but with many of the traits of CPG businesses, such as: (1) universal consumer audience given lower absolute average price points; (2) predominantly multi-brand distribution channels; and (3) specialist, scale-advantaged competitors.

Luxury goods companies playing directly in Cosmetics & Fragrances face material scale disadvantage versus larger incumbents — LVMH is a case in point. While ROIC for the P&C division of LVMH is particularly high, one wonders whether joining forces with specialist partners could create higher value (like PPR recently did through a long-term license agreement and the sale of the YSL Beauté business to L'Oréal, and P&G has successfully done manufacturing fragrances for Hugo Boss and Dolce & Gabbana). That being said, having a winning retail format in-house creates material benefits to the LVMH P&C division, making the issue of a potential third-party license far less critical than in the case of PPR and YSL Beauté.

The beauty retailer Sephora has become a key business in the LVMH portfolio. In the past 10 years, estimated revenues have grown at CAGR of 21% to represent 18% of LVMH group revenues in 2008. Estimated EBIT has grown at CAGR 48% per year since 1999 to represent 8% of LVMH operating profit. In the same time frame, Sephora has moved from 124 stores in 1998 to 898 stores by the end of 2008, with operations in 23 countries. Sephora's performance has become increasingly positive, contributing to advance LVMH group results.

The beauty retail market is attractive as it grows faster than GDP and is very fragmented, even in developed countries. The premium beauty segment has grown on average at 4% in the past 10 years, marginally above GDP growth over the same period, while Sephora has achieved a growth rate well in excess of that. Premium beauty retailing is still largely in the hands of mature/independent formats — mainly department stores and perfumeries. Stronger and more modern concepts — supermarkets and mass merchants — have focused on the mass portion of the beauty segment, as they would hardly have the range, service and quality characteristics to be credible premium beauty retailers.

**Sephora Has Become an Increasingly Important Piece of LVMH's Business**

Sephora's retail concept strength is proving highly effective in penetrating markets, both in developed and in emerging countries. Sephora's unique retail concept — maximizing range depth, brand choice and category accessibility in a modern and high-end self-service context — is proving a success in all markets where present, from the most advanced such as the United States to the faster-growth areas of Eastern Europe and mainland China. Sephora's share of the premium market has grown to approximately 6% in countries like the United States, 10% in Italy and 12% in France. In less developed beauty premium markets like China and Eastern Europe, we calculate that Sephora's share is even higher at around 10% and 20-30%, respectively.

We expect Sephora will represent a continuing opportunity of profitable investment for LVMH. Premium beauty should be more cyclical than mass H&B, with demand and store expansion softening in 2009 in a subdued OECD GDP growth and luxury market growth scenario. But long-term organic growth opportunities abound, as Sephora has yet to grow materially in both developed markets (where its share is still relatively low) and emerging markets (where it will benefit from its dominant position and faster demand growth).

**Valuation Methodology**

For companies in our coverage we set our price target using a target relative P/FE multiple against our forward EPS estimates. In the case of LVMH, we target a relative market multiple of 1.6x. As we are currently past mid-year, we use EPS estimates and MSCI P/FE multiples for both 2009E and 2010E and calendarize accordingly.

**Risks**

A risk to luxury goods would be a further slowdown in the global economy. Consumer retrenchment, higher propensity to save and increased taxation would all be negatives. Currency also represents a risk to the fashion and luxury sector, though FX should be supportive to European luxury players in 2009. Any unforeseen event significantly disrupting travel patterns — terrorism, epidemics, war, etc. — would act as a sharp negative on the stocks and the luxury sector, as we saw very clearly in 2003, plunging luxury stocks relative P/FE below the historical long-term correlation to luxury growth demand. A milder-than-expected slowdown than we currently expect would act as a positive catalyst for luxury stocks, representing upside risk.

**Investment Conclusion: LVMH's Strong "Two-Legged" Approach Contributes to Earnings Quality and Stability**

Luxury goods stocks relative share price performance seems more tightly aligned to the broader macroeconomic cycle. European luxury goods stocks have marginally underperformed the market in the past two recessions, while they have out-performed the index during expansionary times. This would suggest a continuing cautious approach, as the end of the recession is not yet in sight. In anticipatory fashion, this could also encourage proactive exposure to luxury goods names, as possible alternatives for investors rotating out of the general retail tail end.

LVMH has a more balanced category portfolio and larger scale — the only company in the top four to have two strong "legs" (in Wines & Spirits and in Fashion & Leather Goods) remains the default investment option in this space, despite continuing likely woes on the spirits side.

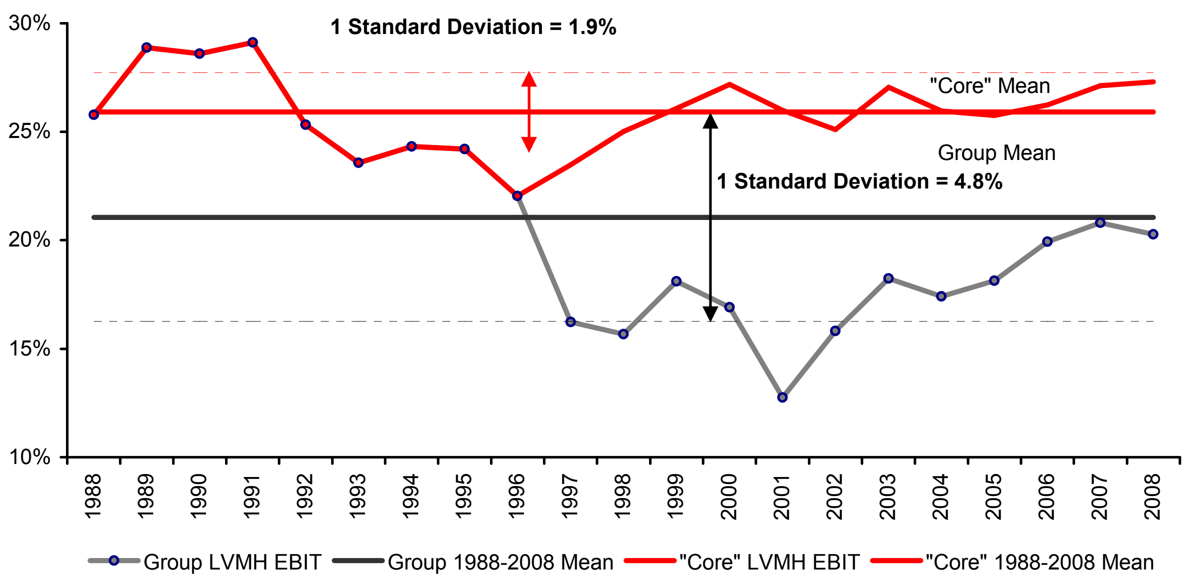
The strength of LVMH's "two-legged" portfolio versus Richemont's "one-legged" portfolio contributes to earnings quality and stability. Nearly 50% of LVMH revenues depends on two businesses — Wines & Spirits and Leather & Fashion Goods — that possess three truly dominant mega-brands (Don Pérignon in Champagne, Hennessy in Cognac, Louis Vuitton in leather goods) with average operating margins of 33%. Additionally, the margins for the two divisions seem to be complementary, moving in opposite directions, hence helping the group maintain more stable EBIT.

By way of comparison, the Jewelry Maisons for Richemont (also accounting for about 50% of sales) is the only division with a true dominant brand (Cartier) within Richemont's "one-legged" portfolio and we estimate its operating margin is about 28%, about 5% lower than the average of LVMH's two key divisions.

Not only did LVMH maintain a higher operating margin throughout the period from 1998-2008 (17.6% versus 15.8%, 180 basis points differential on average), but its margin also had a much lower standard deviation (2.3% versus 4.5%). Furthermore, we suspect margin visibility for LVMH was reduced due to changes in perimeter that took place in the late 1990s. As shown versus a 20-year Group time series in Exhibit 7, if we were to exclude "non-core" business divisions (those assimilated/launched in the late 1990s, including Watches & Jewelry), LVMH's long-term average EBIT would be even higher at 25.9%, that is about 8% above 2008 group margin and about 10% above Richemont's 2008 margin, and the standard deviation would be even lower at 1.9%.

We rate LVMH outperform, with a price target of €79.

**Exhibit 7** **LVMH — Last 20 Years EBIT (1988-2008)**




**Notes**: "Core" LVMH = Wines & Spirits + Leather & Fashion Goods + Perfumes & Cosmetics. Arrows represent 1 Standard Deviation of Group and "Core" EBIT: 4.8% for Group versus 1.9% for "Core" over 1988-2008 period.

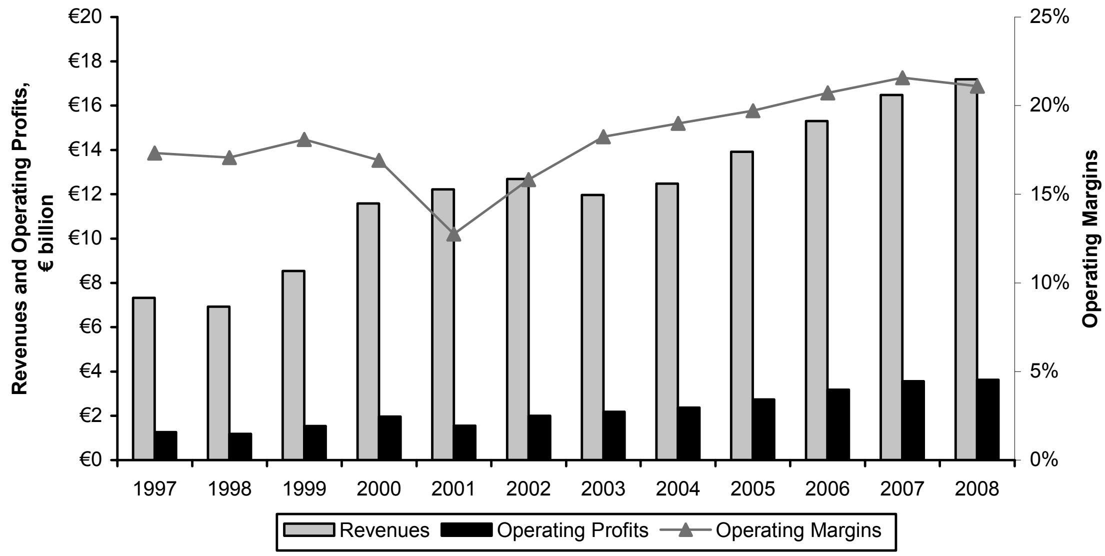
Source: Corporate reports and Bernstein analysis.

# LVMH Group — King of the Jungle

**Summary Overview**

With FY 2007 sales of more than €16 billion and operating profit of more than €3.5 billion, LVMH is the leading Luxury & Fashion company in the world. The group has consistently expanded operating margins since the trough 2001 (see Exhibit 8).

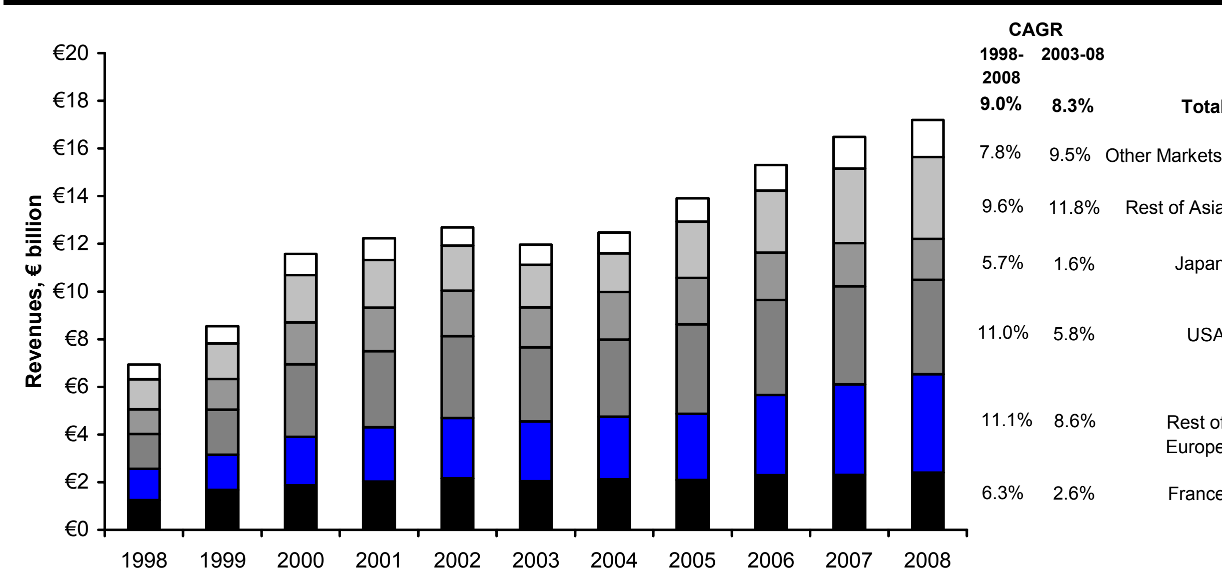
**Exhibit 8** **LVMH: Group Operating Results — 1997-2008**




Source: Corporate reports and Bernstein estimates and analysis.

Revenue growth in Europe (excluding France) and the United States has been the fastest at 12.5% and 12.2% per year on average between 1998 and 2007. However, Asia (excluding Japan) has been the main growth region for LVMH over the last five years at 14.9% per year on average (see Exhibit 9).

**Exhibit 9** **Revenues by Geography — Group, 1998-2008**




Source: Corporate reports and Bernstein estimates and analysis.

LVMH's performance is driven by its Wines & Spirits and by its Fashion & Leather Goods businesses: the two combined produced around 82% of FY 2008 group operating profit and about 53% of FY 2008 group revenues (see Exhibit 10). Other major activities include Perfumes & Cosmetics, Watches & Jewelry and Selective Retailing: the three combined produced approximately 22% of FY 2008 group operating profit and approximately 47% of FY 2008 group revenues. Other minor activities and eliminations account for the difference to 100%.

**Exhibit 10** **Divisional Revenues and Operating Profits — 1997 and 2008 (€ million)**

| | Revenues | | | | Operating Profits | | | |
|---|---|---|---|---|---|---|---|---|
| | 1997 | 2008 | 1997 Share | 2008 Share | 1997 | 2008 | 1997 Share | 2008 Share |
| Wines & Spirits | €1,896 | €3,126 | 26% | 18% | €457 | €1,060 | 36% | 29% |
| Fashion & Leather Goods | €1,837 | €6,010 | 25% | 35% | €656 | €1,927 | 52% | 53% |
| Perfumes & Cosmetics | €1,406 | €2,868 | 19% | 17% | €94 | €290 | 7% | 8% |
| Watches & Jewelry | €0 | €879 | 0% | 5% | €0 | €118 | 0% | 3% |
| Selective Retailing | €2,170 | €4,376 | 30% | 25% | €102 | €388 | 8% | 11% |
| Other and Eliminations | €14 | -€66 | 0% | 0% | -€40 | -€155 | -3% | -4% |
| **LVMH Group** | **€7,323** | **€17,193** | 100% | 100% | **€1,269** | **€3,628** | 100% | 100% |

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 11** **LVMH: Brands and Activities by Division**

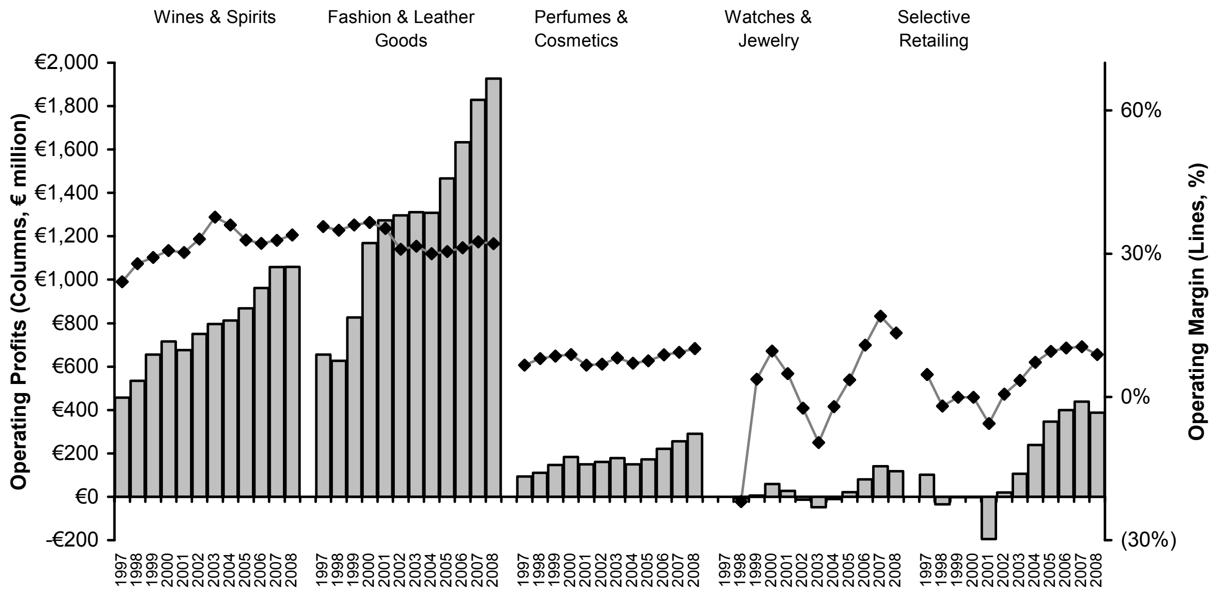
| Wines & Spirits | Fashion & Leather Goods | Perfumes & Cosmetics | Watches & Jewelry | Selective Retailing | Other |
|---|---|---|---|---|---|
| Moët & Chandon | Louis Vuitton | Parfums Christian Dior | TAG Heuer | DFS | D.I group |
| Dom Pérignon | Loewe | Guerlain | Zenith | Miami Cruiseline Services | Connaissances des Arts |
| Veuve Clicquot | Celine | Parfums Givenchy | Benedom - Dior Watches | Sephora | |
| Krug | Berluti | Kenzo Parfums | Fred Joaillier | sephora.com | |
| Mercier | Kenzo | La Brosse et Dupont | Chaumet | Le Bon Marché | |
| Ruinart | Givenchy | Benefit Cosmetics | De Beers LV | | |
| Château d'Yquem | Marc Jacobs | Make Up For Ever | Hublot | | |
| Hennessy | Fendi | Acqua di Parma | | | |
| Glenmorangie | StefanoBi | Perfumes Loewe | | | |
| Belvedere | Emilio Pucci | | | | |
| Chopin | Thomas Pink | | | | |
| Domaine Chandon California | Donna Karan | | | | |
| Bodegas Chandon | eLUXURY.com | | | | |
| Domaine Chandon Australia | | | | | |
| Cloudy Bay | | | | | |
| Cape Mentelle | | | | | |
| Newton | | | | | |
| Terrazas de los Andes | | | | | |
| Cheval des Andes | | | | | |
| 10 Cane | | | | | |
| Wen Jun | | | | | |

Source: Corporate reports.

Wines & Spirits and Fashion & Leather Goods not only account for the largest portion of group revenue but also consistently produce higher operating margins (see Exhibit 12).

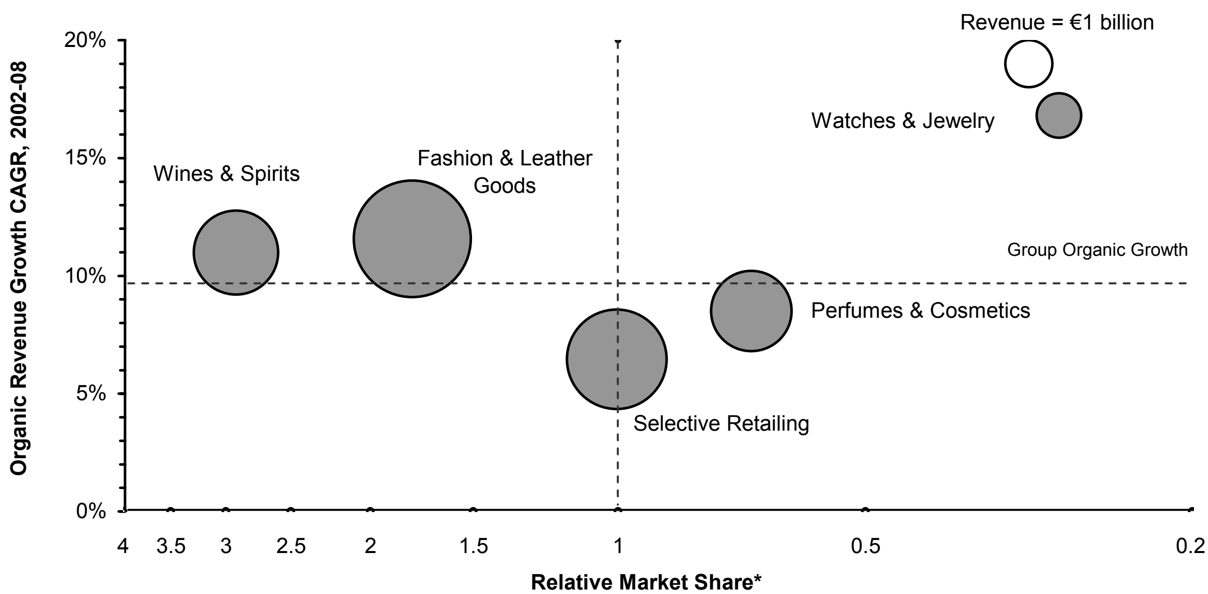
***LVMH has a balanced and attractive asset portfolio***. While still materially growing, Wines & Spirits and Fashion & Leather Goods are the segments where LVMH leads in relative market share and can act in time as an industry consolidator (see Exhibit 13). These are the current "stars" and future "cash cows" in the portfolio. Perfumes & Cosmetics, Selective Retailing and Watches & Jewelry are the segments where LVMH is taking a bet for the future: value-creation should come from faster-than-average organic growth — as well as focused M&A — leading in time to improving operating profit and cash performance. These are the "question marks" (and "dogs") in the group's portfolio.

**Exhibit 12** **Operating Profit and Margin by Division, 1997-2008**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 13** **BCG Matrix — LVMH by Division**

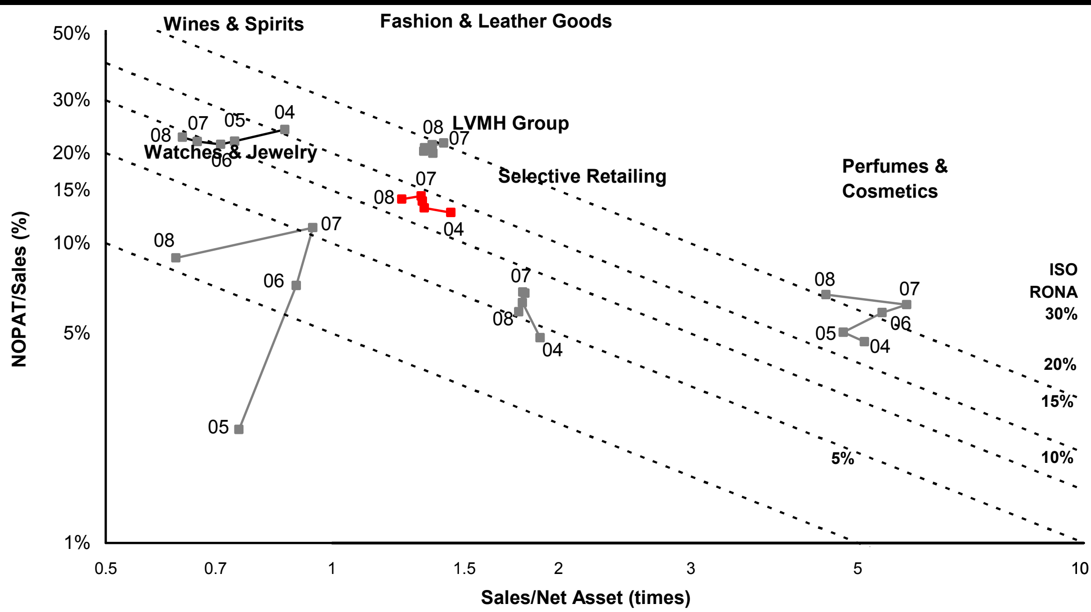



**Note:** Relative market share is calculated by dividing of sales from each division by the largest player in the respective industries, or second largest if the division is the industry leader.

Source: Corporate reports and Bernstein estimates and analysis.

For the purpose of calculating RONA, we have allocated group assets and liabilities into each division based on operating asset values. The results show that LVMH has consistently improved RONA over the last three periods. Although Perfumes & Cosmetics has a relatively low NOPAT margin it enjoys higher RONA to other divisions, at approximately 31% in 2008 (see Exhibit 14). The most profitable division in the group, Fashion & Leather Goods, traded at a RONA of approximately 29% in 2008 while that of other divisions hovered around 15%, leaving group RONA at about 17% in 2008.

**Exhibit 14** **Return on Net Assets by Division**




Source: Corporate reports and Bernstein estimates and analysis.

Perfumes & Cosmetics has been "best in class" with an average cash conversion rate of 127% over the last three years (see Exhibit 15). Fashion & Leather Goods generated the most cash in the group at a conversation rate of 51% in 2008 (c. 80% in prior periods), while that of Wines & Spirits has been very suppressed due to significant absorption in net working capital in the last four years.

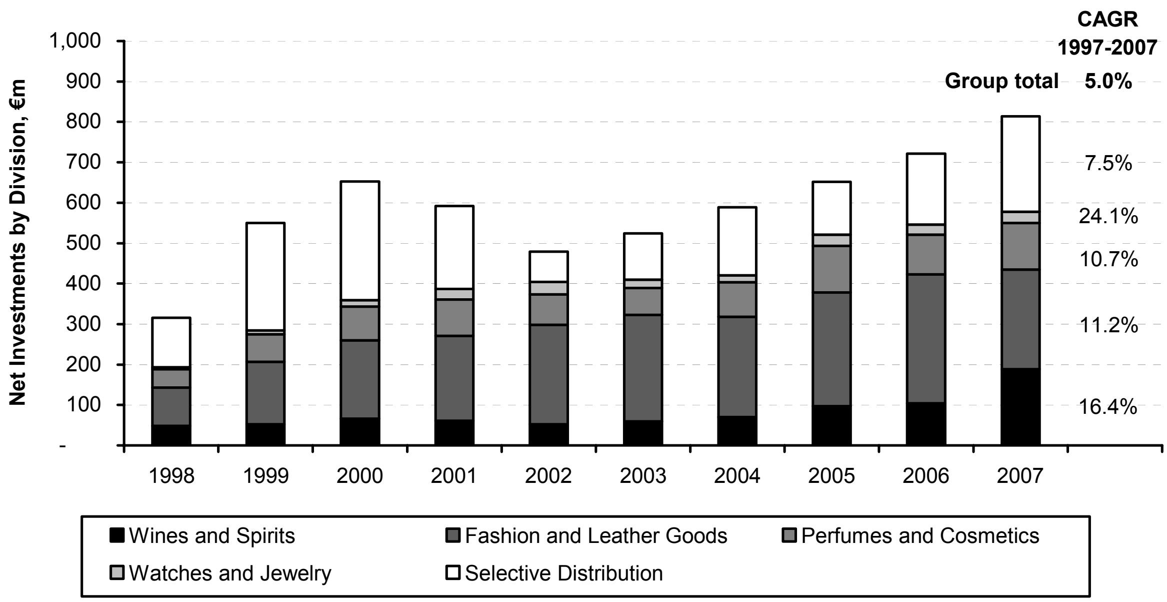
**Exhibit 15** **Net Operating Cash Flow by Division (2005-08) (€ million)**

| | 2005 | 2006 | 2007 | 2008 | Total | *% Share* |
|---|---|---|---|---|---|---|
| **Operating Profit** | | | | | | |
| Wines & Spirits | €869 | €962 | €1,058 | €1,060 | €3,949 | *43.8%* |
| Fashion & Leather Goods | €1,467 | €1,633 | €1,829 | €1,927 | €6,856 | *76.0%* |
| Perfumes & Cosmetics | €173 | €222 | €256 | €290 | €941 | *10.4%* |
| Watches & Jewelry | €21 | €80 | €141 | €118 | €360 | *4.0%* |
| Selective Distribution | €347 | €400 | €439 | €388 | €1,574 | *17.5%* |
| Other | -€134 | -€125 | -€168 | -€155 | -€582 | *-6.5%* |
| **LVMH** | **€2,743** | **€3,172** | **€3,555** | **€3,628** | **€13,098** | ***145.2%*** |
| | | | | | | |
| **Changes in NWC (+ve = -ve cash)** | | | | | | |
| Wines & Spirits | €421 | €479 | €476 | €516 | | |
| Fashion & Leather Goods | €79 | €47 | -€36 | €272 | | |
| Perfumes & Cosmetics | -€16 | -€74 | -€17 | €76 | | |
| Watches & Jewelry | €23 | €14 | €71 | €150 | | |
| Selective Distribution | -€2 | €90 | €195 | -€263 | | |
| | | | | | | |
| **Operating Cash** | | | | | **Total** | ***% Share*** |
| Wines & Spirits | €262 | €266 | €354 | €322 | €1,203 | *13.3%* |
| Fashion & Leather Goods | €1,146 | €1,305 | €1,550 | €980 | €4,981 | *55.2%* |
| Perfumes & Cosmetics | €224 | €310 | €292 | €124 | €950 | *10.5%* |
| Watches & Jewelry | €11 | €58 | €49 | -€111 | €8 | *0.1%* |
| Selective Distribution | €232 | €296 | €229 | €554 | €1,311 | *14.5%* |
| Other | €119 | €53 | -€16 | €410 | €565 | *6.3%* |
| **LVMH** | **€1,994** | **€2,288** | **€2,458** | **€2,278** | **€9,018** | ***100.0%*** |
| | | | | | | |
| **Cash Converstion Rate, %** | | | | | | |
| Wines & Spirits | 30% | 28% | 33% | 30% | 30% | |
| Fashion & Leather Goods | 78% | 80% | 85% | 51% | 73% | |
| Perfumes & Cosmetics | 130% | 140% | 114% | 43% | 101% | |
| Watches & Jewelry | nm | 73% | 35% | -94% | 2% | |
| Selective Distribution | 67% | 74% | 52% | 143% | 83% | |
| Other | nm | nm | nm | nm | nm | |
| **LVMH** | **73%** | **72%** | **69%** | **63%** | **69%** | |

Source: Corporate reports and Bernstein estimates and analysis.

Fashion & Leather Goods and Selective Retailing share the largest portion of the group's investment wallet (see Exhibit 16).

**Exhibit 16** **Net Investment by Division (1998-2007)**




Source: Corporate reports and Bernstein estimates and analysis.

Subtracting annual cash investments by division, Fashion & Leather Goods appears to be the only significant net cash generator, generating approximately 55% of the group's net cash in 2008 and close to 90% in 2007 (see Exhibit 17).

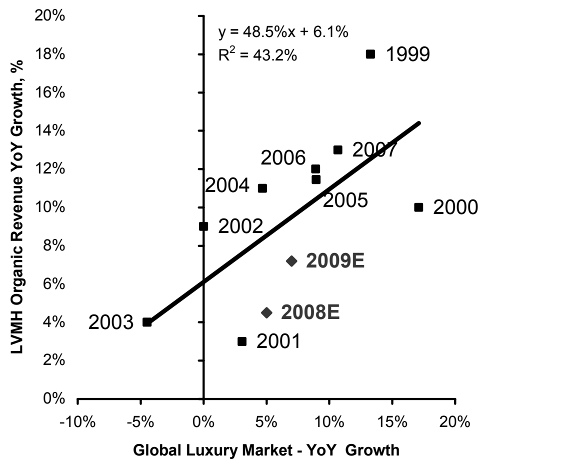
**Exhibit 17** **Net Cash Performance by Division (2005-08)**

| | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|
| **Operating Cash** | | | | |
| Wines & Spirits | €262 | €266 | €354 | €322 |
| Fashion & Leather Goods | €1,146 | €1,305 | €1,550 | €980 |
| Perfumes & Cosmetics | €224 | €310 | €292 | €124 |
| Watches & Jewelry | €11 | €58 | €49 | -€111 |
| Selective Distribution | €232 | €296 | €229 | €554 |
| Other | €119 | €53 | -€16 | €410 |
| **LVMH** | **€1,994** | **€2,288** | **€2,458** | **€2,278** |
| | | | | |
| **Operating Investments (Cash)** | | | | |
| Wines & Spirits | €100 | €107 | €199 | €157 |
| Fashion & Leather Goods | €302 | €308 | €241 | €338 |
| Perfumes & Cosmetics | €115 | €99 | €116 | €146 |
| Watches & Jewelry | €26 | €25 | €28 | €39 |
| Selective Distribution | €135 | €186 | €243 | €228 |
| Other | €36 | €50 | €173 | €160 |
| **LVMH** | **€714** | **€775** | **€1,000** | **€1,068** |
| | | | | |
| **Net Cash** | | | | |
| Wines & Spirits | €162 | €159 | €155 | €165 |
| Fashion & Leather Goods | €844 | €997 | €1,309 | €642 |
| Perfumes & Cosmetics | €109 | €211 | €176 | -€22 |
| Watches & Jewelry | -€15 | €33 | €21 | -€150 |
| Selective Distribution | €97 | €110 | -€14 | €326 |
| Other | €83 | €3 | -€189 | €250 |
| **LVMH** | **€1,280** | **€1,513** | **€1,458** | **€1,210** |

Source: Corporate reports and Bernstein estimates and analysis.

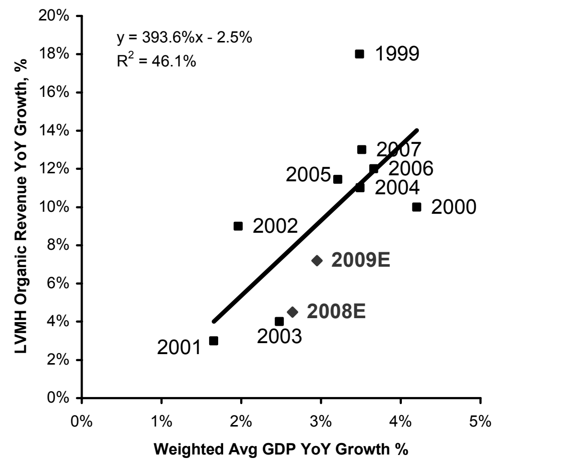
The group's top-line organic growth seems to be driven by GDP growths weighted by geography and it has outgrown the global luxury market consistently in the last nine years, suggesting above-average resilience during economic downturns (see Exhibit 18 and Exhibit 19). We forecast revenue growth at below the regression line for the next two periods as we expect the luxury market will experience weak growth.

**Exhibit 18 LVMH: Organic Revenue Growth vs. Global Luxury Market Growth (1999-2007)**




Source: Altagamma, corporate reports and Bernstein estimates and analysis.

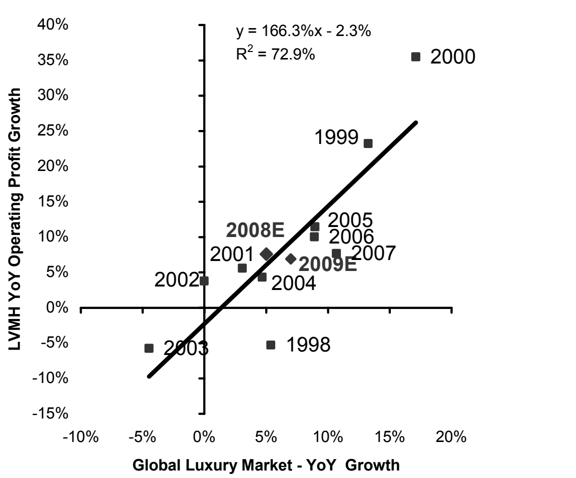
**Exhibit 19 LVMH: Organic Revenue Growth vs. Weighted Average GDP Growth (1999-2007)**




Source: *Global Insight,* corporate reports and Bernstein estimates and analysis.

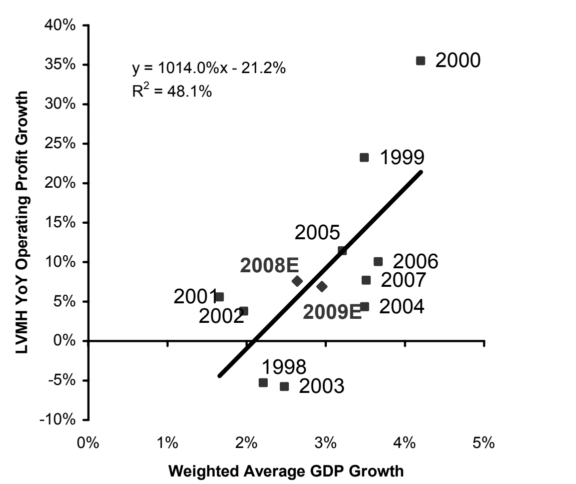
Similarly, operating profit growth seems to track global luxury market growth and weighted average GDP growth, indicating that LVMH operating profit line is also somewhat cyclical (see Exhibit 20 and Exhibit 21). The regression trends back up our operating profit forecasts for 2008E and 2009E.

**Exhibit 20 LVMH: Operating Profit Growth vs. Global Luxury Market Growth (1998-2007)**




Source: Altigama, corporate reports and Bernstein estimates and analysis.

**Exhibit 21 LVMH: Operating Profit Growth vs. Weighted Average GDP Growth (1998-2007)**



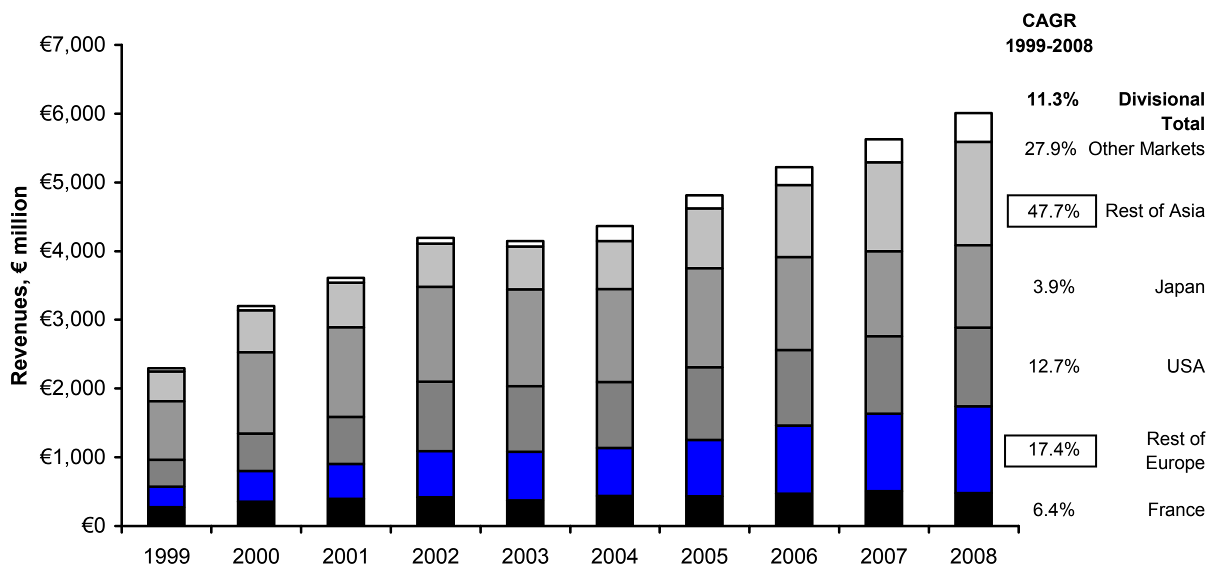

Source: *Global Insight*, corporate reports and Bernstein estimates and analysis.

**Fashion & Leather Goods**

We have few doubts about the opportunity of investing in LVMH for the medium-to-long term. In fact, we expect that "winners will continue to win" in Fashion & Leather Goods: (1) mega-brands like Louis Vuitton secure aspirational and emerging markets demand, leading to faster growth and superior margins; (2) scale provides cost advantage in SG&A (e.g., advertising expenditure, store rental costs), a key advantage for LVMH as the largest player in the industry; (3) mega-brands and scale also allow first-mover advantage in emerging markets, where LVMH can push its other brands ahead of competition. In this context, LVMH clearly emerges as a long-term winner and a potential consolidator of the luxury industry. This will translate, we expect, in continuing above average top-line growth of some 8-9% long term.

The Fashion & Leather Goods division holds an extensive range of luxury brands, including five of the top 18 most coveted brands worldwide, such as: Louis Vuitton, Fendi, Givenchy, Donna Karan and Celine (see Exhibit 32). Revenues have been growing at 11.3% over the 1999-2008 period, with Europe (excluding France) and Asia (excluding Japan) becoming increasingly important to the division during the last two to three years (see Exhibit 22).

**Exhibit 22** **Revenues by Geography — Fashion & Leather Goods (1998-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

Despite slow growth rates, Japan still remains the biggest single market for Fashion & Leather Goods, accounting for 20% of revenues in 2008 while the rest of Asia combined accounted for 25% (see Exhibit 23). The division also has significant revenue exposure to the United States (c. 19%) and tops the table with PPR's luxury group (c. 19%), as shown in Exhibit 23 and Exhibit 24.

**Exhibit 23 Fashion & Leather Goods: Revenues by Geography in 2008**

| LVMH | Geographic Mix | As Pct. of Group Revenue from the Region |
|---|---|---|
| France | 8% | 20% |
| Rest of Europe | 21% | 31% |
| United States | 19% | 29% |
| Japan | 20% | 70% |
| Rest of Asia | 25% | 44% |
| Others | 7% | 27% |
| **Total** | **100%** | |

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 24 European Luxury Players: Revenues by Geography**

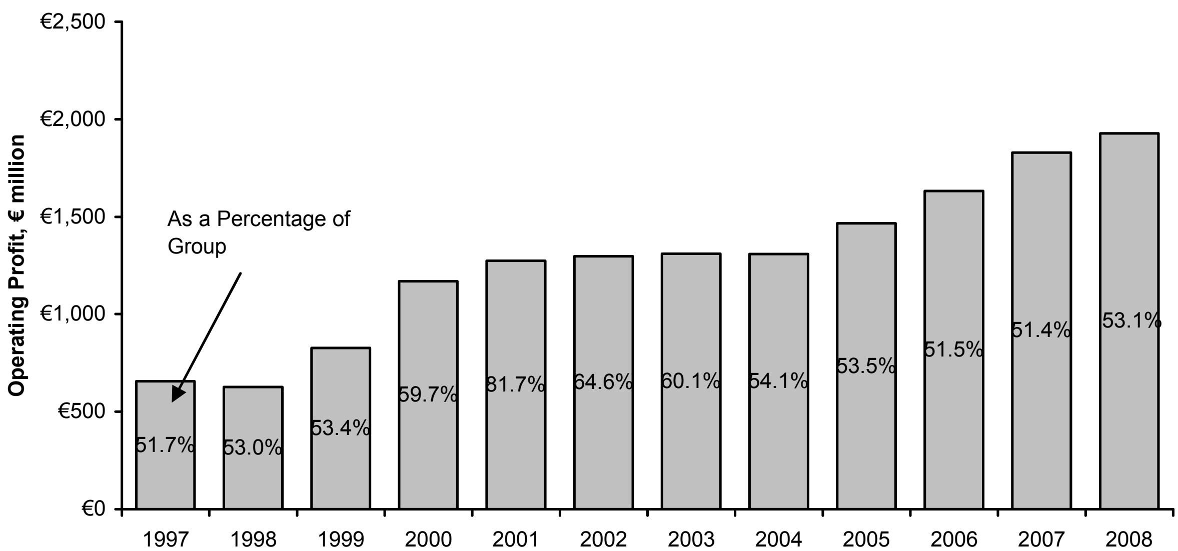
| 2008/09 | PPR (Luxury) | Richemont* | Swatch |
|---|---|---|---|
| Europe | 40% | 44% | 47% |
| United States | 19% | 16% | 10% |
| Japan | 16% | 13% | 10% |
| Rest of Asia | 23% | 27% | 31% |
| Others | 2% | 0% | 2% |
| **Total** | **100%** | **100%** | **100%** |

**Note:** Used "Americas" region as proxy for U.S. Sales

Source: Corporate reports and Bernstein estimates and analysis.

The division experienced a period of flat operating profit growth between 2001 and 2004 due to adverse currency impacts and the acquisitions of Fendi and Donna Karan in 2001 (see Exhibit 25). However, operating profit growth has accelerated since 2004 and the division has earned more than €1.9 billion in 2008, which accounted for approximately 51% of group total.

**Exhibit 25 Operating Profit as a Percentage of Group — Fashion & Leather Goods (1997-2008)**

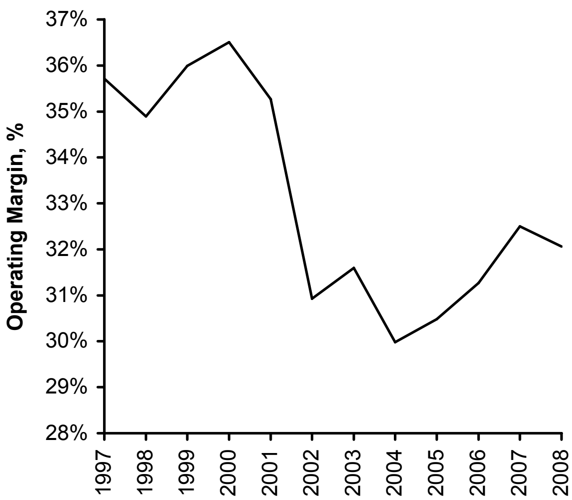



Source: Corporate reports and Bernstein estimates and analysis.

Adverse currency impacts and the acquisitions of controlling stakes in Fendi and Donna Karan in 2001, coupled with the events of September 11 led to a decline in operating margin by more than 400 bp in 2002. The SARS epidemic in 2003 further reduced operating margin. However, successful post-acquisition restructuring, continued brand developments and a positive economic conjuncture contributed to margin expansion post-2004 (see Exhibit 26).

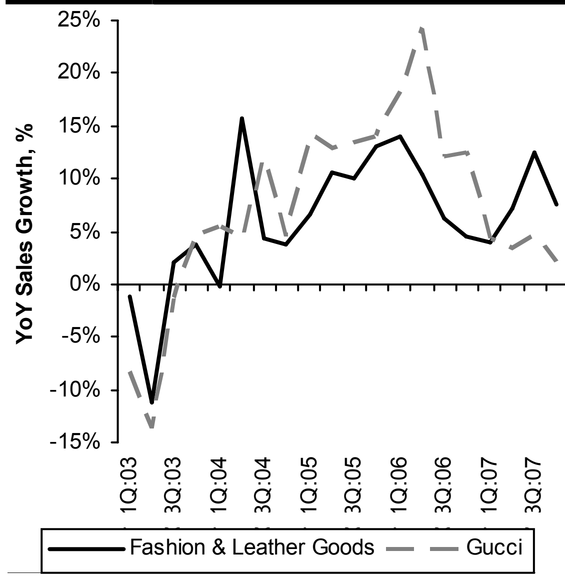
Revenue growth of the division has overtaken Gucci in 2007 due to strong growth in emerging markets (see Exhibit 27).

**Exhibit 26 Operating Margin History: Fashion & Leather Goods**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 27 YoY Sales Growth: Fashion & Leather Goods vs. Gucci**

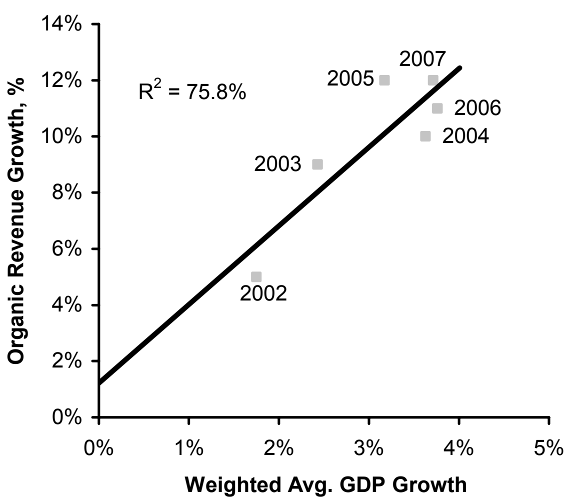



Source: Corporate reports and Bernstein estimates and analysis.

The company started reporting divisional organic revenue growth in 2002. Organic revenue growth in Fashion & Leather Goods correlates strongly to real GDP growth weighted by geographic revenue mix. This indicates the cyclical nature of demand for the group's fashion and leather products. We believe that the increasing weight of the aspirational luxury segment has caused Fashion & Leather Goods to be more susceptible to macroeconomic trends (see Exhibit 28).

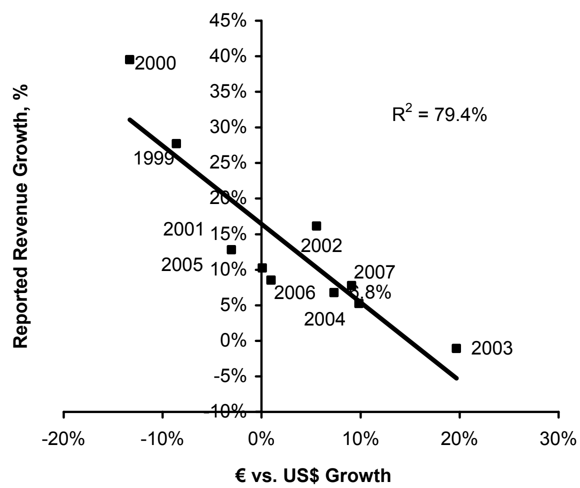
Fluctuations in the euro-dollar rate play a significant role in reported revenue growth (see Exhibit 29). European luxury players derive a significant portion of revenue from the United States, historically the biggest market for luxury goods — specifically, Fashion & Leather Goods has c. 20% of revenue exposure to the United States. Continued weaknesses in the euro versus the dollar would weaken revenue growth on a reported basis.

**Exhibit 28 Organic Revenues Growth vs. GDP**




Source: *Global Insights,* corporate reports and Bernstein estimates and analysis.

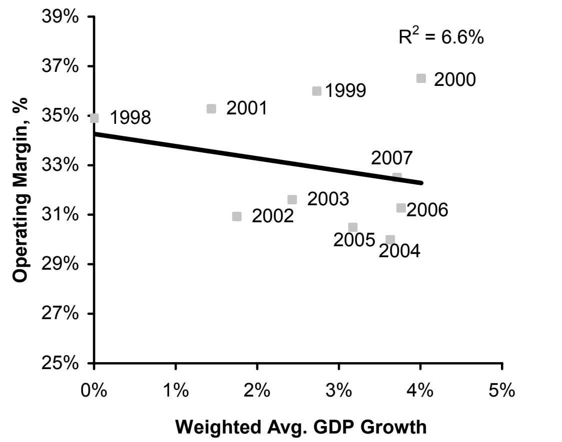
**Exhibit 29 Reported Revenue Growth vs. €/US$ Movements**




Source: Oanda, corporate reports and Bernstein estimates and analysis.

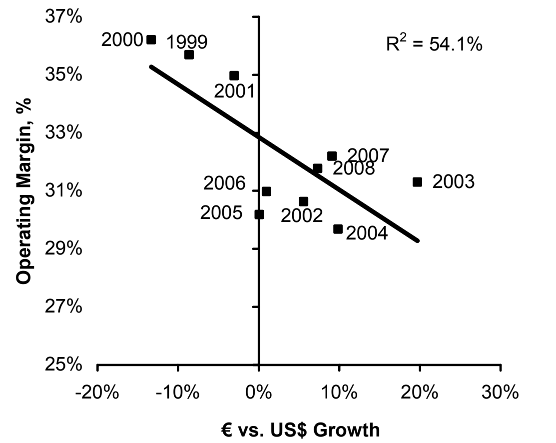
While we could identify no meaningful correlation to GDP growth, operating margin does correlate to euro-dollar fluctuations. The lower degree of sensitivity of operating line to FX movements is a function to the division cost base (see Exhibit 30 and Exhibit 31).

**Exhibit 30 Operating Margin vs. GDP**




Source: *Global Insight*, corporate reports and Bernstein estimates and analysis.

**Exhibit 31 Operating Margin vs. €/US$ Movements**



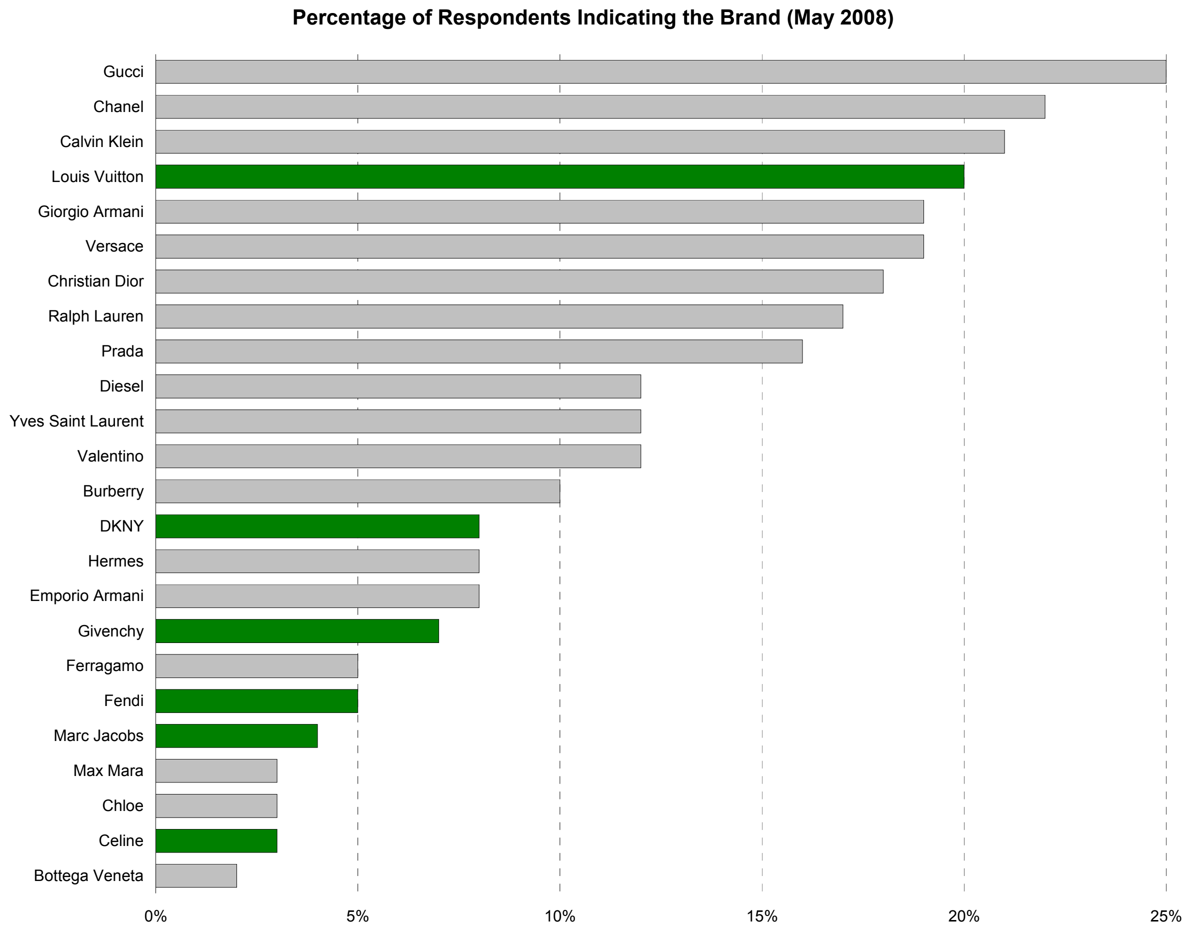

Source: Oanda, corporate reports and Bernstein estimates and analysis.

**The "Virtuous Cycle" of Luxury and Fashion Mega-Brands**

Leadership in Fashion & Leather Goods comes from the Louis Vuitton "mega" brand status, scale and first-mover advantage, as well as best-in-class operations. Louis Vuitton — with estimated FY 2007 sales of around €4.2 billion and FY 2008 operating profit of approximately €1.6 billion — is one of the most recognized Luxury & Fashion brands in the world (No. 4 in 2007 and No. 6 in 2006 according to AC Nielsen) and a phenomenal cash generator (see Exhibit 32).

As emerging markets and aspirational consumers are the key drivers of the luxury market growth, Louis Vuitton is in a unique position to capitalize on this opportunity and continue to grow. First-mover push into key emerging markets should allow LVMH to accelerate the development of its other brands as well — Fendi, first and foremost.

**Exhibit 32** **The Most Coveted Luxury and Fashion Brands in the World (2008)**

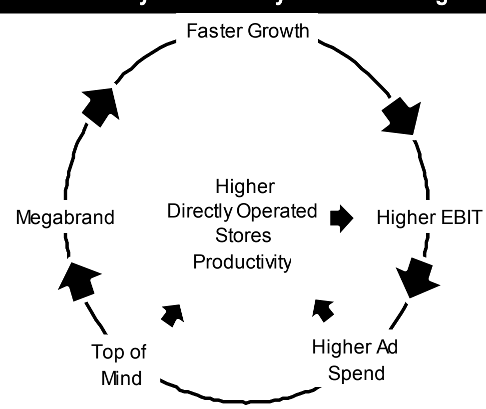



**Note:** LVMH brands highlighted in black.

Source: AC Nielsen.

Louis Vuitton benefits from the effect of a "virtuous cycle": top-of-mind status generates faster sales growth and better economics, better economics provide stronger advertising muscle and the ability to dwarf competition with overwhelming media budgets. This in turn reinforces the top-of-mind nature of “mega” brands (see Exhibit 33).

**Exhibit 33** **The Virtuous Cycle of Luxury & Fashion Mega-Brands**



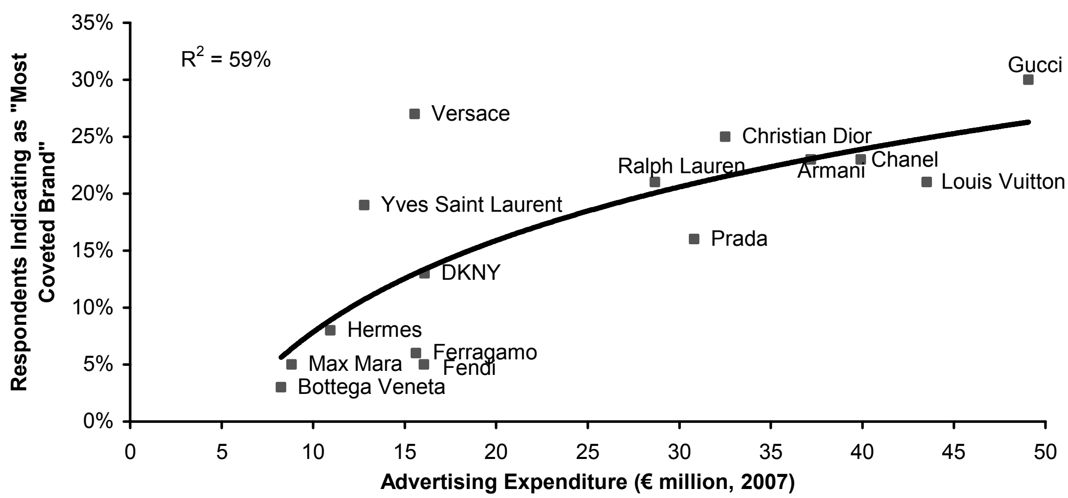

Source: Bernstein analysis.

We have collected advertising expenditure data by brand for major countries, namely Italy, France, the United Kingdom, Spain, Germany, Russia and the United States. These advertising expenditure figures represent post-discount amounts — assuming 70% discounts in Italy and 20% on international markets over advertising list prices. Data include all print advertising expenditure for apparel, leather accessories, eyewear, jewelry and watches. It does not include fragrances and cosmetics, as well as all other non-print media. We show the effects of top-of-mind status versus advertising spend in Exhibit 34.

As we expected, we have found that top-of-mind status correlates with advertising expenditure. Brands like Louis Vuitton and Gucci lead the luxury and fashion advertising league with €44 million and €49 million, respectively, in 2007. Fendi, which has been part of LVMH since 2001, is yet to achieve high top-of-mind status despite growth in advertising.

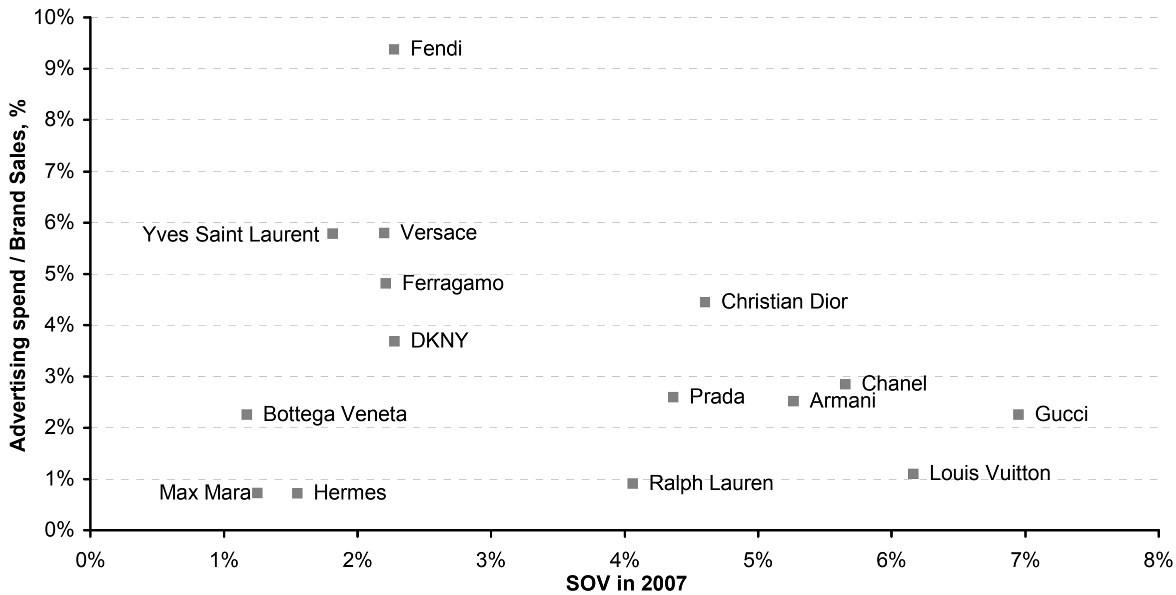
Scale pays, as mega-brands can lead the advertising expenditure league while committing a smaller portion of their sales. Louis Vuitton spent only an estimated 1.1% of brand sales on advertising while achieving over 6% of share of voice (SOV) in 2007 (see Exhibit 35). Similarly, Gucci spent 2.3% of sales for 7% of SOV. Both mega brands stand in stark contrast to smaller brands — like Yves Saint Laurent, for example, which needs to commit 5.8% of sales to advertising, while achieving only 26% of Gucci's SOV. This illustrates how difficult it is to challenge mega-brands, and how scale provides a "natural defense" for dominant luxury and fashion brands.

**Exhibit 34 Top-of-Mind Status vs. Advertising Expenditure (2006)**




Source: AC Nielsen, Creative Club, industry interviews and Bernstein estimates and analysis.

**Exhibit 35 Advertising Spend as a Percentage of Sales vs. Share of Voice (2007)**

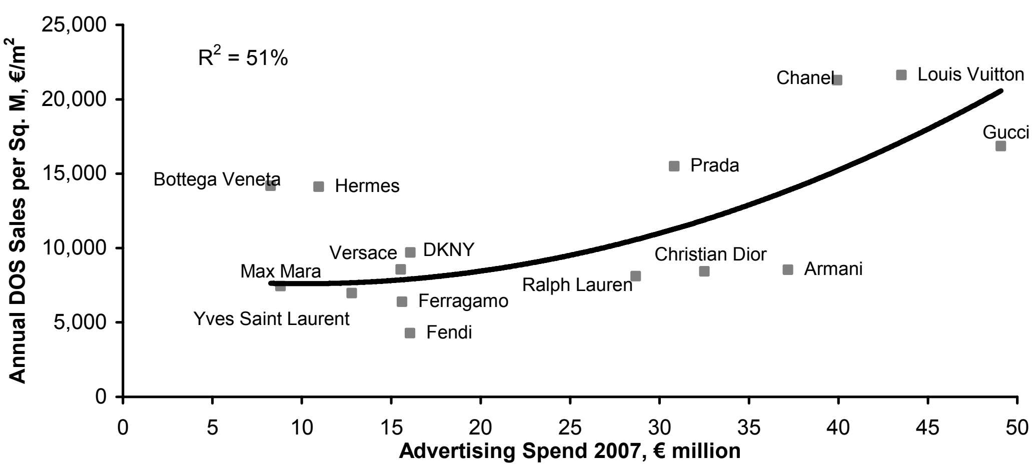



Source: AC Nielsen, Creative Club, industry interviews and Bernstein estimates and analysis.

Scale allows superior downstream integration into retail. Our data confirm that there exists a direct relationship between sales per square meter and advertising expenditure. Exhibit 36 shows that higher advertising spend correlates to higher sales per square meter in DOS, with Louis Vuitton, Chanel and Gucci being the clear leaders in productivity. High productivity is of paramount importance: only when a threshold level of productivity is reached can a DOS generate profit. This is the result of high fixed costs associated with DOS operations (see Exhibit 37).

This means that Louis Vuitton can enjoy materially higher profitability not simply from scale alone, but also by running its brands as integrated manufacturing-to-retailing businesses. This, in turn, allows for better control of brand execution, as well as superior economics. DOS — which represent "advertising investments" (i.e., losses) for most luxury and fashion brands — are in fact cash-generating machines for mega-brands.

**Exhibit 36 DOS Productivity Correlates to Advertising Spend**




Source: AC Nielsen, Creative Club, industry interviews and Bernstein estimates and analysis.

**Exhibit 37 DOS Productivity — Mega-Brand vs. Other Brands**

| | | Mega Brand | Other Brand | Notes/Assumptions |
|---|---|---|---|---|
| Store | $m^2$ | 400 | 400 | Same space and location |
| Productivity | €/$m^2$ | 20,000 | 5,000 | |
| Sales | € Million | €8.0 | €2.0 | |
| Store Costs (simplified) | | | | |
| Rent | € Million | €2.5 | €2.5 | Same space and location |
| Staff | € Million | €1.0 | €0.7 | Store staff slope c.60% |
| Other Cost | € Million | €0.5 | €0.5 | Utilities, Display, Local Tax, Other |
| **Margin Contribution to COGS** | € Million | **€4.0** | **-€1.7** | |
| Product Costs (1) | | | | |
| Achieved Retail/Wholesale Price Multiplier | X | 3.0 | 2.5 | |
| Achieved Wholesale Price/COGS Multiplier | X | 3.0 | 3.0 | |
| COGS | € Million | €0.9 | €0.3 | |
| **Margin Contribution to Central Costs: Manufacturing & Commercial** (2) | € Million | **€3.1** | **-€2.0** | |
| | % of Sales | 39% | -98% | (3) |

Note
(1) Does not include profit/loss from leftover inventory.
(2) Does not include central costs (HQ, R&D, Manufacturing, Commercial) and central revenues (Royalty).
(3) It is obviously possible for losses to be > 100% of sales.

Source: Bernstein estimates and analysis.

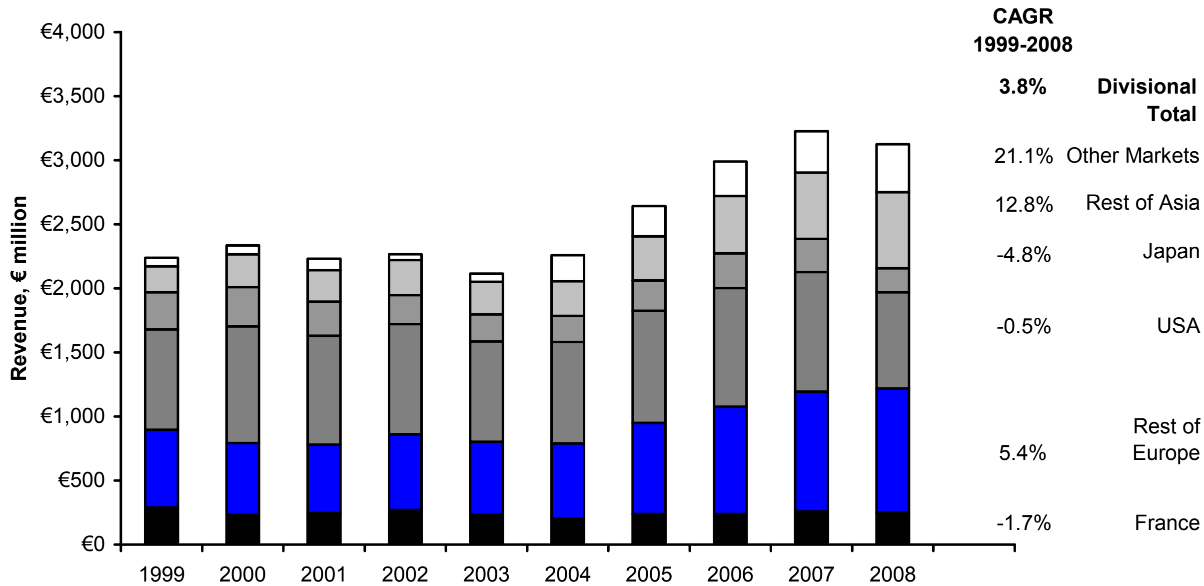
## Wines & Spirits

We expect Wines & Spirits to provide operating profit upside, as the champagne sector faces capacity constraints. Short-term de-stocking trends that materialize due to reduced consumer demand will no doubt pressure margins — as seen in 1H:09 — however, the fundamental quality of the business will continue to remain the same. We see higher-than-average upstream integration at LVMH as a positive in the current capacity situation, causing lower COGS inflation. We expect highly positioned LVMH brands to continue to have pricing power. Strong international distribution is another positive, enhancing margin. Wines & Spirits has generated lower free cash flow versus Fashion & Leather Goods because of high working capital requirements. This will likely continue, as LVMH is replenishing its high-quality cognac stocks and preparing to face high demand of XO and VSOP in the future. Strong pricing power should continue to provide top-line growth of approximately 6% despite market maturity and capacity constraints

The Wines & Spirit division holds some of the most famous brands in champagne and cognac which go as far as 250 years back in history. The group's backbone was formed following the merger of Moët et Chandon, the champagne maker, and Jas Hennessy & Company, the cognac maker, in 1971. The combined group was named Moët-Hennessy. The group continued to make acquisitions and expand operations, notably in the United States. In 1987, the merger of Louis Vuitton and Moët-Hennessy formed the current group, LVMH. The division now trades through 20 brands including Moët & Chandon, Dom Pérignon, Veuve Clicquot, Krug, Mercier, Ruinart, Hennessy and Glenmorangie. Diageo currently has a significant interest in the Wines & Spirits division through its 30% stake in Moët-Hennessy.

Wines & Spirits' revenues from mature markets, namely Japan and France, have declined on average by approximately 2% per year between 1999 and 2008. These declines have been offset by growth in rest of Asia, Europe (excluding France) and other markets, resulting in a CAGR of 3.8% for the division (see Exhibit 38).

**Exhibit 38** **Revenues by Geography: Wines & Spirits (1999-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

The United States and Europe combined amount to 63% of Wines & Spirits' divisional revenues. Slower GDP growth in the United States and/or Europe would have negative impacts on sales (see Exhibit 39).

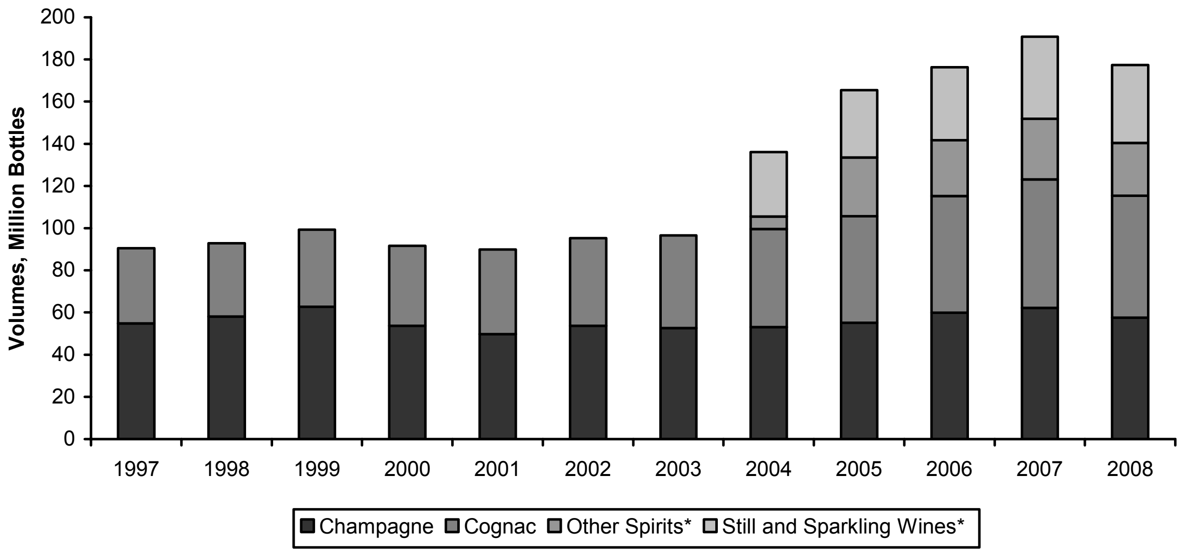
**Exhibit 39** **Wines & Spirits: Revenues by Geography in 2008**

| | Geographic Mix | As Pct. of Group Revenue from the Region |
|---|---|---|
| France | 8% | 10% |
| Rest of Europe | 31% | 23% |
| United States | 24% | 19% |
| Japan | 6% | 11% |
| Rest of Asia | 19% | 17% |
| Others | 12% | 24% |
| **Total** | **100%** | |

Source: Corporate reports and Bernstein estimates and analysis.

Cognac volumes have grown significantly from 35.6 million bottles in 1997 to 57.7 million bottles in 2007, while Champagne volumes have been relatively flat at around 60 million bottles throughout the 1997-2008 historical periods (see Exhibit 40).

**Exhibit 40** **Wines & Spirits: Sales Volumes, 1997-2008**

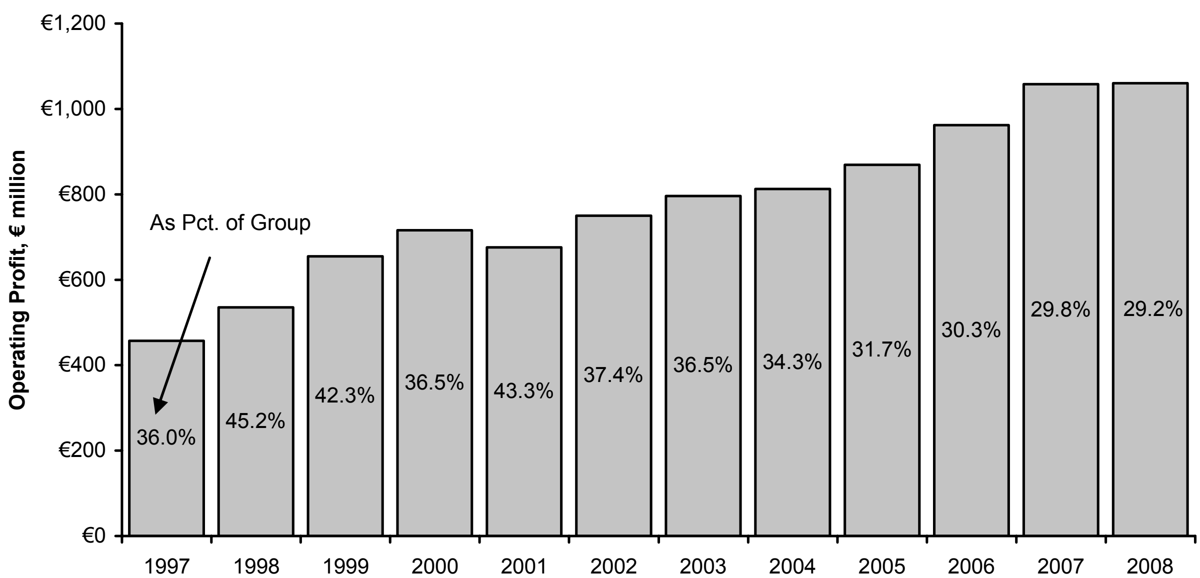



**Note:** Other Spirits and Still and Sparkling Wines not reported previously.

Source: Corporate reports and Bernstein estimates and analysis.

Wines & Spirits account for significant portion of group operating profit which exceeded the €1 billion mark (roughly 29% of group total) for the first time in 2007 (see Exhibit 41).

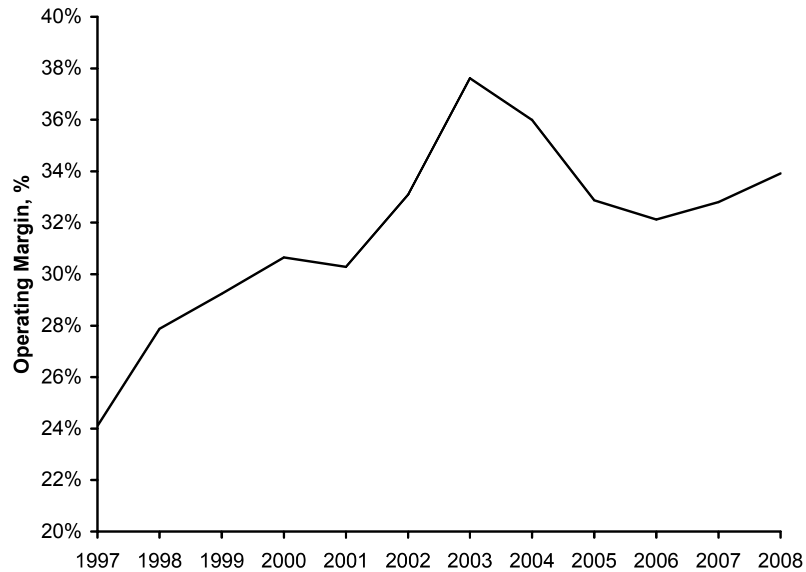
**Exhibit 41** **Operating Profits as a Percentage of Group: Wines & Spirits (1997-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

The euro had significantly strengthened against the dollar by about 20% in 2003 and a further 10% in 2004 on an average annual rate basis. The movements had led to decreases in Wines & Spirits' revenues on a reported basis. However, due to gains from currency hedging, operating margin reached the peaks of 37.6% and 36.0%, respectively, in 2003 and 2004 (see Exhibit 42).

**Exhibit 42** **Operating Margin History: Wines & Spirits**




Source: Corporate reports and Bernstein estimates and analysis.

LVMH introduced Champagnes & Wines and Cognac & Spirits as sub-divisions of Wines & Spirits in 2007 with prior-year comparables. Champagnes & Wines enjoys higher operating margins (36.1% in 2007) than Cognac & Spirits (28.7% in 2007), as shown in Exhibit 43.

**Exhibit 43** **Operating Results by Sub-Division (2006-07) (€ million)**

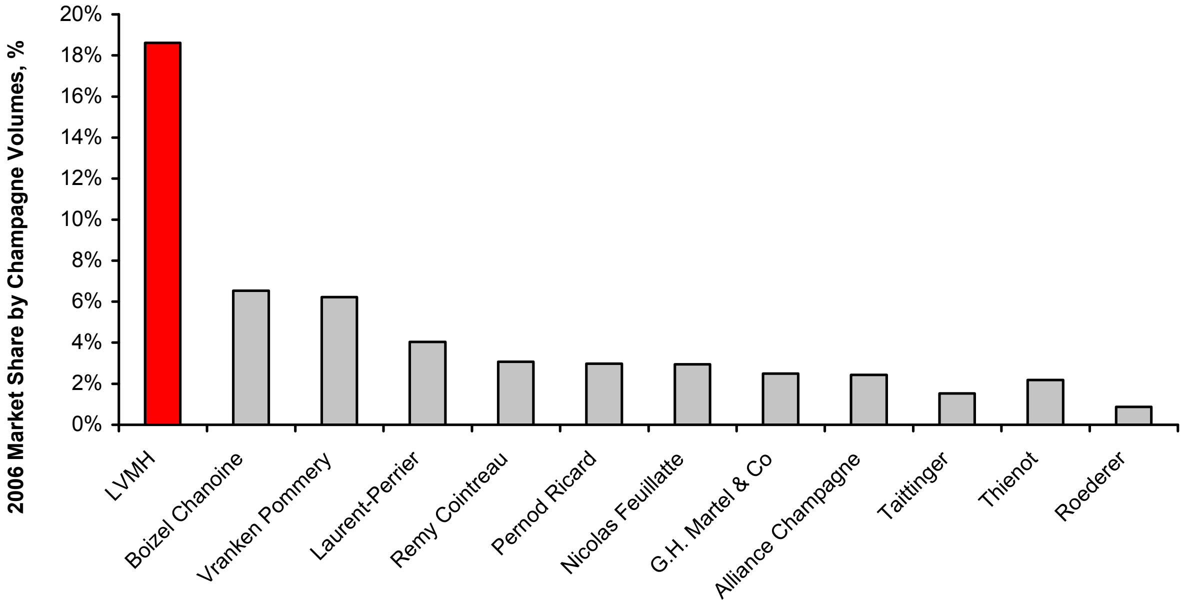
| | | | |
|---|---|---|---|
| **Revenues** | Champagnes & Wines | £1,684 | £1,802 |
| | Cognac & Spirits | £1,306 | £1,424 |
| | **Total Division** | **£2,991** | **£3,226** |
| | Champagnes & Wines Growth | | *7%* |
| | Cognac & Spirits Growth | | *9%* |
| **Operating Profits** | Champagnes & Wines | €596 | €650 |
| | Cognac & Spirits Operating Profit | €364 | €408 |
| | **Total Division** | **€961** | **€1,058** |
| | Champagnes & Wines Growth | | *9%* |
| | Cognac & Spirits growth | | *12%* |
| **Operating Margin** | Champagnes & Wines | 35.4% | 36.1% |
| | Cognac & Spirits | 27.9% | 28.7% |
| | **Total Division** | **32.1%** | **32.8%** |

Source: Corporate reports and Bernstein estimates and analysis.

**Champagnes & Wines**

Leadership in Wines & Spirits comes from brand exclusivity, as well as from upstream integration into direct vineyards ownership and strong international distribution. LVMH is a clear leader in champagne, commanding more than 18% of the market in volumes terms. This is three times larger than the runner-up, Boizel (see Exhibit 44).

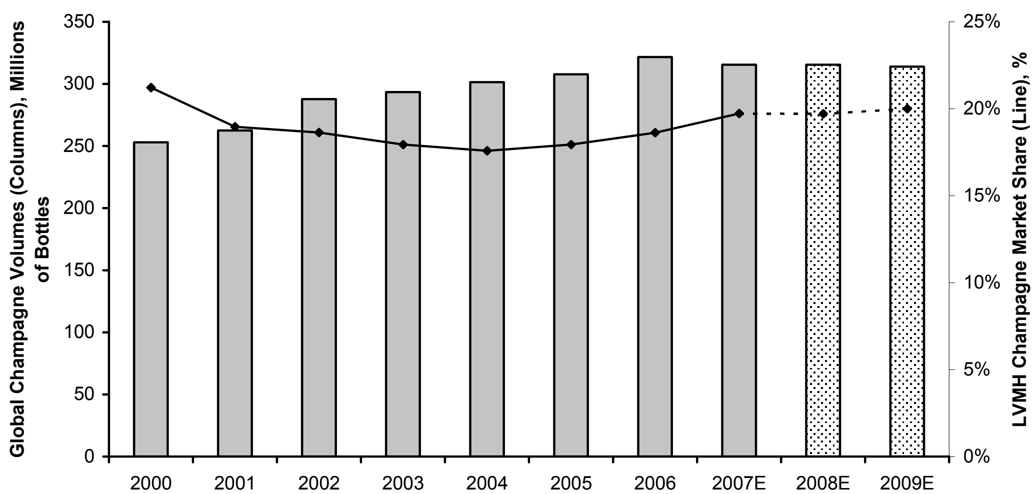
**Exhibit 44** **Global Champagne Market Share by Major Players**




Source: *Just-Drinks*, corporate reports and Bernstein estimates and analysis.

The champagne market is set to experience a period of subdued growth in volume terms. This is chiefly due to supply shortage as designated champagne grape growing land is fully planted and yields have been pushed to maximum levels. An extension of designated growing area is in its proposal phase, but it is unlikely to solve supply shortages in the next eight to 10 years — given that it will take two to three years for the proposal to materialize, two to three years to plant grapes, and another two to three years for the ageing process before the "new" champagne supplies come on the market. Industry forecasts a flat market in the next two years and we expect LVMH to hold market share at approximately 20% in the short term (see Exhibit 45).

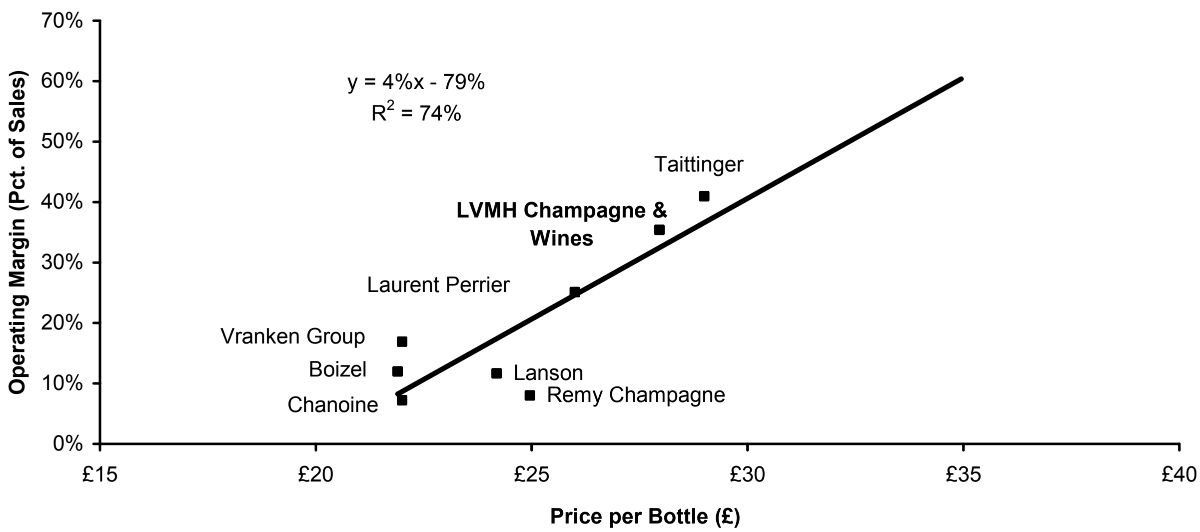
**Exhibit 45** **Evolution of Champagne Volumes and LVMH Market Share (2000-09E)**




Source: CIVC, corporate reports and Bernstein estimates and analysis.

LVMH champagne brands command the highest prices in the market. We have collected retail prices for non-vintage and generally available champagnes from *Wine Searcher* for the selected brands. We found strong correlation between operating margins and average retail price per bottle. This would indicate a similar operating cost structure between players in this category (see Exhibit 46). As LVMH holds some of the highest premium brands in this category, we believe that LVMH can continue to enjoy attractive and sustainable margins.

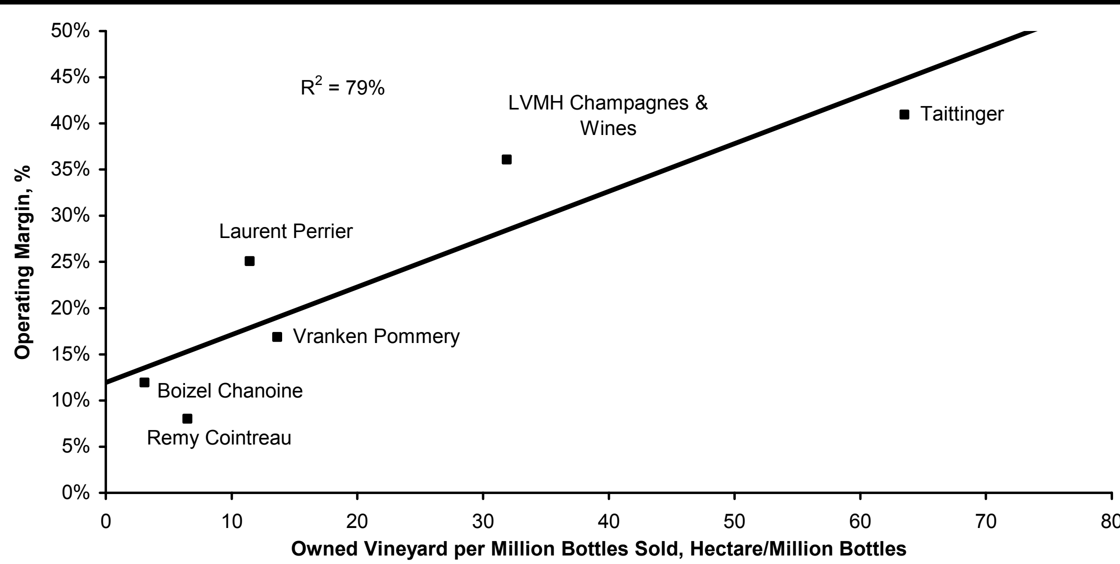
**Exhibit 46** **Operating Margin vs. Average Price: Champagnes**




Source: *Wine Searcher*, corporate reports and Bernstein estimates and analysis.

LVMH is one of the most upstream-integrated producers, behind Taittinger. A high degree of upstream integration seems to correlate positively to operating margins (see Exhibit 47). Again, as vineyards are a limited resource, we see LVMH margins in this segment as defensible long term. As demand for premium products continues to increase faster than GDP, we expect margins to improve over time.

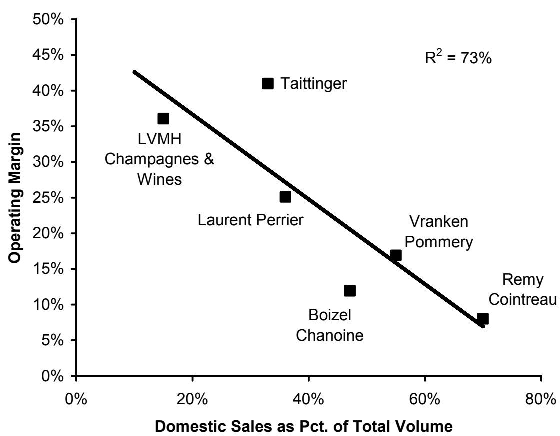
**Exhibit 47** **Operating Margin vs. Level of Vertical Integration: Champagnes**




Source: *Just-Drinks*, corporate reports and Bernstein estimates and analysis.

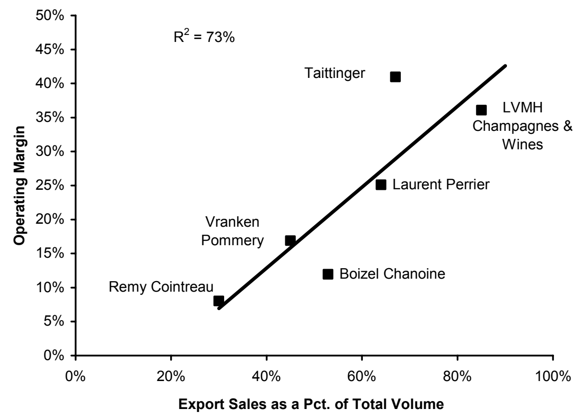
Strong international distribution allows LVMH to have materially higher market share abroad — e.g., more than 50% in the United States and approximately 80% in Asia — than in France, as international markets are both growing faster and less price competitive. Because of its strong international distribution network, LVMH exports roughly 90% of champagne volumes. This produces higher margins as champagne and wine sales in France are primarily channeled through supermarkets, which have significant purchasing power. Conversely, champagne and wine products are sold at full prices in international markets with a higher proportion of on-trade (see Exhibit 48 and Exhibit 49).

**Exhibit 48 Operating Margin vs. Percentage of Domestics Sales**




Source: *Just-Drinks*, corporate reports and Bernstein estimates and analysis.

**Exhibit 49 Operating Margin vs. Percentage of Export Sales**

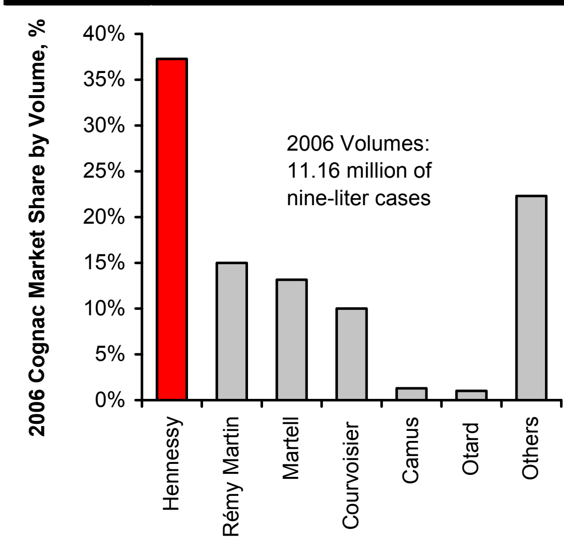



Source: *Just-Drinks*, corporate reports and Bernstein estimates and analysis.

## Cognac & Spirits

LVMH also leads the Cognac market with its largest brand, Hennessy, being a clear leader of global cognac volumes. Hennessy's share of the market was 37% in 2006 (see Exhibit 50). The United States is by far the biggest market for the group, followed by China (see Exhibit 51).

**Exhibit 50 Cognac Market Share by Player (2006)**




Source: *Just-Drinks* and Bernstein estimates and analysis.

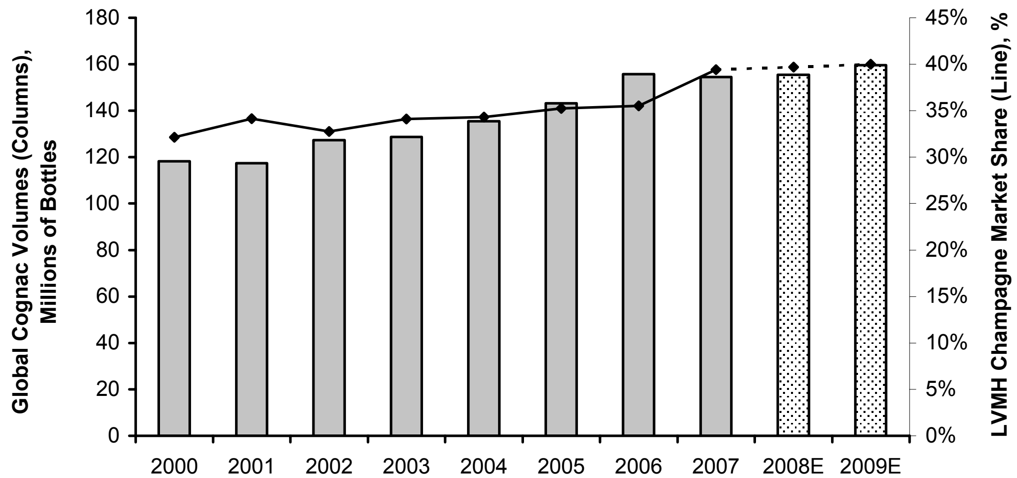
**Exhibit 51 Hennessy Volumes (2006)**

| | | |
|---|---|---|
| United States | 53% | 2,205,118 |
| China | 12% | 499,272 |
| Taiwan | 4% | 166,424 |
| Ireland | 4% | 166,424 |
| Duty Free | 6% | 249,636 |
| Others | 21% | 873,726 |
| **Total** | **100%** | **4,160,600** |

Source: *Just-Drinks* and Bernstein estimates and analysis.

We believe that cognac demands in emerging markets — China and Singapore in particular, which grew in volume terms respectively by 27.3% and 25.4% in 2006 versus 2005 — should compensate for the expected softer demand in the United States. Overall, we forecast approximately 1% market growth in 2008E and approximately 3% in 2009E (see Exhibit 52). We expect LVMH to hold market share in mature markets such as the U.S. and France, and gain market share due to increasing popularity of its brands in high-growth markets such as China. We forecast approximately 30 bp increase in market share per annum.

**Exhibit 52** **Evolution of Cognac Volumes and LVMH Market Share (2000-09E)**




Source: BNIC, corporate reports and Bernstein estimates and analysis.

## Other Divisions

Among the "emerging" sectors, RONA analysis indicates that Perfumes & Cosmetics generate higher returns on net assets, despite LVMH trailing industry leaders in market share terms in this sector. We expect more profitable growth in Watches & Jewelry as well as in Selective Retailing. At first sight, it would appear that organic growth could be combined with M&A in order for LVMH to improve its competitive position in these sectors — first and foremost in Watches & Jewelry.

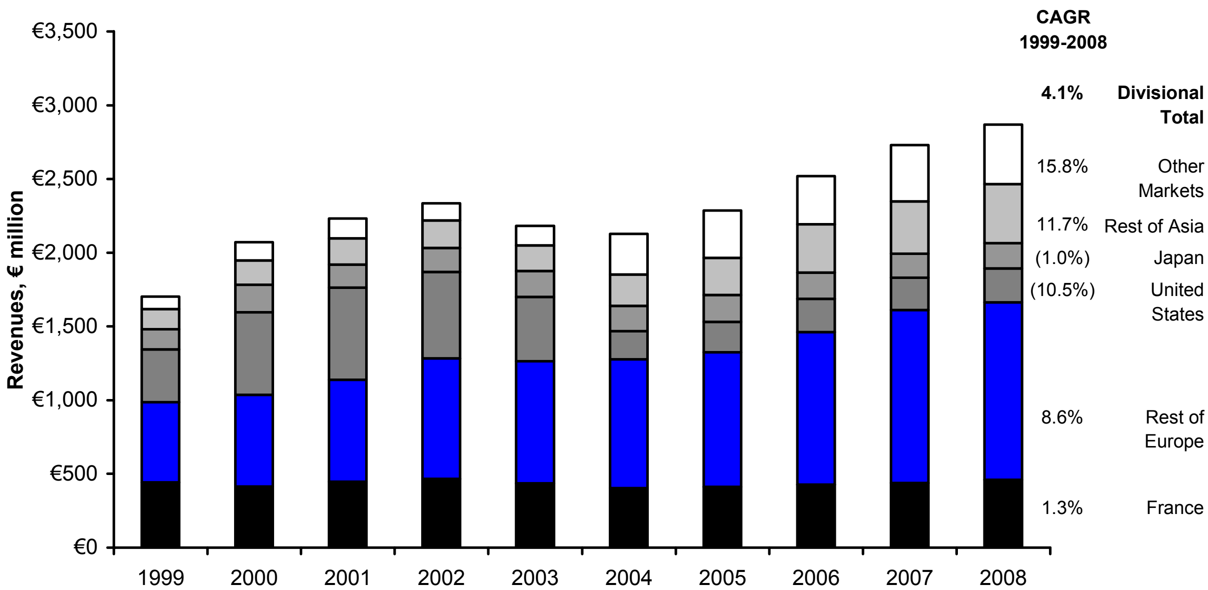
## Perfumes & Cosmetics

Fragrances & Cosmetics looks set to provide further growth support; LVMH lags sector leaders in this area, but should continue to produce higher-than-group-average ROCE returns from the strength of its brands and the relatively modest invested capital requirements.

Perfumes & Cosmetics competes in the high-end perfumes and cosmetics market through its range of brands which include Christian Dior, Guerlain, Givenchy and Kenzo. Perfumes & Cosmetics also owns two American companies, BeneFit Cosmetics and Fresh, which target the younger end of the population. The division also owns Acqua di Parma, Parfums Loewe and Make Up For Ever. LVMH continued to develop its range of brands by launching two perfumes for the Fendi and Pucci brands in 2007.

Revenue growth mainly comes from Asia (excluding Japan) and Europe (excluding France), as shown in Exhibit 53.

**Exhibit 53** **Revenues by Geography — Perfumes & Cosmetics, 1999-2008**




Source: Corporate reports and Bernstein estimates and analysis.

Europe is the biggest market for Perfumes & Cosmetics, accounting for c. 58% of divisional revenue in 2008 (see Exhibit 54). The division has a relatively small exposure to the United States, where it faces competition from global beauty giant L'Oréal (see Exhibit 54 and Exhibit 55). However, lower exposure to the United States translates in lower susceptibility to euro-dollar rate movements.

**Exhibit 54** **Perfumes & Cosmetics: Revenue by Geography in 2008**

| | Geographic Mix | As % of Group Revenue from the Region |
|---|---|---|
| France | 16% | 19% |
| Rest of Europe | 42% | 29% |
| United States | 8% | 6% |
| Japan | 6% | 10% |
| Rest of Asia | 14% | 12% |
| Others | 14% | 26% |
| **Total** | **100%** | |

Source: Corporate reports and Bernstein estimates and analysis.

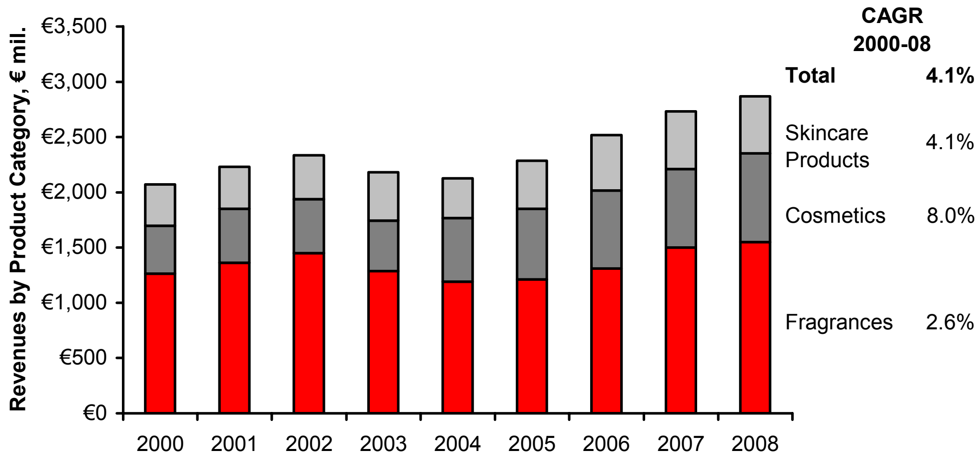
**Exhibit 55** **L'Oréal — Revenue by Geography in 2007**

| | Geographic Mix |
|---|---|
| Western Europe | 33% |
| North America | 22% |
| Japan | 13% |
| RoW | 33% |
| **Total** | **100%** |

Source: Corporate reports and Bernstein estimates and analysis.

Perfumes & Cosmetics is further split into three product categories. These are Fragrances, Cosmetics and Skincare products (see Exhibit 56). Fragrances is the largest product category for the division, accounting for roughly 60% of divisional revenues in 2007. The main source of growth had come from Cosmetics which grew at a CAGR of 8.0% between 2000 and 2008, compared to 2.6% and 4.1% in Fragrances and Skincare Products, respectively, over the same period.

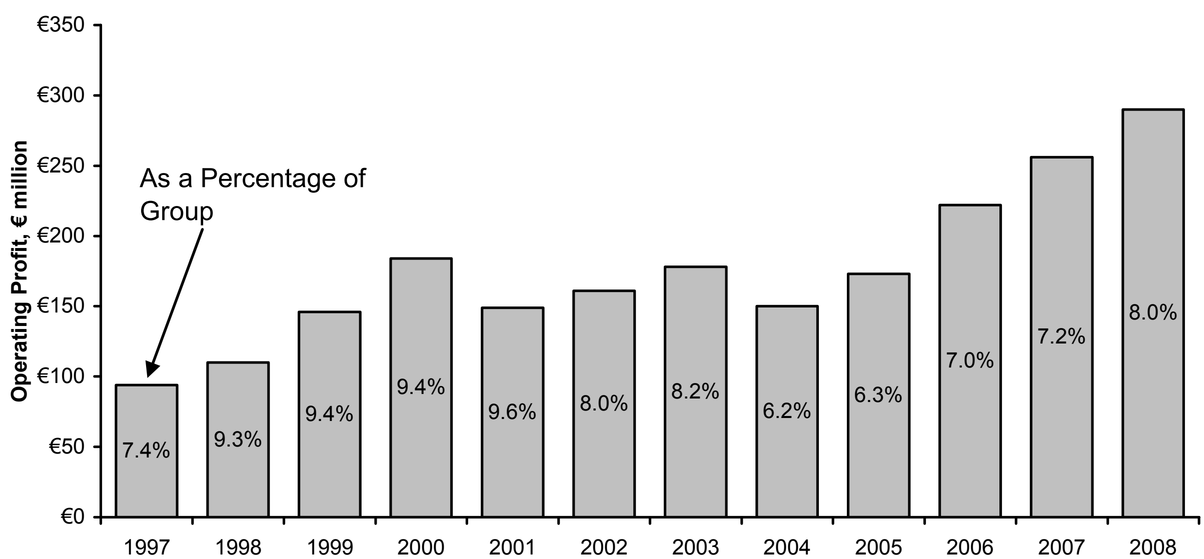
**Exhibit 56** **Product Mix: Perfumes & Cosmetics (2000-08)**




Source: Corporate reports and Bernstein estimates and analysis.

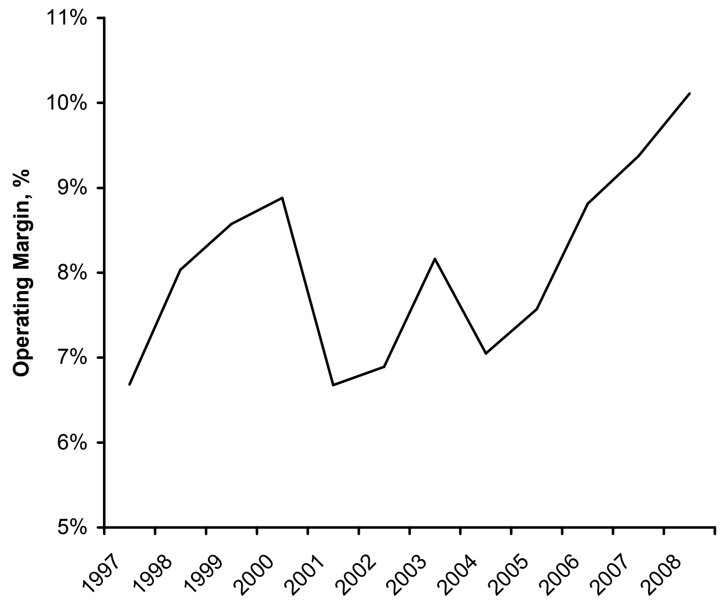
Though Perfumes & Cosmetics has more than doubled operating profit since 1997, it still remains relatively small in absolute terms compared to the group (see Exhibit 57). Operating margin has fluctuated over time but has consistently increased in the last three years, reaching approximately 10% in 2008 (see Exhibit 58).

**Exhibit 57** **Operating Profits as a Percentage of Group — Perfumes & Cosmetics (1997-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 58** **Operating Margin: Perfumes & Cosmetics (1997-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

## Watches & Jewelry

We expect LVMH to grow its relative share in Watches & Jewelry through focused acquisitions (like the most recent Hublot deal), reducing its scale disadvantage to Swatch and Richemont and producing — over time — improved operating profit from manufacturing and distribution scale.

Watches & Jewelry was formed in 1999 through a series of acquisitions; TAG Heuer, Ebel and Zenith at the end of 1999; Chaumet, the French jeweller, in the last quarter of 1999, alongside Fred Joaillier and Benedom (now Dior Watches), which joined the LVMH stable in 1995 and 1999, respectively. In 2000, the group created a joint venture with De Beers, under the De Beers brand, to strengthen its jewelry business. The composition of the business group has not significantly changed since.

The Watches & Jewelry division operates for the most part in the intermediate price points. In this space, it competes with other established watches and jewelry brands such as Tiffany and Bulgari, watch specialists including Breitling, Omega and Officine Panerai, as well as with the high-end of designer brands (see Exhibit 59).

**Exhibit 59 — Watch Brands Positioning by Price Category**

| | Swatch | | Richemont | | LVMH | Bulgari | PPR |
|---|---|---|---|---|---|---|---|
| ***Market Share*** | *14.1%* | | *13.8%* | | | | |
| **Segment** | **Brands** | **Sales (€m)** | **Brands** | **Sales (€m)** | | | |
| **Elitist Luxury Segment > €10k** | Breguet | 317 (11%) | A. Lange & Söhne<br>Piaget<br>Roger Dubuis<br>Greubel Forsey (20% stake) | 200 (5%) | | Daniel Roth (Bulgari)<br>Gerald Genta (Bulgari) | Girard-Perregaux (PPR) |
| **Exclusive Luxury Segment €6k - €10k** | Jaquet Droz<br>Léon Hatot<br>Blancpain<br>Glashütte Original | 423 (15%) | Vacheron Constantin | 175 (5%) | Zenith (LVMH)<br>Hublot (LVMH) | | |
| **Luxury Segment €4k to €6k** | | | Jaeger LeCoultre<br>IWC<br>Cartier<br>Van Cleef & Arp. | 2,957 (78%) | Louis Vuitton (LVMH) | | |
| **High-priced Segment €2k to €4k** | Omega<br>Tiffany & Co. | 424 (15%) | Officine Panerai<br>Montblanc | 100 (3%) | Chaumet (LVMH)<br>TAG Heuer (LVMH)<br>Dior (LVMH) | Bulgari | |
| **Mid-priced Segment €1k to €2k** | Longines<br>Rado<br>Union Glashütte | 578 (20%) | Baume & Mercier<br>Dunhill | 377 (10%) | | | |
| **Low-priced Segment < €1k** | Tissot<br>cK Watch<br>Pierre Balmain<br>Certina<br>Mido<br>Hamilton<br>Swatch<br>Flik Flak | 1,125 (39%) | | | | | |

Source: Koncept Analytics and Bernstein analysis.

The luxury watch market — using Swiss watch export as a proxy — has grown at 7.2% CAGR between 2000 and 2008. This has been driven primarily by exceptional growth experienced in the highest price segment — where Zenith and Hublot operate — which grew at 14.8% CAGR over the same period (see Exhibit 60). We believe the continued focus in high-end watches — enhanced by the most recent acquisition of Hublot — should support our long-term forecast operating profit growth of about 7-8%.

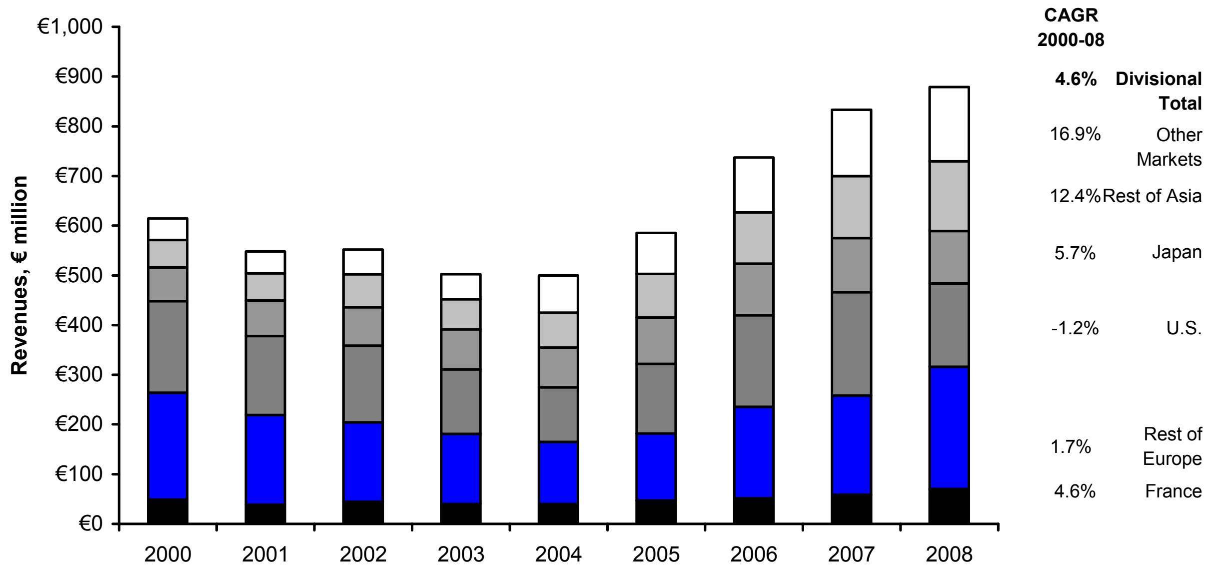
**Exhibit 60 — Swiss Export of Watches by Ex-Factory Price Segment (CHF million), 2000-08**

| Value (CHF million), Ex-Factory Prices | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | *CAGR 2000-08* |
|---|---|---|---|---|---|---|---|---|---|---|
| Mass Market (0-200) | 1,231 | 1,100 | 1,097 | 1,019 | 1,065 | 1,072 | 1,077 | 1,167 | 1,215 | *-0.2%* |
| Accessible Luxury (200-500) | 1,036 | 915 | 820 | 745 | 813 | 842 | 772 | 856 | 839 | *-2.6%* |
| Exclusive Luxury (500-3000) | 4,023 | 4,110 | 4,047 | 3,986 | 4,310 | 4,581 | 4,639 | 4,945 | 4,565 | *1.6%* |
| High-End Luxury (3000+) | 2,986 | 3,484 | 3,699 | 3,501 | 3,932 | 4,923 | 6,250 | 7,830 | 9,513 | *15.6%* |
| **Total** | **9,276** | **9,609** | **9,663** | **9,251** | **10,121** | **11,418** | **12,737** | **14,798** | **16,133** | ***7.2%*** |

Source: FHS and Bernstein estimates and analysis.

Since 2000, divisional revenue growth came primarily from Asia and other markets, while Europe and the United States remained static (see Exhibit 61).

**Exhibit 61** **Revenues by Geography: Watches & Jewelry (2000-08)**




Source: Corporate reports and Bernstein estimates and analysis.

Europe and the United States are the largest markets for Watches & Jewelry accounting for 36% and 19% of revenues in 2008, respectively, while main competitors, Richemont and Swatch, seem more focused in Europe and Asia (see Exhibit 62 and Exhibit 63).

**Exhibit 62** **Watches & Jewelry: Revenue by Geography in 2008**

| | Geographic Mix | As a Pct. of Group Revenue from the Region |
|---|---|---|
| France | 8% | 3% |
| Rest of Europe | 28% | 6% |
| United States | 19% | 4% |
| Japan | 12% | 6% |
| Rest of Asia | 16% | 4% |
| Others | 17% | 10% |
| **Total** | **100%** | |

Source: Corporate reports and Bernstein estimates and analysis.

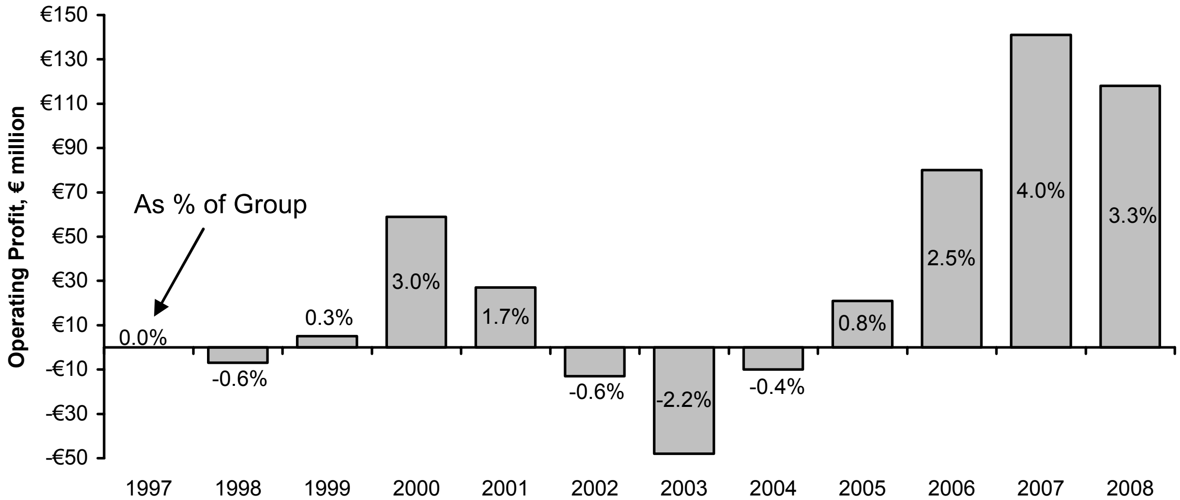
**Exhibit 63** **Richemont and Swatch: Revenue by Geography in 2008**

| 2008 | Richemont | Swatch |
|---|---|---|
| Europe | 45% | 47% |
| North America | 18% | 10% |
| Japan | 11% | 10% |
| Rest of Asia | 26% | 31% |
| Others | 0% | 2% |
| **Total** | **100%** | **100%** |

Source: Corporate reports and Bernstein estimates and analysis.

Operating profit appears to be highly cyclical. Since it was formed in 1998, the division has seen a period of low and negative profitability in its early years of trading. However, the division has achieved significant operating profit growth in the last two years (see Exhibit 64).

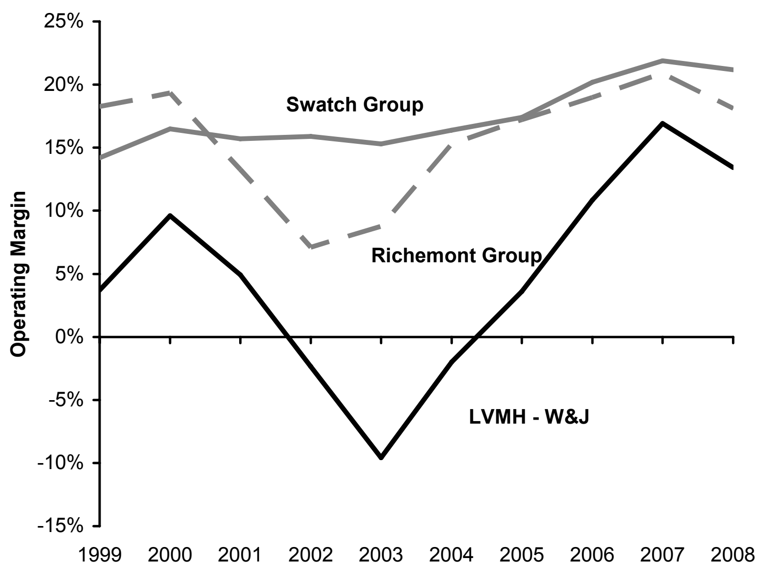
**Exhibit 64** **Operating Profits as a Percentage of Group: Watches & Jewelry (1997-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

We found that the cyclicality of Watches & Jewelry operating profit and margin is mirrored in Richemont's own results while it seems materially lower at Swatch (see Exhibit 65). The difference in performance seems to originate from materially lower exposure to North America and the dollar at Swatch than at LVMH and Richemont (see Exhibit 62 and Exhibit 75).

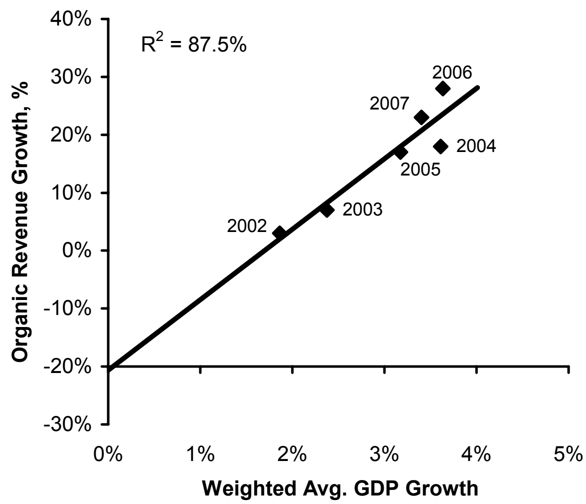
**Exhibit 65** **Operating Margin: Watches & Jewelry (1997-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

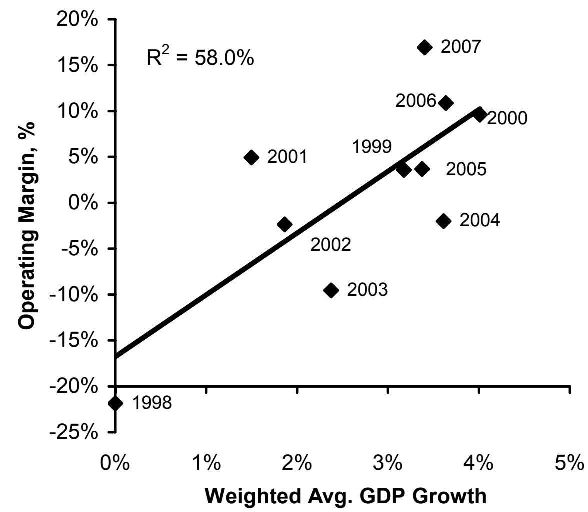
Organic revenue growth in Watches & Jewelry correlates strongly to real GDP growth weighted by geographic revenue mix (see Exhibit 66). While we could find no meaningful correlation between operating margin and GDP growth in any of the other divisions, operating margin in Watches & Jewelry correlates to GDP with a regression coefficient of 58%. This seems to indicate that profitability in Watches & Jewelry is more sensitive to the economic cycle (see Exhibit 67).

**Exhibit 66** **Watches & Jewelry: Organic Revenue Growth vs. GDP**




Source: *Global Insight* and Bernstein estimates and analysis.

**Exhibit 67** **Watches & Jewelry: Operating Margin vs. GDP**




Source: *Global Insight*, corporate reports and Bernstein estimates and analysis.

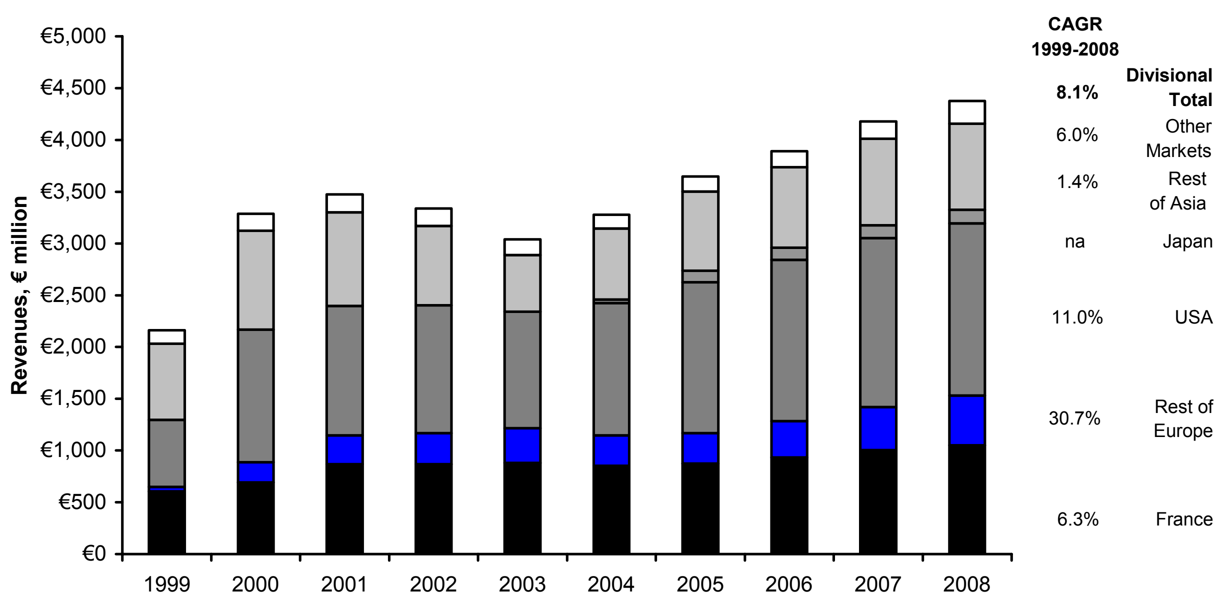
**Selective Retailing**

Increasing success at Sephora, with growing like for like and space, should push ROCE ahead in this area too — closing the gap to group average.

The main activities of Selective Retailing include the beauty product retailing business, Sephora, and the airport retailing business, DFS, both acquired in 1997. Other businesses included La Samaritaine (now closed), Le Bon Marché and Miami Cruiseline Services.

Over the 1997-2008 period, revenue growth primarily came from Europe, excluding France, though the United States remained the biggest market for the division (see Exhibit 68).

**Exhibit 68** **Revenues by Geography: Selective Retailing (1999-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

Selective Retailing is the business with the highest exposure to the United States in the whole group. The division earns 38% of its total revenues from the U.S., which equates to 42% of the group's U.S. revenues (see Exhibit 69).

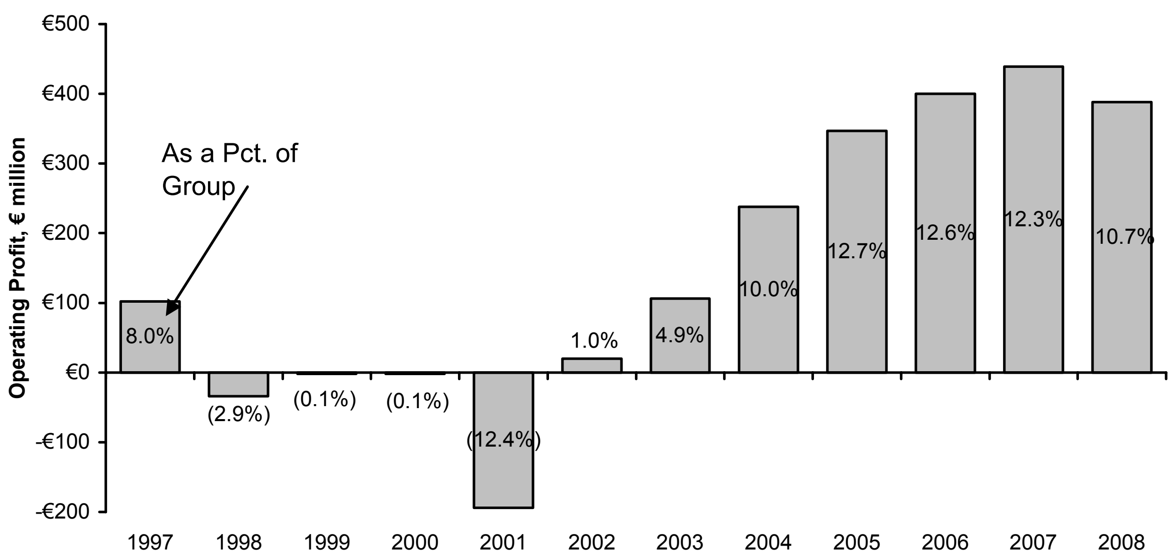
**Exhibit 69** **Selective Retailing Revenue by Geography in 2008**

| | Geographic Mix | As a Pct. of Group Revenue from the Region |
|---|---|---|
| France | 24% | 44% |
| Rest of Europe | 11% | 12% |
| United States | 38% | 42% |
| Japan | 3% | 8% |
| Rest of Asia | 19% | 24% |
| Others | 5% | 14% |
| **Total** | **100%** | |

Source: Corporate reports and Bernstein estimates and analysis.

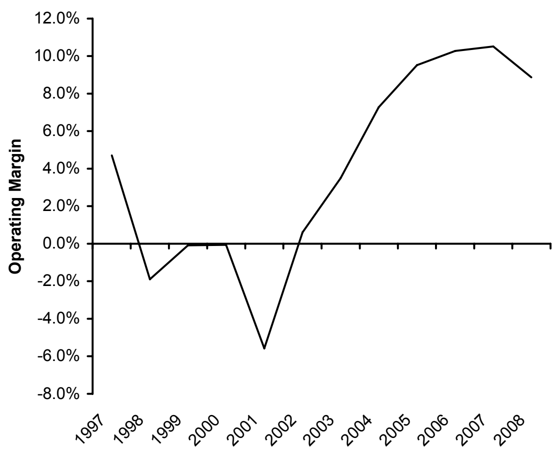
The division was unprofitable in the early years of trading and seemed to suffer materially from travel disruption and weak demand in 2001 (see Exhibit 70). Since 2001, profitability has returned to positive territory, partly fueled by a positive economic backdrop. Divisional operating margin has recovered from the trough it hit in 2001 and reached approximately 11% of sales in 2008 (see Exhibit 71).

**Exhibit 70** **Operating Profits as a Percentage of Group: Selective Retailing (1997-2008)**



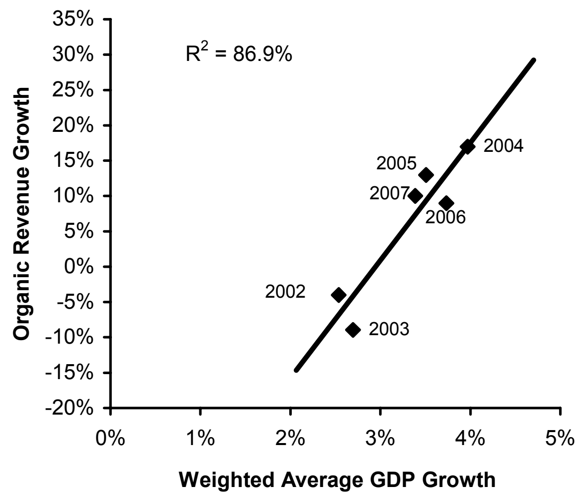

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 71 Operating Margin: Selective Retailing (1997-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 72 Selective Retailing Organic Revenue Growth vs. GDP**

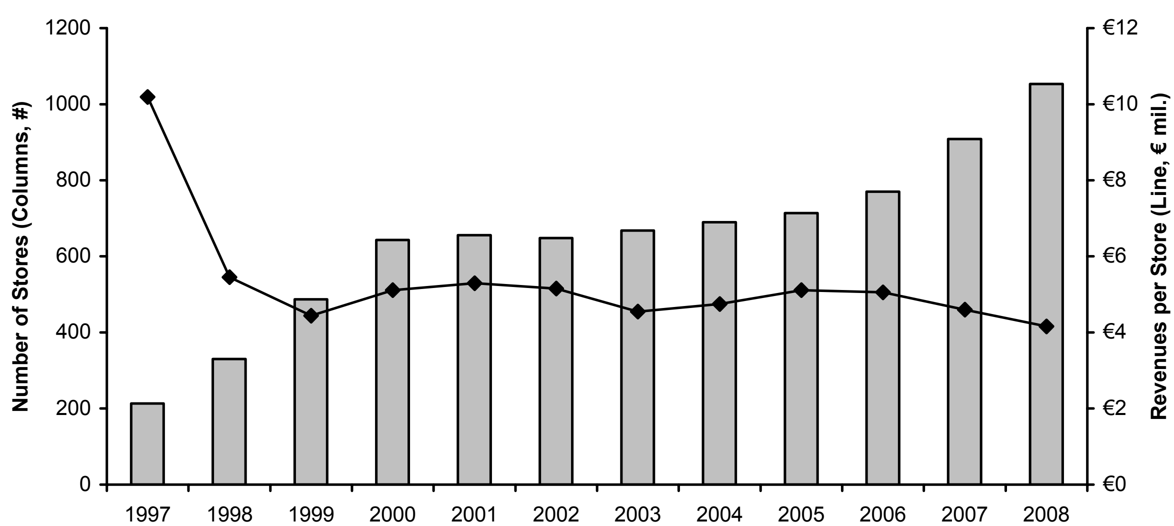



Source: *Global Insight*, corporate reports and Bernstein estimates and analysis.

Organic revenue growth in Selective Retailing correlates strongly to real GDP growth weighted by geographic revenue mix. This seems to indicate that demand for luxury cosmetic products and air travel are very sensitive to the economic cycle (see Exhibit 72).

Revenue per store was diluted significantly following the acquisition of Sephora at the end of 1997, but the metric has since been relatively stable at approximately €5 million per store (see Exhibit 73). The division has opened 144 stores during 2008, of which 142 were Sephora stores primarily opened in Europe and America.

**Exhibit 73 DOS Performance: Selective Retailing (1997-2008)**




Source: Corporate reports and Bernstein estimates and analysis.

**Other Activities**

LVMH also owns DI Group, which has several business and finance publications. These include Les Echos, a French finance publication group, acquired at the end of 2007; *Investir*, a personal investing publication; Défis and Notes d'Infos, publishers for small business executives and entrepreneurs; *Connaissance des Arts*, a magazine that covers art and culture; Radio Classique, a French radio station that features music, business and culture; and *Le Monde de la Musique,* France's leading classical music magazine. DI Group is also the organizer of the trade show, Le Salon des Entrepreneurs, an event designed for people seeking to create or purchase businesses, as well as specialized advisors and heads of businesses.

For the purpose of this report, we will not analyze these activities further due to their immaterial relative size.

**Impact of Foreign Exchange**

The dollar rate is a key element impacting LVMH operations, as approximately 25% of LVMH revenues come from the United States and roughly 30% of revenues are transacted in U.S. dollars — the highest percentage of any major Luxury & Fashion player (see Exhibit 74 and Exhibit 75). Except for Perfumes & Cosmetics, all other divisions have significant exposure to the United States, deriving between 19-38% of divisional revenues from the market (see Exhibit 74). The Japanese yen is also a key currency for LVMH, accounting for 10% of group sales in 2008.

**Exhibit 74** **Sales in the United States by Division (2008)**

| | Group Sales Mix by Geography |
|---|---|
| France | 14% |
| Rest of Europe | 24% |
| United States | 23% |
| Japan | 10% |
| Rest of Asia | 20% |
| Other Markets | 9% |
| **Total** | **100%** |

| Division | Total Sales, € mil. | U.S. Sales, € mil. | Pct.of Divisional Sales | Pct. of Group Sales | Pct. of Group U.S. Sales |
|---|---|---|---|---|---|
| Wines & Spirits | €3,126 | €750 | 24% | 4% | 19% |
| Fashion & Leather Goods | €6,010 | €1,142 | 19% | 7% | 29% |
| Perfumes & Cosmetics | €2,868 | €229 | 8% | 1% | 6% |
| Watches & Jewelry | €879 | €220 | 25% | 1% | 6% |
| Selective Retailing | €4,376 | €1,663 | 38% | 10% | 42% |
| Other and Eliminations | -€66 | | | | |
| **Total** | **€17,193** | **€4,004** | | **23%** | **101%** |

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 75** **Sales by Currency in 2007 — Key European Luxury Players**

| | LVMH | PPR - Luxury | Richemont | Swatch* |
|---|---|---|---|---|
| Euro | 31% | 42% | 43% | 49% |
| U.S. Dollar | 30% | 20% | 20% | 12% |
| Japanese Yen | 11% | 16% | 13% | 11% |
| Other | 28% | 22% | 24% | 28% |

* 2006 breakdown

Source: Corporate reports and Bernstein estimates and analysis.

Our historical analysis indicates that FX has acted as a major headwind to sales growth for the European players reporting in euros over the 2001-07 historical period. Continuing U.S. dollar weakness is a negative factor for a short-term investment in LVMH (see Exhibit 76).

**Exhibit 76** **Foreign Exchange Impact on Revenue by Key European Luxury Players (2001-07)**

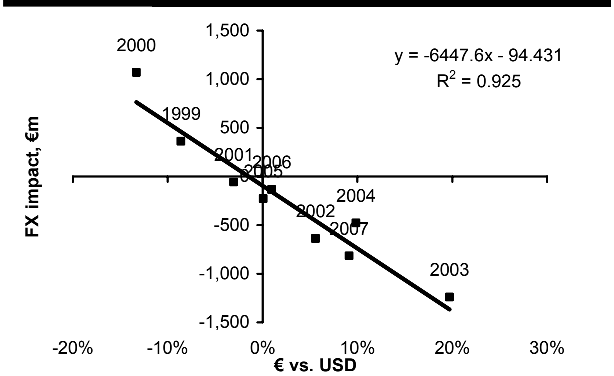
| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **PPR (Luxury)** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| Sales - reported | 2,538 | 2,542 | 2,556 | 2,712 | 3,036 | 3,568 | 3,867 |
| Growth reported | | 0% | 1% | 6% | 12% | 18% | 8% |
| FX impact - Favourable/ (Unfavourable) | | -14% | -35% | -15% | -3% | -2% | -9% |
| FX impact as % of sales growth | | nm | nm | -252% | -26% | -9% | -106% |
| | | | | | | | |
| **LVMH** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| Sales - reported | 12,229 | 12,693 | 11,962 | 12,623 | 13,910 | 15,306 | 16,481 |
| Growth reported | | 4% | -6% | 6% | 10% | 10% | 8% |
| FX impact - Favourable/ (Unfavourable) | | -5% | -10% | -4% | -2% | -1% | -5% |
| FX impact as % of sales growth | | -137% | 169% | -72% | -18% | -10% | -69% |
| | | | | | | | |
| **Richemont** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| Sales - reported | 3,684 | 3,860 | 3,651 | 3,375 | 3,717 | 4,308 | 4,827 |
| Growth reported | | 5% | -5% | -8% | 10% | 16% | 12% |
| FX impact - Favourable/ (Unfavourable) | | | | -8% | -3% | 0% | -4% |
| FX impact as % of sales growth | | | | 100% | -28% | -1% | -33% |
| | | | | | | | |
| **Swatch** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| Sales - reported (CHF million) | 4,182 | 4,063 | 3,966 | 4,152 | 4,497 | 5,050 | 5,941 |
| Growth reported | | -3% | -2% | 5% | 8% | 12% | 18% |
| FX impact - Favourable/ (Unfavourable) | | | | -2% | 1% | 1% | 0% |
| FX impact as % of sales growth | | | | -32% | 7% | 5% | 2% |

**Note:** PPR does not split FX impacts from other one-off impacts.

Source: Corporate reports and Bernstein estimates and analysis.

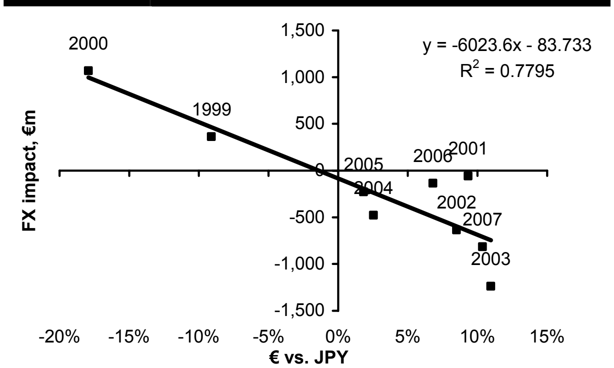
Due to significant revenue exposure to the U.S. dollar (c. 30% of group revenues) and Japanese yen (10% of group revenues), it is not surprising that movements in the two currencies against the euro are strongly correlated to FX impact on the top line (see Exhibit 77 and Exhibit 78).

**Exhibit 77** **LVMH: FX Impact on Top Line vs. €/US$ Exchange Rate**




Source: Bloomberg L.P., corporate reports and Bernstein estimates and analysis.

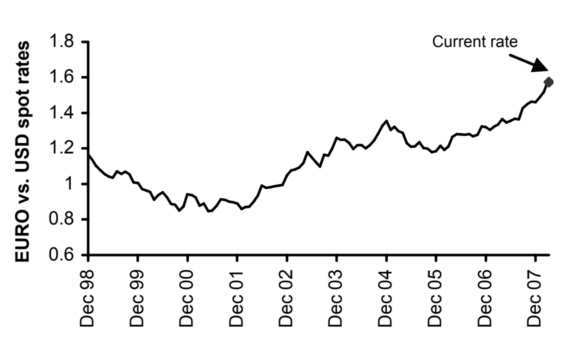
**Exhibit 78** **LVMH: FX Top-Line Impact vs. €/JPY Exchange Rate**




Source: Bloomberg L.P., corporate reports and Bernstein estimates and analysis.

After a long period of a strong euro, this trend is expected to reverse for the euro-yen rate during the course of 2008 — 12-month forward rates on euro-yen point to an approximate 6% decline (see Exhibit 80). This represents an upside for European players, though it is expected to be partially offset by the continued weakness of the U.S. dollar versus the euro (see Exhibit 79).

**Exhibit 79 Euro vs. US$ Rates (1998-2007)**




Source: Bloomberg L.P., and Bernstein analysis.

**Exhibit 80 Euro vs. JP¥ Rates (1998-2007)**


Source: Bloomberg L.P. and Bernstein analysis.

Applying the forward FX rates for 2008 to the relationships found in our correlation analysis, we have calculated the likely FX impact on 2008 sales, as shown in Exhibit 81. The results show a relatively immaterial impact for both LVMH and PPR on a geographically weighted basis — €326 million negative for LVMH and €101 million negative for PPR (Luxury). As a percentage of sales, the impact represents 1.9% and 2.4% of current estimated sales for 2008E for LVMH and PPR (Luxury) respectively. This is significantly lower than for 2007 (at 4.9% and 8.2%, respectively).

Therefore, we believe that LVMH should be relatively unaffected by FX in 2008 and should report solid sales growth. Given the current macroeconomic conjuncture, we expect a softer luxury and fashion market in 2008, with underlying growth of 5-7%. However, on a reported basis, we could see 2008 sales growth matching, if not exceeding, those achieved in 2007 as the negative impact of FX fluctuations should be absent.

**Exhibit 81 Estimated FX Impact in 2008**

| | Correlation | | 2008 growth | | Calculated sales impact (€m) | | Weighted average (€m) | 08E sales (€m) | FX impact as % of 08E sales | FX impact as % of 07 sales* |
|---|---|---|---|---|---|---|---|---|---|---|
| | EUR/USD | EUR/JPY | EUR/USD | EUR/JPY | EUR/USD | EUR/JPY | | | | |
| LVMH | 93% | 78% | 6.2% | -3.6% | (494 ) | 133 | -326 | 17,533 | **-1.9%** | -4.9% |
| PPR - Luxury | 91% | 70% | 6.2% | -3.6% | (295 ) | 136 | -101 | 4,177 | **-2.4%** | -8.2% |

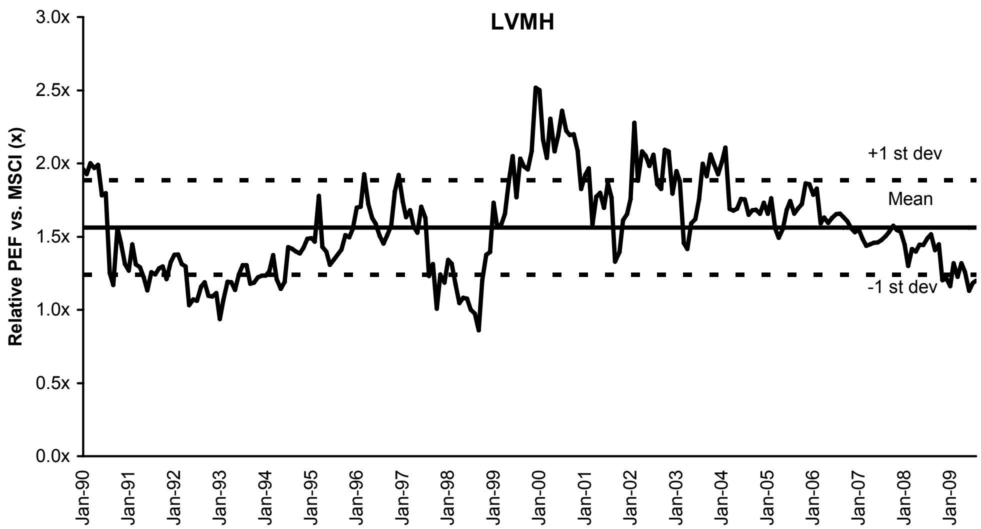
Source: Bloomberg L.P., corporate reports and Bernstein estimates and analysis.

## The Stock Price Seems Attractive

The key controversy on luxury investment is the short term; specifically, the impact of the current macro slowdown. Calling the macro picture and its timing at this point seems exceedingly difficult. We see current depressed luxury stocks valuations as an opportunity to buy quality stocks on the cheap, but this may work in the medium and long term and does point to short-term risks — the risk we see is more in the shape of sideways trading than in downside terms, given the material recent correction.

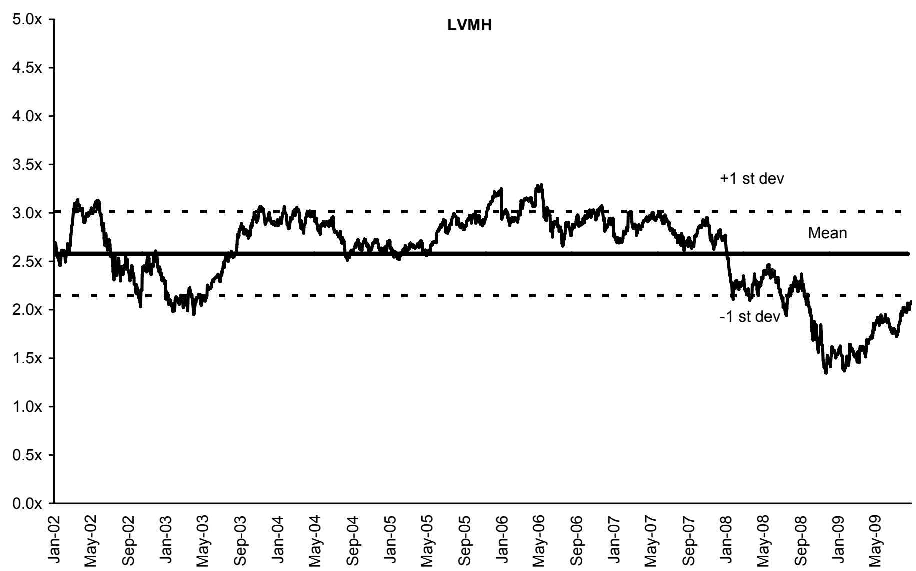
The LVMH stock is currently trading well below its long-term mean P/FE and EV/sales multiple, after a broad-brush de-rating which affected the consumer and retail sectors (see Exhibit 82 and Exhibit 83). Despite likely softer underlying demand in the coming 12-24 months, the LVMH stock would seem to represent a long-term high-quality growth investment opportunity. Besides, the price correction seems overdone, with the stock now trading at the lowest relative P/FE since September 1998 (see Exhibit 82).

**Exhibit 82** **LVMH Historical P/FE Relative to MSCI (1990-2009)**




Source: FactSet and Bernstein estimates and analysis.

**Exhibit 83** **LVMH Historical EV/Sales Multiple (1990-2009)**

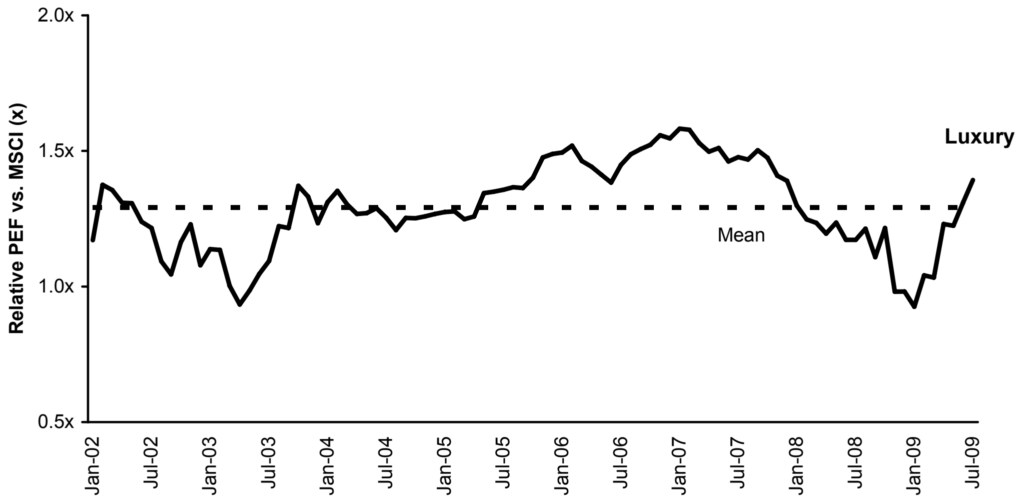



Source: FactSet and Bernstein estimates and analysis.

We have created an index to track the evolution of P/E (FY1) of stocks in the luxury space relative to the market (as represented by the MSCI Europe index). Our European luxury index comprises PPR, LVMH, Richemont, Swatch and Bulgari.

For luxury stocks, the picture is somewhat compelling. On a P/FE basis, the sector is currently near historical averages (see Exhibit 84) while EV/Sales multiple is at just below historical mean. In fact, if we exclude the instance of multiple contraction linked to extraordinary events such as the 9/11 terrorist attacks in 2001 or the SARS pandemic in 2003 — both of which had a material impact on global travel patterns and consequently luxury sales — P/FE multiples are at their lowest since October 1997.

**Exhibit 84** **Current Luxury Index P/FE Relative to MSCI Europe Are Close to Historical Averages**




**Note:** Our index includes: LVMH, Richemont, PPR, Swatch, Burberry and Bulgari.

Source: FactSet and Bernstein estimates and analysis.

## Sum-of-the-Parts

We have built a sum-of-the-parts valuation model using the following estimates:

**Wines & Spirits:** We have taken the P/E multiple of Laurent Perrier (17.5x) and applied it to our 2009E earnings of €699 million. Remy Cointreau is also a comparable to Wines & Spirits but a P/E multiple is not available due to operating losses in the last reported period. However, its P/FE of roughly 20x supports our valuation for Wines & Spirits.

**Fashion & Leather Goods**: We have chosen a P/E multiple of 19x for Fashion & Leather Goods, mirroring our current estimates for PPR's Gucci Group. This multiple reflects our estimated impact on valuation due to the expected slower economic environment.

**Perfumes & Cosmetics**: We value Perfumes & Cosmetics on an EV/Sales basis due to its limited profitability in absolute terms. We have taken the EV/Sales multiple of 3.2x for L'Oreal and applied it to our estimated 2009E sales of €2.7 billion for the division.

**Watches & Jewelry**: Similar to Perfumes & Cosmetics, we have taken an EV/Sales approach due to relatively limited divisional profits. We assigned an EV/Sales multiple of 3.3x to the division based on the average multiple of Swatch (2.8x) and Richemont (3.7x).

**Selective Retailing**: We have applied our current P/E estimates of 13x for PPR's general businesses to Selective Retailing.

Other operating income and expense: We have discounted other income and expense using the group's average P/E multiple of 20x.

Based on our 2009E estimates and using current P/E and EV/Sales multiples for comparables, our sum-of-the-parts analysis confirms that a target price of about €88 is realistic (see Exhibit 85).

## Exhibit 85 Sum-of-the-Parts Analysis

| Division | Driver | Sales | EBIT | *EBIT %* | EBITDA | *EBITDA %* | NOPAT | P/E | EV/Sales | Total | Per Share |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Year to December 2009 (€ million) | | | | | | | | | |
| Wines & Spirits | P/E | 2,616 | 699 | *26.7%* | 800 | *30.6%* | 503.9 | 17.5 | 3.4 | 8,819 | €18.6 |
| Fashion & Leather Goods | P/E | 6,360 | 2,059 | *32.4%* | 2,305 | *36.2%* | 1,484.9 | 19.0 | 4.4 | 28,213 | €59.6 |
| Perfumes & Cosmetics | EV/Sales | 2,725 | 288 | *10.6%* | 393 | *14.4%* | 207.7 | 42.0 | 3.2 | 8,719 | €18.4 |
| Watches & Jewelry | EV/Sales | 752 | 46 | *6.1%* | 75 | *10.0%* | 33.4 | 73.5 | 3.3 | 2,451 | €5.2 |
| Selective Retailing | P/E | 4,592 | 359 | *7.8%* | 537 | *11.7%* | 259.0 | 13.0 | 0.7 | 3,367 | €7.1 |
| Other and Eliminations | P/E | -110 | -150 | | -150 | | -108 | 20.7 | | -2,242 | -€4.7 |
| Other Operating Income and Expenses | | | -110 | | -110 | | -79 | 20.7 | | -1,644 | -€3.5 |
| **Equity Value** | | **16,934** | **3,191** | ***18.8%*** | **3,850** | ***22.7%*** | **2,301** | **20.7** | **2.82** | **47,682** | **€100.7** |
| Elimination of Diageo's 33% Minority Stake in W&S | | | | | | | | | | -2,910 | -€6.1 |
| **Equity Value (excl. Diageo's 33% W&S Minority)** | | | | | | | | | | **44,772** | **€94.5** |
| Net Debt | | | | | | | | | | 3,112 | €6.6 |
| **Enterprise Value** | | | | | | | | | | **47,884** | **€101.1** |

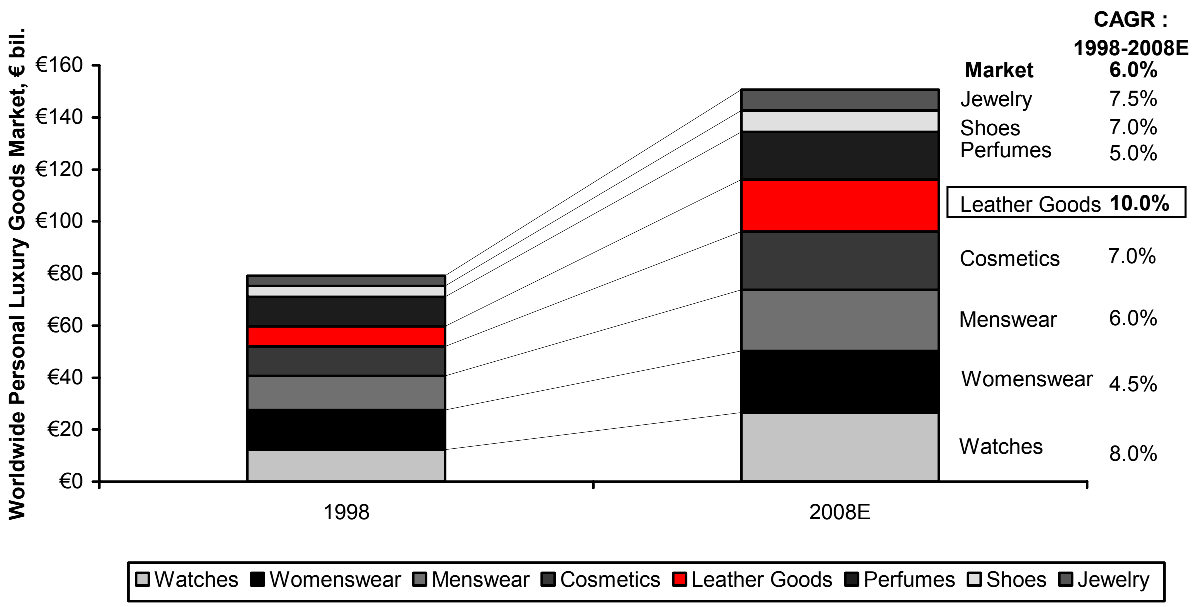
Source: FactSet, corporate reports and Bernstein estimates and analysis.

# Fashion & Leather Goods — Handbags Are a Pillar of Luxury

**Handbags Are a Key Category for Luxury Players**

Handbags have been one of the fastest-developing categories in the luxury market in the past 10 years. Over the 1998-2008E period, leather goods — of which handbags is the most important product category — have shown a CAGR of about 10% p.a. This is materially above that of women's apparel, which has risen +4.5% p.a., and the broader luxury goods market, which has posted a CAGR of 6% p.a. (see Exhibit 86).

**Exhibit 86** **Handbags Have Been One of the Fastest-Developing Categories in the Luxury Market in the Past 10 Years**

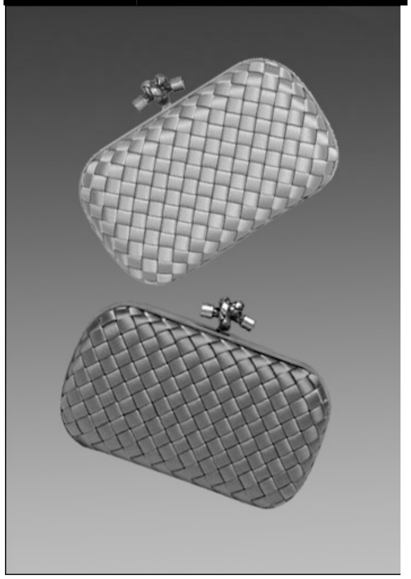



Source: Altagamma and Bernstein analysis.

*Handbags serve as "image anchors" and offer brands a unique opportunity to differentiate.* Handbags — like watches — serve as "image anchors" and are largely immune from "mix and match." As a category, handbags also offer brands a unique opportunity to differentiate themselves from competitors. This can be done in a number of ways, some more subtle than others.

*Shape and texture*. Handbags are unique in "soft" luxury in that they can take on various geometric shapes. As such, brands can exploit the recognizable geometric attribute of a handbag and turn it into a unique brand-differentiating feature. We take the example of Bottega Veneta's iconic *The Knot* handbag collection to illustrate this point (see Exhibit 87 to Exhibit 90). Similarly, specific textures can combine with geometric shapes to become brand differentiators. For Bottega Veneta, the "woven" leather texture has become a powerful symbol of the brand's high-caliber artisan credentials (see Exhibit 91 to Exhibit 93).

**Exhibit 87** **Bottega Veneta: "The Knot"**



Source: Company Web site.

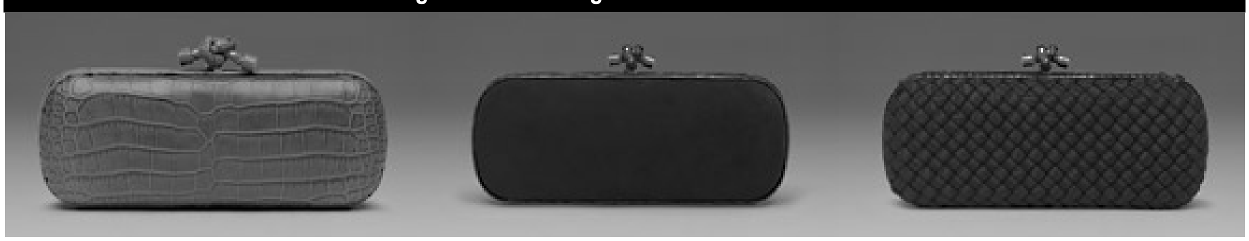
**Exhibit 88** **Bottega Veneta: "The Knot"**

Source: Company Web site.

**Exhibit 89** **Bottega Veneta: "The Knot"**

Source: Company Web site.

**Exhibit 90** **Bottega Veneta: "Elongated Knot"**



Source: Company Web site.

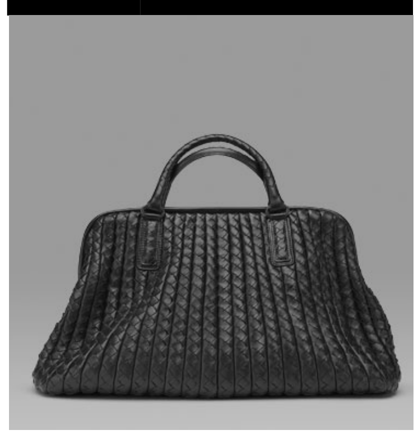
**Exhibit 91** **Bottega Veneta: "Intrecciato" Woven Shoulder Bag**

Source: Company Web site.

**Exhibit 92** **Bottega Veneta: "Intrecciato" Woven Tote Bag**

Source: Company Web site.

**Exhibit 93** **Bottega Veneta: New Bond Bag**



Source: Company Web site.

*Logo*. An outside logo is possibly the most unmistakable way to differentiate a branded handbag. It is especially effective (and exploited) in the aspirational and accessible segments of the luxury market, while elitist brands tend to rely on less prominent differentiators. However, it is not unknown for very high-end brands to produce very well-received collections featuring prominent outside logos (e.g., Chanel's Cambon collection). Brands can and do play with established logos to produce new and fresh collections relying on this powerful differentiator. We show Louis Vuitton iconic "LV" monogram and Coach as examples of this (see Exhibit 94 to Exhibit 99).

**Exhibit 94 Louis Vuitton "Speedy 30" — Classic**

Source: Company Web site.

**Exhibit 95 Louis Vuitton "Speedy 30" — Multicolor**

Source: Company Web site.

**Exhibit 96 Louis Vuitton "Speedy 30" — Mini Line**

Source: Company Web site.

**Exhibit 97 Coach: Op Art Julianne**

Source: Company Web site.

**Exhibit 98 Coach: Leather Op Art Julianne**

Source: Company Web site.

**Exhibit 99 Coach: Graphic Op Art Julianne**

Source: Company Web site.

*Metal components*. Luxury players rely on brand-specific metal components to differentiate themselves. Metal components can be used as outside logos, or to differentiate specific collections from well-established classic designs. We show Chanel iconic flap bag (see Exhibit 100 to Exhibit 102) and Gucci's "Babouska" collection for winter 2008 (see Exhibit 103 to Exhibit 105).

**Exhibit 100 Chanel: Classic Flap Bag**

Source: Company Web site.

**Exhibit 101 Chanel: Shiny Patent Calfskin Classic Flap Bag**

Source: Company Web site.

**Exhibit 102 Chanel: Calfskin Flap Bag With Mademoiselle Chain Strap**

Source: Company Web site.

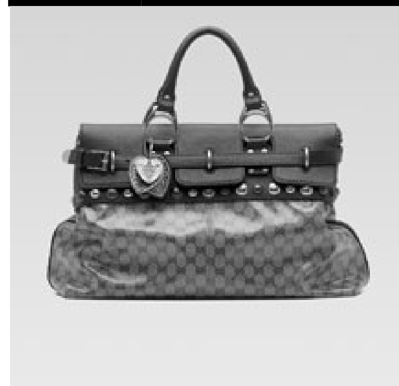
**Exhibit 103** **Gucci's Babouska Tote Bag**

Source: Company Web site.

**Exhibit 104** **Gucci: Babouska Boston Bag**

Source: Company Web site.

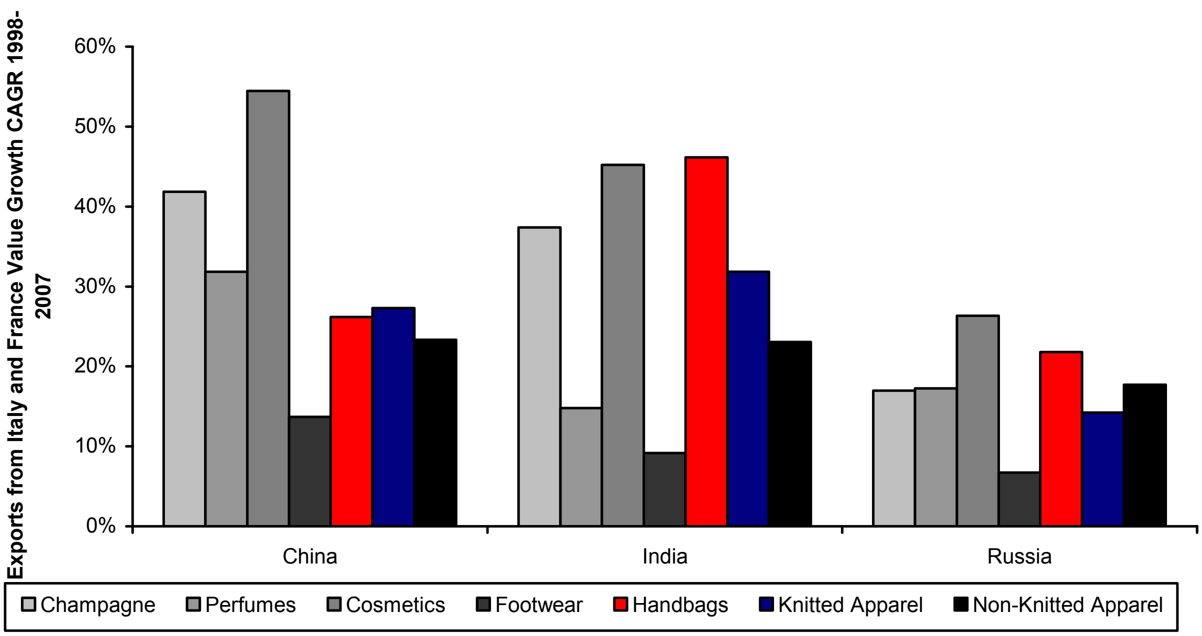
**Exhibit 105** **Gucci: Babouska Top-Handle Bag**



Source: Company Web site.

Handbags are one the fastest-growing product categories in emerging markets, making them a powerful way for top brands to establish themselves with emerging consumers. Using Italian and French exports as a proxy, we calculate that handbags sales posted CAGR (1998-2007) of about 22% for Russia, 26% for China and 46% for India (see Exhibit 106). With the exception of China, where knitted apparel showed similar growth over the period, handbags were the fastest-growing category in "soft" luxury (and in the case of India, the highest-growth product among all those surveyed).

**Exhibit 106** **Italian and French Exports Show That Handbags Have Been One of The Fastest-Growing Categories in Emerging Markets Over the Last 10 Years**

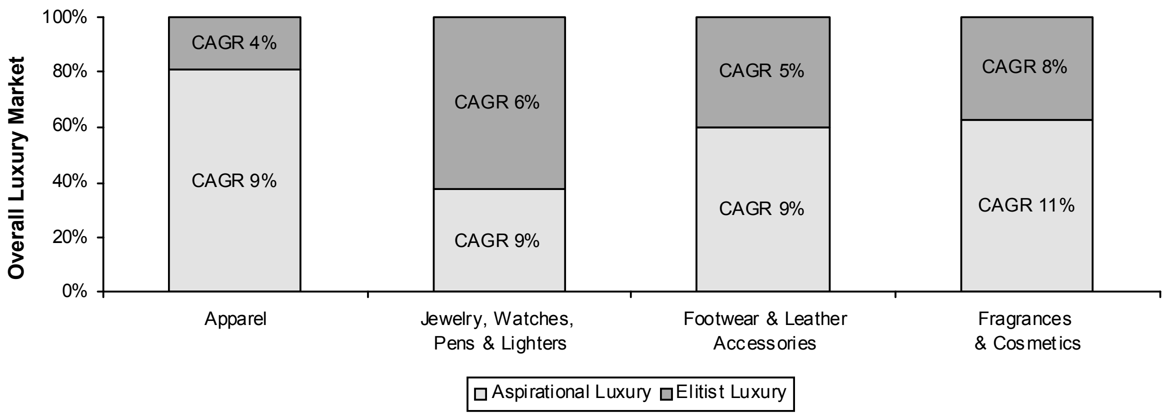



Source: *Eurostat* and Bernstein estimates and analysis.

**Accessible Luxury Handbags Show the Highest Growth**

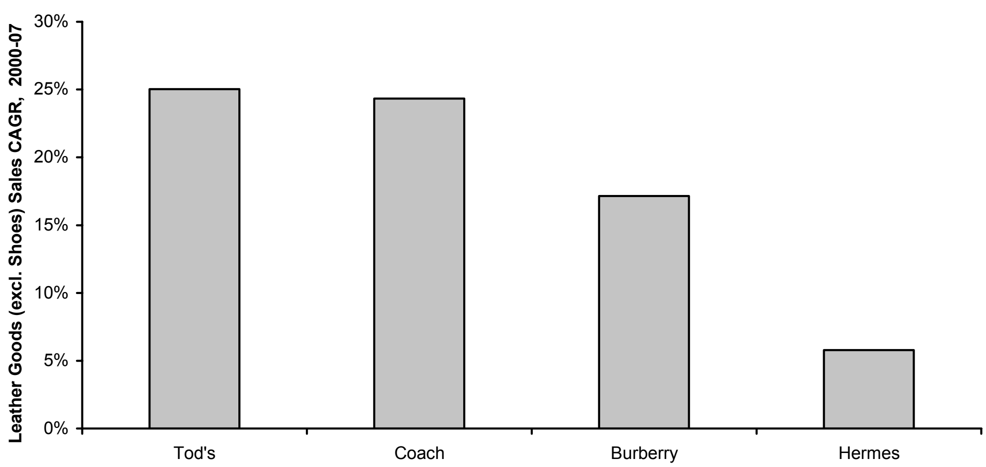
Within handbags, the accessible luxury segment has been growing the fastest. Demand from "aspirational" consumers has been a key driver of luxury and fashion market growth. In the past 15 years, growth of aspirational luxury has outstripped growth of elitist luxury across all products categories — roughly 40% higher in fragrances and cosmetics, roughly 50% higher in hard luxury, approximately 80% higher in leather accessories and more than 100% higher in apparel (see Exhibit 107). This is apparent in the superior growth performance achieved by aspirational and accessible brands — such as Coach and Tod's, at approximately 25% CAGR (2000-07) — relative to their elitist competitors, such as Hermes at about 6% for the same period (see Exhibit 108). As a conservative estimate, aspirational luxury now represents over 60% of the luxury market.

**Exhibit 107** **Aspirational Luxury Is Growing Faster Than Elitist Luxury, and Already Represents Over 60% of the Overall Luxury Market**




Source: Altagamma and Bernstein analysis.

**Exhibit 108** **Within Handbags, Accessible Luxury Handbags Have Been Growing the Fastest**

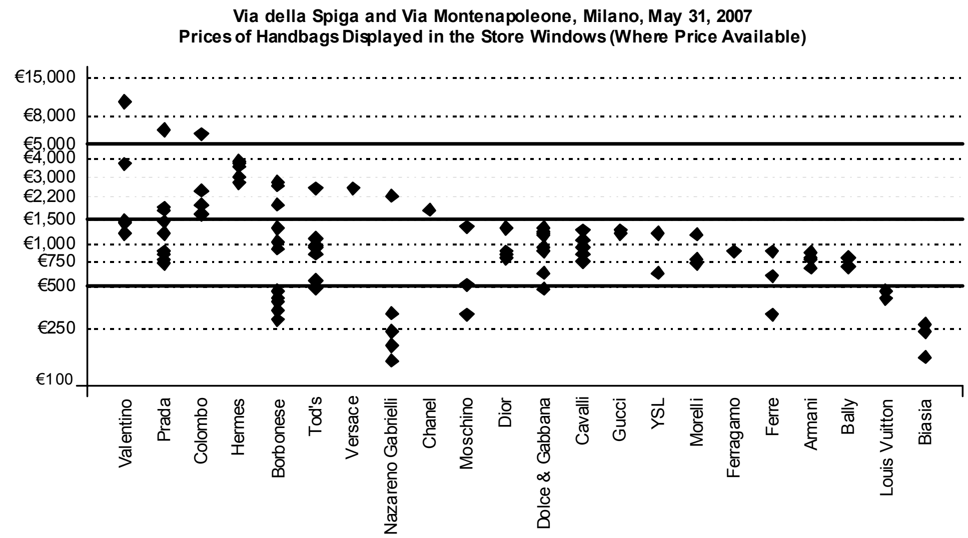



Source: Corporate reports and Bernstein estimates and analysis.

*Major European leather goods brands are now "pushing the envelope" below €500...* Among the most recent developments, major European leather goods brands have begun to "push the envelope" below the €500 price threshold. At PPR, for instance, efforts in the last two years to anchor Gucci in the high-end had resulted in a lower emphasis on mid-price points, both in advertising and merchandising. This was borne out by our store checks, as average handbag prices in Milan (Via Montenapoleone store) in May 2007 were about €1,250 at Gucci vs. just below €500 at Louis Vuitton (see Exhibit 109).

On May 1, 2008, though, the situation seemed reversed, with the "Joy" line bringing Gucci to approximately €820 versus Louis Vuitton at €1,300. Indeed, Joy line products are now abundant in store windows: we counted seven in Milan, starting at €150 for the "mini" version and up to €1,650. Our recent price checks for Louis Vuitton and Gucci handbags confirm a comparable proliferation of handbags priced at or below the €500 threshold (see Exhibit 110).

**Exhibit 109** **Most Recent Developments Are Seeing Major European Leather Goods Brands "Pushing the Envelope" Below €500**




Source: Window display checks, Milan, May 31, 2007 (special thanks to Olga Lampignano).

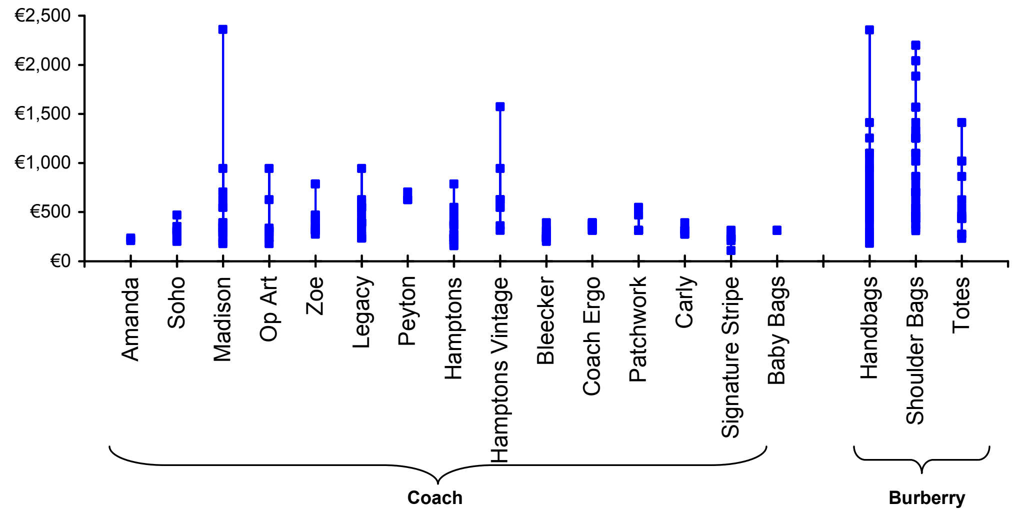
**Exhibit 110** **Louis Vuitton and Gucci Handbags at c.€500**

| Louis Vuitton | | Gucci | |
|---|---|---|---|
| Monogram Canvas Neverfull GM | €590 | Ladies Web Medium Hobo | €590 |
| Monogram Canvas Speedy 40 | €590 | Abbey Shoulder Bag | €590 |
| Monogram Canvas Batignolles | €590 | D Gold Medium Tote | €590 |
| Damier Canvas Neverfull GM | €590 | Abbey Hobo | €590 |
| Monogram Canvas Speedy 35 | €570 | New Britt Messenger Bag | €590 |
| Damier Canvas Speedy 35 | €570 | Princy Large Hobo | €590 |
| Damier Azur Speedy 35 | €570 | Abbey Medium Shoulder Bag | €590 |
| Damier Canvas Pochette Bosphore | €558 | D Gold Large Hobo | €590 |
| Damier Azur Pochette Bosphore | €558 | Guccioli Medium Tote | €574 |
| Monogram Canvas Speedy 30 | €551 | Joy Boston | €574 |
| Monogram Canvas Papillon 26 | €551 | Ladies Web Large Hobo | €570 |
| Monogram Canvas Mini Noé | €551 | Jolio Large Tote | €566 |
| Damier Canvas Neverfull MM | €551 | Joy Medium Boston | €547 |
| Damier Canvas Speedy 30 | €551 | New Britt Large Tote | €547 |
| Damier Canvas Papillon 26 | €551 | Joy Medium Tote | €539 |
| Damier Azur Speedy 30 | €551 | Abbey Large Tote | €527 |
| Monogram Multicolore Pochette | €551 | Abbey Medium Shoulder Bag | €515 |
| Damier Canvas Rift | €535 | Joy Medium Boston | €515 |
| Monogram Canvas Speedy 25 | €531 | New Britt Medium Tote | €511 |
| Damier Canvas Speedy 25 | €531 | Abbey Medium Shoulder Bag | €488 |
| Damier Azur Speedy 25 | €531 | Abbey Medium Shoulder Bag | €488 |
| Monogram Canvas Neverfull PM | €511 | Abbey Small Shoulder Bag | €484 |
| Damier Canvas Neverfull PM | €511 | New Britt Medium Hobo | €433 |
| Papillon 19 | €476 | Joy Small Boston | €395 |
| Monogram Canvas Mini Sac HL | €338 | Joy Small Boston | €365 |
| Mini Platine Mini Pochette | €279 | Joy Mini Bag | €150 |
| Monogram Mini Lin Pouch | €256 | | |

Source: Company online store checks, SCB store checks and Bernstein analysis.

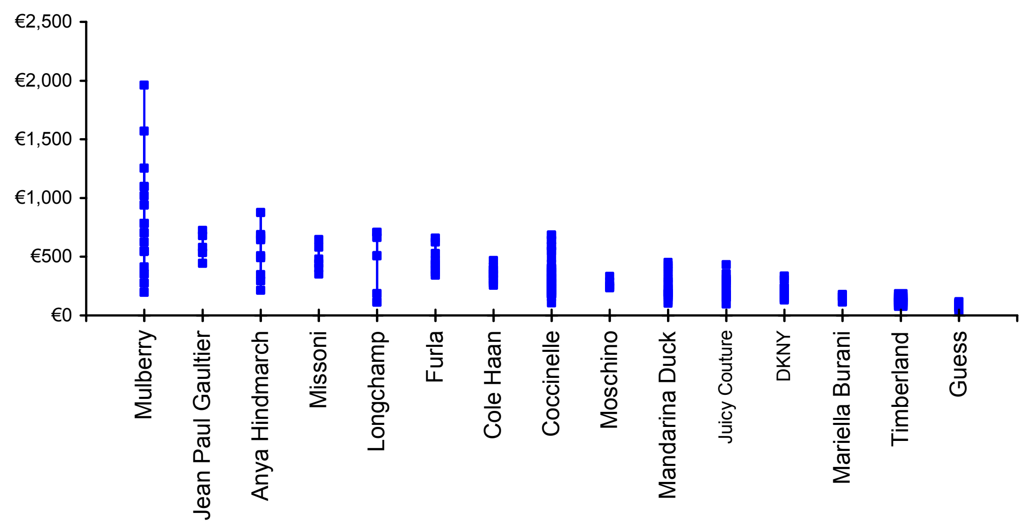
***...which, in our view, is the right strategic move for mega-brands to "box the ground" and fend off competition.*** We believe that mega-brands' offensive into the €200-€500 price band is the right strategic move to "box the ground" in these fast-growth areas and fend off attacks from specialist "accessible luxury" brands. Coach and Burberry are prime examples of these, offering an extensive range of handbags collections at less than €500 (see Exhibit 111). A broad range of accessible luxury "second-tier" brands — such as Missoni, Furla, Moschino, DKNY, etc. — also focus on the €200-€500 price band (see Exhibit 112).

**Exhibit 111** **This Seems the Right Strategic Move for "Mega Brands" to Fend Off Attacks From Specialist "Accessible Luxury" Brands in the €200 to €500 Price Band...**




Source: Online store checks and Bernstein analysis.

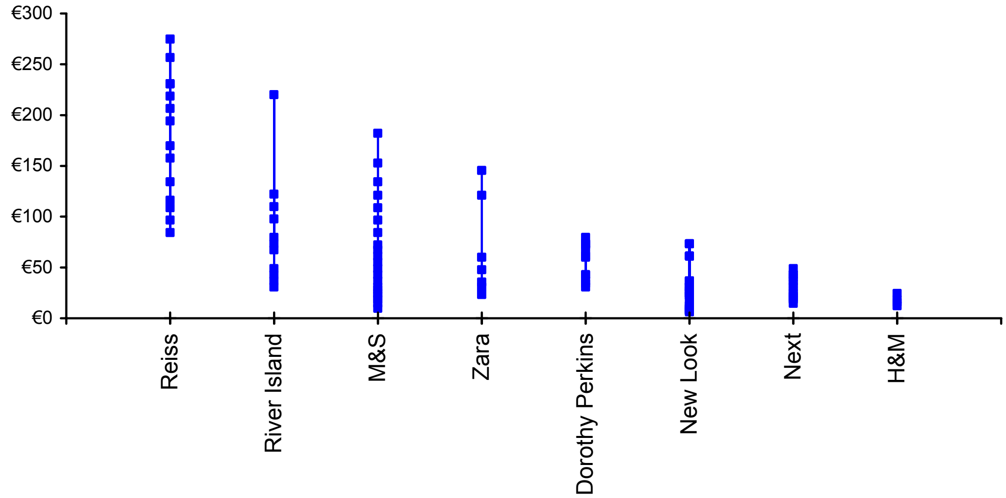
**Exhibit 112** **...As Well as a Broad Range of Accessible Luxury "Second-Tier" Brands That Also Focus in the €200 to €500 Price Band**




Source: Online store checks and Bernstein analysis.

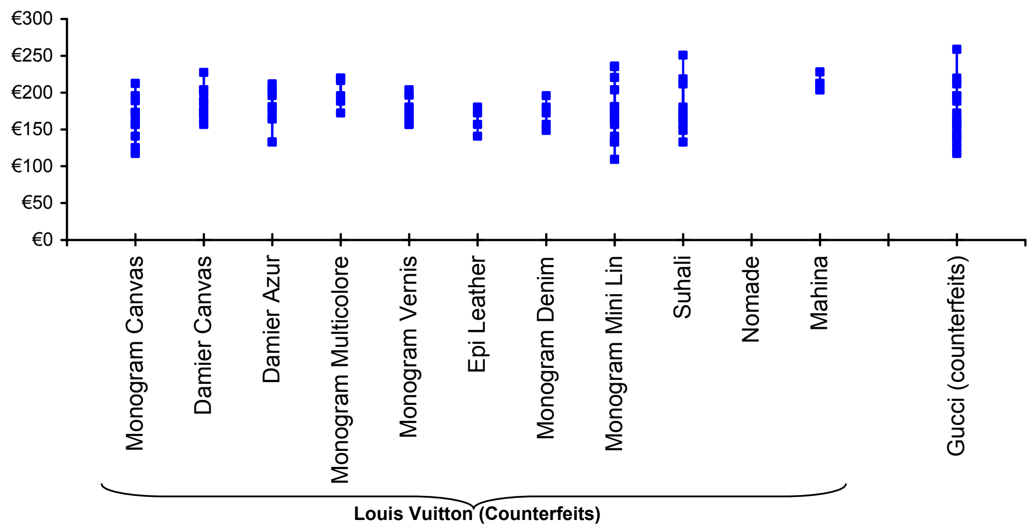
Lower quality/specification brands and counterfeiters have dominated the below-€200 segment so far. The segment of the handbags market that falls below the €200 threshold has so far been the realm of lower-quality and lower-specification brands — such as mass fashion and value retailers — and, importantly, that of counterfeiters (see Exhibit 113 and Exhibit 114).

**Exhibit 113** **Mass Fashion and Retail Brands Have So Far Dominated the <€200 Segment of the Handbag Market…**




Source: SCB store checks and Bernstein analysis.

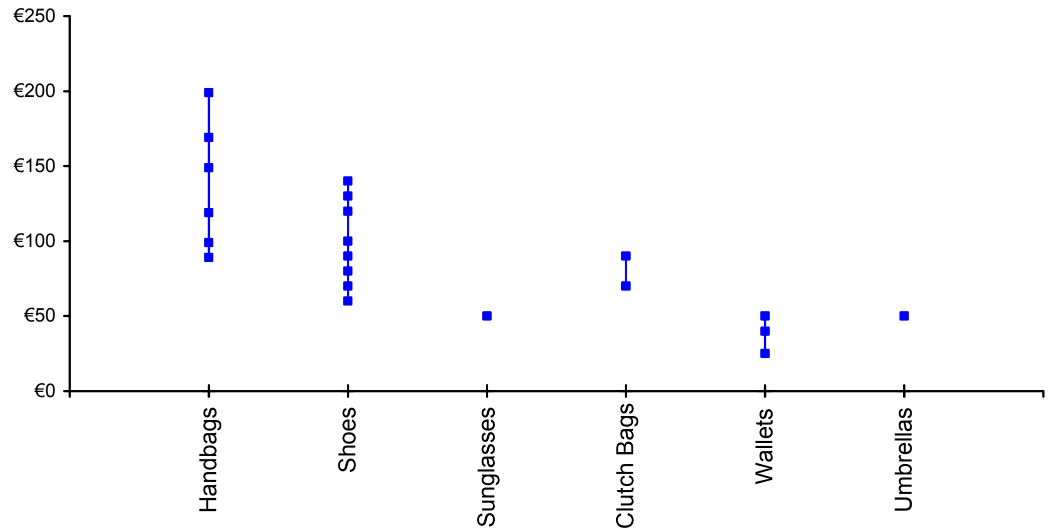
**Exhibit 114** **…While Imitators and Counterfeiters Have Provided Luxury Handbags at "Affordable" < €200 Prices**




Source: Internet and Bernstein analysis.

*Most recently, Inditex's Uterque has provided the quality answer in the lower-than-€200 price range.* We are impressed with Inditex new leather accessories store concept. We carried out store checks in Madrid in the past two weeks, and we found the new concept "ticking" many of the right boxes: (1) appealing product; (2) appropriate price range; (3) compact space to maximize productivity; and (4) high-quality environment to enhance the shopping experience. Both handbags and footwear have good range depth, with compelling price points on "iconic" designs. Handbags prices range from €89 to €199, with price points around €150 offering the widest choice (see Exhibit 115). We have a sense that the format may be ready for a high-profile rollout sooner rather than later. When we visited, the Serrano store was packed with people buying the products.

**Exhibit 115** **Most Recently, Inditex's Uterque Is the Quality Answer in the Lower-Than-€200 Price Range**

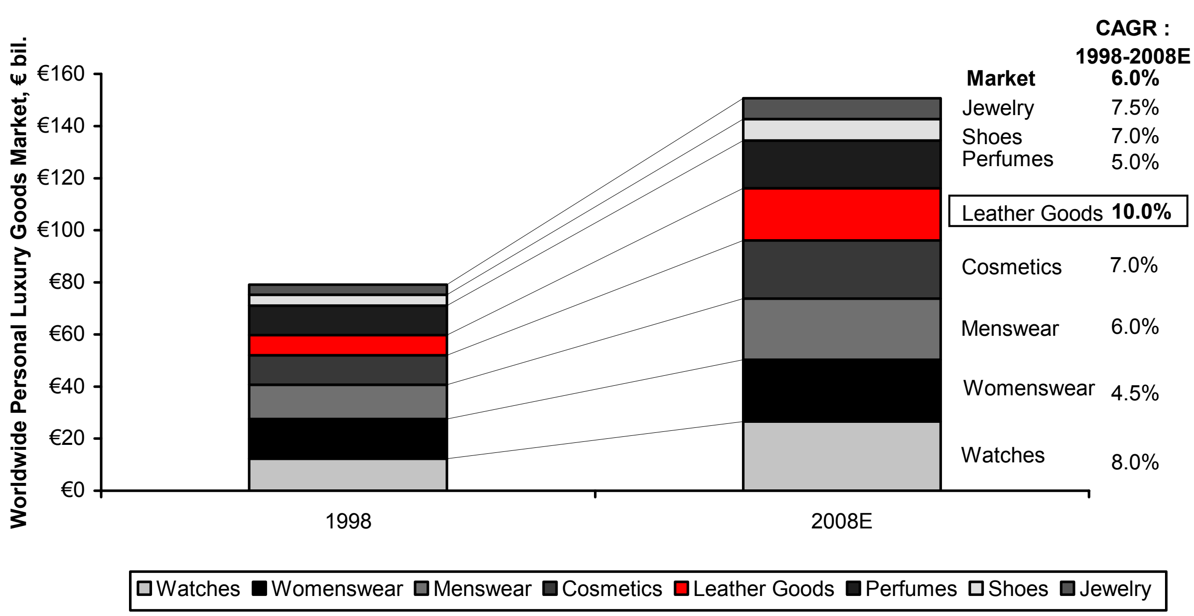



Source: SCB store check and Bernstein analysis.

**We Expect Handbags Will Continue to Remain Key for Luxury Players in Years to Come**

We expect handbags will continue to remain a key product category for "mega-brands" and for luxury players in years to come. Based on our historical correlation of luxury market growth to OECD real GDP growth, we anticipate that handbags will grow at a CAGR (2008-13E) of about 10%, versus approximately 4% for women's apparel and roughly 6% for the broader luxury goods market (see Exhibit 116).

**Exhibit 116** **We Expect Handbags Will Continue to Remain Key for "Mega-Brands" and For Luxury Players in Years to Come**



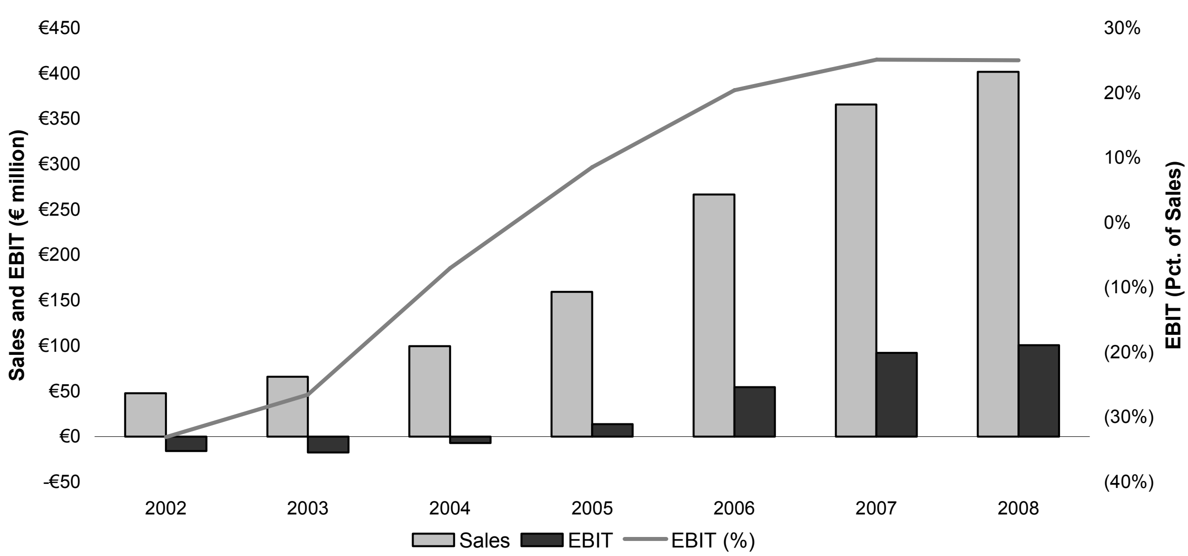

Source: Altagamma and Bernstein estimates and analysis.

While the development of the accessible segments is going to be an important driver of growth, we also see a window for global luxury players to seize the opportunity offered by the very high end of the market. High-end sophisticated consumers have been eager to embrace high-end niche brands that provide differentiation from the luxury "mainstream" mega-brands. However, high-end incumbents like Hermes and Chanel have provided little innovation on their iconic products. Hence, this space has opened up to new high-end champions: in our view, the best of these has been Bottega Veneta (see Exhibit 117).

We see further opportunity in this area, as consumers across markets continue to mature. Hence the interest for leading groups to develop or acquire brands that would allow them to play in the very high-end portion of the market (please refer to our recent *Blackbook* "Big Thinking on Small Caps: M&A Targets in Luxury Goods" published October 24, 2008). Brand layering is obviously another appropriate way to capture the opportunity, as experience indicates from other industries. Brands like Louis Vuitton have developed beefed-up "high-end" assortments in its offer, choosing to articulate the brand at various price points (e.g., on a recent store visit we found a limited edition crocodile-skin Lockit bag retailing at around £11,000).

In other sectors, like cars, Mercedes has been highly successful in maintaining high-end and mainstream luxury appeal through a brand layering strategy. We believe this could also prove productive in luxury leather goods, although the jury is still out.

**Exhibit 117 Bottega Veneta**




Source: Corporate reports and Bernstein analysis.

# Fashion & Leather Goods — A "Long Bench" of Tail Brands

**Mega-Brands Drive the Bulk of LVMH and PPR's Fashion & Leather Goods Results**

Both LVMH and PPR rely on mega-brands — Louis Vuitton and Gucci — for the bulk of their Fashion & Leather Goods results. We estimate that Louis Vuitton represents 71% of LVMH Fashion & Luxury Goods sales and >100% of LVMH Fashion & Luxury Goods EBIT. Gucci accounts for 65% of PPR luxury sales and 82% of PPR luxury EBIT. The 11 remaining brands in the LVMH Fashion & Luxury Goods portfolio account for 29% of Fashion & Luxury Goods sales and contribute negatively to EBIT. The remaining brands in the PPR portfolio account for 35% of luxury sales and 18% of luxury EBIT. Richemont does not have a mega-brand in Fashion & Luxury Goods; its five brands produce €642 million in sales and €1 million in EBIT (includes small non-Fashion & Luxury Goods brand Purdey).

In principle, it makes sense for leading luxury players to have a portfolio of niche brands to complement mega-brands. Mega-brands are perfect to satisfy the "need to belong" of emerging markets and aspirational consumers. Niche brands could instead serve the smaller audience of sophisticated luxury consumers and their "need to differentiate" — all the more so, as mega-brands continue to expand and to thrive both in developed markets and abroad (see Exhibit 118).

**Exhibit 118** **LVMH Has a Larger Stable of Non-Mega-Brands in the Fashion & Leather Goods Category Compared to Competitors**

*(Sales € billion/percentage of total fashion & leather goods sales)*

| | LVMH | PPR | Richemont |
|---|---|---|---|
| **Mega-Brands:** | Louis Vuitton (€4.3/71%) | Gucci (€2.2/65%) | — |
| **Other Brands:** | | | |
| Leather Goods: | Fendi<br>Celine<br>Loewe<br>Berluti (shoes)<br>Stefanobi (shoes) | Bottega Veneta<br>Sergio Rossi (shoes) | Dunhill<br>Lancel<br>Chloe |
| Fashion: | Donna Karan<br>Givenchy<br>Kenzo<br>Marc Jacobs<br>Pucci<br>Thomas Pink | Yves Saint Laurent<br>Balenciaga<br>Alexander McQueen<br>Stella McCartney | Shanghai Tang<br>Alaia |
| Total Other Brand Sales: | €1.73 | €1.17 | €0.64 |

**Note:** Richemont other brand sales of €0.64 represent 2008E estimates (fiscal year ending March 2009).

Source: Corporate reports and Bernstein analysis.

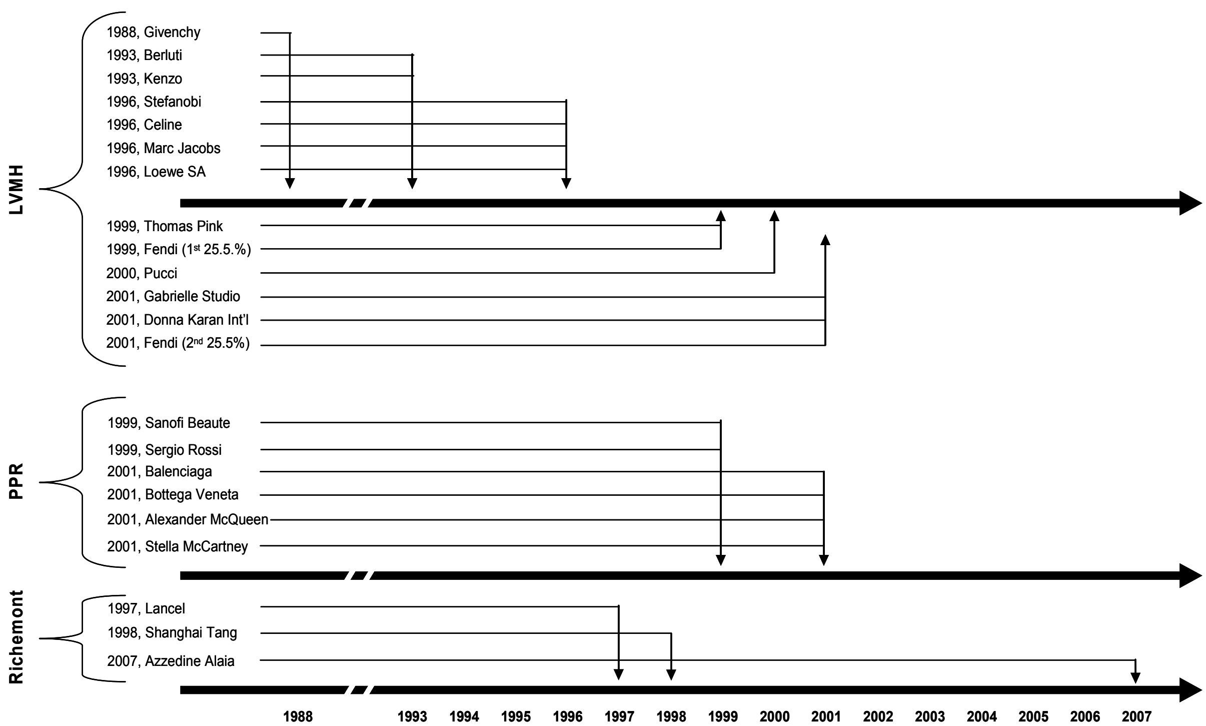
In practice, though, the complementary play of mega-brands and niche brands is working in only a handful of cases. The acquisition spree of the late 1990s has provided only isolated success stories, and created a "long bench" of underperforming brands. Bottega Veneta is the perfect example of a high-end niche brand honed to serve sophisticated consumers and rival Chanel and Hermes on their turf.

The most important lesson from the late 1990s is that designer and fashion brands (such as Donna Karan and Yves Saint Laurent) struggle to become profitable niche champions. For starters, re-launching designer brands and putting them back to center stage has proven close to impossible. This we believe depends on their more modest staying power and limited perceived intrinsic value. On top of that, running a designer brand is inherently more expensive, as it requires larger stores, more costly product development budgets, fashion shows, higher end-of-season clearance costs, etc.

The second most important lesson from the late 1990s is that "everything is not possible". Even when dealing with specialist brands: (1) mid-level brands (like in the case of Lancel) are very hard (impossible?) to move upwards; (2) tentative marketing execution and brand positioning backfire (like in the case of Celine); (3) questionable product and design content fails to put brands on the map (like in the case of Chloe); and (4) last, but not least, developing a luxury brand takes time and cannot be achieved overnight and according to formulaic procedures.

Exhibit 119 to Exhibit 122 show the acquisition history during the 1990s and provide color on the scale, premium and strategic rationale of these transactions.

**Exhibit 119** **Acquisition Activity in the Fashion & Luxury Goods Sector Gained Momentum in the Late 1990s and Early 2000s**




Source: Corporate reports and Bernstein analysis.

**Exhibit 120** **In the Late 1990s/Early 2000s Boom, LVMH Pursued Many Expensive Acquisitions ($ million)…**

| | | | | | Multiple of: | | | |
|---|---|---|---|---|---|---|---|---|
| Brand | Year Acquired | Transaction Value (mil.) | Sales | EBIT | Sales | EBIT | Transaction Notes | Transaction Rationale |
| Fendi | 2001 | $260 | — | — | — | — | Purchased 25.5% Prada Stake | Majority control; Prada was a willing seller |
| Donna Karan Int'l | 2001 | $243 | $706 | — | 0.3x | — | | 1st major fashion entrance into U.S. market; access to Donna Karan's design expertise; opportunity for synergies with LVMH International distribution infrastructure |
| Gabrielle Studio | 2001 | $400 | — | — | — | — | Gabrielle Studio owned Donna Karan trademarks | Completed just prior to DKI (above) transaction |
| Pucci | 2000 | — | $15 | — | — | — | 67% stake; three stores at time of purchase; internet strategy | Extremely strong brand name in Italy; growth avenue in accessories; viewed as having a high upside via internet channel |
| Fendi | 1999 | $1,788 * | $210 | — | 8.5x | — | 51% Joint Stake with Prada for $912 million | Aimed to quadruple revenues and make Fendi the next Prada |
| Thomas Pink | 1999 | £43 * | — | — | — | — | Acquired 70% stake for £30 million<br>20 retail stores at time of purchase | Participate in the accelerated development of the luxury shirt brand in the U.S. market |
| Loewe SA | 1996 | $207 * | $140 | — | 1.5x | — | Acquired remaining 77% for $160 million | Defense of 90% stake in Loewe Int'l — a distributor outside of Spain |
| Marc Jacobs | 1996 | | | | | | 96% Stake in Mark Jacobs Int'l and 33% in Trademark. Provided funding of store ops in 1996 in conjunction with partnership | Wanted a "hip" designer; also funded Jacobs' own line as part of deal |
| Celine | 1996 | $535 | $393 | $40 | 1.4x | 13.5x | | Continued effort to realize synergies in Fashion & Luxury |
| Stefanobi | 1996 | — | — | — | — | — | | |
| Kenzo | 1993 | $88 | $150 | — | 0.6x | — | | Fashion & Perfumes Expertise |
| Berluti | 1993 | — | — | — | — | — | | |
| Givenchy (fashion) | 1988 | $26 | — | — | — | — | Already owned perfume business | |

**Note:** Transaction values grossed up to reflect partial purchases made by LVMH.

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 121** **…PPR Acquired Fewer Companies, But Nonetheless Pursued Multiple Premium Acquisitions ($ million)**

| Brand | Year Acquired | Transaction Value (mil.) | Sales | EBIT | Multiple of: Sales | Multiple of: EBIT | Transaction Notes | Transaction Rationale |
|---|---|---|---|---|---|---|---|---|
| Balenciaga | 2001 | — | $18 | — | — | — | | Red-hot brand and designer at time of purchase; potential to transform into a mega-brand |
| Bottega Veneta | 2001 | $234 * | $50 | — | 4.7x | — | 67% stake for $157 million | Strong brand in the high-quality leather accessories and shoes segment fits into core areas of expertise |
| Alexander McQueen | 2001 | — | — | — | — | — | 51% Stake | |
| Stella McCartney | 2001 | — | — | — | — | — | Partnership | |
| Sergio Rossi | 1999 | $137 * | $60 | — | 2.3x | — | 70% stake for $90 million | Transform into a global brand outside of Italy that leverages Gucci distribution infrastrucutre |
| Sanofi Beaute (YSL & Beauty Business) | 1999 | $1,000 | $700 | — | 1.4x | — | Announced concurrently with deal to purchase Gucci stake | |

**Note**: Transaction values grossed up to reflect partial purchases made by PPR.

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 122** **Richemont Has Gone for a Lower-Risk M&A Approach, in Comparison to LVMH and PPR ($ million)**

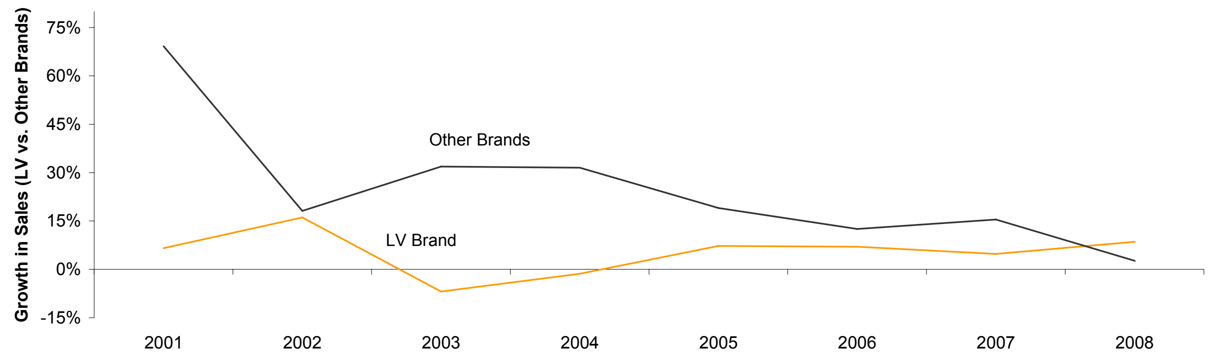
| Brand | Year Acquired | Transaction Value (mil.) | Sales | EBIT | Multiple of: Sales | Multiple of: EBIT | Transaction Notes | Transaction Rationale |
|---|---|---|---|---|---|---|---|---|
| Azzedine Alaia | 2007 | — | $18 | — | — | — | | Partnership with renowned fashion designer |
| Shanghai Tang | 1998 | — | — | — | — | — | Majority Stake | |
| Lancel | 1997 | $236 | $2,068 | $352 | 0.1x | 0.7x | | Reinforce position in luxury leather goods |

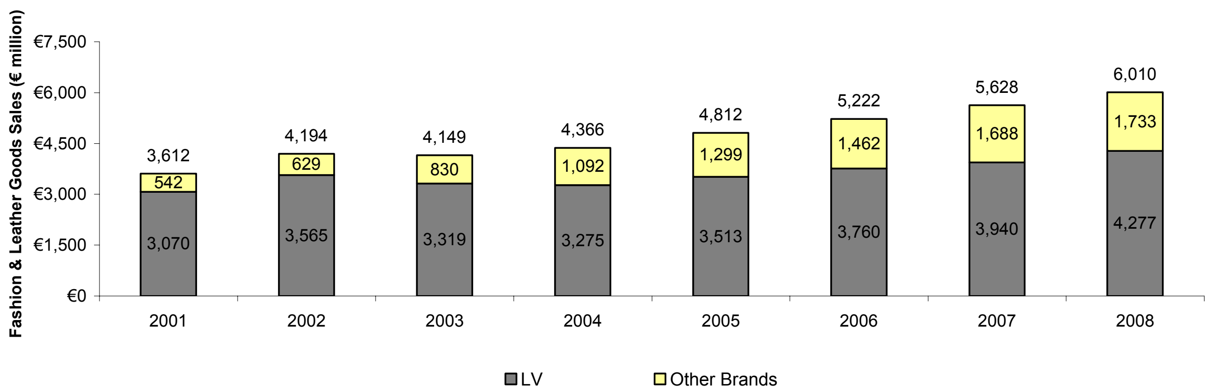
Source: Factiva, corporate reports and Bernstein estimates and analysis.

At the top line, both PPR's and LVMH's other brands have generally exhibited stronger growth relative to each of the respective mega-brands. Given that a key strategy of many of these smaller brands is to branch out and become increasingly global, it is no surprise that sales have come in as a result of significant investments being made with an eye to achieving this top-line trajectory — whether it be via advertising spend, DOS expansion or licensing agreements, etc.

Since 2001, LVMH's other brands have been able to grow at a rapid pace and at levels above the LV brand — with the exception of 2008 (see Exhibit 123). Consequently, these brands now contribute 10% of total LVMH group sales compared to only 4% of total sales in 2001 (see Exhibit 124). Over this period the Louis Vuitton brand contribution has held constant at around 25% of total sales, and when its sales are added to the other brands, the combined brands make up 35% of total LVMH group sales.

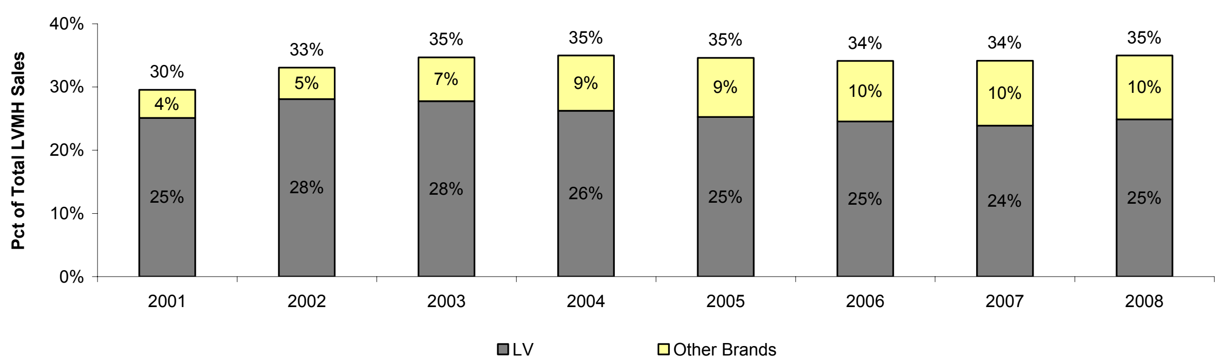
**Exhibit 123** **LVMH's Fashion & Leather Goods Non-Mega-Brands Have Outgrown the Core Louis Vuitton Brand in Recent History…**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 124** **…And Now Contribute Approximately 10% of Total LVMH Group Sales**

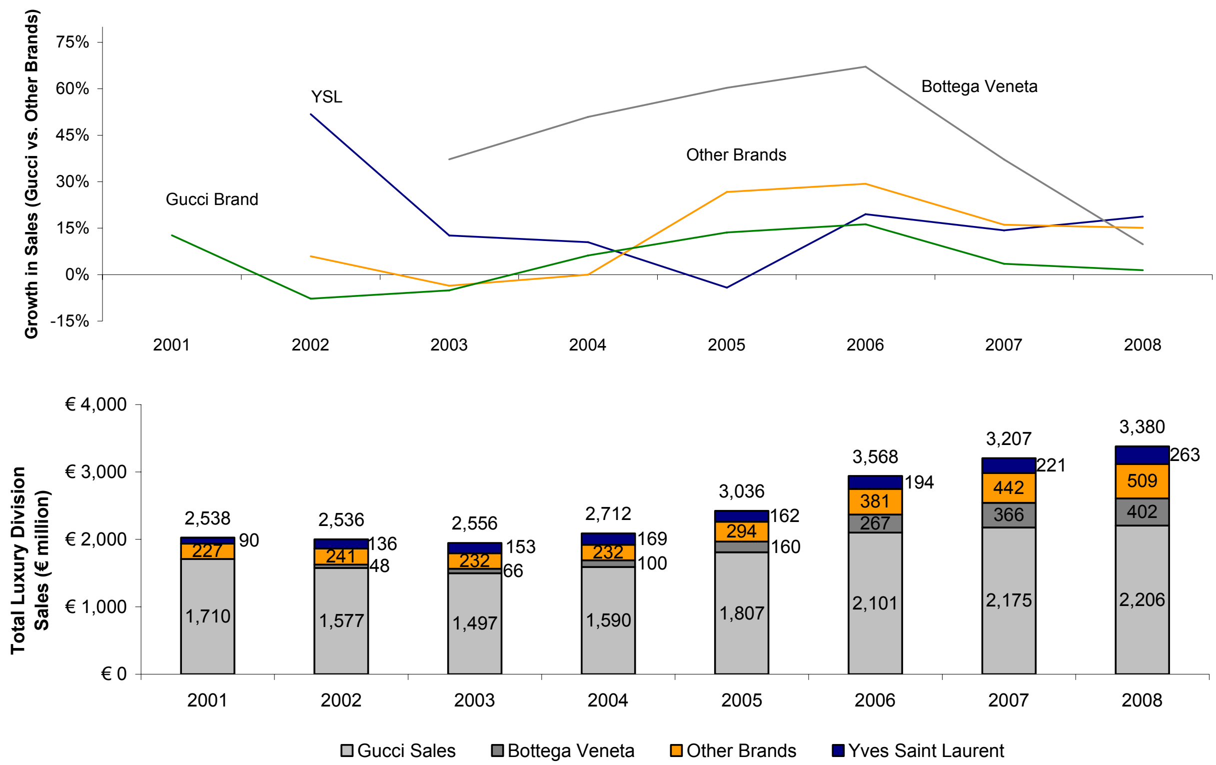



Source: Corporate reports and Bernstein estimates and analysis.

Growth in PPR's other brands follows a similar trend to that at LVMH. Growth has outpaced the Gucci mega-brand, and more specifically, the Bottega Veneta brand has experienced significantly higher growth compared to both Gucci and the other brands (see Exhibit 125).

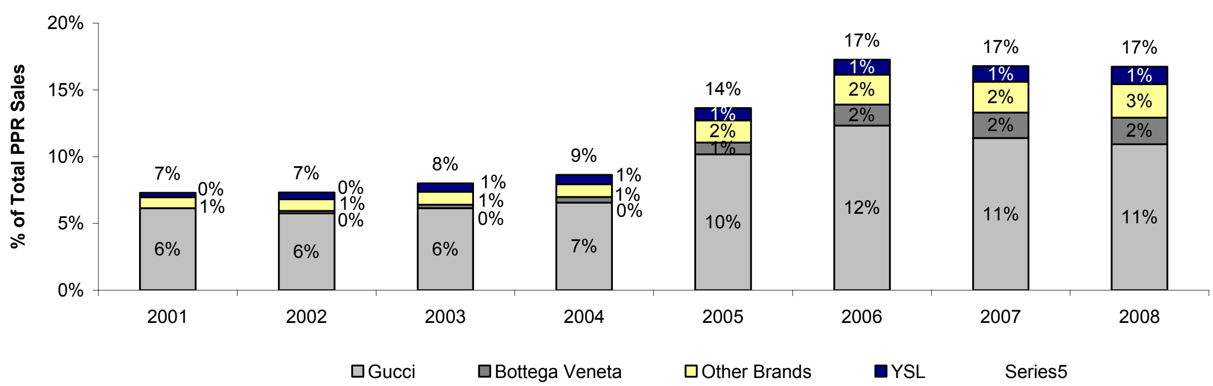
In contrast to LVMH, the total sales contribution (17%) of PPR Luxury (Gucci + Other Brands) to total group sales is almost half the contribution of LVMH's Fashion & Leather Group division to total LVMH sales (35%) (see Exhibit 126). A large contributing factor to this situation is PPR's retail division, which generates a significant amount of sales (€14 billion) accompanied by low EBIT margins (4.9%).

**Exhibit 125** **Similar to the Trend With LVMH, PPR'S Other Fashion & Leather Group Brands Have Also Outgrown the Mega-Brand Gucci…**




Source: Corporate reports and Bernstein analysis.

**Exhibit 126** **Through Faster Growth and General Retail Divestitures, the PPR Luxury Brands Have Moved from 7% to 17% of Total PPR Group Sales**

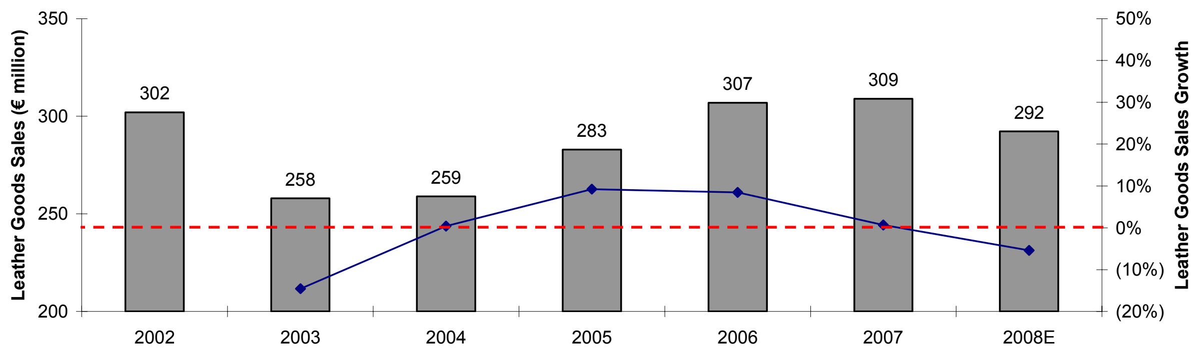


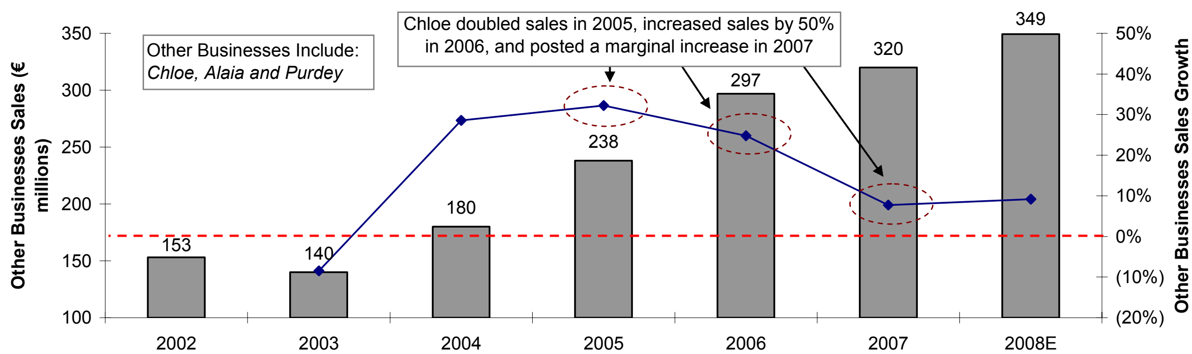

Source: Corporate reports and Bernstein analysis.

Richemont does not have a mega-brand in the Fashion & Leather Group, and its other brands — with the exception of Chloe — have been unable to sustain strong growth momentum (see Exhibit 127). In fact, Dunhill has been undergoing a restructuring of its business and looking to improve its wholesale position in the United States and improve the productivity of its directly-operated stores (DOS) footprint. On the positive side, the new boutique format has already shown some signs of success, though there is still much work to be done.

On the other hand, Chloe has undergone rapid growth over the past few years — albeit weak in 2007 — and seems to be on track for a promising niche champion role. Although Richemont does not disclose sales figures for the brand (classified in "Other Businesses"), the aforementioned rapid growth has helped to make Chloe a much more sizeable brand. Richemont does, however, disclose Chloe's growth. This enabled us to back into Chloe's sales after making an assumption about Purdey's growth and after backing out other disposed/acquired businesses. From our analysis, we calculated Chloe sales to be approximately €245 million — approximately the same size as YSL (see Exhibit 128).

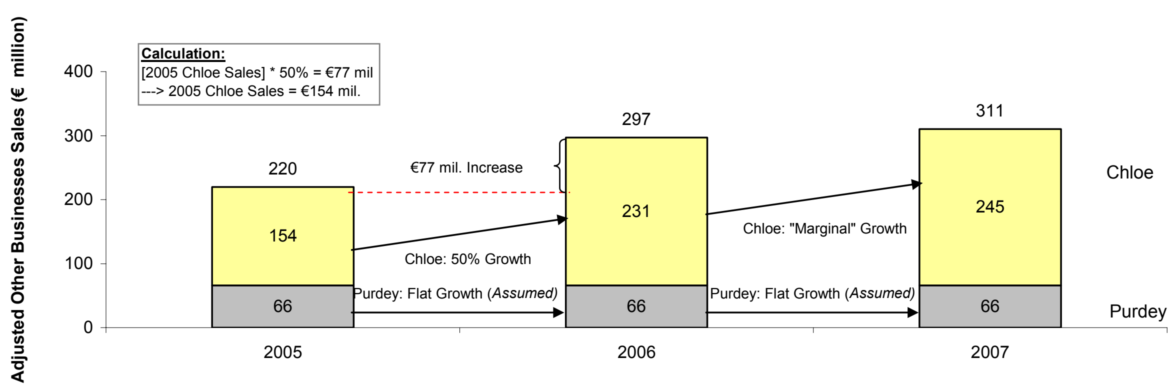
**Exhibit 127** **Richemont's Leather Goods Businesses — Alfred Dunhill and Lancel — Have Struggled to Generate Healthy Top-Line Growth, Whereas Chloe Has Boosted Sales Via Rapid Expansion of Its Directly-Operated Stores**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 128** **Chloe Is Growing and Seems to Be on Track For a Promising Niche Champion Role**

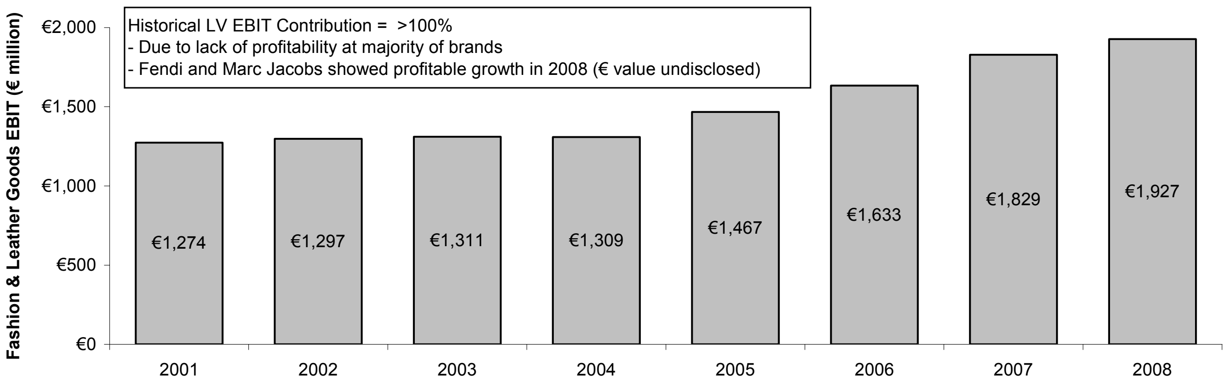



**Note**: Chloe's sales figures not disclosed by company. 2005 reflects P/F adjusted sales, revised downward from €238 million due to €18 million attributable to the disposal of Hacket and Old England during 2005. 2007 reflects addition of Alaia in late 2007 and smaller add-ons.

Source: Corporate reports and Bernstein estimates and analysis.

Within LVMH's Fashion & Leather Group division, the Louis Vuitton brand contributes the vast majority of EBIT. Although the exact figures are not disclosed, we believe it has more than 100% EBIT contribution due to the negative contribution of the other brands and relatively marginal impact on profitability of Fendi and Marc Jacobs (see Exhibit 129).

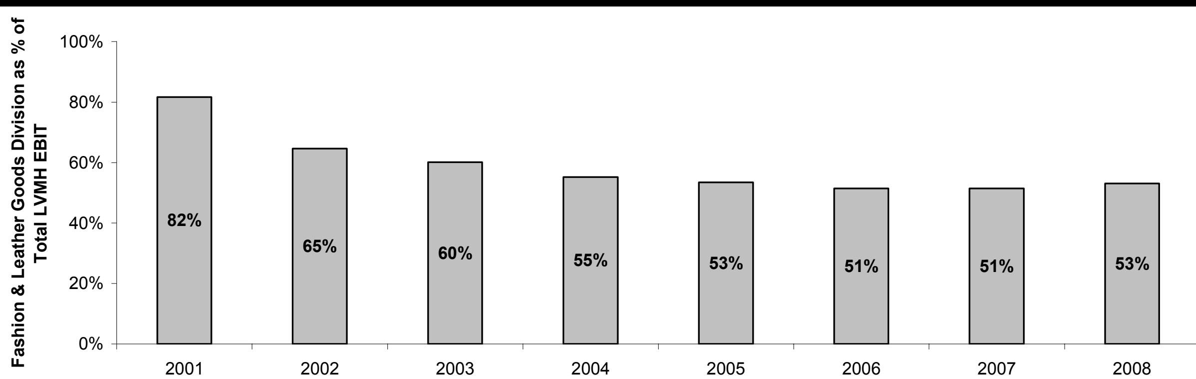
**Exhibit 129** **The LV Brand Continues to Be the Main Driver of LVMH's Profitability, as the Other Fashion & Leather Goods Brands Have Yet to Achieve Material Levels of Operating Income…**




Source: Corporate reports and Bernstein estimates and analysis.

Even with increasing absolute levels of profitability from LVMH's Fashion & Leather Group, the division as a whole contributes less to total company EBIT now when compared to previous years, as smaller divisions have outgrown the Fashion & Leather Group. Currently, it contributes 53% of total company EBIT (see Exhibit 130).

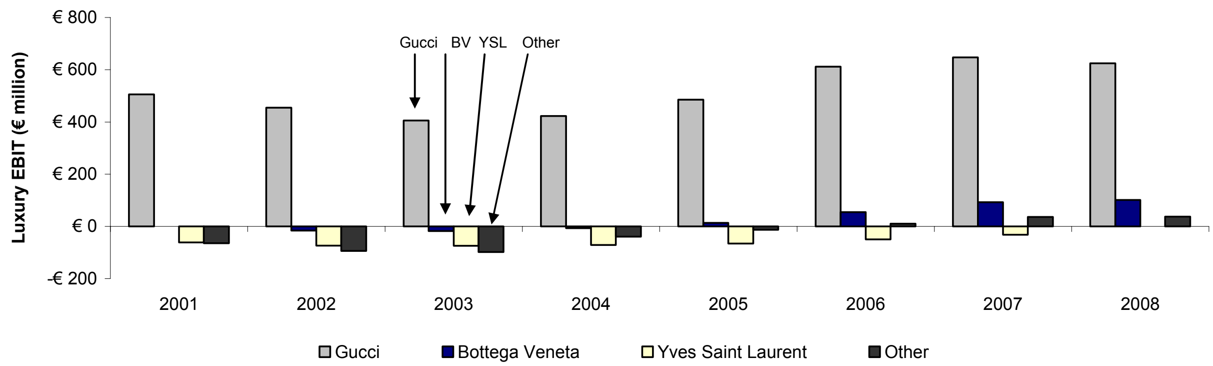
**Exhibit 130** **…Yet the LV Brand — And the Fashion & Leather Goods Division as a Whole — Has Had Less of an Impact on Total Company Profitability in Recent Years, as Smaller Divisions Have Outgrown F&LG**




Source: Corporate reports and Bernstein analysis.

Similar to LVMH, PPR had to focus efforts to bring its other brands to profitable levels. In the past few years PPR has been able to bring all of its Fashion & Leather Group brands into positive territory, showing particular success with the Bottega Veneta brand (see Exhibit 131). Although not profitable to the same degree as Bottega Veneta, Yves Saint Laurent (YSL) has steadily turned itself around from the negative EBIT performances earlier in the decade.

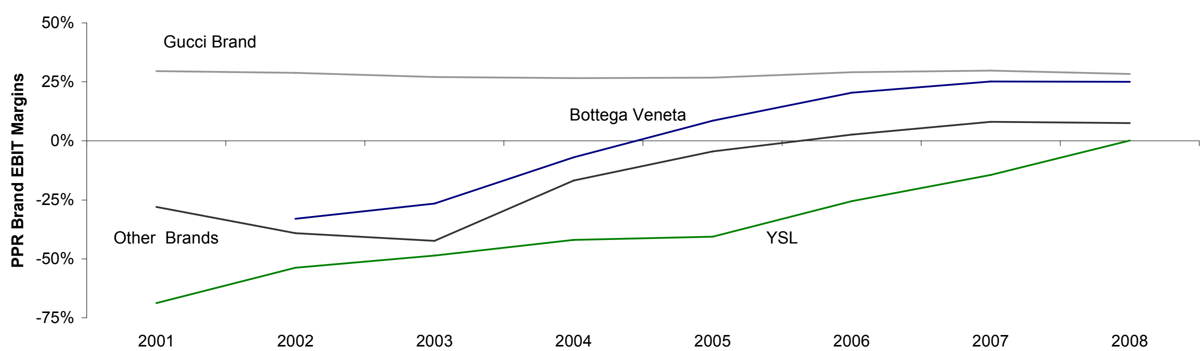
**Exhibit 131** **As Observed With LVMH, PPR's Other F&LG Brands Have Contributed Negatively to Operating Profit — However, in the Past Few Years PPR Has Been Able to Bring All of Its F&LG Brands Into Positive Territory**




Source: Corporate reports and Bernstein analysis.

By examining margin trends, the performance improvement at PPR's other brands is even clearer. First, Bottega Veneta's margins were below negative 25% in 2002 and have dramatically increased to around 25% currently — only slightly below the margins Gucci has been consistently posting (see Exhibit 132). This is a remarkable achievement, and possibly the best success story in the industry for the past five years. Second, YSL has gone from a significant cost burden to approximately breakeven in 2008.

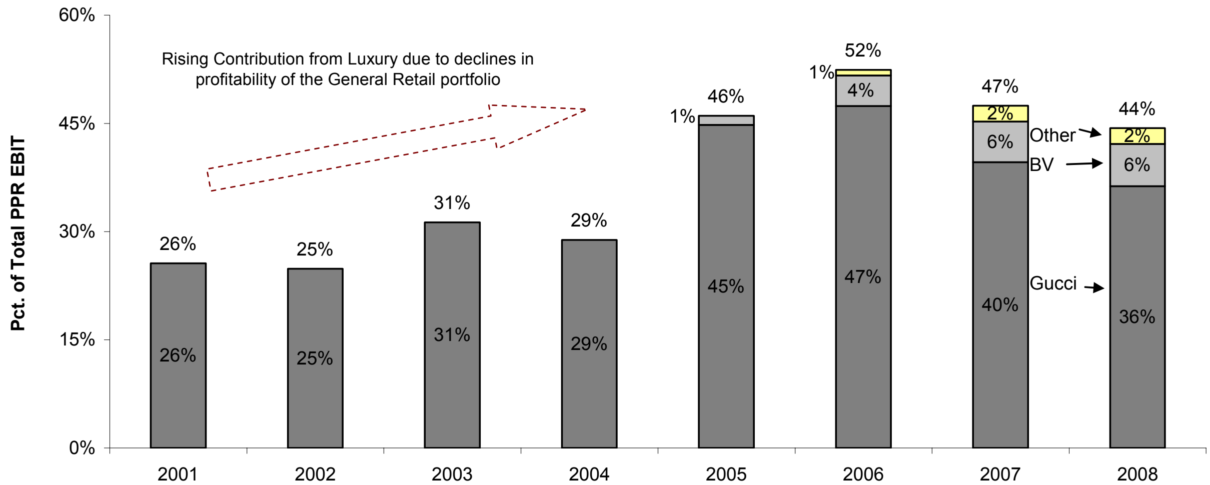
**Exhibit 132** **In Fact, Bottega Veneta Has Already Begun to Achieve Operating Margins Near Those of Gucci — a Remarkable Achievement, and Possibly The Best Success Story in the Industry for the Past Five Years**




Source: Corporate reports and Bernstein analysis.

The improving margin trends and absolute margin levels generally associated with premier luxury brands highlight the potential earnings power of PPR's other brands. Interestingly, although PPR's luxury brands only contribute 17% of total group sales, they contribute 44% of total group EBIT — demonstrating the importance to successfully execute on these brands (see Exhibit 133).

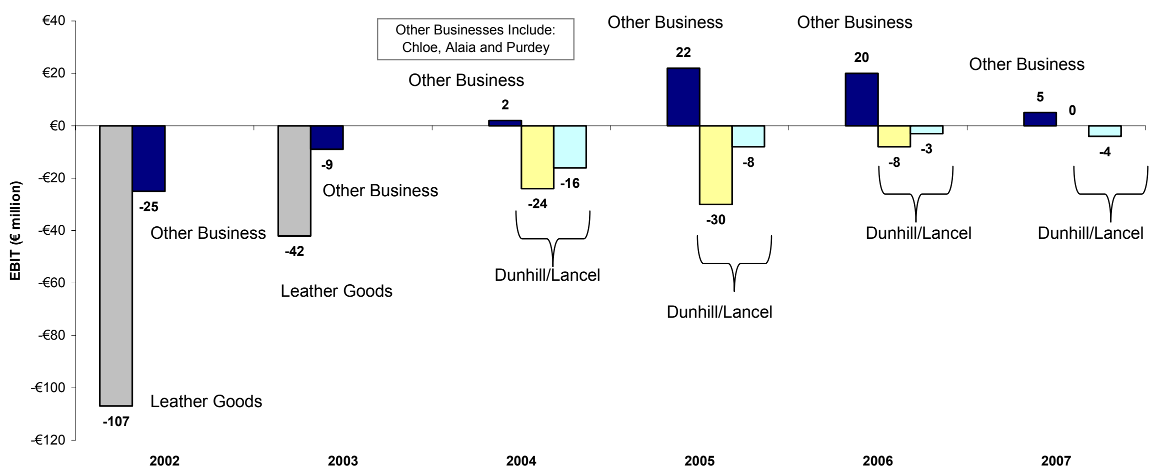
**Exhibit 133** **Although a Small Top-Line Contributor, Bottega Veneta's Recent Performance Has Increased Its Total Company EBIT Contribution to 6% — Lower Than That of Gucci But Nonetheless Evidencing the Potential Impact of Non-Mega-Brands on Total Group Profitability**




Source: Corporate reports and Bernstein analysis.

Richemont's brands in leather goods have had significant issues in the past, but recent restructuring efforts at Dunhill have seen the division reduce the negative contribution to approximately breakeven at the end of 2007. Coinciding with the restructuring at Dunhill, disposals of non-core other businesses and the rapid expansion at Chloe has helped to better align that business segment for future profitability (see Exhibit 134).

**Exhibit 134** **Richemont's Presence and Performance in Fashion & Leather Goods has Lagged LVMH and PPR; Alfred Dunhill and Lancel have Historically Underperformed, Though Restructuring Efforts are Making Progress**

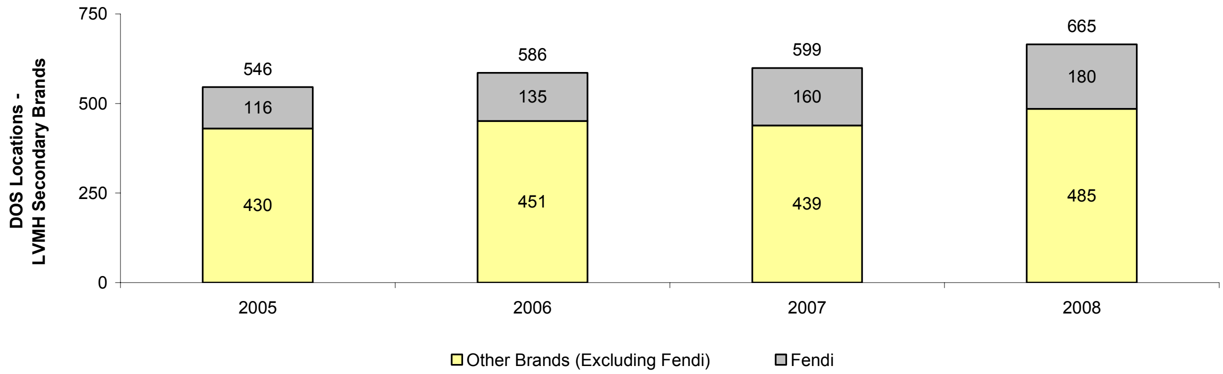



**Note:** Dunhill and Lancel breakdown of operating profit not provided prior to 2004.

Source: Corporate reports and Bernstein estimates and analysis.

The other brands at all three companies utilize different channel mixes. In each case, the larger, more global brands have directed much attention to developing a DOS footprint. The leader in DOS distribution by store count is LVMH, as its DOS footprint for its other brands is almost twice the size of either PPR or Richemont (see Exhibit 135). Fendi constitutes the majority of DOS footprint for LVMH, while smaller brands such as Berluti and Pucci do not ignore the channel, but are more selectively located (less than 50 locations each).

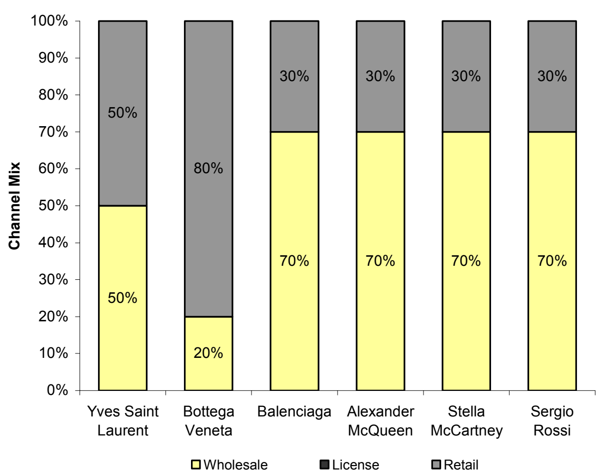
**Exhibit 135** **LVMH's Other F&LG Brands Have a DOS Footprint That Is More Than 2x the Size of PPR or Richemont's Other Brand Retail Footprint**

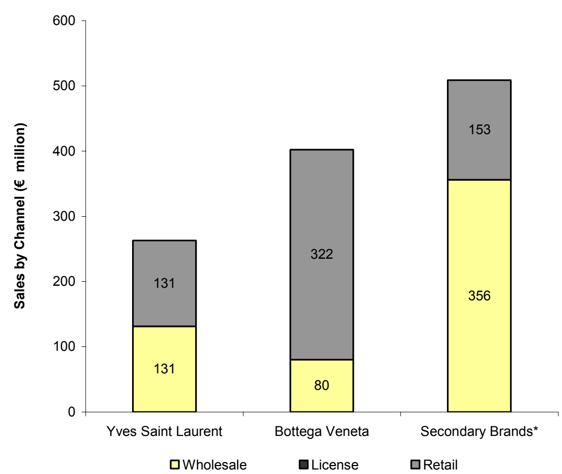



Source: Corporate reports and Bernstein analysis.

PPR's largest other brands are also more highly exposed to the retail channel than the smaller ones, which instead utilize wholesale and licensing to a greater extent (see Exhibit 136). Much of PPR's expansion into the retail channel has been on the momentum of Bottega Veneta's growth. Since 2005, Bottega Veneta's DOS footprint has grown 46%, from 83 locations to 121 locations (see Exhibit 137).

**Exhibit 136** **PPR's Largest Brands Are Focused on the Retail Channel, While Wholesale Constitutes the Majority of the Other Brands' Sales**

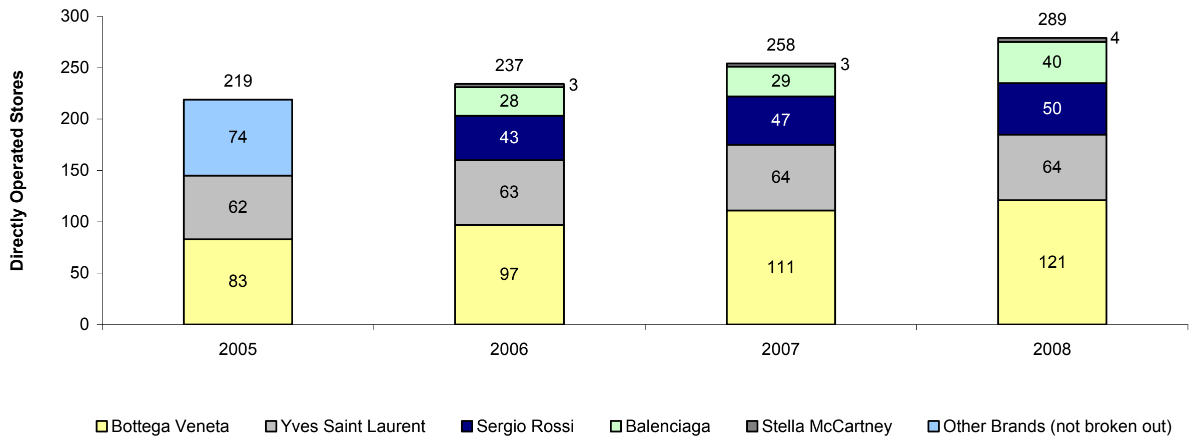



**Note:** Other Brands reflects an average channel mix of Balenciaga, Alexander McQueen, Stella McCartney and Sergio Rossi.

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 137** **Bottega Veneta's DOS Count Has Grown by 46% Since 2005, While PPR's Other Brands Have Experienced More Subdued DOS Growth**

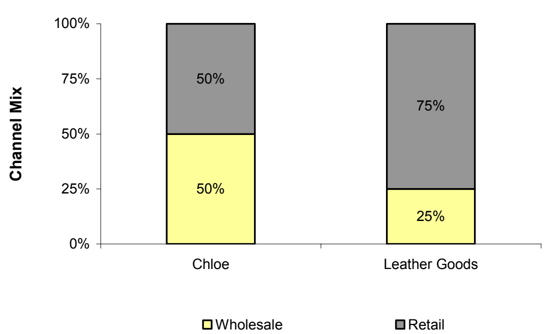


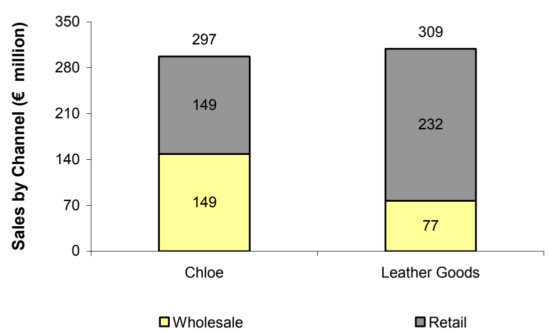

Source: Corporate reports and Bernstein analysis.

The retail channel is an essential component of Richemont's Fashion & Leather Group brands. The balance of which has been part of the focus of Dunhill's restructuring, which has seen it seek to improve wholesale operations in the United States, as well as to rationalize and improve the store formats.

Chloe, meanwhile, has approximately equal exposure to each channel (see Exhibit 138). Much of the brand's recent top-line growth can be attributed to the rapid retail expansion over the past few years, which has seen its store count go from 14 in 2004 to 248 by 2007 (see Exhibit 139).

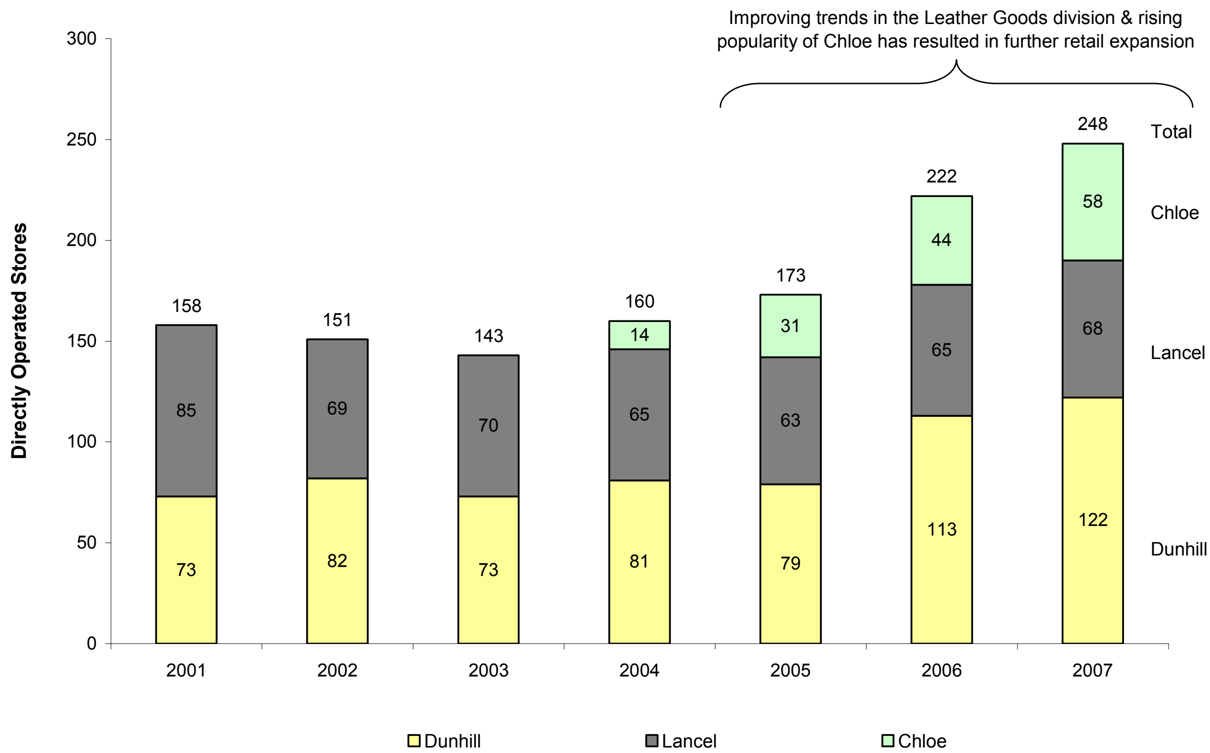
**Exhibit 138** **Richemont Channel Mix: Chloe Has Expanded Its Retail Operations While the Leather Goods Division Began to Increase Focus on the U.S. Wholesale Market and to Implement Redesigned DOS Formats**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 139** **Richemont Has Rolled Out More Chloe Retail Points of Sale in an Effort to Expand the Channel, While More Dunhill Stores Have Been Added as the New Boutique Concept Has Been Successfully Implemented in c. 25% of the Network**



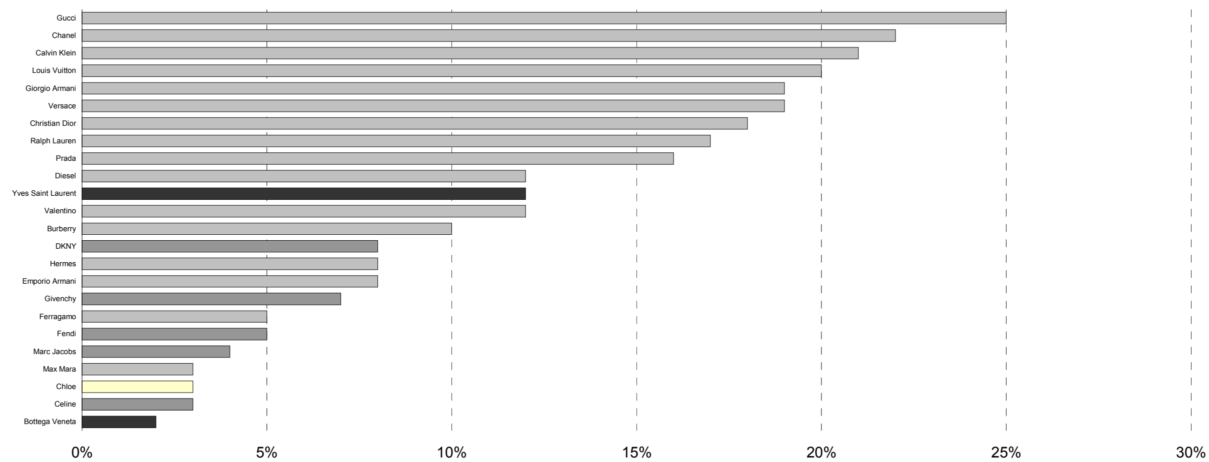

Source: Corporate reports and Bernstein analysis.

Not surprisingly, the mega-brand status enjoyed by Gucci and LV make these brands some of the most coveted in the world. A further positive lies in the fact that these companies' other brands also populate the list of the most coveted luxury brands according to a survey conducted by AC Nielsen research (see Exhibit 140).

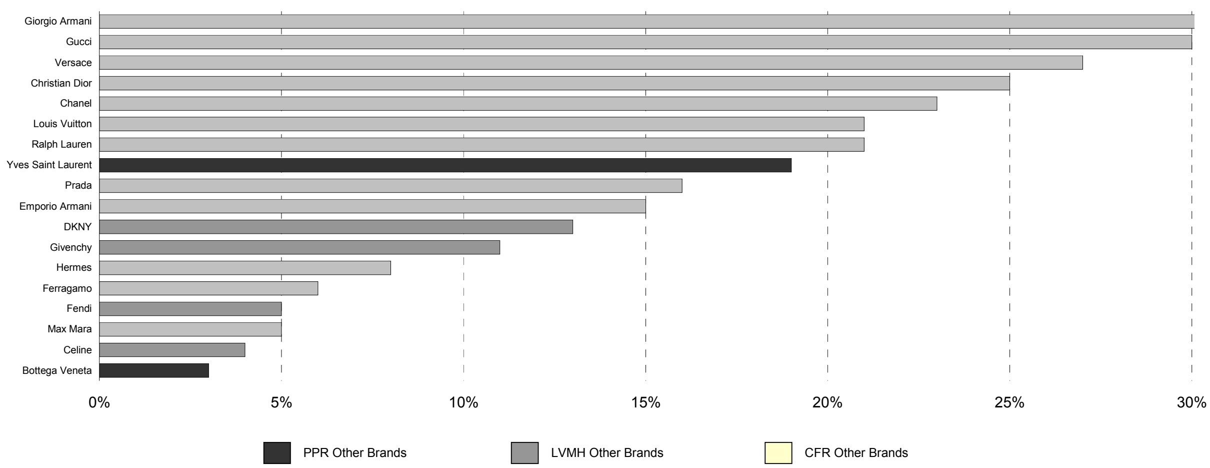
YSL and Bottega Veneta represent PPR, Chloe represents Richemont and DKNY, Givenchy, Fendi, Mark Jacobs and Celine all represent LVMH.

**Exhibit 140** **Both PPR and LVMH Have Multiple Other Brands at the Top of Consumers' Minds — Consumers Responded as Follows When Asked the Question: "Which of the Following Brands' Products Would You Prefer to Buy in the Future If Money Was No Object?**

**Percentage of Respondents Indicating the Brand (May 2008)**




**Percentage of Respondents Indicating the Brand (May 2006)**




Source: AC Nielsen and Bernstein analysis.

In summary, of the companies in our coverage PPR seems to have the most compact brand line-up. Bottega Veneta is probably the most credible non mega-brand champion, ahead of rival Fendi. YSL — far from being a key contributor — is now back in the black. Other small brands like Balenciaga seem to show a potential of continuing future development as high-end niche champions. LVMH, on the other hand, remains saddled with a "long bench", bound to revert to red ink in a difficult time like this. Richemont is well behind the leaders in the Fashion & Leather Group, its brands in this area would not seem enough to put it on the map as a key force in this category.

# Champagne — The Bubble Has Burst, But Ultimately the Fizz Is Likely to Return

## What Makes Champagne Special?

At its simplest, champagne is a sparkling wine made from grapes grown in a specified area in Northern France.

The process starts with the production of a base wine. There are three predominant permitted grape varieties: pinot noir (which gives body), pinot meunier (which gives fruit) and chardonnay (which gives elegance). So champagne is one of the few examples in the world of a white wine that is made from red grapes. The first critical factor is that Champagne region is right at the northern climatic limit of where it is possible to reliably ripen grapes. As a result, the base wine is very, very acidic and often low in natural sugar so that is often chaptalized i.e., extra sugar is added to give sufficient substrate for the yeast to increase the alcohol content by up to an extra 1.5% to reach 10.5-11.0%. Another feature of champagne is that yields per hectare of land are very high compared to other fine wine regions. Current regulations permit production in good years of up to 15,500 kilograms/hectare which equates to just under 100 hectoliter/hectare, compared to 40 hectoliter/hectare that is typical in other regions. Furthermore, this is the average yield; the maximum per individual plot is 21,700 kilograms/hectare equivalent to 140 hectoliter/hectare.

The wines are generally fermented in stainless steel but some of the luxury cuvées are fermented in oak barrels. This is most notably the case for Krug and Bollinger and produces very full-bodied wines.

Next we come to the bubbles. The base wine is turned into sparkling wine by a secondary fermentation. The wine is filled into bottles, a mixture of wine sugar and yeast *(liqueur de tirage*) is added, and the bottle is sealed, typically with a crown cap. The yeast turns the sugar into alcohol (bringing the ABV up to 12%) & $CO_2$, which makes the bubbles. The yeast die, fall to bottom of the bottle and decompose. Although it sounds a bit messy, this so-called autolysis is very important part of achieving the right flavor profile and gives champagne its characteristic biscuity aromas.

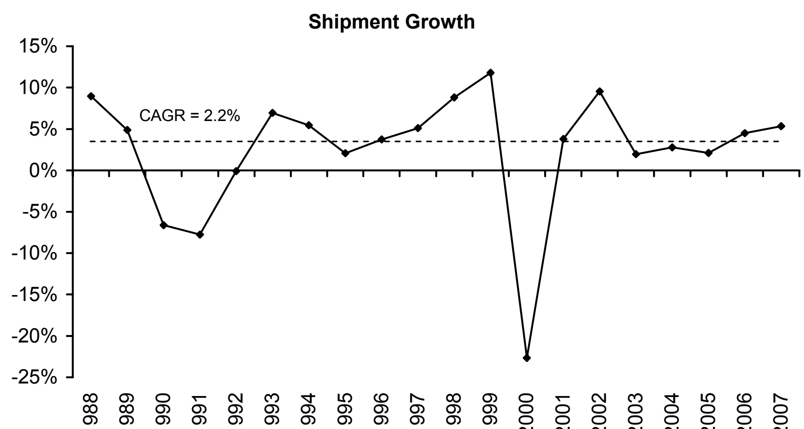
Champagne is aged for a minimum of 15 months to enable the secondary fermentation to complete and for the flavor profiles to harmonize. Most champagne sees only 15 months of ageing but vintage champagne must be aged for three years and some deluxe champagnes are aged up to 10 years. In general, the longer the ageing, the smaller the bubbles. When the secondary fermentation is complete, the bottle is slowly inverted and turned over the course of several weeks, so that all the sediment settles on top of the cap (a process known as *remuage*). After all the sediment has settled, the neck of the bottle is frozen, the cap is removed and the frozen plug pops out. The bottle is then refilled with a mixture of wine and sugar (the so-called *liqueur de dosage*) and corked. Nearly all champagne, whether sweet or dry, contains some sugar to balance the intense natural acidity. For instance, Brut champagne can contain up to 15 grams of sugar per liter.

The final particularity of champagne is that most champagne is non-vintage (NV). Because Champagne is in an area of marginal production for grapes, the weather and hence the quantity and quality of grapes can vary enormously from one year to the next. The actual liquid that goes into the secondary fermentation is typically a vertical blend of wines across vintages and the wine is labeled NV. The major firms will typically use between 10% and 50% of wines from previous vintages to ensure consistency across the years. In good vintages (at least in theory only in good vintages), the best wines are bottled as vintage champagne, with only wines from that year going into the blend. Furthermore, all the major houses have ultra-premium products, known as deluxe or prestige cuvées. Arguably the first of these was Cristal from Roederer which was created for the Russian Imperial court at the end of the 19th century. Perhaps the most famous of the prestige cuvées is Dom Pérignon which was launched in 1928 using the 1921 vintage.

The industry is divided between champagne houses and growers. The most famous representatives of champagne are the large champagne houses who own well-known brands such as Moët et Chandon and Laurent Perrier. However, the big producers do not in general own the land. Only 11% of the champagne vineyards are owned by the champagne houses. The rest is owned by over 15,000 growers. This makes access to sufficient quantity of high-quality grapes critical to success, especially since the bought-in grapes make up approx 75% of the costs of making champagne. As well as the big houses who produce 70% of volume and 90% of exports, there are two other major types of producers: owner-producers (i.e., growers who make champagne under their own label) and the co-operatives (e.g., CVC who own the Nicholas Feuillatte brand).

Long-term supply-demand prospects are positive. Over there last 20 years, there has been an underlying steady increase in demand for champagne, with an average volume growth of 2.2% per annum (see Exhibit 141). However, the pattern of growth has been interspersed by regular crises. In 1990, the price of grapes was de-regulated and grape prices rose 18%. The champagne houses attempted to recoup their cost by raising their prices, right in the teeth of a global recession and demand fell by 14% over two years. Even after subsequent falls in both grape prices and the price of champagne, it took until 1996 before the high-water mark of 1989 was passed.

**Exhibit 141** **Over The Last 20 Years, There Has Been Average Volume Growth of 2.2% Per Annum**




Source: CIVC, corporate reports and Bernstein analysis.

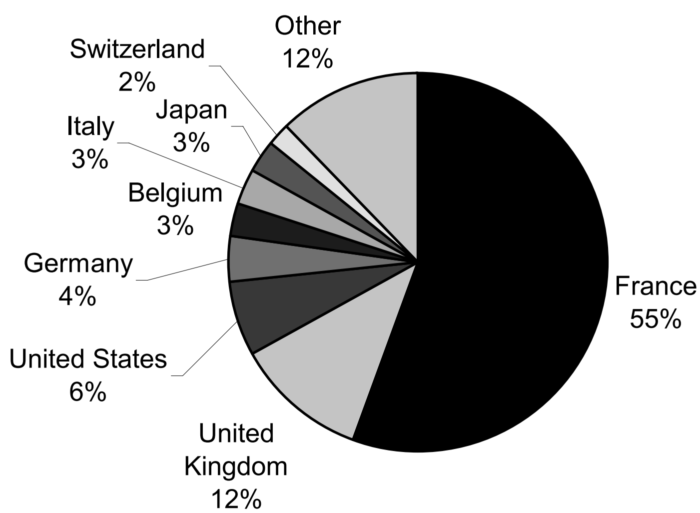
The next crisis came 10 years later. Shipments in 1998 and 1999 were strongly influenced by the hype surrounding the Millennium New Year's Eve. However, the degree of optimism on consumption was unwarranted and there was massive channel overstocking, leading to a 23% fall in 2000 shipments. After these three years of boom and bust, 2001 came in at much the same level as 1997.

## The French Market Remains Extremely Important to the Champagne Industry

France remains the largest market by far, accounting for 55% of global volumes (see Exhibit 142). However, its value share is much lower because most of the consumption is supermarket exclusive brands and growers' own brands rather than *grandes marques*. The United Kingdom is the second biggest market by volume, with 12% of shipments and the United States is number three.

**Exhibit 142 France Remains the Largest Volume Market by Far**

**Champagne Markets by Volume**

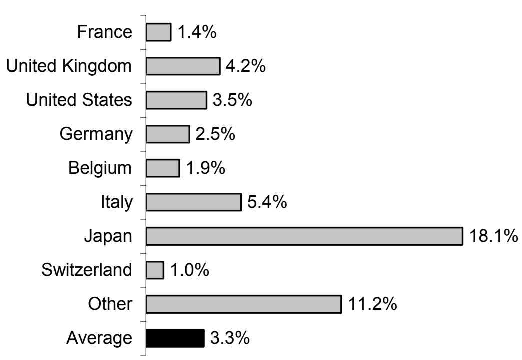



Source: CIVC and Bernstein analysis.

Although France is the biggest market, growth rates are much higher elsewhere, with the United Kingdom and the United States averaging 4% growth over the last five years (see Exhibit 143). Of the top markets, the country which has seen the most spectacular growth is Japan, averaging 18% growth. However, even though France has seen much more modest growth, its sheer scale as a market means that it was still the largest absolute contributor to volume growth (see Exhibit 144), with the United Kingdom in second place and Japan in third.

**Exhibit 143 Even Though France Has Grown More Slowly Than the Average….**

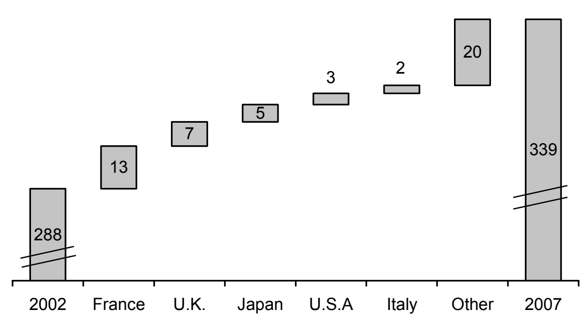
**Volume Growth Rate, Pct. CAGR 2002-07**




Source: CIVC and Bernstein analysis.

**Exhibit 144 …It Is Still Easily the Largest Contributor to Volume Growth, Followed by the U.K. and Japan**

**Sources of Absolute Volume Growth, 2002-07 mbtl**



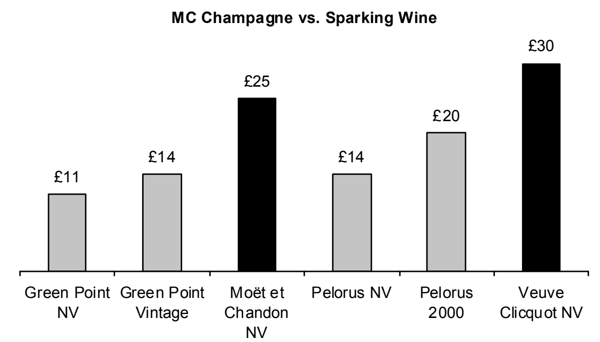

Source: CIVC and Bernstein analysis.

## Power of the Champagne Brand

The champagne houses have invested a huge amount of time and effort over the last century and a half in building the image of the "Champagne" brand. The history of champagne is littered with amazing characters such as the widow (Veuve in French) Clicquot who during the Napoleonic Wars established her wine in royal courts throughout Europe, notably that of Imperial Russia. After the widow came a wave of young entrepreneurs from the Rhineland, including Messrs Krug, Bollinger, Mumm and Roederer. Perhaps the most famous *champenois* of German ancestry was the original Champagne Charlie, Charles Heidsieck who is credited with popularizing Champagne in the United States in the mid-19th century.

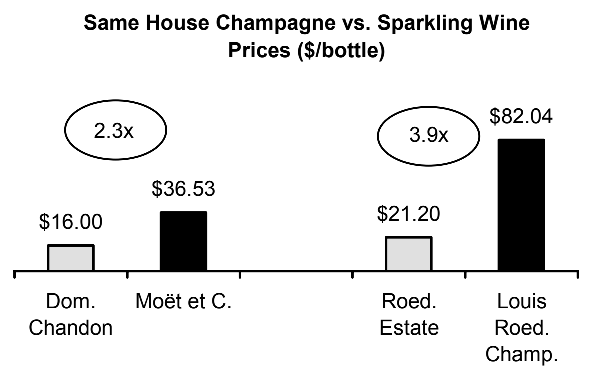
This sustained investment in advertising and publicity has enabled the champagne houses to charge significant premium versus other sparkling wines. Particularly noticeable is the premium versus their own brands. For example, Moët et Chandon established a winery in the relatively cool-climate Yarra valley of Australia where they grow grapes from the classic champagne varieties. Veuve Clicquot (now part of LVMH) bought Cloudy Bay in New Zealand which also makes a champagne-style sparkling wine called Pelorus. Yet both these wines sell at a substantial discount to their mother brands (see Exhibit 145). No doubt soil structures and climates are somewhat different from Champagne. But we suspect that the main cause of the price differential is higher grape prices in champagne (reflected in astronomically expensive land and grape growers who drive Mercedes) as well as the cost of A&P and most likely higher net margins.

**Exhibit 145 Moët et Chandon's Sparkling Wines Brands Sell at a Substantial Discount to Their Champagne Brands**




Source: *Wine Searcher* and Bernstein analysis.

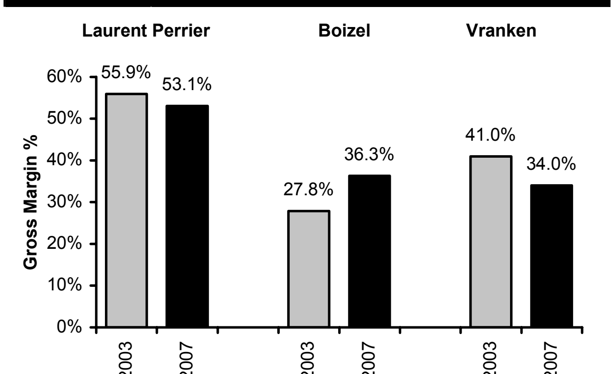
**Exhibit 146 Champagne Is Sold at a Considerable Premium to Its Sparkling Wine Cousin**




Source: AC Nielsen and Bernstein analysis.

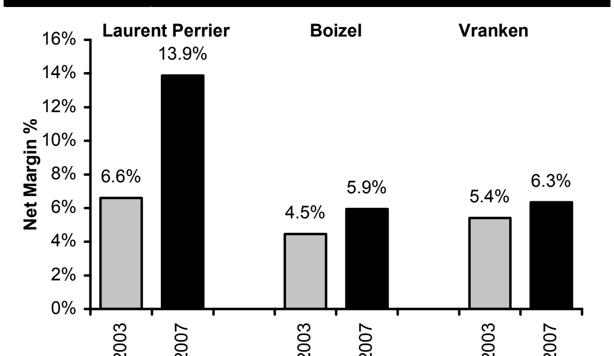
Much of the benefit of robust pricing has been eaten up by increased grape costs and other input costs so that gross margins have been broadly stable (see Exhibit 147). However, the increased price and steady volume growth had led to substantial operating leverage and net operating margins have steadily expanded (see Exhibit 148).

**Exhibit 147 Gross Margins Have Been Broadly Stable…**




Source: Capital IQ, corporate reports and Bernstein analysis.

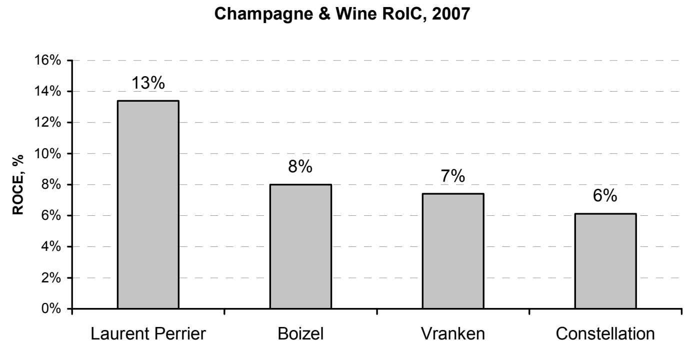
**Exhibit 148 …But Operating Margins Have Expanded**




Source: Capital IQ, corporate reports and Bernstein analysis.

These strong net margins have given champagne a level of RoIC that is unusually high by the standards of the wine world. This is particularly true for premium players such as Laurent Perrier, who has much stronger RoICs than global giants such as Constellation (see Exhibit 149).

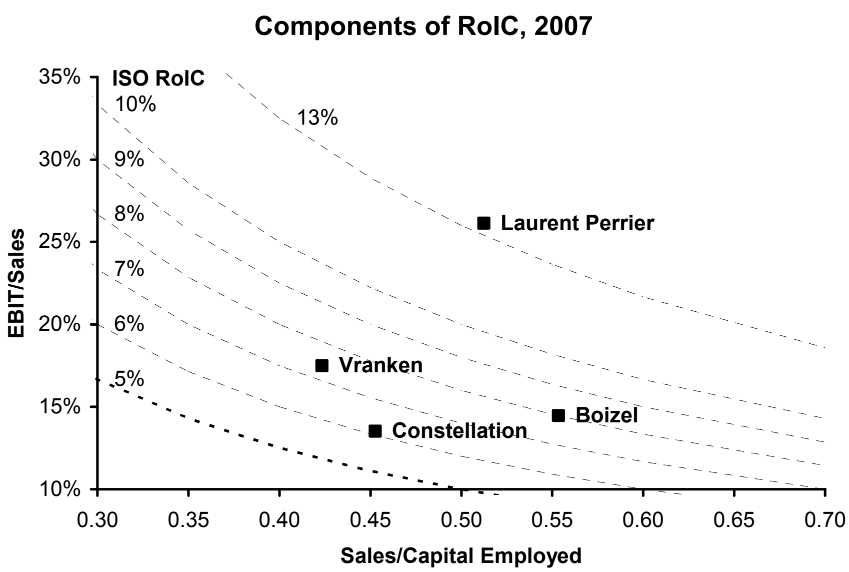
**Exhibit 149** **RoICs Are Unusually High by the Standards of the Wine World, Particularly for Premium Players**




Source: Capital IQ, corporate reports and Bernstein analysis.

Even though the ageing of champagne increase working capital, buying in grapes keeps invested capital low and asset turns reasonably high, so that high net margins translate into high RoICs (see Exhibit 150).

**Exhibit 150** **Components of RoIC**




Source: Capital IQ, corporate reports and Bernstein analysis.

**The Industry Is Dominated by LVMH's Moët et Chandon**

LVMH's champagne division, Moët et Chandon, is the clear leader in champagne, commanding more than 18% of the market in volume terms, three times larger than the runner-up, Boizel. In value terms LVMH is even more dominant, making up 22% of the industry (see Exhibit 151). As a very crude segmentation the leading champagne houses fall into four categories:

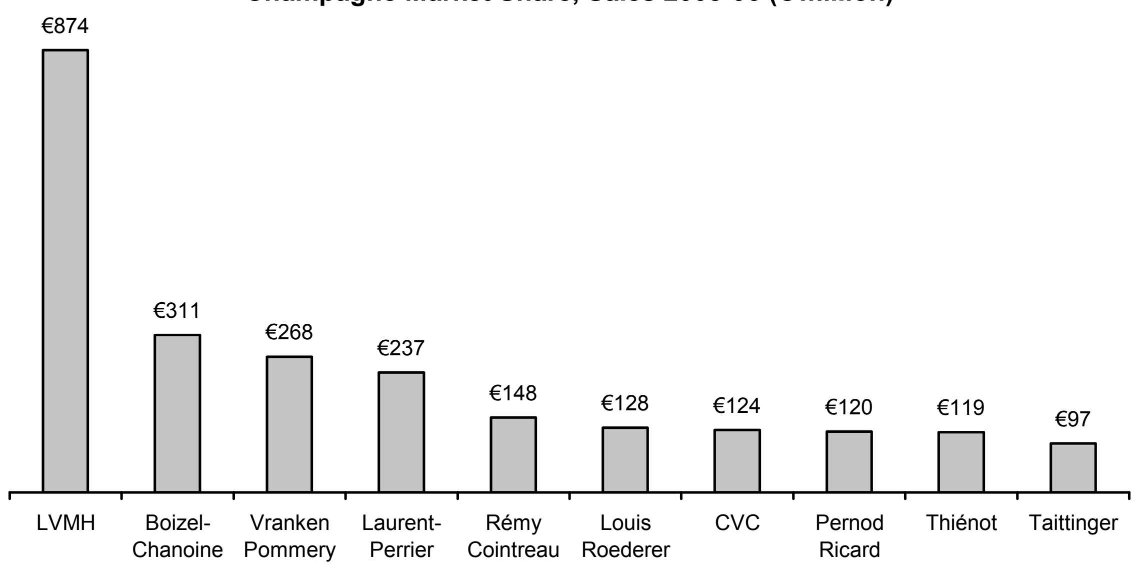
- Moët et Chandon is the big kahuna. As well as the eponymous brand, the group also produces Dom Pérignon and owns Veuve Clicquot, Mercier, Ruinart and

Krug, giving it a range of brands which runs from lower mass market (Mercier) to ultra-premium (Krug)

- Tier 2 global branded, encompassing Pernod (Mumm and Perrier-Jouët) and Rémy Cointreau (Piper Heidsieck and Charles Heidsieck)
- Niche premium. Roederer, Bollinger, Taittinger, Laurent Perrier (esp. Rosé & Grand Siècle)
- Predominantly mass market. Vranken (Pommery), Boizel (Lanson), CVC (Nicholas Feuillatte), Thiénot (Canard Duchêne). Though each of these houses has its own premium cuvées.

**Exhibit 151** **LVMH Is Three Times the Size of Its Nearest Competitor**

**Champagne Market Share, Sales 2005-06 (€ million)**

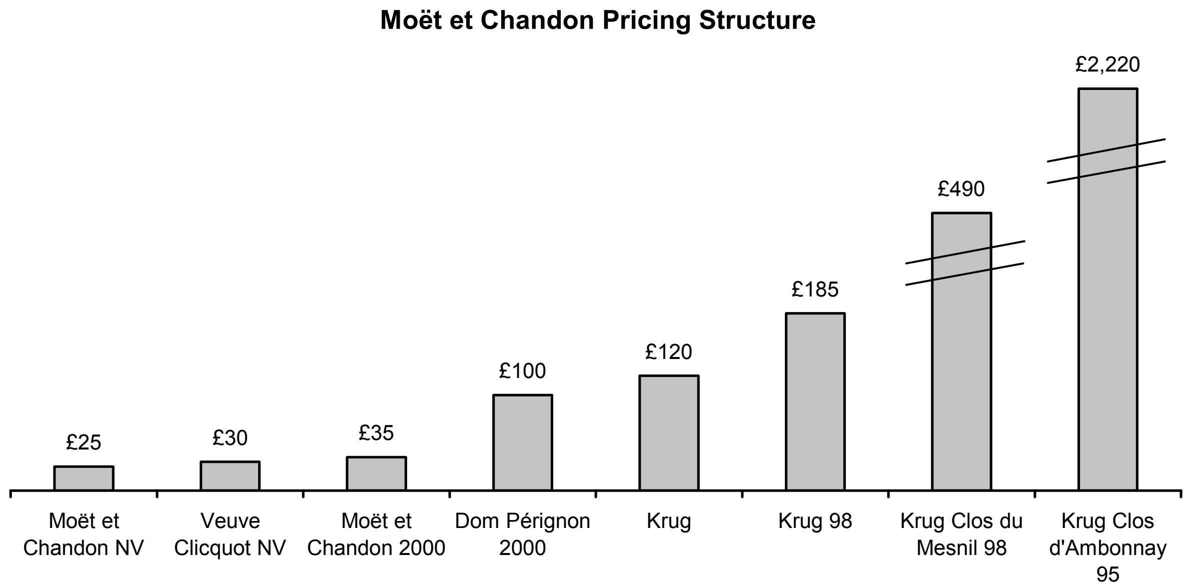



Source: Corporate reports and Bernstein estimates and analysis.

**Key Drivers of Profitability**

One of the reasons for the success of the Moët et Chandon group is that it covers an extraordinary range of price points, from the global benchmark core brand to eye-wateringly expensive single-vineyard champagnes from Krug, including the recently launched Clos d'Ambonnay at over £2,000 per bottle. As well as benefiting from premiumization as consumers trade up this scale, Moët et Chandon and indeed the broader champagne industry have benefited from increased demand for premium-priced rosé champagne.

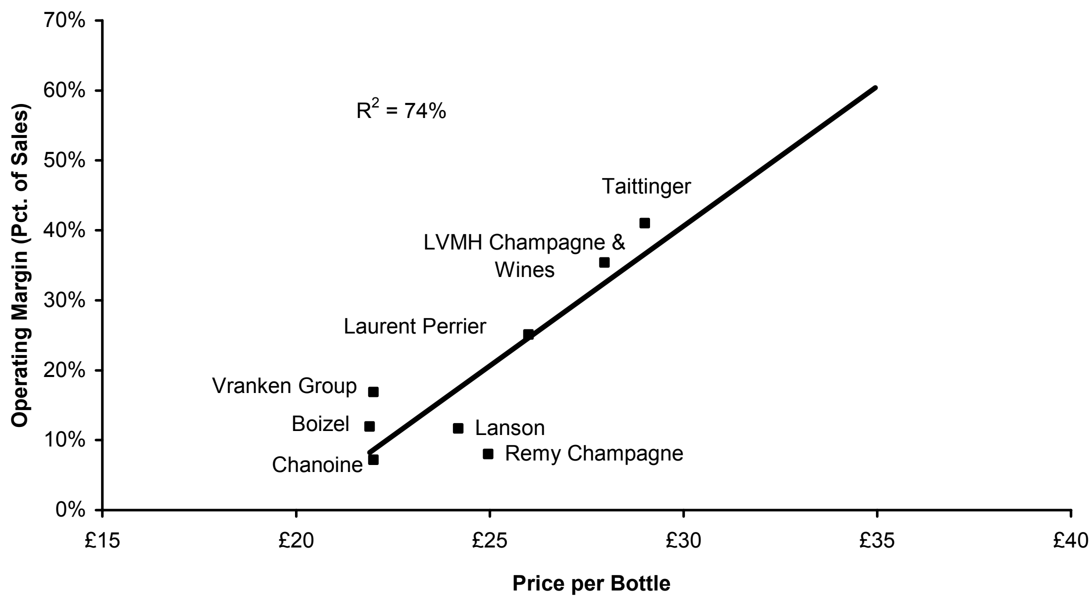
**Exhibit 152** **The Moët et Chandon Group Covers an Extraordinary Range of Price Points**




Source: *Wine Searcher* and Bernstein analysis.

We have collected retail prices for non-vintage and generally available champagnes from *Wine Searcher* for the selected brands. We found strong correlation between operating margins and average retail price per bottle. This would indicate a similar operating cost structure between players in this category (see Exhibit 153).

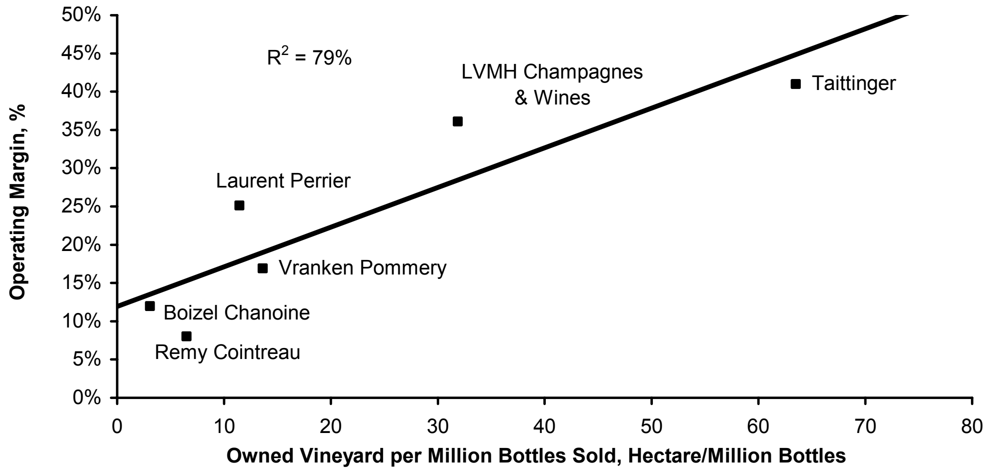
**Exhibit 153** **Operating Margin vs. Average Price — Champagnes**




Source: *Wine Searcher*, corporate reports and Bernstein estimates and analysis.

A high degree of upstream integration seems to correlate positively to operating margins (see Exhibit 154).

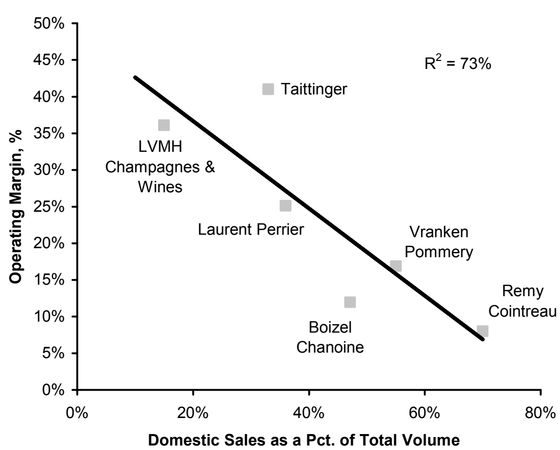
**Exhibit 154** **Operating Margin vs. Level of Vertical Integration — Champagnes**




Source: *Just-Drinks*, corporate reports and Bernstein estimates and analysis.

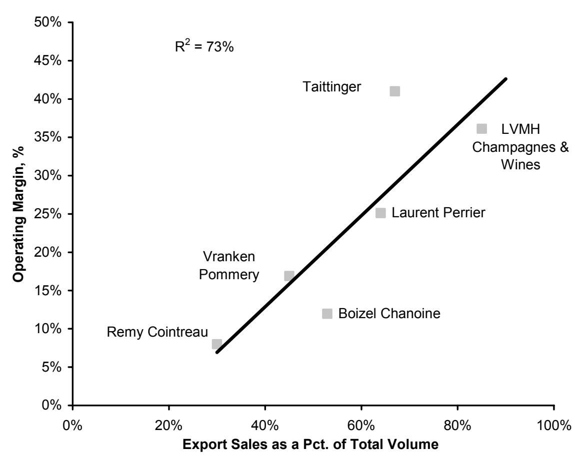
Strong international distribution allows LVMH to have materially higher market share abroad — e.g., more than 50% in the United States, and around 80% in Asia — than in France, as international markets are both growing faster and are less price competitive. This produces higher margins as champagne and wine sales in France are primarily channeled through supermarkets, which have significant purchasing power. Conversely, champagne and wine products are sold at full prices in international markets with a higher proportion of on-trade (see Exhibit 155 and Exhibit 156**).**

**Exhibit 155** **Operating Margin vs. Pct. of Domestics Sales**




Source: *Just-Drinks*, corporate reports and Bernstein estimates and analysis.

**Exhibit 156** **Operating Margin vs. Pct. of Export Sales**

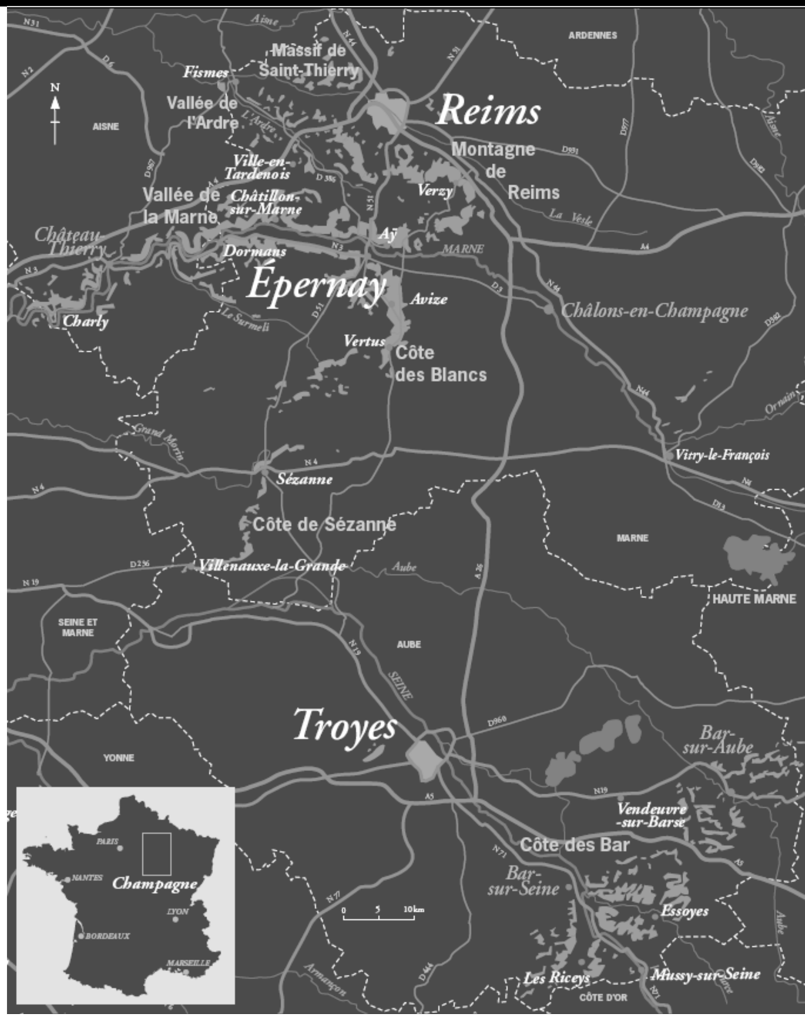



Source: *Just-Drinks*, corporate reports and Bernstein estimates and analysis.

**Production Close to Maximum**

The boundary for the Champagne area was set in 1927. The theoretical maximum area that can be planted in Champagne is approximately 35,000 hectares (see Exhibit 157). At the end of the Seventies only 20,000-25,000 hectares were under vine. This has steadily increased to 30,000 hectares at the end of the nineties, and today stands at 32,700 hectares.

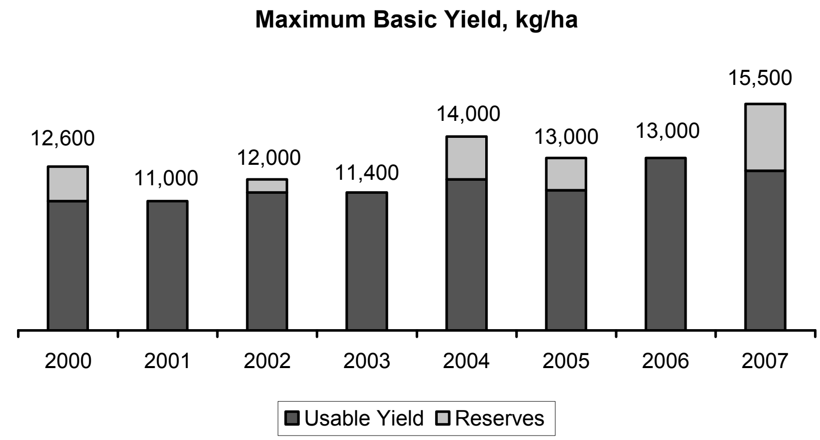
**Exhibit 157 The Champagne Vineyards**




Source: CIVC.

As the area under vine approaches its theoretical maximum, pressure has grown to increase yields. Fortunately, this has coincided with a series of bumper harvests where warm weather ensured both quantity and quality. This gave the authorities the excuse to lift the permitted maximum yields (see Exhibit 158). Furthermore, the maximum permitted yield in any one year has been raised from 13,000 kilograms/hectare to 15,500 kilograms/hectare.

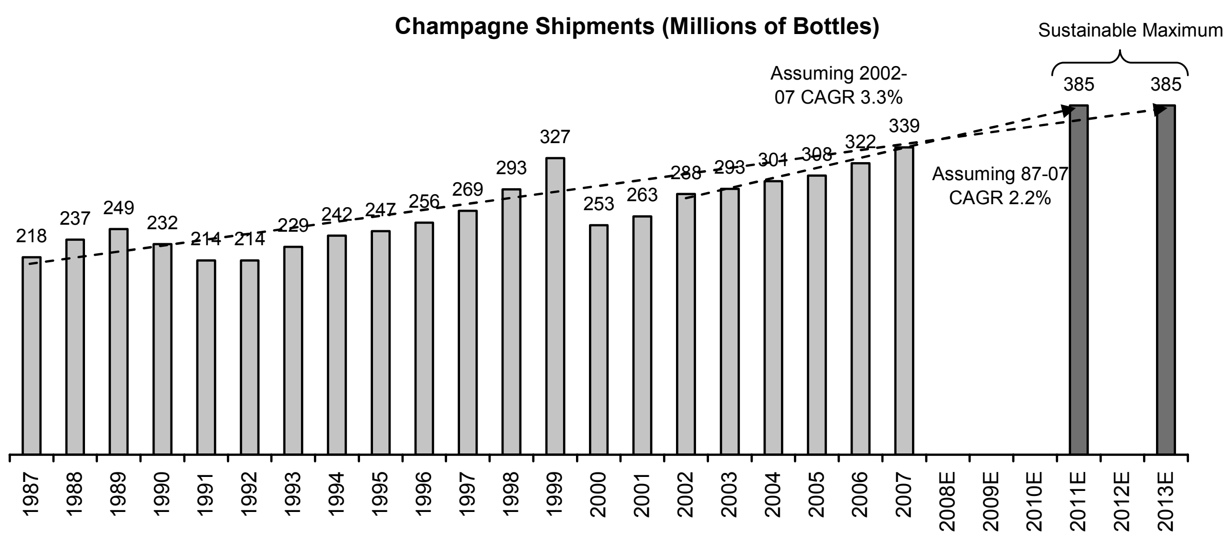
**Exhibit 158** **Maximum Permitted Yields Have Risen in Recent Years**




Source: CIVC, corporate reports and Bernstein estimates and analysis.

However, champagne is still facing medium-/long-term supply constraints. Assuming that all the 35,000 hectares are planted at an average yield of around 13,000 kilograms per hectare, this equates to approximately 385 million 75 cl bottles per annum. If one uses 2007 shipments as a base (which as we shall see may be optimistic), then shipments would reach their sustainable maximum in 2011-2013 (see Exhibit 159). Assuming 14,000 kilograms/hectare average yield would postpone the date to 2014-16.

**Exhibit 159** **If One Uses 2007 Shipments as a Base, Shipments Would Reach Their Sustainable Maximum in 2011-13**

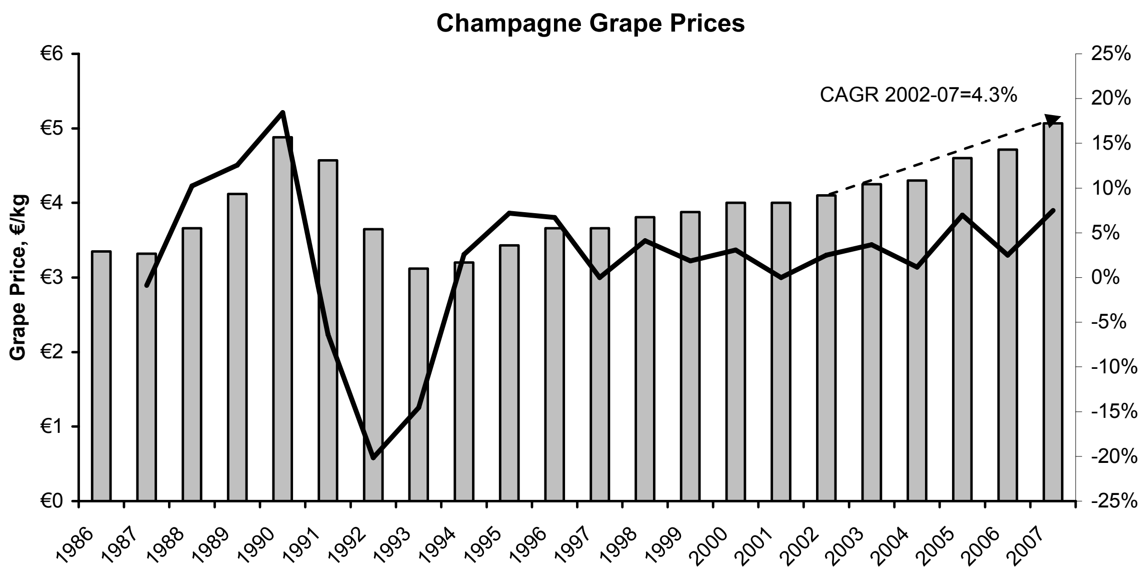



Source: CIVC, corporate reports and Bernstein estimates and analysis.

In the late eighties contract prices between growers and the champagne houses were liberalized, leading to very significant increases. However, this coincided with the recession of 1990/91 and volume declined sharply, and champagne prices fell back to approximately the same level that they had been at in 1986 (see Exhibit 160). The prospects of increasingly tight supply have led to a sharp uptick in grape prices, with prices increasing an average of 4.3% from 2002 to 2007 and 7.5% in

2007 alone. The supply situation has been exacerbated by growers holding back grapes to make and bottle their own champagne which is then sold unlabelled to larger producers who put their own label on the bottle — the so-called *vins sur lattes.* This practice has been banned by the association of large houses but not by the growers and co-operatives.

**Exhibit 160** **Grape Price Have Risen Steadily Since the Nadir of 1994**




Source: CIVC, corporate reports and Bernstein estimates and analysis.

An expansion of the vineyard area is planned but will not bring new supply to the market before 2020 at the earliest. In order to address the long-term supply issues, a plan has been drawn up to extend the area where it is permissible to grow grapes for champagne. A committee of experts took four years to draw up a list of 40 new villages to be added to the existing 319 villages within whose boundaries champagne can be produced (and two villages to be removed). This report has been approved by the national body governing appellations (INAO) and subsequently went to the governmental Conseil d'État.

Assuming the council agrees, this is when the hard work begins — the revision of the so-called "*zone parcellaire*"— that is, within the new villages, which plots of land are eligible for approval. This could well be very litigious because of the money at stake. There is an enormous difference between value of normal agricultural land (approximately €5,000/hectare) and approved delimited land (€1,000,000) i.e., a factor of 200x. Industry estimates are that this process could take until 2015.

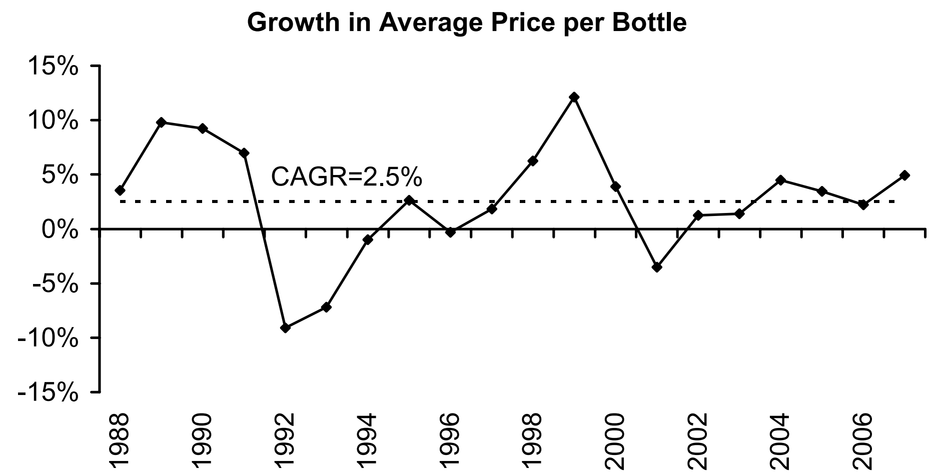
Even after new areas are agreed and planted, it will take a minimum three years until the vines are sufficiently mature to produce grapes. Then the wine will have to mature for at least 15 months. So it will probably be at least 2020 until the first bottles are opened made from grapes in the new areas.

It is also uncertain how much capacity will be added. The number of villages will rise by 12% but industry estimates of the increase in surface area range up to a 30% rise.

Net net: Rising demand and significant supply constraints leading to robust value growth. At the start of this year, the outlook for champagne was exceptionally rosy — or should that be rosé?

*Near-term crisis, as aggressive pricing takes the fizz out of volume growth.* Two thousand eight saw a remarkable turnaround in the fortunes of the champagne industry. During the course of 2007, pricing accelerated (see Exhibit 161), partly reflecting approximately a 7.5% increase in grape costs. At the same time the dollar was weak against the euro. But global volume growth remained robust; so the major house pushed through 5-10% price increases.

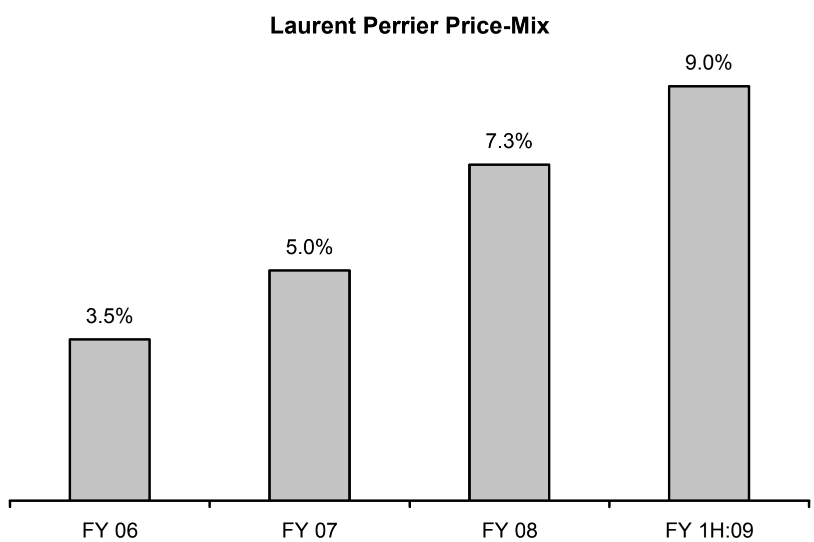
**Exhibit 161** **Industry Pricing Accelerated in 2007…**




Source: CIVC, corporate reports and Bernstein estimates and analysis.

Laurent Perrier was a prime example of this where price-mix has accelerated from 3.5% in FY 2006 to 9% in first-half FY 2009 i.e., second- and third-quarter of 2008 (see Exhibit 162).

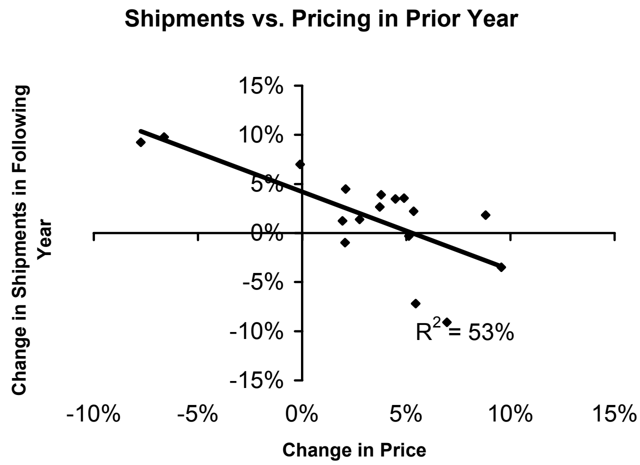
**Exhibit 162** **…As Champagne Houses Sharply Increased Prices, Notably Laurent Perrier**




Source: Corporate reports and Bernstein analysis.

However, in so doing, the champagne houses appear to be ignoring the lessons of history, with a very strong correlation between the growth in shipments and the increase in prices in the prior year (see Exhibit 163).

**Exhibit 163** **Growth in Shipments Is Strongly Correlated With Pricing in the Prior Year**

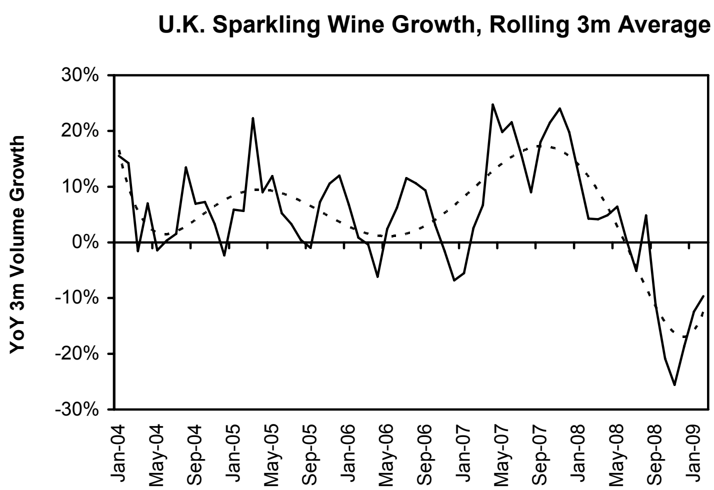



Source: CIVC, corporate reports and Bernstein estimates and analysis.

Indeed, the champagne industry seems to have an unerring ability to jack up prices just as the world is about to enter an economic slowdown (e.g., 1989/1990, 1999/2000) and then suffer the consequences in a sharp fall in volume. Once again, consumers are voting with their wallets.

HMRC data on shipments of sparkling wine show a rapid deceleration over the course of 2008 (see Exhibit 164), in third-quarter 2008, the sector declined 10% in volume terms versus third-quarter 2007.

**Exhibit 164** **Sales of U.K. Sparkling Wine Appear to Have Entered a Sharp Decline**

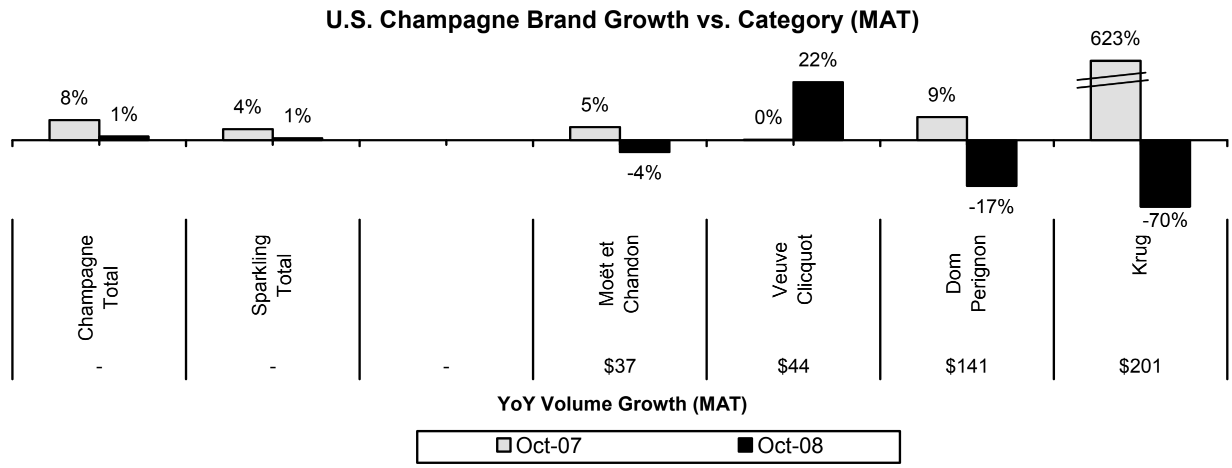



Source: HMRC and Bernstein analysis.

In the United States, AC Nielsen data indicate a similar negative trend (see Exhibit 165) with a significant slowdown in the latest rolling 12-month period over the year-ago numbers.

This worrying off-trade data from Nielsen are backed up by anecdotal evidence from champagne importers who report that restaurant sales dried up in October as the restaurants horded cash and ran down stocks. It is perhaps more of a comment on the state of the London economy, but the author recently noticed a poster for a promotion offering Lanson champagne for £20/bottle in a London pub.

**Exhibit 165** **Total Champagne Has Declined Substantially Year-Over-Year**

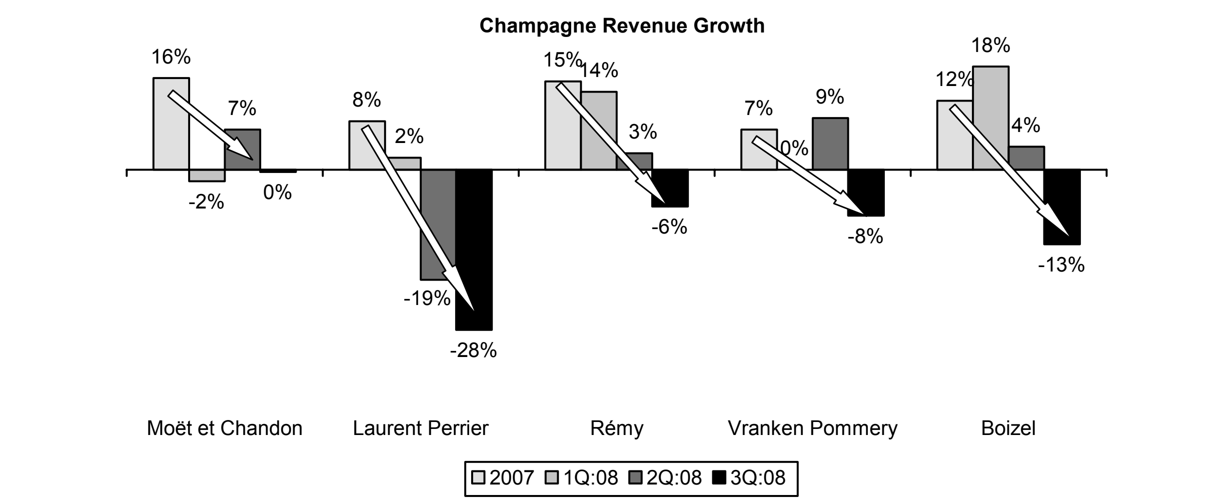



Source: AC Nielsen and Bernstein analysis.

Elsewhere in the world of luxury and fine liquor, China appears to be holding up well so far. But although this market is very important for cognac, it is relatively insignificant in terms of champagne.

Last but not least, we can clearly see the bubble burst in the revenue results of the champagne houses, who have universally reported sharp declines in the third quarter (see Exhibit 166). The only partial exception to this was Moët et Chandon who reported flat revenue growth but sharp underlying volume decline, offset by strong pricing. It is also interesting to note that the house that has been most aggressive on price (Laurent Perrier) is also the house that has seen the biggest fall in revenue.

**Exhibit 166** **All the Major Champagne Houses Have Seen Steep Falls in Revenue Growth and Most Are in Decline**



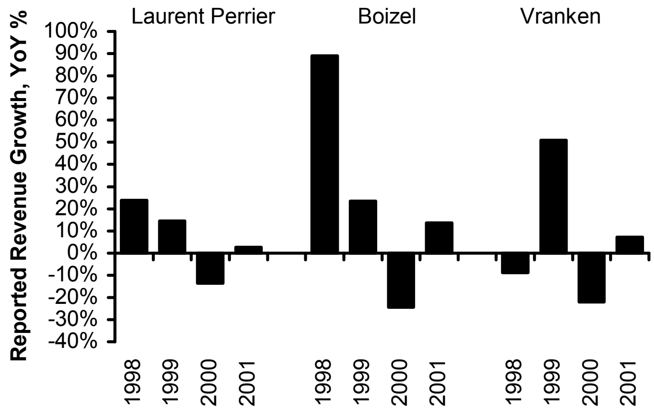

Source: Corporate reports and Bernstein analysis.

**Outlook for 2009 and Beyond**

For the moment, the champagne industry appears to be in denial — in public at least — with cries of "*Crise? Quelle crise?*" echoing around Rheims and Épernay. Indeed, some industry actors are saying that they intend to keep on raising prices to compensate for the lost volumes and to "continue the repositioning" of their brands. This to us seems to be ignoring the lessons of history.

In 2000, admittedly an exceptional set of circumstances, revenue fell in the order of 15-25% before recovering to low single digits in 2001 (see Exhibit 167).

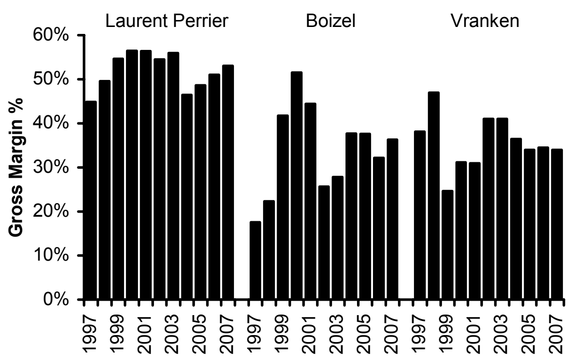
**Exhibit 167 Revenue Growth in 1998-2001**




Source: Capital IQ, corporate reports and Bernstein estimates and analysis.

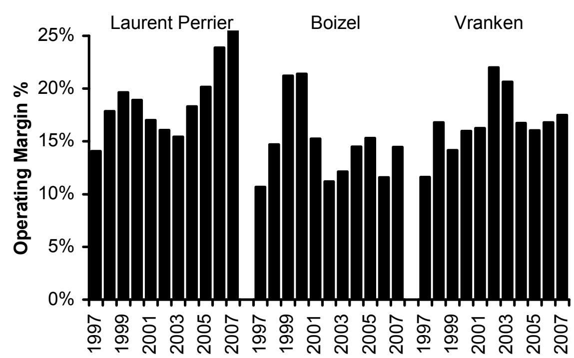
Gross margins remained broadly stable (see Exhibit 168), indicating that the fall in average price that we saw in Exhibit 161 was due to mix — most likely because it was higher-value export markets that were grossly overstocked. However, net margins tumbled due to lower operating leverage (see Exhibit 169).

**Exhibit 168 Gross Margins Over Time (1998-2007)**




Source: Capital IQ, corporate reports and Bernstein estimates and analysis.

**Exhibit 169 Operating Margins Were Stable in 1997-2003**




Source: Capital IQ, corporate reports and Bernstein estimates and analysis.

Our best guess is that 2008/2009 will look more like 1990/1991 than 1999/2000. The sharp fall in demand will likely continue into 2009 — as seen in the first-half 2009 LVMH results. Despite the protestations of some houses, we also expect some unwinding of the price increases that have been pushed through perhaps in the form of off-invoice rebates, or currency adjustments in order to preserve face. Although, a strong dollar should take the pressure off the U.S. market without the houses having to take a big hit in euro price.

Pressure on gross margins will be reflected in negotiations on grape prices which will at best be flat next year and may fall depending on the intensity of the pricing pressure. And net margins will fall due to reduced operating leverage.

In the longer term, we expect that champagne will recover, as it always has. The product remains very attractive (if somewhat overpriced) and the cachet unrivalled. Ultimately, the fizz will return but it may take three to five years.

## Thumbnail Sketches of Small Caps

**Exhibit 170** **Laurent Perrier: Financials (€ million)**

| Laurent Perrier (€m) | FY04 | FY05 | FY06 | FY07 | FY08 |
|---|---|---|---|---|---|
| **Revenue** | **166.10** | **191.00** | **208.10** | **236.65** | **249.43** |
| COGS | 73.20 | 102.30 | 106.90 | 115.95 | 117.09 |
| Gross Income | 92.9 | 88.7 | 101.2 | 120.7 | 132.34 |
| Operating Expenses | 67.3 | 53.7 | 59.3 | 65.44 | 67.17 |
| **EBIT** | **25.6** | **35.0** | **41.9** | **56.66** | **65.81** |
| Interest Expense | | | | 9.95 | 12.24 |
| PBT | 25.6 | 35 | 41.9 | 46.71 | 53.57 |
| Tax | 14.6 | 18.7 | 19.4 | 16.36 | 18.83 |
| **NI** | **11** | **16.3** | **22.5** | **30.35** | **34.74** |
| | | | | | |
| **EPS (Basic)** | **1.89** | **2.82** | **3.87** | **5.11** | **5.88** |
| **EPS (Diluted)** | **1.89** | **2.8** | **3.81** | **5.06** | **5.81** |

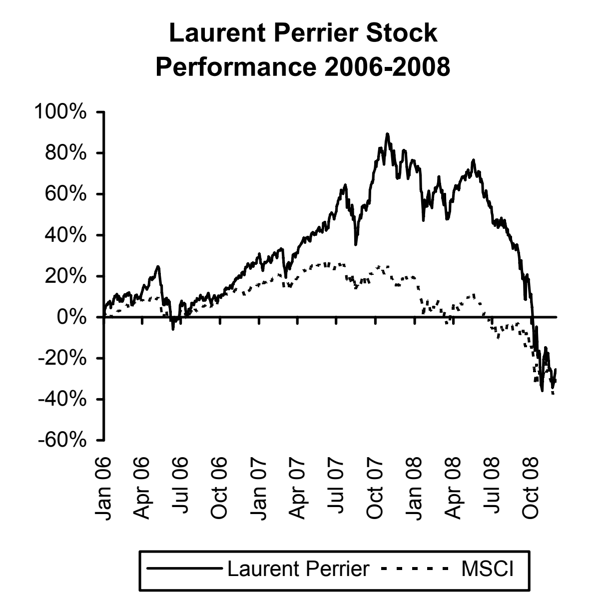
| | | | | | |
|---|---|---|---|---|---|
| **Gross Margin** | 56% | 46% | 49% | 51% | 53% |
| **Operating Margin** | 15% | 18% | 20% | 24% | 26% |
| **Net Margin** | 7% | 9% | 11% | 13% | 14% |

| | |
|---|---|
| **Market Cap (€m)** | 324.05 |
| **Revenue (03-07 CAGR)** | 11% |
| **EBIT (03-07 CAGR)** | 27% |
| **Net Income (03-07 CAGR)** | 33% |
| **Closing P/E (TTM)** | 11.1x |

**Note:** Financial year-end is June 30.

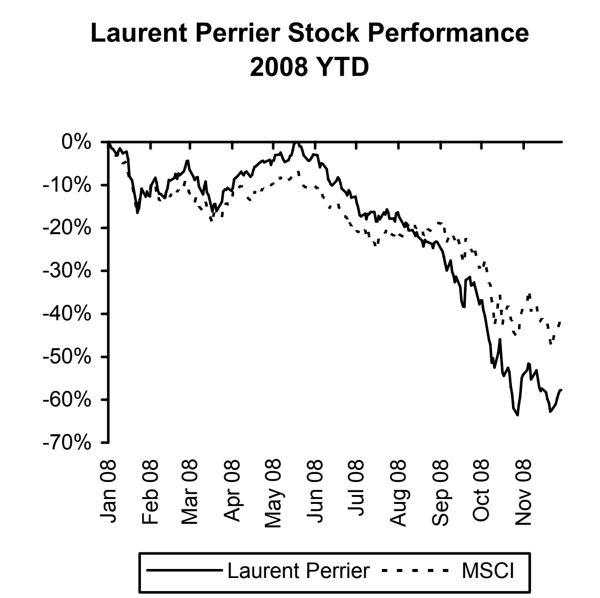
Source: Capital IQ, corporate reports and Bernstein analysis.

**Exhibit 171** **Laurent Perrier Stock Performance (2006-2008)**




Source: Bloomberg L.P. and Bernstein analysis.

**Exhibit 172** **Laurent Perrier Stock Performance YTD**




Source: Bloomberg L.P. and Bernstein analysis.

**Exhibit 173** **Boizel Chanoine Financials (€ million)**

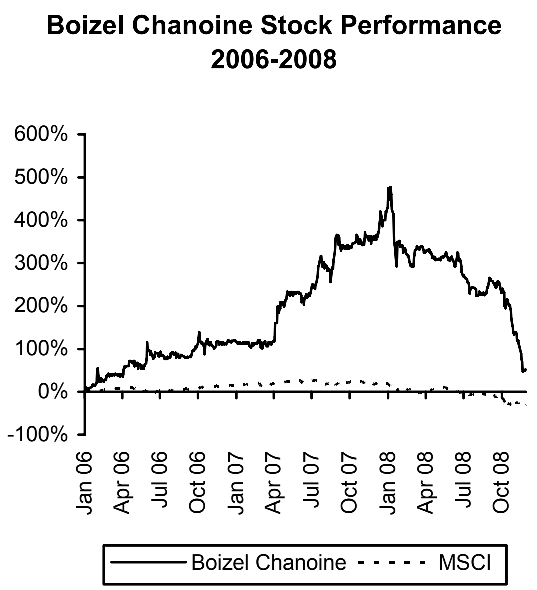
| Boizel Chanoine | CY03 | CY04 | CY05 | CY06 | CY07 |
|---|---|---|---|---|---|
| **Revenue** | **88.00** | **97.10** | **311.30** | **359.4** | **327.3** |
| COGS | 54.90 | 60.60 | 211.10 | 228.9 | 195.1 |
| Gross Income | 33.1 | 36.5 | 100.2 | 130.5 | 132.2 |
| Operating Expenses | 20.4 | 21.6 | 64 | 78.5 | 76.4 |
| **EBIT** | **12.7** | **14.9** | **36.2** | **52** | **55.8** |
| Interest Expense | 2.5 | 2.7 | 15.1 | 19.5 | 19.2 |
| PBT | 10.2 | 12.2 | 21.1 | 32.5 | 36.6 |
| Tax | 3.6 | 4.3 | 7.4 | 11.1 | 13.4 |
| **NI** | **6.6** | **7.9** | **13.7** | **21.4** | **23.2** |
| | | | | | |
| **EPS** | **1.46** | **1.76** | **3.24** | **4.66** | **5.06** |
| **EPS** | **1.46** | **1.76** | **3.02** | **4.26** | **4.62** |

| | | | | | |
|---|---|---|---|---|---|
| **Gross Margin** | 38% | 38% | 32% | 36% | 40% |
| **Operating Margin** | 14% | 15% | 12% | 14% | 17% |
| **Net Margin** | 8% | 8% | 4% | 6% | 7% |

| | |
|---|---|
| **Market Cap (€m)** | 137.75 |
| **Revenue (03-07 CAGR)** | 39% |
| **EBIT (03-07 CAGR)** | 45% |
| **Net Income (03-07 CAGR)** | 37% |
| **Closing P/E (TTM)** | 6.67x |

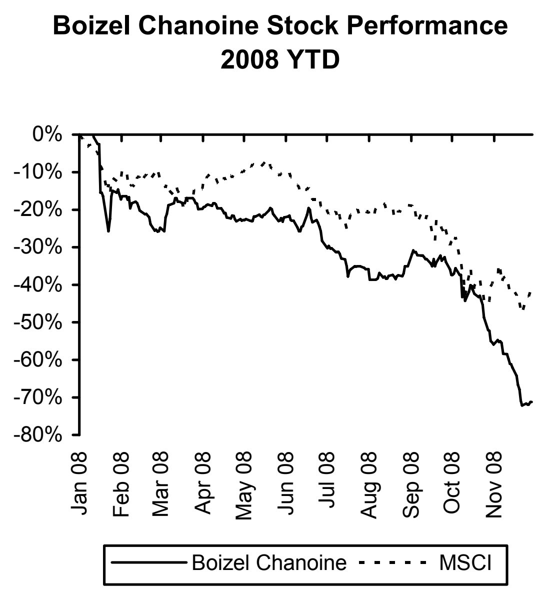
Source: Capital IQ, corporate reports and Bernstein analysis.

**Exhibit 174** **Boizel Chanoine Stock Performance (2006-08)**




Source: Bloomberg L.P. and Bernstein analysis.

**Exhibit 175** **Boizel Chanoine Stock Performance YTD**




Source: Bloomberg L.P. and Bernstein analysis.

**Exhibit 176 Vranken Pommery Financials (€ million)**

| Vranken-Pommery | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| **Revenue** | **227.5** | **250.5** | **268.3** | **286.8** | **289.8** |
| COGS | 144.6 | 165.3 | 175.8 | 189.4 | 187.7 |
| Gross Income | 82.9 | 85.2 | 92.5 | 97.4 | 102.1 |
| Operating Expenses | 44.9 | 45.1 | 47.4 | 47.3 | 48.2 |
| **EBIT** | **38.0** | **40.1** | **45.1** | **50.1** | **53.9** |
| Interest Expense | 16.2 | 16 | 18.3 | 23.6 | 27.4 |
| FX gains (losses) | -2.7 | -0.2 | 1.1 | 1.2 | 1.8 |
| Other Charges | -0.3 | -2.5 | -3.3 | -0.3 | -0.6 |
| PBT | 18.8 | 21.4 | 24.6 | 27.4 | 27.7 |
| Tax | 6.9 | 6.4 | 8.2 | 8.9 | 9.2 |
| Minority Interests | -1.8 | -0.3 | -0.1 | -0.3 | -0.2 |
| **NI** | **10.1** | **14.7** | **16.3** | **18.2** | **18.3** |
| | | | | | |
| **EPS** | **2.19** | **3.24** | **3.13** | **3.49** | **3.51** |
| **EPS** | **2.19** | **3.24** | **3.13** | **3.49** | **3.51** |

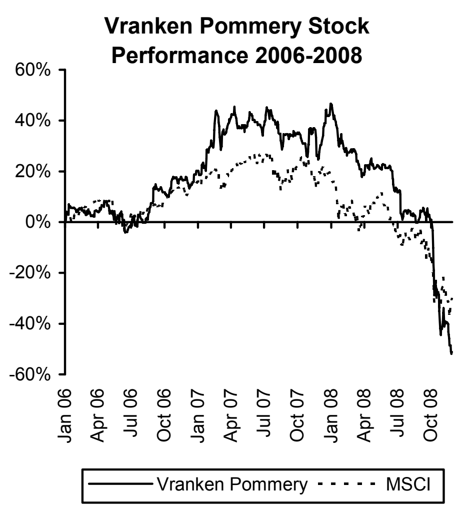
| | | | | | |
|---|---|---|---|---|---|
| **Gross Margin** | 36% | 34% | 34% | 34% | 35% |
| **Operating Margin** | 17% | 16% | 17% | 17% | 19% |

| | |
|---|---|
| **Market Cap (€m)** | 107.96 |
| **Revenue (03-07 CAGR)** | 6% |
| **EBIT (03-07 CAGR)** | 9% |
| **Net Income (03-07 CAGR)** | 16% |
| **Closing P/E (TTM)** | 5.83x |

**Note:** Financial year-end is June 30.

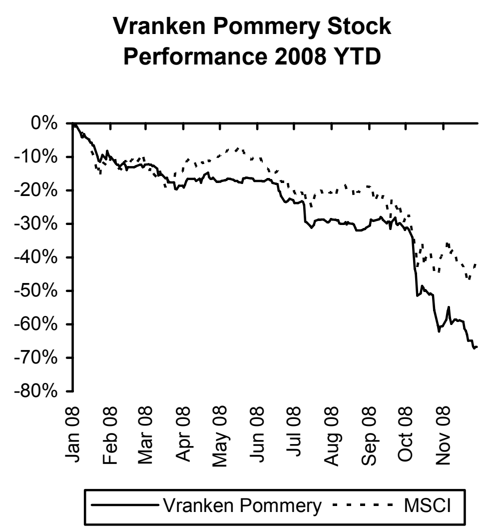
Source: Capital IQ, corporate reports and Bernstein analysis.

**Exhibit 177 Vranken Pommery Stock Performance (2006-08)**




Source: Bloomberg L.P. and Bernstein analysis.

**Exhibit 178 Vranken Pommery Stock Performance YTD**




Source: Bloomberg L.P. and Bernstein analysis.

# Cognac — Long-Term Analysis Indicates a Severe Kink in the Curve Rather Than a Catastrophic Turning Point

**What Makes Cognac Special (and Different from Scotch)?**

The cognac industry as we know it started in the 16th Century, when Dutch merchants came to the Cognac area looking for cheap alcohol (some things never change). The wines of the area were too weak to withstand the journey to the Netherlands; so the Dutch merchants set up distilleries to produce what they called "brandwijn" — burnt wine — hence the origin of the English name "Brandy." The brandy was also much cheaper to ship per unit of alcohol than still wine. However, it was the rich dandies of Restoration England who were first willing to pay a premium for "coniack" brandy — an early example of bling culture.

Brandy is a generic term for a certain style of spirit distilled from still wine, whatever the origin of the wine. "Cognac" must be distilled from the delimited area of Cognac in Southwest France (see Exhibit 179). However, although the definition of cognac is more restrictive than say "distilled in Scotland" is for scotch, it is not as restrictive as Champagne, where virtually every eligible square meter is already planted with vines.

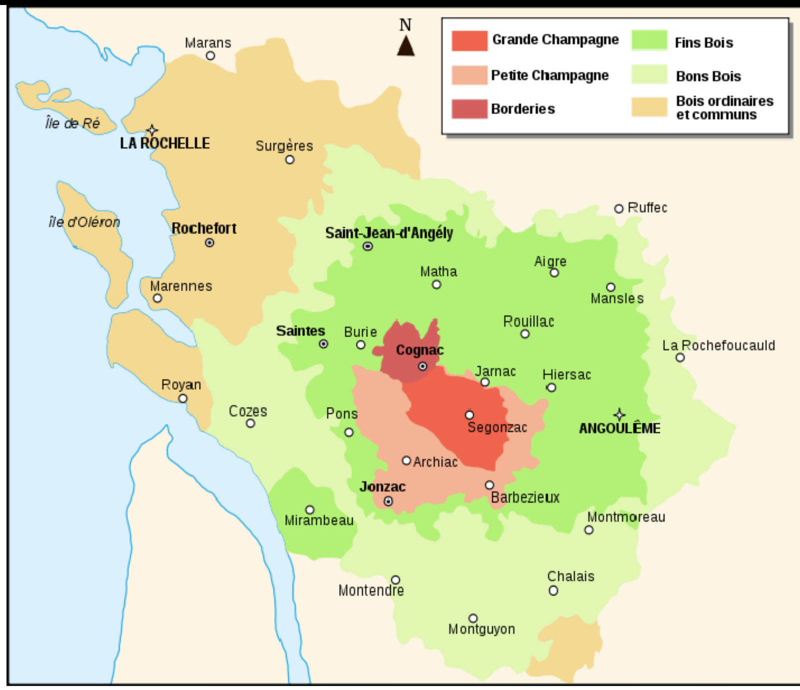
**Exhibit 179** **Cognac Is Produced in the Cognac Region of SW France**

Source: Bernstein research.

Cognac is further divided into six crus or sub-regions (see Exhibit 180). In general, the further one goes from the heart of the region, the lower the quality of the wine, with Champagne and Borderies being regarded as the highest-quality areas. As a result, over 50% of the agricultural land is planted with vines in Grande Champagne and Borderies but only 1% in the Bois Ordinaires. Not surprisingly, spirits from these crus command a higher price. Unlike champagne, increased demand for cognac can be addressed by planting more land. However, the new vineyards will inevitably be mainly in the historically lower-quality outer vineyards and hence better suited for lower qualities of cognac.

The vast majority of wine used to produce cognac is made from the Ugni Blanc grape — the same grape known as Trebbiano in Italy, which is the base of oceans of insipid white wine. As in champagne, the base wine is deliberately made as an unappealing, highly-acidic, low-alcohol wine. Indeed too much flavor is perceived to be a bad thing because distillation concentrates the flavors.

**Exhibit 180** **Cognac Is Further Divided Into Six Crus or Sub-Regions**




Source: Bernstein analysis.

Cognac is distilled in batches in a pot still (similar to malt whisky but unlike grain whisky, which is produced via much lower-cost continuous distillation). The first stage takes the 10% ABV wine to 28-32% alcohol and the second stage to approximately 60%. Distillation of cognac takes place in the autumn after the harvest and must be completed by March 31 of the following year. This is the date at which the clock starts on the ageing process.

The cognac is aged in oak casks which remove the unpleasant volatile compounds and, as in wine, impart sweeter, vanilla notes. The porous character of the oak also encourages gentle oxidation, providing color to the originally clear spirit (though much of the final brown color of younger spirit comes from caramel, a technique also used in scotch finishing). The porosity of the oak also leads to evaporation of the alcohol, the so-called "angel's share". Very old cognacs are often stored in large glass containers called demi-johns in order to control oxidation and evaporation.

There are three broad categories of cognac (see Exhibit 181): VS (more than two years), VSOP (more than four years) and XO (more than six years, more than 10 years from 2016). Compared to premium scotch, which is typically at least 12 years old, VSOP spends less time maturing and has lower levels of maturing inventory than scotch. Hence, although the initial production costs of cognac are higher than premium blended scotch, it has lower working capital requirements.

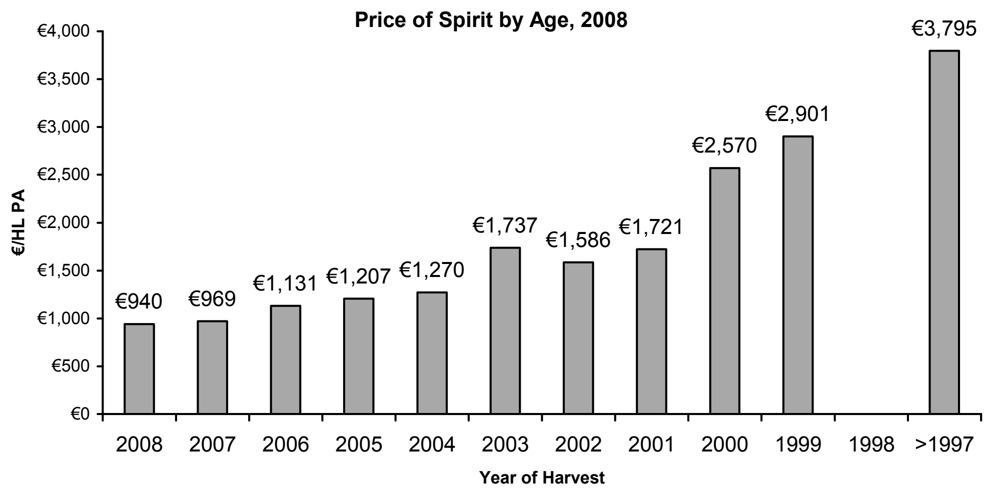
**Exhibit 181** **There Are Three Broad Age Qualities of Cognac**

| Category | Minimum Age of Spirit |
|---|---|
| VS (Very Special) | Two years |
| VSOP (Very Special Old Pale) | Four years |
| XO (Extra Old) | Six years (10 years from 2016)<br>Most Houses Include Portions of Much Older Vintages. |

Source: BNIC and Bernstein analysis.

Not surprisingly perhaps, old spirit is much more valuable than young spirit (see Exhibit 182), with 10-year-old cognac worth four times more than young spirit. However, this is not just a reflection of the time value of money but also that it is only the highest-quality spirits that are aged in the first place.

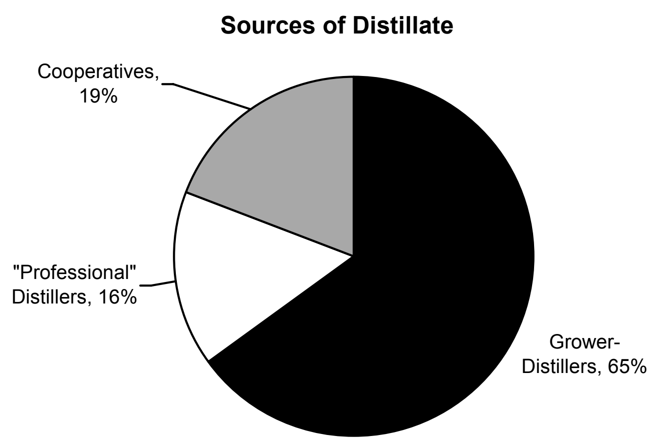
**Exhibit 182** **10-Year-Old Cognac Is Worth More Than Four Times More Than Young Spirit**




Source: BNIC and Bernstein analysis.

The vineyards are in general owned by small growers. However, there is nothing like the same premium for cognac vineyards that there is in champagne because the cultivated area has much more flexibility. The final particularity of cognac is that most of the distillation is carried out by a large body of independent distillers who sell to the big houses, with approximately 66% of distillate produced by grower-distillers (see Exhibit 183), 19% by co-operative and 16% by professional distillers (which includes some distilleries that are owned by the large houses). In many cases, these owner-distillers also age spirit. So the large houses buy a mixture of wine to distil themselves, new spirit and aged spirit. None of the houses buy grapes to make wine themselves, though the large houses do have very small vineyard holdings. Instead, they source as much as possible via long-term contracts with growers/distillers, e.g., Hennessy has 700 growers under contract.

**Exhibit 183** **66% of Distillate Is Produced by Grower-Distillers**



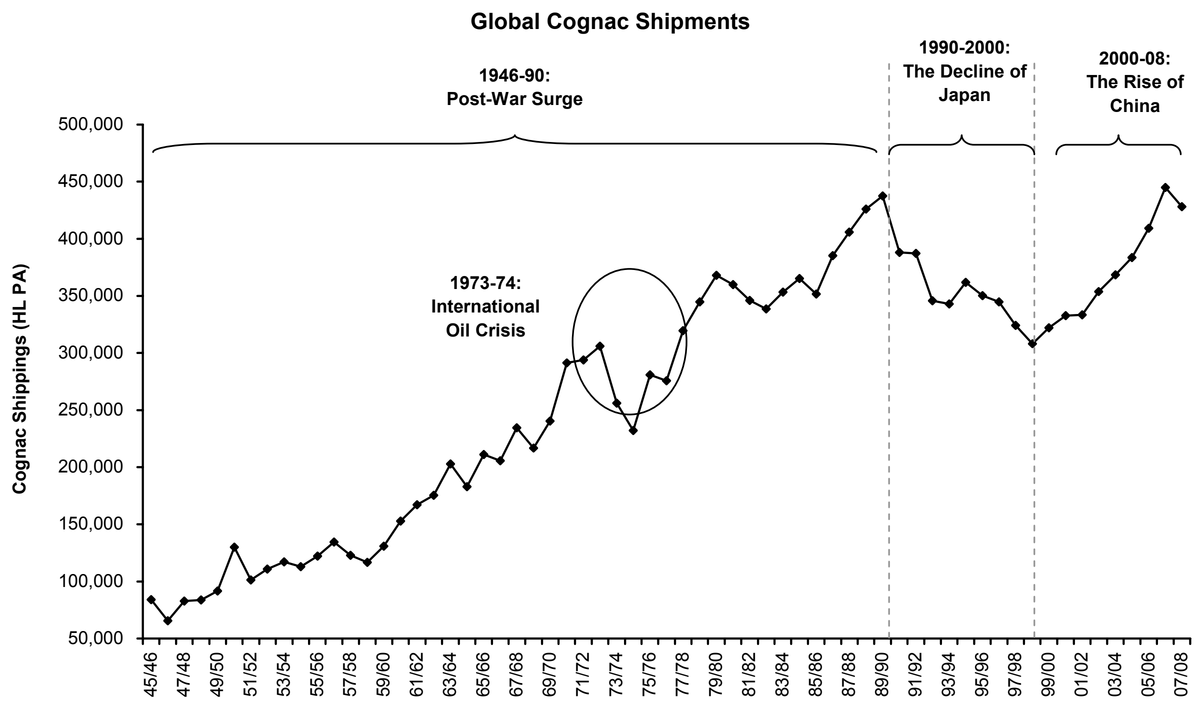

Source: BNIC and Bernstein analysis.

This is in marked contrast to scotch where the large houses distil and age nearly all their own spirit requirements. This complexity of the distillation and storage arrangements makes inventory management much more complicated than scotch. The big scotch companies decide themselves how much spirit they will distil and store. The large cognac houses have to exert subtle influence on a myriad of independent actors. Even if many grower-distillers are on long-term contracts, it is still much harder to get the industry aligned than scotch, which is controlled by a small number of vertically integrated houses. On the other hand, just like champagne, the production of cognac is highly regulated through the Bureau National Interprofessionnel du Cognac (BNIC) and this provides industry cohesion.

**Long-Term View of Demand**

Cognac experienced remarkably steady growth post-war up to 1980 (see Exhibit 184). The oil crisis of 1973 led to a 24% drop in shipments between 1973 and 1975. But global markets rapidly recovered and by 1978, shipments had exceeded their previous high. Growth continued through the 1980s driven primarily by Japan. However, 1990 saw a dramatic turning point in the fortunes of the global cognac industry.

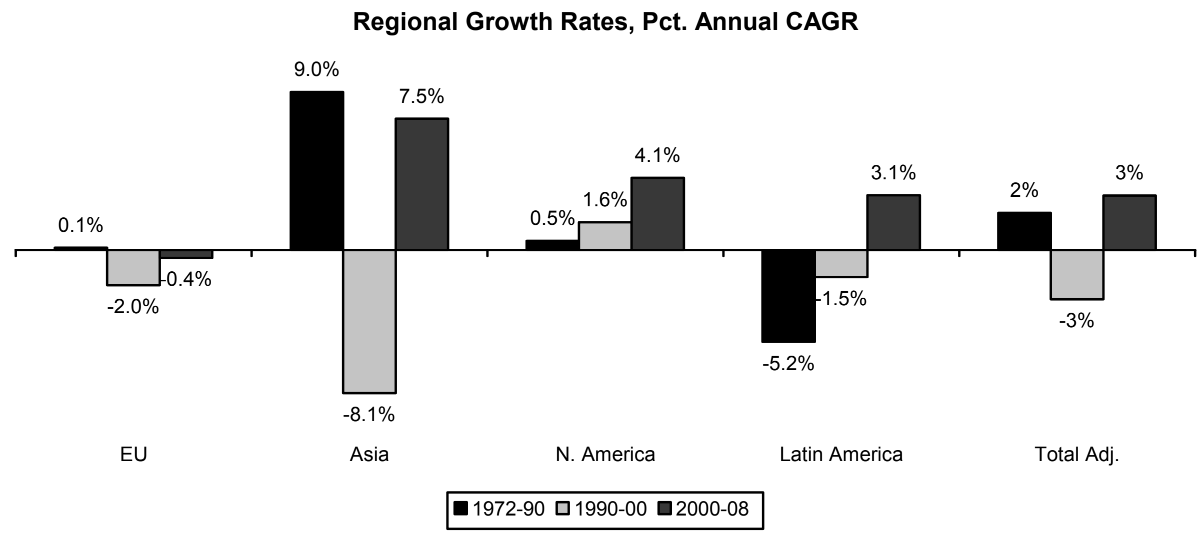
**Exhibit 184** **After 45 Years of Strong Growth Following the End of WWII, the Last 20 Years Have Been Dominated by the Decline of Japan and the Rise of China**




Source: BNIC and Bernstein analysis.

***What Happened in the 90s?:*** The fall in cognac shipments in the 1990s was primarily due to a slump in demand for cognac in Asia. Volumes grew at a CAGR of 9% in Asia from 1972 to 1990, primarily driven by Japan (see Exhibit 185). However, Asian shipments fell by 8% CAGR between 1990 and 2000 before recovering sharply after 2000 (see below for detailed discussion of 2000-08).

**Exhibit 185** **Demand for Cognac in Asia Slumped in the 1990s**

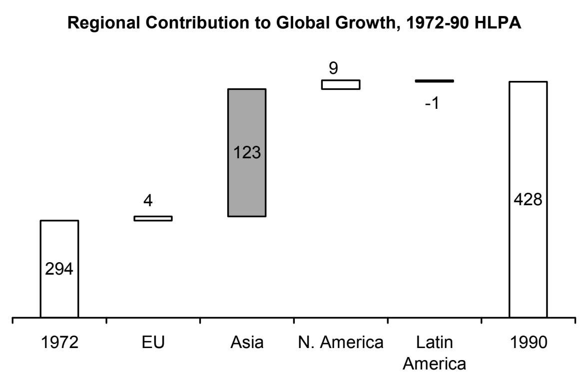



**Note:** EU includes France; total is calculated as = EU + Asia + N. America + Latin America (N. America is implied for 1972-1988).

Source: BNIC and Bernstein analysis.

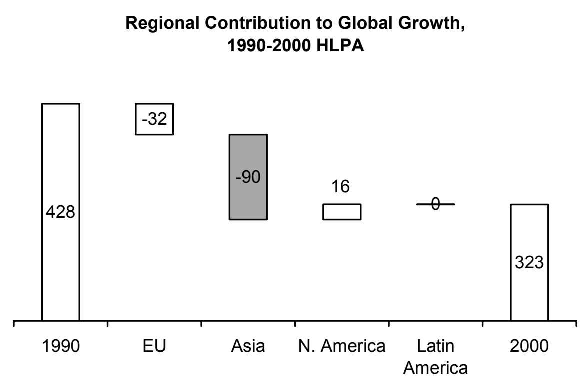
The impact was even more dramatic when looked at in absolute terms. Having driven global growth from 1972 to 1990 (see Exhibit 186), Asia was the primary driver of the decline from 1990 to 2000 (see Exhibit 187). Two-thirds of this came from the decline of Japan, a decline that continued into the next decade. The other one-third of the decline came from the economic difficulties of East Asia in 1997 and 1998, but this rapidly recovered in the following years.

**Exhibit 186** **Having Driven Global Growth from 1972-90…**




Source: BNIC and Bernstein analysis.

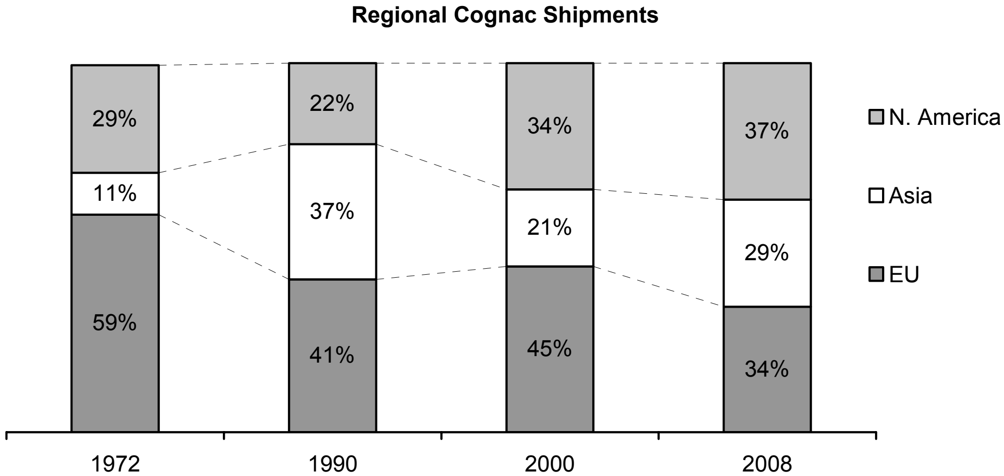
**Exhibit 187** **…Asia Was the Primary Driver of the Decline from 1990-2000**




Source: BNIC and Bernstein analysis.

As a result, we have seen huge swings in the relative importance of Asia as a region to overall cognac volumes (see Exhibit 188). Two other trends are evident from this analysis. The first is the steady increase in the importance of North America between 1990 and 2008 (though as we will see later, most of this has been in lower value VS cognac). The second is the inexorable relative (and absolute) decline in European consumption.

**Exhibit 188** **We Have Seen Big Swings in the Relative Importance of Regions to Overall Global Volumes**

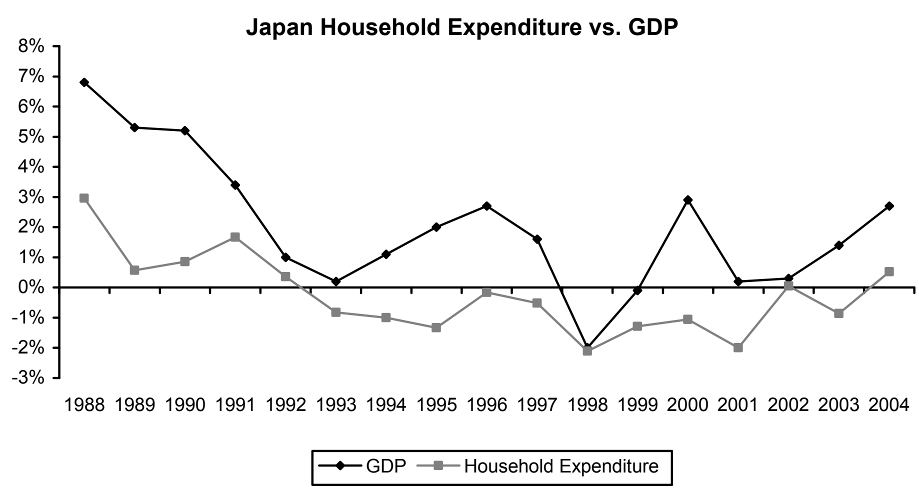



**Note:** EU includes France; total is calculated as = EU + Asia + N. America+ Latin America (N. America is implied for 1972-1988).

Source: BNIC and Bernstein analysis.

***Japan — The Bursting of the Asset Bubble and the "Lost Decade":*** In most Asian and Latin American economic crises, the economies fell sharply for one or two years, with a mid-high single-digit fall in GDP and approximately a 30% fall in the premium brown spirits market, which then recovered very quickly (see European Beverages *Research Call* from February 26, 2009, "European Beverages & Spirits: How Bad Could It Get? Learnings from Prior Asian and LatAm Recessions" for more detail). However, Japan in the nineties was very different. This crisis was much more related to the deflation of a gigantic asset bubble. Although exports and GDP growth remained robust for several years (see Exhibit 189), household expenditure slowed dramatically and fell in real terms from 1992 though to 2002.

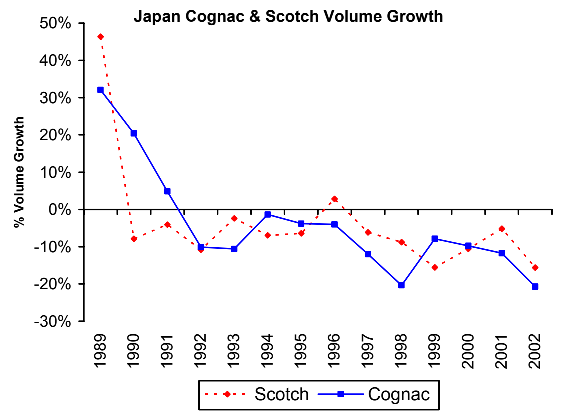
**Exhibit 189** **GDP Only Fell Once in the 1990s But Consumer Expenditure Was Very Weak Throughout the Decade**




Source: Japan Statistics Bureau and Bernstein analysis.

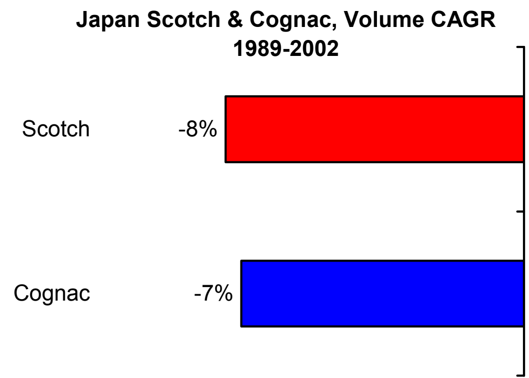
Cognac volumes initially held up better than scotch (which started to decline in 1990) and did not start to decline until 1992. However, cognac volume declines rapidly caught up with and even overtook scotch. Over the course of the deflationary years from 1989 to 2002, scotch volumes averaged 8% annual decline and cognac 7% (see Exhibit 191).

**Exhibit 190 Cognac Initially Held Up Better Than Scotch But Volume Declines Rapidly Caught Up With and Even Overtook Scotch**




Source: IWSR and Bernstein analysis.

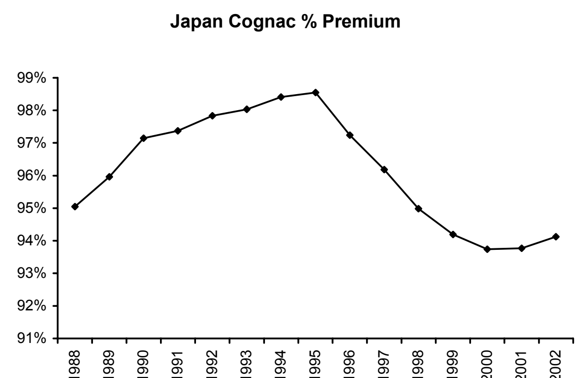
**Exhibit 191 From 1989 to 2002, Scotch Volumes Averaged 8% Annual Decline and Cognac 7%**




Source: IWSR and Bernstein analysis.

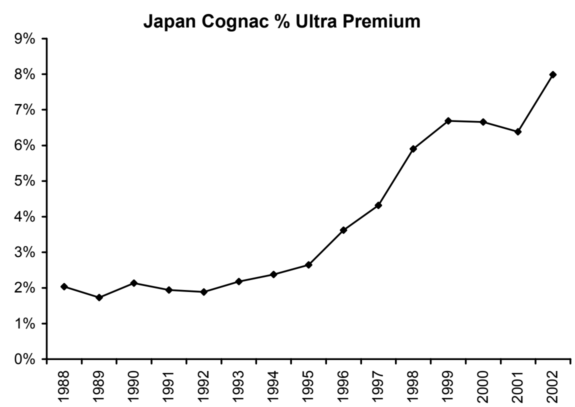
The only ray of light for both categories was that despite the steep declines in volume, there was sustained premiumization in terms of less rapid decline among premium qualities (see Exhibit 192 and Exhibit 193).

**Exhibit 192 Premium Scotch Held Up Better Than Standard…**




Source: IWSR and Bernstein analysis.

**Exhibit 193 …As Has Ultra-Premium Cognac**



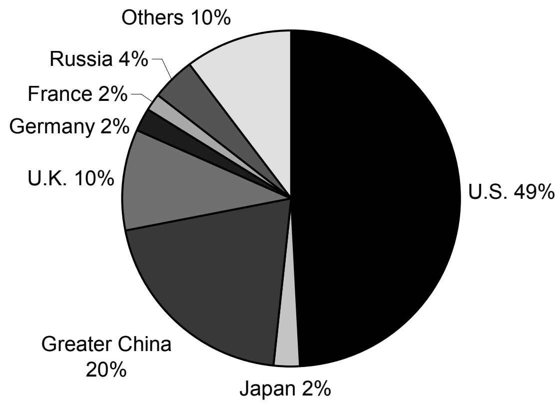

Source: IWSR and Bernstein analysis.

However, even though the decline of Japan has continued throughout the last decade, this has been more than outweighed by significant growth elsewhere in the world.

***Detailed Review of the Glorious "Noughties":*** By the end of 2007, three countries accounted for approximately 80% of global cognac consumption (see Exhibit 194).[1]

**Exhibit 194** **Three "Countries" Account for Approximately 80% of Global Cognac Consumption**

**Country Volume as Pct. of Total Sales, 2007**



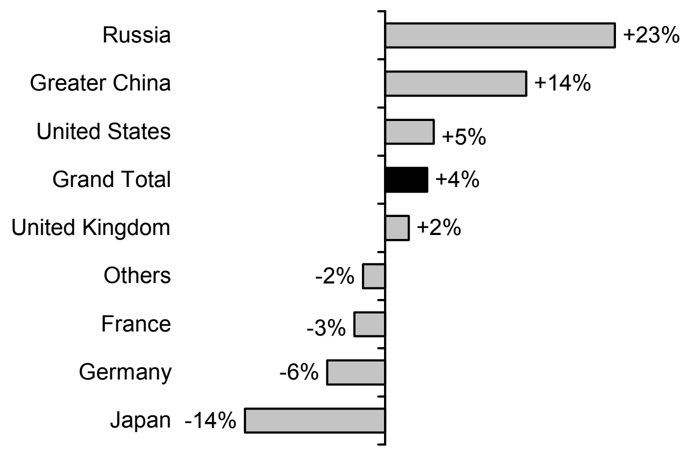

**Note:** "Greater China" = China + Hong Kong in terms of consumption.

Source: IWSR and Bernstein analysis.

Russia and China were by far the fastest-growing large countries between 2000 and 2007 (see Exhibit 195).

**Exhibit 195** **Russia and China Have Been the Fastest-Growing Countries Between 2000 and 2007**

**Consumption Growth Rates, Pct. CAGR 2000-07**



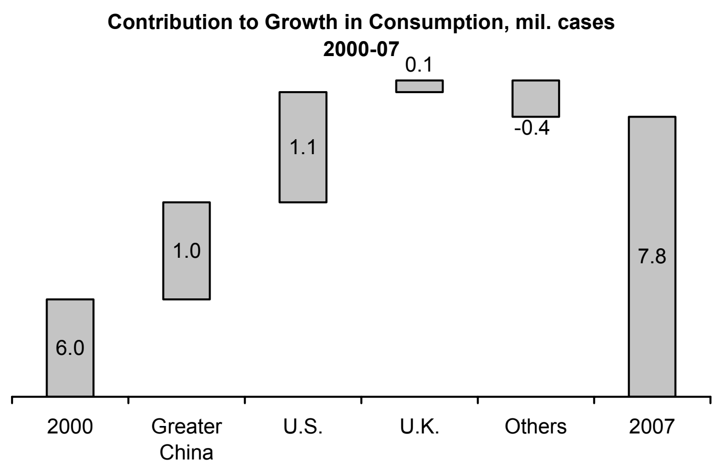

Source: IWSR and Bernstein analysis.

However, because China was growing off a much larger base than Russia, it accounted for 50% of the increase in global consumption in the 2000-07 period (see Exhibit 196). The other major driver of growth was the United States, which actually delivered marginally more total growth in volume. However, as we will

[1] There can be material discrepancies between global consumption data (for which IWSR is our preferred data source) and shipment data (as supplied by the industry association BNIC). These discrepancies arise because the country to which cognac is shipped is not necessarily the end destination, and because of changes in inventory/destocking and swings in unaudited brands.

explore later, the U.S. increase was mainly lower-value VS cognac, whereas the Chinese volumes were nearly all higher-value VSOP and XO. Furthermore, the relative importance of China accelerated during this period, with China accounting for over 70% of global volume growth from 2004 to 2007 and probably closer to 85% of global value growth in this period.

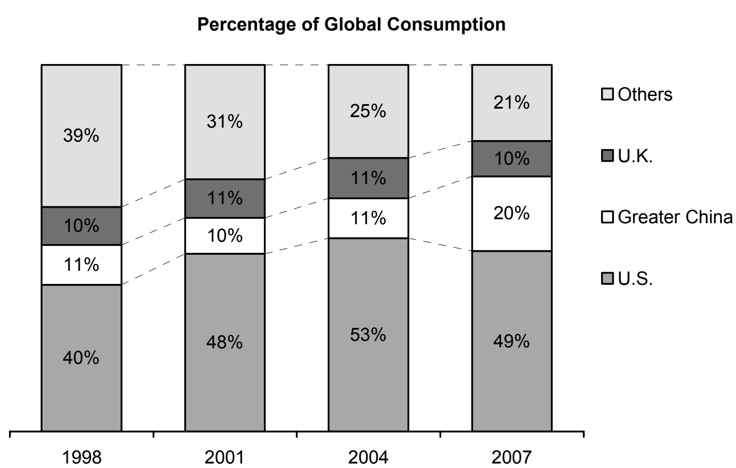
**Exhibit 196** **China Accounted for Two-Thirds of Absolute Growth in Consumption and the United States Most of the Rest**




Source: IWSR and Bernstein analysis.

As a result, China went from accounting for 11% of global cognac consumption in 2001 to 20% of consumption in 2007 (see Exhibit 197).

**Exhibit 197** **China Went from Accounting for 11% of Global Cognac Consumption in 2001 to 20% of Consumption in 2007**



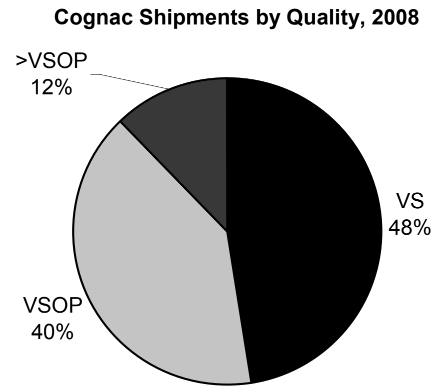

Source: IWSR and Bernstein analysis.

But as we mentioned above, age/quality is perhaps even more important to the industry than volume.

**The Importance of Age/Quality**

As we described above, there are three broad categories of cognac: VS (more than two years, ~$30 RSP), VSOP (more than four years, ~$50 RSP) and XO (more than six years, ~$150 RSP). In 2008, approximately half the industry shipments were superior, higher-margin qualities (see Exhibit 198).

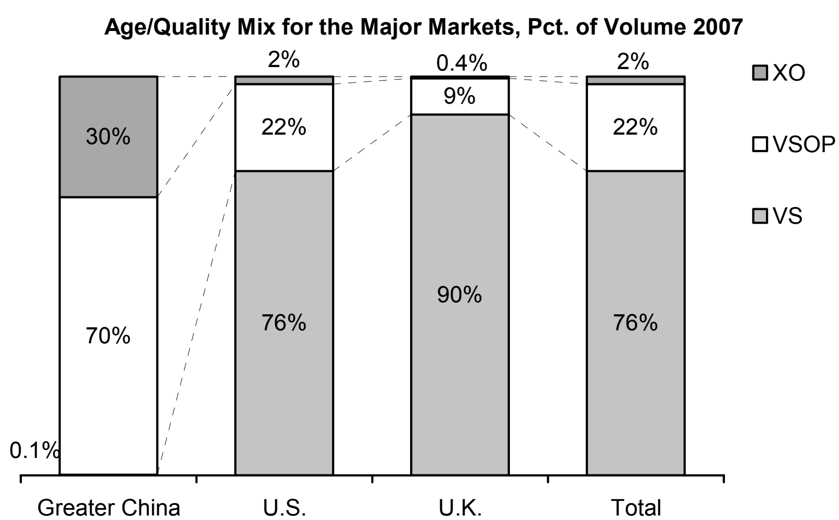
**Exhibit 198** **Approximately Half the Market Is VS and Half Superior Qualities**




Source: BNIC and Bernstein analysis.

However, the age/quality mix varies widely across markets. The Chinese market is almost entirely superior qualities (see Exhibit 199), 30% of consumption is XO and there is next to no VS. In contrast, the United Kingdom is over 90% VS.

**Exhibit 199** **The Chinese Market Is Almost Entirely Superior Qualities; in Contrast, the U.K. Is Over 90% VS**

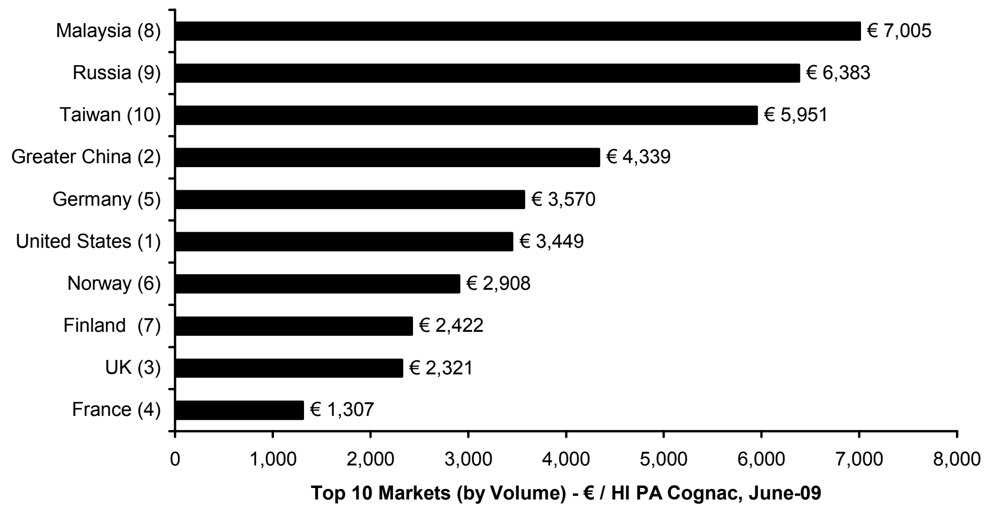



**Note**: Excludes c. 300,000 nine-liter cases of "intermediate" Cognac in China.

Source: IWSR and Bernstein analysis.

This huge difference in quality mix is reflected in average selling price. The average unit value of cognac shipped to Greater China in 2008 was €4,339/HLPA, approximately twice the unit value of cognac shipped to the United Kingdom (see Exhibit 200). Smaller cognac-consuming countries such Malaysia and Russia have even higher unit values.

**Exhibit 200** **Shipments of Cognac to China Are Worth Almost Twice as Much as Shipments to the United Kingdom**

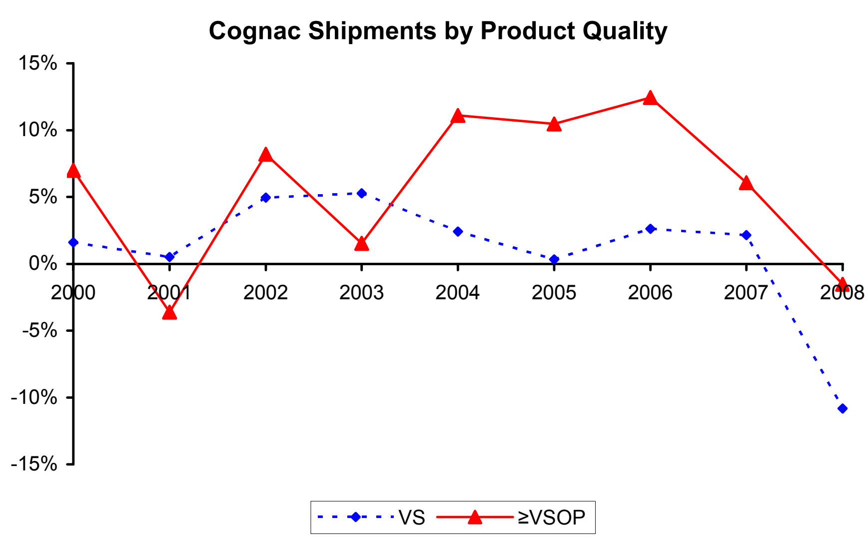



**Note:** "Greater China" = China + Hong Kong + Singapore (blended price per HLPA). Numbers in brackets indicate ranking by shipments volume in HLPA (hectoliters of pure alcohol).

Source: BNIC and Bernstein analysis.

Not only are the superior qualities much more valuable, volumes of VSOP and older have been growing much more strongly than VS. Even in the face of economic headwinds in 2008, superior qualities declined more slowly than VS (see Exhibit 201).

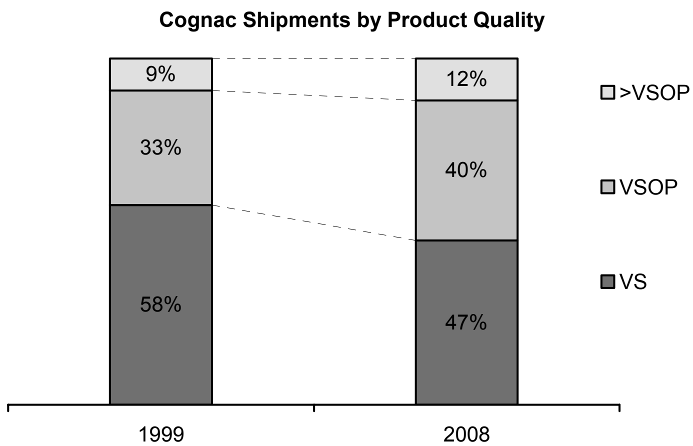
**Exhibit 201** **Superior Qualities Have Grown Consistently Faster Than VS**




Source: BNIC and Bernstein analysis.

This in turn has increased the importance of superior qualities from approximately 42% of industry shipments in 1999 to 52% in 2008 (see Exhibit 202).

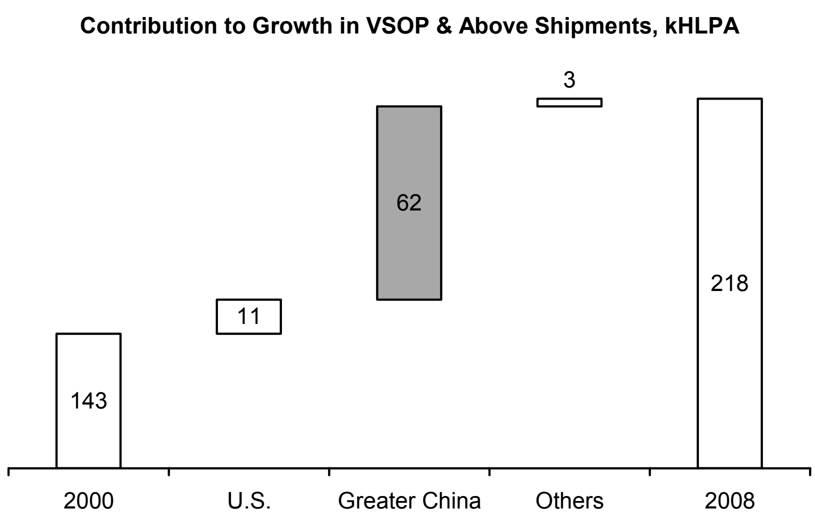
**Exhibit 202** **Leading to a Significant Shift Upwards in Average Quality**




Source: BNIC and Bernstein analysis.

There have been two components of this shift in quality. The first driver, which has been the focus of most observers' attention, is trading up in mature markets, notably the United States. However, the explosive growth of cognac in China, which is almost exclusively a high-quality market, has been much more important to the global industry's positive mix shift. Over the period from 2000 to 2008, over 80% of the incremental growth in superior qualities was generated in China (see Exhibit 203). Put it another way, *industry growth in China was responsible for over 80% of global premiumization in cognac.*

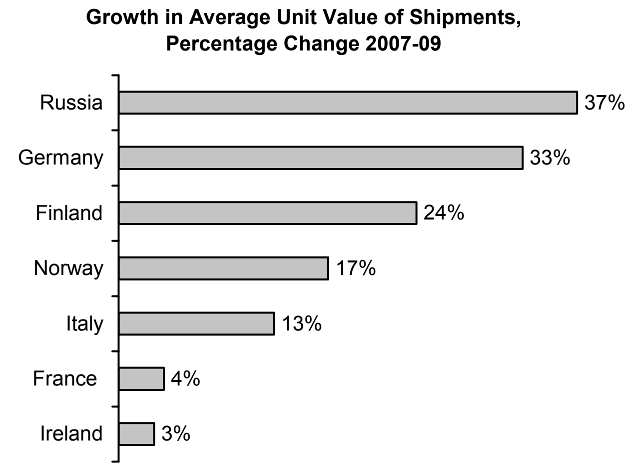
**Exhibit 203** **Over 80% of the Incremental Growth in Superior Qualities Was Generated in China**




Source: BNIC and Bernstein analysis.

As a result of this rapid growth, the cognac houses started to run tight on aged inventory (see discussion below). In order to maximize the value of their stocks, the houses (notably Martell), took up price aggressively on VS. The net effect of price and mix was big increases in the unit value of shipments to major European countries (see Exhibit 204) [n.b. the unit value of shipments to the United States and the United Kingdom decreased due to the weakness of the pound and dollar versus the euro].

**Exhibit 204** **The Industry Generated Big Increases in the Unit Value of Shipments to major European Countries**




**Note**: Shows average value / HLPA for 12-month periods ended June-07 and June-09, respectively.

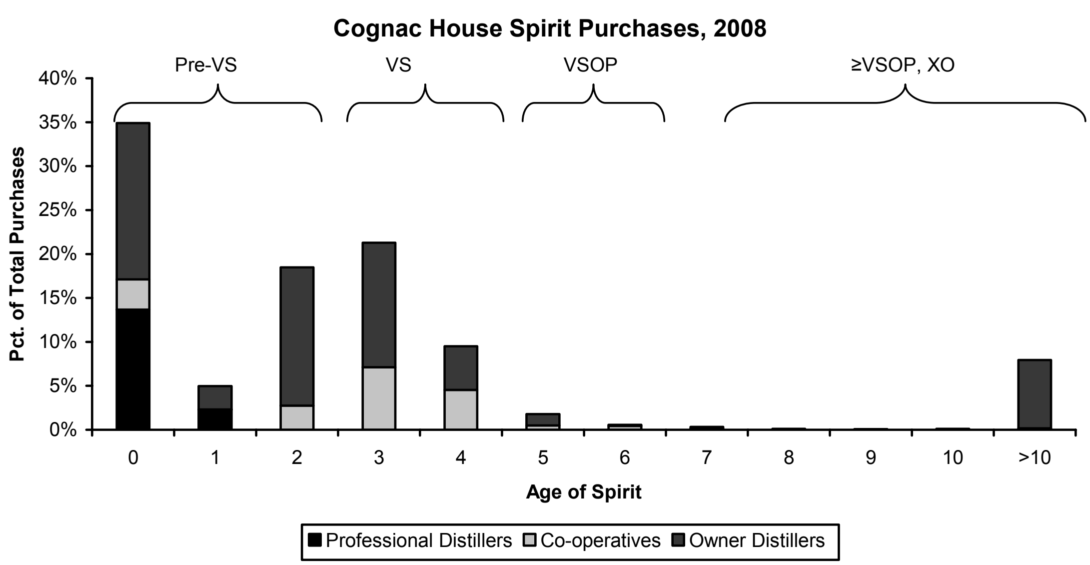
Source: BNIC and Bernstein analysis.

## Sourcing, Ageing and Implications for Capital Investment

The age of spirit is calculated from the March 31 following the harvest, with "'Compte 1" being spirit that has had more than one year's ageing after that date. The vast majority of spirit goes to make cognac but a small proportion is used in other products, including Pineau de Charentes (a local fortified wine/apéritif), other liqueurs and as filling in specialty chocolates.

As described above, the major houses purchase most of their spirits from independent distillers. They buy a mixture of newly distilled spirit (which they age themselves), VS grade spirit (some that is ready for shipping and some which will be aged for VSOP) and old vintages (for use in deluxe/XO blends) — see Exhibit 205.

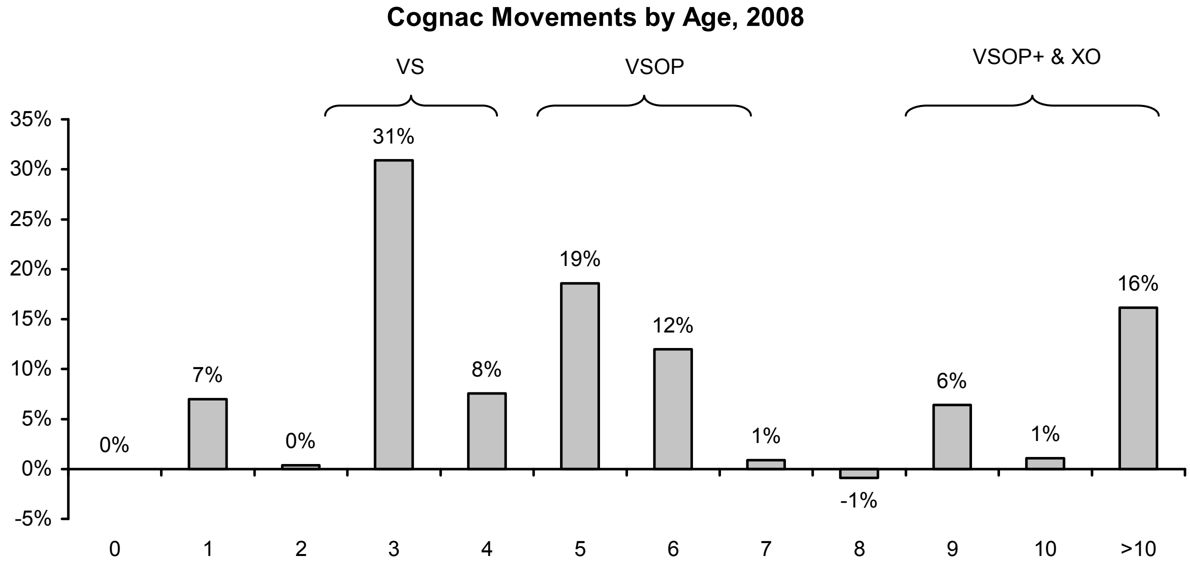
**Exhibit 205** **Cognac Houses Buy a Mixture of Newly Distilled Spirit, VS and Old Vintages**




Source: BNIC and Bernstein analysis.

They ship a much older age profile (see Exhibit 206).

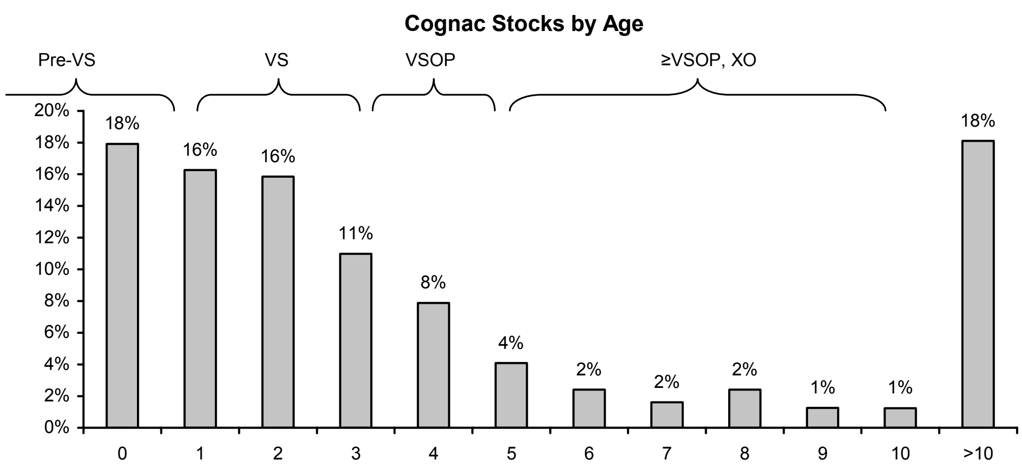
**Exhibit 206** **Cognac Net Stock Movements by Age**




Source: BNIC and Bernstein analysis.

This means that the industry typically has to hold considerable maturing inventory (see Exhibit 207). However, this does not all appear on the balance sheets of the major houses. Through the use of forward contracts for part of their purchases, the major houses only pay for the eau-de-vie when it is delivered from the distiller's warehouse to the cognac house, rather than when it is first distilled under contract.

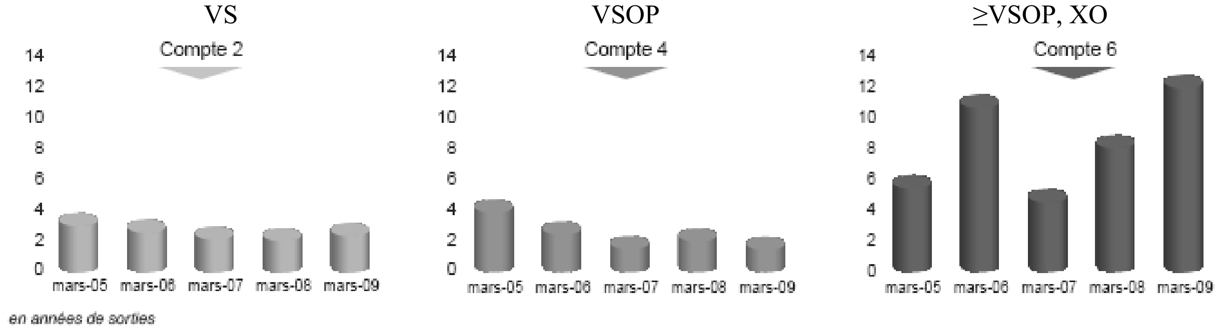
**Exhibit 207** **Cognac Stocks by Age**




Source: BNIC and Bernstein analysis.

In order to be alert for pinch points in maturing inventory, the industry measures stock in terms of number of years of demand by product quality. In the run-up to the current crisis, stocks had been tightening in terms of VSOP in particular (see Exhibit 208).

**Exhibit 208** **Stocks Had Been Tightening on VSOP in Particular**



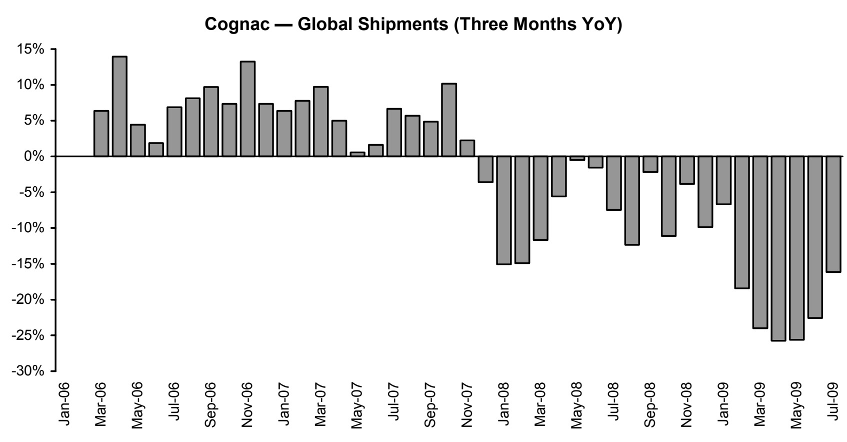

Source: BNIC and Bernstein analysis.

As described above, Martell had been raising prices on VS in order to suppress demand for lower-margin younger variants and preserve stock for higher-margin VSOP. As well as aggressive pricing on VS, Martell also increased purchases of sprits for ageing. With the recent sharp decline in demand for cognac in general, and more recently premium qualities, we believe that industry stock levels are probably fairly balanced. There is a possibility that we may see slightly lower-than-usual additions to inventory. However, we suspect that the major houses do not want to be caught short if demand rebounds quickly. Furthermore, if as we believe China is the future engine of growth, there could quickly be another pinch point on aged qualities. Therefore, a significant reduction in fillings is unlikely in the near term.

**What Has Gone Wrong in the Last 18 Months and Outlook for Next Five Years?**

Global shipments of cognac had been running at approximately 8% up year-over-year though to the third quarter of 2007 (see Exhibit 209). However, from first-quarter 2008 onwards, shipments started to decline and steadily worsened so that by second-quarter 2009, shipments were running at approximately 25% down year-on-year. Part of this reflects channel destocking in the United States in particular, and to a lesser extent a trimming of the Chinese stock build. We estimate that global trade off-take is running at approximately -15% including the impact of retail destocking in the United States, and probably at mid-high single digits in terms of consumer demand.

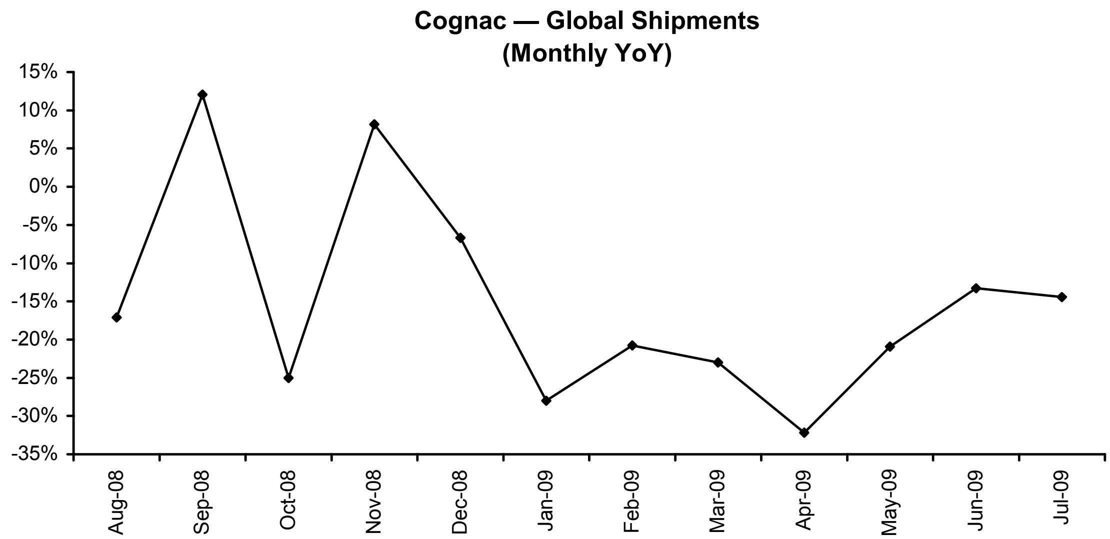
**Exhibit 209** **Cognac Shipments Went Into Decline in 1Q:08 and Trends Have Steadily Deteriorated to Approximately 25% Decline in 2Q:09**




Source: BNIC and Bernstein analysis.

Although monthly shipment data are highly volatile, there are signs that the rate of decline may be slowing (see Exhibit 210), which is consistent with industry comments that we are probably through the worst of the channel destocking.

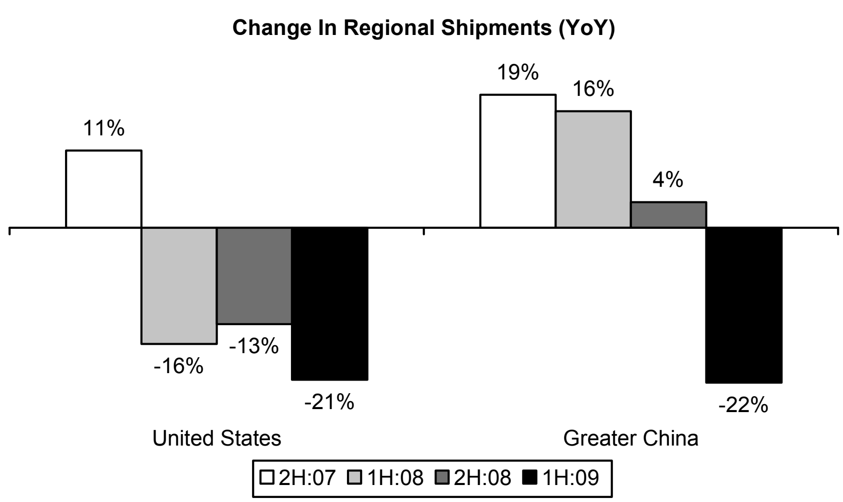
**Exhibit 210** **Monthly Shipment Data Are Highly Volatile But There Are Signs That the Rate of Decline May Be Slowing**




Source: BNIC and Bernstein analysis.

The crisis first hit the United States in first-half 2008, as American consumers were hit by the sub-prime loans crisis (see Exhibit 211). However, the decline spread to China through second-half 2008 and first-half 2009 as the Chinese economy was hit by the slump in exports. Cognac was especially badly hit because consumption is skewed toward Hong Kong and the export-oriented south of the country.

**Exhibit 211** **The Crisis Hit the United States in 1H:08, But China Followed Through 2H:08 and 1H:09**

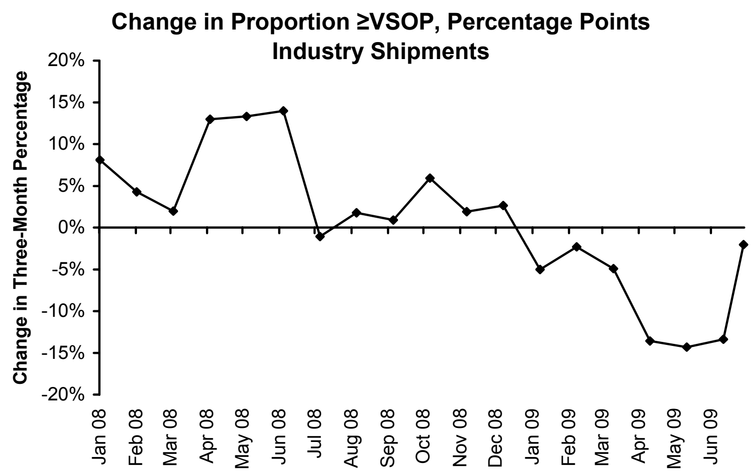



**Note:** "Greater China" = China + Hong Kong + Singapore.

Source: BNIC and Bernstein analysis.

The decline in shipments to high-value China in first-half 2009 also took their toll on age mix, with VSOP and above declining faster than VS, though there encouraging signs that as shipments to China pick up, this negative mix shift is abating (see Exhibit 212).

**Exhibit 212** **The Decline in High-Value China Also Took Its Toll on Age Mix in 1H:09**

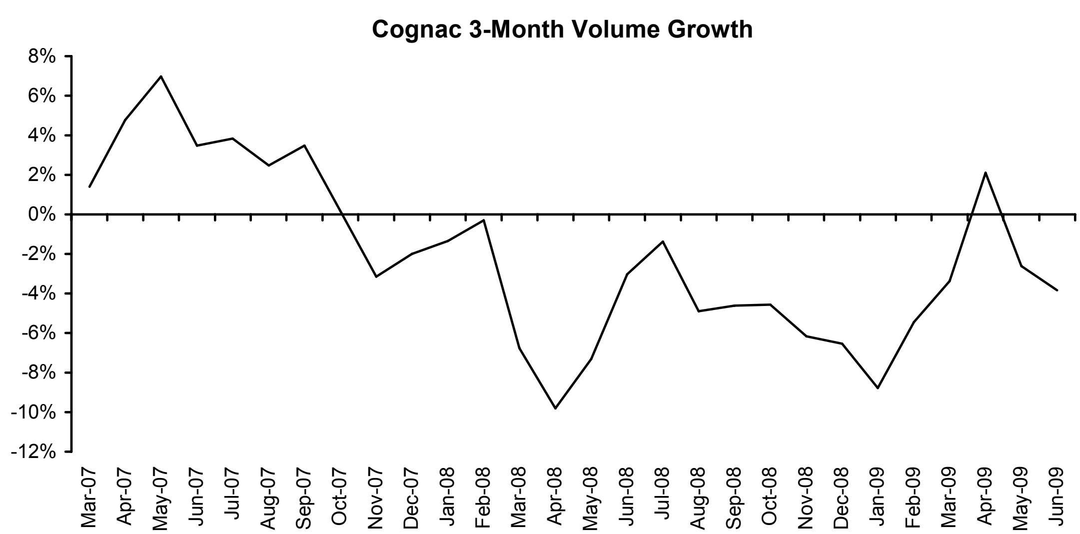



Source: BNIC and Bernstein analysis.

**We Are Cautious on the Prospects for the United States.**

***So What Is the Outlook for the Rest of 2009 and Beyond?*** The rate of decline of U.S. cognac volumes sold into retail has not slowed as much as industry shipments to the United States. Retail shipments were declining at high-single digits though most of 2008. However, the rate of decline appears to have slowed and is running at around a mid-single-digit decline (see Exhibit 213).

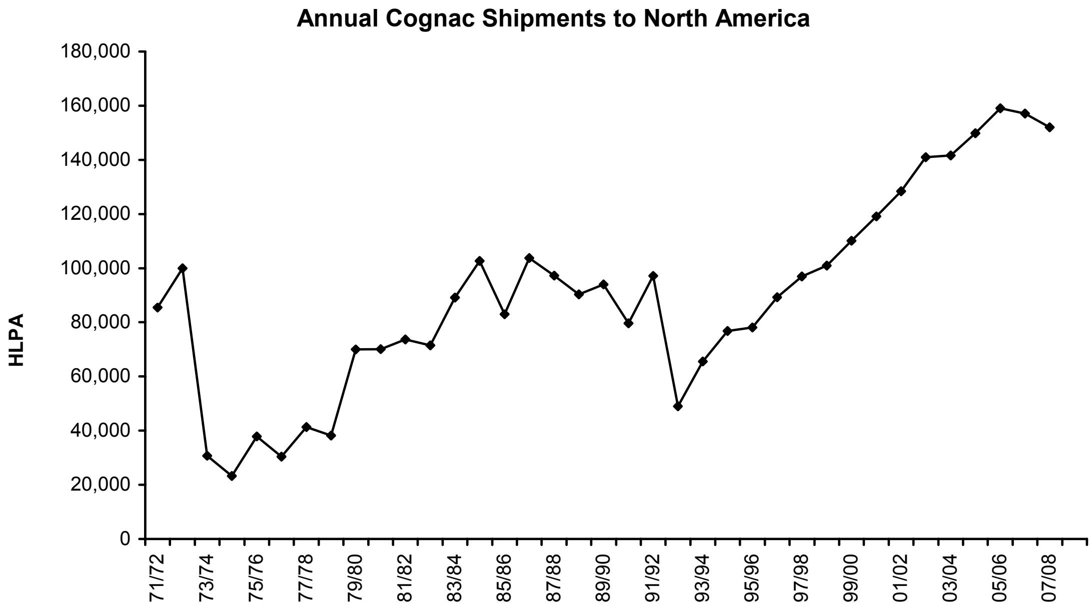
**Exhibit 213** **The Rate of Decline of U.S. Cognac Volumes Sold Into Retail Is Running at Around a Mid-Single-Digit Decline**




Source: NABCA and Bernstein analysis.

In the previous recessions of 1973 and 1991 it took the industry five years or more to get back to pre-recession shipments (see Exhibit 214).

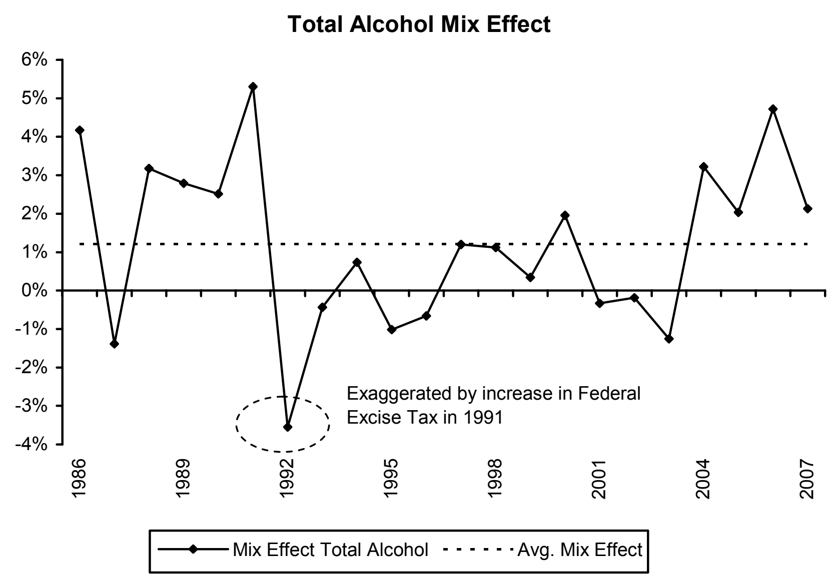
**Exhibit 214** **In 1973 and 1991 it Took the Industry Five Years or More to Bounce Back**




Source: BNIC and Bernstein analysis.

This is consistent with our analysis of patterns of premiumization in U.S. spirits. Over the last 20 years, premiumization in alcohol has been worth an average of 150 bp of extra value growth over and above volume growth and category CPI (see Exhibit 215). However, it is a case of three steps forward, one step back. In typical recessionary years, mix falls by approximately 100 bp (n.b. 1991/92 was exceptional because of a significant increase in Federal Excise Tax in the middle of a recession). Positive mix does return, but it typically takes two to three years.

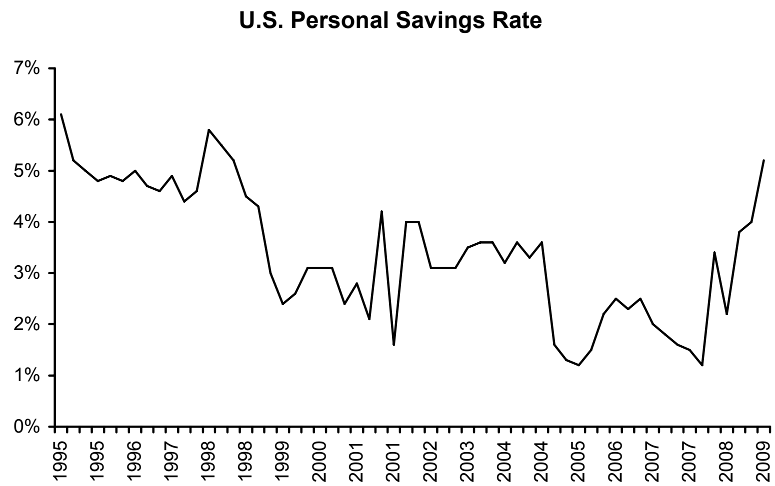
**Exhibit 215** **Long-Term Mix Averages 150 bp But Falls in a Recession and Is Slow to Return**




Source: BLS, BEA, Impact, Plato, Discus and Bernstein analysis.

This is consistent with the dramatic increase in U.S. savings rate which we have seen in the last 12 months (see Exhibit 216). If this is maintained, then consumer expenditure will remain constrained for several years to come.

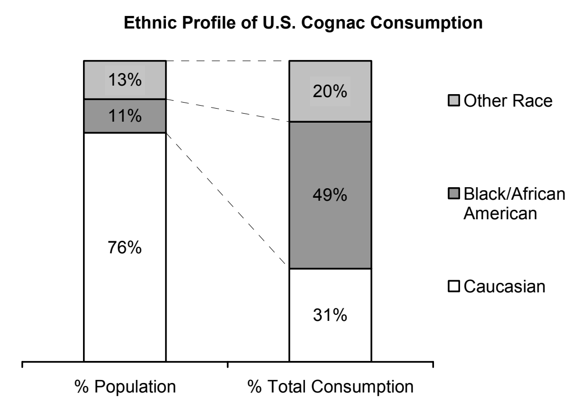
**Exhibit 216** **We Have Seen a Dramatic Increase in U.S. Savings in the Last 12 Months**




Source: BEA and Bernstein analysis.

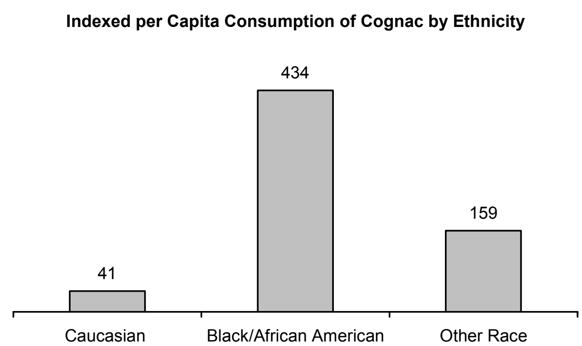
A further complicating factor is that consumption of cognac is strongly skewed to African Americans, who consume approximately 50% of total consumption (see Exhibit 217) and over-index tenfold versus Caucasian Americans (see Exhibit 218).

**Exhibit 217** **African Americans Consume 50% of All Total U.S. Cognac...**




Source: MRI and Bernstein analysis.

**Exhibit 218** **...And Over-Index Tenfold vs. Caucasians**




Source: MRI and Bernstein analysis.

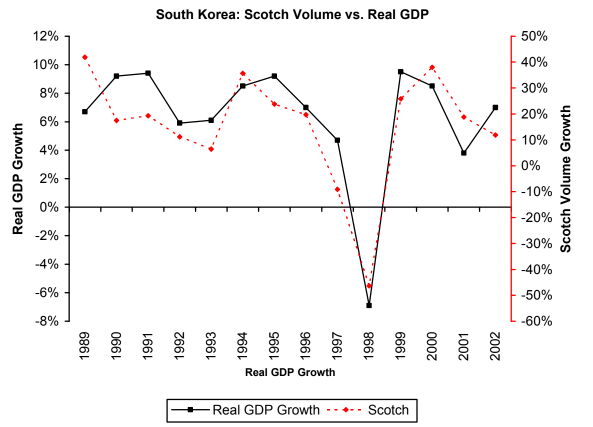
It is uncertain if and when the American consumer is sufficiently de-levered to start spending again, will urban African Americans return to cognac as the preferred vehicle of conspicuous consumption, or will they move on to another drinks category?

**We Are Positive About the Prospects for a Bounce-Back in Economic Growth in China and a Return to Growth in Luxury**

Emerging market economies have not been immune to the current global crisis, with Eastern Europe in particular being very badly impacted. However, experience from prior emerging-market recessions demonstrates that if the economy bounces back, so does consumption of premium brown spirits. In both South Korea in 1997/98 and Mexico in 1995, the economy retreated strongly, with real GDP falling approximately 7% and sales of scotch falling 50% in Korea and 30% in Mexico (see Exhibit 219 and Exhibit 220).

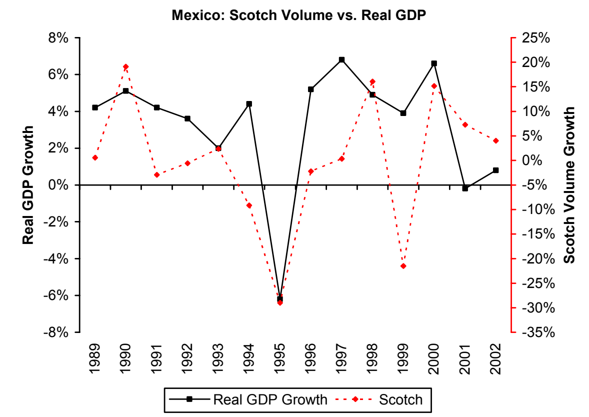
In Korea, scotch fell 50% but grew approximately 30% for the next two years, i.e., within two years volumes were back at pre-crisis levels. In Mexico in 1995, scotch fell 30%, recovered in 1996 but took several years to recover fully.

**Exhibit 219 In Korea in 1998, Scotch Fell 50% But Grew Approximately 30% for the Next Two Years**




Source: IWSR and Bernstein analysis.

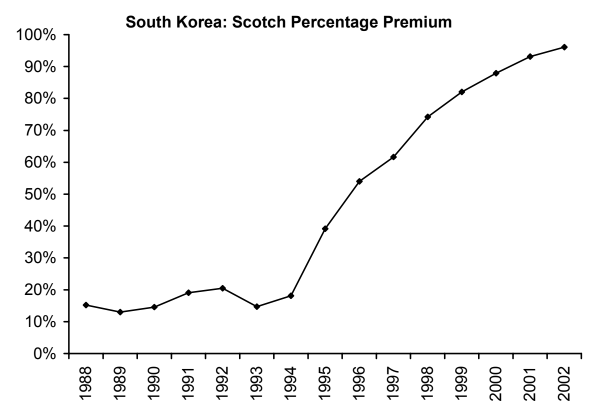
**Exhibit 220 In Mexico in 1995, Scotch Fell 30% But Took Several Years to Recover**




Source: IWSR and Bernstein analysis.

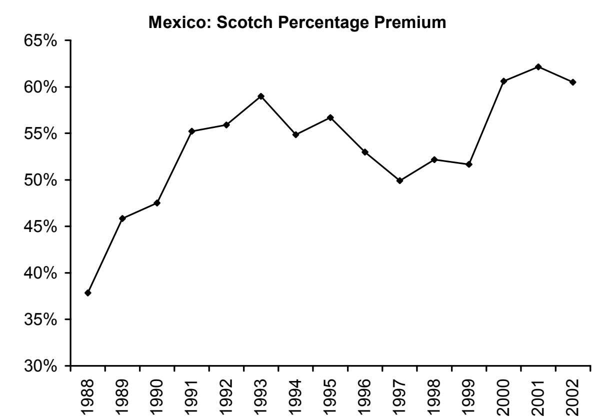
Although volumes were weak, there was no significant down trading. In Korea, mix improved through the crisis (see Exhibit 221) and in Mexico, mix was broadly stable (see Exhibit 222). In other words, consumers drank less in the crisis but brand loyalty and aspiration remained strong.

**Exhibit 221 In Korea in 1998, Scotch Fell 50% But Grew Approximately 30% for the Next Two Years**




Source: IWSR and Bernstein analysis.

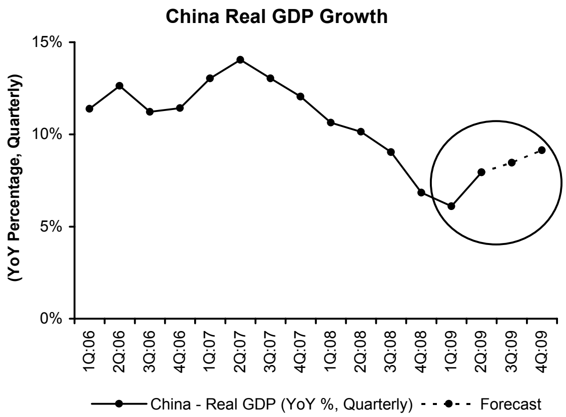
**Exhibit 222 In Mexico in 1995, Scotch Fell 30% But Took Several Years to Recover**




Source: IWSR and Bernstein analysis.

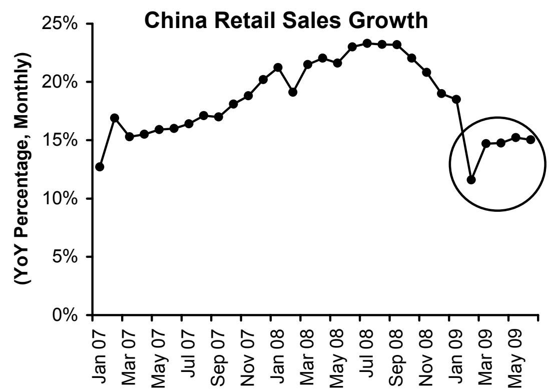
The latest macroeconomic statistics from China are also positive. Real GDP growth picked up in 2Q:09 and is forecast to further improve in the second half (see Exhibit 223), and growth in retail sales has also picked up (see Exhibit 224), although neither measure has reached the dizzy heights of 2007 and early 2008.

**Exhibit 223 Real GDP Growth Picked Up in 2Q:09 and Is Forecast to Further Improve in 2H…**




Source: *Global Insight*, NBS China and Bernstein analysis.

**Exhibit 224 …And Growth in Retail Sales Has Also Picked Up**

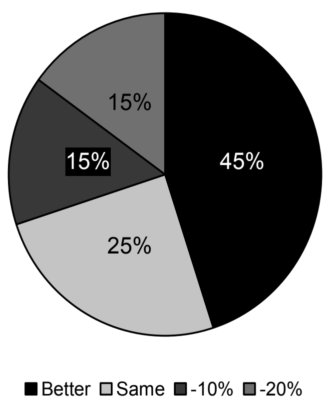



Source: NBS China and Bernstein analysis.

We are also encouraged by company comments. Regarding its first-half results, in a very gloomy environment for champagne, LVMH noted on "Improving trends (for cognac) in China after the first quarter was impacted by Chinese New Year". And commenting on its 2Q CY 2009 results Rémy Cointreau commented that "the growth in Rémy Martin's turnover was sustained in China".

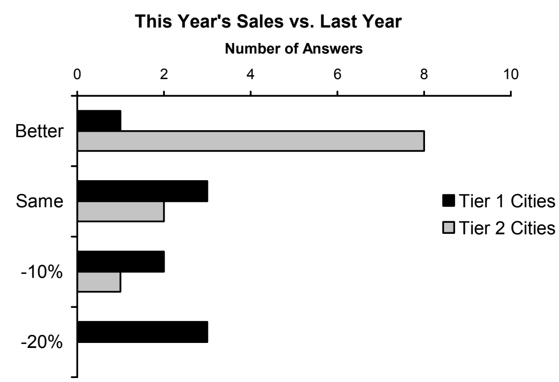
Finally, evidence from Bernstein Proprietary Surveys also indicates that luxury sales are holding solid in China (see Exhibit 225), especially in Tier 2 cities (see Exhibit 226).

**Exhibit 225 Luxury Sales Are Holding Solid in China….**




Source: Bernstein Proprietary Survey.

**Exhibit 226 …Especially in Tier 2 Cities**




Source: Bernstein Proprietary Survey.

**We Are Cautiously Optimistic That the Near-Term Excess of Supply Over Demand Will Not Lead to Pressure on Pricing**

Investors have expressed concerns to us that the fall in demand may lead to pressure in pricing, as was the case in champagne in the last crisis (and despite the protests of some champagne houses we expect the same again this time round). We are cautiously optimistic that this will not be the case in cognac because the industry structure is so different.

In champagne, 56% of volume is sold on the very fragmented and price-competitive French market and 44% goes to export. Even on the export markets, the five largest producers only account for 47% of the volume. Furthermore, some of the key players in champagne are heavily indebted. When stocks were tight, the industry was happy to follow Moët et Chandon's lead on pricing. With the current excess of stock, we are likely to see pricing pulled down in French market — and 'Tier 2" brands offered at very attractive prices in the United States and the United Kingdom.

Cognac is much more concentrated. The French market is fragmented but only accounts for 2% of global consumption. On the major export markets, especially outside Europe, two or three of the big four houses normally dominate (see below for detailed discussion) because it is simply too expensive for the small houses to establish strong distribution networks. In short, the big players are unlikely to lead a reduction in prices and the small players don't have access to the critical export markets.

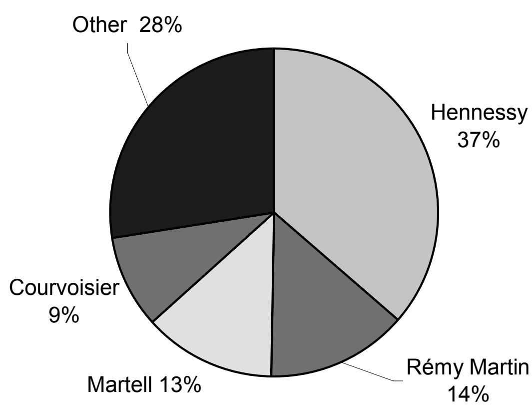
**Industry Structure: Winners and Losers Largely Driven by the Combination of Geographic Mix and Distribution Power**

The global cognac industry is dominated by four companies (see Exhibit 227).[2]

***Hennessy*** is the behemoth of the cognac industry, with a 37% share. Like many of the houses it was founded in the 18th century, in this case by Anglo-Irish money. In 1971 Moët et Chandon merged with Hennessy and in 1987 Moët-Hennessy merged with Louis Vuitton, (which at that time was only one-third the size of Moët-Hennessy). LVMH subsequently came under the control of Bernard Arnault. It was around this time that the link was established with Guinness, who ultimately allied with Arnault in the acquisition of LVMH. The subject of Guinness/Diageo's relationship with LVMH is complex but suffice to say that Diageo today holds a 34% stake in Moët-Hennessy, and the two groups cooperate around the world, but LVMH has complete management control.

**Exhibit 227 The Global Cognac Industry Is Dominated by Four Companies**

**Cognac — 2007 Global Volume Shares (%)**




Source: BNIC, IWSR and Bernstein analysis.

LVMH's 66% share of Moët-Hennessy accounted for 29% of group EBIT in 2008 on a 100% consolidated basis and 24% adjusted for the Diageo stake. Cognac & Spirits[3] was 43% of Moët-Hennessy's EBIT versus 57% for Champagne & Wine (i.e., it accounted for just over 10% of LVMH's adjusted EBIT). Diageo's stake in Moët-Hennessy accounted for approximately 10% of Diageo's earnings in FY 2009 (i.e., approximately 4% of group earnings was derived from Hennessy's cognac business).

***Rémy Martin*** is the second-largest house, with a 14% share, owned by the Rémy Cointreau group. The house was founded in 1724 by Rémy Martin, a French winemaker. In 1965, André Renaud, the then controlling shareholder, died and split the company between his two daughters, 51% to the eldest Anne-Marie Hériard Dubreuil, and 49% her younger sister Geneviève Cointreau, who had married Max

[2] Other defined as difference between BNIC industry shipments and IWSR estimated sales volumes. Probably over-estimates other sales because of strong inventory sales build in 2007.

[3] Moët-Hennessy owns a number of other spirits brands such as Glenmorangie malt Scotch, the Belvedere and Chopin vodka brands and 10 Cane rum, but these are not material to earnings.

Cointreau, one of the heirs to the eponymous French liqueur. After years of family feuding, the two companies merged to form Rémy Cointreau and today the business is 43% owned by the Hériard Dubreuil family and 14% by the Cointreau family.

***Martell*** is the third-largest house, with a 13% share, owned by Pernod Ricard. It was founded in 1715 by Jean Martell from Jersey in Channel Islands. The Martell family sold the business to Seagram in 1988. Pernod subsequently gained control of Martell when it jointly acquired Seagram with Diageo in 2001. Pernod releases no details on what proportion of its EBIT is accounted for by Martell. We estimate that cognac accounts for 9% of Pernod's revenue and approximately 12% of group contribution.

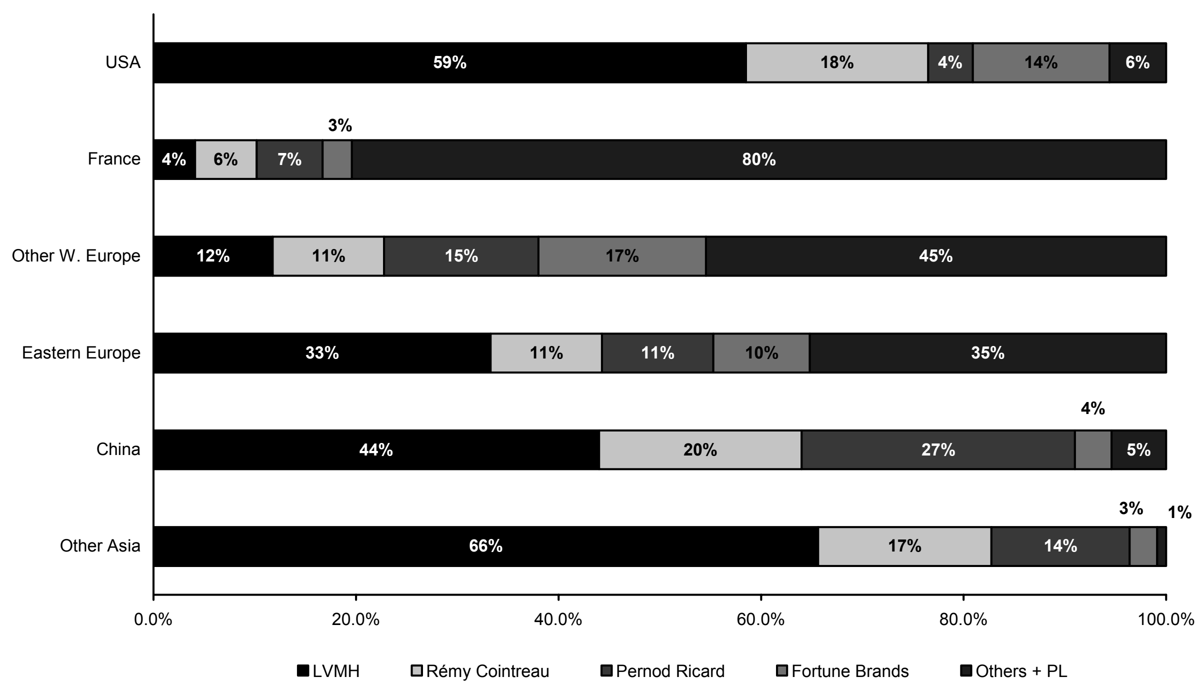
***Courvoisier*** is the fourth major house, with a 9% share, owned by Beam Global, the spirits division of Fortune Brands. Established in 1835, Courvoisier has been caught up in many M&A deals in the last few decades. In 1964, it was bought by Hiram Walker, which was then bought by Allied Lyons in 1986, before being sold on to Fortune Brands as part of Pernod Ricard's acquisition breakup of Allied Domecq. Courvoisier's sales are very much focused on the U.S. and U.K. markets.

None of the next tier of companies has much more than a 1% share of the global market and includes companies such as Camus (strong in Asian D/F), Otard (owned by Bacardi) and a number of brands sold only in Scandinavia such as Larsen, Grönstedts and Braastad.

Finally, there are a number of small but highly regarded premium niche producers such as Delamain, Frapin and Hine.

The four big houses have very different regional strengths and weaknesses (see Exhibit 228). In the United States, Hennessy is the largest company by far, with Rémy No. 2 and Courvoisier No. 3, Martell being a distant No. 4. In China, Hennessy is also the largest company but the gap is not so large to Martell No. 2 and Rémy No. 1. In Western Europe, the market is much more balanced, with none of the major houses having a dominant regional share.

**Exhibit 228** **Cognac — Volume Share by Region, 2007 (%)**



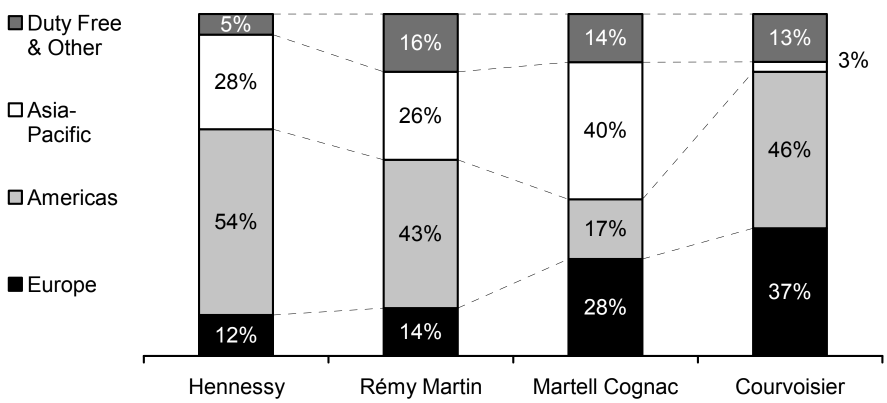

Source: *Euromonitor* and Bernstein analysis.

Looked at from a company perspective, Hennessy sells over 50% of its volume in the United States, whereas Martell is much more oriented to Asia Pacific (see

Exhibit 229). Courvoisier's sales are nearly in the United States and Western Europe. Rémy has a broadly balanced mix of geographic exposures.

**Exhibit 229** **Hennessy Sells Over 50% of Its Volume in the United States, Whereas Martell Is Much More Oriented to Asia Pacific**

**Regional Importance for the Major Houses, Percentage by Volume**

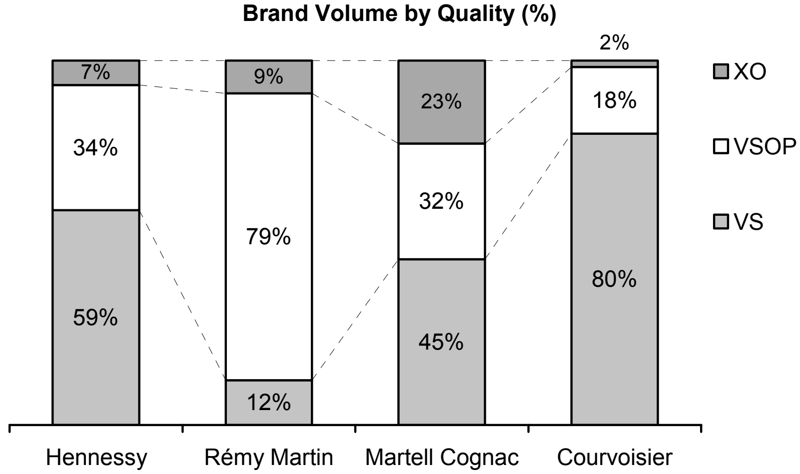



Source: IWSR and Bernstein analysis.

Rémy has historically had the most premium portfolio, with a business that is almost exclusively VSOP and above (see Exhibit 230). However because of its very high regional exposure to China, Martell has seen explosive growth on its ultra-premium variants Cordon Bleu and XO.

**Exhibit 230** **Courvoisier Has the Highest Proportion VS, Rémy Is Strongest in VSOP and Martell Has the Highest Percentage XO**

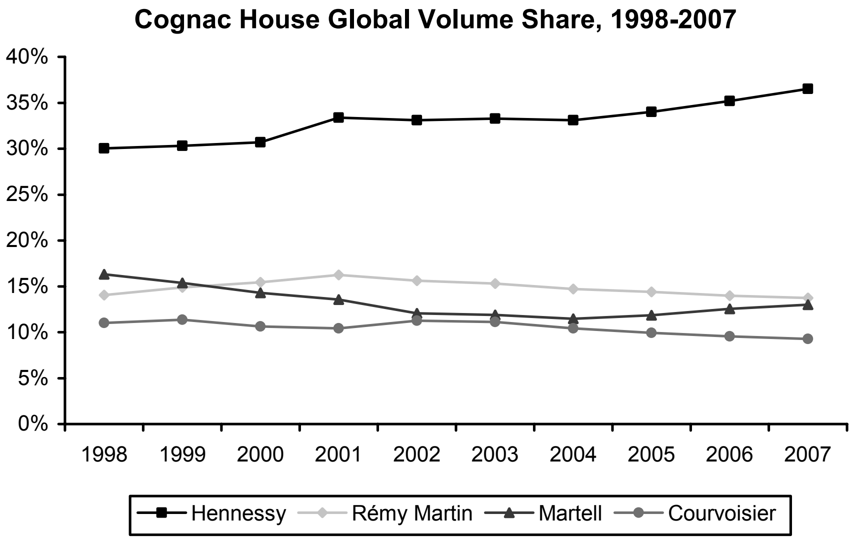
**Brand Volume by Quality (%)**




Source: IWSR and Bernstein analysis.

Hennessy has steadily reinforced its position as the largest house (see Exhibit 231). Martell had been steadily losing share under Seagram's ownership but Pernod has succeeded in turning the franchise around, boosted by a favorable tailwind from the rapid growth of the Chinese economy. In contrast, Rémy has been steadily losing ground for the last six years. Courvoisier has also steadily lost global share due to high exposure to low-growth markets.

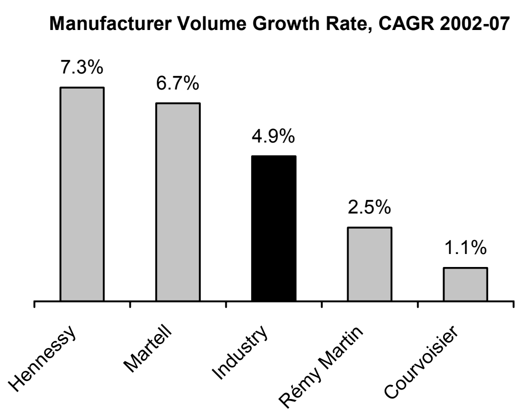
**Exhibit 231** **Hennessy Has Steadily Reinforced Its Position as the Largest House**




Source: BNIC, IWSR and Bernstein analysis.

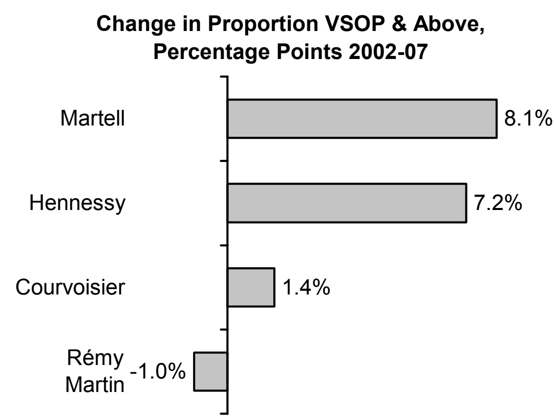
The growth gap between Hennessy and Martell on one hand, and Rémy and Courvoisier on the other hand, has steadily widened in recent years (see Exhibit 232). Furthermore, Martell and Hennessy have both seen strong premiumization in their portfolio (see Exhibit 233). Because Rémy already has a very high proportion of VSOP, it would have been almost impossible for it to match the other two on this measure. Nevertheless, Rémy has lost ground in high-value China, and Martell in particular now has a much stronger relative presence in XO (see Exhibit 230).

**Exhibit 232** **Rémy and Courvoisier Have Been Losing Share to Hennessy and Martell**




Source: BNIC, IWSR and Bernstein analysis.

**Exhibit 233** **Hennessy and Martell Have Seen Strong Premiumization of Their Portfolios**




Source: BNIC, IWSR and Bernstein analysis.

An analysis of regional gains and losses clearly highlights the drivers of Hennessy's and Martell's relative outperformance (see Exhibit 234). Hennessy has been gaining at the expense of Courvoisier in the United States (approximately 6 percentage points of share from 2002-07) and Hennessy and Martell have gained at the expense of Rémy in China (approximately 7-10 percentage points of share from 2002-07).

**Exhibit 234** **Hennessy Has Been Gaining at the Expense of Courvoisier in the United States and Hennessy and Martell Have Gained at the Expense of Rémy in China**

| | Δ Share 2002-07 | | | |
|---|---|---|---|---|
| | Hennessy | Rémy Martin | Martell | Courvoisier |
| U.S. | 5.8% | -0.4% | -1.6% | -3.4% |
| W. Europe | 0.0% | -2.7% | 0.2% | 4.0% |
| CE Europe | 0.1% | 1.6% | -0.3% | -1.0% |
| Greater China | 10.3% | -9.1% | 6.8% | -1.5% |

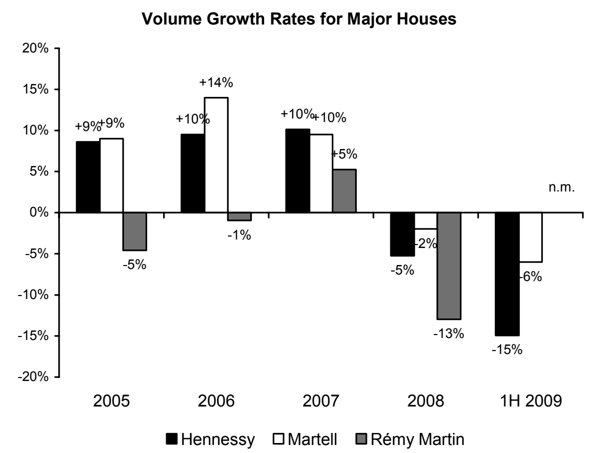
**Note:** Greater China = China + Hong Kong + Singapore. Light shading indicates share gains of +3% or more; dark shading indicates share losses of -3% or more.

Source: IWSR and Bernstein analysis.

These trends in market share are fully reflected in the major companies' reported results. Hennessy and Martell have grown volumes consistently faster than Rémy (see Exhibit 235). Martell has seen spectacular value growth through to 2008 (see Exhibit 236). Part of this relates to faster growth on aged qualities than its peers but also a very aggressive pricing strategy on VS. However, all the houses have seen rapid growth turn to steep decline through 2008 and into 2009. Rémy Martin's reported growth has been particularly badly affected because of technical effects moving from Maxxium to its own distribution network.

It is too early to talk of recovery but at least things seem to have stopped getting worse. Hennessy's rate of decline was stable at a 12% organic drop in value in both 1Q and 2Q and Rémy was broadly stable at -14%. With nearly all the de-stocking apparently over, we expect to see a modest improvement in trends in 2H:09.

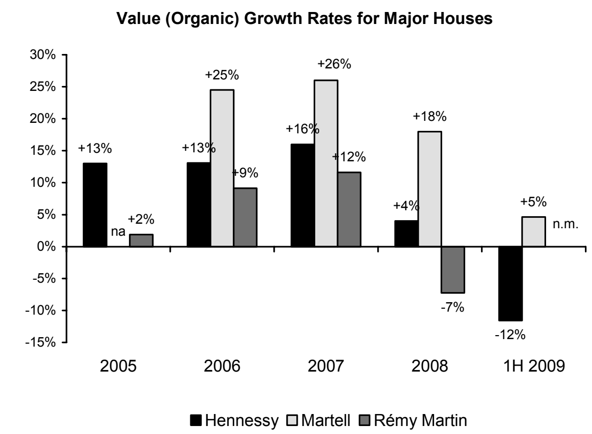
**Exhibit 235** **Hennessy and Martell Have Grown Volumes Consistently Faster Than Rémy…**




**Note:** Calendarized growth rates used for comparability.

Source: Corporate reports and presentations and Bernstein analysis.

**Exhibit 236** **…And Martell Saw Spectacular Value Growth Through to 2008**

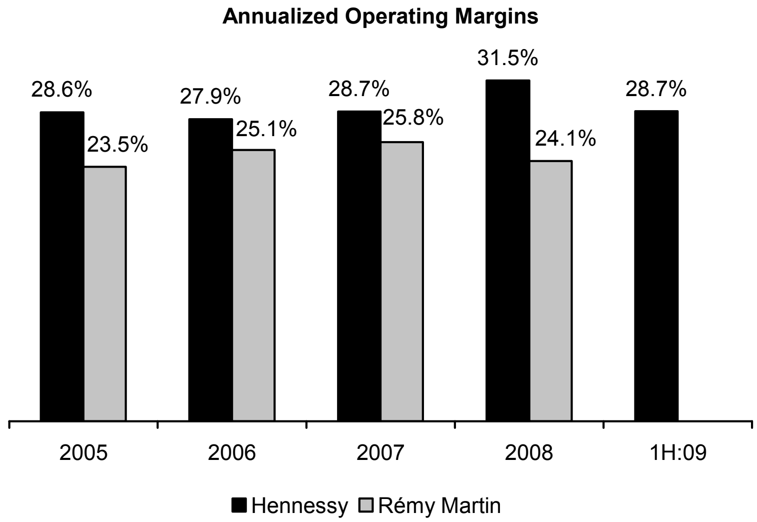



**Note:** Calendarized growth rates used for comparability.

Source: Corporate reports and presentations and Bernstein analysis.

Both Hennessy and Rémy saw steady improvements in margin through the glory years (see Exhibit 237). Rémy's margins already came under pressure in 2008, due to share losses in China and the costs of withdrawing from the Maxxium network. Hennessy's margin did not suffer until 1H:09 when the sharp fall in sales put severe pressure on operating leverage. Combined with negative mix, this drove a contraction of 640 bp in 1H:09 margins versus 1H:08, equivalent to a 280 bp fall in annualized margins. Though if the second half does see improved trends (or rather less worse), then the margin hit should be correspondingly lower.

**Exhibit 237** **Operating Margins by Major House — FY05-FY08**




**Note:** We have treated RM FY09 (year-end 31 March 2009) as equivalent to 2008.

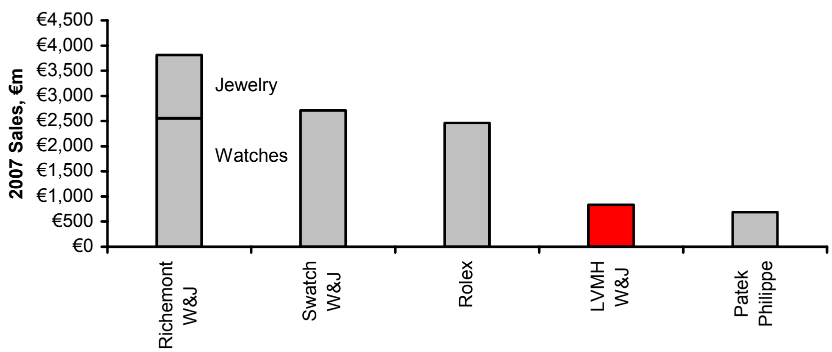
Source: Corporate reports and presentations and Bernstein analysis.

# Watches & Jewelry — A Difficult Time to Fight "Hard Luxury" Giants

**LVMH Is a Follower In the Watches & Jewelry Industry**

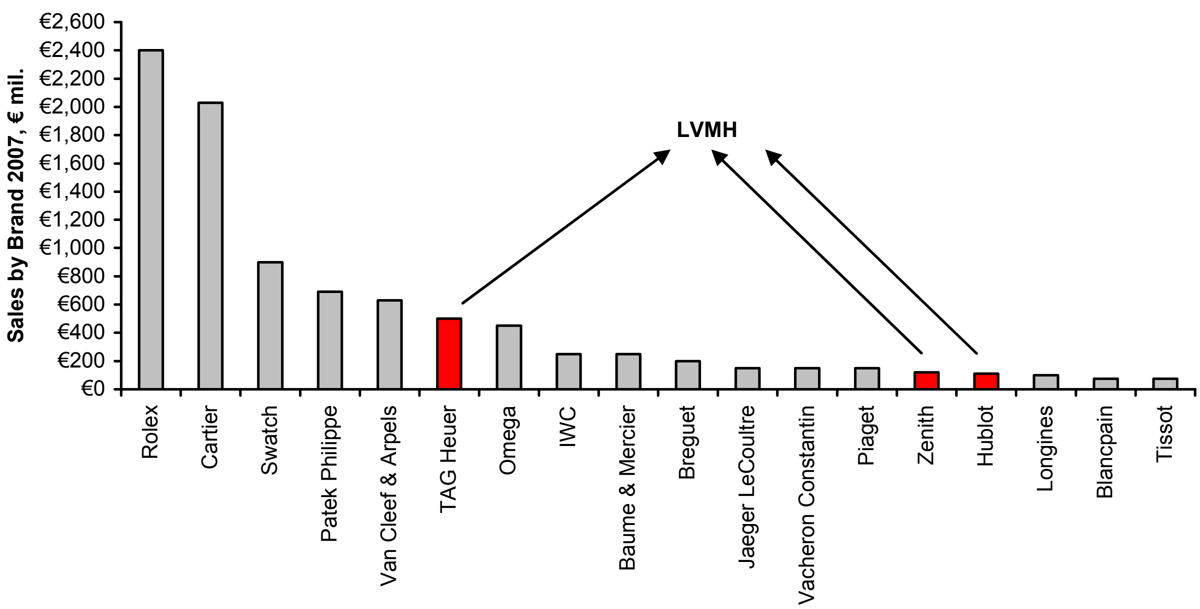
With sales of €879 million in FY08, LVMH is between one-third and a quarter of the size of Richemont and UHR, as well as materially smaller than privately held Rolex (see Exhibit 238). The LVMH Watch & Jewelry brands are smaller and — for the most part — "middle of the road" in terms of price point, product content, consumer recognition and distribution network (see Exhibit 239 through to Exhibit 248).

**Exhibit 238** **LVMH Watch & Jewelry Lacks Scale vs. Industry Leaders**




Source: Corporate reports and Bernstein estimates and analysis.

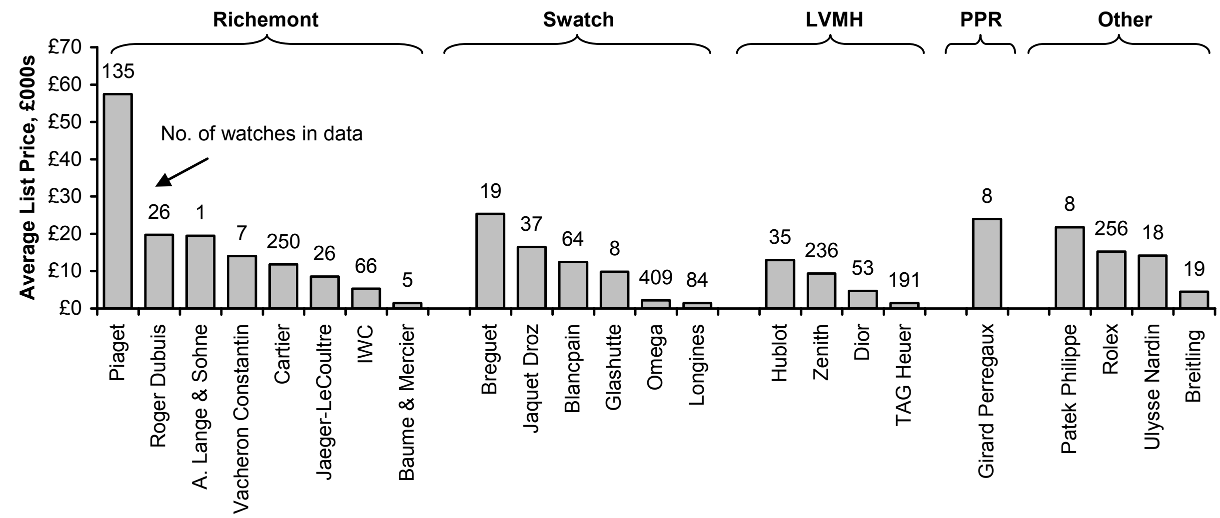
**Exhibit 239** **The LVMH Watch & Jewelry Brands Are Smaller, as We See from 2007 Sales by Brand (Rough-Cut Estimates)**




**Note:** Brand sales shown above are rough-cut estimates based on the number of point of sales, comparable brands and other indirect assessments.

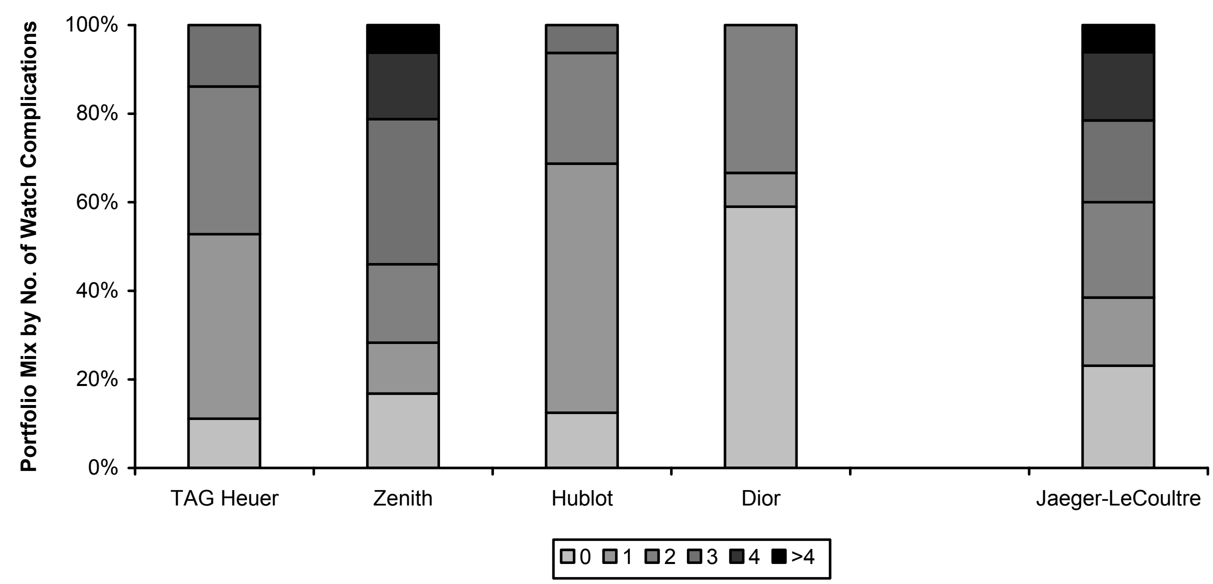
Source: Brand Web sites, Capital IQ and Bernstein estimates and analysis.

**Exhibit 240** **The LVMH Watch & Jewelry Brands Are "Middle Of The Road" in Terms of Price Point, as We See from the Analysis of Average List/Recommended Retail Prices for Watches by Brand**




Source: Brand Web sites, brand brochures, thewatchsource.co.uk, swissluxury.com, thewatchquote.com and Bernstein estimates and analysis.

**Exhibit 241** **The LVMH Watch & Jewelry Brands Also Appear — On Average — To Have Intermediate Product Content in Its Range, as We See from the Analysis of the Number of Complications by Brand**




**Note:** We have used Jaeger-LeCoultre (part of the CFR portfolio) as an example of a "luxury segment" (€4,000-€6,000) brand.

Source: Brand Web sites, brand brochures, thewatchsource.co.uk, swissluxury.com, thewatchquote.com and Bernstein estimates and analysis.

**Exhibit 242** **LVMH Watch & Jewelry Brands Are Lagging Competitors in Consumer Recognition**

**China: Best Complicated Watch, 2009**

| Brand | Rank |
|---|---|
| Patek Philippe | 1 |
| Vacheron Constantin | 2 |
| Blancpain | 3 |
| Breguet | 4 |
| Audemars Piguet | 5 |
| IWC | 6 |
| Jaeger-Le Coultre | 7 |
| Glashütte | 8 |
| Franck Muller | 9 |

Source: Hurun and Bernstein analysis.

**Exhibit 243** **China: Best Jewelry Watch, 2009**

| Brand | Rank |
|---|---|
| Piaget | 1 |
| Cartier | 2 |
| Bvlgari | 3 |
| Chanel | 4 |
| Chopard | 5 |

Source: Hurun and Bernstein analysis.

**Exhibit 244** **China: Best Jewelry Brand, 2009**

| Brand | Rank |
|---|---|
| Cartier | 1 |
| Van Cleef & Arpels | 2 |
| Tiffany | 3 |
| Bvlgari | 4 |
| Chanel | 5 |
| Piaget | 6 |
| Mikimoto | 7 |
| Harry Winston | 8 |
| Adler | 9 |
| Chaumet | 10 |

Source: Hurun and Bernstein analysis.

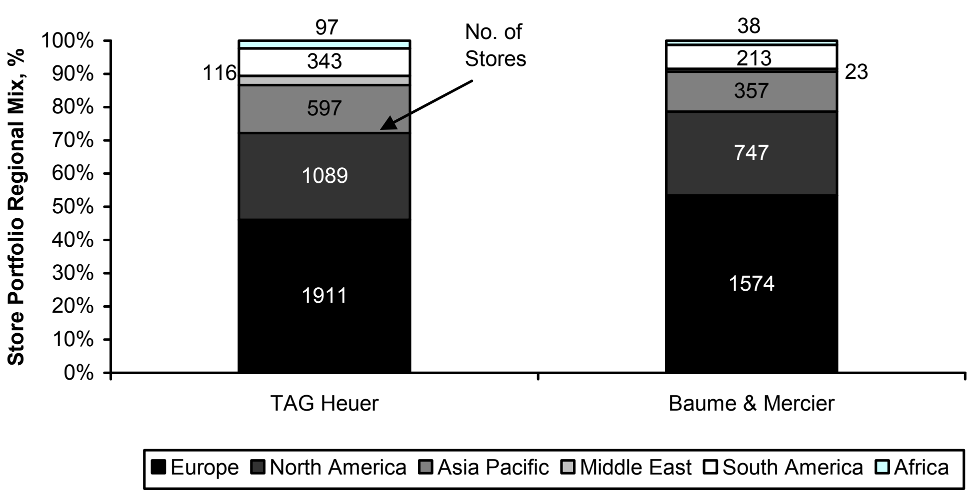
**Exhibit 245** **LVMH Watches & Jewelry Distribution Network by Brand**

Store Network by Brand by Region, No. of Stores

| | TAG Heuer | Zenith | Hublot | Dior | De Beers | Fred | Chaumet | Total |
|---|---|---|---|---|---|---|---|---|
| Asia Pacific | 597 | 173 | 75 | 103 | 18 | 14 | 104 | 1,084 |
| Europe | 1,911 | 470 | 337 | 46 | 8 | 6 | 207 | 2,985 |
| Middle East | 116 | 38 | 17 | 7 | 3 | 1 | 19 | 201 |
| North America | 1,089 | 80 | 49 | 35 | 11 | 1 | 1 | 1,266 |
| South America | 343 | 49 | 77 | 1 | - | - | 21 | 491 |
| Africa | 97 | 6 | 18 | 1 | - | - | 14 | 136 |
| **Total** | **4,153** | **816** | **573** | **193** | **40** | **22** | **366** | **6,163** |

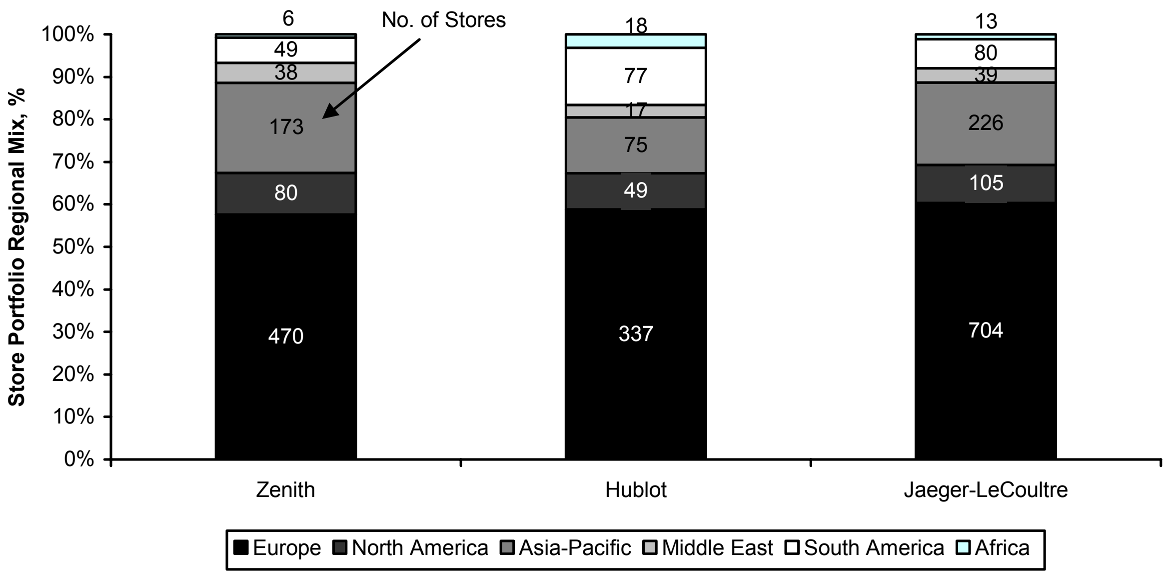
Source: Brand Web sites and Bernstein analysis.

**Exhibit 246** **Store Portfolio by Region — TAG Heuer vs. Baume & Mercier**



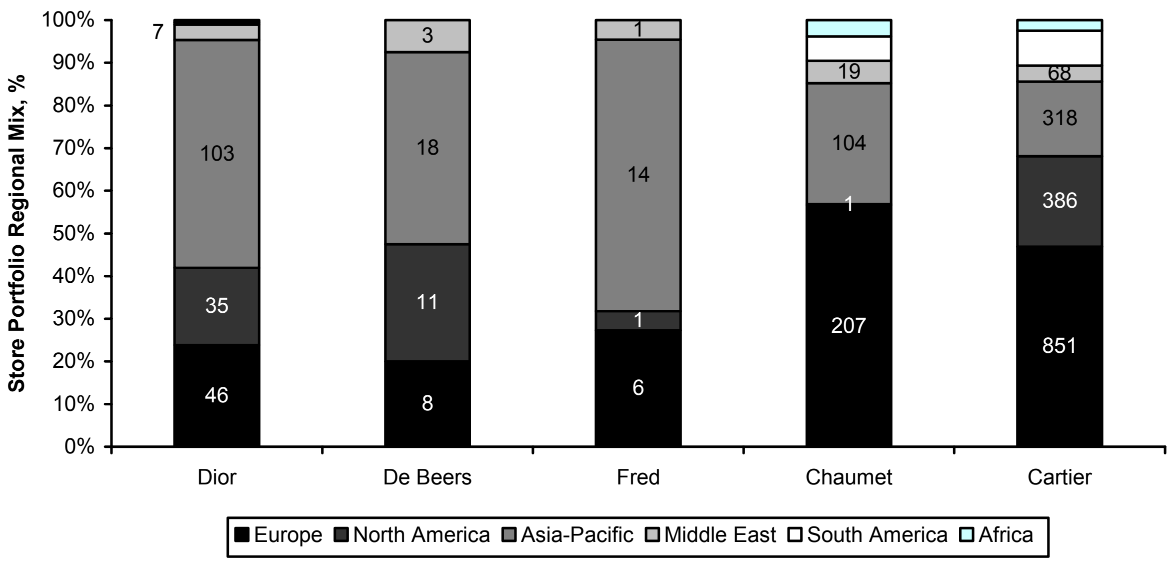

Source: Company Web sites and Bernstein analysis.

**Exhibit 247** **Store Portfolio by Region — Zenith and Hublot vs. Jaeger-LeCoultre**




Source: Company Web sites and Bernstein analysis.

**Exhibit 248** **Store Portfolio by Region – Dior, De Beers, Fred and Chaumet vs. Cartier**

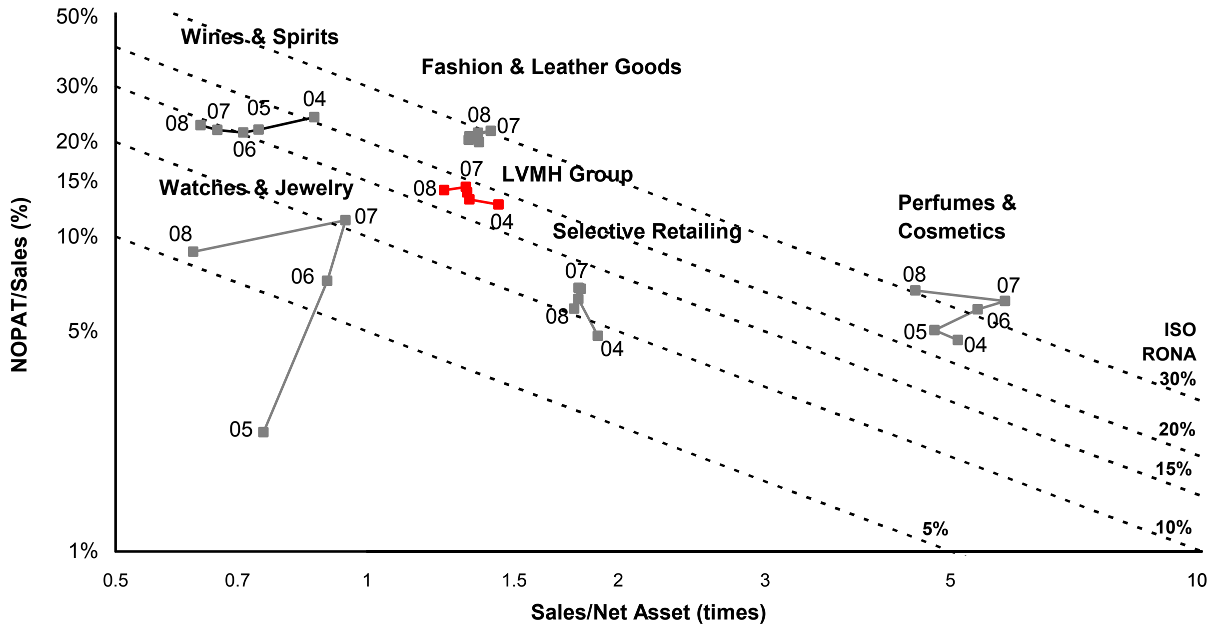



Source: Corporate Web sites and Bernstein analysis.

**The Watches & Jewelry Division's Performance Is Lagging Other Businesses in the LVMH Portfolio**

RoIC at around 5% was the lowest in the Group in FY08 (LVMH Group average was roughly 17%). This followed 2007 in which Watches & Jewelry had a RoIC of approximately 10%, though still below the Group average of approximately 19% (see Exhibit 249). Watches & Jewelry EBIT% in FY08 was deteriorating the quickest, with a decline of -350 bp (-16.3% in euros) against Selective Retailing (the second-weakest business) with a decline of -130 bp (-8.9% in euros) and the LVMH Group average of -50 bp (+2% in euros) (see Exhibit 250).

**Exhibit 249** **Watch & Jewelry ROIC at Approximately 5% Was the Lowest in the Group in FY08**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 250** **Watches & Jewelry EBIT in FY08 Was Deteriorating the Quickest, With a Decline of 350 Basis Points**

| | FY06 | FY07 | FY08 | Delta, % FY07/06 | FY08/07 |
|---|---|---|---|---|---|
| **LVMH EBIT** | | | | | |
| Wines & Spirits | 962 | 1,058 | 1,060 | *10.0%* | *0.2%* |
| Fashion & Leather Goods | 1,633 | 1,829 | 1,927 | *12.0%* | *5.4%* |
| Perfumes & Cosmetics | 222 | 256 | 290 | *15.3%* | *13.3%* |
| Watches & Jewelry | 80 | 141 | 118 | *76.3%* | *(16.3%)* |
| Selective Retailing | 400 | 426 | 388 | *6.5%* | *(8.9%)* |
| Other and Eliminations | (125) | (155) | (155) | | |
| **LVMH Group** | **3,172** | **3,555** | **3,628** | ***12.1%*** | ***2.1%*** |
| | | | | **Delta, bp** | |
| **EBIT Margin (%)** | | | | **FY07/06** | **FY08/07** |
| Wines & Spirits | 32.1% | 32.8% | 33.9% | *67* | *111* |
| Fashion & Leather Goods | 31.3% | 32.5% | 32.1% | *123* | *(43)* |
| Perfumes & Cosmetics | 8.8% | 9.4% | 10.1% | *56* | *74* |
| Watches & Jewelry | 10.9% | 16.9% | 13.4% | *607* | *(350)* |
| Selective Retailing | 10.3% | 10.2% | 8.9% | *(9)* | *(136)* |
| **LVMH Group** | **20.7%** | **21.6%** | **21.1%** | ***85*** | ***(49)*** |
| Swatch W&J | 19.8% | 20.6% | na | *82* | *na* |
| Richemont - Watchmakers | 22.8% | 27.3% | na | *451* | *na* |
| Richemont - Jewelry | 27.4% | 28.9% | na | *147* | *na* |

Source: Corporate reports and Bernstein estimates and analysis.

**Recent Moves by LVMH as Well as Management Comments Suggest That Watch & Jewelry Could Be an Area Where Further M&A Is on the Agenda**

LVMH acquired Hublot in April 2008, after Mr. Toni Belloni (group managing director) indicated that LVMH had a strategic goal to grow in the Watches & Jewelry business, both organically and through M&A. Insistent press speculation (please refer for example to the *FT/WSJ/Bloomberg* of May 22, 2008) points to Tiffany and Bulgari as the most likely targets (see Exhibit 251 and Exhibit 252).

**Exhibit 251** **M&A Targets in Luxury Goods – Overall Ranking of Desirability**

| | Size, Positioning and Category Mix | Brand Visibility and Geo Reach | Valuation | Score |
|---|---|---|---|---|
| Tod's | 4 | 3 | 4 | 11.0 |
| Bulgari | 4 | 3 | 3 | 10.0 |
| Prada | 3 | 4 | 2 | 9.0 |
| Salvatore Ferragamo | 4 | 3 | 2 | 9.0 |
| Tiffany | 2 | 3 | 3 | 8.0 |
| Geox | 2 | 1 | 3 | 6.0 |
| Folli Follie SA | 2 | 0 | 4 | 6.0 |
| Longchamp | 3 | 2 | 2 | 7.0 |
| Mariella Burani | 4 | 2 | 1 | 7.0 |
| Burberry | 1 | 2 | 3 | 6.0 |
| Cavalli | 1 | 3 | 2 | 6.0 |
| Coach | 2 | 0 | 4 | 6.0 |
| Ermenegildo Zegna | 1 | 3 | 2 | 6.0 |
| Escada | 1 | 2 | 3 | 6.0 |
| Dolce & Gabbana | 0 | 4 | 2 | 6.0 |
| Versace | 1 | 3 | 2 | 6.0 |
| Chanel | 0 | 3 | 2 | 5.0 |
| Furla | 3 | 0 | 2 | 5.0 |
| Ralph Lauren | 0 | 2 | 3 | 5.0 |
| Valentino | 0 | 3 | 2 | 5.0 |
| Vivienne Westwood | 0 | 3 | 2 | 5.0 |
| Aquascutum | 0 | 2 | 2 | 4.0 |
| Bijou Brigitte | 0 | 0 | 4 | 4.0 |
| Wolford | 0 | 0 | 4 | 4.0 |
| Aeffe | 0 | 3 | 0 | 3.0 |
| Armani | 0 | 1 | 2 | 3.0 |
| Calida Holding | 0 | 0 | 3 | 3.0 |
| Damiani | 3 | 0 | 0 | 3.0 |
| Gerry Weber | 0 | 0 | 3 | 3.0 |
| Hermes | 0 | 2 | 1 | 3.0 |
| IC Companys | 0 | 0 | 3 | 3.0 |
| Van de Velde | 0 | 0 | 3 | 3.0 |
| Timberland | 1 | 0 | 1 | 2.0 |

| | |
|---|---|
| Desirable | 4 |
| Undesirable | 0 |

**Note:** Please refer to our *Research Report*: "Big Thinking on Small Caps, M&A Targets in Luxury Goods", of October 24, 2008.

Source: Bernstein estimates and analysis.

**Exhibit 252** **Privately Held Potential Targets for Watches & Jewelry**

| | Watch Brands | 2007 Sales, € mil. | Jewelry Brands | 2007 Sales, € mil. |
|---|---|---|---|---|
| Elitist/Exclusive Luxury | Patek Philippe | €700 | Graff | €700 |
| | Franck Muller | €250 | Mikimoto | €200 |
| | Audemars Piguet | €250 | Buccellati | |
| | F.P. Journe | | Asprey | |
| | Ulysee Nardin | | | |
| | Richard Mille | | | |
| | Parmigiani | | | |
| | Dubey & Schaldenbrad | | | |
| Mainstream Luxury | Rolex | €2,500 | H.Stern | |
| | Chopard | €400 | | |
| | Breitling | | | |
| | Corum | | | |

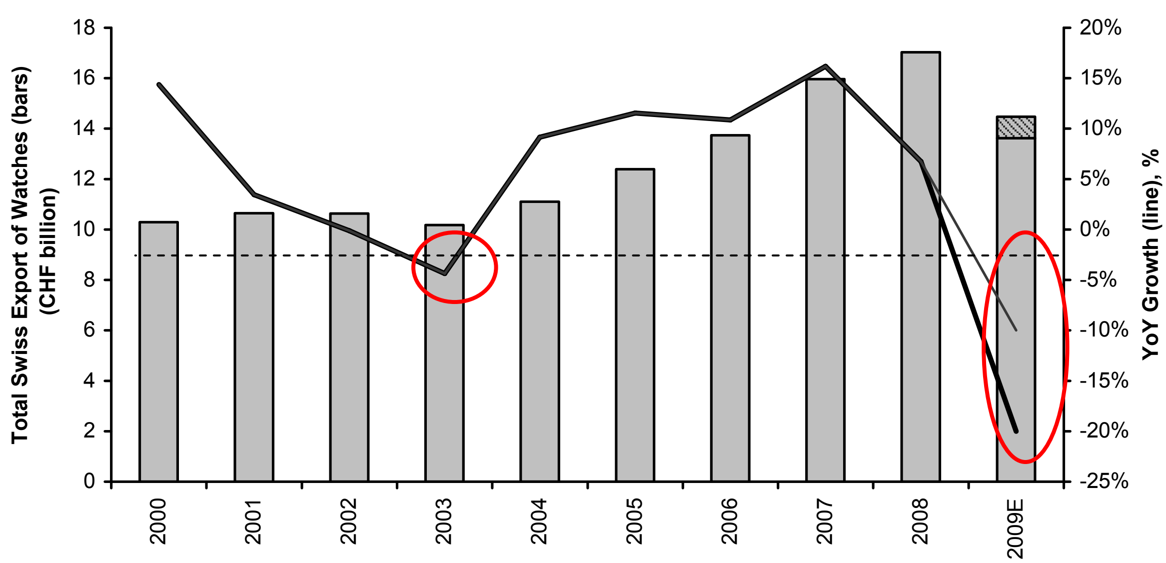
**Note:** Sales where shown are rough-cut estimates.

Source: Koncept Analytics, Capital IQ, Oanda and Bernstein estimates and analysis.

**In the Meantime, We Expect the LVMH Watches & Jewelry Division to Continue to Suffer**

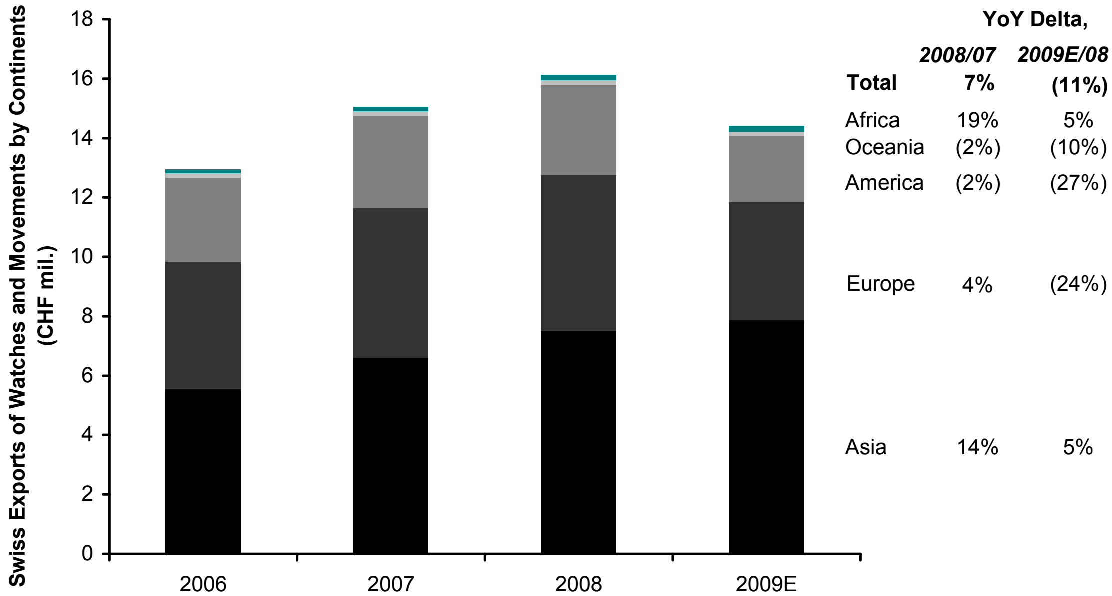
As a follower in the Watches & Jewelry industry, we expect LVMH to be hit more than the industry leaders by the slowdown (see Exhibit 253 and Exhibit 254). In fact, as in other luxury goods categories, we expect both consumers and retailers to become increasingly conservative in their brand choices against the recession, and to focus their purchases on the most prominent brands, disproportionately penalizing others.

**Exhibit 253** **Swiss Watch Exports Are Expected to Decline 10-15% in 2009**




Source: Industry interviews and Bernstein analysis.

**Exhibit 254** **Swiss Watch Demand in America and Europe Is Set to Decline Significantly in 2009**




Source: FHS and Bernstein estimates and analysis.

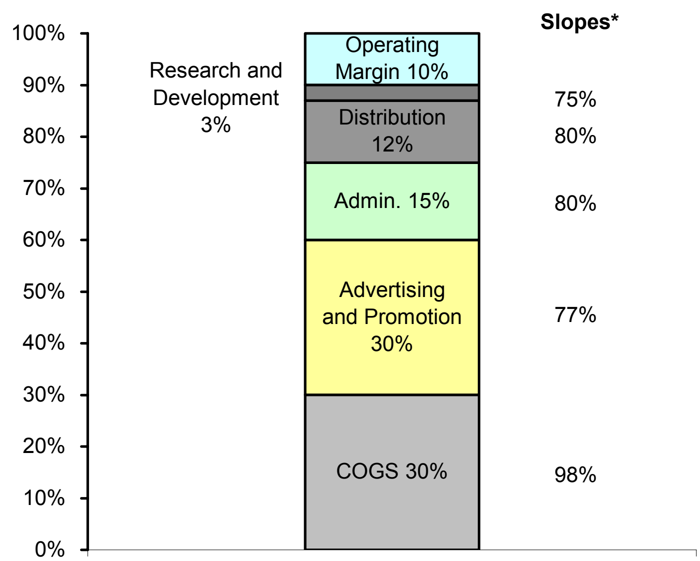
# Cosmetics & Fragrances — Where Luxury Meets CPG

**Market Leaders Enjoy a Major Scale Advantage**

Cosmetics & Fragrances businesses operate on high fixed costs (see Exhibit 255). Hence, market leaders that dominate their categories and enjoy scale advantages are capable of generating higher margins and grow more profitably than their smaller peers.

While COGS generally represent some 30% of sales for most Cosmetics & Fragrances players, SG&A as a percentage of sale varies significantly as a function of scale — from about 42% of sales at larger companies such as Procter & Gamble's beauty business to 65% at Estée Lauder (see Exhibit 258). Hence, market leaders enjoy superior operating profitability than their smaller competitors. L'Oréal and Procter & Gamble EBIT stands at approximately 17-18%, significantly higher than that of smaller competitors such as Estée Lauder and LVMH P&C division at approximately 9-10% (see Exhibit 257 and Exhibit 258).

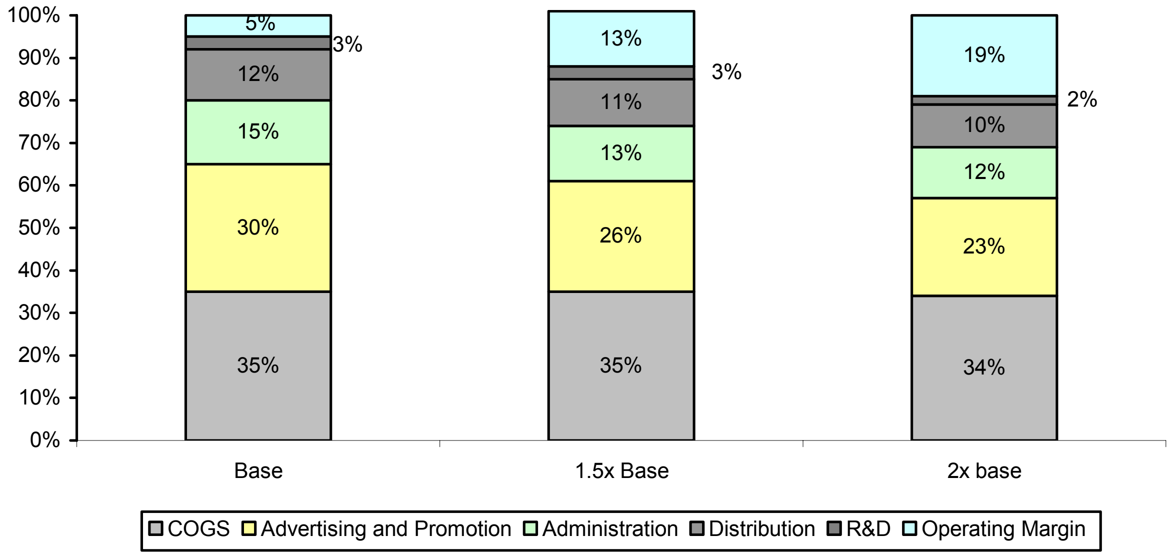
**Exhibit 255** **P&L Breakdown in Cosmetics & Fragrances**




**Note:** BCG slopes represent the behavior of fixed versus relative costs as scale varies. A slope of 100% refers to costs changing at the same rate as revenues, i.e., being fully variable.

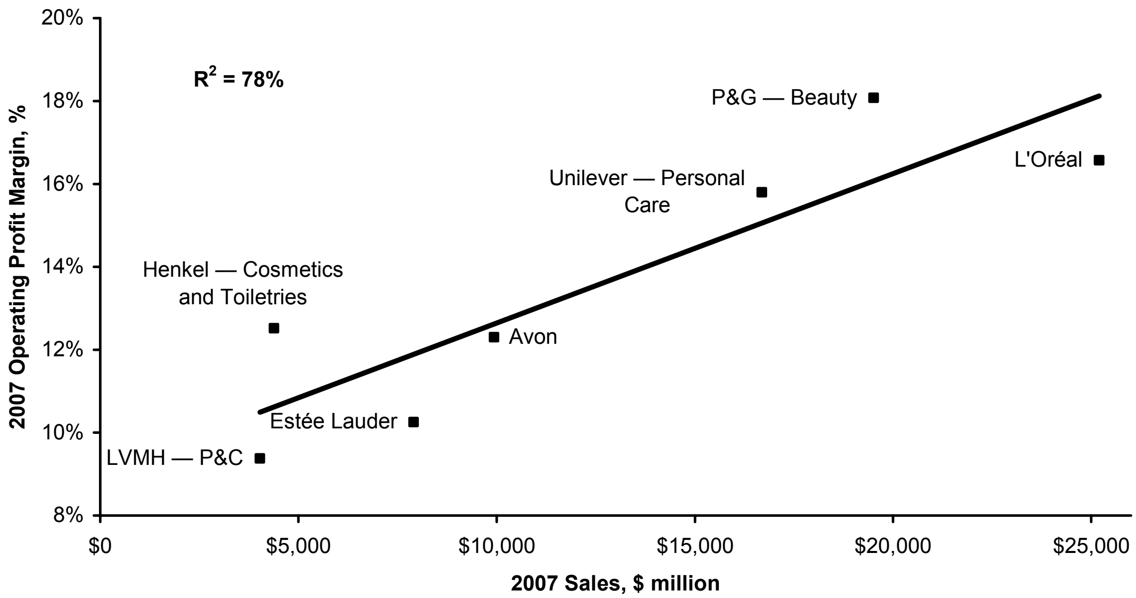
Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 256** **P&L of Cosmetics & Fragrances Companies: Scale Benefits**



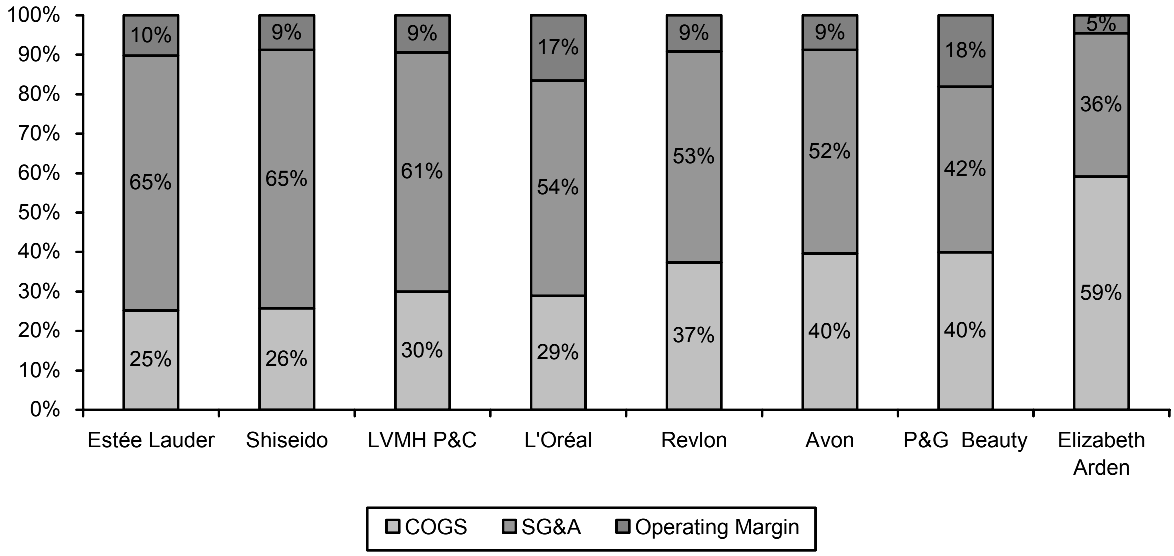

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 257** **Scale Allows Companies to Generate Structurally Higher Margins**




Source: Capital IQ and Bernstein estimates and analysis.

**Exhibit 258** **Analysis of Leading Cosmetics & Fragrances Companies' P&L**




**Note:** Operating margin of 18% for P&G Beauty is based on EBT as the company does not report divisional EBIT.

Source: Corporate reports and Bernstein estimates and analysis.

**Category and Brand Dominance Amplify Scale Benefits**

Category and brand dominance tend to go hand-in-hand, and amplify the benefits of scale advantage. Category leaders derive a significant proportion of their sales from "top 10" brands: this is the case for P&G in hair care, where three "top 10" brands — Pantene, Head & Shoulders and Herbal Essences — account for just short of 90% of P&G hair care category sales (see Exhibit 259 to Exhibit 270). Brand dominance allows cosmetics and fragrances businesses to leverage their fixed cost base, by consolidating brand-related costs — and more specifically communication costs — into a small number of blockbusters. Additionally, category leaders tend to enjoy greater brand share gains over time than non-category leaders in most cases (see Exhibit 271 to Exhibit 275).

**Exhibit 259** **Top 10 Brands by Company — Number of "Top 10" Brands by Category**

**Top 10 brands by Category**
(# of brands in "top 10" per company)

| | Procter & Gamble | L'Oréal | Unilever | Avon | Estée Lauder | Beiersdorf | LVMH |
|---|---|---|---|---|---|---|---|
| **Hair care** | 3 | 6 | 2 | - | - | - | - |
| **Colour cosmetics** | 2 | 3 | - | 1 | 2 | - | - |
| **Fragrances** | - | 1 | - | 1 | - | - | 1 |
| **Skin care** | 1 | 2 | 1 | 1 | 2 | 2 | - |
| **Sun care** | - | 2 | - | 1 | - | 1 | - |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 260 Top 10 Brands by Category — Hair Care

Hair care

| Rank (#) | Brand | Company name | 2007 Share (%) | Premium vs. Mass |
|---|---|---|---|---|
| 1 | Pantene Pro-V | Procter & Gamble | 7.3 | M |
| 2 | Sunsilk | Unilever Group | 4.2 | M |
| 3 | Head & Shoulders | Procter & Gamble | 3.0 | M |
| 3 | Garnier Fructis | L'Oreal | 3.0 | M |
| 5 | Elixir Elvive | L'Oreal | 2.7 | M |
| 6 | Dove | Unilever Group | 2.3 | M |
| 7 | Clairol Herbal Essences | Procter & Gamble | 1.6 | M |
| 8 | Excellence | L'Oreal | 1.6 | M |
| 9 | Studio Line | L'Oreal | 1.1 | M |
| 10 | Preference Recital | L'Oreal | 1.0 | M |
| 10 | Garnier Nutrisse | L'Oreal | 1.0 | M |
| 10 | Paul Mitchell | John Paul Mitchell Syste | 1.0 | P |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 261 Top 10 Brands by Category — Color Cosmetics

Colour cosmetics

| Rank (#) | Brand | Company name | 2007 Share (%) | Premium vs. Mass |
|---|---|---|---|---|
| 1 | Gemey/Maybelline/Jade | L'Oréal | 7.6 | M |
| 2 | Avon | Avon Products Inc | 6.3 | M |
| 3 | L'Oréal Paris | L'Oréal | 5.6 | M |
| 4 | Lancome | L'Oréal | 3.5 | P |
| 5 | Clinique | Estée Lauder Cos Inc | 3.2 | P |
| 6 | Revlon | Revlon Inc | 2.7 | M |
| 6 | Max Factor | Procter & Gamble | 2.7 | M |
| 8 | Estée Lauder | Estée Lauder Cos Inc | 2.5 | P |
| 9 | Cover Girl | Procter & Gamble | 2.4 | M |
| 10 | Kanebo | Kao Corp | 2.1 | P |
| 10 | Mary Kay | Mary Kay Inc | 2.1 | M |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 262 Top 10 Brands by Category — Fragrances

Fragrances

| Rank (#) | Brand | Company name | 2007 Share (%) | Premium vs. Mass |
|---|---|---|---|---|
| 1 | Avon | Avon Products Inc | 6.5 | M |
| 2 | Natura | Natura Cosmeticos | 3.3 | M |
| 3 | O Boticario | Botica Com. Farmaceutica | 2.3 | M |
| 4 | Chanel N5 | Chanel SA | 1.2 | P |
| 5 | Oriflame | Oriflame Cosmetics AB | 1.1 | M |
| 6 | adidas | Coty Inc | 0.9 | M |
| 7 | Jafra | Vorwerk | 0.8 | P |
| 7 | Mary Kay | Mary Kay Inc | 0.8 | M |
| 9 | Acqua di Gio pour Homme | L'Oréal | 0.7 | P |
| 10 | J'adore | LVMH | 0.6 | P |
| 10 | Arabian Oud | Arabian Oud Co | 0.6 | P |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 263 Top 10 Brands by Category — Skin Care

Skin care

| Rank (#) | Brand | Company name | 2007 Share (%) | Premium vs. Mass |
|---|---|---|---|---|
| 1 | Avon | Avon Products Inc | 4.8 | M |
| 2 | Olay | Procter & Gamble | 3.8 | M |
| 3 | Nivea Visage/Vital | Beiersdorf AG | 3.3 | M |
| 4 | L'Oréal Dermo-Expertise | L'Oréal | 3.1 | M |
| 5 | Nivea Body | Beiersdorf AG | 2.3 | M |
| 6 | Lancome | L'Oréal | 2.0 | P |
| 7 | Clinique | Estée Lauder Cos Inc | 1.8 | P |
| 7 | Estée Lauder | Estée Lauder Cos Inc | 1.8 | P |
| 9 | Shiseido | Shiseido Co Ltd | 1.6 | P |
| 9 | Mary Kay | Mary Kay Inc | 1.6 | M |
| 10 | Pond's | Unilever Group | 1.4 | M |
| 10 | Clarins | Clarins SA | 1.4 | P |
| 10 | Kanebo | Kao Corp | 1.4 | P |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 264 Top 10 Brands by Category — Sun Care

Sun care

| Rank (#) | Brand | Company name | 2007 Share (%) | Premium vs. Mass |
|---|---|---|---|---|
| 1 | Nivea Sun | Beiersdorf AG | 11.9 | M |
| 2 | Garnier Ambre Solaire | L'Oréal | 7.5 | M |
| 3 | Coppertone | Schering-Plough Corp | 5.2 | M |
| 4 | Banana Boat | Energizer Holdings Inc | 3.2 | M |
| 4 | Neutrogena | Johnson & Johnson Inc | 3.2 | M |
| 6 | Sundown | Johnson & Johnson Inc | 2.8 | M |
| 7 | L'Oréal Dermo-Expertise | L'Oréal | 2.2 | M |
| 8 | Avon | Avon Products Inc | 2.1 | M |
| 9 | Hawaiian Tropic | Energizer Holdings Inc | 1.8 | M |
| 10 | Shiseido | Shiseido Co Ltd | 1.7 | P |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 265 Top 10 Brands by Company — Aggregate Sales of "Top 10" Brands by Category

**Top 10 brands by Category**

($m aggregate sales of "top 10" brands per company)

| | Procter & Gamble | L'Oréal | Unilever | Avon | Estée Lauder | Beiersdorf | LVMH |
|---|---|---|---|---|---|---|---|
| **Hair care** | 6,344 | 5,544 | 3,465 | - | - | - | - |
| **Colour cosmetics** | 1,833 | 6,001 | - | 2,264 | 2,048 | - | - |
| **Fragrances** | - | 219 | - | 2,030 | - | - | 187 |
| **Skin care** | 2,413 | 3,239 | 889 | 3,048 | 2,286 | 3,556 | - |
| **Sun care** | - | 656 | - | 142 | - | 804 | - |

**Note:** Sales in US$ million.

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 266 Top 10 Brands by Company — L'Oréal

| L'Oréal | | | |
|---|---|---|---|
| Rank (#) | Brand | Sales, US$m | Premium vs. Mass |
| 1 | Maybelline/Gemey/Jade | 2,731 | M |
| 2 | Lancome | 2,528 | P |
| 3 | L'Oréal Paris | 2,012 | M |
| 4 | Dermo-Expertise | 1,969 | M |
| 5 | Garnier Fructis | 1,599 | M |
| 6 | Elvive | 1,439 | M |
| 7 | Excellence | 853 | M |
| 8 | Studio Line | 586 | M |
| 9 | Vichy | 572 | M |
| 10 | The Body Shop | 572 | M |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 267 Top 10 Brands by Company — P&G

| P&G | | | |
|---|---|---|---|
| Rank (#) | Brand | Sales, US$m | Premium vs. Mass |
| 1 | Pantene Pro-V | 3,892 | M |
| 2 | Olay | 2,413 | M |
| 3 | Head & Shoulders | 1,599 | M |
| 4 | Max Factor | 970 | M |
| 5 | Cover Girl | 862 | M |
| 6 | Clairol Herbal Essences | 853 | M |
| 7 | SK-II | 445 | P |
| 8 | Rejoice | 426 | M |
| 9 | Wella Koleston | 426 | M |
| 10 | Clairol Nice 'n' Easy | 267 | M |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 268 Top 10 Brands by Company — Estée Lauder

| Estée Lauder | | | |
|---|---|---|---|
| Rank (#) | Brand | Sales, US$m | Premium vs. Mass |
| 1 | Clinique | 2,293 | P |
| 2 | Estée Lauder | 2,041 | P |
| 3 | Mac | 683 | P |
| 4 | Aveda | 213 | P |
| 5 | Origins | 199 | P |
| 6 | Bobbi Brown | 180 | P |
| 7 | Prescriptives | 171 | P |
| 8 | Pleasures | 156 | P |
| 9 | Clinique Happy | 125 | P |
| 10 | Beautiful | 94 | P |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 269 Top 10 Brands by Company — LVMH

| LVMH | | | |
|---|---|---|---|
| Rank (#) | Brand | Sales, US$m | Premium vs. Mass |
| 1 | Christian Dior | 649 | P |
| 2 | J'adore | 187 | P |
| 3 | BeneFit | 144 | P |
| 4 | Guerlain | 235 | P |
| 5 | Fahrenheit | 94 | P |
| 6 | Flower by Kenzo | 94 | P |
| 7 | Dior Addict | 62 | P |
| 8 | Poison | 62 | P |
| 9 | Shalimar | 62 | P |
| 10 | Givenchy | 36 | P |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 270 Top 10 Brands by Company – Avon

| Avon | | | |
|---|---|---|---|
| Rank (#) | Brand | Sales, US$m | Premium vs. Mass |
| 1 | Avon | 7,911 | M |

**Note:** *Euromonitor* does not break out Avon sub-brands.

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 271 Hair Care — Brand Share Gains (2001-07)

| Hair care | | | |
|---|---|---|---|
| Rank (#) | Brand | Company name | 2001-07 Share Gains (bps) |
| 1 | Pantene Pro-V | Procter & Gamble | 120 |
| 2 | Garnier | L'Oréal | 230 |
| 3 | Sunsilk | Unilever Group | 200 |
| 4 | Head & Shoulders | Procter & Gamble | 80 |
| 5 | Elixir Elvive | L'Oréal | 60 |
| 5 | Clairol | Procter & Gamble | (60) |
| 7 | Dove | Unilever Group | 200 |
| 8 | Excellence | L'Oréal | 20 |
| 9 | Studio Line | L'Oréal | 0 |
| 10 | Preference Recital | L'Oréal | (20) |
| 10 | Paul Mitchell | John Paul Mitchell Systems | (10) |

Source: *Euromonitor* and Bernstein analysis.

## Exhibit 272 Color Cosmetics — Brand Share Gains (2001-07)

| Colour cosmetics | | | |
|---|---|---|---|
| Rank (#) | Brand | Company name | 2001-07 Share Gains (bps) |
| 1 | Gemey/Maybelline/Jade | L'Oréal | 110 |
| 2 | Avon | Avon Products Inc | 90 |
| 3 | L'Oréal Paris | L'Oréal | 100 |
| 4 | Lancome | L'Oréal | 0 |
| 5 | Clinique | Estée Lauder Cos Inc | (40) |
| 6 | Revlon | Revlon Inc | (70) |
| 6 | Max Factor | Procter & Gamble | 20 |
| 8 | Estée Lauder | Estée Lauder Cos Inc | (10) |
| 9 | Cover Girl | Procter & Gamble | (50) |
| 10 | Kanebo | Kao Corp | N.a. |
| 10 | Mary Kay | Mary Kay Inc | 40 |

Source: *Euromonitor* and Bernstein analysis.

**Exhibit 273 Fragrances — Brand Share Gains (2001-07)**

| Rank (#) | Brand | Company name | 2001-07 Share Gains (bps) |
|---|---|---|---|
| 1 | Avon | Avon Products Inc | 50 |
| 2 | Natura | Natura Cosmeticos | 200 |
| 3 | O Boticario | Botica Com. Farmaceutica | 100 |
| 4 | Chanel N5 | Chanel SA | 0 |
| 5 | Oriflame | Oriflame Cosmetics AB | 70 |
| 6 | adidas | Coty Inc | 10 |
| 7 | Jafra | Vorwerk | 80* |
| 7 | Mary Kay | Mary Kay Inc | 0 |
| 9 | Acqua di Gio pour Homme | L'Oréal | 0 |
| 10 | J'adore | LVMH | (10) |
| 10 | Arabian Oud | Arabian Oud Co | 30 |

**Note:** * 2003-07 period.

Source: *Euromonitor* and Bernstein analysis.

**Exhibit 274 Skin Care — Brand Share Gains (2001-07)**

| Rank (#) | Brand | Company name | 2001-07 Share Gains (bps) |
|---|---|---|---|
| 1 | Nivea | Beiersdorf AG | 30 |
| 2 | Avon | Avon Products Inc | 60 |
| 3 | Olay | Procter & Gamble | 130 |
| 4 | L'Oréal Dermo-Expertise | L'Oréal | 310* |
| 5 | Lancome | L'Oréal | (10) |
| 6 | Clinique | Estée Lauder Cos Inc | (30) |
| 6 | Estée Lauder | Estée Lauder Cos Inc | (20) |
| 8 | Shiseido | Shiseido Co Ltd | (10) |
| 8 | Mary Kay | Mary Kay Inc | 40 |
| 10 | Pond's | Unilever Group | (30) |
| 10 | Clarins | Clarins SA | 20 |
| 10 | Kanebo | Kao Corp | N.a. |

**Note:** * 2003-07 period.

Source: *Euromonitor* and Bernstein analysis.

**Exhibit 275 Sun Care — Brand Share Gains (2001-07)**

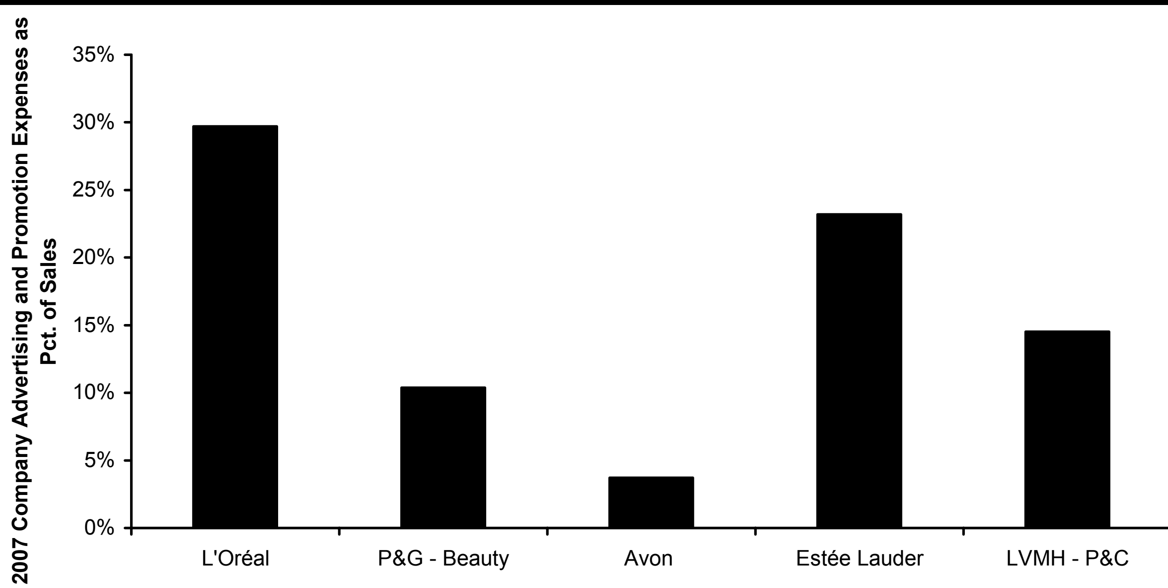
| Rank (#) | Brand | Company name | 2001-07 Share Gains (bps) |
|---|---|---|---|
| 1 | Nivea Sun | Beiersdorf AG | 170 |
| 2 | Garnier Ambre Solaire | L'Oréal | 130 |
| 3 | Coppertone | Schering-Plough Corp | (120) |
| 4 | Banana Boat | Energizer Holdings Inc | N.a. |
| 4 | Neutrogena | Johnson & Johnson Inc | 40 |
| 6 | Sundown | Johnson & Johnson Inc | 160 |
| 7 | L'Oréal Dermo-Expertise | L'Oréal | 100* |
| 8 | Avon | Avon Products Inc | 30 |
| 9 | Hawaiian Tropic | Energizer Holdings Inc | N.a. |
| 10 | Shiseido | Shiseido Co Ltd | (10) |

**Note:** * 2003-07 period.

Source: *Euromonitor* and Bernstein analysis.

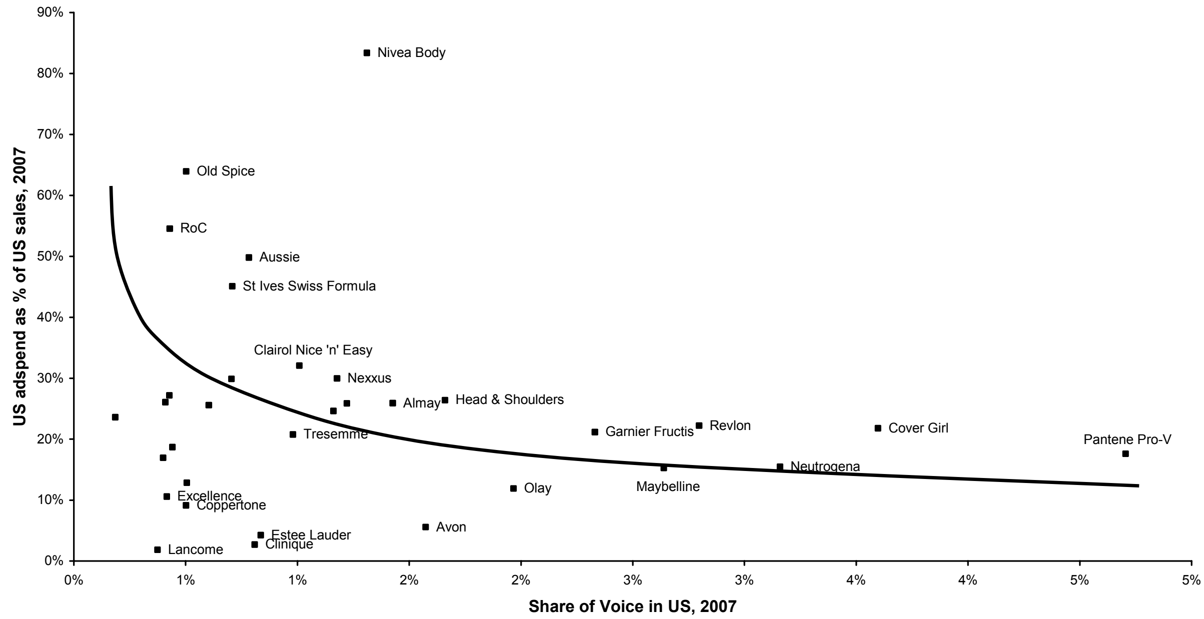
*High advertising spend requirements compound scale advantage.* Scale allows Cosmetics & Fragrances companies to achieve a higher share of voice while committing a lower proportion of revenues to their advertising effort (see Exhibit 276 to Exhibit 278).

**Exhibit 276 Perfumes & Cosmetics Companies: Advertising and Promotion Spend Is High for Traditional Beauty Companies**



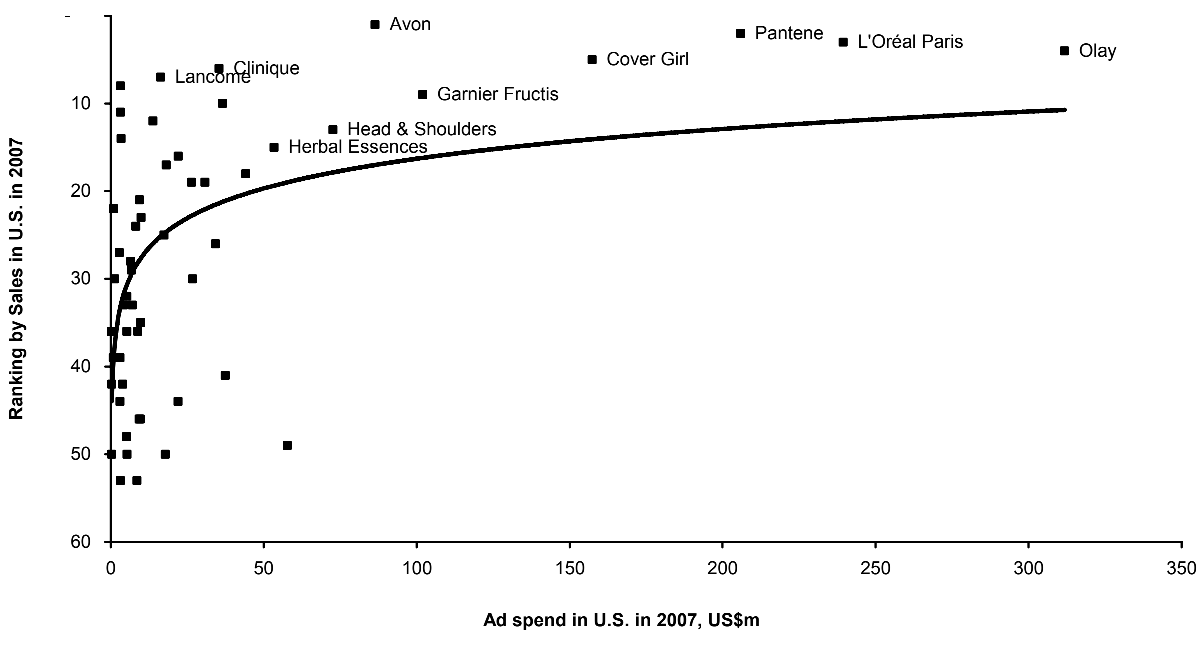

Source: TNS Media Intelligence, corporate reports and Bernstein estimates and analysis.

**Exhibit 277** **Scale Produces Higher SOV While Committing a Small Portion of Sales to Advertising Budgets**




Source: TNS Media Intelligence, corporate reports and Bernstein estimates and analysis.

**Exhibit 278** **Perfumes and Cosmetics Companies: Brand Strength and Ad Spend Are Correlated**



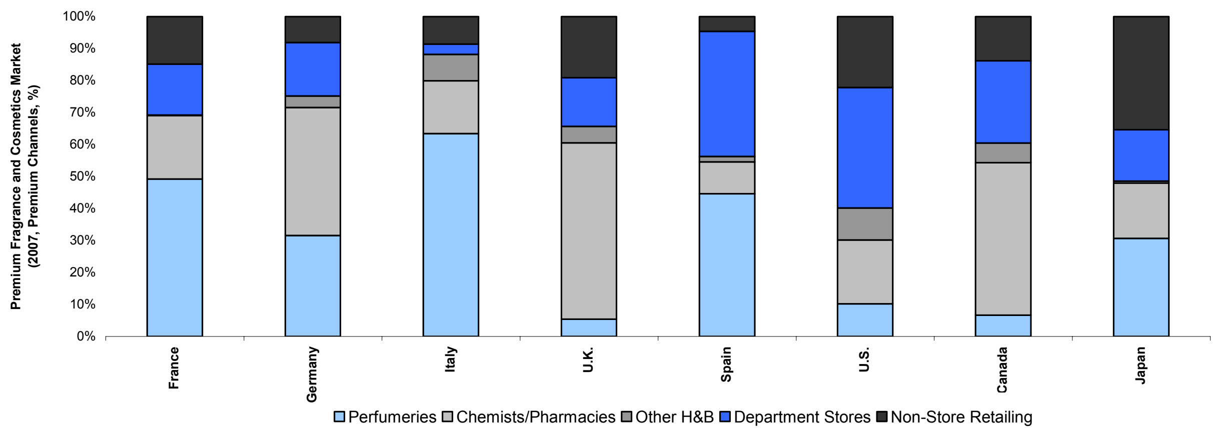

Source: TNS Media Intelligence, corporate reports and Bernstein estimates and analysis.

**Downstream Retail Integration Creates Potential Future Business Opportunities**

Downstream retail integration creates potential future business opportunities for cosmetics and fragrances brands — especially in the premium segment. Premium cosmetics and fragrances distribution is still largely in the hands of traditional retailers — like department stores and independent perfumeries. Innovative self-service retail formats like Sephora, offering a deep range in an attractive environment, have proven to be highly effective in gaining share and consumer favor (see Exhibit 279 and Exhibit 280).

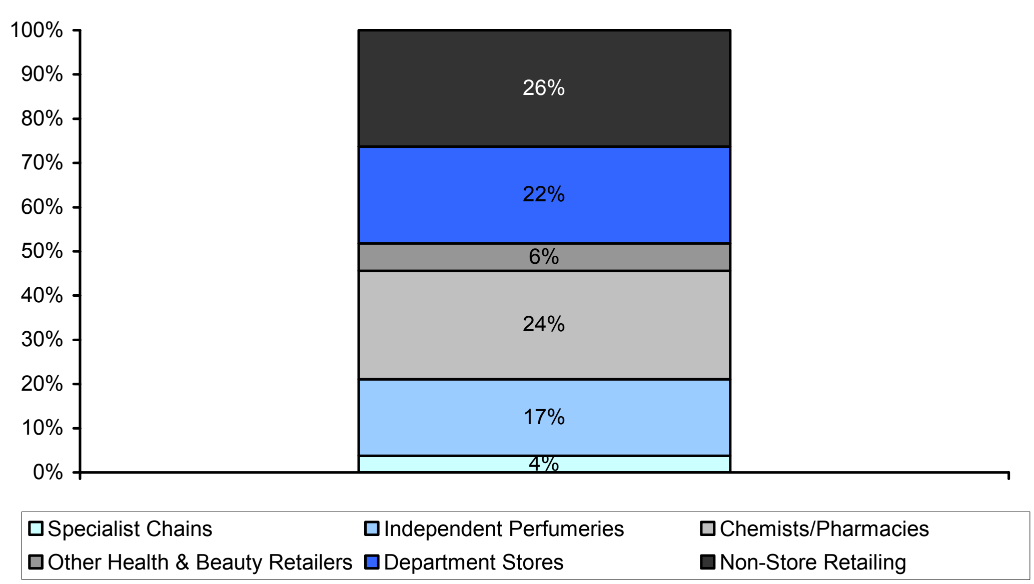
However, contrary to other luxury product categories — e.g., leather goods and fashion — we expect self-standing mono-brand stores to be less attractive to cosmetics and fragrances brands. Indeed, while high-profile flagship stores contribute to affirm and confirm the fashion and leather goods' brand status in consumers' mind, cosmetics and fragrances consumers shop for range rather than brand. In this light, we believe pursuing a multi-brand strategy (like LVMH) is likely preferable to a single-brand format (like Estée Lauder).

**Exhibit 279** **Premium Cosmetics & Fragrances Distribution Is Still Largely in the Hands of Traditional Retailers**




Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 280** **Global Premium Cosmetics & Fragrances Distribution Channel Mix, 2007**




**Note:** Specialist chains include Sephora, Estée Lauder's free-standing stores and L'Oréal's The Body Shop.

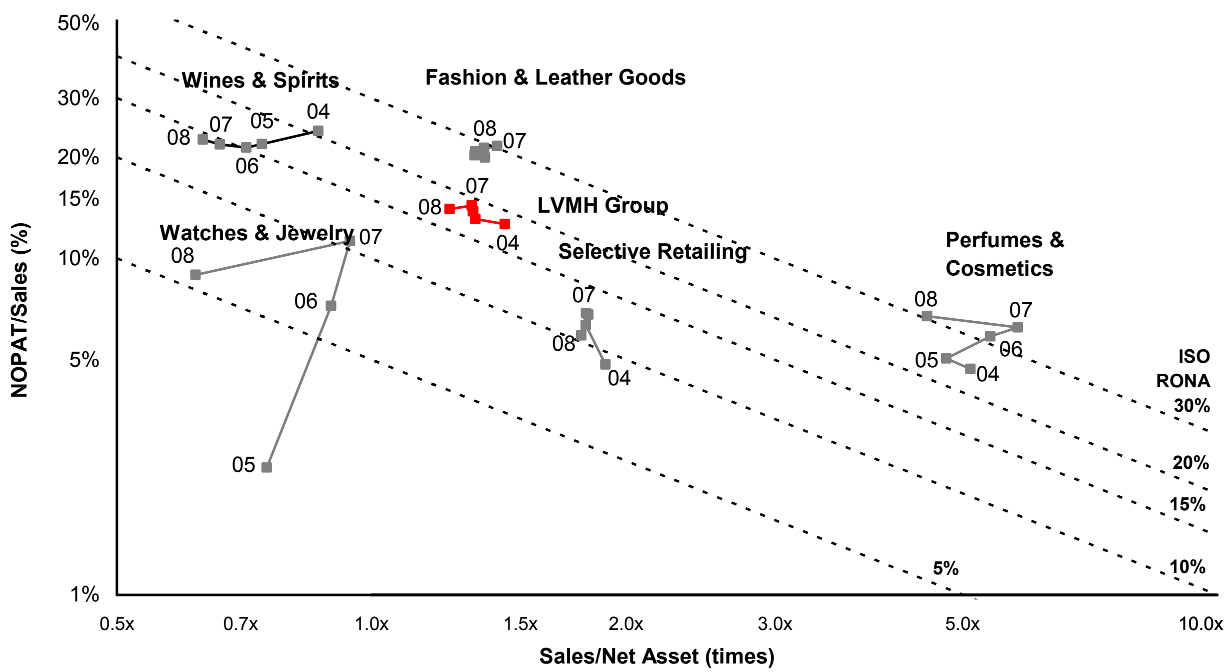
Source: *Euromonitor* and Bernstein estimates and analysis.

**Cosmetics & Fragrances Is a Borderline Business Between Luxury and the Mass Market**

Cosmetics & Fragrances is a borderline business — with some of the allure and brand dynamics of quintessentially luxury categories, but with many of the traits of CPG businesses, such as: (1) universal consumer audience given lower absolute average price points; (2) predominantly multi-brand distribution channels; and (3) specialist, scale-advantaged competitors.

Luxury goods companies playing directly in cosmetics and fragrances face material scale disadvantage versus larger incumbents — LVMH is a case in point. While RoIC for the P&C division of LVMH is particularly high (see Exhibit 281), one wonders whether joining forces with specialist partners could create higher value (like PPR recently did though a long-term license agreement and the sale of the YSL Beauté business to L'Oréal and P&G has successfully done manufacturing fragrances for Hugo Boss and Dolce & Gabbana). That being said, having a winning retail format in house creates material benefits to the LVMH P&C division, making the issue of a potential third-party license far less critical than in the case of PPR and YSL Beauté.

**Exhibit 281** **LVMH — Divisional RONA**




Source: Corporate reports and Bernstein estimates and analysis.

# Cosmetics & Fragrances — Analyzing Sales Growth Prospects Within the Global Beauty Industry

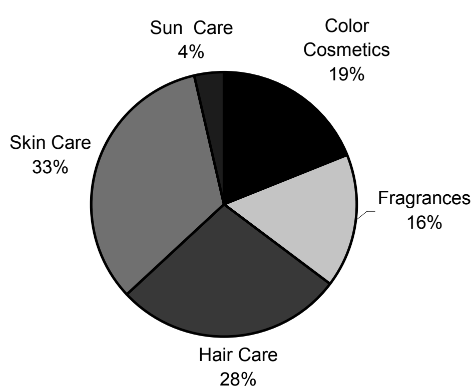
In this chapter, we analyze the global beauty industry by (1) product category, (2) geographic region, (3) segment (i.e., premium versus mass), and (4) distribution channel to identify the best opportunities for growth within the industry. We then assess our coverage companies' — Avon, Estée Lauder, LVMH and P&G — strengths and weaknesses along these four dimensions.

## The Global Beauty Industry Overview

We define the global beauty industry to include color cosmetics, fragrances, skin care, hair care and sun care (see Exhibit 282). Currently, sales of beauty products total $191 billion, with skin care and hair care representing 33% and 28% of the total global beauty expenditure, respectively. On a regional basis, Western Europe is the largest beauty market (29% of global beauty spend), followed by North America and Developed Asia, each representing 20% (see Exhibit 283).

**Exhibit 282 The Largest Category Within The Global Beauty Market Is Skin Care (33% of Global Beauty Sales), Followed by Hair Care (28% of Global Beauty Sales)**

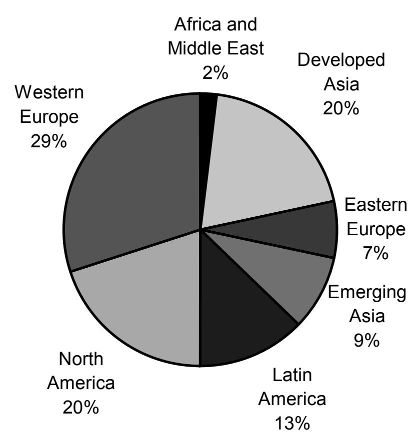
**Global Beauty: 2007 Retail Sales by Category ($191 billion)**




Source: *Euromonitor* and Bernstein analysis.

**Exhibit 283 Western Europe Is the Largest Beauty Market, Followed by North America and Developed Asia**

**Global Beauty: 2007 Retail Sales by Geography ($191 billion)**

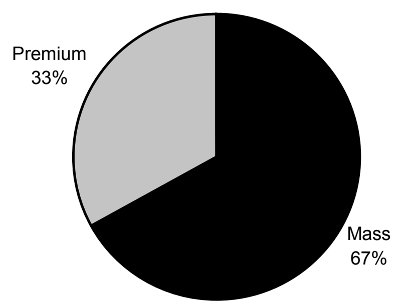



Source: *Euromonitor* and Bernstein analysis.

Beauty products can also be segmented between "premium" versus "mass" products based on brand prestige, price, and distribution channel exposure (see Exhibit 284). On a global basis, the mass segment represents 67% of sales, while the premium segment represents the remaining 33%. As expected, the bulk of global premium segment sales are concentrated within the developed markets (see Exhibit 285).

**Exhibit 284** **Sales of Premium Products Make Up ~1/3 of Sales Globally**

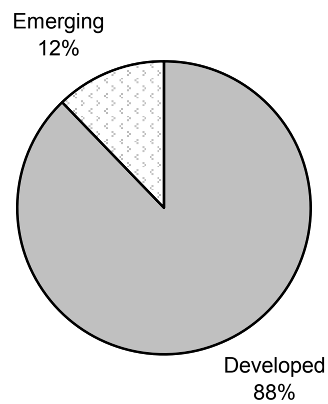
**Global Beauty: 2007 Retail Sales by Segment ($191 billion)**




Source: *Euromonitor* and Bernstein analysis.

**Exhibit 285** **Eighty-Eight Percent of the Sales in the Premium Segment Is Generated Within the Developed Markets**

**Global Beauty: Premium Segment by Developed vs. Emerging Market**

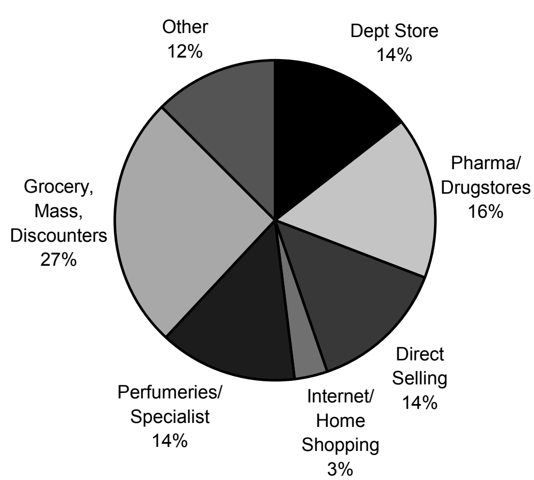



Source: *Euromonitor* and Bernstein analysis.

Beauty products are sold through a variety of distribution channels. We estimate that 43% of beauty products are sold through grocery, mass and discounters and pharmacy/drug store channels (see Exhibit 286). Department stores, perfumeries/specialist beauty stores (e.g., Body Shop, Marionnaud and Sephora) and direct selling each represent 14% of total global beauty spend.

**Exhibit 286** **Grocery, Mass and Discounters Are the Largest Sellers of Beauty Products Today, Followed by Pharmacies/Drugstores**

**Global Beauty: 2007 Retail Sales by Channel ($191 billion)**




**Note:** "Other" includes small Health and Beauty retailers (4%), other grocery/non-grocery retailers including outdoor markets (4%), small grocery retailers (3%) and variety stores (1%).

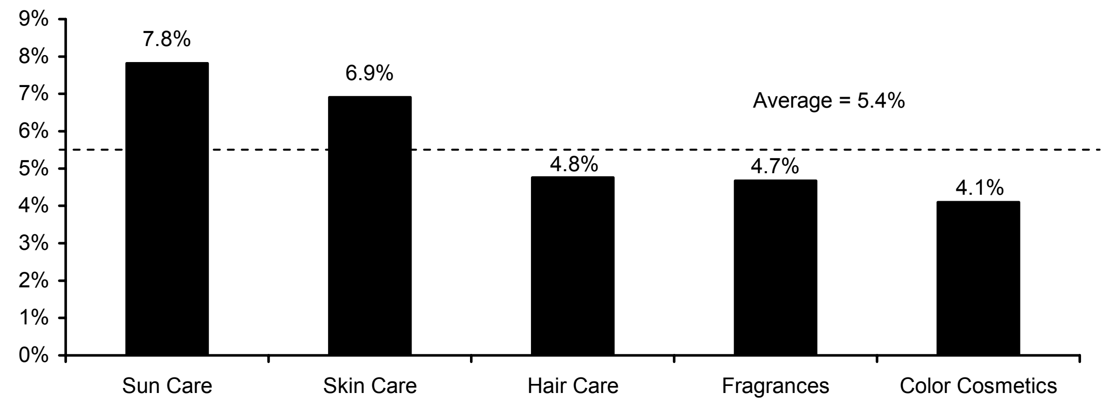
Source: *Euromonitor* and Bernstein analysis.

**(1) Product Categories**

We estimate that the beauty industry is growing at a 5.4% CAGR on a global basis (see Exhibit 287). Sun care and skin care sales are rising faster than the overall beauty sales, growing at 7.8% and 6.9%, respectively. We believe that skin care represents the most attractive growth opportunity for beauty companies given its relatively large size (33% of global sales) and contribution to growth (41% between 2002 and 2007) (see Exhibit 288). Although sun care sales have contributed disproportionately to overall beauty growth over the past five years, sun care still only represents 4% of global beauty sales. Within skin care, hair care, and color cosmetics, three sub-categories within these broader categories are growing faster than others (see Exhibit 289). For example, conditioners (+8.9%), perms and relaxants (+7.2%), and shampoo (+7.1%) are growing faster than hair care average growth of 4.8%, while colorants (+3.9%), salon hair care (+1.8%), styling agents (+1.6%), and 2-in-1 products (-2.9%) are growing much slower than the average hair care growth. Similarly, eye make-up is growing at 5.6%, above the overall color cosmetics growth of 4.1%.

**Exhibit 287** **Sun Care Is the Fastest-Growing Beauty Product Category Globally, Followed by Skin Care**

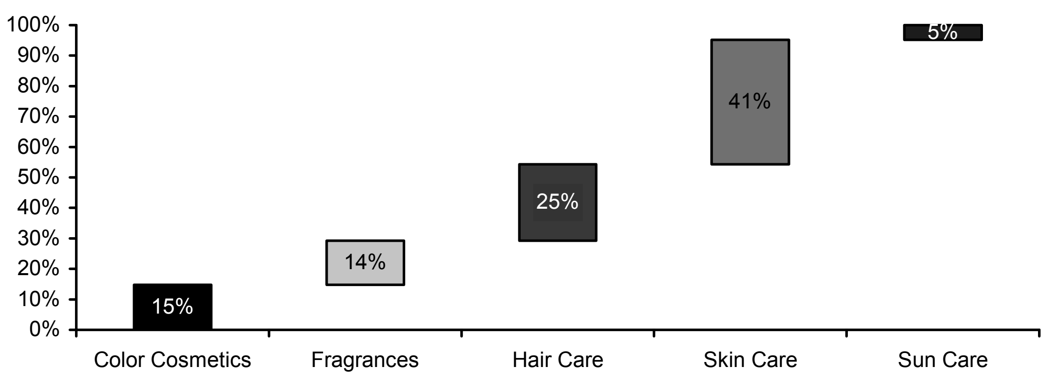
**Global Beauty: 2002-07 CAGR by Category**




Source: *Euromonitor* and Bernstein analysis.

**Exhibit 288** **Growth in Skin Care Accounted for 41% of Global Beauty Growth Between 2002 and 2007**

**Global Beauty: 2002-07 Contribution to Growth by Product Category**




Source: *Euromonitor* and Bernstein analysis.

**Exhibit 289** **While the Overall Hair Care Growth of 4.8% Is Below the Total Beauty Sales of 5.4%, Conditioners, Perms and Relaxants, and Shampoo Are Growing Faster Than Hair Care and Beauty Overall; Similarly, Eye Make-Up Within Color Cosmetics Is Growing at 5.6%, Faster Than the Overall Color Cosmetics Growth of 4.1%**

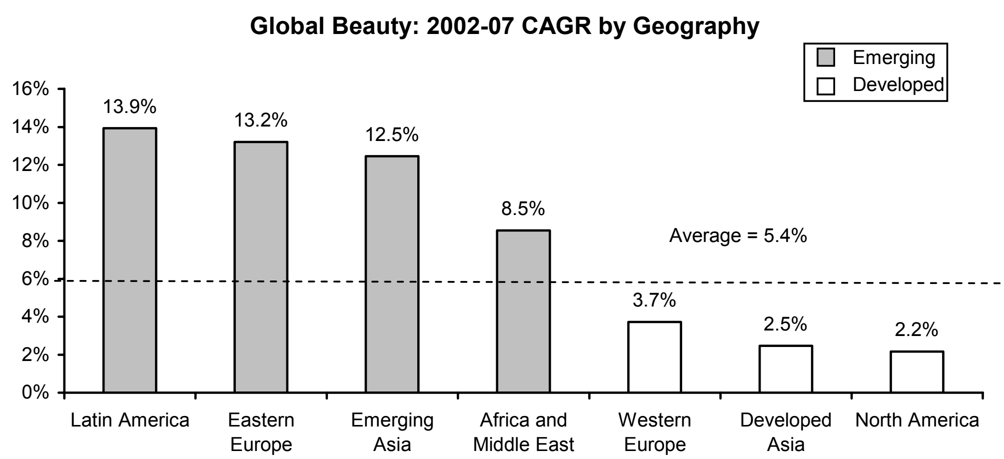
| | Pct. of Total Sales | 2002-07 CAGR |
|---|---|---|
| Facial Care | 26.7% | 6.8% |
| Body Care | 5.8% | 7.9% |
| Hand Care | 0.8% | 5.4% |
| **Skin Care** | **33.3%** | **6.9%** |
| Shampoo | 8.4% | 7.1% |
| Conditioners | 5.7% | 8.9% |
| Colourants | 5.3% | 3.9% |
| Styling Agents | 4.1% | 1.6% |
| Salon Hair Care | 2.5% | 1.8% |
| 2-in-1 Products | 1.5% | -2.9% |
| Perms and Relaxants | 0.5% | 7.2% |
| **Hair Care** | **27.9%** | **4.8%** |
| Facial Make-Up | 7.0% | 4.1% |
| Eye Make-Up | 5.1% | 5.6% |
| Lip Products | 5.0% | 3.5% |
| Nail Products | 1.7% | 1.9% |
| **Color Cosmetics** | **18.8%** | **4.1%** |
| **Fragrances** | **16.4%** | **4.7%** |
| **Sun Care** | **3.5%** | **7.8%** |
| **Total** | **100.0%** | **5.4%** |

Source: *Euromonitor* and Bernstein analysis.

**(2) Geographies**

On a geographic basis, beauty sales in Latin America (13.9%), Eastern Europe (13.2%), Emerging Asia (12.5%) and Africa and the Middle East (8.5%) are outpacing global beauty growth (see Exhibit 290). In other words, the contribution to global beauty growth from emerging markets is disproportionately large (61%) relative to these markets' contribution to absolute sales (31%) (see Exhibit 291 and Exhibit 292).

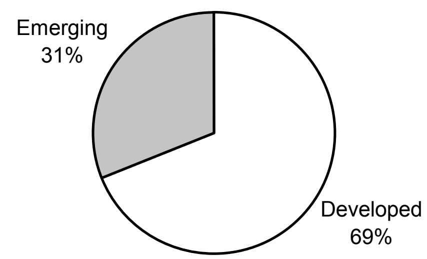
**Exhibit 290** **Latin America, Eastern Europe, Emerging Asia and Africa and the Middle East — Geographies That We Define as the Emerging Markets — Are Growing Faster Than the Global Average Growth of 5.4%**




Source: *Euromonitor* and Bernstein analysis.

**Exhibit 291 The Emerging Markets Represent 31% of Sales…**

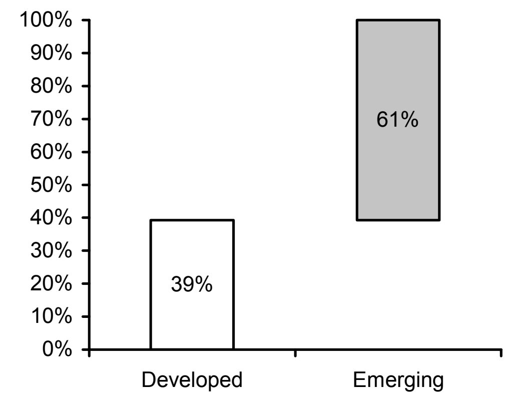
**Global Beauty Sales, 2007 Retail Sales by Region ($191 billion)**




Source: *Euromonitor* and Bernstein analysis.

**Exhibit 292 …While Contributing 61% of the Global Growth in Beauty Product Sales Over the Last Five Years**

**Global Beauty: Contribution to Growth, 2002-07**



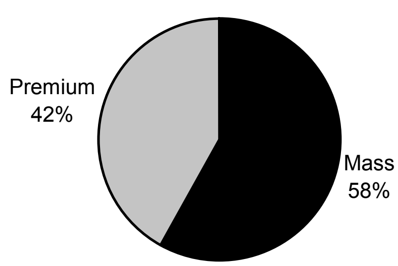

Source: *Euromonitor* and Bernstein analysis.

**(3) Segments**

On a segment basis, sales of premium products are rising faster than sales of mass products. In the developed markets, premium segment sales rose at a CAGR of 3.3% over the last five years, 80 bp ahead of mass segment sales growth (see Exhibit 293 and Exhibit 294). This trend is also observed in the emerging markets, where the premium segment grew at a CAGR of 14.6%, 210 bp ahead of mass segment sales growth (see Exhibit 295 and Exhibit 296). We note that on a global basis, premium products appear to be growing at a slower rate than mass products due to mix, given that the premium segment over-indexes to the developed markets.

**Exhibit 293 In the Developed Markets, the Premium Segment Makes Up 42% of Beauty Sales…**

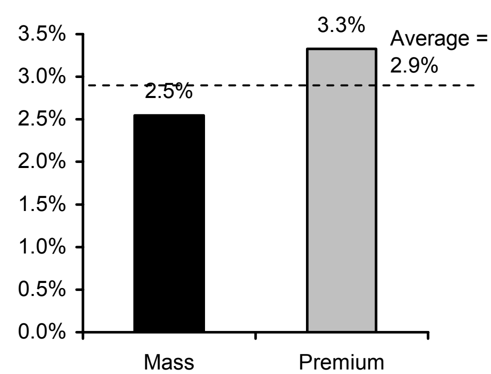
**Developed Markets: Premium vs. Mass Sales by Segment**




Source: *Euromonitor* and Bernstein analysis.

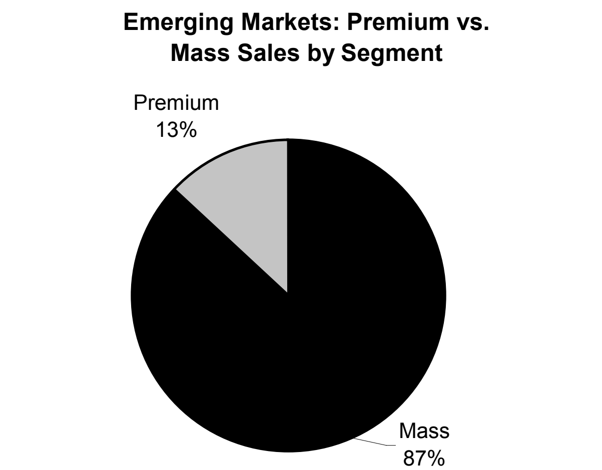
**Exhibit 294 …And Is Growing 80 bp Ahead of the Mass Segment**

**Developed Markets: 2002-07 CAGR by Segment**



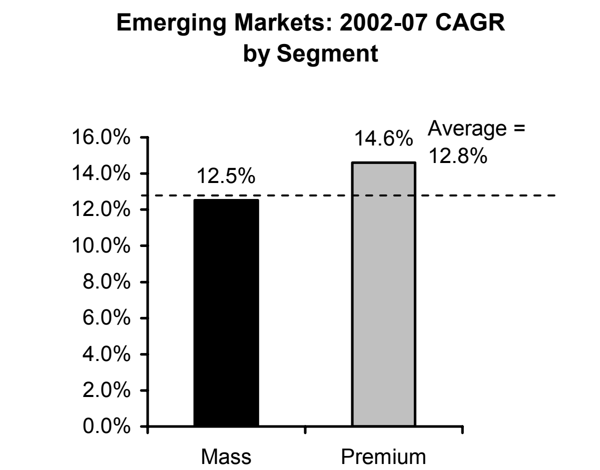

Source: *Euromonitor* and Bernstein analysis.

**Exhibit 295** **In the Emerging Markets, The Premium Segment Only Makes Up 13% of Beauty Sales…**




Source: *Euromonitor* and Bernstein analysis.

**Exhibit 296** **…But Appears to Be Poised For Share Gain Given That It Is Growing 210 bp Ahead of the Mass Segment**

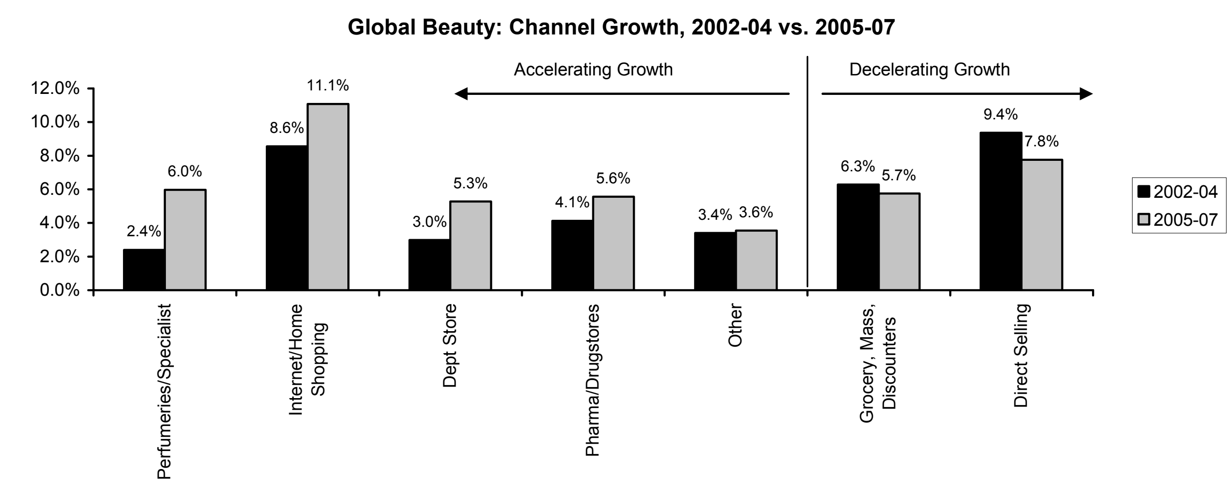



Source: *Euromonitor* and Bernstein analysis.

**(4) Distribution Channels**

In terms of distribution channels, sales growth is accelerating in perfumeries, Internet/home shopping, department stores and pharmacies/drugstores on a global basis. Conversely, sales are decelerating in the grocery, mass and discounters and direct-selling channels (see Exhibit 297).

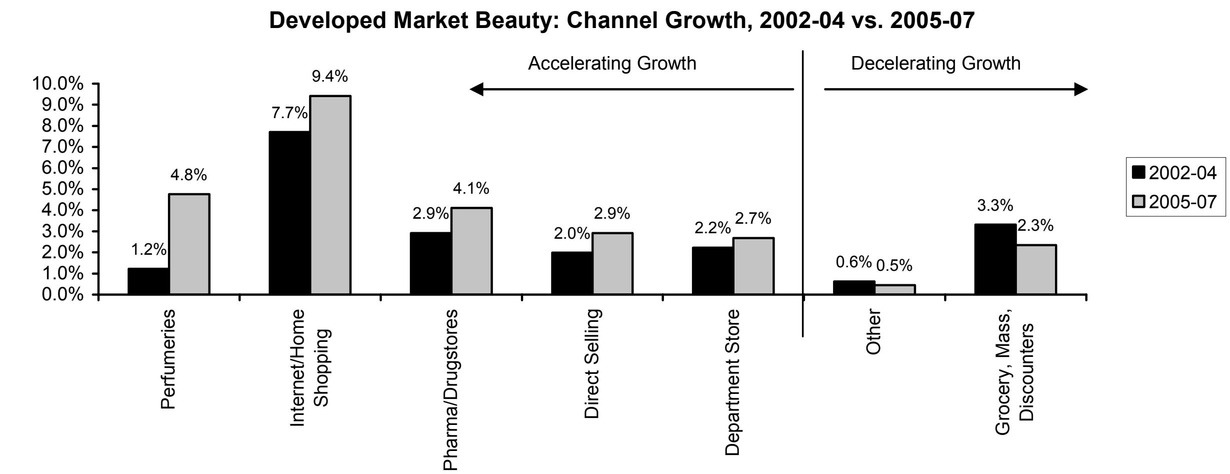
**Exhibit 297** **On a Global Basis, Perfumeries' Sales Growth Has Accelerated the Most in 2005-07 vs. 2002-04, While Grocery, Mass and Discounters and Direct-Selling Channels Have Decelerated**




Source: *Euromonitor* and Bernstein analysis.

However, given the differences in retail infrastructure in the developed markets versus the emerging markets, channel trends vary by market (see Exhibit 298 and Exhibit 299). In developed markets, perfumeries that focus on selling beauty products have seen a clear acceleration in sales growth in 2005-07, versus 2002-04, aided by the consolidation of department stores. Pharmacies/drugstores have also recently emerged as winners in the developed markets, given their recent efforts to differentiate among peers based on beauty product offerings and services. As a result, grocery, mass and discounters that compete with the pharmacies/drugstores are losing share. Although direct-selling and department store sales growth rates have improved in 2005-07 versus 2002-04, these channels continue to lose share given that they continue to grow slower than the market overall. Lastly, alternative channels such as the Internet and home shopping are growing the fastest at 9.4%, albeit off a low base (4% of beauty markets in the developed markets).

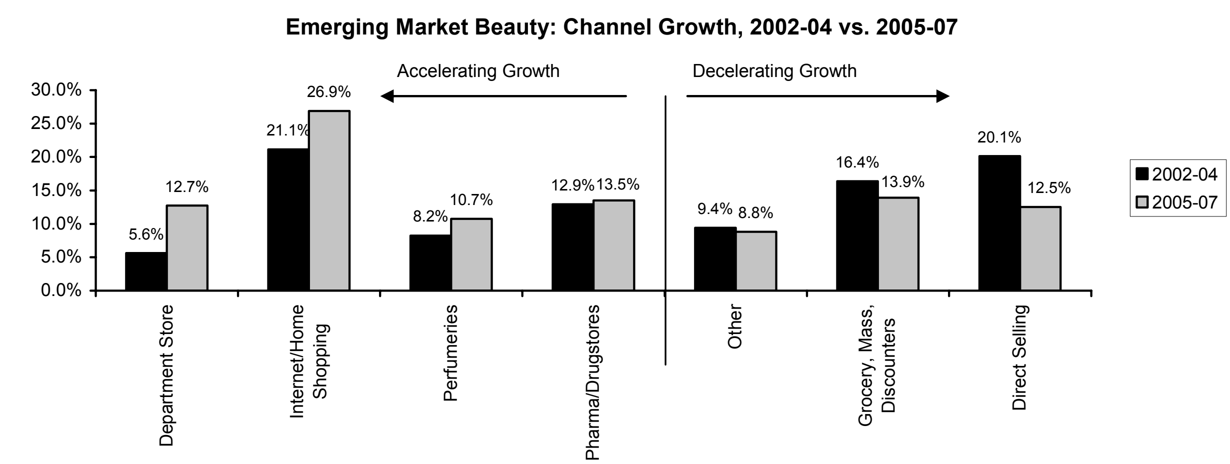
**Exhibit 298** **In the Developed Markets, Sales in Perfumeries and Pharmacies/Drugstores Are Accelerating, While Sales in Grocery, Mass and Discounters Are Slowing**




Source: *Euromonitor* and Bernstein analysis.

At a first glance, the direct selling and grocery, mass and discounters appear to be the most attractive distribution channels in the emerging markets given that they continue to grow faster than the overall beauty sales (see Exhibit 299). However, the direct-selling channel has seen a sharp deceleration in sales growth from 20.1% in 2002-04, versus 12.5% in 2005-07. Similarly, sales growth in grocery, mass and discounters has also slowed given that these channels tend to be the first types of modern retail infrastructure to penetrate emerging markets. Conversely, sales in more "modern" retail channels such as department stores, Internet/home shopping, perfumeries, and pharmacies/drugstores have accelerated in 2005-07 versus 2002-04 as these economies continue to "emerge".

**Exhibit 299** **In the Emerging Markets, Sales of Beauty Product Sales in the Direct-Selling Channel Have Decelerated Sharply Between 2005 and 2007, vs. 2002 and 2004**

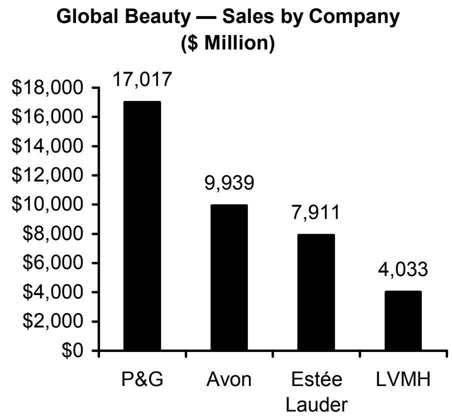



Source: *Euromonitor* and Bernstein analysis.

**How Do Our Coverage Companies Rank in Terms of Their Exposure to Faster-Growing (and Thus More Attractive) Categories, Regions, Segments and Distribution Channels?**

Our coverage companies — Avon, Estée Lauder, LVMH and P&G — vary widely in terms of size and exposure to categories, geographies, segments and distribution channels. P&G is the largest beauty company among our coverage with annual Beauty sales of $17 billion (excluding sales of deodorants and personal cleansing products that represent 12.8% of the company's reported Beauty segment sales) (see Exhibit 300). Avon, Estée Lauder and LVMH follow with sales of $10 billion, $8 billion and $4 billion, respectively. Combined, we believe that our coverage companies represent ~20% of the global beauty market (see Exhibit 301). Exhibit 302 shows our coverage companies' major brands.

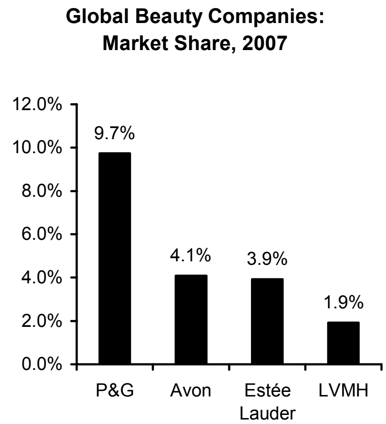
**Exhibit 300 P&G Leads the Group in Terms of Annual Sales**




**Note:** Sales for PG and EL represent FY08 sales; sales for all other companies represent FY07 numbers. PG sales excludes the deodorant and personal cleansing categories (12.8% of total sales) for the purposes of this analysis.

Source: Corporate reports and Bernstein estimates.

**Exhibit 301 We Estimate That Our Coverage Companies Represent ~20% of the Market**




**Note:** Represents retail value market share.

Source: *Euromonitor* and Bernstein analysis.

**Exhibit 302 Our Coverage Companies Own a Wide Variety of Brands**

| Company | Business Segment | Brands |
|---|---|---|
| **LVMH** | Fashion Brands | Dior, Guerlain, Givenchy, Kenzo, Acqua di Parma |
| | Specialist Brands | Benefit, La Brosse et Dupont, Fresh, Make Up For Ever, Perfumes Loewe S.A. and Sephora |
| **Estée Lauder** | Core Brands | Estée Lauder and Clinique |
| | Specialist Brands | Origins, MAC, Bobbi Brown, La Mer, Bumble and bumble, Aramis, Prescriptives, Lab Series, Jo Malone, Darphin, American Beauty, Flirt!, Good Skin™, Grassroots, Ojon and Eyes by Design |
| | Licensed Fragrances/Make-Up | Tommy Hilfiger, Kiton, Donna Karan, Michael Kors, Sean John, Missoni, Daisy Fuentes, Tom Ford and Mustang |
| **Avon Products** | Direct-Marketing/Mass Brands | Avon Color, Anew, Avon Naturals, Advance Techniques, Skin-So-Soft, and mark. |
| **Procter & Gamble** | Fine Fragrances Brands | Giorgio Beverly Hills, Hugo Boss, Escada, Lacoste, bruno banani, Ghost, Puma, Naomi Campbell, Valentino, Dolce & Gabbana, Baldessarini |
| | Specialist Brands | SK-II, Frederick Fekkai |
| | Mass Brands | Cover Girl, Olay, Infusium, Max Factor, Pantene, Clairol, Wella, Aussie, Rejoice, Herbal Essence |

Source: Corporate reports.

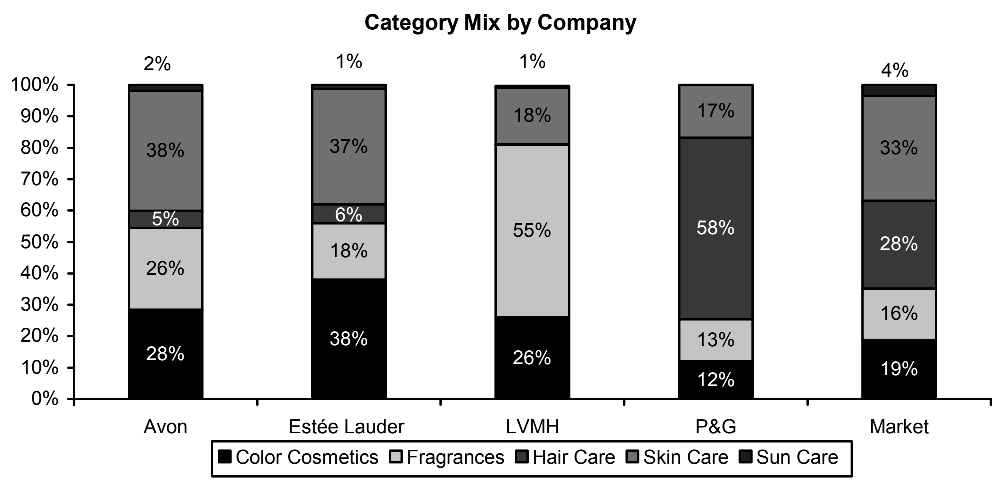
All else equal, we believe that sales growth of companies that are most exposed to faster-growing (1) categories, (2) geographies, (3) segments and (4) distribution channels will likely outperform growth of their peers on a sustainable basis. As such, we evaluate our companies' top-line prospects along these four dimensions in detail in the following section.

**(1) Category Exposure**

Exhibit 303 shows our estimated category exposure by company. As a group, our coverage companies are over-indexed to fragrances and color cosmetics versus the market, and under-indexed to hair care, skin care and sun care. Based on our coverage companies' exposure to various product categories, we have calculated our coverage companies' "Beauty Category Growth Index" — the average growth rates of the beauty categories in which they compete, weighted by their sales in the corresponding categories (see Exhibit 304).

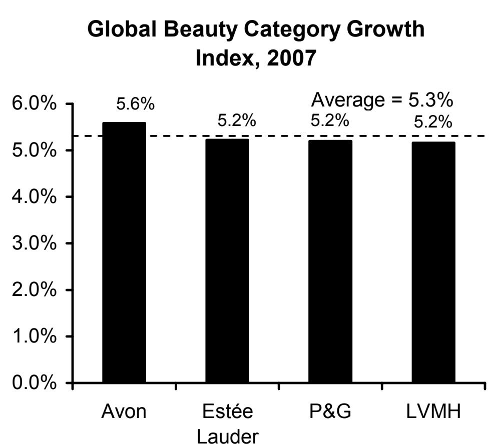
Assuming that these companies grow their sales in line with the categories in which they participate, Avon will likely grow its top line faster than peers given that it is most exposed to the faster-growing skin care category. P&G, Estée Lauder and LVMH follow with weighted average category growth rates of 5.2%. We note that Avon, P&G and LVMH have improved their category exposures between 2002 and 2007, while Estée Lauder's exposure has remained the same (see Exhibit 305).

**Exhibit 303** **Overall, Our Coverage Companies Are Mostly Over-Indexed to Fragrances and Color Cosmetics vs. the Market**



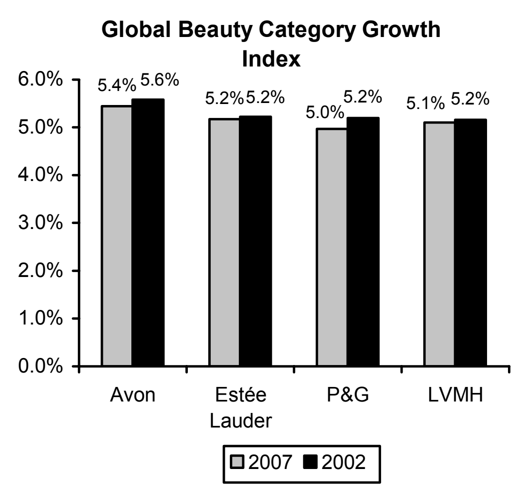

Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 304** **On Average, the Weighted Average Growth Across the Categories in Which Our Coverage Companies Compete Is 5.3%**




Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 305** **Our Coverage Companies Have Improved Their Category Growth Exposures Over Time**



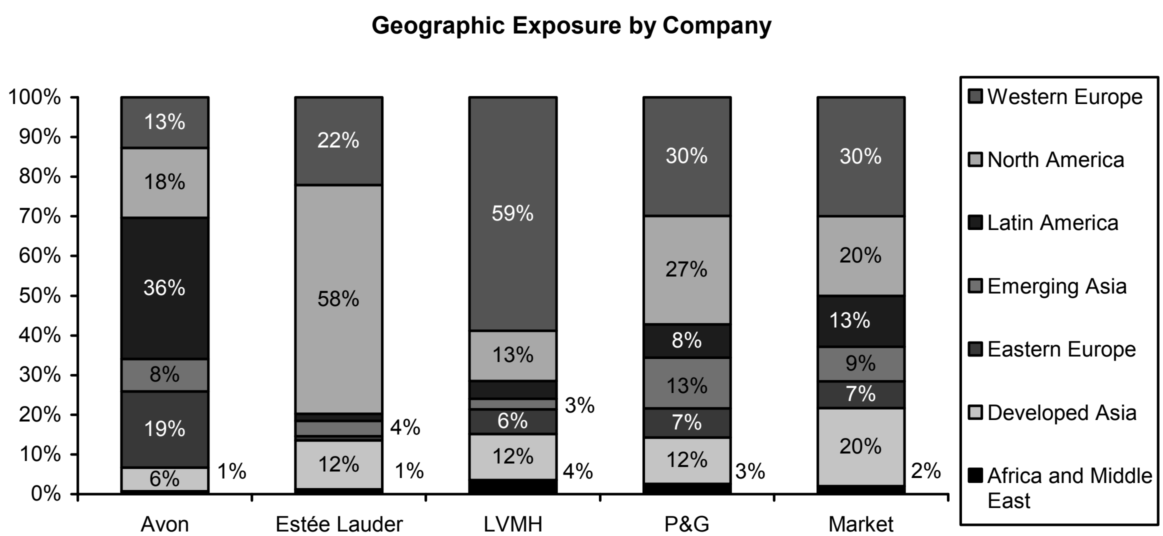

Source: *Euromonitor* and Bernstein estimates and analysis.

**(2) Geographic Exposure**

We have also assessed the top-line growth potential for Avon, Estée Lauder, LVMH and P&G based on their geographic exposures across 52 countries. As expected, our coverage companies are over-indexed to North America and Europe as a group. Based on these companies' exposures to various geographies, we have also estimated the "Beauty Geographic Growth Index"— the average growth rates of the geographic markets in which they compete, weighted by their sales in the corresponding geographies (see Exhibit 306 and Exhibit 307). We find that Avon ranks first among our coverage given that it generates 64% of its sales in the emerging markets, which includes Latin America, Eastern Europe, Emerging Asia and Africa and the Middle East, while the group generates 30% of its sales from emerging markets on average. P&G follows second as the company generates 31% of sales from emerging markets, largely in line with the market. LVMH and Estée Lauder's weighted average growth rates across their geographies lag the group average given that they are less exposed to the faster-growing emerging markets.

Over the last five years, our coverage companies have improved their geographic footprint, with increasing exposure to faster-growing geographies (see Exhibit 308). We believe this trend is likely to continue. In that light, companies such as Estée Lauder and LVMH that are currently under-indexed to the emerging markets could improve their top-line prospects the most by increasing their penetration in the faster-growing geographies. Conversely, companies that are over-exposed to the emerging markets, such as Avon, have less room for improvement going forward. Moreover, as the emerging markets continue to "emerge" and the marketplace becomes more crowded, companies that are overexposed to the emerging markets will likely struggle to deliver sales growth rates that are in line with historical rates.

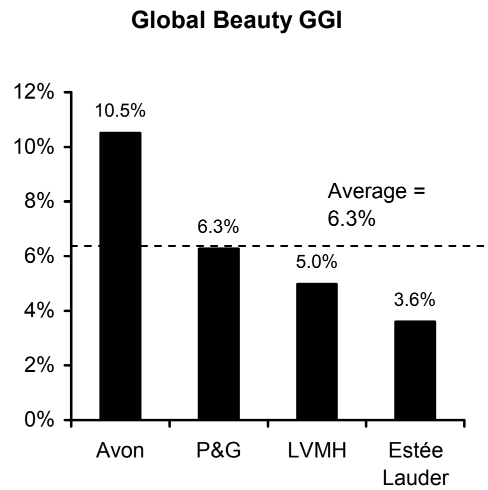
**Exhibit 306** **On Average, Our Coverage Companies Are Overexposed to North America and Western Europe**




**Note**: Numbers may not exactly match companies' reported figures as *Euromonitor* sales represent US$ retail.

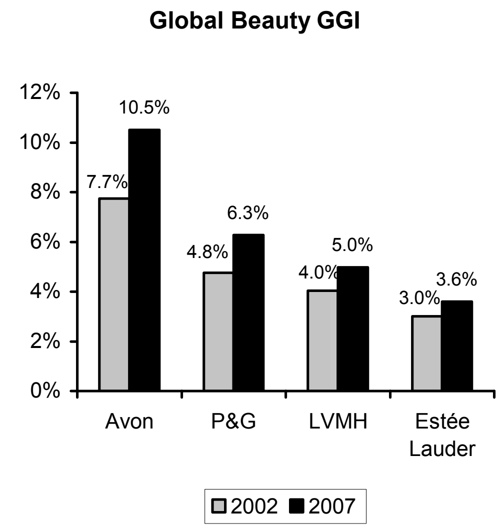
Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 307** **On Average, Beauty Sales in the Geographies in Which Our Coverage Companies Compete Are Growing at 6.3%**




Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 308** **Our Coverage Companies' Geographic Footprints Have Improved Over Time**

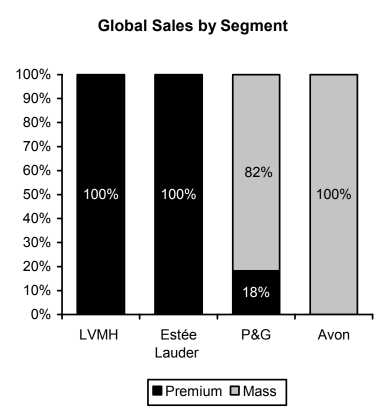



Source: *Euromonitor* and Bernstein estimates and analysis.

**(3) Segment Exposure**

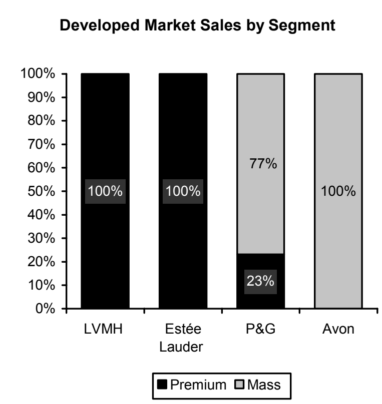
LVMH and Estée Lauder effectively generate 100% of their sales from products that fall within the premium segment given their relatively high price points and brand prestige, along with the fact that their products are sold through high-end distribution channels such as department stores and perfumeries (see Exhibit 309). Conversely, Avon generates 100% of its sales from products that fall within the "mass" segment. P&G sells a combination of premium and mass products, but are generally more levered toward the mass segment, particularly in the emerging markets (see Exhibit 310 and Exhibit 311).

**Exhibit 309** **LVMH and Estée Lauder Participate in the Premium Segment, While Avon Participates Exclusively in the Mass Segment…**



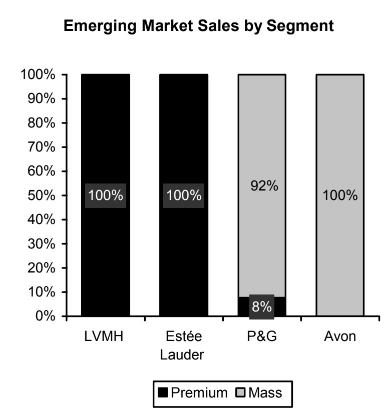

Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 310** **…P&G Sells a Combination of Premium and Mass Products…**




Source: *Euromonitor* and Bernstein estimates and analysis.

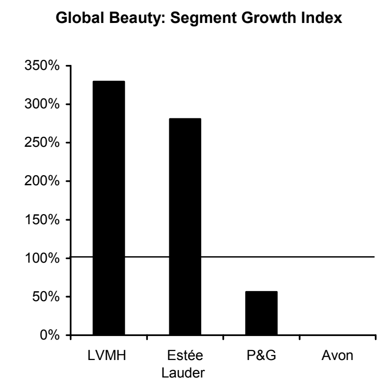
**Exhibit 311** **…And Its Proportion of Sales from Mass Products Is Higher in the Emerging Markets Than in the Developed Markets**




Source: *Euromonitor* and Bernstein estimates and analysis.

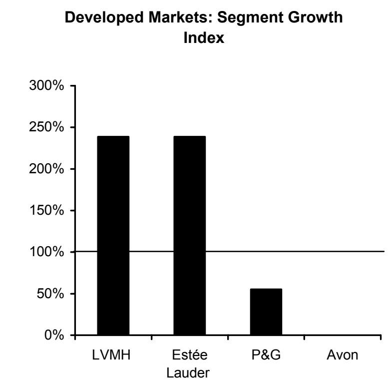
We have quantified our coverage companies' growth potential based on their exposure to the premium segment versus the market in both the developed and the emerging markets (see Exhibit 312, Exhibit 313 and Exhibit 314). Companies that score above 100% have higher exposure to the premium segment versus the market. Overall, we find that LVMH ranks first on this measure, followed by Estée Lauder, given that LVMH has a greater exposure to the emerging markets than Estée Lauder. P&G is under-indexed to the premium segment versus the market, while Avon ranks last given that it generates 100% of its sales from products that are considered mass in both the developed and emerging markets.

**Exhibit 312 LVMH and Estée Lauder Are Over-Indexed to the Premium Segment…**



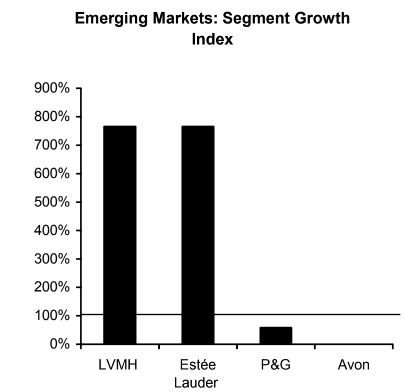

Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 313 …P&G Is Under-Indexed to the Premium Segment…**




Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 314 …Avon Only Participates in the Mass Segment**

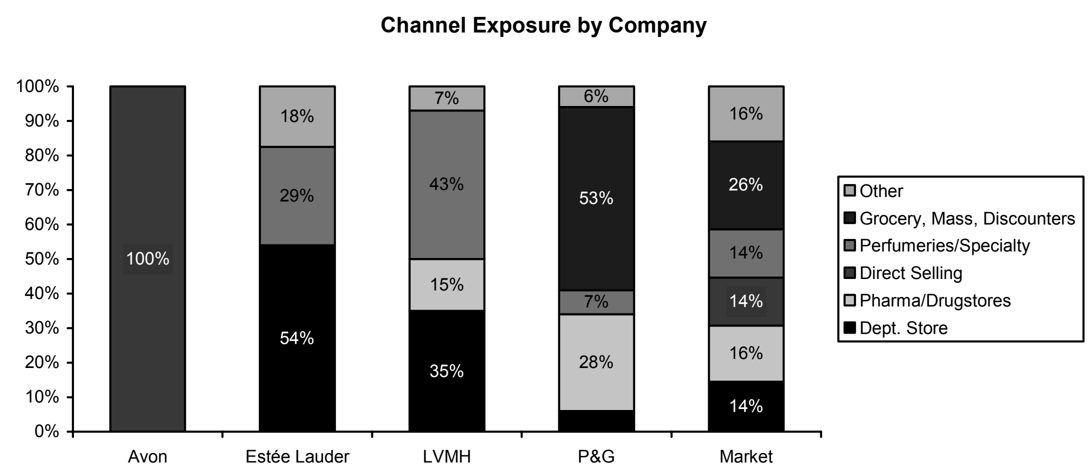



Source: *Euromonitor* and Bernstein estimates and analysis.

### (4) Channel Exposure

Lastly, we examine our coverage companies' exposure to various distribution channels (see Exhibit 315). Among the companies in our coverage, Avon is the only direct seller of beauty products. Estée Lauder and LVMH sell 83% and 78% of their sales through department stores and perfumeries, respectively. (Recall that "perfumeries" include LVMH's Sephora and Estée Lauder's free-standing stores.) P&G is much more exposed to grocery, mass and discounters and pharmacies, which account for 81% of its sales.

**Exhibit 315 Our Coverage Companies' Exposures to Different Channels Vary Significantly from One Company to Another**



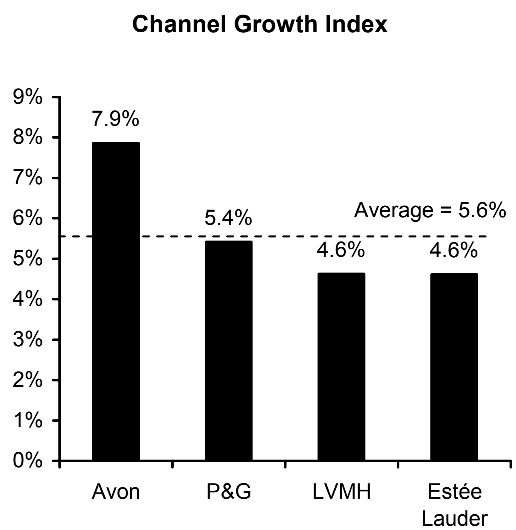

Source: Company reports, *Euromonitor* and Bernstein estimates and analysis.

Based on our coverage companies' exposure to various channels, we have calculated the "Channel Growth Index" — the average growth rates of channels in which companies sell their products, weighted by their sales in the corresponding channels (see Exhibit 316). Overall, we find that Avon ranks first on this measure among our coverage companies given its exposure to the direct-selling channel, which has benefited from above-market growth in the emerging markets. P&G follows given its exposure to grocery, mass, and discount stores and pharmacy channels. LVMH and Estée Lauder are the laggards given their exposure to the department stores, which are growing slower than the overall market.

However, the "Channel Growth Index" does not reflect the changing tide in retail dynamics within the beauty industry. As we discussed above, the direct-selling channel is experiencing a sharp deceleration in sales growth in the emerging markets, while growth rates of more modern retail formats are accelerating. Within the developed markets, sales of beauty products through perfumeries are accelerating as consumers trade up to the premium segment and the department stores that have traditionally offered prestige beauty products have consolidated. As such, we have designed a "Channel Growth Acceleration Index" — the average rank of sales growth acceleration across the channels in which our companies participate, weighted by their exposure to the corresponding channels (see Exhibit 317).

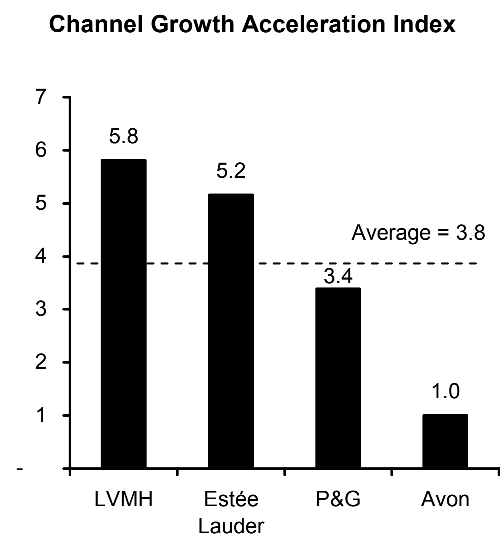
By this measure, LVMH ranks first given its high exposure to perfumeries, including Sephora (see Exhibit 318 and Exhibit 319). Estée Lauder ranks second given its exposure to perfumeries (including its own retail stores), salons and travel retail. The company is also pushing into alternative channels such as Internet (company-owned sites in the U.S. and five foreign countries) and home shopping (Clinique, Bobbi Brown, Origins and Ojon on QVC and Beauty Bank Eyes by Design on HSN), albeit off a lower base. P&G ranks third, while Avon ranks last given the sharp deceleration in the direct-selling sales growth.

**Exhibit 316 Based on Exposure to Various Channels and Current Growth Rates, Avon Appears to Rank First…**



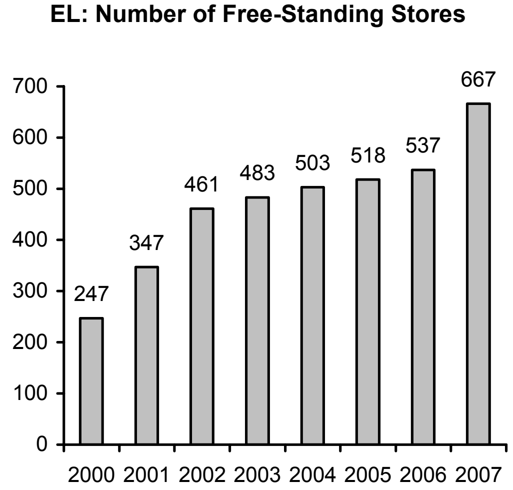

Source: *Euromonitor,* corporate reports and Bernstein estimates and analysis.

**Exhibit 317 …However, Based on Acceleration/Deceleration of Sales Growth Trends by Channel, Avon Ranks Last Given the Rapid Slowdown of Growth in the Direct-Selling Channel**



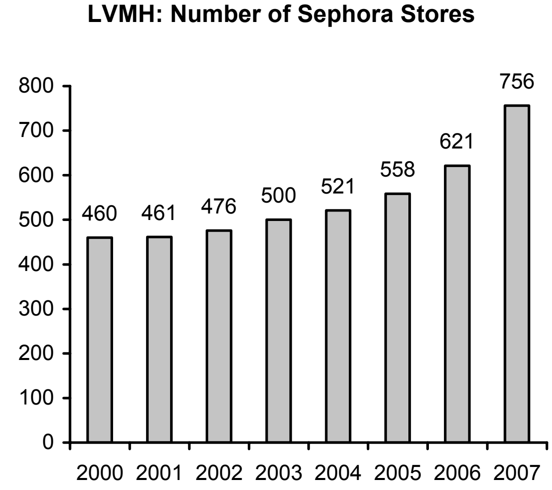

Source: *Euromonitor,* corporate reports and Bernstein estimates and analysis.

**Exhibit 318** **The Growth of Estee Lauder's Free-Standing Stores Has Been Accelerating…**




Source: Corporate reports.

**Exhibit 319** **…As Has the Growth of LVMH's Sephora Stores**




Source: Corporate reports.

## Conclusion by Company

Exhibit 320 summarizes our analysis by company and by exposure to (1) categories, (2) geographies, (3) segments and (4) distribution channels. A score of "1" represents the most attractive top-line prospects among its peer group, while a score of "5" represents the least attractive.

**Exhibit 320** **Overall Top-Line Prospects Within the Global Beauty Industry**

| | Avon | Estée Lauder | LVMH | P&G |
|---|---|---|---|---|
| 1) Category | 1.0 | 2.0 | 4.0 | 3.0 |
| 2) Geography | 1.0 | 4.0 | 3.0 | 2.0 |
| 3) Segment | 4.0 | 2.0 | 1.0 | 3.0 |
| 4) Channel | 2.5 | 3.0 | 2.0 | 2.5 |
| **Average Rank** | **2.1** | **2.8** | **2.5** | **2.6** |

**Note:** (4) "Channel" rank for each company represents the average of Channel Growth Index and Channel Growth Acceleration Index measures.

Source: Bernstein estimates and analysis.

**Avon**: Avon participates in faster-growing categories and geographies relative to its peers, but risks to its top-line growth prospects exist given rapidly decelerating sales growth in the direct-selling channel. On average, Avon's categories and geographies are growing at 5.6% and 10.5%, 30 bp and 420 bp ahead of its peer group averages, respectively. However, the company's fate is tied to the direct-selling channel, which is demonstrably beginning to show signs of deterioration, particularly in the emerging markets.

**Estée Lauder:** Estée Lauder's portfolio is relatively attractive with respectable exposures to faster-growing categories and segments, but the company ranks last among its peers given its exposure to less attractive geographies and channels. Looking forward, we believe that opportunities to improve its top-line prospects exist as the company increasingly pushes into the emerging markets and continues to diversify its distribution channels, particularly in the "alternative" channels such as the Internet and home shopping. However, we are concerned that Estée Lauder may become over-reliant on its lower-RoIC free-standing stores to grow its sales, perhaps driving a negative impact on valuation.

**LVMH:** On the one hand, LVMH's weighted average geographic growth rate is 130 bp below the group average of 6.3%. On the other hand, LVMH will likely benefit from growing consumer preference for the premium segment; share gains by Sephora will also likely boost its sales going forward. We note that from a financial perspective, beefing up the retail operations makes much more sense for a company like LVMH (than it does for Estée Lauder) that already has a network of retail operations and plays in the more premium segment.

**P&G:** P&G operates in an attractive set of categories within beauty and benefits from respectable exposure to the emerging markets. On a category basis, the company's weighted average growth rate is 5.2%, largely in line with the peer average. Moreover, the company's weighted average growth rate across the geographies in which it competes is 6.3% — also in line with its peer group average. However, P&G is less exposed to the premium segment, particularly in the emerging markets, and is also less exposed to pharmacies/drugstores that we believe are poised for faster growth in the future, both potential for improvement.

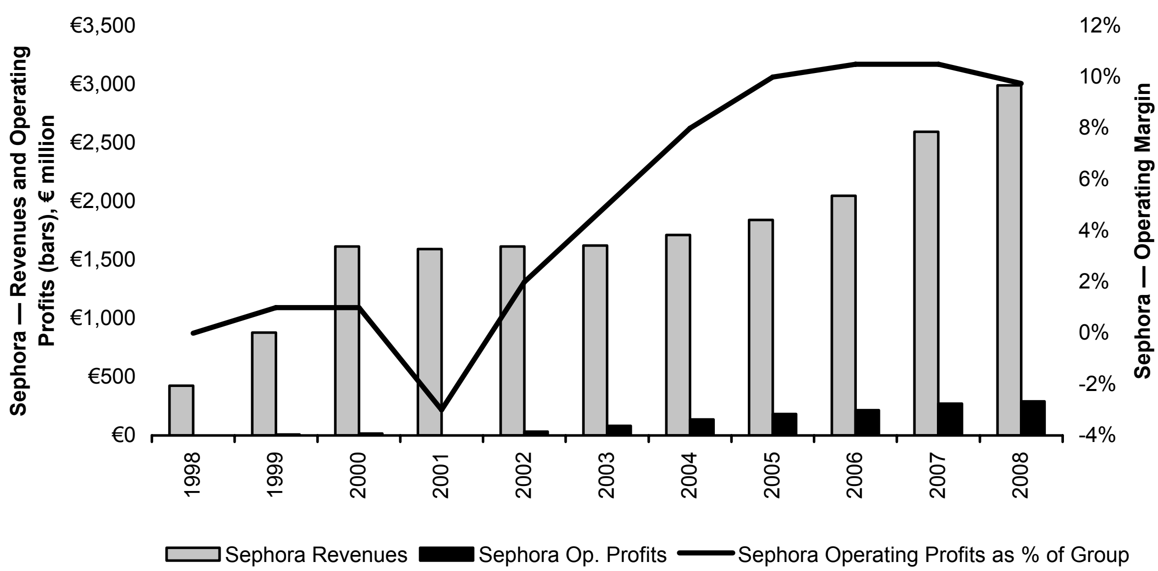
# Sephora — A Major Growth Avenue

**Sephora Has Become a Major Contributor to the LVMH Portfolio**

The beauty retailer Sephora has become a key business in the LVMH portfolio. In the past 10 years, estimated revenues have grown at CAGR of 21% to represent 18% of LVMH group revenues in 2008. Estimated EBIT has grown at CAGR 48% since 1999 to represent 8% of LVMH operating profit (see Exhibit 321 and Exhibit 322).

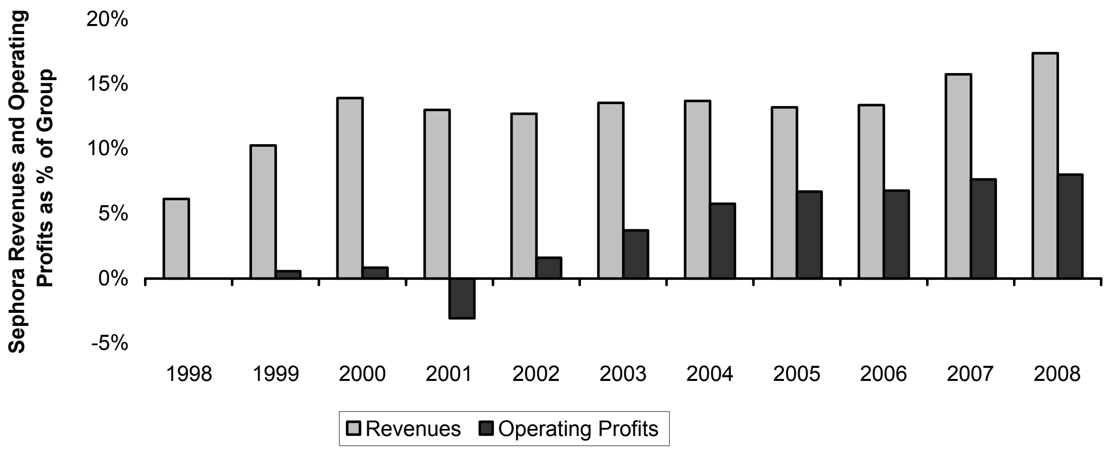
In the same time frame, Sephora has moved from 124 stores in 1998 to 898 stores by the end of 2008, with operations in 23 countries (see Exhibit 323 and Exhibit 324). Sephora's performance has become increasingly positive, contributing to advance LVMH group results. We estimate that Sephora's operating profit margin has grown from nil in 1998 to approximately 10% in 2008, while RONA has grown from 9.2% in 2004 to nearly 14% in 2007; 2008 saw RONA fall slightly for the Selective Distribution, most likely the result of weakness at DFS and other businesses (see Exhibit 325 and Exhibit 326). As a premium beauty retailer, we anticipate that Sephora should be more cyclical than mass Health & Beauty retailers — our calculated LFL suggest that this has been the case in the past (see Exhibit 327 and Exhibit 328).

**Exhibit 321** **Sephora Revenues and Operating Profits, 1998-2008**



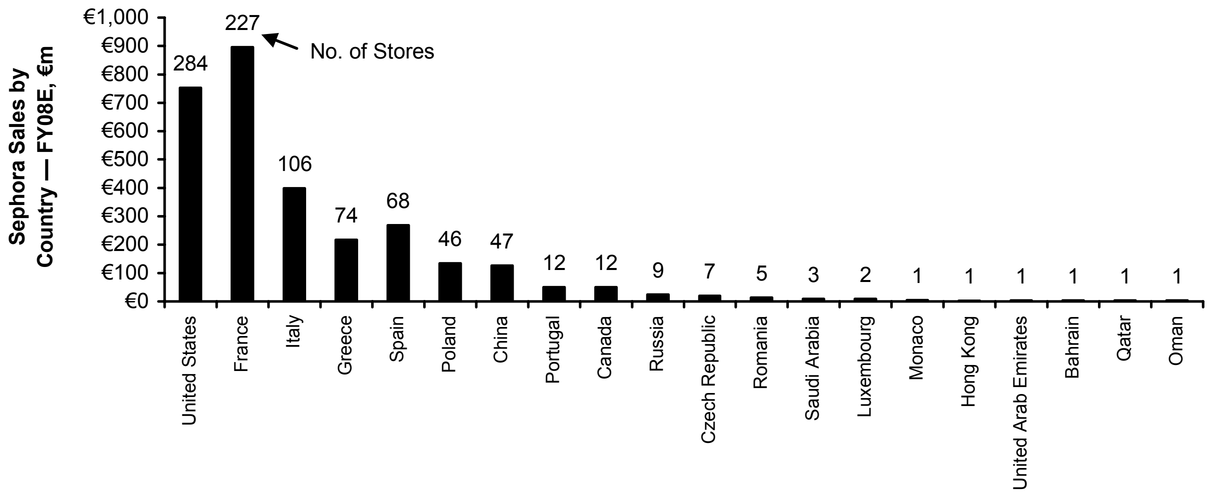

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 322** **Sephora Has Been an Important Contributor to Revenues and Operating Profits**



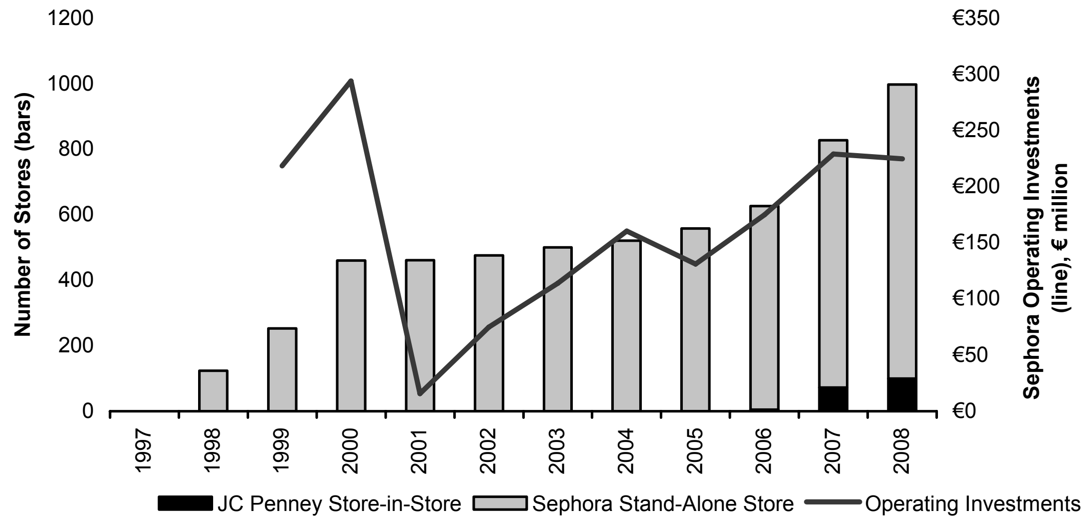

Source: Bernstein estimates and analysis.

**Exhibit 323** **Sephora Sales Are Concentrated in the United States and France**




Source: Bernstein estimates and analysis.

**Exhibit 324 JC Penney Store-in-Store Is Set to Boost Sephora's Network**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 325 Return on Net Assets by Division (2004-08)**

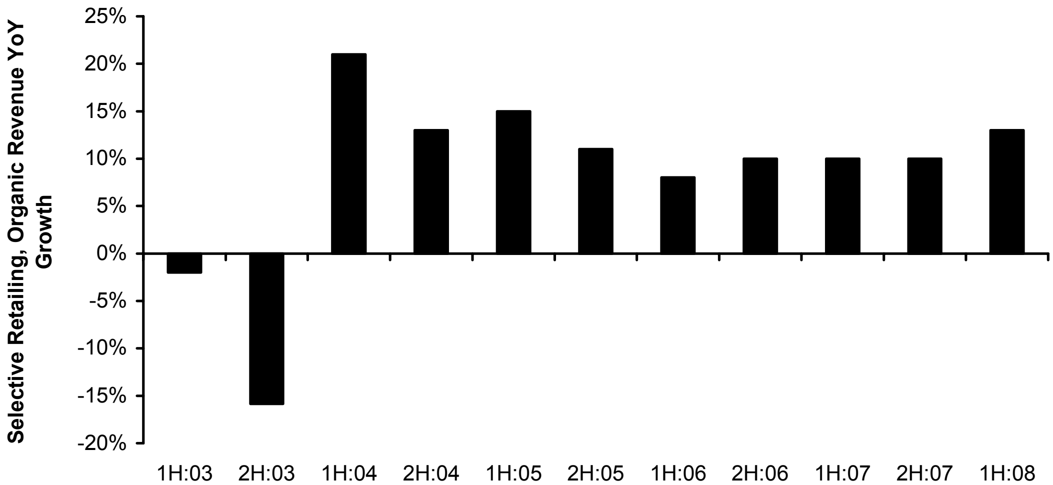

Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 326** **LVMH Net Asset and NOPAT by Division (2007)**

| | Net Asset (Allocated) | | NOPAT | |
|---|---|---|---|---|
| | *€ mil.* | *% Group* | *€ mil.* | *% Group* |
| Wines & Spirits | €4,605 | 39% | €705 | 30% |
| Fashion & Leather Goods | €3,772 | 32% | €1,219 | 51% |
| Perfumes & Cosmetics | €411 | 3% | €171 | 7% |
| Watches & Jewelry | €836 | 7% | €94 | 4% |
| Selective Distribution | €2,155 | 18% | €293 | 12% |
| Corporate | | | -€112 | -5% |
| **LVMH** | **€11,780** | **100%** | **€2,370** | **100%** |

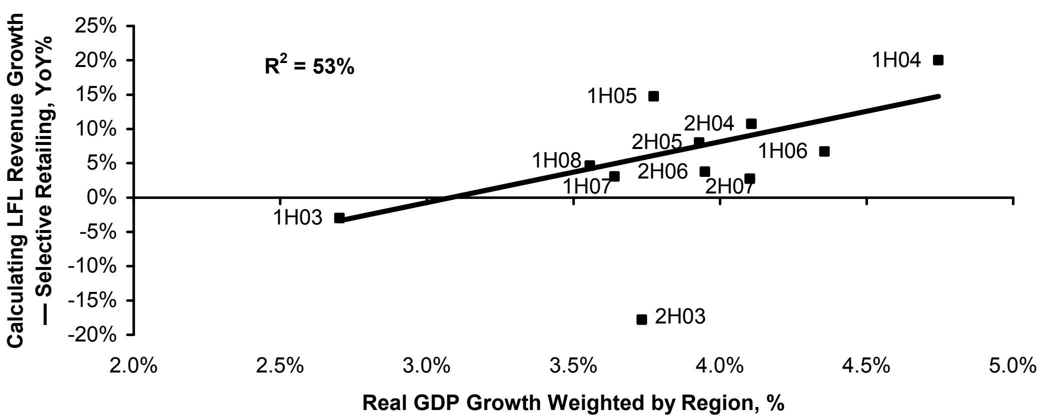
Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 327** **Calculated LFL Revenue Growth (%, YoY) — Selective Retailing (1H:03-1H:08)**




Source: Corporate reports and Bernstein analysis.

**Exhibit 328** **Calculated LFL Revenue Growth (%, YoY) vs. Weighted Average GDP — Selective Retailing**



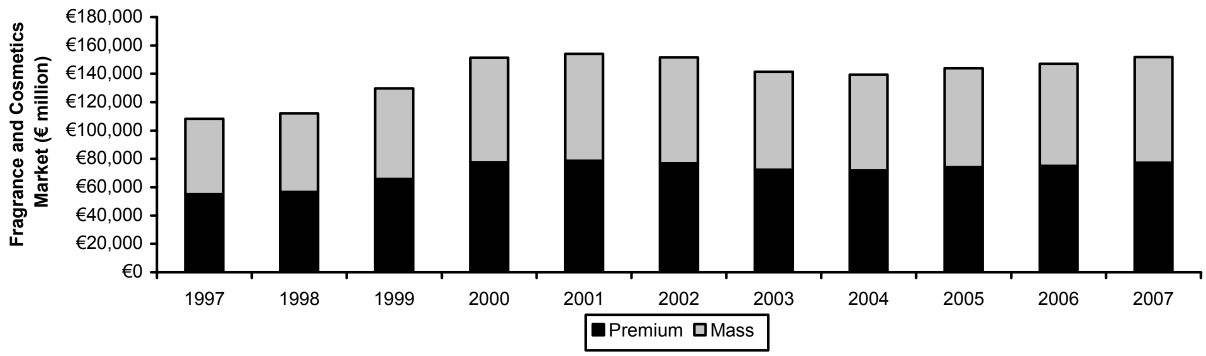

**Note:** The regression excludes the 2H:03 outlier.

Source: Corporate reports and Bernstein analysis.

## Sephora Operates in a Market Sweet Spot

The beauty retail market is attractive as it grows faster than GDP and is very fragmented, even in developed countries. The premium beauty segment has grown on average at 4% in the past 10 years, above GDP growth over the same period (see Exhibit 329 through to Exhibit 333). Some product families — such as skin care in Asia, or cosmetics in North America — have come to dominate specific markets (see Exhibit 334).

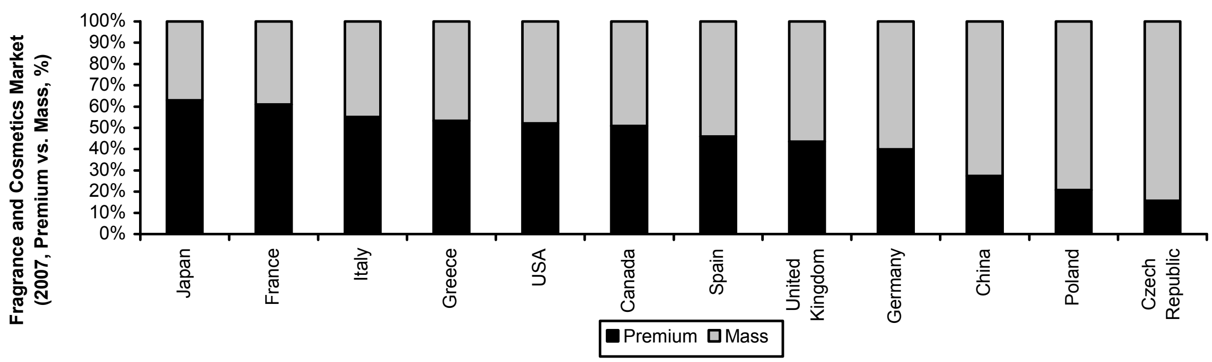
**Exhibit 329** **Fragrances and Cosmetics Market Value — Premium vs. Mass Market (1997-2007)**




**Note:** Markets included in computation are Canada, China, Czech Republic, France, Germany, Greece, Italy, Japan, Poland, Spain, the United Kingdom and the United States.

Source: *Euromonitor* and Bernstein estimates and analysis.

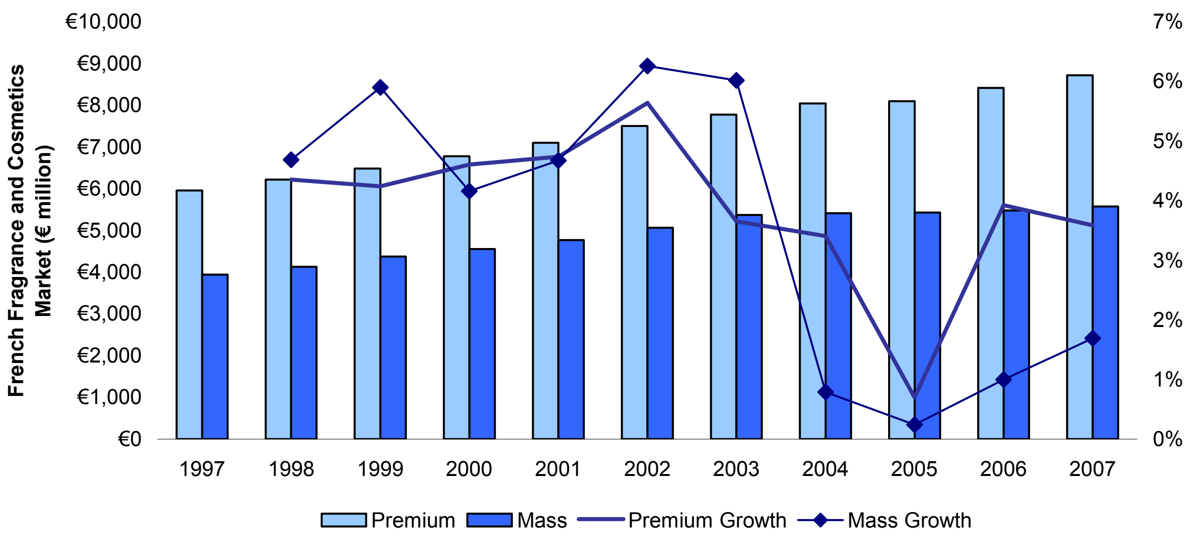
**Exhibit 330** **Fragrances and Cosmetics Market Mix by Country — Premium vs. Mass Market (2007)**




**Note:** Markets included in computation are Canada, China, Czech Republic, France, Germany, Greece, Italy, Japan, Poland, Spain, the United Kingdom and the United States.

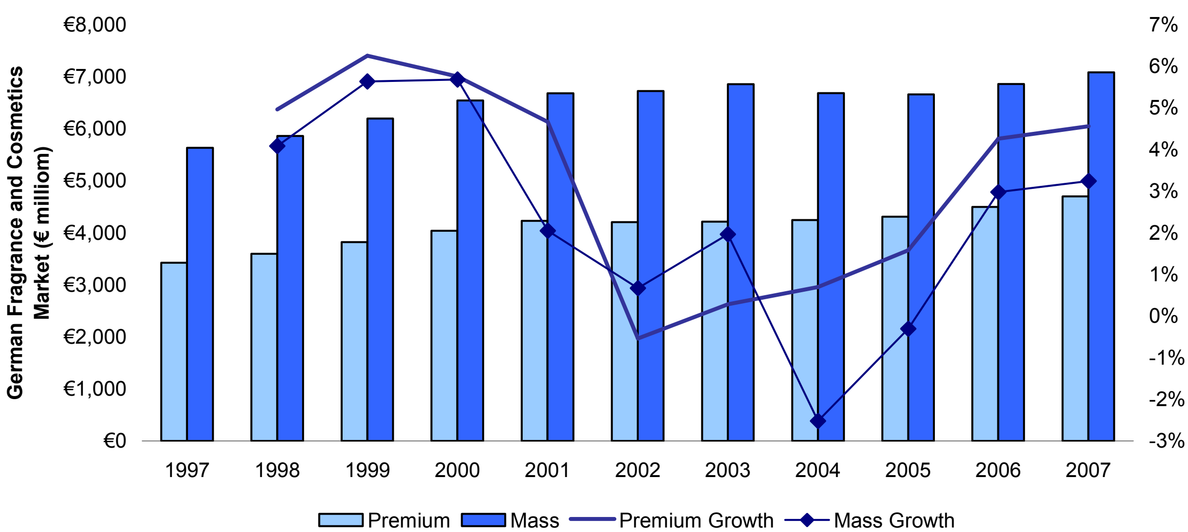
Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 331** **Fragrances and Cosmetics Market — France (1997-2007)**



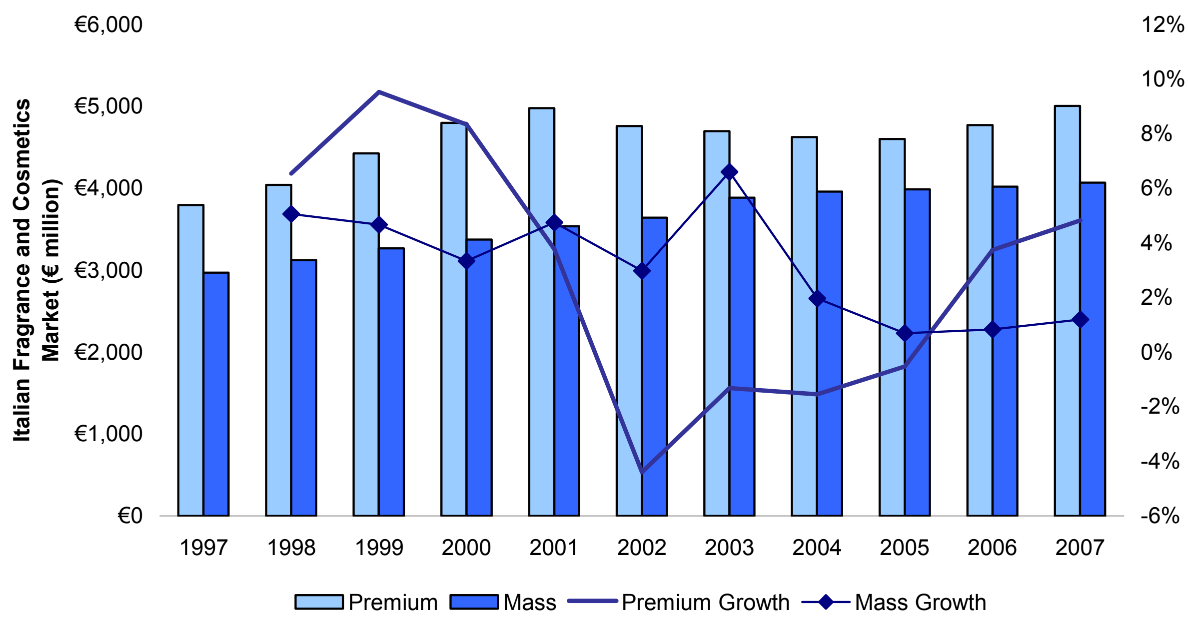

Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 332** **Fragrances and Cosmetics Market — Germany, 1997-2007**




Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 333** **Fragrances and Cosmetics Market — Italy (1997-2007)**




Source: *Euromonitor* and Bernstein estimates and analysis.

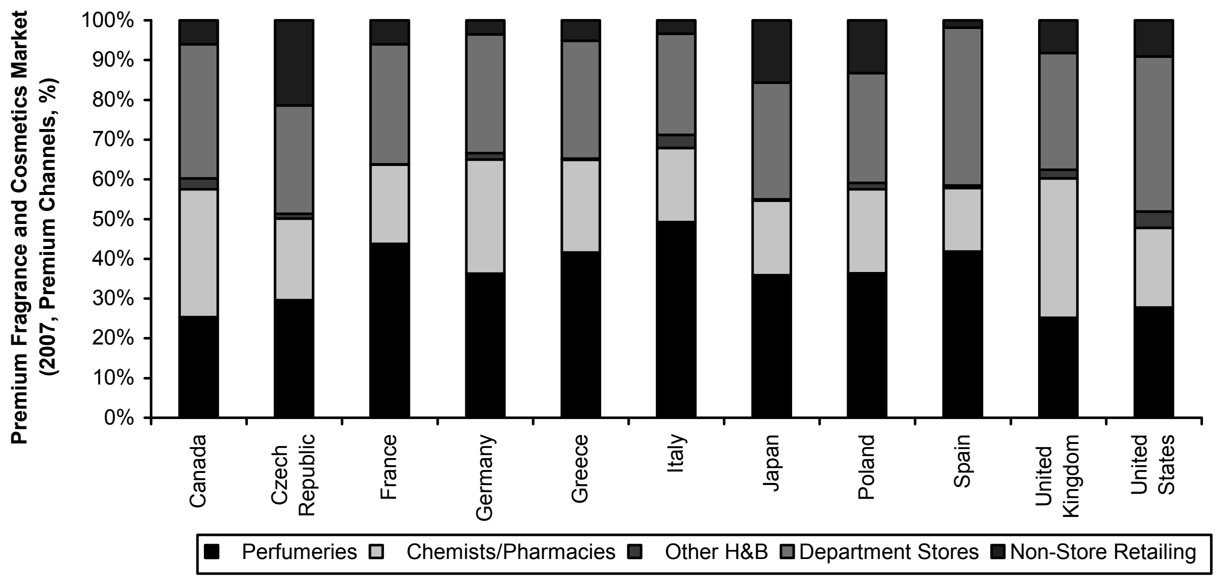
**Exhibit 334** **Fragrances and Cosmetics Category Mix by Country (2007)**

| | Cometics | Fragrances | Skin Care | Other |
|---|---|---|---|---|
| China | **24%** | **3%** | **41%** | 33% |
| Japan | **46%** | **1%** | **34%** | 18% |
| **Asia (avg.)** | | **2%** | **38%** | |
| U.S. | **41%** | **10%** | **21%** | 27% |
| Canada | **41%** | **9%** | **20%** | 30% |
| **North America (avg.)** | **41%** | **10%** | **20%** | |
| U.K. | **36%** | **9%** | **32%** | 22% |
| Greece | **35%** | **10%** | **30%** | 25% |
| France | **39%** | **13%** | **31%** | 18% |
| Italy | **38%** | **11%** | **29%** | 22% |
| Spain | **32%** | **18%** | **29%** | 21% |
| Germany | **31%** | **17%** | **29%** | 24% |
| Czech | **23%** | **14%** | **30%** | 33% |
| Poland | **22%** | **18%** | **29%** | 31% |
| **Europe (avg.)** | **32%** | **14%** | **30%** | |

Source: *Euromonitor* and Bernstein estimates and analysis.

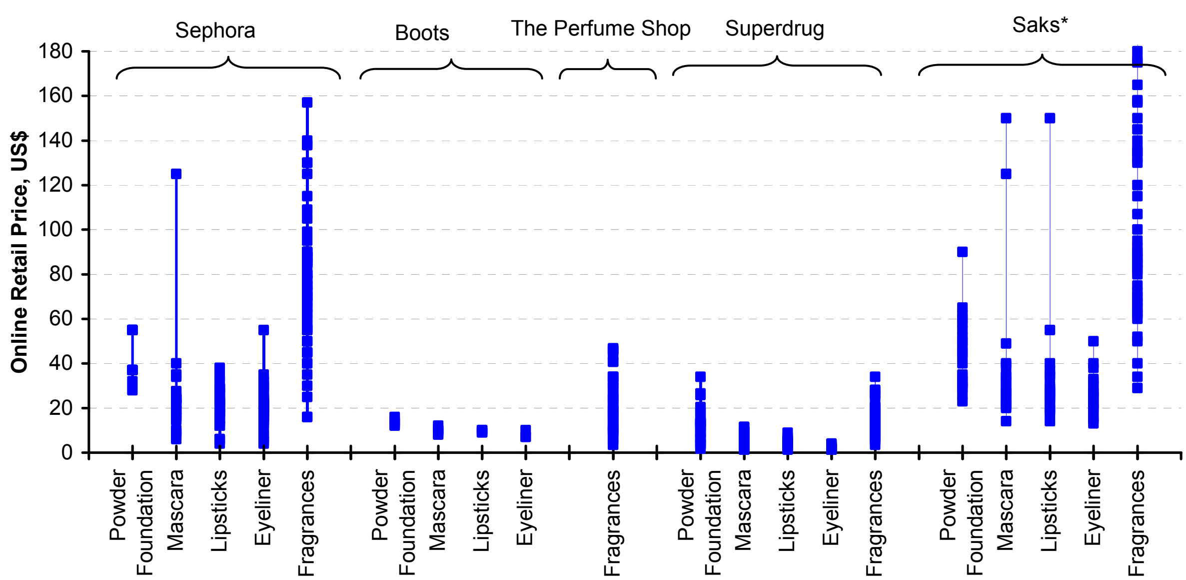
Premium beauty retailing is still largely in the hands of mature/independent formats — mainly department stores and perfumeries (see Exhibit 335). Stronger and more modern concepts — supermarkets and mass merchants — have focused on the mass portion of the beauty segment, as they would hardly have the range, service and quality characteristics to be credible premium beauty retailers (see Exhibit 336, Exhibit 337 and Exhibit 338).

**Exhibit 335** **Premium Beauty Retailing Is Still Largely in the Hands of Mature/Independent Formats**




Source: *Euromonitor* and Bernstein estimates and analysis.

**Exhibit 336** **Sephora Generally Has Higher Average Price and Wider Range Than Other Channels**




**Note:** *For ease of comparison, fragrances price points >US$180 are not shown.

Source: Bernstein online store checks and Bernstein analysis.

## Exhibit 337 Relative Attractiveness of Retail Formats

| | # Brands | Price range | Brand's expression | Category/ need expression | Category advice | Self-service | Distance to customer | Quality of locations | Total Score | Rank |
|---|---|---|---|---|---|---|---|---|---|---|
| Sephora | ● | ◕ | ◔ | ● | ● | ● | ◑ | ◕ | 25 | 1 |
| Perfumeries | ◑ | ● | ● | ○ | ◔ | ◑ | ◑ | ◑ | 17 | 2 |
| Department Stores | ◕ | ◕ | ● | ◔ | ◔ | ○ | ◔ | ◕ | 16 | 3 |
| Non-store Retailers | ◑ | ◕ | ◕ | ◑ | ◑ | ◑ | ○ | ○ | 14 | 4 |
| Pharmacies | ◔ | ◔ | ◔ | ◔ | ○ | ◑ | ● | ◑ | 12 | 5 |

Positive ●
Negative ○

Source: Bernstein estimates and analysis.

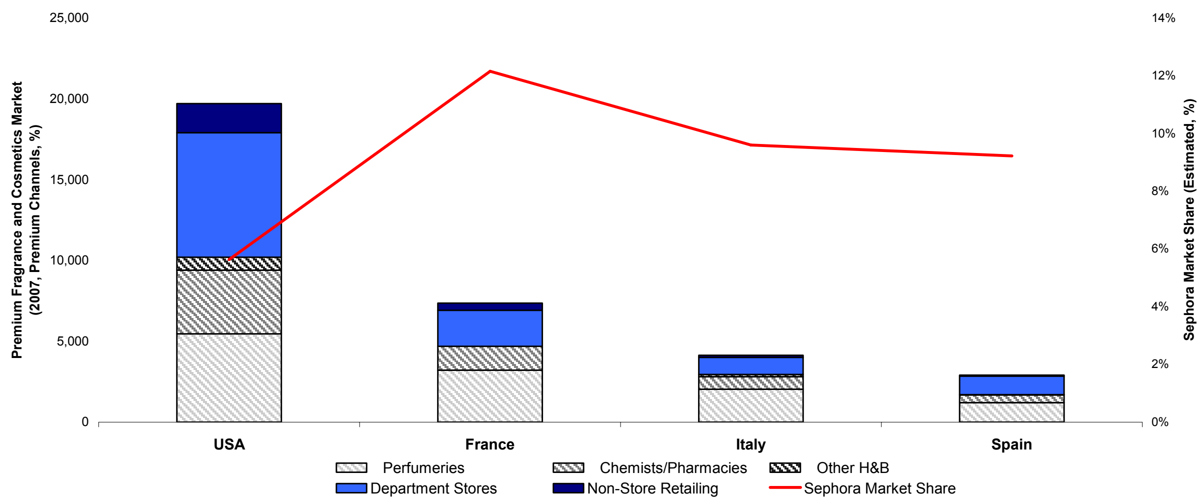
## Exhibit 338 Sephora: Available Brands

Agent Provocateur
Alchimie Forever
Amatokin
American Crew
Anna Sui
Aquolina
Armani
Arthur et les Minimoys
Azzaro
Babar
Balmain
Balmshell
bareMinerals
Benefit
Berdoues
Biotherm
Biotherm Homme
black'Up
Bliss
Bobbi Brown
Bond n°9
Boucheron
Bremenn
Burberry
Bvlgari
By Terry
Cacharel
Calvin Klein
Cargo
Carita
Carolina Herrera
Caron
Cartier
Castelbajac
Cathy Guetta
Cerruti
Chloé
Clarins
ClarinsMen
Clayeux
Clinique
Colorist Christophe Robin
Comodynes
Dali
Davidoff
Decléor
Diesel
Dior
DKNY
Dolce & Gabbana
Dr. Brandt Skincare
Eden Park
Elizabeth Arden Soin
Emilio Pucci
Escada
Estée Lauder
Esthederm
Eyliplex-2
Fendi
Frédéric Fekkai
Fusion Beauty
Garancia
Geoffrey Beene
Giambertone
Giorgio Beverly Hills
Givenchy
GoSMILE
Grès
Gucci
Guerlain
Guess
Guy Laroche
Hairgum Move
Hanae Mori
Helena Rubinstein
Hello Kitty
Herborist
Hérôme
Hip
Home Skin Lab
Houbigant
Hugo Boss
Ice Cream
IKKS
Iman
Imedeen
Indult
Institut Très Bien
Issey Miyake
Jacadi
Jacomo
Jean-Charles Brosseau
Jean Louis Scherrer
Jeanne Piaubert
Jean Patou
Jean Paul Gaultier
Jennifer Lopez
Jil Sander
Jimmy Jane
John Frieda
John Galliano
John Masters Organics
Joop!
Juice Beauty
Kaloo
Kanebo
Kanellia
Kenzo
Kenzoki
Kirikou
Kiss
Lacoste
Lalique
Lancaster
Lancôme
Lanvin
La Prairie
La Ric
La Sultane de Saba
Laura Mercier
Laurence Dumont
Le Manège Enchanté
Le Nid des Marques
Leonor Greyl
Lolita Lempicka
Make Up For Ever
Mama Mio
Marc Jacobs
Mavala
Max Mara
Menard
Mimi La Souris
Molinard
Molton Brown
Molyneux
Montana
Montblanc
Moschino
Murad
Nars
Nickel
Night Fever
Nina Ricci
No!No!
One Minute Manicure
OPI
Oscar De La Renta
Oxyprolane
Paco Rabanne
Paloma Picasso
Paul Smith
Perricone
Phytosolba
Phytospecific
Pierre Cardin
Planet Kid
Prada
Prevage
Ralph Lauren
Reminiscence
Rexaline
Robert Piguet
Rochas
Roger&Gallet
Salvatore Ferragamo
Sampar
Sarah Jessica Parker
Sephora
Sexy Hair
Shiseido
shu uemura
Skeen
SkinVitals
Smashbox
Smooth 365
SoftSheen-Carson
Sonia Rykiel
Spiderman
Stella McCartney
Stila
StriVectin
Talika
Tartine et Chocolat
Task essential
Ted Lapidus
The Different Company
Thierry Mugler
Tom Ford
Tom Robinn
Too Faced
Tri-Aktiline
Ungaro
Urban Decay
Van Cleef & Arpels
Vegeticals
Vera Wang
Versace
Viktor & Rolf
Wellbox
YESforLOV
Yves Saint Laurent
Zelens
Zirh

Source: Corporate reports and Bernstein analysis.

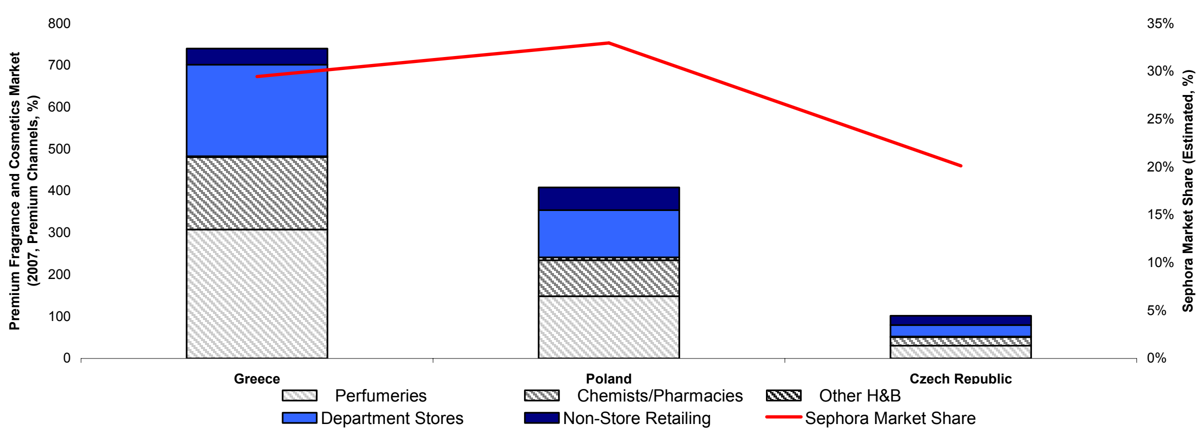
Sephora's retail concept strength is proving highly effective in penetrating markets, both in developed and in emerging countries (see Exhibit 339 and Exhibit 340). Sephora's unique retail concept — end self-service context — is proving a success in all markets where it is present, from the most advanced like the United States to the faster-growth areas of Eastern Europe and mainland China. Sephora's share of the premium market has grown to approximately 6% in countries like the United States, 10% in Italy and 12% in France. In lower-developed beauty premium markets like China and Eastern Europe, we calculate that Sephora's share is even higher at approximately 10% and 20-30%, respectively.

**Exhibit 339** **Sephora: Estimated Premium Market Size by Premium Distribution Channel (United States and Western Europe)**




Source: *Euromonitor,* corporate reports and Bernstein estimates and analysis.

**Exhibit 340** **Sephora: Estimated Premium Market Size by Premium Distribution Channel (Greece and Emerging Europe)**

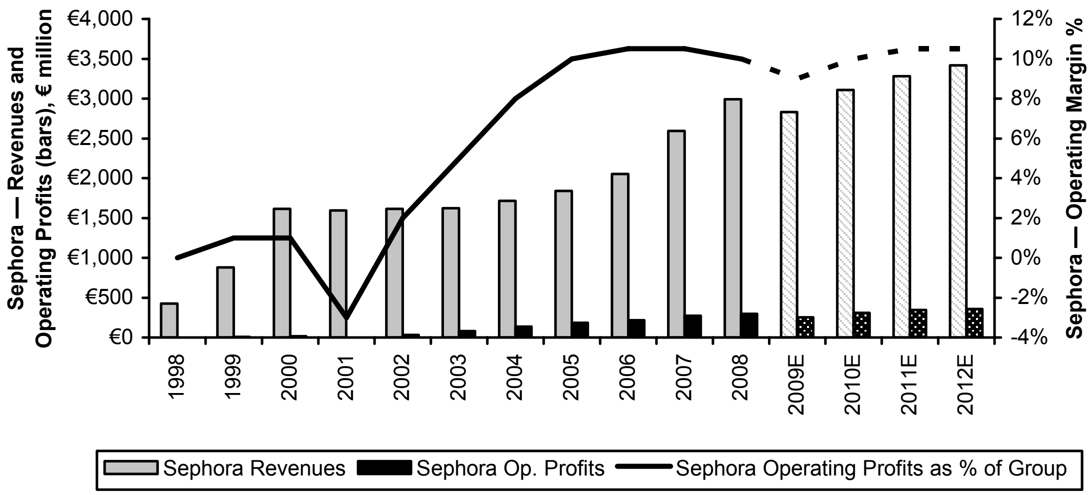



Source: *Euromonitor,* corporate reports and Bernstein estimates and analysis.

### Sephora Provides an Opportunity for Profitable Growth at LVMH

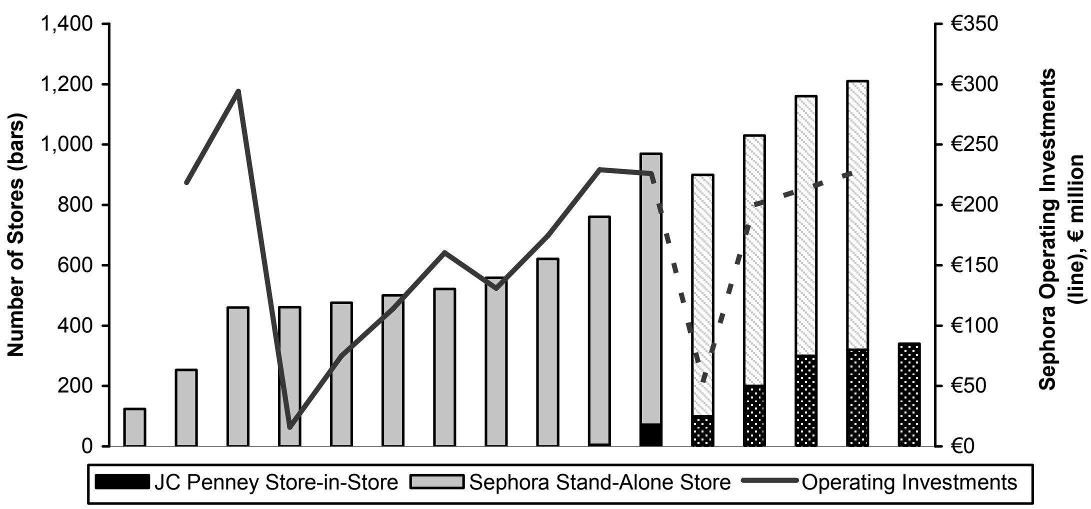
We expect Sephora will represent a continuing opportunity of profitable investment for LVMH (see Exhibit 341 and Exhibit 342). Premium beauty should be more cyclical than mass H&B, with demand and store expansion softening in 2009 in a subdued OECD GDP growth and luxury market growth scenario. But long-term organic growth opportunities abound, as Sephora has yet to grow materially in both developed markets (where its share is still relatively low) and emerging markets (where it will benefit from its dominant position and faster demand growth).

**Exhibit 341** **Sephora: Revenues and Operating Profits, 1998-2012E**




Source: Corporate reports and Bernstein estimates and analysis.

**Exhibit 342** **Sephora: Store Network and Operating Investments (1998-2012E)**




Source: Corporate reports and Bernstein estimates and analysis.

# Valuation Considerations

**The Valuation Landscape**

The low-hanging fruit from an early cyclical sector rotation seem gone. This calls into question a more selective exposure to European General Retail names. Proactive exposure to luxury goods stocks may be tempting, in anticipation of a macroeconomic rebound. Our preference here would be for LVMH — given its balanced category portfolio and scale leadership. Among hard luxury players, Swatch would seem better positioned geographically and more exposed to medium and entry price point watches, which should be the first to rebound. Lack of jewelry exposure — key in supporting Richemont's latest results — would seem a minus. PPR remains a speculative way to play the sector, given its lower multiple and possible re-rating from continuing luxury focus and exit from general retail.

We think investors strongly believe in the underlying fundamentals of these major luxury players and have a strong preference to hold them. Accordingly, we believe that despite the potential for further downward revisions to earnings, investors will continue to hold these stocks at trough earnings multiples — providing support for the stock price in the face of headwinds. Furthermore, given that the average trough P/FE multiples for these stocks is approximately 19x, when we factor this multiple into valuations we find that the traditional *and* hard luxury players will both have cushions in case of further EPS downward revisions.

Luxury goods stocks have outperformed the market since the start of 2009, although beginning in the early months of the summer some of these gains have been given back. As of August 25, the sector outperformed the benchmark index by a clear margin (c.+30%). All companies within our coverage outpaced the market, with General Retail stocks having outperformed the market more than the luxury players since January 2009 (see Exhibit 343).

**Exhibit 343** **Luxury Has Outperformed the MSDLE15 Index During the Beginning of 2009 But Gave Up Some Gains at the Start of the Summer**

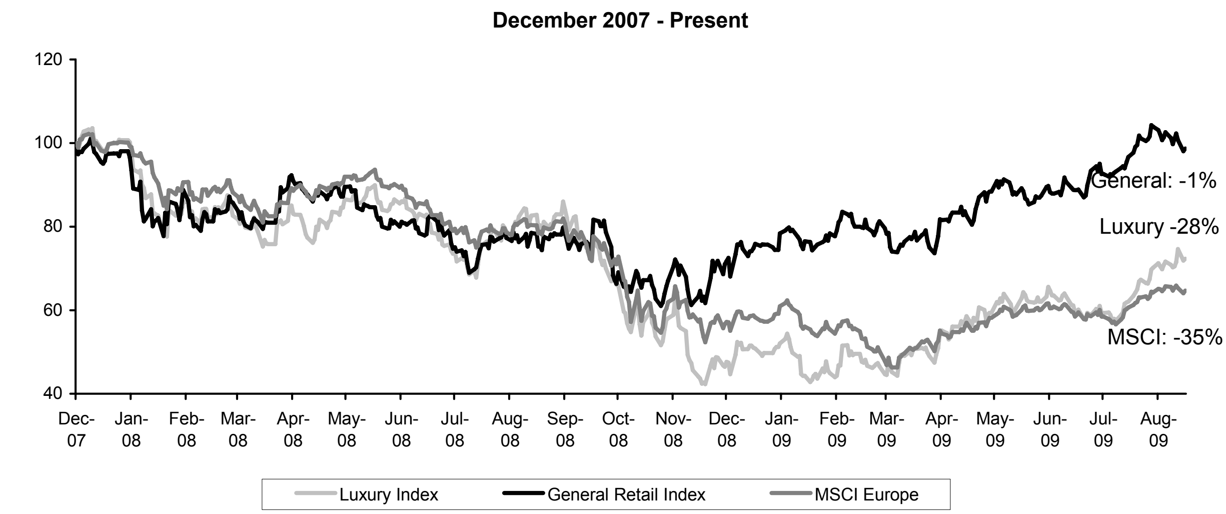
| | Abs. Performance | | | | Rel. Performance | | | | YTD Rank |
|---|---|---|---|---|---|---|---|---|---|
| | 1Q09 | 2Q09 | 3Q09 TD | 2009YTD | 1Q09 | 2Q09 | 3Q09 TD | 2009YTD | |
| MSCI Europe 15 | -12% | +13% | +15% | +15% | n.m. | n.m. | n.m. | n.m. | - |
| **Luxury Goods** | | | | | +9% | +7% | +12% | +32% | |
| PPR | +4% | +20% | +38% | +72% | +16% | +7% | +23% | +57% | 3 |
| LVMH | -1% | +15% | +22% | +39% | +11% | +2% | +7% | +24% | 9 |
| Burberry | +27% | +50% | +14% | +118% | +39% | +37% | -1% | +103% | 2 |
| Richemont | -12% | +27% | +28% | +42% | -0% | +14% | +12% | +27% | 8 |
| Swatch | -6% | +27% | +32% | +58% | +6% | +13% | +17% | +43% | 5 |
| **General Retail** | | | | | +14% | +10% | -4% | +23% | |
| Inditex | -6% | +16% | +10% | +20% | +6% | +3% | -5% | +5% | 11 |
| H&M | +1% | +25% | +5% | +33% | +13% | +11% | -10% | +18% | 10 |
| Marks & Spencer | +38% | +3% | +12% | +59% | +50% | -10% | -3% | +45% | 4 |
| Next | +22% | +11% | +14% | +55% | +35% | -2% | -1% | +41% | 7 |
| Kingfisher | +11% | +19% | +20% | +58% | +23% | +5% | +4% | +43% | 6 |
| DSGI | +19% | +50% | +26% | +125% | +31% | +37% | +11% | +110% | 1 |

Source: FactSet as of August 25, 2009, Bloomberg L.P. and Bernstein analysis.

Analysis of relative share price performance indicates that European general retail stocks tend to perform at their best toward the mid-part of a recession. Subsequently, general retail stock performance seems to fall more broadly in line with the market. This would suggest a more selective stock-picking approach in the coming months, and a step away from a broad-brush sector exposure. While so far more speculative stocks have outperformed — like DSGI and PPR — we expect the market to turn to more conservative quality-focused choices (see Exhibit 344 to Exhibit 348).

In contrast, luxury goods stocks' relative share price performance seems more tightly aligned to the broader macroeconomic cycle. European luxury goods stocks have marginally underperformed the market in the past two recessions, while they have outperformed the index during expansionary times. This would suggest a continuing cautious approach, as the end of the recession is yet not in sight. In anticipatory fashion, this could also encourage proactive exposure to luxury goods names, as possible alternatives for investors rotating out of the general retail tail-end.

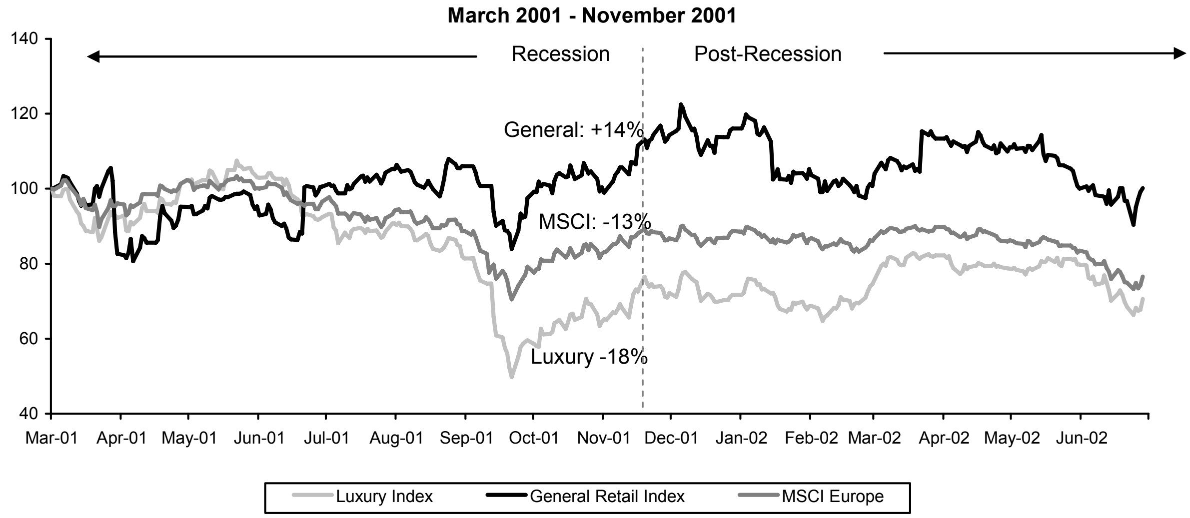
**Exhibit 344** **General Retail Stocks Performed Strongly Toward the Mid-Part of the Current Recession While Luxury Stocks Have Been More Tightly Aligned With the Broader Market and Have Only Recently Started to Outperform**




**Note:** Luxury index includes Richemont, Swatch, PPR, LVMH, Bulgari and Burberry. General retail index includes Inditex, H&M, Kingfisher, M&S, Next and DSGi.

Source: FactSet, NBER and Bernstein analysis.

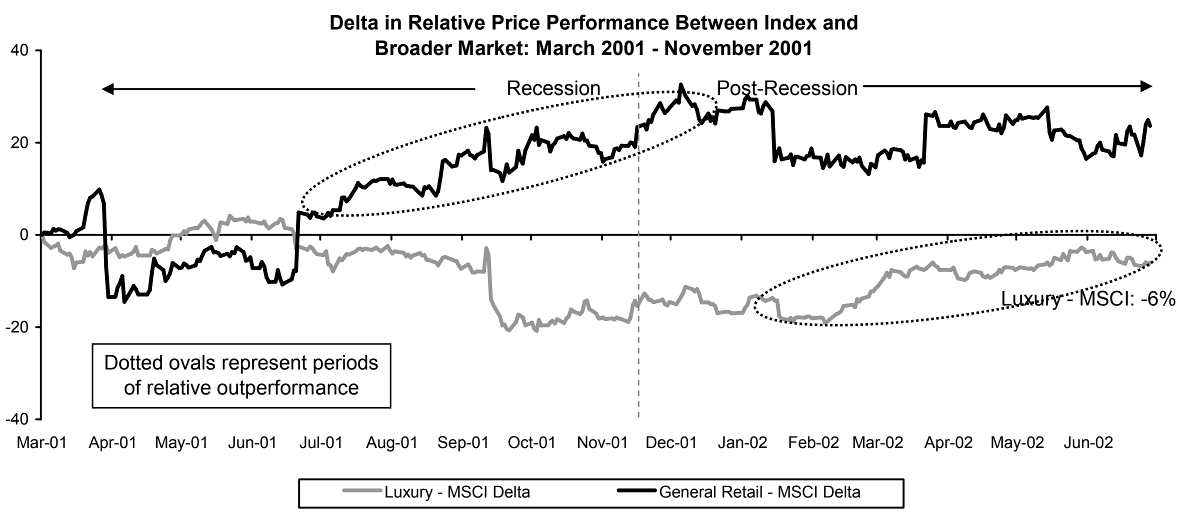
**Exhibit 345** **Similarly, the 2001 Recession Saw General Retail Stocks Once Again Perform Well Toward the Middle of the Recession, With the Following Months Seeing Luxury Stocks Realign More Closely With the Broader Market**




**Note:** Luxury index includes Richemont, Swatch, PPR, LVMH, Bulgari and Burberry. General retail index includes Inditex, H&M, Kingfisher, M&S, Next and DSGi.

Source: FactSet, NBER, and Bernstein analysis.

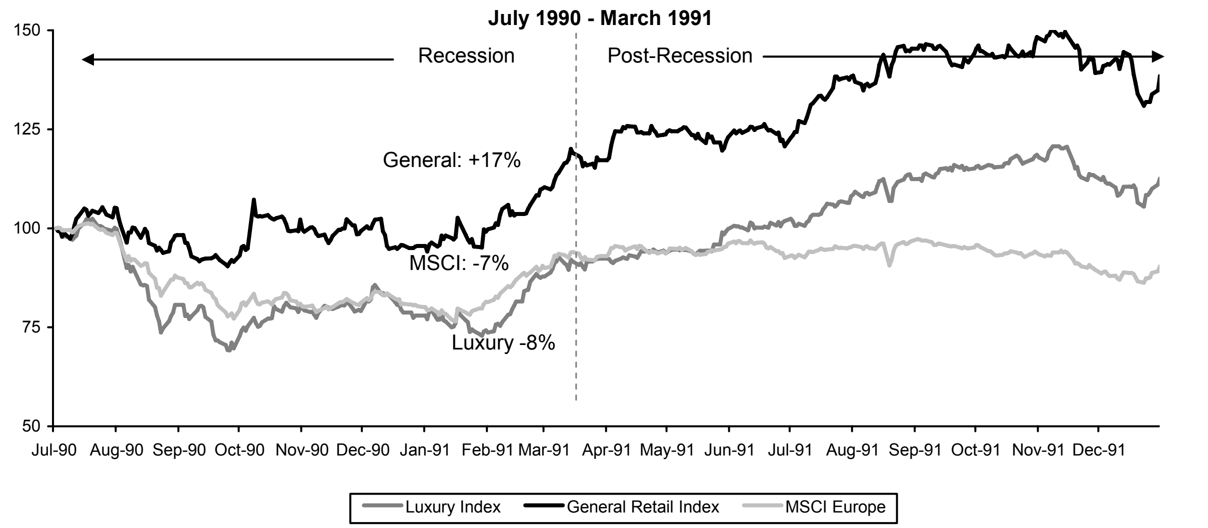
**Exhibit 346** **Relative to the Broader Market in the 2001 Recession, General Retail Stocks' Initial Strong Performance Slowed Somewhat Following the Recession, While the Luxury Goods Stocks Began to Make Up Ground in the Subsequent Period**




**Note:** Luxury index includes Richemont, Swatch, PPR, LVMH, Bulgari and Burberry. General retail index includes Inditex, H&M, Kingfisher, M&S, Next and DSGi.

Source: FactSet, NBER and Bernstein analysis.

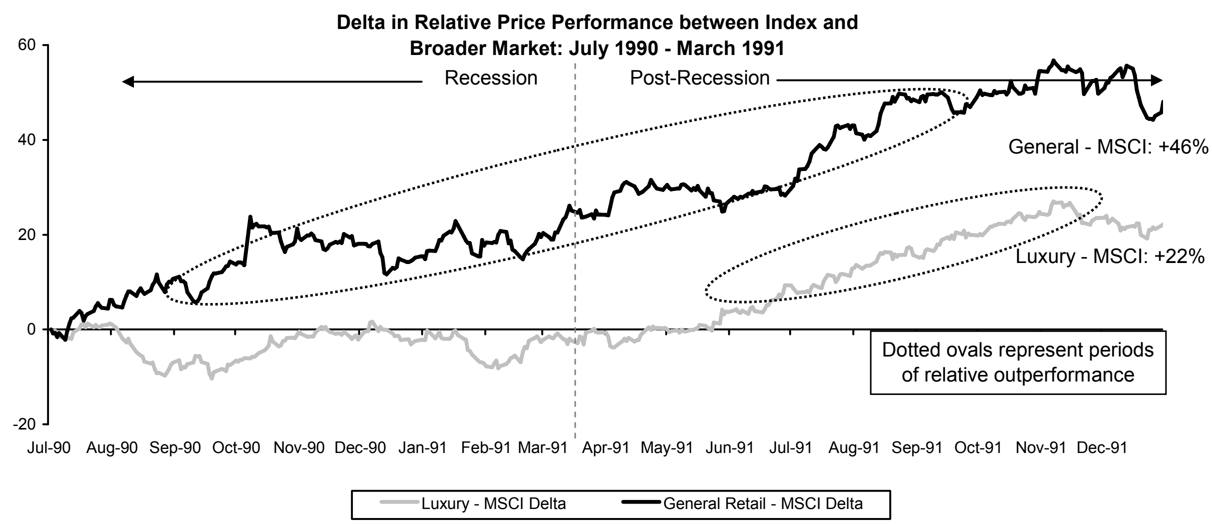
**Exhibit 347** **During the 90/91 Recession, General Retail Outperformed the Broader Market and Luxury by ~25%...**




**Note:** Luxury index includes Richemont, Swatch, PPR, LVMH, Bulgari and Burberry. General retail index includes Inditex, H&M, Kingfisher, M&S, Next and DSGi.

Source: FactSet, NBER and Bernstein analysis.

**Exhibit 348** **… And Relative to the Broader Market, Luxury Stocks Began to Outperform Following the Recession**

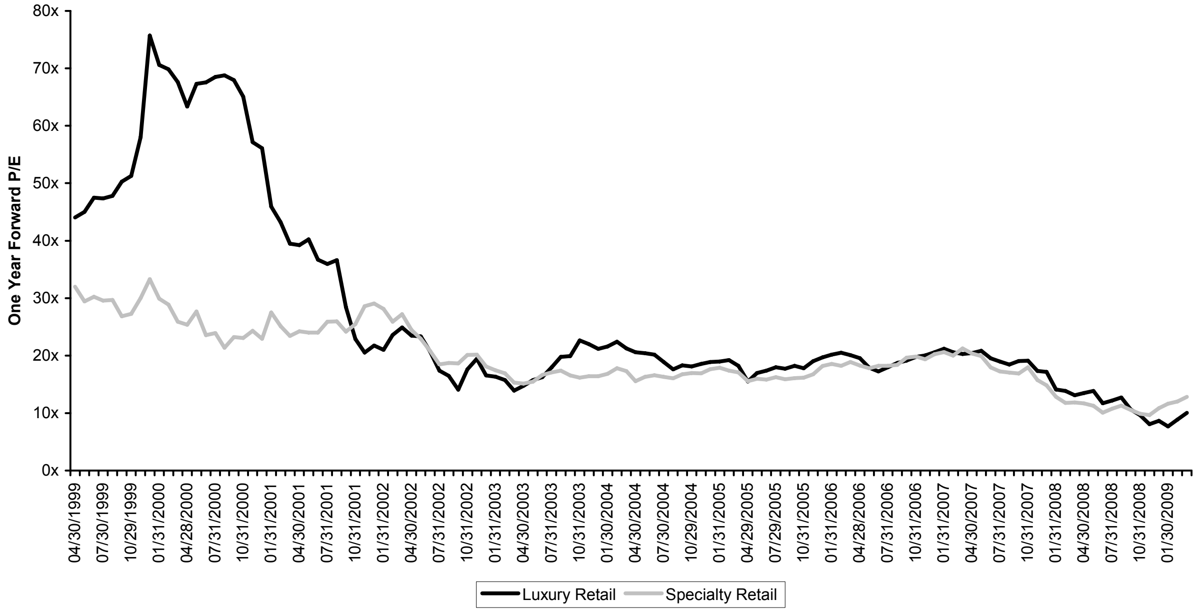



**Note:** Luxury index includes Richemont, Swatch, PPR, LVMH, Bulgari and Burberry. General retail index includes Inditex, H&M, Kingfisher, M&S, Next, DSGi.

Source: FactSet, NBER and Bernstein analysis.

In the past 10 years, multiple compression/expansion seems to have gone hand in hand for general retail and luxury goods stocks. In the presence of sector rotation benefiting general retailers, this would seem to call for momentum in luxury goods stocks as well (see Exhibit 349 and Exhibit 350).

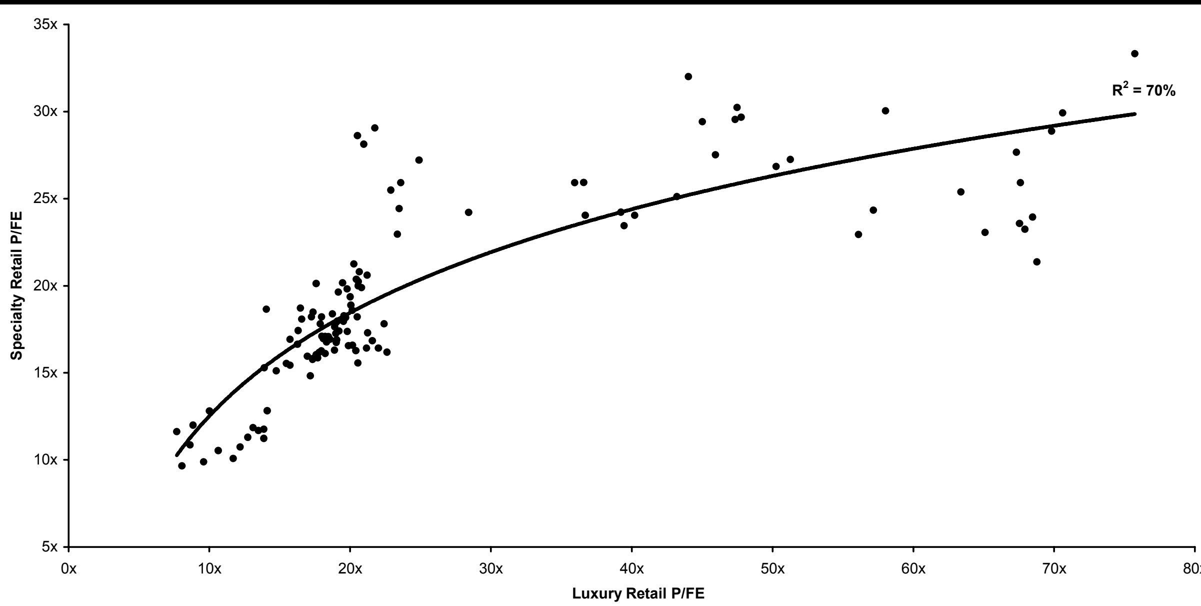
**Exhibit 349** **In the Past 10 Years, Multiple Expansion/Compression Seems to Have Gone Hand in Hand for the Two Sectors…**




**Note:** Monthly data in local currency, equal-weighted average; Luxury includes PPR, LVMH, Swatch, Burberry, Bulgari and Richemont ex-BAT (until Nov-2008); Specialty includes Inditex, H&M, M&S, Next, DSGi and KGF.

Source: FactSet, corporate reports and Bernstein analysis.

**Exhibit 350** **…Resulting in a 70% R-Squared Relationship Between the P/FE for General and Luxury Retailers**

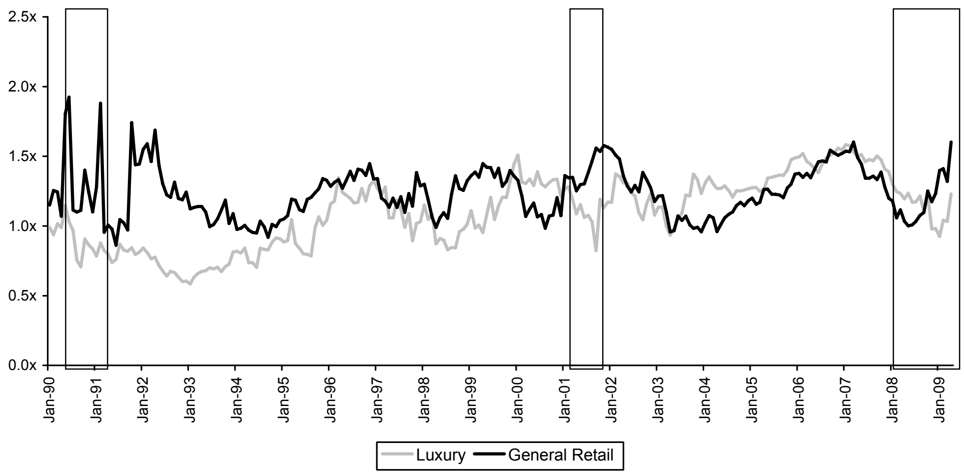



**Note:** Monthly data in local currency, equal-weighted average; Luxury includes PPR, LVMH, Swatch, Burberry, Bulgari and Richemont ex-BAT (until Nov-2008); Specialty includes Inditex, H&M, M&S, Next, DSGi and KGF.

Source: FactSet, corporate reports and Bernstein analysis.

However, when examining particular periods at a more granular level during times of recession, some noteworthy patterns emerge. Relative multiple for the general retail stocks have tended to expand during recessions while the luxury stocks have done the opposite and contracted over the same period (see Exhibit 351). When comparing the trough multiple versus the peak multiple during each recession, general retail stocks' relative multiples have expanded in a range of 26-71% (see Exhibit 352). Luxury stocks on the other hand have experienced peak to trough multiple contractions in the range of -33% to -24%. Recently, however, the relatively strong price performance has driven the luxury stock relative multiple upwards.

**Exhibit 351** **At the Start of a Recession General Retail Stocks' Relative P/FE Multiples Expands Until the Recession Is Over, While in Contrast, Luxury Stocks' Multiples Tend to Contract Over the Same Periods**




**Note:** Shaded regions denote U.S. economic contractions as defined by NBER.

Source: FactSet, NBER and Bernstein analysis.

**Exhibit 352** **During U.S. Recessions, General Retail Stocks Have Tended to Expand Their Relative P/FE Multiples, Whereas Luxury Stocks' Multiples Have Tended to Contract**

**General Retail — Relative Multiple Expansion Analysis**

| Period | Trough | Maximum | % Expand |
|---|---|---|---|
| 2007-Present | | | |
| Jun-08 | 1.0x | — | |
| Apr-09 | — | 1.6x | 59% |
| Mar-01-Nov-01 | | | |
| Apr-01 | 1.3x | — | |
| Nov-01 | — | 1.6x | 26% |
| July-00-Mar-01 | | | |
| Aug-90 | 1.1x | — | |
| Feb-91 | — | 1.9x | 71% |

**Luxury — Relative Multiple Expansion Analysis**

| Period | Trough | Maximum | % Contract |
|---|---|---|---|
| 2007-Present | | | |
| Dec-07 | 1.4x | — | |
| Jan-09 | — | 0.9x | -33% |
| Mar-01-Nov-01 | | | |
| Mar-01 | 1.2x | — | |
| Sep-01 | — | 0.8x | -31% |
| July-00-Mar-01 | | | |
| Jun-90 | 1.0x | — | |
| Jan-91 | — | 0.8x | -24% |

**Note:** Shaded regions denote U.S. economic contractions as defined by NBER.

Source: FactSet, NBER and Bernstein analysis.

# Index of Exhibits

Disclosure Appendix

## VALUATION METHODOLOGY

For companies in our coverage we set our price target using a target relative P/FE multiple against our forward EPS estimates. In the case of LVMH, we target a relative market multiple of 1.6x. As we are currently past mid-year, we use EPS estimates and MSCI P/FE multiples for both 2009E and 2010E and calendarize accordingly.

## RISKS

A risk to luxury goods would be a further slowdown in the global economy. Consumer retrenchment, higher propensity to save and increased taxation would all be negatives. Currency also represents a risk to the fashion and luxury sector, though FX should be supportive to European luxury players in 2009. Any unforeseen event significantly disrupting travel patterns — terrorism, epidemics, war, etc. — would act as a sharp negative on the stocks and the luxury sector, as we saw very clearly in 2003, plunging luxury stocks relative P/FE below the historical long-term correlation to luxury growth demand. A milder-than-expected slowdown than we currently expect would act as a positive catalyst for luxury stocks, representing upside risk.

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  Outperform: Stock will outpace the market index by more than 15 pp in the year ahead.

  Market-Perform: Stock will perform in line with the market index to within +/-15 pp in the year ahead.

  Underperform: Stock will trail the performance of the market index by more than 15 pp in the year ahead.

  Not Rated: The stock Rating, Target Price and estimates (if any) have been suspended temporarily.
- As of 09/09/2009, Bernstein's ratings were distributed as follows: Outperform - 43.8%; Market-Perform - 48.3%; Underperform - 8.0%; Not Rated - .0%.
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**12-Month Rating History as of 09/09/2009**

| Ticker | Rating Changes | | |
|---|---|---|---|
| BRBY.LN | M (RC) 08/27/09 | U (IC) 06/24/09 | |
| CFR.VX | M (IC) 06/04/08 | | |
| KGF.LN | O (RC) 03/11/09 | M (RC) 09/11/08 | O (RC) 01/30/08 |
| MC.FP | O (IC) 04/29/08 | | |
| UHR.VX | M (IC) 04/24/09 | | |

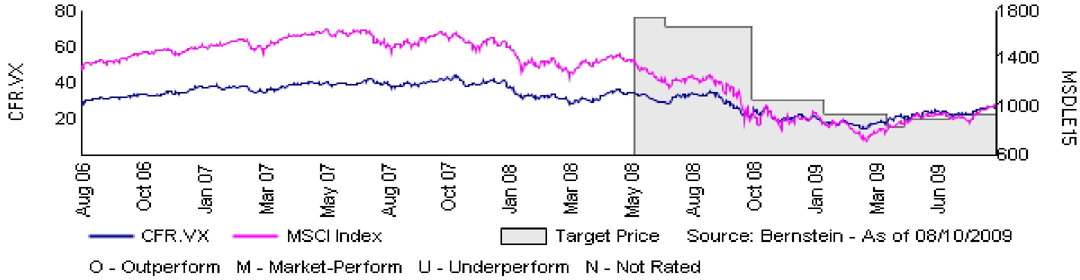
Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated

Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

### CFR.VX / Compagnie Financiere Richemont SA

| Date | Rating | Target(CHF) |
|---|---|---|
| 06/04/08 | M(IC) | 76.00 |
| 07/10/08 | M | 71.00 |
| 10/22/08 | M | 30.00 |
| 01/16/09 | M | 22.00 |
| 04/02/09 | M | 15.00 |
| 04/24/09 | M | 19.50 |
| 06/18/09 | M | 22.00 |

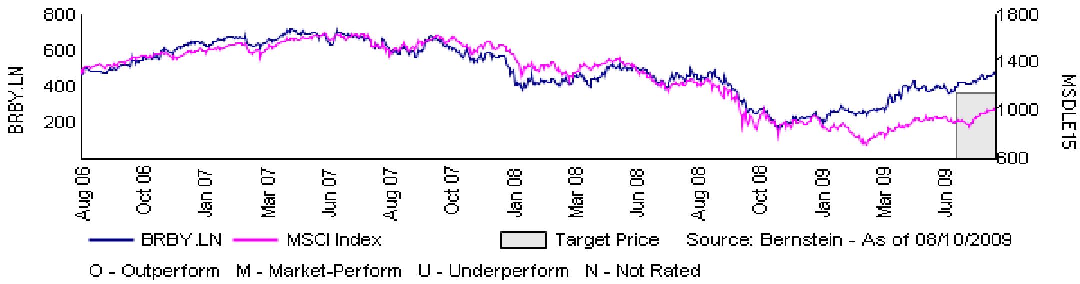
IC - Initiated Coverage




### BRBY.LN / Burberry Group PLC

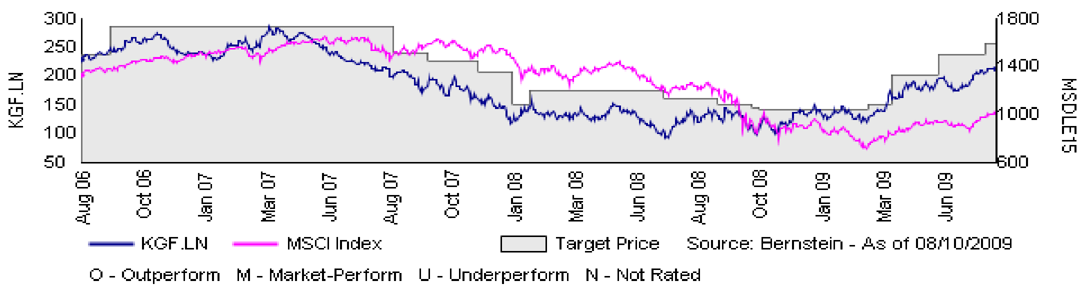
| Date | Rating | Target(GBp) |
|---|---|---|
| 06/24/09 | U(IC) | 360.00 |

IC - Initiated Coverage




### KGF.LN / Kingfisher PLC

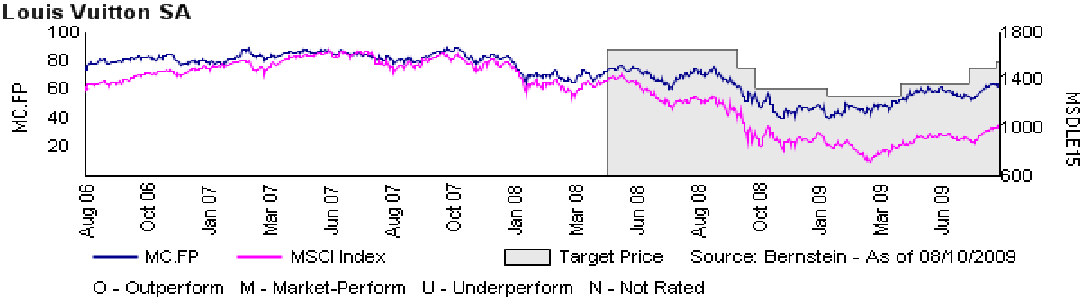
| Date | Rating | Target(GBp) |
|---|---|---|
| 09/15/06 | O | 285.00 |
| 04/04/07 | M | 285.00 |
| 08/21/07 | M | 240.00 |
| 10/01/07 | M | 225.00 |
| 11/29/07 | M | 205.00 |
| 01/10/08 | M | 150.00 |
| 01/30/08 | O | 175.00 |
| 07/09/08 | O | 160.00 |
| 09/11/08 | M | 150.00 |
| 10/22/08 | M | 145.00 |
| 10/31/08 | M | 140.00 |
| 03/11/09 | O | 150.00 |
| 04/07/09 | O | 200.00 |
| 06/03/09 | O | 235.00 |
| 07/29/09 | O | 255.00 |




### MC.FP / LVMH Moet Hennessy Louis Vuitton SA

| Date | Rating | Target(EUR) |
|---|---|---|
| 04/29/08 | O(IC) | 88.00 |
| 10/01/08 | O | 75.00 |
| 10/22/08 | O | 60.00 |
| 01/16/09 | O | 55.00 |
| 04/15/09 | O | 64.00 |
| 07/06/09 | O | 74.00 |
| 08/06/09 | O | 79.00 |

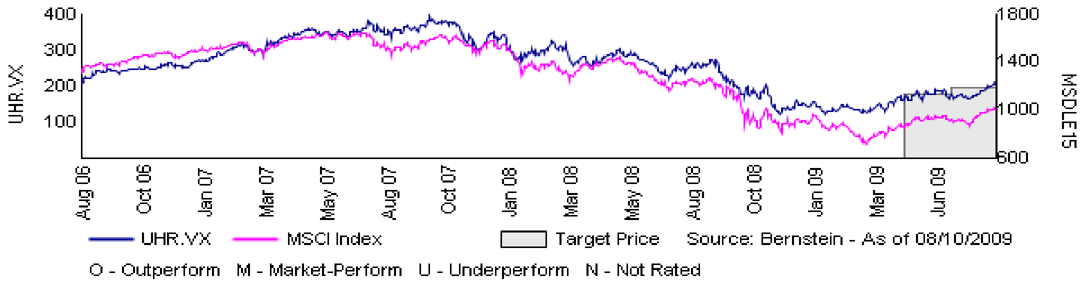
IC - Initiated Coverage



**UHR.VX / Swatch Group AG**

| Date | Rating | Target(CHF) |
|---|---|---|
| 04/24/09 | M(IC) | 178.00 |
| 06/18/09 | M | 195.00 |

IC - Initiated Coverage

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