

Around the world, around the world ...

We view travel as one of the key drivers of luxury demand in the future, favouring the bigger, and already more global, brands. While some investors look at Greater China in fear, we remain bullish on sales for the sector there and, more importantly, on sales to Chinese travellers abroad

Following this summer's equity market turmoil and fresh fears on the economy, one of the recurring investor questions has become "Can China save the world?" For the luxury sector, we are taking the view that travellers, notably Chinese, can at least put a floor under growth

We have cut our growth projections and target prices for most companies. Our highest conviction calls are Hengdeli, Richemont, Swatch and PPR. We initiate on Prada with a Neutral (V) rating and a HKD39 target price



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Disclosures and Disclaimer This report must be read with the disclosures and analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

Summary

Global travel is to become incrementally supportive to demand for luxury goods, not only as high end consumers shop in better conditions (mood, price...) while travelling but more importantly long term, as they are developing awareness of the brands and an appetite to own them as they become more exposed to them abroad. We believe tourism accounts for c30% of total luxury purchases and should provide a floor under growth even in a tough macro scenario

The post-summer debate on the luxury goods sector

Recently, the luxury goods stocks have taken a hit after having evolved pretty much in line with the markets over the summer. We believe that this is down to macro fears on China mostly. While equity market slumps have had a known delayed negative impact on high end demand in the US and while slow growth (what our economist have in mind) could mean local demand in Europe will be down (while tourism inflows compensate for it), the big concern of investors is China. In our September 2 report [Greater China watches and jewellery: No "hard luxury" landing](#), we have reiterated our view that while current growth rates in Asia ex-Japan are not sustainable, we think we are not in a bubble and growth will moderate but to a c20% level (from the c40% rates seen in 9M11). We continue to see support from social and cultural trends and think these are more relevant than financial considerations at this stage (as the industry is still in a recruitment phase). While more investors ask us every day how different China is from Japan (and we understand they are trying to time a correction), we think that while a correction will eventually happen, growth linked to this recruitment phase still has legs. While we acknowledge that playing the Chinese consumer equates to putting many eggs in the same basket, we think for now that visibility on growth is good.

Positive long term outlook on global travel

We look within this report at facts and figures related to global travel and look at how these trends can be supportive to luxury demand in the long term. Of course, the global population is still expanding but what is more relevant is the fact that tourism flows are expanding at a faster pace (with EM logically outperforming DM) and that leisure spending growth is bound to outpace both the volumes of travellers and GDP growth. The world is currently becoming an easier place to travel with many political restrictions easing (eg outbound travel from China) and authorities looking at ways to alleviate admin barriers to entry (eg ESTA program in the US). Beyond the motivation of discovering other cultures, there are also increasing incentives to travel from an economic standpoint as purchasing power and currency fluctuations can play an important role as well as relative price positioning. Of course, there are hiccups in travel trends which are linked to financial crises (Asia in 97-98, the world in 08-09), terrorist attacks (9/11), epidemics (SARS late 02-March 03) but the negative effects have proven to be quite short lived in nature.

What's in it for luxury?

We have assessed that as much as 30% of sales in the sector are generated with travellers and while some investors may feel concerned that c20% of the sector's sales occur in Greater China (China + HK + Macau), we believe up to a third are actually made with Chinese or Hong Kong consumers wherever the area of purchase. This may be a cause of concern for many (and probably a reason to perceive the sector as riskier), but we believe it is a reason for enthusiasm. We have looked at the reasons travel specifically triggers purchases of luxury goods and we are also seeing brands adapting to a context of an ever more knowledgeable and well-travelled consumer. We have also identified limitations to the theme as a) there may be a risk for brands in being too influenced by a specific group of customers, b) expansion will be putting pressure on investments for the brands and c) some smaller players may be trapped into expanding too quickly.

In conclusion, we believe the constraints involved in capturing the travelling consumer are far outweighed by the opportunities that this effort brings to the companies in the sector. And while we are not naïve enough to think the Western consumer will hold up in the current economic environment, we believe the Asian consumer (whether locally or abroad) and tourism generally should provide a floor under growth for companies in the sector; we believe this floor depending on the companies' exposure will be between high single digit and low double digit organic sales growth for most companies in the sector.

What have we done to our estimates and ratings?

Following on from our reasoning in our September 2011 report *No "hard luxury" landing*, we are taking the view that high end consumers in the US will be the most affected by the recent equity market slump and have now factored in a c10% decline for the US for the industry in Q4 2011 and the first 9 months of 2012. Conversely, we have taken the view that local European consumption will decline by 5% to 10% in the same timeframe (ie less than in the US despite macro issues related to economic challenges in peripheral European countries as high end consumers in Europe are less driven by equity markets) but that this will be more than offset at the European level by tourism inflows. This implies that all in Europe could still see slight sales growth for the sector. Our estimates for growth in Asia ex-Japan (and Asian consumers purchasing abroad) remain unchanged for the next 12 months at c+20%. With extremely volatile markets and macro concerns looking to be a key driver for the stocks, we have decided to increase the sector beta we use for luxury goods stocks from 1.10x previously to 1.20x now.

We are not playing soft luxury against hard luxury as we believe regional exposure is more relevant than product category exposure in the space and we think that the concept of "hiding in LVMH" as a defensive stock may prove not to be the safest of moves in the current environment. Our highest conviction calls on the travel theme are those that are exposed to the bigger, and already more global, Asia-driven brands:

- ▶ **Richemont:** Cartier is becoming the "Louis Vuitton" of watches and jewellery with strong Asian exposure
- ▶ **Swatch:** a greater exposure to Asia and to watches so theoretically more risky
- ▶ **Hengdeli:** a higher beta pure play on the watch market in Greater China (high risk/high return)
- ▶ **PPR:** while retail disposals will have to wait, the luxury division has one of the most attractive earnings prospects of the industry

We initiate on **Prada:** almost a monobrand investment case with an aggressive roll-out story containing risks that seem to have been at least partially discounted by the market, in our view. Our rating is N(V) and our target price is HKD39.

Key data - Luxury Goods

Stock	Ric	Rating		Currency	Share price (at 05/10/2011)		Target price		Potential return	PE		
		New	Old		New	Old	2010a	2011e		2012e		
Hengdeli	3389.HK	OW(V)	unchanged	HKD	2.25	4.20	4.60	86.7%	15.6	11.4	9.1	
Richemont (*)	CFR.VX	OW	unchanged	CHF	42.40	58.00	58.00	36.8%	22.7	17.2	13.2	
The Swatch Group	UHR.VX	OW	unchanged	CHF	316.60	430.00	450.00	35.8%	15.6	14.7	12.7	
PPR	P RTP.PA	OW	unchanged	EUR	98.25	130.00	145.00	32.3%	13.4	12.1	10.3	
Christian Dior	DIOR.PA	OW	unchanged	EUR	83.42	109.00	122.00	30.7%	11.8	11.7	10.3	
Tod's	TOD.MI	OW	unchanged	EUR	63.80	80.00	102.00	25.4%	17.9	15.3	14.1	
Prada	1913.HK	N(V)	initiation	HKD	33.50	39.00	na	16.4%	31.8	19.9	16.1	
LVMH	LVMH.PA	N	unchanged	EUR	101.95	115.00	128.00	12.8%	16.1	16.8	15.0	
Burberry*	BRBY.L	N	unchanged	GBP (p)	1187.00	1325.00	1450.00	11.6%	26.2	20.7	17.9	
Coach*	COH.N	N	unchanged	USD	53.25	59.00	67.00	10.8%	20.3	17.7	16.6	
Tiffany	TIF.N	N	unchanged	USD	62.58	69.00	77.00	10.3%	21.4	17.2	16.4	
Hermès	HRMS.PA	N	unchanged	EUR	220.00	240.00	200.00	9.1%	55.0	42.2	37.3	
Luxottica	LUX.MI	UW	unchanged	EUR	19.40	19.50	21.00	0.5%	19.7	17.4	16.0	
Average**									19.4	16.0	14.0	

*based on calendar data, **averages do not include Hermès
Source: HSBC estimates, company data

Share price performances - Luxury goods

	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	Q1 11	Q2 11	Q3 11	Q4 11TD**	YTD 11**
LVMH	-35	-14	47	-2	33	7	3	-42	64	57	-9	11	-20	-2	-20
Hermes	15	-24	17	-4	44	35	-9	16	-7	68	-1	32	11	-1	43
Richemont	-29	-16	15	27	52	24	10	-74	71	58	-3	4	-26	0	-26
The Swatch Group	-26	-23	29	12	17	37	27	-57	80	59	-3	4	-29	-1	-28
Christian Dior	-32	-7	50	4	50	8	11	-55	78	49	-7	9	-22	-3	-23
Burberry	nm	-2	63	10	5	54	-12	-61	170	88	4	24	-19	-7	-3
Tod's	6	-34	13	1	63	7	-22	-37	72	42	13	11	-31	-1	-15
PPR	-37	-52	9	-4	29	19	-3	-58	81	41	-9	13	-21	-1	-19
Luxottica	20	-32	9	9	43	9	-7	-42	42	26	1	-4	-13	1	-15
Average*	-15	-23	28	6	37	22	0	-46	72	54	-2	12	-19	-2	-12
Average excluding Hermès*	-19	-22	29	7	37	20	1	-53	82	53	-2	9	-23	-2	-19
Eurotop 300	-18	-32	12	9	22	16	2	-45	26	7	0	-1	-17	-1	-18
Tiffany	-1	-24	89	-29	20	2	17	-42	61	45	-1	28	-23	-3	-6
Coach	36	69	129	49	18	29	-29	-32	76	52	-6	23	-19	-2	-9
S&P 500	-13	-23	26	9	3	14	4	-38	23	13	5	0	-14	0	-10
Prada***	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	-30	2	-15
Hengdeli	nm	nm	nm	nm	nm	220	37	-73	268	57	-11	0	-34	-10	-47
Hang Seng Index	-24	-18	35	13	5	34	39	-48	52	5	2	-5	-21	-8	-29

*excluding Christian Dior
**share prices at 5 Oct 2011
*** IPO on June 23 2011
Source: Thomson Financial Datastream

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Summary of HSBC estimate changes and comparison with Bloomberg consensus

(Millions)	Currency	2011e EBIT					2012e EBIT				
		HSBC		Change	Consensus	HSBC vs Consensus	HSBC		Change	Consensus	HSBC vs Consensus
		New	old				New	Old			
LVMH	EUR	5,138	4,920	4%	5,002	3%	5,598	5,500	2%	5,681	-1%
Richemont*	EUR	1,644	1,580	4%	1,658	-1%	1,850	1,775	4%	1,834	1%
Hermès	EUR	801	770	4%	804	0%	915	878	4%	891	3%
The Swatch Group	CHF	1,555	1,535	1%	1,625	-4%	1,700	1,665	4%	1,808	-6%
Burberry*	GBP	367	368	0%	370	-1%	410	442	-6%	436	-7%
Hengdeli	EUR	1,189	1,143	4%	1,205	-1%	1,482	1,468	1%	1,499	-1%
Prada***	EUR	579	nm	nm	573	3%	712	nm	nm	729	-2%
Tod's	EUR	187	198	-6%	191	-2%	203	233	-13%	215	-5%
Christian Dior	EUR	5,201	4,983	4%	4,936	5%	5,675	5,588	2%	5,670	0%
PPR	EUR	1,665	1,640	2%	1,684	-1%	1,890	1,900	-1%	1,901	-1%
Luxottica	EUR	820	810	1%	832	-1%	885	890	-1%	932	-5%
Tiffany	USD	718	719	0%	739	-3%	767	809	7%	840	-9%
Coach**	USD	1,375	1,516	-9%	1,515	-9%	1,480	1,690	-12%	1,715	-14%

*FY March n+1 **FY June n+1 *** Recently covered
Source: HSBC estimates, Bloomberg consensus

Summary of HSBC estimate changes and comparison with Bloomberg consensus

(Millions)	Currency	2011e Net Income					2012e Net Income				
		HSBC		Change	Consensus	HSBC vs Consensus	HSBC		Change	Consensus	HSBC vs Consensus
		New	old				New	Old			
LVMH	EUR	2,910	2,850	2%	3,067	-5%	3,271	3,273	0%	3,507	-7%
Richemont*	EUR	1,166	1,346	-13%	1,347	-13%	1,578	1,516	4%	1,570	1%
Hermès	EUR	550	504	9%	533	3%	623	575	8%	594	5%
The Swatch Group	CHF	1,167	1,151	1%	1,245	-6%	1,342	1,316	2%	1,409	-5%
Burberry*	GBP	267	270	-1%	268	0%	303	326	-7%	316	-4%
Hengdeli	EUR	794	756	5%	787	1%	987	975	1%	994	-1%
Prada***	EUR	405	nm	nm	400	4%	502	nm	nm	511	-1%
Tod's	EUR	127	136	-6%	130	-2%	139	160	-13%	148	-6%
Christian Dior	EUR	1,274	1,248	2%	1,251	2%	1,443	1,452	-1%	1,439	0%
PPR	EUR	1,026	1,014	1%	1,050	-2%	1,211	1,231	-2%	1,232	-2%
Luxottica	EUR	515	508	1%	498	3%	559	562	-1%	575	-3%
Tiffany	USD	446	472	-6%	481	-7%	493	521	-5%	480	2%
Coach**	USD	920	1,014	-9%	1,004	-8%	993	1,136	-13%	1,140	-13%

*FY March n+1, net income down on financial results in FY March 2012 **FY June n+1 *** Initiate coverage in this report
Source: HSBC estimates, Bloomberg consensus

Calendar of events

Luxury goods calendar of events

Company	Type of event	Date
Burberry	H1 2011/12 results	15 November 2011
Burberry	Q3 2011 sales	January 2012
Christian Dior	Q3 2011 sales	18 October 2011
Christian Dior	FY 2011 results	Likely the week of 30 January 2012
Coach	Q1 2011/12 results	25 October 2011
Essilor	Q3 2011 sales	21 October 2011
Essilor	FY 2011 results	Likely the week of 27 February 2012
Ferragamo	Q3 2011 results	14 November 2011
Hengdeli	FY 2011 results	Likely the week of 19 March 2012
Hermès	Q3 2011 sales	4 November 2011
Hermès	FY 2011 results	Likely the week of 27 February 2012
Luxottica	9M 2011 results	24 October 2011
LVMH	Q3 2011 sales	18 October 2011
LVMH	FY 2011 results	Likely the week of 30 January 2012
PPR	Q3 2011 sales	26 October 2011
PPR	FY 2011 results	Likely the week of 13 February 2012
Prada	Q3 2011 results	Likely the week of 28 November 2011
Prada	Preliminary 2011 results	Likely the week of 5 March 2012
Richemont	H1 2011/12 results	11 November 2011
Swatch	FY 2011 results	Likely the week of 5 March 2012
Tiffany	Q3 2011 results	29 November 2011
Tod's	Q3 2011 results	11 November 2011
Swiss watch federation export data	September 2011 period	20 October 2011
	October 2011 period	22 November 2011
	November 2011 period	20 December 2011
	December 2011 period	02 February 2012
HK retail sales statistics	September 2011 period	01 November 2011
	October 2011 period	01 December 2011
	November 2011 period	03 January 2012
	December 2011 period	02 February 2012

Source: Company data

Changes, valuation and ratings

- ▶ We remain positive on Asian growth; we are cutting our estimates for North America and moderating those for Europe
- ▶ In an uncertain world and a volatile market, we apply a higher sector beta to take into account the risks perception of the market
- ▶ Our favourite stocks are Richemont, Swatch, Hengdeli and PPR. We initiate on Prada with an N(V) rating and a HKD39 target price

Cutting estimates in the West...

As explained in our September 2 report, we see evidence that past crises and boom phases have shown that the high-end consumers in the US are often the first to cut and the first to rebound and equity markets do influence demand. In the US, we believe the psychological aspect of the 'feel good factor' influences purchasing patterns more than the financial aspect. Today, we suspect the political fight on debt, the S&P rating downgrade of the US and more importantly the equity market slump will start to play on the high-end consumer's psyche.

We are now factoring in a c10% drop in sales in the US for the sector in Q4 2011 and the first 9 months of 2012 and this is for most of our stocks the biggest of our cuts.

Europe could also be affected by the equity market slump, fragile debt situation and lower GDP performances than expected. However, we feel that tourism inflows, which for Richemont account for c50% of sales in Western Europe, offer more

protection there than in the US. We are now factoring in a 5% to 10% drop in sales in Europe to local consumers over the same timeframe (Q4 2010 to Q3 2011). As tourism inflows can represent between 35% and 60% of sales in our view depending on the company, our Europe cuts are less deep than the one taken for the US.

... not in Asia ex-Japan

We predict that our China Red Bull theme (see [Luxury "red bull"](#) report, 25 Jan 2010) is very much intact and that Chinese luxury-conscious consumers will continue buying not only due to their increasing purchasing power, but also because of deeply ingrained social and cultural factors. We think the contagion risk from the West is low.

We are not naive enough to think that macro fears about China or any other negative news stemming from the region (political unrest, noise of government potentially clamping down on conspicuous consumption, etc) would not have a negative impact on share prices. Indeed, they have had already.

Since the Chinese luxury market became relevant (ie in 2003 when China started to account for more than 1% of luxury groups' sales), it has grown at rates above 30% without interruption, meaning that nobody on the sell-side or the buy-side, or even within companies themselves, has ever experienced an industry downturn in China. This lack of historical reference may have led investors to "shoot first, think later".

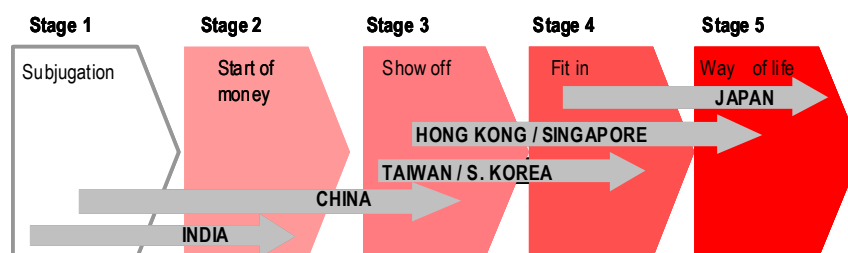
We have detailed in our 2 September report reasons we remain confident on China:

- ▶ From a macro perspective, HSBC believes the Chinese economy will not experience a sharp decline this year. According to our China economist Hongbin Qu (see [China: Cooling, not collapsing](#), 09 August 2011), China is still on track for a soft landing. With a target of 9% GDP growth for this year, HSBC predicts that Chinese domestic demand will be strong enough to offset any potential slowdown in exports, with consumer demand fuelled by income growth and high savings
- ▶ Social and cultural trends: Displaying wealth has become a trend in China and we think this will continue to translate into growing purchases of luxury goods for oneself, or as gifts. Sales of global luxury brands in China have also grown by over 30% per year in the last 4 years (HSBC estimates), again outpacing income growth. We think consumer habits may not necessarily always correspond to income levels due to the need to socially fit in and show off wealth



- ▶ Penetration of retail is still very limited as compared to Japan, the US and Europe (see our 2 Sept report for more)
- ▶ There is an obvious trading up phenomenon that can be seen in many product categories from sporting goods to cognac to handbags
- ▶ And travel trends continue to support Hong Kong sales (c10% of total luxury sales, ie still as big as mainland China itself in our view) as we will see in the thematic part of this report.

Asian countries' stages of luxury evolution



Source: The Cult of the Luxury Brand, inside Asia's love affair with luxury, Radha Chadha & Paul Husband

Sales growth at constant forex and perimeter

%	FY 01A	FY 02A	FY 03A	FY 04A	FY 05A	FY 06A	FY 07A	FY 08A	FY 09A	FY 10	Q1 11a	Q2 11a	Q3 11e	Q4 11e	FY 11e	FY 12e	FY 13e
Hengdeli								20	7	39	na	na	na	na	34	21	18
Hermès	8	6	8	12	7	8	11	9	4	19	21	22	15	11	17	12	12
LVMH	4	4	4	11	11	12	13	7	-3	14	14	15	14	7	12	6	8
o/w Louis Vuitton	12	7	14	13	12	11	14	12	7	15	13	14	13	9	12	8	9
Richemont*	0	0	0	13	17	16	16	2	-5	19	13	35	29	9	19	10	10
Swatch Group	1	1	1	6	8	12	17	4	-8	22	23	25	20	8	18	9	9
Burberry*	14	12	15	10	3	15	19	7	1	15	22	24	26	13	18	9	9
Gucci brand	1	-8	4	13	18	17	11	4	-1	11	20	23	20	10	18	10	9
Tod's	27	13	8	15	20	14	17	9	0	9	16	17	12	6	13	7	7
Luxottica	na	3	-2	11	11	14	10	-1	-4	7	9	10	7	6	9	5	6
Prada**	na	na	na	na	na	na	na	na	-6	24	na	24****	na	19****	21	14	13
Tiffany	0	4	14	8	9	11	13	-4	-5	12	16	24	17	4	14	4	10
Coach***	21	32	37	29	26	29	20	-1	9	15	15	11	14	6	7	8	8

*year ending March n+1 **year ending January n+1***year ending June n+1 **** Q3 and Q4 are the H1 and H2 organic sales growth Source : Companies, HSBC estimates

Luxury goods: contribution of each geographic region to organic sales growth

	2007	2008	2009	2010	H1 2011	H2 2011e	2011e	2012e	2013e
Geographic breakdown									
Europe	42%	42%	39%	36%	35%	35%	35%	34%	32%
Japan	12%	12%	11%	9%	8%	8%	8%	7%	7%
US	20%	19%	18%	18%	17%	17%	17%	17%	17%
China	3%	5%	6%	8%	10%	10%	10%	12%	14%
Rest of Asia & other	22%	23%	25%	28%	29%	29%	29%	30%	31%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Organic sales growth rate									
Europe	13%	5%	-7%	9%	15%	7%	11%	4%	5%
Japan	6%	-9%	-15%	-4%	2%	0%	1%	1%	1%
US	16%	2%	-14%	14%	23%	5%	14%	-5%	6%
China	40%	45%	30%	45%	50%	40%	45%	33%	25%
Rest of Asia & other	22%	13%	8%	23%	19%	17%	18%	15%	10%
Total	15%	6%	-4%	15%	20%	12%	16%	9%	9%
Contribution to growth									
Europe	5.1%	1.9%	-2.8%	3.1%	5.3%	2.4%	3.9%	1.3%	1.5%
Japan	0.9%	-1.1%	-1.8%	-0.5%	0.2%	0.0%	0.1%	0.1%	0.1%
US	3.5%	0.3%	-2.7%	2.4%	4.0%	0.9%	2.4%	-0.8%	1.0%
China	1.2%	1.5%	1.4%	3.4%	4.9%	3.9%	4.4%	4.0%	3.5%
Rest of Asia & other	4.7%	2.9%	1.8%	6.4%	5.6%	5.0%	5.3%	4.5%	3.1%
Total	15%	6%	-4%	15%	20%	12%	16%	9%	9%

Source: HSBC estimates

Luxury goods companies - 2010 geographical sales breakdown

	Europe	Americas	Japan	Asia & others	Mainland China	HK+Taiwan+Macau	Rest of Asia & Others
Hermès	38%	16%	19%	28%	5%	8%	15%
Richemont*	38%	14%	11%	37%	10%	15%	12%
LVMH	34%	23%	9%	34%	8%	8%	18%
of which Louis Vuitton	24%	18%	17%	40%	10%	12%	18%
PPR	61%	21%	6%	12%	4%	4%	4%
of which Gucci Group	33%	18%	14%	35%	10%	9%	17%
Burberry*	35%	25%	5%	35%	5%	8%	22%
Tod's	75%	7%	6%	12%	4%	4%	5%
The Swatch Group	39%	8%	3%	50%	17%	17%	16%
Luxottica	23%	61%	2%	14%	2%	1%	11%
European average	43%	22%	8%	28%	7%	8%	13%
Coach**	0%	72%	20%	8%	1%	2%	5%
Tiffany	12%	53%	18%	18%	3%	6%	9%
Hengdeli	0%	0%	0%	100%	68%	32%	0%
Prada***	41%	15%	11%	20%	9%	11%	0%
Total average	33%	26%	9%	31%	11%	10%	10%

Note: this average including PPR (rather than the Gucci Group) FY March 11 **FY June 11 ***FY Jan 2011 Source: Company data, HSBC estimates

Growth during a crisis?

Late 2008, when we discussed with investors and mentioned the concept of “de-coupling”, many looked at us laughingly (or angrily, depending!). It turns out that in the 08-09 downturn, watch sales in China were down just for a quarter as retailers (not end consumers) became cautious.

Three years later, we now see that the Asian contribution has become far greater for the sector and we believe that while local consumption in the US and Europe may go into negative territory for the next 12 months, the Asian consumer should continue to power on and provide a floor under growth for the sector.

Depending on the company, we estimate that this floor will range from 4% (Tiffany) to 14% (Prada) for 2012e depending on the regional exposure and the aggressiveness of the companies’ retail roll-out. If our assumptions on the Asian consumer are right, we find it difficult to imagine many sectors can post growth rates in 2012e that will approach that of the luxury sector.

Applying a higher sector beta

In the Lehman era, we used to apply a 1.20x beta to the luxury goods sector as we understood that many investors would not want to look at the sector. Ever since, we have used 1.10. In this report we are reverting to a 1.20 sector beta. We are not hearing comments like “luxury is dead and will never be relevant again” like we did then but we do feel that currently the “China” tag that is sticking to the sector is a reason to be bullish or bearish sometimes beyond reason and the stocks may well have jumps and drops that amplify equity market moves.

To be fair the sector held up pretty much in line with markets during the summer. It is only recently that China doomsayers have triggered strong and nervous reactions on these stocks. Working for an asset manager and recommending luxury stocks is undoubtedly not an easy task these days as the macro risks are well flagged and the strong fundamentals are currently ignored.

FX back to being a tailwind

It seems that every time we publish a sector report, FX winds have changed in the interim. When we published our Sept 2 report, we cut our estimates on Swatch and Richemont partly on fundamentals, partly on FX (due to a very strong headwind at the time).

The shift that has occurred since is staggering:

- ▶ The EUR/CHF spot has gone from 1.12 to 1.21 following the Swiss authorities’ intervention to try to peg the currency to the EUR with a minimum of EUR/CHF 1.20 level. This is a positive for Swatch and Richemont as they produce in CHF but not that relevant for the other companies in the sector



- ▶ More importantly for the sector as a whole is the recent move in the EUR/USD going from 1.45 to 1.33, a very big driver potentially ahead of the all important Q4 sales period

We usually take into account the spot rates for our models. However as recent moves have been sharp and sudden, we have decided to take a rough average of the rates seen over the past few weeks. For the EUR/CHF, we use 1.15 now (vs 1.10 previously). For the EUR/USD, we use 1.40 (vs 1.45 previously).

FX rates used in HSBC forecasts for luxury goods companies

	Average			Y-O-Y	
	2009	2010	2011 ytd	2010	2011 ytd
EUR/USD	1.39	1.32	1.41	-4.7%	6.3%
EUR/JPY	1.30	1.16	1.13	-10.7%	-2.3%
EUR/CHF	1.51	1.38	1.22	-8.6%	-11.4%
EUR/GBP	0.89	0.86	0.87	-3.7%	1.6%

Source: HSBC estimates

Key ratings

Overweight ratings

Our highest conviction calls are currently:

- ▶ **Hengdeli:** a pure play on watches and on China, so in the minds of some investors, high risk. In our view and given where the stock is trading, we see potentially high reward
- ▶ **Richemont:** we believe Cartier (c70% of group's EBIT) is becoming the "Vuitton of hard luxury" ie the reference brand for consumers. Besides, the shift from wholesale to retail is proving efficient and offers protection on sales
- ▶ **Swatch:** broadly the same fundamentals as Richemont and to be honest usually trades in line. The higher dependency on watches and on wholesale makes the positioning theoretically more exposed to negative impacts of a downturn
- ▶ **PPR:** while the story of asset reallocation is unlikely to unfold short term (PPR mentioning retail asset sales had been frozen for now), we think the luxury portfolio is currently well positioned for outperformance and probably undervalued by the market

We also have OW ratings on:

- ▶ **Christian Dior:** a value play on LVMH's strong fundamentals with a c30% discount now. More for the long term investor still and remember, liquidity is c1/7th of that of LVMH
- ▶ **Tod's:** despite a still-important exposure to Italy, the stock might turn out to be the defensive play within the sector as growth will likely be more moderate but, we feel, visibility on it is stronger. Italy trends going wrong have now been discounted in our view

Neutral ratings

- ▶ **Prada:** We are surprised at how aggressive the retail roll out plan is and that entails some risks. We feel that those risks have been at least partially discounted by the market. We believe the stock offers greater growth prospects than peers but at a higher cost
- ▶ **Tiffany and Coach:** we believe that such high exposure to the high end consumer in the US means these are stocks that may disappoint in the upcoming Holiday season
- ▶ **Burberry:** strong positioning, strong management but all well-known in our view and the stock is well-owned we feel as well. The greater exposure to the US and, still to wholesale accounts, remains a risk and relative valuation is not that compelling, in our view
- ▶ **LVMH:** we are not playing soft luxury against hard luxury despite macro concerns as we feel regional exposure now far exceeds product category exposure in terms of growth drivers. We believe Louis Vuitton's growth should be good yet sub par vs peers and wines & spirits could well temporarily suffer from regional exposure (Champagne very Franco-British-American in consumption) and the cost of doing business (Hennessy now number 2 in China needs to reinvest)

EBIT margin evolution by group 1996a-2013e

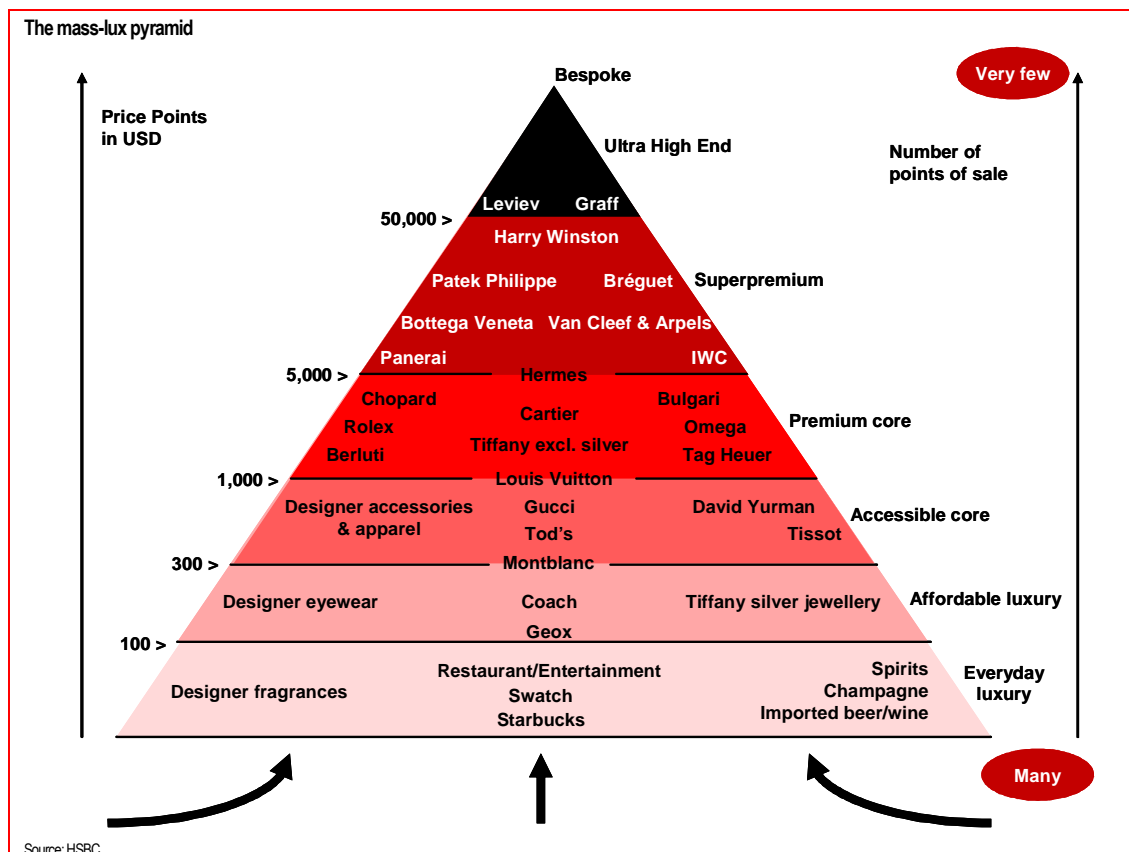
%	FY 96a	FY 97a	FY 98a	FY99a	FY 00a	FY 01a	FY 02a	FY 03a	FY 04a	FY 05a	FY 06a	FY 07a	FY 08a	FY 09a	FY 10a	FY 11e	FY 12e	FY 13e
Hengdeli							3.0	7.0	11.0	14.0	13.0	12.6	9.9	9.8	10.0	10.8	11.1	11.4
Hermès	18.0	20.6	20.7	20.7	25.0	25.0	25.8	27.1	26.8	26.9	26.5	25.5	25.5	24.2	27.8	29.0	29.7	30.4
Luxottica	na	na	na	na	17.1	16.7	18.9	15.3	15.1	14.1	16.2	16.8	14.4	11.4	12.3	13.4	13.8	14.3
Tiffany	11.9	13.7	13.7	18.1	20.0	19.3	18.7	17.8	13.4	16.0	15.7	14.5	16.5	16.3	19.3	19.8	20.4	21.0
Burberry*	na	na	na	8.2	16.1	18.1	19.7	21.1	22.5	20.8	21.8	20.7	15.0	17.2	20.1	20.6	21.1	21.7
Tod's	na	na	na	na	14.1	17.6	17.7	11.8	15.9	17.9	19.8	19.3	17.8	17.7	20.3	21.3	21.7	22.1
LVMH	22.6	17.3	17.1	18.1	16.9	12.8	15.8	18.2	19.0	19.7	20.7	21.6	21.1	19.7	21.3	22.2	22.2	22.8
Gucci brand	27.2	24.3	23.0	24.4	27.0	30.5	28.9	27.9	26.6	26.9	29.1	29.7	28.3	27.3	28.7	30.2	31.1	31.7
Swatch Group	9.6	13.4	13.5	14.1	16.0	15.4	15.6	14.9	16.6	17.1	20.2	21.9	21.2	17.6	23.5	24.6	25.6	26.7
Richemont*	16.6	16.1	16.9	18.3	19.3	13.3	9.6	9.1	13.2	16.6	18.6	20.9	17.9	16.0	19.7	20.5	20.9	21.4
Coach**	na	na	na	10.4	16.9	18.6	25.6	33.6	33.5	35.1	38.0	37.1	31.0	31.9	31.4	31.0	30.8	30.8
Prada	na	na	na	na	na	na	na	na	na	na	na	na	na	11.5	20.2	23.6	24.6	25.1
Average	17.7	17.6	17.5	18.9	18.8	18.7	19.6	19.7	20.3	21.1	22.7	22.8	20.9	19.2	22.2	23.3	23.8	24.4

*year ending March n+1 **year ending June n+1 Source : Companies, HSBC estimates

► **Hermès:** still disconnected from fundamentals, despite announcement of holding structure, we think holding the stock is not risky as there is a natural predator (LVMH) out there

Underweight rating

► **Luxottica:** clear outperformance recently. Captain of the industry and probably a great stock for the long run but short term risks (US, downtrading...) are currently too high in our view to keep for the short term.



Around the world...

- ▶ Positive long-term outlook on global travel: leisure travel spending likely to outpace GDP growth rates. Hiccups are short-term in nature
- ▶ Growth in tourism from emerging economies (above all Asia) likely to accelerate, with spending per capita increasing at the same time
- ▶ With c30% of global sales of luxury goods generated overseas, changes in global travel will affect luxury groups long-term, as stores and services adapt to travellers

Global travel: background and perspectives

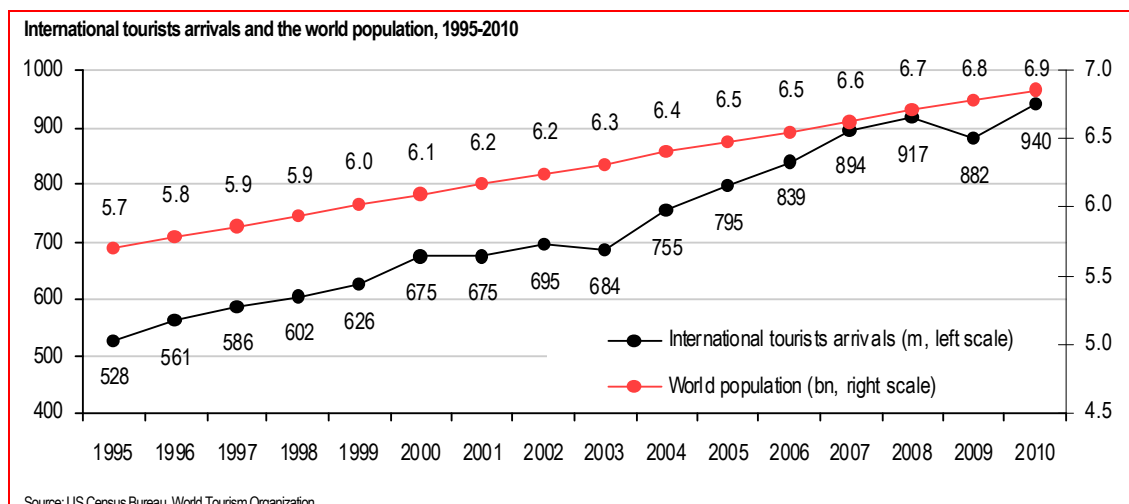
One billion travellers globally

The UNWTO (World Tourism Organization) estimates that inbound tourism represented c.5% of the world GDP in 2010. As an export industry generating income, tourism ranked fourth, after fuels, chemicals and automotive products. Growth in tourists' flows is rapid. In 2010, 940m tourists went abroad or 6.6% more than in 2009. All together, they generated USD919bn worth of receipts worldwide, up 4.7% vs. 2009.

Long-term, steady growth...

Expanding population

Travel is logically correlated to population growth. But global tourists' arrivals have increased at a much faster pace than the world population over the past 15 years. This supports the idea that global travel is also driven by wealth expansion as well as social/cultural patterns.



Tourists' flows from emerging markets to outpace flows from developed markets

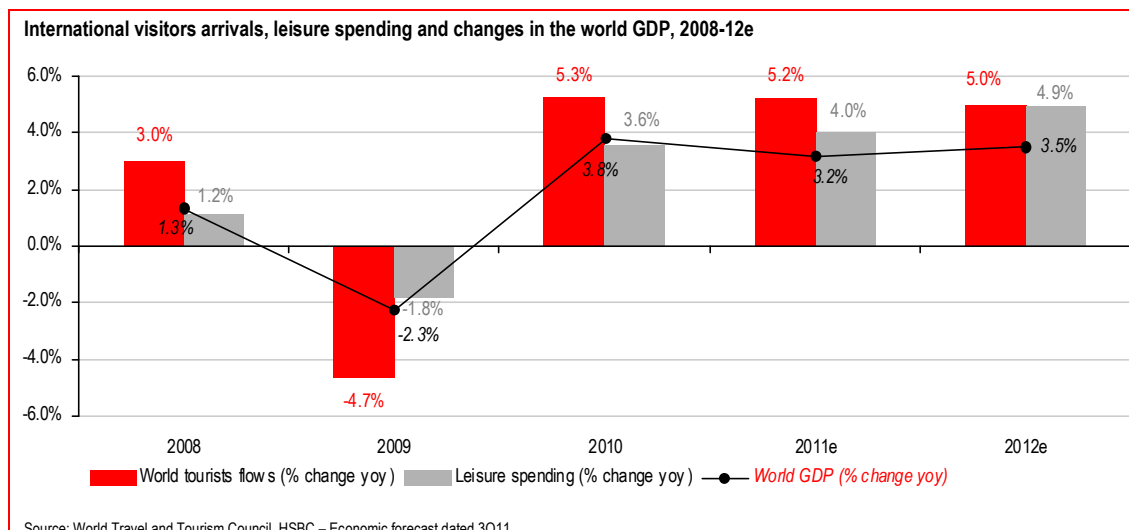
Populations are expanding much faster in emerging markets. In [The World in 2050: Quantifying the shift in the global economy](#) (4 January 2011), Karen Ward, senior economist at HSBC, expects eight out of the 10 most populated countries in the world to be current emerging countries by 2050. Furthermore, according to her, emerging markets will not only make up the majority of the world population by then; they will also represent an increasingly important share of the world's GDP: "19 of the top 30 economies by GDP will be countries that we currently describe as 'emerging'".

Growth in the global travel market is therefore likely to be uneven across the world as fast-growing emerging economies will be both sources of outgoing newly affluent travellers and destinations. In 2010, tourists' flows to emerging markets grew 8% vs. 5% for developed countries (UNWTO). No surprise then, to see a DFS Galleria store open in Denpasar, Bali, with advertising in... Russian!

However, ageing populations in the western world do not hinder global travel growth. Indeed, retirees tend to have more time and greater available income to spend on trips.

Leisure spending to outpace both volumes of travellers and GDP growth

Over the past 20 years, receipts from international tourism have grown faster than volumes of tourists (at a 6.5% CAGR vs. 3.9% for tourists' flows, see table above). We see this trend continuing (as disposable income grows in emerging countries) and leisure spending also outpacing GDP growth. The bottom chart shows that leisure spending will accelerate in 2011e-12e vs. world flows of tourists, according to the WTTC.



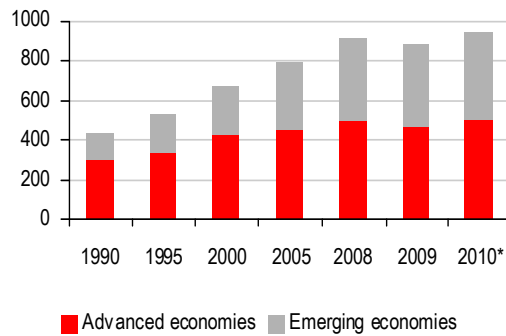
Emerging markets driving global travel: as source of travellers and destinations

Top-10 countries by size of the economy, 2010-50

Rank in 2050	Country	Size of economy in 2050 (bn, constant 2000 USD)	Rank in 2010
1	China	24,617	3
2	US	22,270	1
3	India	8,165	8
4	Japan	6,429	2
5	Germany	3,714	4
6	UK	3,576	5
7	Brazil	2,960	9
8	Mexico	2,810	13
9	France	2,750	6
10	Canada	2,287	10

Source: HSBC calculations, from *The World in 2050*, Karen Ward

International tourist arrivals - 1990-2010



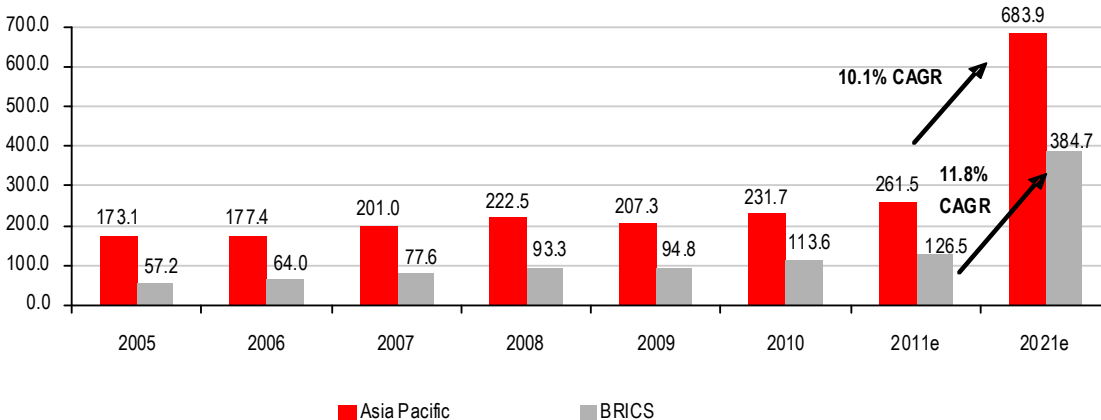
Source: Data as collected by UNWTO, June 2011

International tourism receipts vs. world tourist arrivals: Global travel has been driven by increased spending

Year	1990	1995	2000	2005	2008	2009	2010	1990-2010 CAGR
International tourism receipts (USDbn)	262	403	475	679	939	851	919	6.5
Advanced economies arrivals (m)	296	334	417	453	495	474	498	2.6
Emerging economies arrivals (m)	139	193	257	345	421	408	442	6.0
World tourist arrivals (m)	435	528	675	798	917	882	940	3.9

Source: UNWTO on July 2011

Expenditure on outbound travel (USDbn) for the Asia Pacific region and the BRIC countries



Source: WTTCs

Why the future looks bright: more and more tourists, with new motivations to travel (and to spend)

Travelling restrictions are easing

Restrictions on travel have tended to decrease. The Schengen Accords in 1985, relatively softer regulations in China and numerous bilateral agreements on visas have all contributed to lifting some of the barriers that weigh on travel. A recent example includes the American Visa Waiver Programme, the Electronic System for Travel Authorization (ESTA) which was implemented in January 2009. It allows citizens of 36 countries to pre-apply for entry, smoothing entrance to the US.

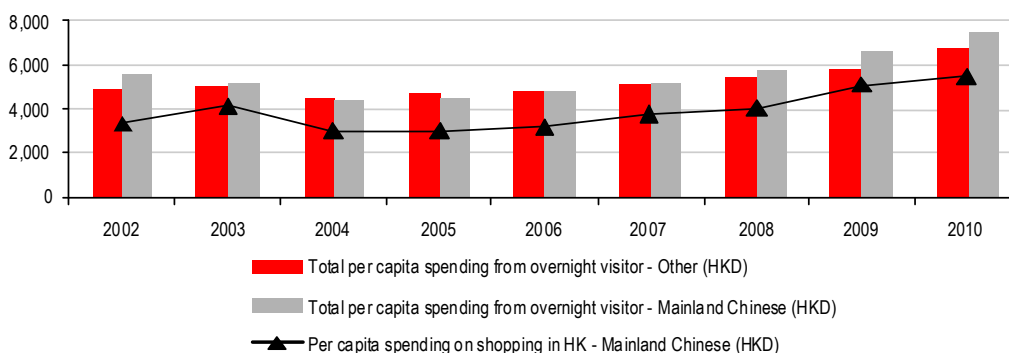
Similarly, China and Taiwan have lifted restrictions on visits from Mainland Chinese to Taiwan over the past few months. Direct flights have multiplied, supporting increasing tourism and business relationships between the two countries. In 2010, according to the Taiwan Tourism Bureau, 1.63m Mainland Chinese visited Taiwan (representing 29.3% of visitors). Until the end of June 2011, Mainland Chinese were only authorized to travel to Taiwan as part of organized tour groups. Under the new scheme, up to 500 individual visitors per day from Beijing, Shanghai and Xiamen, are now authorized to travel to Taiwan (vs. 4,000/5,000 a day in groups).

There are already more Mainland Chinese visiting Taiwan than Japanese (the latter were “only” 1.08m in 2010, or 19.4% of visitors).

New motivations to travel: why leisure spending will rise, and remain high

Motivations for travel have changed. Mass tourism in the 1960s was driven by increasing disposable income, a thirst for novelty and the emergence of commercial airlines. Today, as well as cultural/entertainment considerations, tourists also take economics into account. Buying an iPad in the US to benefit from a weaker USD, or buying a Swiss-made watch in Hong Kong rather than in Mainland China to benefit from lower VAT and to avoid consumption and import tax, is more common than before. In 2010, we estimate that 50% of handbags and 75% of watches sold in Hong Kong were purchased by Mainland Chinese (refer to our publication [Luxury: Understanding Chinese: Feedback from our Hong Kong and China trip](#), 21 March 2011). Indeed, the price for a return flight to HK from the Mainland is more than offset by more favourable tax and duties on high-end watches. In 2010, 63% of overnight visitors in Hong Kong came from Mainland China (CEIC), compared to 21% in 1997 at the time of the Hong Kong handover to China.

Overnight visitors, per capita spending in Hong Kong (2002-10): Mainland Chinese are spending more than other nationalities



Source: CEIC

Outbound flows of tourists, 2007-13e (% change yoy): EMs resist even in the crisis

	2008	2009	2010	CAGR 2008-10	2010	2011e	2012e	2013e	CAGR 2010-13e
World	3.0%	-4.7%	5.3%	1.1%	5.3%	5.2%	5.0%	3.5%	4.6%
Americas	0.7%	-2.4%	6.8%	1.6%	6.8%	3.9%	6.1%	4.5%	4.8%
North America	0.7%	-3.4%	6.1%	1.1%	6.1%	1.7%	4.7%	3.7%	3.4%
Caribbean	-12.7%	3.5%	5.9%	-1.5%	5.9%	8.2%	8.1%	5.2%	7.2%
Latin America	5.2%	0.0%	9.8%	4.9%	9.8%	11.2%	10.5%	6.9%	9.5%
Europe	0.6%	-6.3%	2.7%	-1.1%	2.7%	3.4%	3.2%	2.8%	3.1%
EU15	1.4%	-3.2%	1.6%	-0.1%	1.6%	1.7%	2.1%	1.8%	1.9%
Eastern Europe	-0.5%	-10.8%	3.7%	-2.7%	3.7%	5.7%	4.2%	4.1%	4.7%
Asia	3.6%	-0.1%	9.6%	4.3%	9.6%	8.9%	7.5%	4.4%	6.9%
Oceania	4.5%	5.2%	11.7%	7.1%	11.7%	3.6%	1.2%	-0.2%	1.5%
Africa	6.9%	-4.5%	5.3%	2.4%	5.3%	3.7%	5.0%	2.3%	3.7%
Middle East	27.5%	-11.1%	7.6%	6.8%	7.6%	7.5%	5.7%	3.4%	5.5%

Source: ETC

Similarly, since 2007, per-capita spending in Hong Kong has been higher for mainland Chinese than for the average visitor.

Travel is increasing around the world but the West lags

Global travel is likely to reflect the rise of emerging markets, both looking at the origin of the travellers, and where spending takes place. Looking at global outbound flows of tourists (ETC data) over 2010-13e, global outflows of tourists from emerging countries are expected to grow at significantly higher rates than outflows from developed countries, with Latin America expected to grow at a 9.5% CAGR, the Middle East at 5.5% and Asia at 6.9%. This compares to 3.1% and 3.4% CAGR for Europe and North America respectively.

Travellers' expenditure abroad is also growing faster in emerging markets. While historical figures suggest that globally, the growth of the travel market has been driven more by an increase in the volumes of trips taken rather than increased spending per capita, we believe they also underline the potential offered by emerging markets like China and Russia.

- ▶ The Asian drive: Chinese and Korean tourism expected to surge

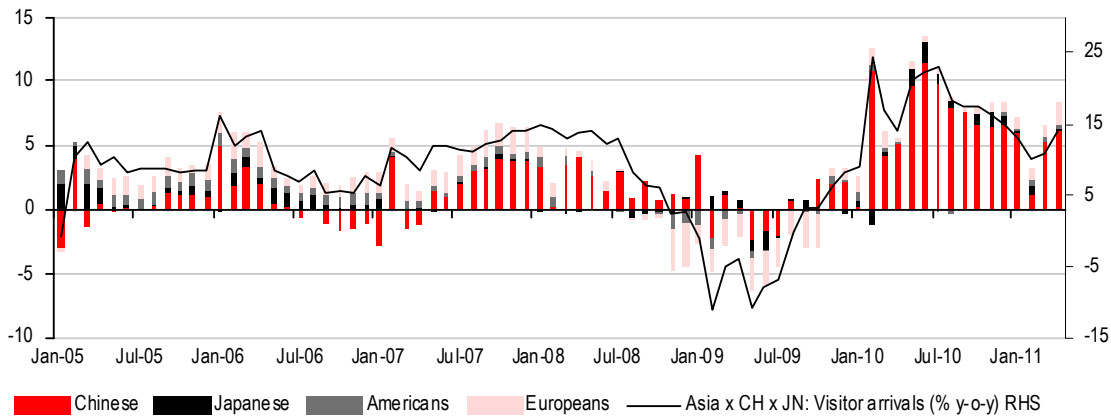
Tourism data from Japan and the US give an insight into the recent evolution in tourism, especially the emergence of Chinese and Korean tourists. According to the US Travel Association's international tourists' arrivals forecasts in the US, South Korean and Chinese arrivals are expected to grow respectively by 15% and 26% pa over 2010-2015e.

Top spenders - The rise of China

Rank 2010		Expenditure (USDbn)					06/10 Rank change	Per capita spending		CAGR 06-10 (%)	
		2010	2009	2008	2007	2006		2010 (USD)	2006 (USD)	Spending	Per capita spending
World		919	852	941	856	742	-	-	-	-	-
1	Germany	77.7	81.2	91	82.9	73.9	unch.	952	908	1.3	1.2
2	USA	75.5	73.2	79.7	76.2	72.1	unch.	244	241	1.2	0.3
3	China	54.9	43.7	36.2	29.8	24.3	+3	41	19	22.6	21.2
4	UK	48.6	50.3	68.5	72.3	63.1	-1	780	1037	-6.3	-6.9
5	France	39.4	38.5	41.4	36.7	31.2	-1	625	529	6.0	4.3
6	Canada	29.5	24.2	27.2	24.8	20.5	+2	866	621	9.5	8.7
7	Japan	27.9	25.1	27.9	26.5	26.9	-2	219	211	0.9	0.9
8	Italy	27.1	27.9	30.8	27.3	23.1	-1	449	397	4.1	3.1
9	Russia	26.5	20.8	23.8	22.3	18.2	unch.	189	132	9.8	9.4
10	Australia	22.5	17.6	n.a	n.a	n.a	n.a	1,014	n.a	n.a	n.a
n.a	South Korea	n.a	n.a	n.a	20.9	18.9	-1	n.a	373	n.a	n.a

Source: UNWTO

Flows of visitors in Asia: predominantly driven by Asian travellers



Source: CEIC

However, flows of Asian tourists seem mainly directed to Asia itself (closer, less time consuming and less expensive transportation).

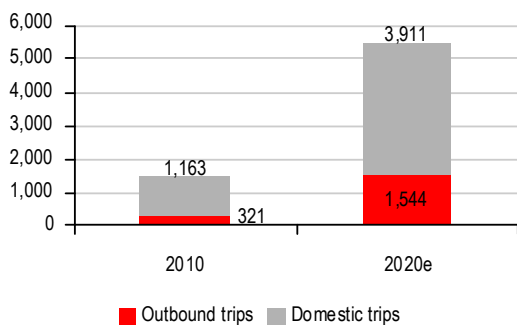
► China to surpass Japan by 2013

The Boston Consulting Group (BCG) recently published research on the rise of travel in China. By 2013, BCG expects China to surpass Japan as the second largest travel and tourism market in the world. It is expected to represent 8% of global tourism revenue in 2013 (14% in 2020) versus 8% and 6% for Japan in 2013 and 2020. The US is expected to remain No 1, representing 27% of the global travel market in 2013, and 25% in 2020.

The travel market in China (including outbound travel and domestic leisure and business travel) is forecasted to grow at a 14% CAGR over 2010-20. It is currently worth RMB1,484bn.

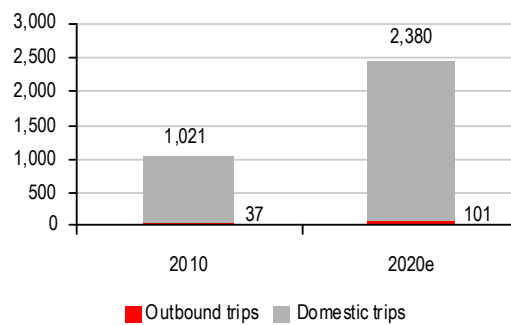
Most trips taken by Mainland Chinese are domestic journeys. They represented 96% of the total number of trips taken in China and 78% of the travel market's value in 2010. They are expected to grow 12.9% pa and to represent a market worth RMB3,900bn by 2020, which compares to a 17.0% growth rate for outbound trips.

China's travel and leisure market value (RMBbn) 2010-20e



Source: BCG

China's travel and leisure market, number of trips (m), 2010-20e



Source: BCG

Top 10 destinations for Chinese visitors (2009)

Rank	Destination	Thousands of travellers
1	Macau	14,439
2	Hong Kong	9,411
3	South Korea	1,031
4	Japan	893
5	Malaysia	890
6	Singapore	819
7	Thailand	581
8	USA	544
9	Vietnam	447
10	Australia	342

Source: Euromonitor International, July 2010

The BCG further estimates that “fewer than 200m urban Chinese consumers have taken an overnight leisure trip. With an average of 25 million people taking their first-ever such trip every year, however, that number will more than double by 2020”.

As outlined by Euromonitor in July 2010, 8 out of the top 10 destinations for Chinese travellers remain located in Asia.

In spending terms, Chinese travellers are now ranking as the third biggest spenders in the world, following German and American travellers. This compares to a fourth position in 2009 and fifth in 2007, according to the UNWTO. However, looking at per capita data, Chinese travellers are spending about a fifth of what the average Russian spends on holidays per capita. There is therefore leeway for Chinese travellers to travel more often, and to spend more on their holidays.

According to Euromonitor, shopping was the biggest spending post in 2009 for Chinese travellers, representing 32% of their budget on holidays. This is close to triple what they spent on accommodation or food that year.

► Looking beyond China: Russia and Brazil

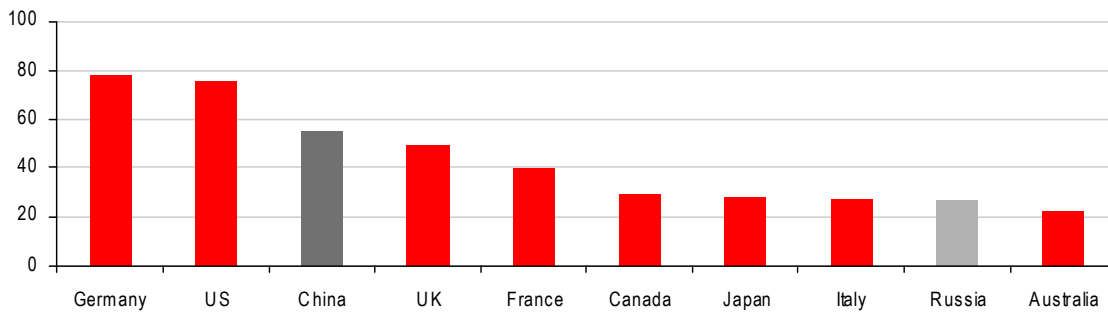
Brazil and Russia are to a certain extent in a similar situation as China. Travellers from both countries have enjoyed recent income rises at the same time that they were getting greater freedom of travel.

Like Mainland Chinese travelling to neighbours HK and Macau, an increasing number of Brazilian tourists travel to the US. According to the St. Petersburg Times (July 2011), Brazil has overtaken the UK as Florida’s main source of overseas visitors. 1.07m Brazilians visited the state in 2010, or 232,000 more than British. But they spent close to twice as much as British tourists. Brazilians are motivated by the hefty import tariffs and taxes in place at home. According to the same article, a pair of Mizuno running shoes that sells for USD100 in Orlando would likely be three times as expensive in Brazil. The USA is also negotiating bilateral agreements with Brazil, aiming at increasing the number of flights between the two countries, and the U.S. Travel Association is lobbying to have Brazil added to the list of 36 countries whose citizens can travel to the United States without a visa.

As for Russia, according to the ETC and UNWTO (2009), only about 15% of Russians have ever travelled abroad. This minority is pretty diverse, ranging from wealthy travellers spending holidays on the Cap d’Antibes to middle class travellers (sorry to refer to such a cliché here, but the number of Russian travellers in France increased 63.8% in 2010, and they spent 28% more nights in French hotels compared to 2009!), who would take on average 2 trips abroad per year (UNWTO, ETC, 2009). Travellers from Moscow still made up 25% of all package tours sold in 2007, mainly to France, Turkey, Spain or Italy.

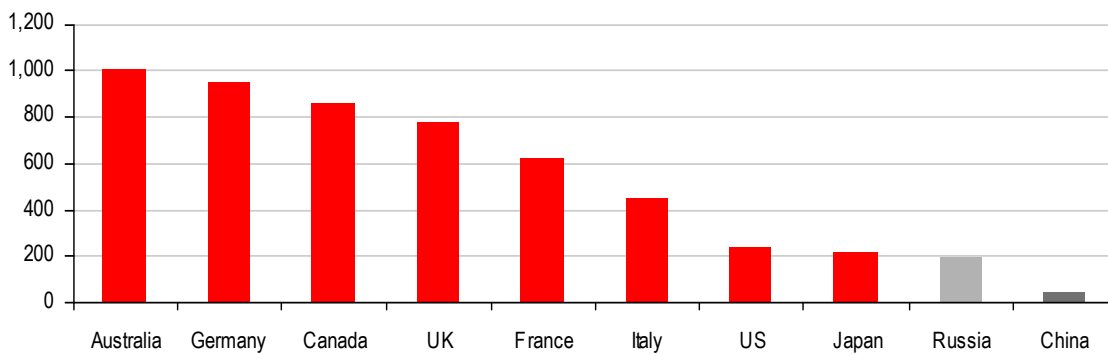
China/Russia outbound tourism, Asia Pac nurturing global travel

International tourism top spenders (Expenditure in USDbn, 2010)



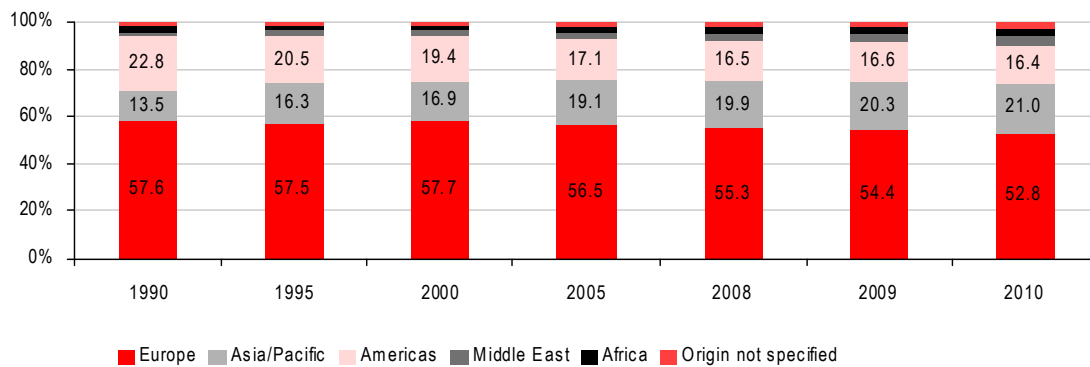
Source: UNWTO

International tourism top spenders (Expenditure per capita, USD)



Source: UNWTO

International tourist arrivals - where are they coming from? (%)



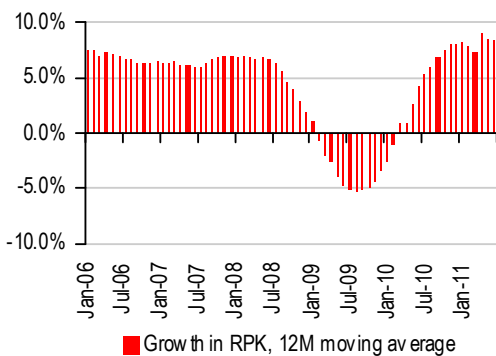
Source: UNWTO, July 2011

Assessing the effects of short-term hiccups on global travel

The non-lasting effects of crises

Sudden travel restrictions or economic shocks have temporarily affected the steady growth of global travel. Recent examples include the 1997-98 Asian financial crisis, the 9/11 terrorist attacks, the SARS epidemic (late 2002-March 2003), and the 2008-09 financial crisis.

Passenger traffic, measured in RPK, Jan06-June11



Source: IATA

Passenger traffic data can help assess the impact of such crises on travel. Revenue passenger kilometres (RPK) measure the volume of passengers carried by an airline. An RPK is flown when a revenue passenger is carried 1km (IATA). Past crises had different impacts on global travel. 9/11 was a psychological global crisis while the SARS epidemic was health-related and Asia-specific.

The example of Japanese earthquakes

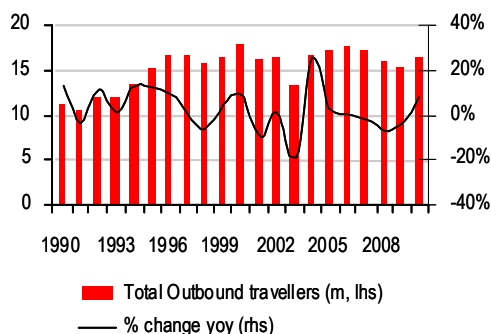
Effects of the March earthquake on Japan - 2011

	Foreign Visitors	% ch. Yoy	Japanese departures	% ch. Yoy
FY 2010	8,611,175	26.8	16,637,224	7.7
Jan-11	714,400	11.6	1,282,000	1.4
Feb-11	679,500	2.2	1,387,000	7.9
Mar-11	352,800	-50.3	1,282,000	-9.1
Apr-11	295,800	-65.5	1,104,000	-9.0
May-11	358,000	-50.4	1,156,000	-8.4
Jun-11	433,100	-36.0	1,274,000	-2.9
Jul-11	561,700	-36.1	1,469,000	4.5
YTD	3,395,300	-33.2	8,954,000	-3.8

Source: JNTO

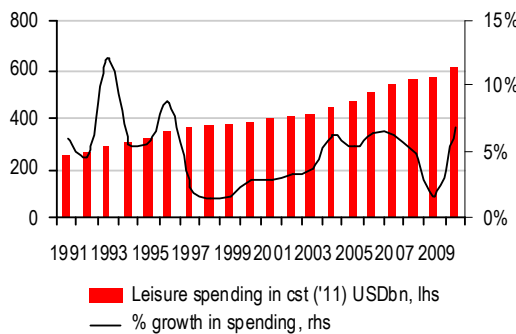
In 2010, 8.6m foreigners visited Japan and 16.6m Japanese took trips abroad, representing about 2% of world travellers flows. In 2010, 75.8% of travellers to Japan came from Asia. South Korea and China/Hong Kong respectively represented 28.3% and 22.3% of the total number of visitors. The tragic events in Japan from March 2011 and the fear of radiation have likely pushed these inbound flows of travellers to other Asian countries. According to the JNTO (Japan National Tourism Organization), in 1995, the year of the Kobe earthquake, outbound flows and inbound flows actually rose 12.7% and 9.0% y-o-y, respectively (JNTO). Travel spending in Asia slowed down after the Kobe earthquake but still recorded 5.9% growth. It is worth remembering that at the time the contribution of Japanese travellers to Asia's travel spending was higher than it is now (see section "China to surpass Japan" page 18).

Total outbound travellers from Japan, 1990-2010



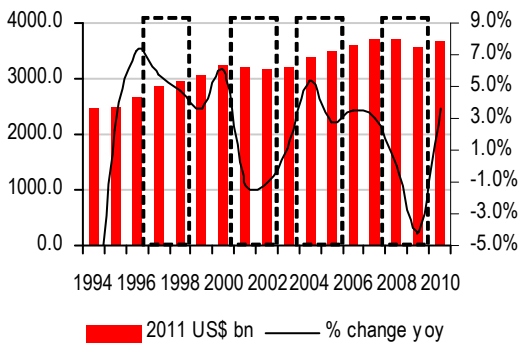
Source: JNTO

Impact of crisis periods on leisure travel spending in Asia



Source: WTTC

Travel spending (business and travel) in crisis periods (1995-2010)



Source: WTTC

The Japan earthquake in March may prove to be a short-term hiccup in travel in Asia.

Similarly, while it is fair to assume that macro-economic conditions might shake up travel growth in North America and in Western Europe, we believe that:

- 1 Emerging Asia and Latin America are likely to be less affected (if at all), which means we should still see close to 800,000 Chinese tourists visiting France in 2011 and their pricing power in EUR has become stronger,
- 2 Potential effects on Western travel might be short-term only. The chart above shows the evolution of travel spending on a global scale over the past 15 years. The 9/11 terrorist attacks and the 08/09 financial crisis globally affected travel, but the general trend points towards growth.

So why play luxury goods?

Travellers' purchases abroad

Travel retail trends

The latest travel retail trends show the strong support that travel brings in a relatively tough macro-environment. Selective retailing at LVMH (an estimated 35% of which was DFS in 2010) reported an 18% organic growth in H1-2011, underlining very favourable trends in travel retail; specifically in Hong Kong, Macao, and Singapore, but also in North America. LVMH specifically commented on this aspect of their business during their latest field trip to Singapore and Dubai, where we understood that 40% of sales at DFS are now generated by Mainland Chinese tourists (vs. 32% by Japanese and 7% by Koreans).

Assessing the contribution of overseas purchases to global sales of luxury goods

First, we estimate that up to 50% of sales of luxury goods in Western Europe are generated by foreigners. This figure would be lower in North America (20%) but comparable in Hong Kong (more than 50%). Following this thinking, and given each region's contribution to global sales of luxury goods, we estimate that global travel could generate as much as 30% of total sales of luxury goods.

The table below gives an outlook of the contribution of overseas purchases to luxury groups' sales. While sales in Mainland China probably contribute to 6% of global sales, sales to Mainland Chinese contribute, we believe, to up to 27% of sales of the Swatch Group.

Sales by nationality of consumer (2010)

	Louis Vuitton brand	Gucci Group	Richemont	Swatch
Western Europe	13%	18%	15%	17%
Eastern Europe	4%	4%	4%	4%
Middle East	7%	5%	10%	11%
Japan	21%	17%	14%	5%
Asia ex Japan	39%	39%	45%	56%
North America	15%	16%	9%	5%
Latam	2%	2%	3%	2%
Total	100%	100%	100%	100%

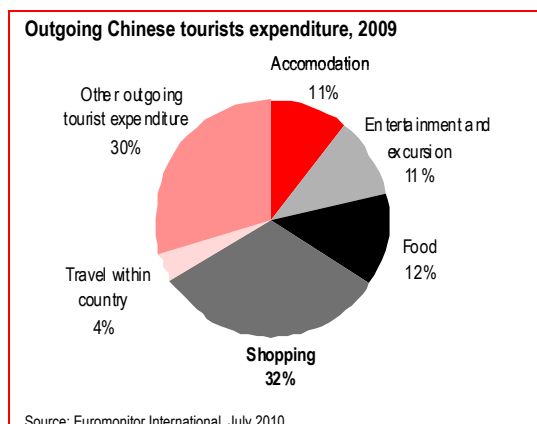
Source: companies, HSBC estimates

The Chinese stake

On average, Chinese travellers spend more than a third of their travel budget on shopping, vs. 11% on accommodation (pie on the right). This differs from Americans or Germans, who are likely to spend more on accommodation, and emphasizes Chinese travellers' thirst for shopping. Given the current low level of per capita spending on travel, the potential for shopping spending by Chinese travellers to increase further is substantial, in our view.

In France specifically, we estimate that Chinese consumers' spending represented 25% of total luxury goods sales in the country last year. According to the Paris Tourism Board, 60% of Chinese travellers' budget in Paris is dedicated to shopping. In 2010, 50% of sales at Galeries Lafayette, the world's biggest department store with EUR1.3bn worth of sales, were generated by overseas visitors, 15% by Chinese travellers alone. Galeries Lafayette recently reported that typical Chinese visitors were spending EUR1,000 in two hours of shopping in 2009, topping tourists from other countries. Galeries Lafayette is, after all, a go-to attraction in Paris for tour-operators and remember that 24% of Chinese (Euromonitor) used organized travel in 2009 (it reduces the hassle such as visa applications or language barrier...).

Galeries Lafayette have actually said they would open a store in Beijing within two years. The same observation was made at Printemps, Galeries Lafayette's number one competitor on Boulevard Haussman, where Chinese customers represented 30% of the Tax-refunded sales in 2010, ahead of Russians.



Measuring impact of "Walking ATMs" on Hong Kong and Asian business

We think mainland tourists will continue to be a major contributor to retail sales in the Asia region. We find that more and more mainland residents are discovering the joys of travelling, with the number of residents departing the mainland growing at a 10.7% CAGR for the past 5 years.

As our economist Frederic Neumann mentioned in his recent report [Chart of the Week: See you at the beach](#) (3 August 2011), intra-regional travel within Asia has been boosted by Chinese tourists, as seen in the chart below, and their spending can help to offset exports to the West. In another report ([Chart of the Week: The Chinese are coming](#), 15 October 2010), HSBC predicted that the annual number of Chinese outbound tourists could rise from about 50 million currently to over 130 million in 2015 and possibly top 200 million by 2020.

These "walking ATMs" are spreading across the region and we think that they will continue to fuel luxury consumption abroad. In addition to buffering other Asian economies, travel can increase consumers' exposure to brands and fashion trends. As more mainland tourists travel abroad, they are also potentially learning more about luxury and may develop into more discerning consumers.

The Hong Kong shopping experience

Mainland tourists have been flocking to Hong Kong to satisfy their shopping needs. The number of tourists has reached record levels this year and 1H 2011 posted 21% growth y-o-y. Tourist arrivals to Hong Kong typically are higher in the second half of the year, due to the summer holidays and the October Golden Week, and we would expect the momentum to continue in 2011. In particular, mainland tourists have come for HK's shopping paradise. The bulk of spending per capita for an overnight mainland Chinese visitor to HK is on shopping (73%), far higher than for any other spending category.

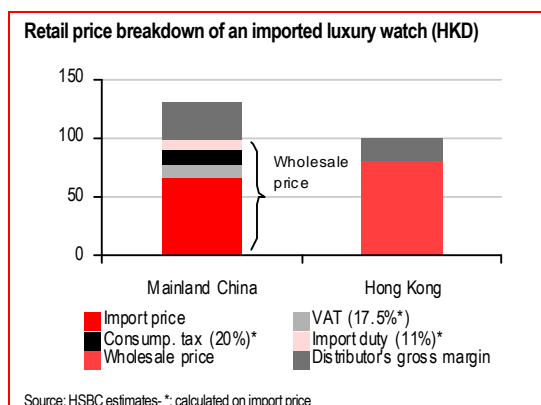
We think there are three primary reasons for mainland tourists to shop in Hong Kong:

Lower prices: HK is favoured for its tax-free prices. Should a consumer choose to buy a watch/jewellery item in China versus Hong Kong, the price will be marked up by three layers of taxes: a) Import taxes: 20-35% for jewellery and 11% for watches; b) Consumption tax: 5% for gold, silver, platinum and diamond jewellery, 10% on gem-sets and 20% for watches; c) Value-added tax (VAT): 17.5%

We outline an example above of how taxes can impact the price differential between HK and mainland China as described in our [China Luxury Tax](#) report dated 18 July 2011. Although there has been speculation of a cut in the import tax later this year, we think an immediate cut is unlikely and even if it does occur, we do not see Hong Kong's position as a key destination for luxury goods diminishing.

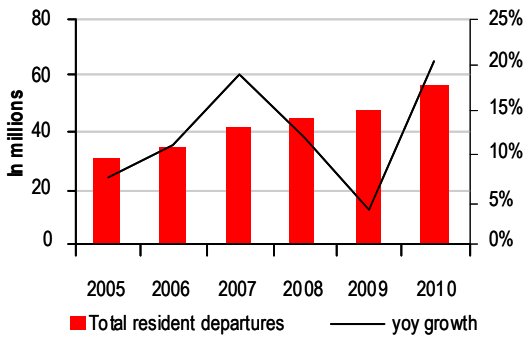
Quality assurance: Another reason mainland tourists come to HK is for the assurance they are buying products of high quality. With the recent food scandals and the market of counterfeit goods in the PRC, we believe consumers in Hong Kong can feel more assured that such products are what they claim to be. For jewellery in particular, measures can be taken to provide quality assurance to customers.

Assortment: the product assortment and the service that goes with it (knowledgeable staff...) is another reason to shop in HK vs the mainland.



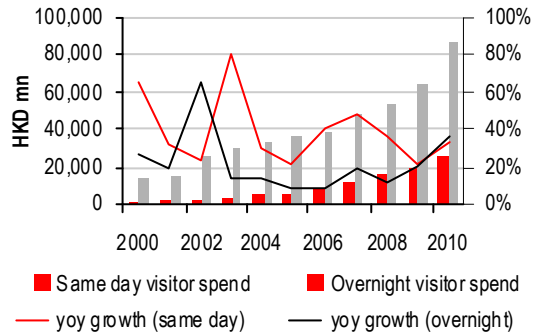
Chinese tourism matrix

Chinese resident departures - 2005-10



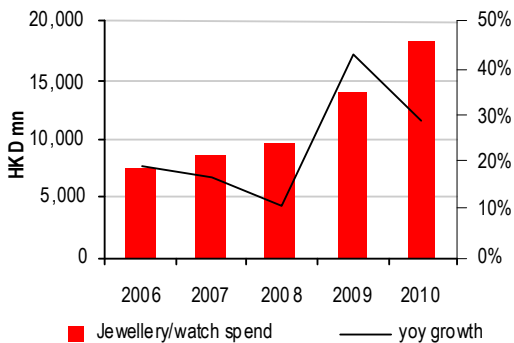
Source: CEIC, HSBC research

Mainland tourist spending, 2000-2010



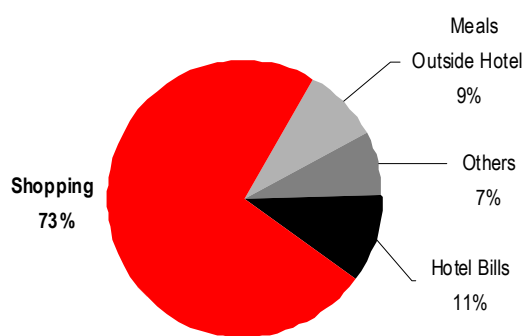
Source: HK Tourism Board, HSBC

Jewellery and watch spending by mainland tourists, 2006-10



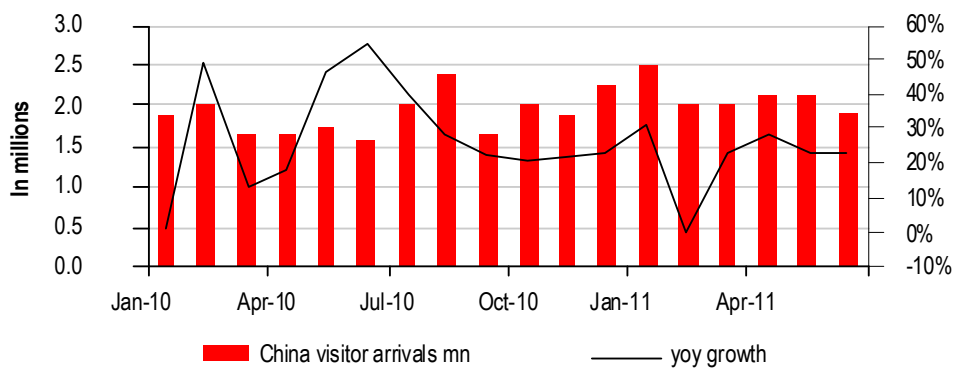
Source: HK Tourism Board, HSBC

Breakdown of mainland visitor spending in Hong Kong, 2010



Source: CEIC, HSBC

Number of visitor arrivals to Hong Kong from China, Jan 2010 - June 2011



Source: CEIC, HSBC

Visitors to France, volume and spending in 2010

	Number of tourists (m)		yoy Change (%)	Total expenditure (EURbn)		yoy change (%)	2010 share (%)		Receipts per traveller (2010)	
	2009	2010		2009	2010		of volumes	of receipts	EUR	Vs. average
Europe	65.2	65	-0.4	24.1	23.5	-2.5	84.7	77.4	362	-9%
Germany	10.7	11.4	6.4	4.3	4.5	5.5	14.8	14.8	395	0%
Russia	0.3	0.4	63.8	0.1	0.3	152.3	0.6	1	750	89%
Other	54.3	53.2	-2	19.7	18.7	-5.1	69.3	61.5	352	-11%
Americas	5.5	5.6	2	3.1	3.2	4.1	7.3	10.6	571	44%
United States	3.1	2.9	-5	1.7	1.7	1.7	3.8	5.6	586	48%
Canada	0.9	0.9	7.2	0.5	0.6	17.6	1.2	2	667	68%
Brazil	0.6	0.8	20.1	0.4	0.4	8.9	1	1.5	500	26%
Asia	3.1	3.3	5.1	1.5	1.5	2.3	4.3	5	455	15%
China	0.7	0.9	23.4	0.3	0.4	19.0	1.2	1.3	444	12%
Japan	0.7	0.6	-14.1	0.3	0.3	-8.8	0.8	0.9	500	26%
India	0.2	0.3	71.6	0.1	0.1	102.7	0.4	0.4	333	-16%
Oceania	1.1	1.2	9.3	0.6	0.9	35.0	1.6	2.8	750	89%
Africa	1.8	1.7	-7.5	1.3	1.3	1.1	2.2	4.3	765	93%
North Africa	1.3	1.2	-8.1	0.7	0.9	20.5	1.5	2.9	750	89%
Total	76.8	76.8	0	30.6	30.4	-0.6	100	100	396	-

Source: DGCS

The power of the BRICS

Summer 2011 in France saw the number of nights booked in hotels growing 3.1% in volumes, despite poor weather. The increase was higher for tourists from Brazil, Russia, India and China (+15% in July), vs. a 2% increase for tourists from the EU. 2.4m tourists from the BRICs visited France in 2010. They spent cEUR1.2bn and represented 3.2% of the total travellers, or 4.2% of total receipts. Interestingly, the average Russian spends close to double what the average traveller to France spends and an American still spends a third more than a Chinese, though Chinese are among the top spenders on shopping in France. Sales of luxury goods in France should be positively correlated to the increased number of travellers from the BRICs than from other regions.

Social patterns: why does travel trigger purchases of luxury goods?

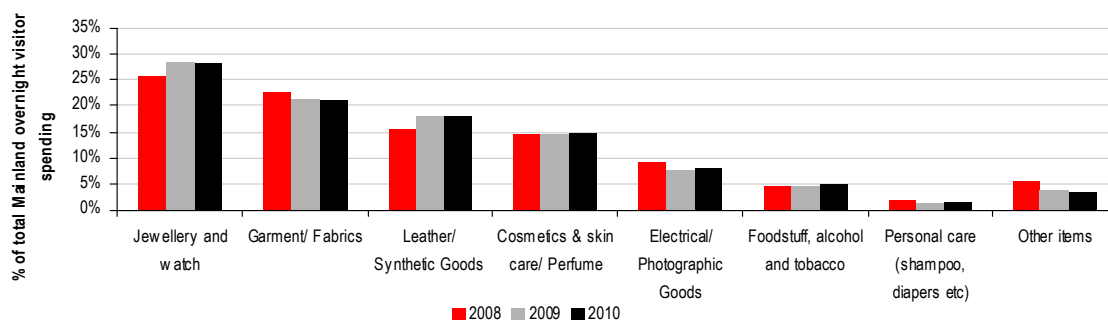
1. Self-indulgence

Think about it, your latest holidays weren't too long ago after all. Most people will be keener to spend during holidays, whether on a restaurant, or a handbag, all the more as low cost airlines increasingly allow savings on transportation cost.

2. Lower price

Taxes and tariffs can severely impact retail prices in countries such as Brazil, Russia or China. We have seen the example of Swiss watches, whose price can vary by as much as 30% between Mainland and HK. Tax-free shopping is driven by lower prices and time. Similarly, currency moves may drive sales of luxury goods by increasing shoppers' spending power.

Breakdown of mainland overnight visitor spending, 2008-2010



Source: HK Tourism Board, HSBC

3. Gift-giving culture

Gift-giving is an important tradition in some Asian countries, like in Japan (“Omiyage”) or China. Reciprocity underlies gift-giving, and holidays are one of many occasions that actually trigger offering gifts.

4. Improved shopping experience

Besides, the overseas shopping experience might prove different from home. First because product assortment can be different from one region to another: it is not rare to find in Hong Kong the more discrete designs of Swiss watches or Vuitton handbags you would not necessarily find in the Mainland. Collections can be wider abroad. Second because there clearly is a feel-good “incentive” to purchase a Chanel bag at the historic Chanel store rue Cambon if you travel to Paris rather than in London.

5. Overseas purchases reinforce status

Beyond the shopping experience, purchasing luxury goods abroad can enhance a traveller’s apparent status. And not only is it nice to say you bought a Coach bag in New York rather than in Shanghai, it also proves you do not buy counterfeit items. This gives the customer a sense of belonging to a international, restricted and sophisticated group of customers more than to their country of origin.

6. Improved knowledge of products

Finally, even back home, as the luxury goods consumers travel abroad, they are exposed to other trends brands and designs, and might develop an even higher taste for luxury goods when they return home, “evolving” from first-buyer to repeat purchaser.

Luxury brands adapting to this context

In a world where economic uncertainties prevail, we think travel could well provide a floor to possibly slower sales growth. While some investors doubt China can save the world, Chinese travellers might. At LVMH, while Mainland China represented an

estimated 8% of group’s sales in 2010, we believe Chinese customers alone, through their domestic and overseas purchases, may have represented up to 17% of the group’s sales.

Similarly while Greater China represented 33% of sales at Swatch in 2010, overall purchases from Chinese customers (we mean here from Mainland, Hong Kong, Macau and Taiwan) generated close to half of the group’s sales that year.

Store expansion plans follow flows of tourists

Luxury goods players seem particularly inclined to play the luxury boom. Store expansion schemes prove it and examples are multiplying. The latest striking example is the opening of the very first Louis Vuitton store in a duty-free space, in Incheon, South Korea. Louis Vuitton representatives in the country explained to *Le Figaro* the reasons for this surprising move: *“Incheon Airport is linked to 35 cities in China, and is to become an Asian hub, attracting increasingly more Chinese and Japanese shoppers”*. He added that Seoul has now become the second biggest Asian city in terms of luxury goods sales, after Tokyo. This shop might therefore target Koreans themselves, as Koreans now represent 4% of global luxury goods purchases, or an est. USD4.5bn worth of sales for the country. Similarly, Hengdeli started to expand in Taiwan in 2008 and bought out an existing network of 31 stores in 2009. It is now very well positioned to benefit from the traffic of Mainland travellers to the island.

As travellers expect to see the names they know wherever they go, luxury brands face the increasing need to be seen as truly global and cosmopolitan. Being perceived as a global brand would indeed enhance brands’ pricing power. Flagship stores have therefore multiplied, from Omega on Fifth Avenue in New York to Coach in Paris’ Printemps department store.

Risks related to the travel theme

We see three main risks related to the travel theme arising: 1) a threat to the truly universal nature of luxury goods as products or services are designed for a specific group of customers; 2) excessive spending being thrown at stores; 3) small to mid sized players expanding globally too quickly.

From global luxury to cultural specifics

As explained in [Luxury “Red Bull” - Why China brings excitement \(and a potential headache\)](#), in January 2010, we believe that the global expansion of luxury players should follow certain steps, as some consumers may be early adopters (typically the Japanese) and other laggards (typically the Western World and even more so the Chinese). This is linked to varying cultural, social and economic factors. Looking at both successful brands’ expansion and those that appear more risky, we had come to the conclusion that there was a logical path of expansion:

The biggest danger in not taking the “CO-J-A-C” path in our mind is that by skipping countries or regions, brands can become too dependent on a single region. Logically, if 50%+ of sales take place in one region, the risk is that management adjust the nature of the brand to try to adapt to local tastes. Chinese luxury consumers purchase Western goods for what they are. We are convinced that some brands have become too Asia-dependent (Piaget for instance) in their design and communication hence losing some of their inherent distinctive attributes.

We had then stressed our cautiousness on Coach, underlining that while the brand had been successful for 50 years in the US, and was entering China, it had failed to develop and nurture the same reputation in Europe as in its home country.

CO-J-A-C: diffusion of a luxury brand globally

Continent of Origin
(up to now, Europe or America)



Japan



Atlantic alternative
(America or Europe)



China

Source: HSBC

Still, Coach opened a store in Le Printemps, in Paris, which we believe might be more a case of “being seen by tourists, above all Chinese and Americans” than an attempt to capture the locals.

The threat of overdependence

Ten years ago, the fear was that luxury sales were European-based with a strong Japanese following and that Japanese consumers had started to represent such a chunk of sales that their attitudes could make or break a brand’s commercial success.

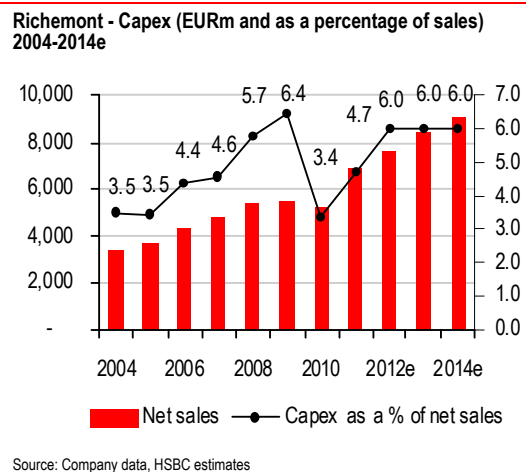
The good thing today is that gradually the luxury sector has become more global and now has a decent proportion of business in the US (though not as high as the US may represent as a percentage of global GDP), a strong presence in Asia ex-Japan (Korea, Greater China) and pockets of growth elsewhere (Eastern Europe, Middle East).

For us, the irony of China's success for the sector is that eventually it will come to be a dominant market, which inevitably brings with it the risk of having many eggs in the same basket.

A simple analysis of sales by nationality for Louis Vuitton (to a certain extent a proxy for the sector), shows that in only 5 years' time Chinese nationals could represent a staggering 31% of sales. Once again, this is not a negative as such since China should gradually become one of the most profitable markets for luxury, but it does represent a theoretical risk in terms of overexposure to a single client type.

EM = China for luxury

The emerging market theme is one that goes way beyond the realm of luxury stocks alone of course. What is interesting though is that for luxury, China is by far the most important driver. Unlike fast moving consumer goods companies (say beverages for instance), luxury goods have a limited footprint in Russia, India, Latam and Africa for reasons that are either economic (affordability), cultural and/or linked to a poor retail infrastructure.



Towards excessive spending?

We also come to question the massive flagship store expansion we have seen in the past months. The levels of CAPEX we are seeing now across the board are not just the consequences of a catch-up versus pre-crisis levels. At Richemont, CAPEX as an absolute amount has more than doubled between FY March 2004 and FY March 2012e, on our estimates. As a percentage of sales, CAPEX is 72% higher compared to 2004.

Louis Vuitton brand sales by nationality of customer

%	2003e	2007e	2010e	2015e	CAGR 10-15e
European	22	19	17	13	3.0
American	13	15	15	14	7.0
Japanese	51	36	21	15	1.0
Chinese mainland & travel	4	12	21	31	17.0
Other Asian	6	11	17	18	9.0
Other	4	7	9	10	11.0
Total	100	100	100	100	8.5

Source: HSBC estimates

Some players expanding too quickly?

Capital is less an issue for big groups that deleveraged in 08/09. However, global development might come into question at small to mid-sized players. One might think Burberry or Prada fit into this theme.

Let's look at Prada here. The fashion group listed in June 2011 on the Hong Kong Stock Exchange. What is striking, is that it stated in the offering prospectus that close to 75% of the expected net proceeds would be aimed at financing store renovation and an impressive (by its scale) store expansion.

In 2010 already 75% of the EUR188m worth of CAPEX was designated to store expansion (+59 directly operated stores to 319 globally, vs. +35 in 2009 and +34 in 2008). This is fairly unusual in the world of luxury goods where scarcity is part of the game.

We expect total capex spending to reach EUR328m in 2011e, and EUR431m in 2012e, or 13.2% and 14.9% of total sales respectively. This compares to 5.6% at LVMH for 2011e and 2012e, or 7.6% at Hermes for both 2011e and 2012e.

The only other player for which we expect to see similar levels of capex is Burberry, which could spend up to 10.9% and 8.5% of sales in CAPEX for 2011e and 2012e. It announced in July 2010 the acquisition of its long-standing franchisees in China. The target is to add c10 stores per year to reach 100 within 4 to 5 years (from 57 at the end of March 2011).

Store openings are not necessarily negative. What makes an international expansion coherent and sustainable (and limits their dilutive effect on margins), we believe, is for logistics, merchandising, planning and store location to follow and be up the standards of a luxury group.

Following Burberry's 2007 reorganization and improved supply chain and systems, we believe the group is able to keep up with such a pace of internationalization.

CAPEX spending as a percentage of sales - mid-sized players seem to overplay their global expansion

Name	2004	2005	2006	2007	2008	2009	2010	2011e	2012e	2013e
Burberry*	5.2	4.1	4.0	4.9	7.5	5.5	7.2	10.9	8.5	6.3
Coach**	5.5	6.3	5.4	5.5	7.4	2.2	3.6	4.5	4.5	4.4
Hermes	7.5	7.0	8.1	7.4	8.8	10.3	5.8	7.6	7.6	7.6
Luxottica	3.6	5.4	5.8	6.6	5.7	3.9	4.0	4.9	4.9	5.0
LVMH	5.0	5.1	5.0	6.0	6.0	4.4	4.9	5.6	5.6	5.5
PPR	nm	2.0	2.3	3.0	2.9	2.1	2.3	2.5	2.5	2.6
Prada***	nm	nm	nm	nm	8.8	8.5	9.2	13.2	14.9	11.0
Richemont*	3.5	4.4	4.6	5.7	6.4	3.4	4.7	6.0	6.0	6.0
Swatch Group	7.4	4.8	6.0	7.1	5.9	4.9	4.9	6.0	6.1	6.0
Tiffany	6.5	6.6	6.9	6.3	5.4	2.8	4.1	6.9	6.0	6.0
Tod's	6.2	4.2	4.9	6.5	6.0	2.8	12.5	8.0	5.3	5.0

*FY March n+1 ** FY June n+1 ***FY Jan n+1
Source: Company data, HSBC estimates

Initiation of coverage

▶ Prada

Prada

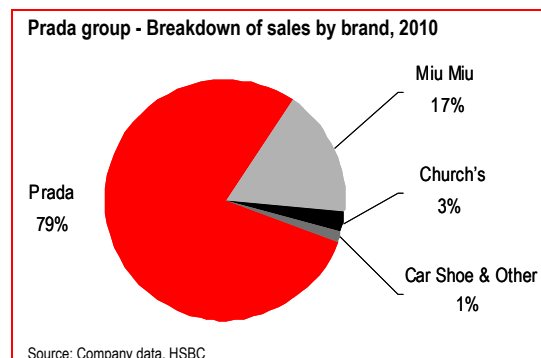
- ▶ Short-term, store openings likely to limit slowdown. Successful focus on retail and Asia to improve EBIT margin by 150bp over 11e-13e
- ▶ Turtle wins the race: long term fears on a too aggressive roll-out are justified... but have been partly discounted already in our view
- ▶ Initiate with an N(V) and a target price of HKD39.0, at which the stock would be trading at 19.0x 2012e calendarized earnings

Why we're not too worried short-term

Tourism to provide a floor to sales

The group's capacity to disappoint in the next 18 months years is limited, we think. Indeed, we believe Prada fits particularly well into our travel theme. Not only has it grown on booming sales in Asia, but sales in Europe and Italy have clearly benefited from tourism. In H1-2011, Italy and Europe retail sales were up 34% and 18% respectively on a like-for-like basis. In cities like Florence or Venice, we understand that the majority of sales were generated by tourists. Local demand was flat over the semester in Italy, implying that demand from tourists actually surged more than 60%. Therefore, while we take a more cautious view on sales, especially in North America, we believe purchases by foreigners will continue to be supportive. Besides, we believe store openings will limit potential downside. We see Asia Pacific (c45% of directly operated stores by 13e) continuing to drive global growth with 37% reported growth in 11e, 30% in 12e and 22% in 13e with space expansion a key factor.

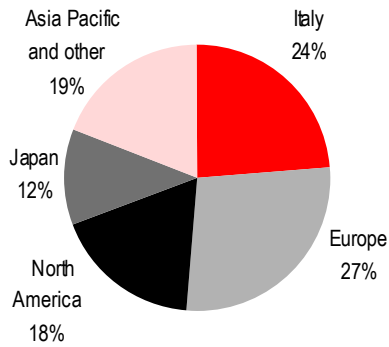
2005-2011: towards a successful retail and Asia-centric business model



Prada was founded in 1913 by Miuccia Prada's grand father, Mario Prada, in Milan. Like Louis Vuitton or Hermès, he retailed leather goods to wealthy Europeans. In the 80's Miuccia Prada and Patrizio Bertelli, her husband, kicked off Prada's internationalization and expansion into ready-to-wear and shoes. Prada acquired Jil Sander and Helmut Lang (1999), Azzedine Alaia (2007), and invested in Church's (1999) and Car Shoe (2000), the latter two now fully owned.

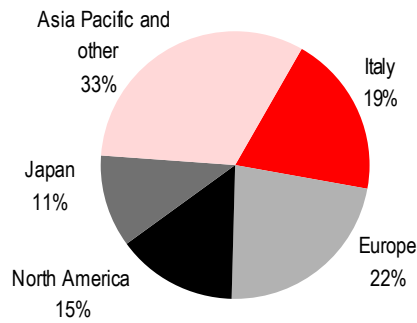
In 2005/06, however, Prada started to refocus on retail distribution, and on its two core brands, Prada and Miu Miu. The process accelerated in 08/09, which marked the beginning of the Asian expansion

Prada group - Breakdown of sales by region, 2008



Source: Company data, HSBC

Prada group - Breakdown of sales by region, 2010



Source: Company data, HSBC

at Prada and saw a 25% cut in the number of wholesale partners. In March 2006, Prada SPA sold Helmut Lang to Japan's Link Theory Holdings, while the holding company disposed of Jil Sander to Change capital Partners a month before, to focus on its core brands. Azzedine Alaia took back his brand in 2007 before selling an interest to the Richemont group. The geographical mix is now biased towards fast-growing markets: Prada will operate its first Russian stores (previously under franchise) in H1-2011. H2 should see the opening of the first store in Brazil. Proceeds of the June 2011 IPO are predominantly directed at the funding of the retail network.

Margins to benefit from scale and increased exposure to retail and Asia

H1-2011 results showed an impressive 400bp improvement of EBIT margin over H1-2010. Given the still strong sales growth we forecast for 2H (organic growth of 19% vs 24% in H1), we see further operating leverage generated by 1) the shift from retail to wholesale; 2) the boom in Asia and with it favourable pricing and product mix; 3) scale.

Gross margin driven by retail vs. wholesale

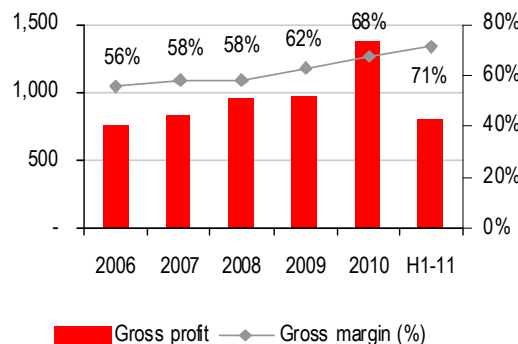
Besides door closures and a reduction of the product offering available for wholesalers, retail sales are to be driven by the opening of 80 DOS a year through to 2013e, to 550. Therefore, after the 544bp gross margin improvement seen in H1-2011, we forecast a further 200bp increase over 11e-13e.

Prada group - Contribution of retail sales, 2006-2010



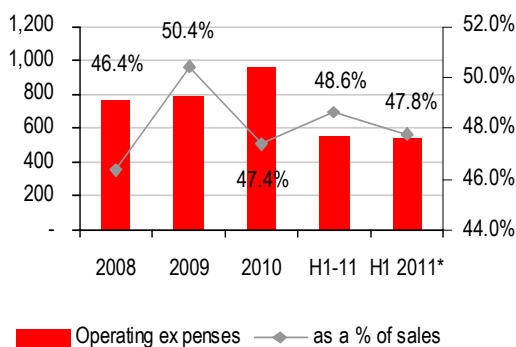
Source: Company data, HSBC

Prada group - Gross profit (EURm) and gross margin, 06-H1 11



Source: Company data, HSBC

Prada group - Operating expenses (EURm, %) 2008-H1 2011



Source: Company data. - *: Operating expenses excl. c. EUR10m one-offs linked to the IPO

Asia's contribution to the group's sales has grown from 17.6% in 2008 to 32.0% in 2010. In addition to the traditionally greater pricing power that luxury goods retailers enjoy in Asia, Asian consumers' taste has also massively driven the highly profitable leather goods category. It represented 50.3% of sales in 2010, vs. 39.5% in 2008.

The decrease in wholesale has also led sales of the less profitable clothing and footwear categories down in terms of contribution.

Operating margins to benefit from gross margin expansion but retail roll-out will weigh

In H1-2011, the operating expenses to sales ratio reached 48.6%, vs. 47.2% in H1 2010. Given current investments (26 DOS were opened over the semester), this lack of leverage seems logical.

We do not see any operating leverage in the next two years despite very strong sales growth as we see the retail expansion weighing on fixed cost.

While product and development expenses, advertising and admin costs should mechanically decrease as a percentage of sales, we are taking the view that this should not be enough to compensate for the rise in selling expenses (rents and store staff costs).

Prada group - EBITDA by brand, 2008-H1 2011

(%)	2008	2009	H1-2010	2010	H1-2011
Prada	19.8%	20.7%	25.8%	28.6%	30.2%
MiuMiu	12.6%	16.6%	21.2%	21.9%	21.5%
Church's	2.8%	2.3%	7.2%	12.8%	12.2%
Car Shoe	6.7%	-----still negative-----			
Group	17.6%	19.0%	24.0%	26.6%	27.8%

Source: Company data, HSBC estimates

Going forward, we see EBITDA margin improving a further 180bp from FY Jan 12 levels to 29.6% of sales in FY Jan 14e, on the back of continuing booming retail sales in emerging markets and expected improvements at Miu Miu, which is currently being heavily pushed and advertised. As shown below, Miu Miu is already more retail, Asia and leather goods driven, meaning that potential for margin expansion (with scale) is probably quite substantial, in our view.

Prada & Miu Miu - Key profitability drivers, 2010

	Prada	Miu Miu
% of group sales	78.7%	17.5%
Breakdown of sales by product category		
Clothing	26.4%	17.9%
Leather goods	49.5%	63.5%
Footwear	23.1%	18.0%
Other	0.9%	0.5%
Retail contribution	70.6%	74.9%
Number of DOS 2008	166	36
Number of DOS H1-11	242	88
Breakdown of sales by region		
Italy	19.0%	17.4%
Europe	21.5%	19.9%
North America	16.4%	9.1%
Asia Pacific	32.6%	35.0%
Japan	9.9%	17.9%
Other	0.6%	0.7%
FY Jan 11 reported growth		
Italy	21%	18%
Europe	20%	26%
North America	28%	46%
Asia Pacific	58%	86%
Japan	16%	18%
Other	-18%	-7%
Total	31%	40%

Source: Company data, HSBC

The turtle wins the race: retail push risky but part discounted

A fairly pushy store expansion plan

Prada and Miu Miu: sales vs. DOS count

	2010 retail sales (EURm)	Number of DOS at year end	Average sales per store
Gucci brand	1,946	317	6.1
LV brand	5,711	450	12.7
Prada brand	1,120	207	5.4
Miu Miu brand	264	71	3.7

Source: Company data, HSBC estimates

The group is pushing both Prada and Miu Miu brands, which could justify the need for 80 store openings a year. However, looking at Louis Vuitton or Gucci store counts relative to their respective turnover, Prada is clearly aggressively expanding. In luxury, in our view, “the turtle wins the race” or as Italians would say “chi va piano, va sano e lontano”.

It is surprising in our view for a family controlled business (see chart bottom right) to be so aggressive in terms of store roll-out. Management likes to mention Gucci and Louis Vuitton as reference points but we actually think a brand like Chanel may be a better proxy and the Prada brand today has more stores than Chanel already. We believe the paradox of luxury is to try to sell more of what is supposed to be exclusive (see our thematic report on this theme called [Less is More](#) from 2007). The pricing power that luxury brands can apply is proportionate to this idea of scarcity associated with service and the notion that a brand can become too “commonplace”.

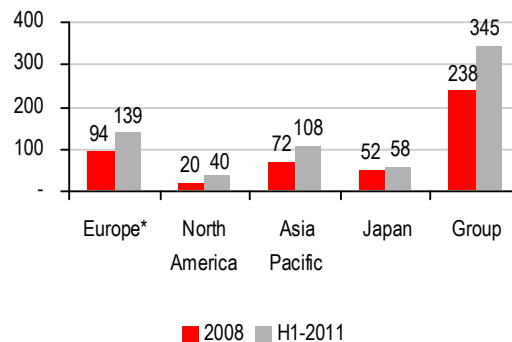
Selling expenses as a percentage of sales have not come up recently, despite the opening of 27 DOS and net sales booming 31.8% in 2010. While this will be supportive of margins short-term, as sales improve, it leads us to question the level of service in the group’s stores and the potential for long-term depreciation of the brand. Current store locations might lose relevance in the coming quarters. As a reference, Louis Vuitton has planned to open no more than 5 stores a year, globally.

Between the end of July and September, Prada added 13 stores, net of closures.

Given the rocky ride in shares however since the late June IPO (stock down c26% since the listing level of HKD39.50), we believe the market has discounted the risks of such an aggressive expansion vs peers.

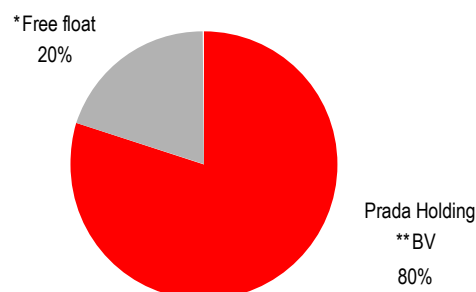
What we believe is quite relevant as well, and we particularly note this having our team based on both continents, is that Prada should trade in line with EU and US-listed peers. In other words the HK-listing premium is difficult to justify as, from an operations perspective, companies like Richemont and LVMH have theoretically as much legitimacy to be HK-listed as Prada has.

Prada group – directly operated stores counted by region



Source: Company data, HSBC; * Italy: 31 to 47, ** Japan: 52 to 58

Prada group - Shareholding structure as of October 2011



Source: Bloomberg, HSBC - * of which Intesa Sanpaolo: 1%; ** of which Patrizio Bertelli and Miuccia Prada Bianchi 33.2%, Alberto and Marina Prada Bianchi: 14.2%

Earnings forecasts, valuation and risks

Like all the other stocks under our coverage in luxury goods globally, we value Prada based on a DCF. Assumptions are detailed on page 41. We use a specific beta of 1.10 and a sector beta of 1.20, as with other stocks under our coverage.

We derive a HKD39.0 target price, offering close to 16% potential return to Prada's current price. This is within the -1.5 to 18.5% Neutral band set by HSBC on volatile stocks listed in Hong Kong. Note that all stocks with less than 12 months of trading history are considered volatile. Thus we initiate with a Neutral (V) rating.

On our estimates, the group is currently trading at 19.9 and 16.1 times 2011e and 2012e calendarized earnings, or at an average 10% premium to its Europe-listed peers for 2012e.

Given Prada's higher exposure to fast-growing markets and very aggressive retail roll-out, we believe this could prove to be the stock in our coverage universe with the greatest organic sales growth over the next 12. We would also argue it is the one with the higher execution risk.

The next event will be the publication of Q3 results, most probably the last week of November. We suspect these results will be very strong as the slowdown we forecast for the sector will not have affected Prada yet. Intesa's six months lock-up period will end in December, but were markets to remain in their current shape; this is unlikely to prompt the sales of their shares.

Risks (on both the upside and downside) include those common to most luxury stocks ie macro-economic conditions in emerging markets and the USD/EUR rate. Company-specific risks include a placement of shares from Prada family members and failure/success to execute the retail strategy (which we find aggressive relative to peers).

Prada SPA - Sales

Split year ending Jan+1 (EURm)	2006	2007	2008	2009	2010	2011e	2012e	2013e
Region								
Italy	341	376	385	330	393	448	483	516
Europe	337	379	436	373	451	518	560	599
North America	286	291	290	228	295	348	376	410
Japan			187	189	221	243	272	280
Asia Pacific	350	349	283	396	646	883	1,146	1,399
Other			23	14	12	13	13	14
Total	1,314	1,396	1,604	1,531	2,017	2,453	2,850	3,219
Italy	26%	27%	24%	22%	19%	18%	17%	16%
Europe	26%	27%	27%	24%	22%	21%	20%	19%
North America	22%	21%	18%	15%	15%	14%	13%	13%
Japan			12%	12%	11%	10%	10%	9%
Asia Pacific	27%	25%	18%	26%	32%	36%	40%	43%
Other			1%	1%	1%	1%	0%	0%
Total	100%	100%	100%	100%	100%	100%	100%	100%
Brand								
Prada	1,128	1,185	1,266	1,210	1,587	1,928	2,223	2,478
MiuMiu	126	153	240	252	353	437	530	632
Church's			50	44	53	59	66	74
Car Shoe	17	18	34	19	18	21	23	24
Azzedine Alaia	10	13						
Other	34	26	15	7	6	8	9	10
Total	1,314	1,396	1,604	1,531	2,017	2,453	2,850	3,219
Prada	86%	85%	79%	79%	79%	79%	78%	77%
MiuMiu	10%	11%	15%	16%	18%	18%	19%	20%
Church's	0%	0%	3%	3%	3%	2%	2%	2%
Car Shoe	1%	1%	2%	1%	1%	1%	1%	1%
Azzedine Alaia	1%	1%						
Other	3%	2%	1%	0%	0%	0%	0%	0%
Total	100%	100%	100%	100%	100%	100%	100%	100%
Product								
Clothing	475	479	471	396	484	491	510	531
Leather goods	474	518	634	712	1,014	1,349	1,635	1,913
Footwear	356	391	488	411	503	593	682	750
Other	11	8	11	12	17	20	23	26
Total	1,314	1,396	1,604	1,531	2,017	2,453	2,850	3,219
Clothing	36%	34%	29%	26%	24%	20%	18%	16%
Leather goods	36%	37%	40%	46%	50%	55%	57%	59%
Footwear	27%	28%	30%	27%	25%	24%	24%	23%
Other	1%	1%	1%	1%	1%	1%	1%	1%
Total	100%	100%	100%	100%	100%	100%	100%	100%
Channel								
Retail	668	701	871	992	1,428	1,880	2,298	2,670
Wholesale	646	695	733	539	590	572	552	549
Total	1,314	1,396	1,604	1,531	2,017	2,453	2,850	3,219
Retail	51%	50%	54%	65%	71%	77%	81%	83%
Wholesale	49%	50%	46%	35%	29%	23%	19%	17%
Total	100%	100%	100%	100%	100%	100%	100%	100%

Source: Company data, HSBC estimates

Prada SPA – P&L

Year ending Jan+1 (EURm)	FY 09	H110	H210	FY 10	H111	H211e	FY 11e	FY 12e	FY 13e
Net Sales	1,531	920	1,097	2,017	1,117	1,335	2,453	2,850	3,219
% change yoy	-5%			32%	21%	22%	22%	16%	13%
Royalties	31	16	13	30	17	20	37	43	48
Net revenues	1,561	936	1,110	2,047	1,134	1,355	2,489	2,893	3,267
Gross Profit	975	614	774	1,388	805	975	1,780	2,112	2,401
Gross margin (%)	62.4%	65.5%	69.7%	67.8%	71.0%	71.9%	71.5%	73.0%	73.5%
change yoy (bp)	444	918	1007	538	544	220	369	150	50
Product and development expenses	(97)	(49)	(48)	(97)	(51)	(54)	(105)	(110)	(115)
as a % of sales	6.2%	5.3%	4.3%	4.7%	4.5%	4.0%	4.2%	3.8%	3.5%
Advertising and promotion expenses	(76)	(37)	(48)	(85)	(54)	(61)	(115)	(133)	(150)
as a % of sales	4.9%	3.9%	4.4%	4.2%	4.8%	4.5%	4.6%	4.6%	4.6%
Selling expenses	(485)	(289)	(353)	(643)	(357)	(439)	(797)	(955)	(1,094)
as a % of sales	31.0%	30.9%	31.8%	31.4%	31.5%	32.4%	32.0%	33.0%	33.5%
General and administrative expenses	(130)	(66)	(78)	(145)	(89)	(95)	(184)	(203)	(222)
as a % of sales	8.4%	7.1%	7.0%	7.1%	7.9%	7.0%	7.4%	7.0%	6.8%
SG&A as a % of sales		47.2%	47.6%	47.4%	48.6%	47.9%	48.2%	48.4%	48.4%
EBIT	187.1	172.2	241.5	413.7	253.4	325.6	579.0	711.7	819.3
EBIT margin (%)	12.0%	18.4%	21.8%	20.2%	22.3%	24.0%	23.3%	24.6%	25.1%
PBT	155.3	152.6	235.6	388.2	241.8	311.7	553.5	686.2	793.8
Taxation	(53)	(49)	(86)	(135)	(61)	(144)	(143.9)	(178.4)	(206.4)
Tax rate	33.8%	31.9%	36.5%	34.7%	25.1%	26.0%	26.0%	26.0%	26.0%
PAT	102.8	103.9	149.6	253.6	181.2	228.4	409.6	507.8	587.4
Discontinued operations	(2)	(1)	0	-	(2)	0	-	-	-
Net profit for group	101	103	151	254	180	230	409.6	507.8	587.4
Net margin (%)	6.4%		13.6%	12.4%		16.5%	16.5%	17.6%	18.0%
Prof. attrib. to non-controlling interests	0	6	(9)	(3)	5	(9)	(4.4)	(5.5)	(6.3)
Prof. attributable to equity owner	98	108	142	251	183	221	405	502	581
Weighted avg number of shares (m)	2,506	2,500	2,500	2,500	2,512	2,512	2,512	2,512	2,512
EPS (Basic) (EUR)	0.040	0.043	0.057	0.100	0.073	0.088	0.161	0.200	0.231

Source: Company data, HSBC estimates

Prada SPA – Cash-flow statement

Year ending Jan+1 (EURm)	FY08	FY09	FY10	FY11	FY12	FY13
PBT	153.2	152.8	388.2	553.5	686.2	793.8
D&A	80.1	94.3	111.5	112.0	130.2	147.0
Impairment of fixed assets	11.8	9.4	6.1	-	-	-
Financial (income) expenses	28.9	29.6	19.3	21.3	21.3	21.3
Share of (profit)/loss of a jointly controlled entity	(1.1)	0.4	4.2	-	-	-
Other non monetary changes	(0.5)	4.8	26.8	-	-	-
Trade receivables, net	8.6	24.4	(46.1)	(74)	(57)	(52)
Inventories, net	41.8	15.0	(46.4)	(56)	(55)	(50)
Other non current assets and liabilities	(4.2)	3.8	(10.0)	(0)	-	-
Trade payables	(8.9)	(33.5)	36.9	52	46	43
Other current assets and liabilities	(10.3)	39.4	(10.0)	24.1	22.0	20.4
Interest paid	(35.4)	(21.2)	(22.8)	(21.3)	(21.3)	(21.3)
Taxes paid	(98.1)	(39.4)	(90.2)	(143.9)	(178.4)	(206.4)
Net cash flow from operations	165.9	279.8	367.5	467.8	595.3	695.0
Purchase of assets	(144.3)	(132.8)	(187.6)	(328.0)	(431.3)	(357.8)
Associated undertakings acquired	(7.8)	(9.3)	(4.0)	-	-	-
Net cash flow from investing activities	(152.1)	(142.1)	(191.6)	(328.0)	(431.3)	(357.8)
Capital increase, net	-	-	-	228.7	-	-
Dividends paid to shareholders	-	(47.8)	(58.9)	(115)	(143)	(166)
Dividends paid to minority shareholders	(1.3)	(0.3)	(0.5)	(1)	(1)	(1)
Repayment of borrowings	(117.5)	(114.6)	(179.7)	(101)	-	-
Proceeds from borrowings	37.3	23.0	307.3	-	-	-
Change in short-term borrowings - third parties	94.7	38.5	(201.8)	-	-	-
Change in short-term borrowings - parent co and related parties	(29.6)	(24.0)	(35.6)	-	-	-
Net cash flow from financing activities	(16.4)	(125.2)	(169.3)	12.0	(143.7)	(166.1)
Change in cash and cash equivalents net of bank overdraft	(2.6)	12.5	6.6	151.8	20.4	171.1
Opening cash and cash equivalents, net of bank overdraft	55.1	59.9	69.2	96.4	248.2	268.6
Exchange differences	7.3	(3.3)	3.5	-	-	-
Closing cash and cash equivalents, net of bank overdraft	59.8	69.1	79.3	248.2	268.6	439.7
Bank overdraft	27.0	29.4	17.1	-	-	-
Closing cash and cash equivalents, net of bank overdraft	86.8	98.5	96.4	248.2	268.6	439.7

Source: Company data, HSBC estimates

Prada SPA – Balance sheet

Year ending Jan+1 (EURm)	FY08	FY09	FY10	FY11	FY12	FY13
Current assets	746.3	687.0	770.0	1,051.6	1,183.0	1,456.9
Cash and cash equivalents	86.9	98.6	96.6	248.2	268.6	439.7
Trade receivables, net	250.5	224.2	274.2	349	405	457
Inventories, net	251.2	231.5	280.4	336	391	441
Derivative financial instruments	3.4	0.2	7.4	7.4	7.4	7.4
Receivables from controlling company and related parties	22.3	56.4	36.3	36.3	36.3	36.3
Other current assets	130.5	74.7	70.2	70.2	70.2	70.2
Assets held for sale	1.4	1.4	4.9	4.9	4.9	4.9
Non current assets	1,430	1,461	1,596	1,812	2,113	2,324
PPE, net	379	418	537	753	1,054	1,265
Intangible assets, net	901	893	869	869	869	869
Associated undertakings	2	2	2	2	2	2
Investment in a jointly controlled entity	8	8	-	-	-	-
Other investments	0	0	0	0	0	0
Deferred tax assets	106	111	141	141	141	141
Derivatives financial instruments	-	-	2	2	2	2
Other non current assets	33	28	45	45	45	45
TOTAL ASSETS	2,176.1	2,148	2,366	2,864	3,296	3,781
Current liabilities	753	830	659	736	804	867
Bank overdrafts and short term loans	367	459	194	194	194	194
Payables to controlling company and related parties	3	6	1	1	1	1
Other shareholders' loan	1	1	1	1	1	1
Trade account payables	231	196	234	286	333	376
Current tax liabilities	34	62	108	108	108	108
Derivative financial liabilities	21	9	5	5	5	5
Obligations under financial leases	3	6	5	5	5	5
Other current liabilities	93	91	112	136	158	178
Non current liabilities	411	261	497	396	396	396
Long term debt, net of current portion	264	111	303	203	203	203
Obligations under financial leases	8	8	3	3	3	3
Pension liabilities and leaving indemnities	36	37	35	35	35	35
Provision for contingencies and commitments	14	13	53	53	53	53
Deferred tax liabilities	65	59	53	53	53	53
Other non current liabilities	22	33	50	50	50	50
Derivative financial instruments	2	0	0	-	-	-
Total liabilities	1,164	1,091	1,156	1,131	1,200	1,263
Equity and reserves						
Share capital	250	250	250	479	479	479
Reserves	753	798	954	1,244	1,602	2,017
of which non distributable legal reserve	7	7	9	20	25	29
as a % of share capital	2.8%	2.8%	3.6%	4.2%	5.2%	6.1%
Equity attributable to owners of the company	1,003	1,048	1,204	1,722	2,081	2,496
Non controlling interests	9	9	6	10	16	22
Total liabilities and equity	2,176	2,148	2,366	2,864	3,296	3,781

Source: Company data, HSBC estimates

Financials & valuation: PRADA SPA

Neutral (V)

Financial statements

Year to	01/2011a	01/2012e	01/2013e	01/2014e
Profit & loss summary (EURm)				
Revenue	2,047	2,489	2,893	3,267
EBITDA	531	691	842	966
Depreciation & amortisation	-118	-112	-130	-147
Operating profit/EBIT	414	579	712	819
Net interest	-21	-21	-21	-21
PBT	388	553	686	794
HSBC PBT	388	553	686	794
Taxation	-135	-144	-178	-206
Net profit	251	405	502	581
HSBC net profit	251	405	502	581
Cash flow summary (EURm)				
Cash flow from operations	374	468	595	695
Capex	-188	-328	-431	-358
Cash flow from investment	-192	-328	-431	-358
Dividends	-59	-116	-144	-166
Change in net debt	-71	-252	-20	-171
FCF equity	112	144	168	341
Balance sheet summary (EURm)				
Intangible fixed assets	869	869	869	869
Tangible fixed assets	725	941	1,242	1,453
Current assets	770	1,052	1,183	1,457
Cash & others	97	248	269	440
Total assets	2,366	2,864	3,296	3,781
Operating liabilities	518	594	663	726
Gross debt	498	397	397	397
Net debt	401	149	128	-43
Shareholders funds	1,204	1,722	2,081	2,496
Invested capital	1,750	2,020	2,363	2,613

Ratio, growth and per share analysis

Year to	01/2011a	01/2012e	01/2013e	01/2014e
Y-o-y % change				
Revenue	31.1	21.6	16.2	12.9
EBITDA	87.9	30.1	21.8	14.8
Operating profit	131.0	39.9	22.9	15.1
PBT	150.2	42.6	24.0	15.7
HSBC EPS	147.9	59.6	24.0	15.7
Ratios (%)				
Revenue/IC (x)	1.2	1.3	1.3	1.3
ROIC	16.0	22.7	24.0	24.4
ROE	22.3	27.7	26.4	25.4
ROA	11.9	16.3	17.0	17.0
EBITDA margin	26.0	27.8	29.1	29.6
Operating profit margin	20.2	23.3	24.6	25.1
EBITDA/net interest (x)	25.0	32.5	39.6	45.4
Net debt/equity	33.1	8.6	6.1	-1.7
Net debt/EBITDA (x)	0.8	0.2	0.2	0.0
CF from operations/net debt	93.2	314.6	464.0	

Per share data (EUR)

EPS Rep (fully diluted)	0.10	0.16	0.20	0.23
HSBC EPS (fully diluted)	0.10	0.16	0.20	0.23
DPS	0.05	0.06	0.06	0.00
NAV	0.48	0.67	0.81	0.98

DCF analysis

HSBC assumptions	DCF, comprising		
Risk-free rate (%)	3.5%	EBIT growth 11-21e CAGR (%)	22.0
Equity Premium (%)	3.5%	EBIT growth 21-41e CAGR (%)	3.4
Sector beta	1.20	Fading period 2041-47e	
Specific beta	1.00	WACC (%)	8.70

Sensitivity and valuation range

Cost of capital vs fade period	4 years	8 years	12 years
8.5%	43.1	43.8	44.4
9.0%	40.6	41.3	41.8
9.5%	38.4	39.0	39.4
10.0%	36.4	36.8	37.3
10.5%	34.5	34.9	35.3

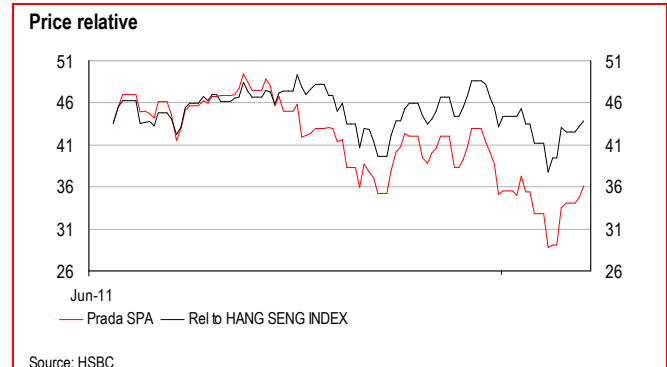
Valuation data

Year to	01/2011a	01/2012e	01/2013e	01/2014e
EV/sales	4.2	3.4	2.9	2.5
EV/EBITDA	16.2	12.1	9.9	8.5
EV/IC	4.9	4.1	3.5	3.1
PE*	31.8	19.9	16.1	13.9
P/NAV	6.6	4.7	3.9	3.2
FCF yield (%)	1.4	1.8	2.0	4.1
Dividend yield (%)	1.4	1.8	2.1	0.0

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (HKD)	33.50	Target price (HKD)	39.00	Potent'l tot rtn (%)	16.4
Reuters (Equity)	1913.HK	Bloomberg (Equity)	1913 HK		
Market cap (USDm)	11,015	Market cap (HKDm)	85,721		
Free float (%)	20	Enterprise value (EURm)	8376		
Country	Hong Kong	Sector	Textiles, Apparel & Luxury Goods		
Analyst	Erwan Rambourg	Contact	852 2996 6572		
	Antoine Belge	Contact	331 5652 4347		
	Sophie Dargnies	Contact	331 5652 4348		



Note: price at close of 06 Oct 2011

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Investment cases

- ▶ Burberry
- ▶ Christian Dior
- ▶ Coach
- ▶ Hengdeli Holdings Ltd
- ▶ Hermès
- ▶ Luxottica
- ▶ LVMH
- ▶ PPR
- ▶ Richemont
- ▶ Swatch
- ▶ Tiffany
- ▶ Tod's

Burberry

- ▶ US exposure and continued investments may weigh
- ▶ Valuation (22% premium to the sector) not compelling in our view
- ▶ Remain Neutral; lower target price to 1,325p (from 1,450p) on lower earnings estimates and higher sector beta

Neutral mostly on valuation

Strong trading Q2 (July-Sept) trading statement

Burberry has been the first luxury company to report sales trends for the July-Sept period. The 25% y-o-y organic sales growth achieved in Q2 even showed an acceleration compared to Q1 (+24% y-o-y). The company raised its H1 ending Sept 2011 EBIT guidance to “unchanged y-o-y” (“down” previously).

Second best performer in terms of share price

Burberry’s share price has been slightly less impacted than its peers in Q3 (-19% vs -23% for European luxury on average excluding Hermès). With a 4% share price increase, Burberry has been the second best performer after Hermès since the beginning of 2011 (compared to -17% for European luxury on average excluding Hermès).

The stock benefited from strong fundamentals but also from press speculation (cf *La Tribune* article on 6 June 2011 citing PPR as a potential buyer) following LVMH’s bid for Bulgari (7 March 2011).

Top-line to be strong but some risks

The second most exposed to the US

Burberry may suffer from its sales exposure to the US, which represented 24% of sales in March 2010,

making the company the second most exposed to the US in our European coverage. As we outlined in the report, we believe that the US could be the region most affected by this summer’s equity market slump.

We continue to believe that Burberry’s story is good (the five strategic themes – leveraging the franchise, intensifying non-apparel development, accelerating retail-led growth, investing in under-penetrated markets, operational excellence – have been rolled out successfully), and the way it is presented to the market is also very compelling: having ambitious managers leading a 100% free float company helps.

We feel that the group may offer top-line expansion, in the high-end range of the industry thanks especially to China. On 16 July 2010, Burberry announced the acquisition of the stores and related assets in previously operated by its long-standing franchisees.

We have been positively surprised by the speed at which China was integrated and started to benefit from accelerated expansion, better management, training, merchandising, planning, refurbishment and store locations. Burberry reported that comparable store sales in China were up by c30% in Q1 11. The target is to add c10 stores pa to reach 100 in four to five years (vs 57 stores today) in China mainland.

Continued investments

However, in a context of weaker growth in Europe and in the US, different investments in customer service, planning, supply chain, digital warehousing and investments on China, Japan non-apparel JVs, Brazil and India ... may weigh on EBIT margin. We thus feel that Burberry's EBIT margin potential expansion may be limited in the next 3 years.

Burberry is guiding that EBIT margin should increase modestly in FY March 2012.

We nonetheless continue to argue Burberry may have an interesting profitability story in the medium-term. Unlike most other luxury brands, the brand generates lower profitability in retail than in wholesale. In 2009, management mentioned an EBIT margin differential of more than 500bp between the two distribution channels, which we believe could be narrowed thanks to improved store productivity. This should be driven by better product mix (outperformance of non-apparel), lower markdowns (fewer leftovers) and stronger sales of bestsellers (more frequent replenishments as a result of improved supply chain and systems).

Earnings, valuation and risks

Company guidance for FY March 2012 includes:

- ▶ **Retail** space (average) to be up c15% in H2. We factor in 15% retail growth at constant FX with 2% comps in H2.
- ▶ **Wholesale** revenue to be up mid-single digit at constant FX in H2, negatively impacted over the short-term by further rationalisation in the Europe and US distribution. We factor in 8% at constant FX including China in H2.
- ▶ **Licence** revenues over the full year should be up by a mid single-digit percentage at constant FX, and by c10% on a reported basis. We factor in 9.5% at constant FX.

We have left our FY March 2012e EBIT estimates unchanged, but have decreased our FY March 2013e-14e EBIT estimates by 7% and 8%, respectively on the back of lower US and to a lesser extent Europe sales forecasts. For 2012e and 2013e, we forecast organic sales growth of 18% (18%, previously) and 9% (13%, previously), respectively and EBIT margins of 20.6% (vs 20.9%, previously) and 21.1% (vs 22.1%, previously).

Burberry is currently trading at 17.9x calendar 12e PE, ie a 22% premium to peers, not a compelling level in our view. We decrease our DCF-based target price from 1,450p to 1,325p on the back of our earnings estimate decreases (see above) and a change in the sector beta from 1.10 to 1.20. The assumptions used to generate our DCF-derived target price are detailed on page 47. Under our research model the Neutral band for UK stocks is 5 percentage points above and below the hurdle rate of 7.5%. Based on our target price, shares offer an 11.6% potential return, which is within the Neutral range; as such we reiterate our Neutral rating.

The main downside risks to our rating include a failure to expand the customer base, and despite the retail roll-out, that the company fails to shift sales towards more non-apparel. In addition, as the brand has attracted outside talent in recent years, there is a risk that this talent may prove difficult to retain. Risks to the upside include a potential takeover bid (Burberry remains a 100% free float company), and the possibility that market share gains translate into much greater sales growth than we have factored in.

Burberry profit & loss

YE March (GBPm)	2007a	Yoy (%)	2008a	Yoy (%)	2009a	Yoy (%)	2010a	Yoy (%)	2011a	Yoy (%)	2012e	Yoy (%)	2013e	Yoy (%)	2014e	Yoy (%)
Sales	850	14	995	17	1,202	21	1,280	7	1,501	17	1,780	19	1,940	9	2,116	9
Gross profit	521	17	618	18	666	8	804	21	1010	26	1199	19	1307	9	1431	9
Gross profit margin	61.3%		62.1%		55.4%		62.8%		67.3%		67.4%		67.4%		67.6%	
Operating expenses	364	25	416	14	485	17	584	20	709	21	832	17	897	8	972	8
As a % of sales	42.8%		41.8%		40.4%		45.6%		47.2%		46.7%		46.2%		45.9%	
Adjusted EBIT	185		206	11	181	-12	220	22	301	37	367	22	410	12	459	12
EBIT margin	21.8%		20.7%		15.0%		17.2%		20.1%		20.6%		21.1%		21.7%	
Reported EBIT	157	2	202	28	-10	-105	171	-1,828	302	77	367	21	410	12	459	12
EBIT margin	18.5%		20.3%		-0.8%		13.4%		20.1%		20.6%		21.1%		21.7%	
Pre-tax profit	156	0	196	25	-16	-108	166	-1,131	296	78	365	24	415	14	469	13
Reported net profit	110	4	135	23	-6	-104	81	-1,456	208	156	267	28	303	14	342	13
Clean net profit	110	4	140	27	132	-6	155	17	217	40	267	23	303	14	342	13
EPS (clean diluted) (p)	24.7	11	31.6	28	30.2	-5	35.1	16	48.8	39	60.1	23	68.2	14	77.1	13

Source: Company data, HSBC estimates

Burberry sales and EBIT by network and geography

YE March (GBPm)	2007a	Yoy (%)	2008a	Yoy (%)	2009a	Yoy (%)	2010a	Yoy (%)	2011a	Yoy (%)	2012e	Yoy (%)	2013e	Yoy (%)	2014e	Yoy (%)
Retail sales	410	29	484	18	630	30	749	19	962	29	1207	25	1352	12	1514	12
Wholesale sales	354	3	426	20	489	15	434	-11	441	2	465	6	481	3	492	2
License Sales	86	6	85	-2	83	-3	97	18	98	1	108	9	108	-	110	2
Total sales	850	14	995	17	1202	21	1280	7	1501	17	1780	19	1940	9	2116	9
Retail & Wholesale EBIT	112	31	136	21	110	-19	138	25	220	59	278	26	321	16	368	15
Retail & Wholesale EBIT margin	14.6%		14.9%		9.8%		11.6%		15.6%		16.6%		17.5%		18.3%	
Licence EBIT	73	6	71	-4	71	0	82	16	82	-1	89	10	89	-	91	2
Licence EBIT margin	85.2%		83.3%		85.6%		84.3%		82.9%		83.0%		83.0%		83.1%	

Source: Company data, HSBC estimates

Burberry sales by geography

YE March (GBPm)	2007a	Yoy (%)	2008a	Yoy (%)	2009a	Yoy (%)	2010a	Yoy (%)	2011a	Yoy (%)	2012e	Yoy (%)	2013e	Yoy (%)	2014e	Yoy (%)
Europe	382	17	453	19	524	16	515	-2	475	5	540	14	561	4	583	4
North America	197	10	235	19	305	30	321	5	387	20	385	-0	401	4	425	6
Asia Pacific	168	16	189	13	240	27	283	18	457	125	637	39	753	18	867	15
Rest of the world	19		33	79	50	64	28	85	72	110	30	118	7	131	11	
Licensing	86		85	-2	83	-3	97	18	98	11	108	9	108	-	110	2
Total sales	850	31	995	17	1202	21	1280	7	1501	39	1780	19	1940	9	2116	9

Source: Company data, HSBC estimates

Financials & valuation: Burberry Group

Neutral

Financial statements

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Profit & loss summary (GBPm)				
Revenue	1,501	1,780	1,940	2,116
EBITDA	365	439	491	548
Depreciation & amortisation	-63	-72	-81	-89
Operating profit/EBIT	301	367	410	459
Net interest	-6	-2	5	10
PBT	296	365	415	469
HSBC PBT	296	365	415	469
Taxation	-83	-99	-112	-127
Net profit	215	267	303	342
HSBC net profit	217	267	303	342

Cash flow summary (GBPm)

Cash flow from operations	273	319	372	421
Capex	-108	-190	-160	-130
Cash flow from investment	-158	-190	-160	-130
Dividends	-69	-85	-105	-119
Change in net debt	-36	-44	-107	-172
FCF equity	148	129	212	291

Balance sheet summary (GBPm)

Intangible fixed assets	115	115	115	115
Tangible fixed assets	282	400	479	520
Current assets	847	953	1,105	1,316
Cash & others	466	511	618	790
Total assets	1,364	1,589	1,820	2,072
Operating liabilities	450	493	525	554
Gross debt	168	168	168	168
Net debt	-298	-342	-450	-622
Shareholders funds	714	895	1,094	1,318
Invested capital	327	464	555	607

Ratio, growth and per share analysis

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Y-o-y % change				
Revenue	17.3	18.6	9.0	9.1
EBITDA	63.3	20.4	11.8	11.6
Operating profit	36.9	21.9	11.7	12.0
PBT	78.2	23.6	13.5	13.0
HSBC EPS	39.2	23.1	13.5	13.0

Ratios (%)

Revenue/IC (x)	5.0	4.5	3.8	3.6
ROIC	72.4	67.8	58.7	57.7
ROE	33.8	33.2	30.5	28.4
ROA	17.0	18.1	17.8	17.6
EBITDA margin	24.3	24.7	25.3	25.9
Operating profit margin	20.1	20.6	21.1	21.7
EBITDA/net interest (x)	57.0	292.7		
Net debt/equity	-40.6	-37.4	-40.4	-46.5
Net debt/EBITDA (x)	-0.8	-0.8	-0.9	-1.1
CF from operations/net debt				

Per share data (GBPp)

EPS Rep (fully diluted)	48.33	60.09	68.23	77.12
HSBC EPS (fully diluted)	48.83	60.09	68.23	77.12
DPS	19.53	24.04	27.29	30.85
NAV	163.90	205.67	251.24	302.61

DCF analysis

HSBC assumptions	DCF, comprising		
Risk-free rate (%)	3.5%	EBIT growth 2011-21e CAGR (%)	9.4
Equity Premium (%)	3.5%	EBIT growth 2021-41e CAGR (%)	3.1
Sector beta	1.20	Fading period 2041-47e	
Specific beta	1.00	WACC (%)	8.30

Sensitivity and valuation range

Cost of capital vs fade period	4 years	8 years	12 years
7.3%	14.81	15.20	15.49
7.8%	13.84	14.17	14.44
8.3%	12.97	13.25	13.49
8.8%	12.19	12.42	12.64
9.3%	11.48	11.68	11.88

Valuation data

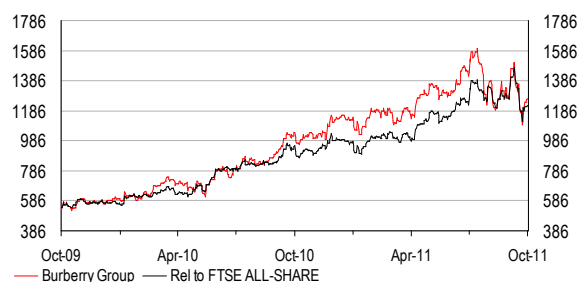
Year to	03/2011a	03/2012e	03/2013e	03/2014e
EV/sales	3.2	2.7	2.4	2.1
EV/EBITDA	13.2	10.9	9.5	8.2
EV/IC	14.7	10.3	8.4	7.4
PE*	24.3	19.8	17.4	15.4
P/NAV	7.2	5.8	4.7	3.9
FCF yield (%)	2.9	2.5	4.1	5.7
Dividend yield (%)	1.6	2.0	2.3	2.6

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (GBPp)	1,187	Target price (GBPp)	1,325	Potent'l tot rtn (%)	11.6
Reuters (Equity)	BRBY.L	Bloomberg (Equity)	BRBY LN		
Market cap (USDm)	8,029	Market cap (GBPm)	5,206		
Free float (%)	100	Enterprise value (GBPm)	4766		
Country	United Kingdom	Sector	Textiles, Apparel & Luxury Goods		
Analyst	Erwan Rambourg	Contact	852 2996 6572		
	Antoine Belge	Contact	331 5652 4347		
	Sophie Dargnies	Contact	331 5652 4348		

Price relative



Source: HSBC

Note: price at close of 05 Oct 2011

Christian Dior

- ▶ A cheaper way to access LVMH's robust fundamentals
- ▶ Reducing target price to EUR109 from EUR122 on the back of the decrease in our LVMH target price to EUR115 (from EUR128)
- ▶ We maintain an Overweight rating and favour Dior over LVMH (remain Neutral on LVMH) since Dior's potential return is 30.7% vs 12.8% for LVMH (based on our target prices)

Still OW Dior in spite of our Neutral rating on LVMH

32% discount to RNAV

Christian Dior is the main holding company for LVMH, controlling 40.9% of the shares and c57% of the voting rights. Besides its stake in LVMH (91% of assets), Dior's only operational entity is the Dior Couture brand (8%). The holding of Christian Dior in LVMH has slightly changed since the dilution linked to the Bulgari deal. Prior to the deal, Christian Dior held a 42.4% stake and c58% of voting rights.

Since the beginning of 2011, Dior shares have lost 23% vs -20% for LVMH shares. Dior's discount to our estimated restated net asset value (RNAV) is thus now 32% (vs 25% on 20 June 2011). Nothing surprising here as conglomerate/holding discounts to RNAV tend to expand during bear market phases and vice versa. In addition, in the light of the recent luxury stocks sell off, it is not abnormal to see Dior suffering from its limited liquidity (compared to that of LVMH).

Having said that, it is worth noting that (i) 32% is close to the historical peak reached on 25 November 2008 (34%), and (ii) the discount only remained above 30% for eight trading days in November 2008.

True, higher levels of discounts were witnessed in the 1995-2005 period, but we would discard them from the analysis since the LVMH control structure was much more complicated and moreover the French tax regime back then (taxation on capital gains) implied a higher level of discount for most French conglomerates.

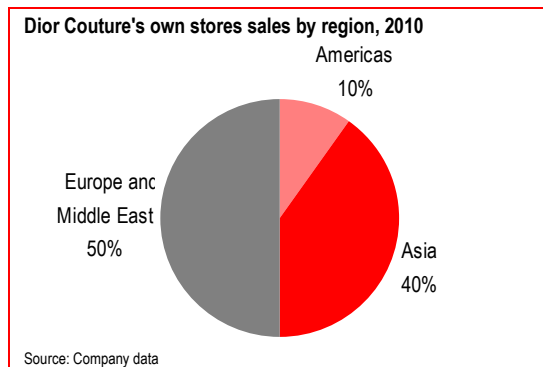
We remain Neutral on LVMH since there is now only a 12.8% potential return to our new EUR115 target price – see our detailed LVMH investment case on page 68.

However, as we base our sum-of-the-parts Dior target price on LVMH reaching the new target price of EUR115 (vs EUR128, previously) and a Dior-targeted discount to RNAV of 20%, our new Dior target price is EUR109 (vs EUR122, previously) – see our detailed assumptions on page 51.

Under our research model, for French stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate of 8.5%. Based on our new target price, Dior shares offer a 30.7% potential return on the current share price. We thus remain Overweight on the stock and favour Dior relative to LVMH as long as investors accept the limited liquidity.

Dior Couture is recovering, but is too small to matter

Dior Couture is recovering but is too small to matter, in our view: organic sales rose 20% in H1 2011 (19% reported) after a 10% increase in 2010. The performance of Dior Couture's own stores (81% of sales in 2010), was striking, posting stellar growth (up 27% organically). Wholesale continued to underperform but Dior's target is to reduce its wholesale footprint (representing 15% of sales in 2010 from 19% in 2009).



Dior Couture's EBIT increased by 100% in H1 2011 EBIT, a 150bp improvement (to 3.6%) thanks to a higher gross margin and a higher proportion of its own stores sales (mainly due to the gross margin improvement).

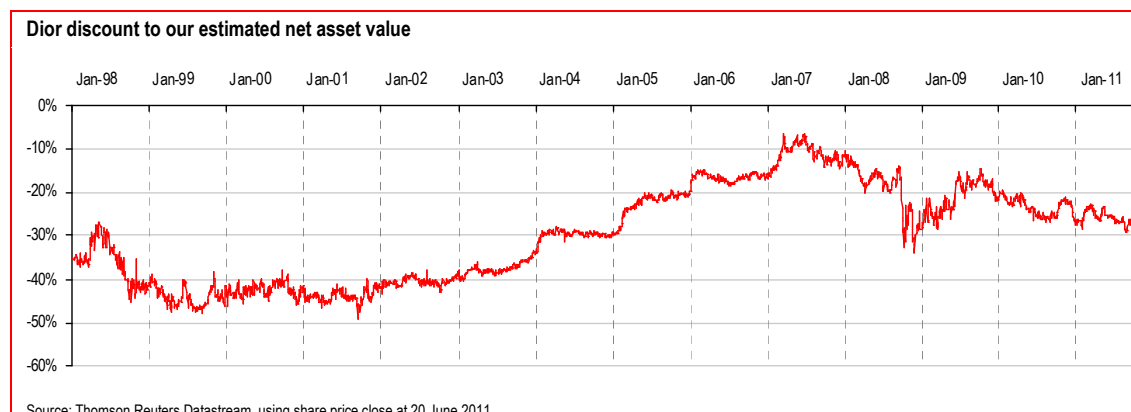
For 2011e, we forecast 12% organic sales growth and a 280bp EBIT margin improvement to 7% on the back of a higher proportion of its own stores sales, higher gross margin (better inventory management) and better SG&A leverage (including improved store productivity). For 2012e, we forecast 6% organic sales growth and a 100bp EBIT margin improvement to 8%.

We consider the value of the Dior Couture brand to be a limited driver, as it is too marginal (only 7% of Dior's RNAV today) relative to Dior's 42.4% stake in LVMH (92% of RNAV).

Risks

The main downside risk to our rating on Dior would be a negative development in LVMH's share price. Another risk would be a change in the market's view of the discount to apply to holding companies.

Since Dior's IPO in 1995, there has been press speculation about a potential streamlining of the current LVMH control structure. In theory, expectations or announcements about such a simplification (eg an LVMH/Dior merger or a Dior minority buy-out) – provided it benefited Dior's minority shareholders – should trigger a sharp narrowing in the company's discount to RNAV. We think this could be a potential upside catalyst for Dior.



Dior Couture sales & EBIT evolution

EURm	1993a	1994a	1995a	1996a	1997a	1998a	1999a	2000a	2001a	2002a	2003a	2004a	2005a	2006a	2007a	2008a	2009a	2010a	2011e	2012e	2013e
Sales	124	137	157	187	200	200	220	296	350	492	523	595	663	731	787	765	717	826	900	963	1,030
EBIT	19	22	24	24	11	-1	9	14	-5	33	40	50	53	56	74	9	13	35	63	77	103
EBIT margin	15.3	16.1	15.1	13.1	5.6	-0.3	3.9	4.7	-1.5	6.7	7.7	8.4	8.0	7.7	9.4	1.2	1.8	4.2	7.0	8.0	10.0
YoY evolution (%)																					
Sales		10	15	19	7	0	10	35	18	41	6	14	11	10	8	-3	-6	15	9	7	7
EBIT		16	8	3	-54	nm	nm	64	nm	nm	21	25	6	6	32	-88	44	nm	80	22	34

Source: company, HSBC estimates

Dior restated net asset value

EURm	% stake	Restated NAV	Method	% of RNAV
LVMH	40.89%	21,187	Share price EUR101.95	90.8%
Dior Couture	100.00%	1,800	2x 2011e sales	7.7%
Property	100.00%	108	9,000m2 at EUR12000/m2	0.5%
Treasury stocks	1.54%	234	Share price EUR83.42	1.0%
Restated NAV		23,329		100%
Parent co.debt		-1,178		
RNAV (EURm)		22,151		
RNAV per share (EUR)		121.90		
Share price		83.42		
Discount (%)		-32%		

Source: HSBC estimates

Dior target price calculation based on HSBC's LVMH target price

EURm	% stake	Restated NAV	Method	% of RNAV
LVMH	40.89%	23,899	HSBC target price EUR115	92%
Dior Couture	100.00%	1,800	2x 2011e sales	7%
Property	100.00%	108	9,000m2 at EUR12000/m2	0%
Treasury stocks	1.54%	234	Share price	1%
Restated NAV		26,041		100%
Parent co.debt		-1,178		
RNAV (EURm)		24,863		
Targeted discount to RNAV (%)		-20%		
HSBC Dior target price (EUR per share)		109		

Source: HSBC estimates

Financials & valuation: Christian Dior

Overweight

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (EURm)				
Revenue	21,123	24,020	26,183	28,170
EBITDA	5,175	6,093	6,625	7,299
Depreciation & amortisation	-837	-892	-950	-1,012
Operating profit/EBIT	4,338	5,201	5,675	6,287
Net interest	566	-315	-230	-150
PBT	4,745	4,743	5,304	5,998
HSBC PBT	4,745	4,743	5,304	5,998
Taxation	-1,476	-1,467	-1,640	-1,855
Net profit	1,261	1,274	1,443	1,644
HSBC net profit	1,261	1,274	1,443	1,645

Cash flow summary (EURm)

Cash flow from operations	4,512	3,796	4,368	4,942
Capex	-1,002	-1,300	-1,400	-1,500
Cash flow from investment	-2,876	-5,600	-1,400	-1,500
Dividends	-362	-416	-479	-551
Change in net debt	-356	1,469	-1,166	-1,439
FCF equity	3,510	2,496	2,968	3,442

Balance sheet summary (EURm)

Intangible fixed assets	17,432	17,432	17,432	17,432
Tangible fixed assets	7,060	7,589	8,171	8,805
Current assets	11,551	12,765	13,676	14,508
Cash & others	2,408	2,408	2,408	2,408
Total assets	41,197	47,407	49,069	50,706
Operating liabilities	5,407	6,106	6,631	7,111
Gross debt	6,846	8,315	7,149	5,710
Net debt	4,438	5,907	4,741	3,302
Shareholders funds	7,703	11,400	13,340	15,528
Invested capital	28,228	29,271	30,240	31,226

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	19.0	13.7	9.0	7.6
EBITDA	22.7	17.7	8.7	10.2
Operating profit	29.3	19.9	9.1	10.8
PBT	71.4	0.0	11.8	13.1
HSBC EPS	81.4	1.0	13.3	14.0

Ratios (%)

Revenue/IC (x)	0.8	0.8	0.9	0.9
ROIC	10.8	12.5	13.2	14.1
ROE	18.1	13.3	11.7	11.4
ROA	7.5	7.9	7.9	8.5
EBITDA margin	24.5	25.4	25.3	25.9
Operating profit margin	20.5	21.7	21.7	22.3
EBITDA/net interest (x)		19.3	28.8	48.7
Net debt/equity	22.7	25.0	18.3	11.6
Net debt/EBITDA (x)	0.9	1.0	0.7	0.5
CF from operations/net debt	101.7	64.3	92.1	149.6

Per share data (EUR)

EPS Rep (fully diluted)	7.06	7.13	8.08	9.21
HSBC EPS (fully diluted)	7.06	7.13	8.08	9.21
DPS	2.11	2.43	2.79	3.21
NAV	43.15	63.86	74.72	86.98

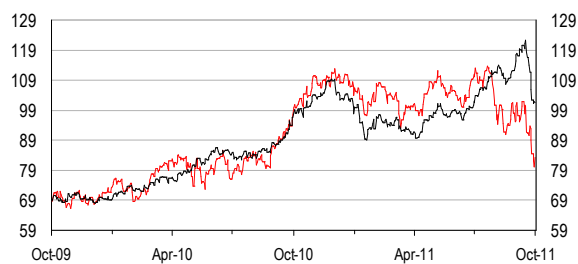
Dior restated net asset value (target price)

EURm	RNAV
LVMH (42.4% stake) @ EUR115 per share	23,899
Dior Couture (2x2010e sales)	1,800
Property (90,000m2 at EUR12,000/m2)	108
Treasury stocks	234
Restated NAV	26,041
Parent co. debt	-1,178
RNAV (EURm)	24,863
Price target Dior	109
Targeted discount (%)	-20%

Issuer information

Share price (EUR)	83.42	Target price (EUR)	109.00	Potentl rtn (%)	30.7
Reuters (Equity)	DIOR.PA	Bloomberg (Equity)	CDI FP		
Market cap (USDm)	20,176	Market cap (EURm)	15,160		
Free float (%)	29	Enterprise value (EURm)	41239		
Country	France	Sector	Textiles, Apparel & Luxury Goods		
Analyst	Antoine Belge	Contact	331 5652 4347		
	Erwan Rambourg	Contact	852 2996 6572		
	Sophie Dargnies	Contact	331 5652 4348		

Price relative



Source: HSBC

Note: price at close of 05 Oct 2011

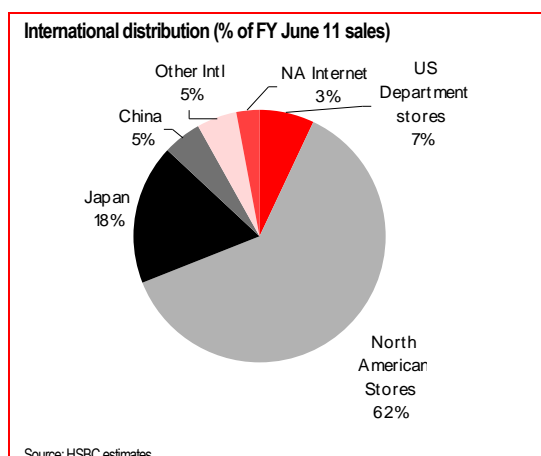
Coach

- ▶ We see Coach's exposure to North America (72% of sales, ie the highest in our universe) as a potential risk
- ▶ Coach's 2nd market (Japan, 18% of sales) is unlikely to be supportive and Asia's love affair with the brand is too young to offer protection in case of a US downturn
- ▶ Remain Neutral, target price lowered to USD59 (from USD67) on higher sector beta and lower US estimates

Highest exposure to the US consumer in our universe

72% exposure to the US consumer

The US has historically been the region for which financial markets slumps and economic downturns have impacted luxury consumption the most. With 72% of sales still in North America, Coach is the stock in our universe the most exposed in case of an economic downturn.



Rather than 'luxury', Coach defines itself as 'affordable luxury'. Indeed, the brand targets the top 20% of the US population (vs probably the top 5% for European luxury brands).

The household income of an average Coach consumer is cUSD100k. Since Q2 ending December 2009, Coach has seen positive North American comps (same store sales growth) with quarterly trends in the 9%-13% range in FY June 2011. Adding up the contribution of new stores, North American sales growth was in the mid-teens throughout the year. Since end 2009, Coach has clearly enjoyed trends relatively similar to its more 'luxury' peers, and thus out-performed broader US consumption trends over the period.

Now that there are fears about the US economic outlook, let's have a look back at what happened in 2008-2009. Well, here again, Coach trends did not differ materially from 'luxury peers': whilst the overall US consumption was already under pressure in calendar 2007 and the first part of 2008, it really took a shock such as the Lehman failure to have the Coach consumer capitulating.

North American comps were negative for four consecutive quarters (-13% in Q2 ending December 2008, -4% in Q3, -6% in Q4 and -1% in Q1 ending Sept 2009). In terms of profitability, we note that Coach's EBIT margin (i) was one of the most affected by the downturn, losing some 600bp to 31%, and (ii) has not recovered since (31.4% in FY June 2011) unlike most peers.

Second largest market Japan unlikely to be supportive

Japan (18% of sales in FY June 11) is Coach's second largest market, which makes the US company one of the most exposed in our universe. Sales were down 7% at constant FX in Q4 ended June 2011. Even if business in Japan is now trending where it was prior to the 11 March Japan disaster (ie slightly positive), we do not expect trends in Japan to be supportive overall for Coach. Coach may continue to gain share (c16% today), but we do not forecast the Japanese sales to grow meaningfully in the next three years.

Asia's love affair with Coach is too young

Looking at growth rates in Asia over the past three years, there is no doubt a love affair between Coach and Asian consumers. The brand's "New York" positioning is unique in China, the accessible luxury positioning will recruit many aspirational consumers, in our view, and the potential for store openings in the 1m+ population cities seems almost limitless (the brand plans to add c60% space this year alone). But, the size of the business is insufficient to offer protection in case of a US downturn.

In FY June 2011, Coach exceeded its guidance for revenues in Greater China (USD185m vs USD100m in FY 2010) which had been raised during the year. The company is targeting to reach USD500m by FY2014, ie a c10% market share vs 6% today). Other Asian markets also look promising, notably Singapore where Coach just acquired operations from its distributor (Malaysia should follow). Vietnam and Brazil will be new markets in FY June 2012.

Earnings, valuation and risks

We have cut our FY2012e and 2013e EPS estimates by 8% and 11% on the back of lower North American comps (we are now forecasting 2.2% in FY12e and 4.3% in FY13e).

We forecast flat gross margin over the next three years, with counter-sourcing helping to offset input cost inflation in China: South America replacing Europe and the US as a purveyor of leather for mixed material product (typically Poppy), assembly shifting slowly out of China (85%) and into Vietnam/India (15%), and tanning (half the cost of finished leather) transferring to Asia.

We lower our DCF-based target price to USD59 (from USD67) on the back of our above-mentioned earnings estimates downgrade and higher WACC (8.33% vs 7.93% as we now use a sector beta of 1.20, instead of 1.10). The assumptions used to generate our DCF-derived target price are detailed on page 55. Under our research model, for US stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate of 7%. Our new target price implies a 10.8% potential return and we therefore maintain our Neutral rating.

On our updated figures, the stock is trading at a 16.6x calendar 2012e PE, a 10% premium to European luxury stocks (vs a 4% discount back in January).

Upside risks to our Coach rating include stronger-than-expected sales growth in North America and greater SG&A leverage than factored into our estimates. Downside risks to our rating include the brand's different positioning in its two channels (full-price retail and outlets), which could pose a threat to its image, potential disruption from non-core projects (Reed Krakoff) and lack of success in entering the European market. Coach does not seem to be in an acquisitive mode so M&A at this stage is not a risk, in our view.

Coach simplified P&L

USDm	FY05/06a	FY06/07a	FY07/08e	FY08/09	1Q10	2Q10	3Q10	4Q10	FY09/10a	1Q11a	2Q11a	3Q11a	4Q11a	FY10/11a	FY11/12e	FY12/13e	FY12/13e
Net sales	2,035	2,612	3,181	3,230	761	1,065	831	950	3,608	912	1,264	951	1,032	4,159	4,430	4,800	5,200
Cost of sales	454	589	774	908	211	294	215	253	974	236	349	259	291	1,135	1,210	1,310	1,419
Gross Profit	1,582	2,023	2,407	2,323	550	771	616	697	2,634	676	915	692	740	3,024	3,220	3,490	3,781
Gross margin	77.7%	77.4%	75.7%	71.9%	72.3%	72.4%	74.1%	73.3%	73.0%	74.2%	72.4%	72.8%	71.8%	72.7%	72.7%	72.7%	72.7%
Selling, G&A	867	1,030	1,228	1,322	327	390	367	400	1,484	391	462	438	428	1,719	1,845	2,010	2,181
SG&A as % of sales	42.6%	39.4%	38.6%	40.9%	42.9%	36.6%	44.1%	42.1%	41.1%	42.8%	36.5%	46.1%	41.5%	41.3%	41.6%	41.9%	41.9%
Operating Income	715	993	1,179	1,000	223	381	249	297	1,150	286	453	254	312	1,305	1,375	1,480	1,600
Operating margin	35.1%	38.0%	37.1%	31.0%	29.3%	35.8%	30.0%	31.3%	31.9%	31.3%	35.9%	26.7%	30.2%	31.4%	31.0%	30.8%	30.8%
Interest income	32.6	41.3	37.1	3.2	-0.6	0.1	0.1	2.2	1.8	-0.6	-0.9	-0.8	-1.4	-3.7	5.0	10.0	15.0
PBT	747	1,035	1,216	1,003	223	381	249	299	1,152	285	452	253	311	1,301	1,380	1,490	1,615
Income taxes	283	398	474	381	82	140	92	104	417	96	149	67	108	420	460	497	537
Tax rate	37.9%	38.5%	39.0%	38.0%	36.7%	36.8%	36.8%	34.6%	36.2%	33.7%	32.9%	26.5%	34.8%	32.3%	33.3%	33.3%	33.2%
Minority interest																	
Net income	464	637	742	622	141	241	158	196	735	189	303	186	202	881	920	993	1,078
Net EPS common (Diluted)	1.19	1.69	2.06	1.91	0.44	0.75	0.50	0.62	2.33	0.63	1.00	0.62	0.68	2.92	3.08	3.32	3.61
Weighted avg com share outst. (D)	388.5	377.4	360.3	325.6	321.1	321.1	314.0	314.0	315.8	301.3	304.7	301.6	298.7	301.6	298.7	298.7	298.7
Net sales	23%	28%	22%	2%	1%	11%	12%	22%	12%	20%	19%	14%	9%	15%	7%	8%	8%
Cost of sales	18%	30%	31%	17%	9%	10%	0%	10%	7%	11%	19%	20%	15%	17%	7%	8%	8%
Gross profit	25%	28%	19%	-4%	-1%	11%	17%	27%	13%	23%	19%	12%	6%	15%	6%	8%	8%
Operating expenses	19%	19%	19%	8%	1%	14%	8%	22%	12%	19%	18%	19%	7%	16%	7%	9%	9%
Income before tax & minority interest	35%	39%	19%	-15%	-4%	9%	34%	35%	15%	28%	19%	2%	5%	13%	5%	8%	8%
Diluted EPS	38%	41%	22%	-7%	0%	12%	40%	47%	22%	43%	33%	23%	9%	25%	5%	8%	9%

Source: Company data, HSBC estimates

Financials & valuation: Coach

Neutral

Financial statements

Year to	06/2011a	06/2012e	06/2013e	06/2014e
Profit & loss summary (USDm)				
Revenue	4,159	4,430	4,800	5,200
EBITDA	1,430	1,513	1,631	1,767
Depreciation & amortisation	-125	-138	-151	-167
Operating profit/EBIT	1,305	1,375	1,480	1,600
Net interest	-4	5	10	15
PBT	1,301	1,380	1,490	1,615
HSBC PBT	1,301	1,380	1,490	1,615
Taxation	-420	-460	-497	-537
Net profit	881	920	993	1,078
HSBC net profit	881	920	993	1,078

Cash flow summary (USDm)

Year to	06/2011a	06/2012e	06/2013e	06/2014e
Cash flow from operations	1,040	1,109	1,191	1,287
Capex	-148	-200	-214	-229
Cash flow from investment	-157	-200	-214	-229
Dividends	-178	-288	-317	-348
Change in net debt	-6	-621	-661	-709
FCF equity	796	813	881	962

Balance sheet summary (USDm)

Year to	06/2011a	06/2012e	06/2013e	06/2014e
Intangible fixed assets	444	444	444	444
Tangible fixed assets	738	801	863	926
Current assets	1,267	1,945	2,667	3,445
Cash & others	702	1,324	1,984	2,694
Total assets	2,635	3,375	4,161	5,001
Operating liabilities	998	1,010	1,023	1,038
Gross debt	23	23	23	23
Net debt	-679	-1,300	-1,961	-2,670
Shareholders funds	1,613	2,341	3,113	3,939
Invested capital	749	856	968	1,084

Ratio, growth and per share analysis

Year to	06/2011a	06/2012e	06/2013e	06/2014e
Y-o-y % change				
Revenue	15.3	6.5	8.4	8.3
EBITDA	12.0	5.8	7.9	8.3
Operating profit	13.5	5.4	7.6	8.1
PBT	13.0	6.1	8.0	8.4
HSBC EPS	25.5	5.5	7.9	8.6

Ratios (%)

Year to	06/2011a	06/2012e	06/2013e	06/2014e
Revenue/IC (x)	5.8	5.5	5.3	5.1
ROIC	122.4	114.3	108.2	104.1
ROE	56.5	46.6	36.4	30.6
ROA	34.5	30.6	26.4	23.5
EBITDA margin	34.4	34.1	34.0	34.0
Operating profit margin	31.4	31.0	30.8	30.8
EBITDA/net interest (x)	386.0			
Net debt/equity	-42.1	-55.5	-63.0	-67.8
Net debt/EBITDA (x)	-0.5	-0.9	-1.2	-1.5
CF from operations/net debt				

Per share data (USD)

Year to	06/2011a	06/2012e	06/2013e	06/2014e
EPS Rep (fully diluted)	2.92	3.08	3.32	3.61
HSBC EPS (fully diluted)	2.92	3.08	3.32	3.61
DPS	0.90	0.99	1.09	1.20
NAV	5.49	8.05	10.71	13.55

DCF analysis

HSBC assumptions	DCF, comprising		
Risk-free rate (%)	3.5	EBIT growth 2011-21e CAGR (%)	6.1
Equity Premium (%)	3.5	EBIT growth 2021-41e CAGR (%)	3.3
Sector beta	1.20	Fading period 2041-46e	
Specific beta	1.15	WACC (%)	8.33

Sensitivity and valuation range

Cost of capital vs fade period	4 years	8 years	12 years
7.3%	65.4	67.2	68.6
7.8%	61.4	62.9	64.2
8.3%	57.7	59.0	60.1
8.8%	54.4	55.5	56.5
9.3%	51.4	52.3	53.2

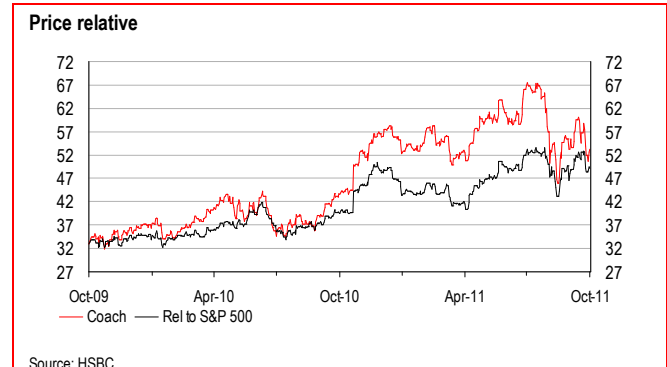
Valuation data

Year to	06/2011a	06/2012e	06/2013e	06/2014e
EV/sales	3.6	3.2	2.8	2.5
EV/EBITDA	10.3	9.4	8.3	7.2
EV/IC	19.7	16.5	13.9	11.8
PE*	18.2	17.3	16.0	14.8
P/NAV	9.7	6.6	5.0	3.9
FCF yield (%)	5.2	5.3	5.7	6.2
Dividend yield (%)	1.7	1.9	2.0	2.2

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (USD)	53.25	Target price (USD)	59.00	Potent'l tot rtn (%)	10.8
Reuters (Equity)	COH.N	Bloomberg (Equity)	COH US		
Market cap (USDm)	15,457	Market cap (USDm)	15,457		
Free float (%)	100	Enterprise value (USDm)	14157		
Country	United States	Sector	Textiles, Apparel & Luxury Goods		
Analyst	Erwan Rambourg	Contact	852 2996 6572		
	Antoine Belge	Contact	331 5652 4347		
	Sophie Dargnies	Contact	331 5652 4348		



Note: price at close of 05 Oct 2011

Hengdeli Holdings Ltd

- ▶ Pure exposure to watches and to Greater China explains why the stock has been in the eye of the equity market storm
- ▶ Chairman's use of shares as collateral for a loan and the Ming Fung deal have put Hengdeli off the radar screen of investors
- ▶ A compelling opportunity as HKD4.20 target price (HKD4.60 previously) offers 80%+ potential return; our rating is OW(V)

Watch this one: the largest de-rating in our coverage by far

Macro fears

At a time when economists and strategists (not ours) are putting out reports on hard landing scenarios in China and others are talking about a clampdown on evidence of wealth disparities, Hengdeli shares have been brutally taken down by macro fears. 1H results released on 23 August confirmed our optimistic stance (see Hengdeli, *Just Can't get enough*, released 4 July 2011) and we believe today that without product scarcity issues, the very strong sales and EBIT growth would have been greater still. Retail sales in the PRC grew 46% y-o-y, at a faster pace than in Hong Kong (+38.5%). On a same-store-sales basis, the PRC grew 38.4%, vs. Hong Kong at 34.4%. We feel average selling price increases contributed 5-7ppt of growth. ASP increases are, we believe, primarily driven by higher tickets (diamonds/gems decorated watches on the rise) and by supply issues (especially affecting higher-end models) which have offered leeway for watch makers to increase retail prices. Wholesale recorded a massive 53.8% increase over six months, in our view due to distributors frontloading ahead of further price increases in 2H.

The latest Swiss watch federation figures (August up 18% for HK, 44% for mainland China), as well as Hong Kong watch and jewellery retail sales (August up 34% in volume terms, 53% in sales) and conversations with industry experts are an indication for us that the July/August/Sept quarter (which Hengdeli does not disclose) will not have seen a dramatically different type of growth rate than in 1H ie probably in the c40% growth region, rather than the 1H 46% level.

What this implies to us is that outlook on sales given by management (+35% over the FY) and even more so our own estimates (+34%) should not be at risk.

Micro issues

Untimely loan announcement

Given the announcement from Chairman Zhang about using his shares in Hengdeli as collateral for a personal loan from the Swatch Group (UHR VX), we understand corporate governance flags have been raised. To recap, on 21 July, Chairman Zhang pledged 300 million of his Hengdeli shares as collateral in return for a 3-year USD100 million personal loan from the Swatch Group. If Zhang defaults on the loan, Swatch's stake in Hengdeli would increase from 9.05% currently to 20.42%.

This loan should not have any impact on Hengdeli's business, in our view. Zhang has specified that neither Hengdeli's management nor its operations will change based on such action and that he has no intention of selling his stake. If anything, we believe the Chairman's action could be a vote of confidence for Hengdeli given Swatch would be willing to take a larger stake in the company.

Ming Fung jewelry venture

On Sept 28, Hengdeli announced it was selling Omas (today high end Italian pen manufacturer started in 1925, tomorrow to develop into jewellery and watches or as Hengdeli management puts it to become a "Chinese Montblanc") for a total consideration of HKD400m. Hengdeli had acquired 90% of Omas from LVMH in 1997. Hengdeli will get in exchange 18.3% of Ming Fung current share capital or 15.5% post allotment and issue of "Consideration Shares".

This announcement is not a surprise as a letter of intent had been issued in May with deadline from exclusive negotiation to terminate on 31 August. If anything it's just coming a bit late, in our view. As explained in our recent report (*No "hard luxury" landing*, 2 Sept 2011), we think this is small but potentially useful as Hengdeli could expand jewellery in part of its existing store base as a complimentary (and more profitable than watch) business.

Earnings, valuation and risks

We have not touched our sales forecast for FY11e (at CNY11.0bn) as we feel that macro fears are mitigated by evidence that the July-Sept period will prove to have been very strong as explained earlier. However, we increase our margin assumptions for the group as we see evidence that China should continue to outperform Hong Kong in H2.

Hengdeli: Store roll-out moderating to focus on SSSG

	1H10	2010	1H11	2011e	2012e	2013e
Total	302	350	378	408	462	529
PRC	252	286	311	331	381	446
HK	15	16	17	19	20	21
Taiwan	35	48	50	58	61	62

Source: Company data, HSBC estimates

This ultimately means that gross margin in 2H11 should improve y-o-y more than we previously forecast (and the group continues to focus on the more profitable brands within its portfolio), meaning an EBIT margin progression should occur again in 2H. In the Mainland, the group will now focus on the smaller cities where rents are still moderate in relative terms and we feel open stores at a more gradual pace than in previous years to make sure same store sales growth is nurtured in the existing store base. We also think staff costs and general and admin costs can be leveraged through a variable wage policy. We still forecast a gradual improvement of the EBIT margin from 10.0% in 2010 to 11.4% in 2013e and we increase our EBIT estimates by 5% in 2011e and 1% in 2012e.

Valuation

We lower our DCF-based target price to HKD4.20 target price (previously HKD4.60), offering a substantial 86.7% potential return to Hengdeli's current price. This is above the 0-20% Neutral band for volatile Chinese stocks under HSBC's research model. Hengdeli remains OW(V) and the highest potential return stock in our coverage. The lowering of our target price reflects the change in the sector beta we use (1.20 vs 1.10 previously) leading to a WACC of 10.3% in our DCF (vs. 9.7% previously) despite an increase in our estimates.

At the current price, and on our EPS estimates, Hengdeli is trading at 9.2x 12e earnings. On our target price, the stock would be trading at 17.2x 12e earnings for 24% EPS growth that year.

Risks

Downside risks to our thesis include execution risk in managing the store expansion plans, higher-than-expected rent and staff cost inflation, and any macro threat in China affecting watch sales (or making investors think that watch sales are at risk). M&A activity (e.g. buyout of retail stores, further investment in Ming Fung) could well be negatively viewed by the market as well.

We do not believe that any change in the luxury tax rates in China could affect the investment case. Finally, we think Hengdeli is relatively protected from a risk of product scarcity, as it enjoys good relationship with suppliers such as LVMH and Swatch group and slower sales in the West should ensure better access to product.

Hengdeli - P&L Statement

Year to Dec (RMBm)	2009	1H10	2H10	2010	1H11	2H11e	2011e	2012e	2013e
Total number of stores	270	302	350	350	380	408	408	462	529
PRC retail (RMBm)	2,722	1,774	1,996	3,770	2,596	2,491	5,087	6,311	7,689
- No. of stores	224	252	286	286	311	331	331	381	446
same-store sales growth	12%	34.1%	14.7%	23.8%	38.4%	12%	26%	15%	12%
% change yoy	17%	40%	37%	38%	46%	25%	35%	24%	22%
HK retail (RMBm)	1,705	1,046	1,366	2,412	1,449	1,717	3,166	3,646	4,193
- No. of stores	13	15	16	16	16	19	19	20	21
same-store sales growth	-37%		12%	12%	34.4%	8%	20%	12%	12%
% change yoy	20%	45%	33%	41%	39%	26%	31%	15%	15%
Taiwan retail (RMBm)	8	68	125	193	103	168	271	328	382
- No. of stores	33	35	48	48	50	8	58	61	62
same-store sales growth			0%	0%		45%	28%	18%	15%
% change yoy				0%	51%	35%	41%	21%	16%
Retailing (RMBm)	4,428	2,888	3,487	6,375	4,148	4,376	8,524	10,285	12,263
y/y		44.4%	41%	44%	44%	26%	34%	21%	19%
same-store sales growth		37.6%		0%	36%	12%	24%	14%	12%
Wholesale (RMBm)	1,330	751	910	1,661	1,156	1,087	2,243	2,725	3,133
y/y	-19%	10%	40%	25%	54%	15%	35%	22%	15%
Others	134	75.6	104	180	104	130	234	290	354
After-sales (RMBm)	-6%	22%	45%	34%	37.1%	24.9%	30.0%	24%	22%
Sales (RMBm)	5,892	3,715	4,501	8,216	5,407	5,593	11,000	13,300	15,750
y/y	6.8%	37.8%	40.8%	39.4%	45.6%	24.3%	33.9%	20.9%	18.4%
Gr profit (RMBm)	1,401	915	1,134	2,049	1,392	1,461	2,853	3,507	4,199
GP margin	23.8%	24.6%	25.2%	24.9%	25.7%	26.1%	25.9%	26.4%	26.7%
bp change	-35.4	-0.8	213.2	115.6	112.9	91.1	99.5	43.1	29.6
EBIT	578	387	432	819	643	546	1,189	1,482	1,802
y/y	6.2%	28.2%	-	41.6%	66.3%	26.5%	45.3%	24.6%	21.6%
EBIT margin	9.8%	10.4%	9.6%	10.0%	11.9%	9.8%	10.8%	11.1%	11.4%
Pre-tax profit	513	425	391	816	647	512	1,159	1,451	1,776
y/y	-14.0%	45.7%	76.1%	58.9%	52.4%	30.9%	42.1%	25.2%	22.4%
Tax	-128	-95	-103	-198	-147	-137	-284	-363	-444
Eff tax rate (excl CB loss)	24.9%	22.4%	26.4%	24.3%	22.7%	26.8%	24.5%	25.0%	25.0%
Minorities	-21	-25	-39	-63	-52	-29	-81	-102	-124
Net profit/(Loss) - report	364	305	249	554	448	346	794	987	1,208
y/y	-16.8%	39.3%	71.1%	52.0%	46.8%	39.0%	43.3%	24.3%	22.4%
Net margin	6.2%	8.2%	5.5%	6.7%	8.3%	6.2%	7.2%	7.4%	7.7%

Source: Company data, HSBC estimates

Financials & valuation: Hengdeli Holdings Ltd

Overweight (V)

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (CNYm)				
Revenue	8,216	11,000	13,300	15,750
EBITDA	872	1,263	1,571	1,907
Depreciation & amortisation	-53	-74	-89	-105
Operating profit/EBIT	819	1,189	1,482	1,802
Net interest	-37	-1	5	11
PBT	816	1,159	1,451	1,776
HSBC PBT	816	1,159	1,451	1,776
Taxation	-198	-284	-363	-444
Net profit	554	794	987	1,208
HSBC net profit	554	794	987	1,208

Cash flow summary (CNYm)

Cash flow from operations	-216	224	460	838
Capex	-350	-170	-149	-148
Cash flow from investment	-584	-159	-149	-148
Dividends	-110	-166	-238	-296
Change in net debt	-15	-28	-44	-328
FCF equity	-846	56	340	695

Balance sheet summary (CNYm)

Intangible fixed assets	304	304	304	304
Tangible fixed assets	905	1,075	1,012	1,162
Current assets	7,623	8,939	9,962	11,190
Cash & others	3,410	3,656	3,700	4,028
Total assets	8,938	10,424	11,394	12,784
Operating liabilities	1,011	1,447	1,775	2,119
Gross debt	3,403	3,621	3,621	3,621
Net debt	-7	-35	-79	-408
Shareholders funds	4,316	4,946	5,695	6,607
Invested capital	4,410	5,216	5,802	6,507

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	39.3	33.9	20.9	18.4
EBITDA	40.2	44.8	24.4	21.4
Operating profit	41.6	45.3	24.6	21.6
PBT	58.9	42.1	25.2	22.4
HSBC EPS	26.5	36.8	24.3	22.4
Ratios (%)				
Revenue/IC (x)	2.2	2.3	2.4	2.6
ROIC	16.6	18.7	20.2	22.0
ROE	15.4	17.1	18.5	19.6
ROA	9.4	9.5	10.3	11.4
EBITDA margin	10.6	11.5	11.8	12.1
Operating profit margin	10.0	10.8	11.1	11.4
EBITDA/net interest (x)	23.3	1096.4		
Net debt/equity	-0.2	-0.7	-1.3	-5.6
Net debt/EBITDA (x)	0.0	0.0	-0.1	-0.2
CF from operations/net debt				

Per share data (CNY)

EPS Rep (fully diluted)	0.12	0.18	0.20	0.25
HSBC EPS (fully diluted)	0.12	0.16	0.20	0.25
DPS	0.04	0.05	0.07	0.08
NAV	1.03	1.12	1.30	1.50

DCF analysis

HSBC assumptions	DCF, comprising		
Risk-free rate (%)	3.50	EBIT growth 09-19e CAGR (%)	13.1
Equity Premium (%)	6.50	EBIT growth 19-39e CAGR (%)	3.0
Sector beta	1.20	Fading period 2039-45e	
Specific beta	1.40	WACC (%)	10.28

Valuation data

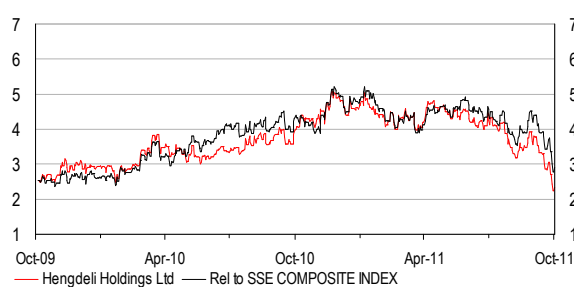
Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	1.0	0.8	0.6	0.5
EV/EBITDA	9.6	6.7	5.4	4.3
EV/IC	1.9	1.6	1.5	1.3
PE*	15.6	11.4	9.2	7.5
P/NAV	1.8	1.6	1.4	1.2
FCF yield (%)	-10.1	0.7	4.0	8.0
Dividend yield (%)	2.2	2.9	3.7	4.5

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (HKD)	2.25	Target price (HKD)	4.20	Potent'l tot rtn (%)	86.7
Reuters (Equity)	3389.HK	Bloomberg (Equity)	3389 HK		
Market cap (USDm)	1,271	Market cap (HKDm)	9,896		
Free float (%)	45	Enterprise value (CNYm)	8431		
Country	China	Sector	Distributors		
Analyst	Erwan Rambourg	Contact	852 2996 6572		
	Antoine Belge	Contact	331 5652 4347		
	Erwan Rambourg	Contact	852 2996 6572		

Price relative



Source: HSBC

Note: price at close of 05 Oct 2011

Hermès

- ▶ We expect Hermès to remain one of the fastest-growing companies (even more in a challenging environment) thanks to its distinctive positioning
- ▶ Technical effects (limited free float and grants of shares to employees) should put a support on shares (+43% YTD)
- ▶ We believe the very few investors who still own Hermès shares (less than 6% free float) should hold on to them. We remain Neutral and increase our target price to EUR240 (from EUR200)

Hold on to them (if you still have some)

Should be one of the best-in-class thanks to its distinctive positioning

Hermès was one of the first luxury companies to speak to the market after the market slump (H1 results publication on 31 August 2011). Two things were striking: (i) the group posted strong sales growth (+21% organically) and a record-high EBIT margin (up 270bp to 32%) in H1 2011, (ii) management mentioned that sales trends indeed slowed down in July-August due to capacity constraints, but that underlying demand remained as strong as in H1.

Following the financial turmoil, we feel that investors may either believe in a completely negative scenario or believe (as we do) that the US and Europe may slowdown but Asia may continue to boom. In one or the other scenario, we feel that Hermès may be one of the best-in-class in our luxury coverage. Indeed, even in 2009, Hermès was able to report a 3% increase in EBIT thanks to its distinctive positioning.

In terms of organic sales growth, the group registered only one quarter of negative trends during the 2008-2009 crisis: organic sales growth in Q1 09 was down 5% (due to third party distribution destocking) but own stores sales growth was still positive (+6%).

Technical effects should continue to support shares

Speculation supporting shares (+43% y-t-d)

End 2010, LVMH announced it had taken a 20.2% stake in Hermès International, then on 26 July, the group announced it had increased that stake to 21.4%.

After LVMH became the second main shareholder (after family heirs), Hermès' shares performance was supported by press speculation that LVMH would make a bid for Hermès. On 9 June 2011, *The Daily Mail* speculated that 'LVMH was preparing a 350 euros-a-share offer for Hermès'. Although LVMH denied the story the day after ('The LVMH group has absolutely no intention of making a bid for Hermès'), Hermès' stock price was the only luxury stock to continue to rise during the market slump (+11% in Q3 vs -23% for European luxury on average).

Hermès' stock was thus the best performer in our luxury coverage since the beginning of 2011 (+43% YTD vs -4%).

On 15 September 2011, France's AMF stock market regulator announced they granted the Hermès family a special exemption from rules forcing it to make a public takeover offer for the whole company. Hermès' family will thus create a new holding company, which will own 50.2% of the total shares and will have preference rights on the remaining stock owned by the family members (12.6% of the stock) who signed the pact. Only 20 people who owned c10% of the stock have decided against being part of this pact.

A shares grant program

Year-to-date, Hermès has bought 1.2m of its own shares for an amount of EUR273m in order to cover grants of shares to employees. The group needs to buy shares to continue to cover those grants. Hermès may do so only when the share price is below the EUR250 AGM authorisation, but this factor should in our view support the shares (especially since free float is now less than 6%). We believe that at some point the AGM will raise the EUR250 ceiling.

Earnings, valuation and risks

On 31 August 2011, Hermès reiterated FY11 sales and EBIT margin guidance. Management expects organic sales growth between 12% and 14% and EBIT margin 'close to the record-high' achieved in 2010 (ie 27.8%). True, H2 will be impacted by: (i) a problem of production capacity (as the level of inventories is low in Hermès' own stores); (ii) communication costs could strongly increase in H2 (cEUR90m in H2 vs EUR56m in H1); (iii) the group will reinforce its production team; (iv) raw material costs increases; and (v) negative FX impact. Even taking into account all those factors, we believe that this sales growth and EBIT margin guidance is conservative in the light of the strong improvement of the H1 results.

We increase our 2011e-13e EBIT estimates by 4%, 4% and 7%, respectively. For 2011e, we expect 17% organic sales growth and a 120bp improvement EBIT margin to 29%.

For 2012e and 2013e, we forecast organic sales growth of 12% and 12%, respectively and EBIT margin of 29.7% and 30.4%.

Since March 2009, we have believed Hermès should trade structurally at a premium to its DCF value (and as a result we apply a 25% premium). For many years, Hermès' stock has been supported by the limited free float, takeover speculation and the potential for short squeezes.

On a fundamental DCF valuation, we value Hermès at EUR192 (up from EUR160) on the back of our earnings estimate increases and a lower WACC assumption (5.30% vs 6.25% as we are now using a 1.20 sector beta instead of 1.10, but using a 0.30 specific beta instead of 0.50 to reflect the above-mentioned supportive technical factors).

Applying a 25% premium to this fundamental valuation, we derive a EUR240 target price (up from EUR200). A full breakdown of our DCF assumptions is provided in the financials and valuation on page 63. Under our research model, for Europe ex-UK stocks without a volatility indicator, the Neutral band is 5% percentage points above and below the hurdle rate of 8.5%. As our target price implies a 9.1% potential return, within the range of 3.5-13.5%, we remain Neutral.

Although the 37.3x 2012e PE multiple still seems very high relative to peers, we believe the very few investors who still own Hermès free float (less than 6%) should hold on to them. Upside risks include a disposal of the family's controlling stake to the second main shareholder at a high multiple. But as explained previously, we believe this risk is quite limited in the foreseeable future as Hermès will create a holding company. On the downside, the top line may suffer more than expected if the company loses share to other high-end leather-goods manufacturers.

Hermès FY results and forecasts

EURm	2004a	YoY (%)	2005a	YoY (%)	2006a	YoY (%)	2007a	YoY (%)	2008a	YoY (%)	2009a	YoY (%)	2010a	YoY (%)	2011e	YoY (%)	2012e	YoY (%)	2013e	YoY (%)
Sales	1,332	8	1,427	7	1,515	6	1,625	7	1,765	9	1,914	8	2,401	25	2,760	15	3,082	12	3,456	12
Gross profit	868	8	929	7	990	7	1,055	7	1,140	8	1,213	6	1,586	31	1,879	19	2,102	12	2,360	12
Gross margin (%)	65.2%		65.1%		65.4%		64.9%		64.6%		63.3%		66.1%		68.1%		68.2%		68.3%	
Communication	71	27	76	7	90	18	93	3	98	5	91	-7	126	38	150	19	150	0	150	0
as a % of sales	5.3%		5.3%		5.9%		5.7%		5.5%		4.8%		5.2%		5.4%		4.9%		4.3%	
Other operating costs	440	6	469	7	499	6	547	10	593	8	658	11	792	20	928	17	1037	12	1160	12
EBIT	357	7	384	7	401	5	415	3	449	8	463	3	668	44	801	20	915	14	1050	15
EBIT margin	26.8		26.9		26.5		25.5		25.5		24.2		27.8		29.0		29.7		30.4	
Financial income	8		4		0		12		18		-13		-13		26		19		23	
Pre-tax profit	344	1	388	13	409	6	438	7	455	4	444	-3	653	47	822	26	934	14	1073	15
Net profit	214	-1	247	16	268	9	288	7	290	1	289	0	422	46	550	30	623	13	717	15
HSBC EPS (EUR)	2.07	3	2.26	10	2.50	11	2.71	8	2.76	2	2.74	-0.5	4.00	46	5.21	30	5.90	13	6.79	15

Source: HSBC estimates, Company

Hermès sales by geographic and product category

EURm	2004a	YoY (%)	2005a	YoY (%)	2006a	YoY (%)	2007a	YoY (%)	2008a	YoY (%)	2009e	YoY (%)	2010e	YoY (%)	2011e	YoY (%)	2012e	YoY (%)	2013e	YoY (%)
By product																				
Silk	150	6%	163	9%	174	6%	193	11%	208	8%	227	9%	284	25%	341	20%	391	15%	438	12%
Handbags & Travel	529	13%	568	7%	664	17%	675	2%	763	13%	936	23%	1,205	29%	1,340	11%	1,511	13%	1,723	14%
RTW & accessories	273	2%	294	8%	294	0%	315	7%	337	7%	360	7%	445	24%	554	24%	636	15%	712	12%
Other activities	134	12%	141	6%	77	-45%	86	11%	80	-6%	78	-2%	87	11%	97	12%	106	9%	114	8%
Perfume	65	20%	73	13%	101	38%	119	18%	125	5%	117	-6%	138	17%	149	8%	150	1%	160	6%
Watches	100	0%	104	4%	110	6%	105	-5%	95	-10%	87	-8%	113	30%	131	16%	140	7%	154	10%
Tableware	35	3%	37	6%	45	21%	51	14%	48	-6%	38	-20%	44	14%	49	12%	49	0%	51	5%
Other products	47	-2%	48	1%	52	8%	82	60%	109	33%	71	-35%	86	21%	99	15%	99	0%	104	5%
Total	1,332		1,427		1,515		1,625		1,765		1,914		2,401		2,760		3,082		3,456	
By geographic																				
France	256	3%	269	5%	290	8%	327	13%	359	10%	370	3%	437	18%	512	17%	573	12%	641	12%
Europe	222	9%	243	9%	280	15%	346	24%	382	10%	385	1%	463	20%	546	18%	607	11%	662	9%
Total Europe	479	6%	512	7%	570	11%	673	18%	741	10%	756	2%	901	19%	1,057	17%	1,180	12%	1,303	10%
Japan	398	7%	415	4%	410	-1%	382	-7%	393	3%	408	4%	453	11%	466	3%	485	4%	489	1%
Asia	217	14%	245	13%	261	6%	282	8%	321	14%	423	32%	631	49%	759	20%	915	21%	1,099	20%
Total Asia	616	9%	660	7%	671	2%	664	-1%	713	7%	831	16%	1,084	30%	1,226	13%	1,400	14%	1,588	13%
America	197	11%	216	10%	232	8%	246	6%	265	8%	294	11%	385	31%	439	14%	462	5%	522	13%
Rest of the world	41	8%	39	-4%	42	8%	43	1%	46	7%	34	-25%	31	-8%	38	20%	40	5%	43	8%
Total	1,332		1,427		1,515		1,625		1,765		1,914		2,401		2,760		3,082		3,456	

Source: HSBC estimates, Company

Financials & valuation: Hermès

Neutral

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (EURm)				
Revenue	2,401	2,760	3,082	3,456
EBITDA	790	930	1,052	1,196
Depreciation & amortisation	-121	-129	-137	-146
Operating profit/EBIT	668	801	915	1,050
Net interest	-13	26	19	23
PBT	653	822	934	1,073
HSBC PBT	653	822	934	1,073
Taxation	-221	-260	-299	-343
Net profit	422	550	623	717
HSBC net profit	422	550	623	717

Cash flow summary (EURm)

Cash flow from operations	655	618	724	825
Capex	-138	-210	-235	-263
Cash flow from investment	-138	-210	-235	-263
Dividends	-119	-120	-206	-234
Change in net debt	-321	-313	-303	-350
FCF equity	477	433	508	584

Balance sheet summary (EURm)

Intangible fixed assets	112	112	112	112
Tangible fixed assets	774	855	953	1,070
Current assets	1,564	1,952	2,301	2,697
Cash & others	844	1,152	1,454	1,804
Total assets	2,918	3,388	3,835	4,348
Operating liabilities	697	725	744	760
Gross debt	44	44	44	44
Net debt	-828	-1,142	-1,445	-1,795
Shareholders funds	2,150	2,581	2,997	3,480
Invested capital	909	1,042	1,169	1,315

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	25.4	15.0	11.7	12.1
EBITDA	42.4	17.8	13.1	13.7
Operating profit	44.4	19.9	14.2	14.8
PBT	47.1	25.9	13.7	14.9
HSBC EPS	45.7	30.3	13.2	15.0

Ratios (%)

Revenue/IC (x)	2.6	2.8	2.8	2.8
ROIC	47.5	56.1	56.3	57.5
ROE	21.4	23.3	22.3	22.1
ROA	16.1	17.8	17.6	17.8
EBITDA margin	32.9	33.7	34.1	34.6
Operating profit margin	27.8	29.0	29.7	30.4
EBITDA/net interest (x)	63.2			
Net debt/equity	-38.3	-43.8	-47.6	-50.9
Net debt/EBITDA (x)	-1.0	-1.2	-1.4	-1.5
CF from operations/net debt				

Per share data (EUR)

EPS Rep (fully diluted)	4.00	5.21	5.90	6.79
HSBC EPS (fully diluted)	4.00	5.21	5.90	6.79
DPS	1.50	1.95	2.21	2.55
NAV	20.09	24.11	28.00	32.52

DCF analysis

HSBC assumptions	DCF, comprising		
Risk-free rate (%)	3.50	EBIT growth 2011-21e CAGR (%)	13.6
Equity Premium (%)	5.00	EBIT growth 2021-41e CAGR (%)	4.4
Sector beta	1.20	Fading period 2041-47e	
Specific beta	0.30	WACC (%)	5.30

Sensitivity and valuation range (DCF) to which we then add a 25% premium to derive our target price (EUR240 per share)

Cost of capital vs fade period	4 years	8 years	12 years
4.9%	196.2	205.9	214.4
5.1%	189.7	198.8	207.0
5.3%	183.6	192.0	199.9
5.5%	177.8	185.6	193.2
5.7%	172.2	179.5	186.9

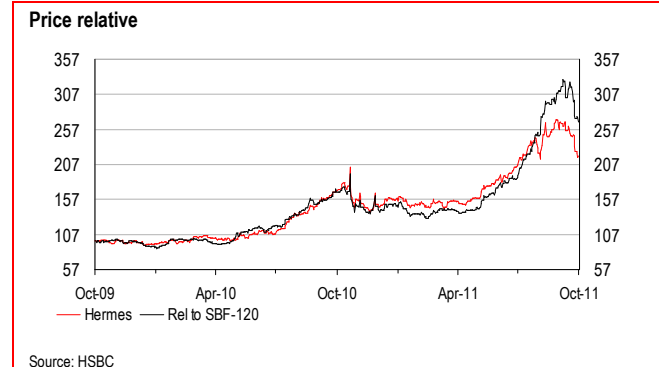
Valuation data

Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	9.1	7.8	6.9	6.1
EV/EBITDA	27.8	23.2	20.3	17.5
EV/IC	24.1	20.7	18.2	15.9
PE*	55.0	42.2	37.3	32.4
P/NAV	11.0	9.1	7.9	6.8
FCF yield (%)	2.1	1.9	2.2	2.6
Dividend yield (%)	0.7	0.9	1.0	1.2

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (EUR)	220.00	Target price (EUR)	240.00	Potent'l rtn (%)	9.1
Reuters (Equity)	HRMS.PA	Bloomberg (Equity)		RMS FP	
Market cap (USDm)	30,911	Market cap (EURm)		23,225	
Free float (%)	6	Enterprise value (EURm)		21615	
Country	France	Sector	Textiles, Apparel & Luxury Goods		
Analyst	Antoine Belge	Contact	33 1 5652 4347		
	Erwan Rambourg	Contact	852 2996 6572		
	Sophie Dargnies	Contact	331 5652 4348		



Note: price at close of 05 Oct 2011

Luxottica

- ▶ Unfavourable geographic mix: North America still accounts for 60% of sales whilst EM is only 7%
- ▶ “Last time around” not supportive: whilst it took the Lehman collapse to bring down the ‘true’ US luxury consumer in September 2008, Luxottica’s US retail business slowed down as from Q1 2007
- ▶ Remain Underweight, DCF target price lowered to EUR19.50 (from EUR21) on lower estimates and higher sector beta

Unfavourable geographic mix

North America still accounts for 60% of sales whilst EM is only 7%

With North America still accounting for 60% of total sales in 2010, Luxottica is the European company in our universe the most exposed to the region of the world in which consumption of premium products has historically been the most impacted by financial markets slumps and economic downturns. On 6 September 2011, HSBC economists downgraded their forecast for US GDP from 2.5% to 1.6% for 2011 and from 2.9% to 1.7% for 2012.

At Luxottica, in spite of a 26% five-year CAGR, EM accounted for only 7% of sales (15% in Wholesale, c5% in Retail) in 2010, compared to more than 50% for Richemont and Swatch.

North American retail vulnerable, in our view

US sales of European ‘pure’ luxury companies increased 16% on average in 2007 and continued to grow at a double-digit pace in 2008 until the Lehman collapse in September. But for Luxottica’s Retail division (for which North America accounted for c90% of sales then, c85% in 2010), the slowdown occurred as early as Q1 2007.

We believe US consumers who buy eyewear products at Lenscrafters, Sunglass Hut, Pearle Vision, Sears and Target may once again prove less resilient than ‘true’ luxury consumers (notably by postponing purchases, trading down and spending less on the second pair – a key driver of store profitability).

Analysing Q2 2011, we already saw signs of slowdowns in North America, especially within Luxottica’s network of lower-end stores: Pearle Vision comps slowed from 4.4% in Q1 to 0.3% in Q2, whilst Licensed brands comps moved into negative territory in Q2 (-4.3%) after a small rise (+0.5%) in Q1; if trends remained positive at Target, they were weak at Sears. At the higher end of the spectrum, Lenscrafters trends also slowed down sequentially (from 7.1% in Q1 to 5.7% in Q2), but remained robust. At Sunglass Hut, US comps remained strong (9.7% vs 10.5%).

It is worth noting that the slight recovery seen in optical comps in Australia/NZ since the beginning of 2011 (+1.8% in Q2 vs +0.4% in Q1 after -10% in 2010) could be short-lived if economic conditions deteriorate in that part of the world.

Comps in Greater China stores accelerated from mid-teens in Q1 2011 to 'significantly more than 20%' in 2012. We believe these trends can be sustained, but Greater China only accounts for c3% of Retail sales.

We are forecasting total Retail comps of 1% for 2012e and 3% for 2013e (after +4.4% in 2011e). In terms of EBIT margin, Q1 (+10bp) and Q2 (-50bp) both came in below our expectations, in spite of a favourable basis of comparison (indeed the Australia/NZ slump significantly impacted margins throughout last year). We forecast Retail margins to be only up 10bp to 12% in 2011e (with the reduction of operating losses in Greater China to EUR9m in 2010 offsetting margin deterioration elsewhere) and to improve 30bp in both 2012e and 2013e.

The geographic sales mix of the Luxottica Wholesale division is less favourable than for luxury pure plays: more American (22% of sales vs 16% on average for pure plays) and slightly more European (46% vs 42%) and thus less exposed to the growing parts of Asia. We therefore forecast Wholesale sales to slow from 12.5% (organic) in H1 2011 to 9% in Q3 and then 6% in Q4 (putting the FY2011 advance at 10%). We forecast 4.5% organic sales growth in 2012, with 2% in Western Europe, -2% in North America, 18% in EM and 9% in ROW. The EBIT margin evolution in the Wholesale division has been the bright spot at Luxottica: +250bp in 2010, +140bp in Q1 2011 and +270bp in Q2 2011.

For this division, which has historically shown a high operating leverage, we forecast less spectacular developments for H2 2011 onwards as organic growth slows.

Earnings, valuation and risks

We have raised our 2011 EPS estimates by 1% on the back of a more favourable EUR/USD assumption (EUR/USD=1.40 instead of 1.45) and lowered our 2012-13 EPS estimates by 1% and 3% on lower Wholesale sales. Luxottica is trading at 16.0x 2012e PE, which we believe is not supportive given the company's risk profile.

We lower our DCF-based target price to EUR19.50 from EUR21 on the back of our lower estimates and higher sector beta (1.20 vs 1.10 previously). The assumptions used in our DCF-derived target price are detailed on page 67. Under our research model, for Italian stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate of 8.5%. Our target price implies a 0.5% potential return; as this is below the Neutral band of 3.5-13.5%, we remain Underweight on Luxottica.

Upside risks to our rating include a better-than-expected resilience of the group's North American business, a faster-than-expected development in EM, a USD/EUR strengthening, value-enhancing acquisitions and new license deals. On the latter, we note that competitor Safilo recently stated that Luxottica was actively bidding for its Armani license up for renewal in 2012.

Luxottica: Retail comps

	Q1	Q2	Q3	Q4
2002	0.0%	-2.7%	1.9%	-1.5%
2003	-3.0%	-3.4%	0.0%	2.9%
2004	4.4%	4.2%	4.0%	4.2%
2005	3.6%	8.3%	5.3%	4.9%
2006	8.3%	6.4%	6.0%	5.7%
2007	1.6%	1.5%	2.9%	-1.7%
2008	-3.0%	-2.8%	-5.6%	-10.3%
2009	-5.0%	-7.5%	-2.4%	-1.7%
2010	3.5%	3.7%	5.5%	5.5%
2011	5.8%	5.4%	4.0% (e)	2.5% (e)

Source: company, HSBC estimates for Q3 and Q4 2011

Luxtottica P&L summary

EURm	2005a	2006a	2007a	2008a**	2009a	2010a	2011e	2012e	2013e	06vs05	07vs06	08vs07	09vs08	10vs09	11vs10	12vs11	13vs12
Wholesale	1,311	1,715	1,993	2,092	1,955	2,236	2,431	2,540	2,698	31%	16%	5%	-7%	14%	9%	4%	6%
Retail	3,062	3,294	3,234	3,109	3,139	3,562	3,687	3,891	4,105	8%	-2%	-4%	1%	13%	4%	6%	5%
Inter-Segments	-238	-333	-348							40%	4%	-100%					
Oakley			88														
Total sales	4,135	4,676	4,967	5,202	5,094	5,798	6,118	6,432	6,803	13%	6%	5%	-2%	14%	6%	5%	6%
Wholesale	304	446	528	440	356	462	546	583	637	46%	18%	-17%	-19%	30%	18%	7%	9%
Retail	355	431	362	431	367	424	442	479	518	21%	-16%	19%	-15%	15%	4%	8%	8%
Inter-Segments	-78	-121	-60	-121	-140	-174	-169	-177	-186	55%	-50%	101%	16%	25%	-3%	5%	5%
Oakley EBIT			3														
Total EBIT	581	756	833	750	583	712	820	885	970	30%	10%	-10%	-22%	22%	15%	8%	10%
Wholesale	23.2%	26.0%	26.5%	21.0%	18.2%	20.7%	22.5%	23.0%	23.6%								
Retail	11.6%	13.1%	11.2%	13.8%	11.7%	11.9%	12.0%	12.3%	12.6%								
Total EBIT margin	14.1%	16.2%	16.8%	14.4%	11.4%	12.3%	13.4%	13.8%	14.3%								
Reported diluted EPS (EUR)	0.73	0.94	1.07	0.83	0.69	0.83	1.00	1.10	1.24	29%	14%	-23%	-17%	21%	21%	10%	12%
HSBC diluted EPS* (EUR)	0.73	0.94	1.10	0.96	0.80	0.99	1.12	1.21	1.35	29%	17%	-13%	-17%	23%	13%	9%	11%
Retail comps (worldwide)	5.5%	6.7%	1.2%	-5.4%	-4.2%	4.5%	4.4%	1.0%	3.0%								

*Excluding Exceptional items and trademark amortisation
** Change in sales & EBIT breakdown methodology
Source: Company data, HSBC estimates

Financials & valuation: Luxottica

Underweight

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (EURm)				
Revenue	5,798	6,118	6,432	6,803
EBITDA	1,034	1,122	1,202	1,303
Depreciation & amortisation	-322	-302	-317	-333
Operating profit/EBIT	712	820	885	970
Net interest	-98	-99	-100	-87
PBT	606	716	785	883
HSBC PBT	606	716	785	883
Taxation	-218	-246	-270	-304
Net profit	382	463	507	570
HSBC net profit	454	515	559	622

Cash flow summary (EURm)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Cash flow from operations	853	715	786	864
Capex	-230	-300	-318	-337
Cash flow from investment	-357	-437	-318	-337
Dividends	-161	-202	-230	-252
Change in net debt	-228	-85	-246	-282
FCF equity	591	420	468	527

Balance sheet summary (EURm)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Intangible fixed assets	4,045	4,045	4,045	4,045
Tangible fixed assets	1,742	1,876	1,877	1,881
Current assets	2,051	2,150	2,231	2,317
Cash & others	680	680	680	680
Total assets	7,994	8,228	8,310	8,399
Operating liabilities	1,446	1,505	1,556	1,609
Gross debt	2,791	2,706	2,460	2,178
Net debt	2,111	2,026	1,780	1,499
Shareholders funds	3,269	3,530	3,807	4,125
Invested capital	5,712	5,888	5,918	5,954

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	13.8	5.5	5.1	5.8
EBITDA	19.0	8.5	7.1	8.4
Operating profit	22.1	15.1	7.9	9.6
PBT	22.5	18.2	9.6	12.5
HSBC EPS	23.2	13.1	8.6	11.3

Ratios (%)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Revenue/IC (x)	1.1	1.1	1.1	1.1
ROIC	8.3	9.3	9.8	10.7
ROE	15.0	15.1	15.2	15.7
ROA	6.0	6.7	7.0	7.6
EBITDA margin	17.8	18.3	18.7	19.2
Operating profit margin	12.3	13.4	13.8	14.3
EBITDA/net interest (x)	10.5	11.3	12.0	15.0
Net debt/equity	63.5	56.5	46.1	35.8
Net debt/EBITDA (x)	2.0	1.8	1.5	1.2
CF from operations/net debt	40.4	35.3	44.2	57.6

Per share data (EUR)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
EPS Rep (fully diluted)	0.83	1.00	1.10	1.24
HSBC EPS (fully diluted)	0.99	1.12	1.21	1.35
DPS	0.44	0.50	0.55	0.62
NAV	7.15	7.72	8.32	9.01

DCF analysis

HSBC assumptions	DCF, comprising		
Risk free rate (%)	3.50	EBIT growth 2011-21e CAGR (%)	8.4
Equity Premium (%)	5.00	EBIT growth 2021-41e CAGR (%)	3.9
Sector beta	1.20	Fading period 2041-47e	
Specific beta	0.95	WACC (%)	8.25

Sensitivity and valuation range

Cost of capital vs fade period	4 years	8 years	12 years
7.25%	23.4	24.0	24.1
7.75%	21.1	21.6	21.8
8.25%	19.1	19.5	19.8
8.75%	17.4	17.7	18.0
9.25%	15.8	16.1	16.4

Valuation data

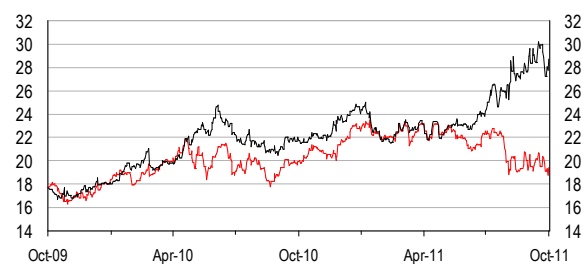
Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	1.9	1.8	1.7	1.5
EV/EBITDA	10.7	9.8	9.0	8.1
EV/IC	1.9	1.9	1.8	1.8
PE*	19.7	17.4	16.0	14.4
P/NAV	2.7	2.5	2.3	2.2
FCF yield (%)	6.6	4.7	5.2	5.8
Dividend yield (%)	2.3	2.6	2.8	3.2

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (EUR)	19.40	Target price (EUR)	19.50	Potent'l tot rtn (%)	0.5
Reuters (Equity)	LUX.MI	Bloomberg (Equity)	LUX IM		
Market cap (USDm)	12,059	Market cap (EURm)	9,060		
Free float (%)	25	Enterprise value (EURm)	11033		
Country	Italy	Sector	Textiles, Apparel & Luxury Goods		
Analysts	Antoine Belge	Contact	331 5652 4347		
	Erwan Rambourg	Contact	852 2996 6572		
	Sophie Dargnies	Contact	331 5652 4348		

Price relative



Source: HSBC

Note: price at close of 05 Oct 2011

LVMH

- ▶ LVMH could prove to be a defensive relative play in a completely negative economic scenario, but since we are not that pessimistic, we continue to see higher potential returns elsewhere in the sector
- ▶ We prefer investing in Dior (OW, TP EUR109), LVMH's parent company, which offers a 30.7% potential return
- ▶ Remain Neutral, target price lowered to EUR115 (from EUR128) on higher sector beta

For the risk adverse investor

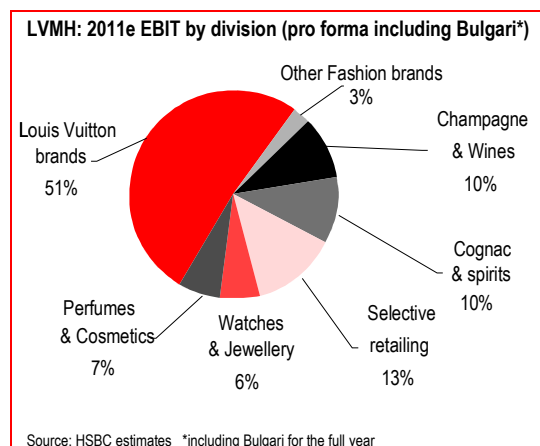
LVMH proved resilient in 2008-2009

For those investors who expect a completely negative economic scenario and still want to be involved in the luxury sector, we believe LVMH would be the most defensive play. If the 2008-2009 downturn was a proxy for what may happen in the near future, there is certainly some comfort to be taken from LVMH's performance back then.

Indeed, in 2009, LVMH EBIT declined only 8%, and would have been flat excluding Champagne (whose EBIT was down 41%). Even H1 2009 alone only saw EBIT declining 12%.

The resilience of LVMH was mostly linked to the defensive profile of the Louis Vuitton brand, which accounted for 28% of sales and 57% of EBIT in 2010 (according to our estimates).

Its iconic status means that when 'core luxury consumers' (ie those consumers buying several handbags a year) reduce their spending on other brands, they continue to buy their LV bag(s). With close to 100% of its sales done through its own stores, LV does not face the risk of third-party de-stocking.



Finally, with the bulk of its hand bag offering being below EUR1,000, LV is in a sweet spot: luxury at a (at least relatively) reasonable price, or at least a price not expensive enough to make the brand vulnerable to the 'guilt factor' which tends to penalise sales of high-end watches and jewellery in the western world during downturns.

In 2009, we estimate that LV registered c7% organic sales growth, (vs -4% for the industry) with Q2 2009 (c+3%) being the worst quarter, and was able to limit the deterioration of its EBIT margin to less than 100bp.

In 2009, Selective Distribution (+1% organic sales growth) and to a lesser extent Perfumes & Cosmetics (-5%) proved also quite resilient. In contrast, Cognac (-8%) and moreover Champagne (-18%) and Watches (-19%) were significantly hit by the downturn.

More Asian, but not less American

Between 2008 and 2011, like most other luxury companies, LVMH has increased its exposure to Asia ex Japan (from 20% to 27%e). But, unlike most peers, its exposure to the US has barely changed (from 23% to 21%e), and LVMH remains the European luxury group the most exposed to the region after Luxottica and Burberry. This is mostly due two divisions:

- ▶ **Selective Distribution** (37% exposure to the US) owing to the perfume chain Sephora's strong presence in the North America (276 stores end 2010) and the on-board duty-free company Miami Cruiseline.
- ▶ **Cognac**, for which the US accounted from 44% of volume sold in 2010, Hennessy having a 59% market share in the region).

Whilst we believe Asian consumption will remain robust, we are become cautious about consumption in the US. We see LVMH organic sales growth in the US slowing from 17% in H1 2011 to 11% in H2 2011e and then being negative (-3%) in 2012e.

Earnings, valuation and risks

H1 2011 EBIT came in 5% above our forecast. The beat of cEUR100m came from Selective Distribution (EUR57m), Perfumes & Cosmetics (EUR28m) and Wines & Spirits (EUR24m, partially due to a positive FX impact).

For 2011e, we forecast 13.8% reported sales growth (12.5% organic, -1.9% FX, consolidation +3.2%) including a 10% organic increase in wines & spirits (with volumes up 8% and price/mix 2%) and a 12% organic increase in fashion and leather. We expect a 19% y-o-y rise in EBIT (+17% excluding Bulgari), implying a 90bp EBIT margin gain over the FY.

Note that we expect Q3 sales (to be released 18 October) to have remained strong (up 14%e organically compared to +13% in Q1 and +15% in Q2). We expect trends to slow in Q4 (+7%) and 2012 (+6%).

We increase our 2011 EPS estimate by 2% to factor in a more favourable EUR/USD (1.40 instead of 1.45), but leave our 2012-2013 EPS estimates unchanged due to lower sales forecasts for the US and Europe.

We lower our DCF-based target price to EUR115 from EUR128 as we use higher sector beta (1.20 vs 1.10 previously). The assumptions used in our DCF-derived target price are detailed on page 71. Under our research model, for Europe ex-UK stocks, the Neutral band is 5 percentage points above and below the hurdle rate of 8.5%. Our target price implies a 12.8% potential return, within the 3.5-13.5% range. We thus remain Neutral.

LVMH could prove to be a defensive relative play in a completely negative economic scenario, but since we are not that pessimistic, we continue to see higher potential returns elsewhere in the sector. LVMH is currently trading at 15.0x 2012e PE, a 15% premium to the sector.

Note that we have a 30.7% potential return on our EUR109 Dior (EUR83.42, DIOR.PA) target price (see detailed investment case on page 48). We thus prefer to play LVMH strong fundamentals via its parent company (for which its 40.9% stake in LVMH accounts for 91% of restated net asset value).

The main specific upside risk would be a greater resilience in sales and greater SG&A leverage. The main downside risk to our rating would be a weaker USD/EUR rate, destocking of Champagne and Spirits in the US and value destruction linked to M&A activity.

LVMH FY results & forecasts

EURm	2006a	YoY (%)	2007a	YoY (%)	2008a	YoY (%)	2009a	YoY (%)	2010a	YoY (%)	2011e	YoY (%)	2012e	YoY (%)	2013e	YoY (%)
Sales	15,306	10	16,481	8	17,193	4	17,053	-1	20,320	19	23,120	14	25,220	9	27,140	8
Current operating income (EBIT)	3,172	16	3,555	12	3,628	2	3,352	-8	4,321	29	5,138	19	5,598	9	6,184	10
Other operating income and expenses	-120		-126		-143		-191		-152		-152		-152		-152	
Operating income	3,052	21	3,429	12	3,485	2	3,161	-9	4,169	32	4,986	20	5,446	9	6,032	11
Net financial expenses	-53		-252		-281		-342		612		-274		-194		-119	
Income before taxes	2,999	26	3,177	6	3,204	1	2,819	-12	4,781	70	4,712	-1	5,252	11	5,913	13
Taxes	-847		-853		-893		-849		-1,469		-1,461		-1,628		-1,833	
Associates	8		7		7		3		7		9		11		13	
Minority interests	-281		-306		-292		-218		-287		-350		-364		-409	
Net pft before goodwill and exceptionals	1,879	31	2,025	8	2,026	0	1,755	-13	3,032	73	2,910	-4	3,271	12	3,684	13
EPS	3.94	30	4.22	7	4.26	1	3.70	-13	6.32	71	6.07	-4	6.82	12	7.68	13
Sales by division																
Wines & Spirits	2,994	13	3,226	8	3,126	-3	2,740	-12	3,261	19	3,488	7	3,547	2	3,808	7
Leather and Fashion	5,222	9	5,628	8	6,010	7	6,302	5	7,581	20	8,338	10	8,930	7	9,645	8
Perfume and cosmetics	2,519	10	2,731	8	2,868	5	2,741	-4	3,076	12	3,215	5	3,388	5	3,541	4
Selective distribution	3,891	7	4,179	7	4,376	5	4,533	4	5,378	19	6,143	14	6,634	8	7,181	8
Watches	737	29	833	13	879	6	764	-13	985	29	1,937	97	2,721	40	2,966	9
Others	-57	nm	-116	nm	-66	nm	-27	nm	39	nm	0	nm	0	nm	0	nm
Total sales	15,306	10	16,481	8	17,193	4	17,053	-1	20,320	19	23,120	14	25,220	9	27,140	8
EBIT by division																
Wines & Spirits	962	11	1,058	10	1,060	0	760	-28	930	22	1,065	14	1,050	-1	1,179	12
Leather and Fashion	1,633	11	1,829	12	1,927	5	1,986	3	2,555	29	2,901	14	3,158	9	3,463	10
Perfume and cosmetics	222	28	256	15	290	13	291	0	332	14	354	7	379	7	404	6
Selective distribution	400	15	439	10	388	-12	388	0	536	38	704	31	792	13	879	11
Watches	80	111	141	76	118	-16	63	-47	128	103	294	130	408	39	460	13
Others	-125	-17	-168	34	-155	-8	-136	-12	-160	18	-180	13	-190	6	-200	5
Total EBIT	3,172	16	3,555	12	3,628	2	3,352	-8	4,321	29	5,138	19	5,598	9	6,184	10
EBIT margin by division																
Wines & Spirits	32.1%		32.8%		33.9%		27.7%		28.5%		30.5%		29.6%		31.0%	
Leather and Fashion	31.3%		32.5%		32.1%		31.5%		33.7%		34.8%		35.4%		35.9%	
Perfume and cosmetics	8.8%		9.4%		10.1%		10.6%		10.8%		11.0%		11.2%		11.4%	
Selective distribution	10.3%		10.5%		8.9%		8.6%		10.0%		11.5%		11.9%		12.2%	
Watches	10.9%		16.9%		13.4%		8.2%		13.0%		15.2%		15.0%		15.5%	
Others	nm		nm		nm		nm		nm		nm		nm		nm	
Total EBIT margin	20.7%		21.6%		21.1%		19.7%		21.3%		22.2%		22.2%		22.8%	

Source: Company data, HSBC estimates

Financials & valuation: LVMH

Neutral

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (EURm)				
Revenue	20,320	23,120	25,220	27,140
EBITDA	5,049	5,909	6,415	7,050
Depreciation & amortisation	-728	-771	-817	-867
Operating profit/EBIT	4,321	5,138	5,598	6,184
Net interest	612	-306	-236	-166
PBT	4,788	4,721	5,263	5,926
HSBC PBT	4,781	4,712	5,252	5,913
Taxation	-1,469	-1,461	-1,628	-1,833
Net profit	3,032	2,910	3,271	3,684
HSBC net profit	3,032	2,910	3,271	3,684
Cash flow summary (EURm)				
Cash flow from operations	4,003	3,318	3,855	4,388
Capex	-1,002	-1,300	-1,400	-1,500
Cash flow from investment	-2,876	-5,600	-1,400	-1,500
Dividends	-953	-1,213	-1,331	-1,497
Change in net debt	-316	1,463	-1,166	-1,439
FCF equity	3,437	2,328	2,765	3,198
Balance sheet summary (EURm)				
Intangible fixed assets	14,131	14,131	14,131	14,131
Tangible fixed assets	6,733	7,262	7,844	8,478
Current assets	11,399	12,613	13,524	14,356
Cash & others	2,588	2,588	2,588	2,588
Total assets	37,460	43,670	45,332	46,969
Operating liabilities	5,522	6,221	6,746	7,226
Gross debt	5,266	6,729	5,563	4,124
Net debt	2,678	4,141	2,975	1,536
Shareholders funds	17,198	20,895	22,835	25,023
Invested capital	24,153	25,196	26,165	27,151

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	19.2	13.8	9.1	7.6
EBITDA	24.6	17.0	8.6	9.9
Operating profit	28.9	18.9	8.9	10.5
PBT	69.7	-1.4	11.5	12.6
HSBC EPS	71.0	-4.0	12.4	12.6
Ratios (%)				
Revenue/IC (x)	0.9	0.9	1.0	1.0
ROIC	12.8	14.4	15.1	16.0
ROE	19.6	15.3	15.0	15.4
ROA	8.3	8.6	8.5	9.1
EBITDA margin	24.8	25.6	25.4	26.0
Operating profit margin	21.3	22.2	22.2	22.8
EBITDA/net interest (x)		19.3	27.2	42.5
Net debt/equity	14.7	18.6	12.1	5.7
Net debt/EBITDA (x)	0.5	0.7	0.5	0.2
CF from operations/net debt	149.5	80.1	129.6	285.6

Per share data (EUR)

	12/2010a	12/2011e	12/2012e	12/2013e
EPS Rep (fully diluted)	6.32	6.07	6.82	7.68
HSBC EPS (fully diluted)	6.32	6.07	6.82	7.68
DPS	2.10	2.31	2.59	2.92
NAV	35.05	41.11	44.93	49.24

DCF analysis

HSBC assumptions	DCF, comprising		
Risk-free rate (%)	4.00	EBIT growth 2011-21e CAGR (%)	7.9
Equity Premium (%)	4.50	EBIT growth 2021-41e CAGR (%)	3.5
Sector beta	1.20	Fading period 2041-47e	
Specific beta	0.90	WACC (%)	8.55

Sensitivity and valuation range

Cost of capital vs fade period	4 years	8 years	12 years
7.6%	133	136	137
8.1%	122	125	126
8.6%	113	115	117
9.1%	105	106	108
9.6%	98	99	101

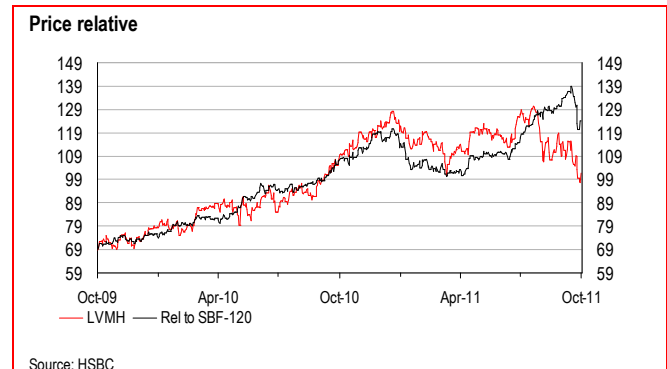
Valuation data

Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	2.6	2.4	2.1	1.8
EV/EBITDA	10.5	9.2	8.3	6.9
EV/IC	2.2	2.2	2.0	1.8
PE*	16.1	16.8	15.0	13.3
P/NAV	2.9	2.5	2.3	2.1
FCF yield (%)	6.8	4.6	5.5	6.8
Dividend yield (%)	2.1	2.3	2.5	2.9

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (EUR)	101.95	Target price (EUR)	115.00	Potent'l rtn (%)	12.8
Reuters (Equity)	LVMH.PA	Bloomberg (Equity)		MC FP	
Market cap (USDm)	68,960	Market cap (EURm)		51,814	
Free float (%)	47	Enterprise value (EURm)		54577	
Country	France	Sector	Textiles, Apparel & Luxury Goods		
Analyst	Antoine Belge	Contact	331 5652 4347		
	Erwan Rambourg	Contact	852 2996 6572		
	Sophie Dargnies	Contact	331 5652 4348		



Note: price at close of 05 Oct 2011

PPR

- ▶ Retail performance to be under pressure and Redcats disposal likely to be postponed, but that is not the point
- ▶ What matters most in our view is that PPR's luxury division continues to have one of the most attractive earnings prospects of the industry
- ▶ Remain Overweight, target price lowered to EUR130 (from EUR145) on lower valuation multiples for luxury and retail assets

All eyes should be on luxury

Excellent earnings growth prospects in luxury

Gucci brand to continue to outperform in our view

Since Q3 2010, the Gucci brand has stopped under-performing the luxury industry, notably thanks to the recovery of its US business driven by the new local management team.

The 15% organic growth seen in H2 2010 was followed by a continued acceleration in Q1 2011 (+20%) and Q2 2011 (+23%). True, the basis of comparison in the US will become less favourable as from Q3 2011 and, beyond that, the global economic slowdown should impact sales trends, notably local demand from US and European consumers. But, we continue to expect the Gucci brand to be one of the best performers in terms of organic sales growth over the H2 2011-FY2013 period.

We forecast the Gucci brand organic sales growth to have remained very strong in Q3 2011 (+20%) before slowing to 10% in Q4 2011 and 10% in 2012.

We believe that the risk of retailers' de-stocking is now lower compared to the 2008-2009 crisis since we estimate that Gucci's exposure to wholesale has been reduced to c25% (vs a bit more than 30% in 2008). In

the US for instance, Gucci has converted many Saks corners into directly-operated shop-in-shops.

The Gucci brand seems well positioned in Asia, in our view, since its 'fashion' positioning is resonating well with Chinese consumers. Gucci has adopted a gradual approach and still only had 39 stores at the end of 2010 compared to 32 at end-2009. The next four years should see 7-10 store openings pa (net of some possible closures/relocations).

For the Gucci brand, Greater Chinese consumers accounted for 35% of total sales in H1 2011 (23% locally and 12% abroad).

In addition, we believe the Gucci brand has strong EBIT margin improvement potential (we forecast EBIT margin to increase from 28.7% in 2010 to 31.7% in 2013e). Gucci is moving average prices higher by focusing on the medium segment of its handbag proposition, with a higher leather content vs canvas and fewer logo products, and achieving a higher share of carry-overs.

This is boosting sales and profitability since management claims that carry-over leather goods products do not have a lower margin than canvas, and markdowns should be more limited. In addition, margins in the watch business reached a trough in 2010 (5% of sales in 2010 vs 14% in 2005).

Bottega Veneta and Balenciaga the rising stars

Bottega Veneta and Balenciaga, in our view, have the potential to outpace the industry average due to their niche positioning and the credibility of their leather goods offering (more than 70% of sales for both of them). For Bottega in particular, which accounts for 20% of PPR's Luxury division's EBIT, we forecast organic sales growth of 24% in 2011e and 12% in 2012e. Regarding YSL, the H1 2011 performance has been outstanding (+30% organic sales growth), but in the light of the historical lesser resilience of the brand, we are forecasting 0% organic sales growth in 2012e (vs +23% in 2011e).

Too much weight given to 'wrong debates' in our view

Talking to investors, it seems that many investors continue to put too much weight on certain debates instead of focusing on the strength of the group's luxury portfolio.

Given the worsening outlook for the French economy, the performance of PPR's retail assets will no doubt be under pressure and the Redcats disposal likely to be postponed, but we believe current valuation is overly discounting these negative factors. In our sum-of-the-parts, we have lowered our estimated valuation for the two remaining retail assets, Redcats and Fnac (combined value of EUR2.3bn vs EUR3.0bn). We note that the disposal of Conforama (finalised in March 2011) was made at an EV of EUR1.6bn, ie c30% above consensus expectations. In an article dated 6 April 2011, the French newspaper Challenge mentioned that Rothschild & Co had been appointed to find a buyer for Redcats and that Redcats could be valued at EUR1.5bn (vs EUR1.0bn in our sum-of-the-parts).

Not only does the market not seem to recognise that PPR's good track record in selling assets is a proxy for future disposals, it is also worried about the potential dilution risk linked to PPR's stated M&A ambitions in luxury and branded goods. We have fewer concerns than most about PPR's possible next move, especially in the next 12-18 months. We notably believe a transformational deal (ie above EUR3bn in terms of

EV) is unlikely. PPR says it intends to use the proceeds to pay down debt (EUR3.8bn at end-2010 to EUR2.6bn at end-2011e, or 21% gearing). The net debt/EBITDA ratio, which was 2.4x at end-2009, reached 2.1x at end-2010 and should be 1.3x at end-2011e.

PPR's main focus is to grow its new sports & lifestyle division around Puma via the acquisition of small to medium-sized brands (the 2011 acquisition of Volcom (for an EV of USD 516m fits in that category), and to expand in watches and jewellery, the two luxury sub-segments to which its luxury division is under-exposed. But management continues to indicate that there are currently very few targets that are both available and not too expensive.

We acknowledge that Puma's disappointing operating and share price performance since its acquisition may lead to scepticism about PPR's ability to create value from acquisitions in sporting goods & lifestyle. On this, only time and more positive developments at Puma may change investor sentiment. Nevertheless, we believe that these concerns are priced in and should not prevent investors from investing in PPR.

Earnings, valuation and risks

We have left our 2011-13 EPS estimates unchanged, since the stronger-than-expected YTD 2011 performance is offsetting lower US and Europe sales forecasts from Q4 2011 onwards.

We are lowering our sum-of-the-parts-based target price to EUR130 (from EUR145) on the back of the use of lower valuation multiples to value luxury and retail assets. For details of our sum-of-the-parts valuation approach, please refer to page 75. Under our research model, for Europe ex-UK stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate of 8.5%. Since our target price implies a 32.3% potential return, our rating remains Overweight. Downside risks to our Overweight rating include underperformance of the Gucci brand, disposals of assets at lower-than-expected prices, and value destruction linked to acquisitions.

PPR earnings forecasts

EURm	2003 pro forma	2004 pro forma	2005a	2006a	2007a	2008a	2009a*	2010a	2011e	2012e	2013e
Sales											
Luxury Goods	2,576	2,712	3,034	3,568	3,867	3,380	3,390	4,011	4,705	5,160	5,617
Retail	13,903	14,358	13,906	14,365	14,196	14,318	10,690	7,909	7,593	7,517	7,710
Puma					1,718	2,524	2,461	2,706	2,930	3,180	3,415
Volcom									128	283	300
Other	-30	-29	-2	-2	-20	-21	-16	-21	-26	-29	-32
Total PPR	16,449	17,042	16,938	17,931	19,761	20,201	16,525	14,605	15,330	16,110	17,010
Sales growth y-o-y (%)											
Luxury Goods		5.3	11.9	17.6	8.4	-12.6	0.3	18.3	17.3	9.7	8.9
Retail		3.3	-3.1	3.3	-1.2	0.9	-25.3	-26.0	-4.0	-1.0	2.6
Puma						47.0	-2.5	10.0	8.3	8.5	7.4
Volcom										121.6	6.0
Total PPR		3.6	-0.6	5.9	10.2	2.2	-18.2	-11.6	5.0	5.1	5.6
EBIT											
Luxury Goods	250	288	392	565	731	731	692	897	1,199	1,361	1,523
Retail	754	760	729	759	785	695	422	353	249	247	281
Puma					236	350	320	337	320	370	420
Volcom									14	33	37
Holding companies & other		-61	-59	-50	-57	-54	-50	-56	-117	-120	-122
Total PPR	1,003	986	1,063	1,275	1,696	1,721	1,383	1,531	1,665	1,890	2,140
EBIT margins (%)											
Luxury Goods	9.7	10.6	12.9	15.8	18.9	21.6	20.4	22.4	25.5	26.4	27.1
Retail	5.4	5.3	5.2	5.3	5.5	4.9	3.9	4.5	3.3	3.3	3.6
Puma					13.7	13.9	13.0	12.5	10.9	11.6	12.3
Volcom									10.8	11.6	12.5
Total PPR	6.1	5.8	6.3	7.1	8.6	8.5	8.4	10.5	10.9	11.7	12.6
EBIT growth y-o-y (%)											
Luxury Goods		15.3	36.3	44.2	29.3	0.0	-5.3	29.7	33.6	13.5	12.0
Retail		0.8	-4.0	4.1	3.4	-11.5	-39.3	-16.3	-29.4	-1.0	14.0
Puma						48.2	-8.6	5.5	-5.1	15.6	13.5
Volcom										138.0	14.2
Total PPR		-1.7	7.7	19.9	33.1	1.5	-19.6	10.7	8.7	13.5	13.2
Other operating inc/charges	nm	nm	3.1	-0.1	100.3	-361	-546.8	-193.9	0	0	0
Operating income	nm	nm	1,066	1,274	1,796	1,360	837	1,337	1,665	1,890	2,140
Net Interest	nm	nm	-307	-290	-322	-373	-381	-254	-213	-180	-148
Tax	nm	nm	-187	-260	-298	-335	-177	-304	-406	-479	-558
Tax rate (%)	nm	nm	-24.7%	-26.4%	-20.2%	-33.9%	-38.8%	-28.1%	-28.0%	-28.0%	-28.0%
Equity Affiliate Share	nm	nm	3	2	1	1	0	36	45	54	66
Minorities	nm	nm	-38	-47	-119	-117	-32	-51	-64	-74	-84
Net profit reported		nm	536	685	922	537	985	964	1,026	1,211	1,415
Net profit (base of diluted EPS calculation)			578	698	904	875	712	932	1,026	1,211	1,415
Avg Number of shares used in diluted EPS		nm	132.5	121.7	128.7	126.1	126.5	126.7	126.7	126.7	126.7
HSBC EPS (diluted)		nm	4.36	5.73	7.03	6.94	5.63	7.35	8.10	9.56	11.17
<i>HSBC EPS growth</i>		<i>nm</i>	<i>nm</i>	31.3	22.6	-1.2	-18.8	30.5	10.1	18.1	16.8

*2009 not restated for the disposal of Conforama
Source: company, HSBC estimates

Financials & valuation: PPR

Overweight

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (EURm)				
Revenue	14,605	15,330	16,110	17,010
EBITDA	1,861	2,042	2,293	2,560
Depreciation & amortisation	-329	-377	-403	-420
Operating profit/EBIT	1,531	1,665	1,890	2,140
Net interest	-254	-213	-180	-148
PBT	1,119	1,497	1,764	2,057
HSBC PBT	1,083	1,452	1,710	1,992
Taxation	-304	-406	-479	-558
Net profit	764	1,026	1,211	1,415
HSBC net profit	932	1,026	1,211	1,415

Cash flow summary (EURm)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Cash flow from operations	1,263	1,262	1,513	1,727
Capex	-343	-384	-411	-439
Cash flow from investment	32	460	-411	-439
Dividends	-417	-448	-475	-503
Change in net debt	-599	-1,199	-638	-796
FCF equity	809	954	1,133	1,318

Balance sheet summary (EURm)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Intangible fixed assets	16,331	16,331	16,331	16,331
Tangible fixed assets	1,424	1,786	1,794	1,813
Current assets	6,940	5,922	6,114	6,316
Cash & others	1,398	1,398	1,398	1,398
Total assets	24,695	24,038	24,238	24,460
Operating liabilities	7,296	7,260	7,361	7,468
Gross debt	5,219	4,020	3,382	2,586
Net debt	3,821	2,621	1,983	1,187
Shareholders funds	10,599	11,177	11,914	12,826
Invested capital	16,001	15,380	15,478	15,594

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	-11.6	5.0	5.1	5.6
EBITDA	3.9	9.8	12.3	11.6
Operating profit	10.7	8.7	13.5	13.2
PBT	145.7	33.8	17.9	16.6
HSBC EPS	30.5	10.1	18.1	16.8

Ratios (%)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Revenue/IC (x)	0.9	1.0	1.0	1.1
ROIC	7.0	7.7	8.9	10.0
ROE	9.1	9.4	10.5	11.4
ROA	4.1	5.1	5.9	6.6
EBITDA margin	12.7	13.3	14.2	15.0
Operating profit margin	10.5	10.9	11.7	12.6
EBITDA/net interest (x)	7.3	9.6	12.7	17.3
Net debt/equity	32.8	21.4	15.3	8.6
Net debt/EBITDA (x)	2.1	1.3	0.9	0.5
CF from operations/net debt	33.1	48.2	76.3	145.5

Per share data (EUR)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
EPS Rep (fully diluted)	6.03	8.10	9.56	11.17
HSBC EPS (fully diluted)	7.35	8.10	9.56	11.17
DPS	3.50	3.71	3.93	4.17
NAV	83.68	88.24	94.05	101.25

PPR Sum-of-the-parts valuation

	valuation (EURm)	Per share (EUR)	Methodology
Gucci brand	11,028	87	10.5x11e EBITDA
Bottega Veneta	2,416	19	13x11e EBITDA
Other luxury businesses	1,251	10	1.5x11e sales
Sub-total Luxury	14,695	116	
Fnac	1,288	10	0.3x11e sales
Redcats	1,000	8	0.3x11e sales
Retail (Fnac+Redcats)	2,288	18	
CFAO (41.98%)	878	7	HSBC target price EUR34
Puma (75.12%)	2,685	21	HSBC target price EUR275
Volcom	356		Acquisition price
Other	-1,410	-11	12,1x11e EBITDA
Total PPR	19,136	151	
Net debt end-11e	-2,621	-21	
Total PPR equity value	16,515	130	

Valuation data

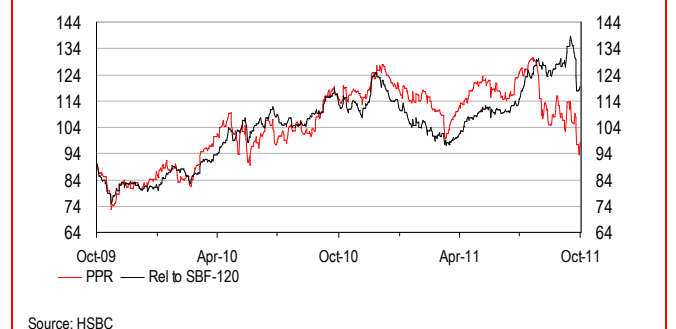
Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	1.1	1.0	0.9	0.8
EV/EBITDA	8.7	7.4	6.3	5.3
EV/IC	1.0	1.0	0.9	0.9
PE*	13.4	12.1	10.3	8.8
P/NAV	1.2	1.1	1.0	1.0
FCF yield (%)	6.5	7.7	9.1	10.6
Dividend yield (%)	3.6	3.8	4.0	4.2

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (EUR)	98.25	Target price (EUR)	130.00	Potent'l rtn (%)	32.3
Reuters (Equity)	PRTP.PA	Bloomberg (Equity)		PP FP	
Market cap (USDm)	16,585	Market cap (EURm)		12,461	
Free float (%)	55	Enterprise value (EURm)		15077	
Country	France	Sector		Multiline Retail	
Analysts	Antoine Belge	Contact		331 5652 4347	
	Erwan Rambourg	Contact		852 2996 6572	
	Sophie Dargnies	Contact		331 5652 4348	

Price relative



Note: price at close of 05 Oct 2011

Richemont

- ▶ Despite macro fears, the CHF move and a very strong 5M trading statement lead us to increase FY Mar 12-14 EBIT estimates by 4%
- ▶ Attractive valuation (13.5x CY12e PE) if our assumption that Asia will hold up is correct
- ▶ Maintain Overweight, unchanged target price of CHF58 as higher sector beta mitigates impact of earnings upgrade

One unchanged story but two events offering more support

7 September 5M trading statement we thought would be a non-event!

The Richemont 5-month (April-August) trading update is always an important event given the group does not release 1Q numbers. This year, in light of the August equity market turmoil, we thought investors would have limited interest in the 5-month figure, but would rather be focusing on the August trend. Well, it turns out the market ignored the release altogether.

The 35% organic sales growth the company reported for the 5M period was obviously a massive beat vs consensus (+21%) and our own estimate (+20%) but what was even more impressive still was the fact that August trends were said to have been broadly in line with the 5M trend apart from a slight slowdown in Europe (compared to the 22% average rate for April/August period).

Of course, 5M figures are not helpful at predicting the future but in terms of ripple effect, despite taking a tougher stance on H2 (7% organic sales growth now vs 10% previously), we have had to increase our organic sales growth projection to 19% for the full year (vs 14% previously).

Let's be franc, currencies matter

Alongside the Swatch Group, Richemont is quite sensitive to currency fluctuations. To be honest, similarly to the rest of the industry, sensitivity is greater to the USD but the recent shift in the CHF, following the intervention of Swiss authorities on September 6 to peg the CHF to the EUR, is a positive.

While, as luxury analysts, we cannot take a view on currency (for that, refer to the 10 Oct currency outlook – Desperately seeking safe havens), our EUR/CHF = 1.10 rate we used previously in our models now looks 11% off the mark from the current 1.23 spot rate. As we do not have a view on sustainability of the 1.20+ level, we factor in an average of what we had and what the Swiss authorities commit to by using a EUR/CHF 1.15 rate in our models now.

2011 vs 2008: what has changed?

First and foremost, the final outcome of the 2008-09 crisis for Richemont was not as bad as initially anticipated. The group registered 12 months of negative sales trends (Sept 2008-August 2009) resulting in 2H ending March 09 and 1H ending Sept 09 sales to be down 12% and 20%, respectively. EBIT margin dropped from 20.9% in FY March 08 to 16.0% in FY March 10.

This 490bp deterioration was far less severe than the 1,020bp collapse (from 19.3% to 9.1%) experienced by Richemont between FY March 2000 and FY March 04.

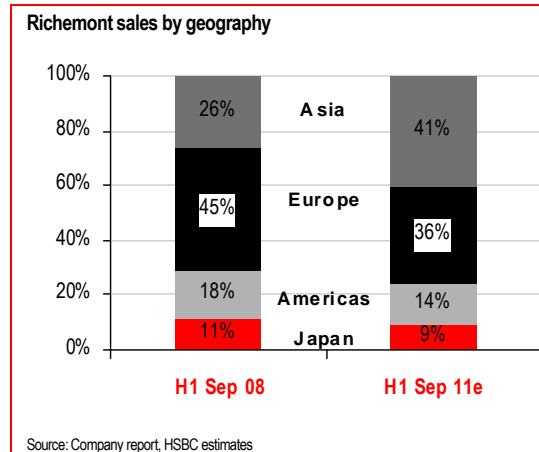
All in all, Richemont's EBIT only declined 25% over the FY March 08-10 period, and this was followed by a 63% rebound in FY March 11.

Between 2008 and 2011, Richemont's geographic mix has changed considerably (see chart top right). Asia ex-Japan now accounts for 41% of sales vs 26% three years ago, and if sales to Asia ex-Japan tourists abroad are taken into consideration, this figure is closer to 50% in our estimates.

As outlined in the thematic section of this report, we are confident that Asian demand will not collapse. We estimate that organic sales growth in Asia will have been 55% in 1H (59% after 5M). We forecast 19% organic growth in Asia for 2H ending March 12 and 20% for FY March 13. Longer term, Richemont should be a beneficiary of our 'future is female' and 'jewellery to outpace watch sales' themes described in our Sept 2 report.

Our new forecasts for the Americas are based on the assumption of a 10% organic sales decline over the 12m period starting September 2011. We expect Europe to see a 3% sales increase in 2H followed by a 5% rise in FY March 13 (with tourist-related sales remaining robust and local demand being slightly negative).

Over the 2008-11 period, Richemont's wholesale/retail channel mix moved from 57%/43% to 50%/50%. On top of that, the group has restructured its wholesale network by concentrating on fewer, but larger and better retailers (notably in the US). This in our view reduces the risk of seeing retailers going into panic mode like they did in 2008, resulting in orders being cut and heavy discounting hurting the brand image. We also note that inventory levels in the trade are healthier today compared to September 2008.



Earnings, valuation and risks

We have increased our FY March 12e-14e EBIT estimates by 4% on the back of the massive 5M beat and a more favourable FX environment. The bulk of the 80bp EBIT margin improvement we forecast for FY March 12 (to 20.5%) will come from the reduction of losses at Baume & Mercier, Net-A-Porter and Roger Dubuis (cEUR70m cumulative loss in FY March 11), whilst the 'true' operating leverage will be negligible.

We have kept our DCF-based target price unchanged at CHF58 as the increase in the sector beta (from 1.10 to 1.20) mitigates the increase in estimates. The assumptions used to generate our DCF-derived target price are detailed on page 79. Under our research model, for Swiss stocks, the Neutral band is 5pp above and below the hurdle rate of 7.5%, or 2.5-12.5%. On the basis of our new target price, Richemont shares offer a 36.8% potential return. We thus remain Overweight on the stock.

On our new estimates, Richemont is trading at 17.5x CY11e and 13.5x CY12e EPS. We believe this is an attractive valuation if our assumption that Asian consumption (local and travel related) will hold up is correct. Specific downside risks include the Swiss franc's strength, the historically lower resilience of watches compared to other luxury segments in case of a severe economic downturn, and failure to improve results of underperforming assets.

Richemont FY results and forecasts

EURm, year ending March	2007a	2008a	2009a	2010a	2011a	2012e	2013e	2014e
Net sales	4,827	5,302	5,418	5,176	6,892	8,000	8,850	9,700
% change	12.0%	9.8%	2.2%	-4.5%	33.2%	16.1%	10.6%	9.6%
Gross profit	3,074	3,405	3,417	3,191	4,394	5,040	5,593	6,140
Gross margin	63.7%	64.2%	63.1%	61.6%	63.8%	63.0%	63.2%	63.3%
Selling & distribution as a % of sales	1,090 22.6%	1,181 22.3%	1,235 22.8%	1,277 24.7%	1,654 24.0%	1,869 23.4%	2,085 23.6%	2,275 23.5%
Administration as a % of sales	503 10.4%	528 10.0%	542 10.0%	545 10.5%	656 9.5%	695 8.7%	744 8.4%	796 8.2%
Communication as a % of sales	570 11.8%	607 11.4%	644 11.9%	506 9.8%	699 10.1%	832 10.4%	914 10.3%	994 10.3%
Other / Non-recurring items	-5	-13	28	33	30	0	0	0
Total operating exps as a % of sales	2,158 44.7%	2,297 43.3%	2,449 45.2%	2,361 45.6%	3,039 44.1%	3,396 42.5%	3,743 42.3%	4,066 41.9%
EBIT reported	916	1,108	968	830	1,355	1,644	1,850	2,075
EBIT underlying	900	1,108	968	830	1,355	1,644	1,850	2,075
EBIT margin underlying	18.6%	20.9%	17.9%	16.0%	19.7%	20.5%	20.9%	21.4%
Financial result	31	47	-101	-137	-283	-249	39	52
Exceptional					102			
Taxation	-158	-195	-133	-94	-196	-233	-316	-355
Minority interest	-1	1	3	4	101	4	4	4
Luxury net profit (reported)	788	961	737	603	1,079	1,166	1,578	1,775

Source: company, HSBC estimates

Richemont FY sales and EBIT by segment

EURm, year ending March	2007a	2008a	2009a	2011a	2012e	2013e	2014e
Sales by segment							
Jewellery maisons	2,435	2,657	2,762	3,479	4,110	4,546	4,969
Specialist watchmakers	1,203	1,378	1,437	1,774	2,040	2,236	2,437
Writing instruments	585	637	587	672	719	777	835
Other businesses	604	630	632	967	1,130	1,292	1,459
Total Sales	4,827	5,302	5,418	6,892	8,000	8,850	9,700
EBIT by segment							
Jewellery maisons	667	767	777	1,062	1,247	1,379	1,525
Specialist watchmakers	274	376	301	379	490	551	609
Writing instruments	110	120	69	109	119	130	144
Other businesses	9	2	-39	-35	-12	11	39
Total EBIT before unallocated costs	1,060	1,265	1,108	1,516	1,844	2,071	2,317
EBIT reported	916	1,108	968	1,355	1,644	1,850	2,075
EBIT margin by segment							
Jewellery maisons	27.4%	28.9%	28.1%	30.5%	30.3%	30.3%	30.7%
Specialist watchmakers	22.8%	27.3%	20.9%	21.4%	24.0%	24.6%	25.0%
Writing instruments	18.8%	18.8%	11.8%	16.2%	16.5%	16.8%	17.2%
Other businesses	1.5%	0.3%	-6.2%	-3.6%	-1.0%	0.8%	2.7%
Total EBIT margin before unallocated costs	22.0%	23.9%	20.4%	22.0%	23.0%	23.4%	23.9%
EBIT margin reported	19.0%	20.9%	17.9%	19.7%	20.5%	20.9%	21.4%

Source: company, HSBC estimates

Financials & valuation: Richemont

Overweight

Financial statements

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Profit & loss summary (EURm)				
Revenue	6,892	8,000	8,850	9,700
EBITDA	1,760	2,089	2,340	2,614
Depreciation & amortisation	-405	-446	-490	-539
Operating profit/EBIT	1,355	1,644	1,850	2,075
Net interest	-283	-249	39	52
PBT	1,174	1,395	1,889	2,127
HSBC PBT	1,072	1,395	1,889	2,127
Taxation	-196	-233	-316	-355
Net profit	1,079	1,166	1,578	1,775
HSBC net profit	978	1,166	1,578	1,775
Cash flow summary (EURm)				
Cash flow from operations	1,495	1,375	1,853	2,080
Capex	-323	-480	-531	-582
Cash flow from investment	-578	-480	-531	-582
Dividends	-141	-205	-242	-279
Change in net debt	-694	-694	-1,084	-1,274
FCF equity	894	895	1,322	1,550
Balance sheet summary (EURm)				
Intangible fixed assets	59	59	59	59
Tangible fixed assets	1,267	1,301	1,342	1,385
Current assets	7,034	7,459	8,908	10,491
Cash & others	3,381	3,404	4,488	5,762
Total assets	9,693	10,152	11,642	13,269
Operating liabilities	1,542	1,712	1,866	1,996
Gross debt	791	120	120	120
Net debt	-2,590	-3,284	-4,368	-5,642
Shareholders funds	6,980	7,940	9,276	10,772
Invested capital	3,437	3,704	3,956	4,177

Ratio, growth and per share analysis

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Y-o-y % change				
Revenue	33.2	16.1	10.6	9.6
EBITDA	53.8	18.7	12.0	11.7
Operating profit	63.3	21.3	12.6	12.1
PBT	70.1	18.8	35.5	12.6
HSBC EPS	60.5	19.2	35.4	12.5
Ratios (%)				
Revenue/IC (x)	2.2	2.2	2.3	2.4
ROIC	35.3	38.3	40.2	42.5
ROE	15.5	15.6	18.3	17.7
ROA	13.9	13.8	14.1	13.9
EBITDA margin	25.5	26.1	26.4	26.9
Operating profit margin	19.7	20.5	20.9	21.4
EBITDA/net interest (x)	6.2	8.4		
Net debt/equity	-37.0	-41.3	-47.0	-52.3
Net debt/EBITDA (x)	-1.5	-1.6	-1.9	-2.2
CF from operations/net debt				
Per share data (EUR)				
EPS Rep (fully diluted)	1.91	2.06	2.79	3.14
HSBC EPS (fully diluted)	1.73	2.06	2.79	3.14
DPS	0.36	0.43	0.49	0.49
NAV	12.16	13.83	16.15	18.76

DCF analysis

HSBC assumptions	DCF, comprising		
Risk-free rate (%)	3.50	EBIT growth 2011-21e CAGR (%)	9.3
Equity Premium (%)	4.00	EBIT growth 2021-41e CAGR (%)	3.9
Sector beta	1.20	Fading period 2041-47e	
Specific beta	1.20	WACC (%)	9.26

Sensitivity and valuation range

Cost of capital vs fade period	4 years	8 years	12 years
8.3%	64.3	65.7	66.7
8.8%	60.5	61.6	62.6
9.3%	57.0	58.0	58.9
9.8%	53.9	54.7	55.5
10.3%	51.1	51.8	52.5

Valuation data

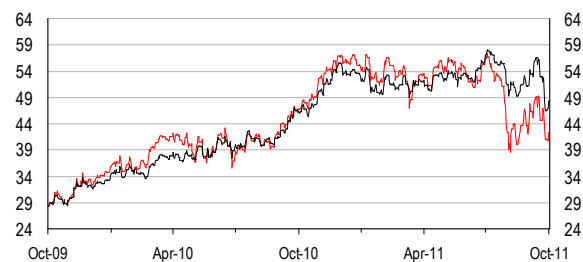
Year to	03/2011a	03/2012e	03/2013e	03/2014e
EV/sales	2.5	1.9	1.6	1.4
EV/EBITDA	9.6	7.5	6.2	5.1
EV/IC	4.9	4.2	3.7	3.2
PE*	20.0	16.8	12.4	11.0
P/NAV	2.8	2.5	2.1	1.8
FCF yield (%)	4.6	4.7	7.0	8.2
Dividend yield (%)	1.0	1.2	1.4	1.4

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (CHF)	42.40	Target price (CHF)	58.00	Potent'l rtn (%)	36.8
Reuters (Equity)	CFR.VX	Bloomberg (Equity)		CFR VX	
Market cap (USDm)	26,038	Market cap (CHFm)		24,026	
Free float (%)	91	Enterprise value (EURm)		15584	
Country	Switzerland	Sector	Textiles, Apparel & Luxury Goods		
Analysts	Erwan Rambourg Antoine Belge Sophie Dargnies	Contact	852 2996 6572 331 5652 4347 33 5652 4348		

Price relative



Source: HSBC

Note: price at close of 05 Oct 2011

Swatch

- ▶ Regional exposure (limited in the US, strong in Greater China) still offers a better relative risk profile in our view
- ▶ Attractive valuation (12.7x 2012e PE) if our assumption that Asia will hold up is correct
- ▶ Remain OW; lower TP to CHF430 (from CHF450 previously) on higher sector beta

Best geographic mix in the industry, higher risk in theory

The last time Swatch released figures was 28 July (1H 2011 earnings publication) and since it does not publish quarterly results (not even sales), we will not get precise figures from the company until January 2012 (FY2011 sales publication). Having said that, CEO Nick Hayek does comment fairly regularly on current trading in the press, at least qualitatively.

In light of the numerous concerns that have emerged since end-July (ie. equity market slump, fear of an economic downturn...), we go through below what we consider as being the key strengths for the Swatch group.

To be honest, we believe the bulk of the investment case is similar to that of Richemont. The reason we would favour the latter though in the current environment is that if our economists' assumptions turn out to be too optimistic, we feel Swatch, as being mostly watch and wholesale-lead may be at risk of greater de-stocking impact than Richemont.

Indeed Richemont has a balanced exposure between watches and other categories and is now more retail driven.

Big in Greater China, small in the US

In the introductory section of this report, we outlined that, on a relative basis, we felt the region the most at risk for watch & jewellery players was the US, the least at risk was Asia ex-Japan, and that Europe was lying somewhere in between, notably because (i) the correlation of the feel-good factor to the state of the equity markets is lower in Europe than in the US, and (ii) sales to Asian tourists are more significant in Europe than in the US.

Based on these assumptions, Swatch offers the best geographic mix in the whole industry:

- ▶ Asia ex-Japan accounted for 50% of total sales in 2010, with Greater China alone representing 33% (evenly split between mainland China and Hong Kong). In addition, Swatch's close relationship with Hengdeli (the leading retailer in Greater China with a c35% market share) enables it to have in-depth knowledge of the market.
- ▶ The Americas (including Latam) accounted for only 8% of total sales; the US is the only region in the world where the Omega brand (Swatch Group) has a lower market share than the Tag Heuer brand (LVMH).

Leading positions in movements and components

In terms of watch movements and components, the Swatch group holds leading market shares, exceeding 80% for certain categories. For most of these movements and components, there is a structural shortage. Unless Swatch's clients – such as Rolex, Richemont or LVMH – take a long-term negative view on their watch brands' growth potential in Asia, we believe they are unlikely to significantly reduce orders. We note that Swatch commented at end July that the 2H 2011 order book for the Production division was full.

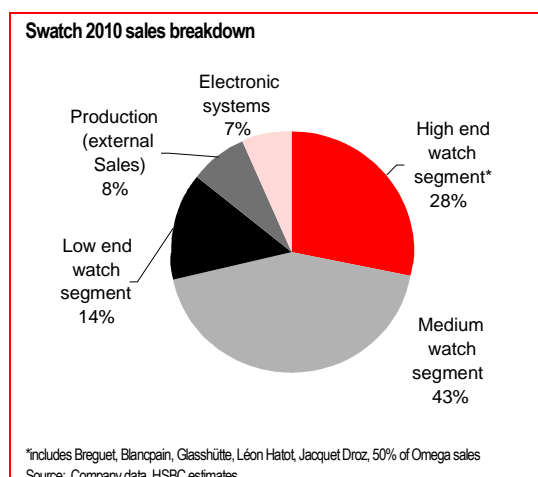
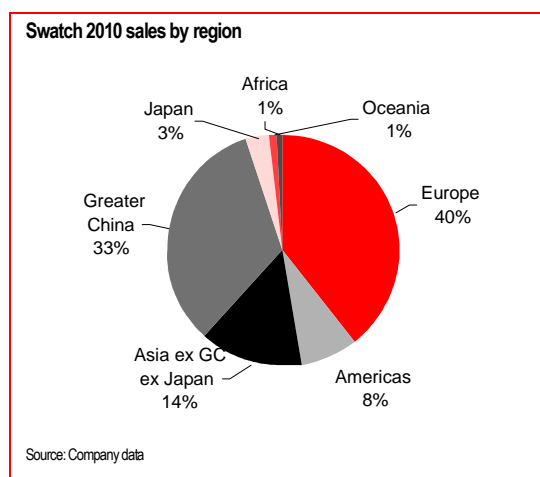
Exposure to medium-priced segment was a source of resilience during the 2008-09 crisis

Even if it had not always been the case in previous downturns, it is worth noting that during the 2008-09 crisis, Swatch's significant exposure to the medium-priced segment (43% of 2010 sales according to our estimates – cf pie below) contributed to the resilience of the group. We see two main reasons behind this: (i) the even stronger exposure of the medium segment to Asia, and (ii) the lesser impact of the 'guilt factor' (buying a USD1,500 watch is less of a statement than buying a USD50,000 watch).

Earnings, valuation and risks

1H 11 results were very strong – Swatch posted organic sales growth of 24% (and 27% for watches & jewellery) and an EBIT increase of 21%. The 190bp EBIT margin improvement to 23.7% was a strong showing given the strengthening of the CHF then. We have increased our 2011-13 EBIT estimates by 1%, 2% and 2%, respectively; on the back of a more favourable FX impact (stronger USD, weaker CHF). We lower our DCF-based target price to CHF430 from CHF450 solely on the back of our change in sector beta (from 1.10 to 1.20).

A breakdown of our DCF assumptions is provided on page 83. Under our research model, for Swiss stocks, the Neutral band is 5pp above and below the hurdle rate of 7.5%, or 2.5-12.5%. Our target price implies a 35.8% potential return. We thus remain Overweight. Swatch currently trades at 14.7x 2011e PE and 12.7x 2012e PE. Restated for the group's net cash pile (CHF2.8bn at end-2012e), Swatch's cash 2012e PE is 11.0x. We believe this is an attractive valuation if our assumption that Asian consumption (local and travel related) will hold up is correct. Downside risks to our rating include a slower-than-expected return of the production division's EBIT margin to 2007 peak; watch movement shortages weighing on sales, negative macro newsflow on China, and a stronger CHF.



The Swatch Group - Results & forecasts

CHFm	2005a	2006a	YoY	2007a	YoY	2008a	YoY	2009a	YoY	2010a*	YoY	2011e	YoY	2012e	YoY	2013e	YoY
Sales																	
Watches & Jewellery	3,272	3,723	14	4,456	20	4,547	2	4,187	-8	5,225	25	5,464	5	5,726	5	6,227	9
Watches Production	1,230	1,335	9	1,624	22	1,742	7	1,429	-18	1,487	4	1,817	22	1,992	10	2,171	9
Electronics Systems	538	586	9	623	6	526	-16	391	-26	436	12	384	-12	393	2	413	5
General services	6	6	0	5	7	7	5	5	5	5	7	7	7	7	7	7	7
Elimination internal sales	-754	-830	10	-1,062	28	-1,145	8	-870	-24	-1,045	20	-1,341	28	-1,468	9	-1,598	9
Total net sales	4,292	4,820	12	5,646	17	5,677	1	5,142	-9	6,108	19	6,330	4	6,650	5	7,220	9
EBITDA	934	1,168	25	1,440	23	1,422	-1	1,123	-21	1,658	48	1,786	8	1,940	9	2,179	12
	21.8%	24.2%		25.5%		25.0%		21.8%		27.1%		28.2%		29.2%		30.2%	
EBIT																	
Watches	626	738	18	920	25	828	-10	804	-3	1,257	56	1,273	1	1,358	7	1,526	12
Watches production	47	147	213	235	60	281	20	94	-67	186	98	318	71	368	16	423	15
Electronics systems	78	106	36	99	-7	104	5	24	-77	62	158	33	-47	45	39	56	23
General services	-16	-18	13	-18	0	-11	-39	-19	73	-69	263	-69	0	-72	4	-75	4
Total	735	973	32	1,236	27	1,202	-3	903	-25	1,436	59	1,555	8	1,700	9	1,930	14
EBIT margin																	
Watches	19.1%	19.8%		20.6%		18.2%		19.2%		24.1%		23.3%		23.7%		24.5%	
Watches production	3.8%	11.0%		14.5%		16.1%		6.6%		12.5%		17.5%		18.5%		19.5%	
Electronics systems	14.5%	18.1%		15.9%		19.8%		6.1%		14.2%		8.5%		11.5%		13.5%	
Total	17.1%	20.2%		21.9%		21.2%		17.6%		23.5%		24.6%		25.6%		26.7%	
Net financial result	49	84		37		-201		41		-38		-35		50		60	
Taxes	-163	-227		-258		-168		-186		-318		-345		-397		-452	
Tax rate	20.8%	21.5%		20.3%		16.7%		19.6%		22.7%		22.7%		22.7%		22.7%	
Minority interest	-7	-3		-4		-4		-4		-6		-8		-10		-12	
Net consolidated income (reported)	614	827	35	1,011	22	834	-18	759	-9	1,074	42	1,167	9	1,342	15	1,526	14
Earnings per bearer share (reported)	10.74	14.87	39	18.50	24	15.76	-15	14.48	-8	20.28	40	21.61	7	24.86	15	28.26	14
Earnings per bearer share (HSBC)	10.55	14.87	41	18.50	24	15.76	-15	14.48	-8	20.28	40	21.61	7	24.86	15	28.26	14

* restated
Source : company, HSBC estimates

Financials & valuation: Swatch

Overweight

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (CHFm)				
Revenue	6,108	6,330	6,650	7,220
EBITDA	1,658	1,786	1,940	2,179
Depreciation & amortisation	-222	-231	-240	-250
Operating profit/EBIT	1,436	1,555	1,700	1,930
Net interest	-38	-35	50	60
PBT	1,398	1,520	1,749	1,990
HSBC PBT	1,398	1,520	1,749	1,990
Taxation	-318	-345	-397	-452
Net profit	1,074	1,167	1,342	1,526
HSBC net profit	1,074	1,167	1,342	1,526

Cash flow summary (CHFm)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Cash flow from operations	1,410	1,118	1,434	1,522
Capex	-301	-380	-407	-435
Cash flow from investment	-354	-380	-407	-435
Dividends	-210	-270	-292	-336
Change in net debt	-1,134	-470	-749	-762
FCF equity	1,109	738	1,028	1,087

Balance sheet summary (CHFm)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Intangible fixed assets	317	317	317	317
Tangible fixed assets	1,488	1,637	1,804	1,989
Current assets	6,235	7,092	8,053	9,172
Cash & others	2,369	2,839	3,588	4,350
Total assets	8,614	9,620	10,748	12,052
Operating liabilities	989	1,088	1,142	1,234
Gross debt	108	108	108	108
Net debt	-2,261	-2,731	-3,480	-4,242
Shareholders funds	7,087	7,971	9,021	10,212
Invested capital	4,682	5,119	5,444	5,895

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	18.8	3.6	5.1	8.6
EBITDA	47.6	7.7	8.6	12.3
Operating profit	59.0	8.3	9.3	13.5
PBT	47.3	8.7	15.1	13.7
HSBC EPS	40.1	6.5	15.0	13.7

Ratios (%)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Revenue/IC (x)	1.3	1.3	1.3	1.3
ROIC	23.5	24.5	24.9	26.3
ROE	16.5	15.5	15.8	15.9
ROA	13.6	13.2	12.9	13.1
EBITDA margin	27.1	28.2	29.2	30.2
Operating profit margin	23.5	24.6	25.6	26.7
EBITDA/net interest (x)	43.6	51.0		
Net debt/equity	-31.8	-34.2	-38.5	-41.4
Net debt/EBITDA (x)	-1.4	-1.5	-1.8	-1.9
CF from operations/net debt				

Per share data (CHF)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
EPS Rep (fully diluted)	20.28	21.61	24.86	28.26
HSBC EPS (fully diluted)	20.28	21.61	24.86	28.26
DPS	5.00	5.40	6.21	7.06
NAV	133.83	147.61	167.06	189.11

DCF analysis

HSBC assumptions	DCF, comprising		
Risk free rate (%)	3.50	EBIT growth 2011-21e CAGR (%)	7.9
Equity Premium (%)	4.00	EBIT growth 2021-41e CAGR (%)	3.8
Sector beta	1.20	Fading period 2041-47e	
Specific beta	1.20	WACC (%)	9.26

Sensitivity and valuation range

Cost of capital vs fade period	4 years	8 years	12 years
8.3%	481	491	497
8.8%	450	459	465
9.3%	423	430	436
9.8%	399	404	410
10.3%	376	381	386

Valuation data

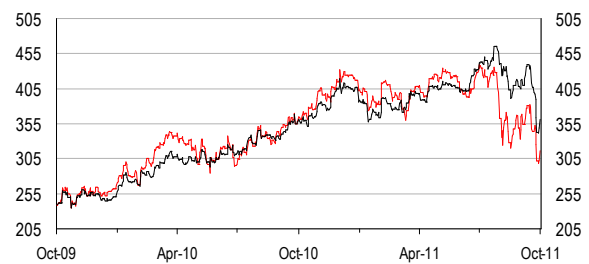
Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	2.3	2.1	1.9	1.7
EV/EBITDA	8.4	7.5	6.5	5.5
EV/IC	3.0	2.6	2.3	2.0
PE*	15.6	14.7	12.7	11.2
P/NAV	2.4	2.1	1.9	1.7
FCF yield (%)	6.9	4.6	6.4	6.7
Dividend yield (%)	1.6	1.7	2.0	2.2

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (CHF)	316.60	Target price (CHF)	430.00	Potentl' rtn (%)	35.8
Reuters (Equity)	UHR.VX	Bloomberg (Equity)	UHR VX		
Market cap (USDm)	18,157	Market cap (CHFm)	16,754		
Free float (%)	73	Enterprise value (CHFm)	13,449		
Country	Switzerland	Sector	Textiles, Apparel & Luxury Goods		
Analysts	Antoine Belge Erwan Rambourg Sophie Dargnies	Contact	331 5652 4347 852 2996 6572 331 5652 4348		

Price relative



Source: HSBC

Note: price at close of 05 Oct 2011

Tiffany

- ▶ Even if Asia and Europe have grown in size for Tiffany, it remains the third most exposed company in our coverage to the Americas (50% of sales)
- ▶ We see a risk that Tiffany only meets the very low end of its recently upgraded FY11 guidance and valuation is not supportive (16.4x 2012e PE)
- ▶ Remain Neutral, lowering target price of USD69 (from USD77) on lower estimates and higher sector beta

US risk, at least theoretically

Current (strong) trends may not be a proxy for the future

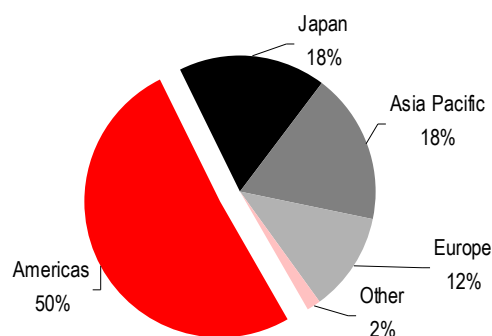
In light of the equity market turmoil in August, Tiffany's 2Q earnings publication last week (26 August) could have been an inflexion point for luxury stocks. Indeed, Tiffany was the first company to comment on August trends.

Not only were Tiffany's results for 2Q ending July 2011 a strong beat (clean diluted EPS up 56% to USD0.86 vs Reuters consensus USD0.70), the company also raised its FY2011 clean EPS guidance by 6% to USD3.65-3.75.

Given the current uncertainties about the world economy, it may sound surprising to see a luxury company raising guidance, especially ahead of the all-important holiday season. Having said that, the magnitude of the 2Q beat and the continuation of these strong trends in August imply that even the new guidance implies a slowdown in trends for the remainder of the year.

Historically, Tiffany's management has always been very candid in terms of sharing its future outlook with investors, and we respect this. The issue is that, with 50% of sales still generated in the Americas, Tiffany remains (at least theoretically) one of the most exposed companies to the region where luxury consumption has historically showed the strongest correlation to GDP trends and the state of financial markets. Investors may therefore not put much weight on current trends (regardless of how strong they are) if the overall market environment does not improve in the run-up to the holiday season.

Tiffany's 2010 sales breakdown by region



Source: Company report

Our caution on US sales is based on historical trends

Our caution on US sales is definitely not based on current trends. Tiffany's comps in the Americas accelerated in 2Q ending July (+22% compared to +15% in 1Q) and, on 26 August, management mentioned that August sales continued to 'trend ahead of internal expectations'.

In our view, what makes forecasting the sales of luxury companies so difficult is that it is hard to foresee what magnitude of an economic downturn the high-end consumer can withstand before finally capitulating. Nevertheless, history has shown that Tiffany tends to be the most affected by changes in the economy and in financial markets affecting the Americas. The most recent example is the severe declines in Americas comps registered in 2008 (-14%) and 2009 (-11%), with the trough quarters being 4Q 2008 (-31%) and 1Q 2009 (-32%).

It is fair to say that (i) Tiffany has reduced its exposure to the Americas region over the last three years (from 60% in 2007 to 50% in 2010) by increasing its exposure to Asia ex-Japan (from 12% to 18%) and Europe (from 8% to 12%) in the same period, and (ii) sales to Asia ex-Japan tourists travelling in the US are becoming meaningful. Nevertheless, Tiffany remains the third most exposed company in our universe to the Americas, behind Coach (72%) and Luxottica (61%).

Earnings, valuation and risks

We have left our EPS estimates for FY2011e (ending January 2012) unchanged, but lowered our FY2012e (ending January 2013) and FY2013e (ending January 2014) EPS estimates by 5% and 4% respectively. We have lowered further our sales estimates for the Americas region: we are now forecasting Americas comps sales to slow from 23% in 2Q to 15% in 3Q, then to -9% in 4Q 2011e. For FY 2012e, we expect a 6% comps decline.

For FY2011e (ending January 2012), we expect 17% reported sales growth: 12% worldwide comps (of which 9% in the Americas), a 2% contribution from new stores and 3% from FX. We forecast a 19.8% EBIT margin (21.0% excluding one-offs). We see gross margin expanding as price increases and leverage on fixed manufacturing costs offset higher raw material costs, and expect SG&A leverage stemming from the Europe and China businesses as they grow in scale.

Note that our USD3.65 clean EPS estimate for FY2011 is at the very low end of the company's guidance of USD3.65-3.75.

We lower our DCF-based target price to USD69 from USD77 on the back of our lower estimates and higher sector beta (1.20 vs 1.10 previously). The assumptions used to generate our DCF-derived target price are detailed on page 87.

Under our research model, for US stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate of 7.0%, ie 2-12%. Since our target price implies a 10.3% potential return, our rating remains Neutral.

At 16.4x 2012e PE, Tiffany is trading at a 24-29% premium to Richemont and Swatch (13.2x and 12.7x calendar 2012e, respectively).

Upside risks to our rating include stronger-than-expected comps in the US and SG&A leverage as well as speculation that Tiffany may be a takeover target following the termination of the watch contract with Swatch (announced Sept 11, 2011) which some described as a poison pill (see FT article from 22 May, 2008). Downside risks to our rating include a more pronounced US slowdown than the one embedded in our forecasts, non-domestic investment weighing on earnings (stores, ad spend) and disappointing results in watches.

Tiffany results & forecasts

USDm	FY08	FY09	Q1 10	Q2 10	Q3 10	Q4 10a	FY10a	Q1 11a	Q2 11a	Q3 11e	Q4 11e	FY11e	FY12e	FY13e
Net sales	2,860.0	2,709.7	633.6	668.8	681.7	1,101.2	3,085.3	761.0	872.7	824.5	1,161.9	3,620.0	3,770.0	4,140.0
Gross Profit	1,645.4	1,530.2	366.0	386.8	398.6	671.0	1,822.3	443.7	514.7	492.2	708.7	2,159.2	2,235.6	2,463.3
Gross margin	57.5%	56.5%	57.8%	57.8%	58.5%	60.9%	59.1%	58.3%	59.0%	59.7%	61.0%	59.6%	59.3%	59.5%
SG&A	1,172.6	1,089.7	260.6	273.1	301.0	392.8	1,227.5	307.7	374.2	338.6	420.3	1,440.8	1,468.2	1,593.0
SG&A as % of sales	41.0%	40.2%	41.1%	40.8%	44.2%	35.7%	39.8%	40.4%	42.9%	41.1%	36.2%	39.8%	38.9%	38.5%
Operating Income	472.8	440.5	105.4	113.6	97.6	278.2	594.8	136.0	140.5	153.6	288.5	718.5	767.4	870.4
Operating margin	16.5%	16.3%	16.6%	17.0%	14.3%	25.3%	19.3%	17.9%	16.1%	18.6%	24.8%	19.8%	20.4%	21.0%
Interest income	28.9	50.5	12.1	11.1	13.0	11.1	47.3	10.1	9.6	12.0	11.2	43.0	20.0	0.0
Earnings before tax	346.1	390.0	93.3	102.5	84.6	267.1	547.4	125.8	130.9	141.6	277.3	675.5	747.4	870.4
Income taxes	126.1	124.3	28.9	34.8	29.5	85.9	179.0	44.8	40.9	48.2	94.3	229.7	254.1	295.9
tax rate	36.4%	31.9%	30.9%	34.0%	34.9%	32.1%	32.7%	35.6%	31.2%	34.0%	34.0%	34.0%	34.0%	34.0%
Net earnings	220.0	264.8	64.4	67.7	55.1	181.2	368.4	81.1	90.0	93.5	183.0	445.8	493.3	574.4
Net EPS common (Diluted) HSBC*	1.74	2.11	0.48	0.55	0.46	1.44	2.93	0.67	0.86	0.88	1.57	3.65	3.81	4.44
Net EPS common (Diluted) reported	1.74	2.11	0.50	0.53	0.43	1.41	2.87	0.63	0.69	0.72	1.41	3.45	3.81	4.44
Weighted avg com share outst. (D)	126.4	125.4	128.5	128.4	127.9	128.8	128.4	129.4	129.8	129.8	129.8	129.4	129.4	129.4
Americas	1,586.6	1,410.9	315.4	350.4	331.8	577.0	1,574.6	374.7	438.2	388.2	534.7	1,735.8	1,683.8	1,835.0
Japan	543.4	527.1	115.0	118.0	130.8	182.7	546.5	123.4	142.5	150.4	204.7	621.0	621.0	621.0
Asia ex-Japan	378.6	430.0	122.3	111.5	127.1	188.3	549.2	167.2	173.2	173.1	244.8	758.3	925.1	1,091.6
Europe	284.6	311.8	68.6	76.9	77.5	137.8	360.8	85.6	101.3	94.6	155.7	437.2	463.4	505.1
Other	66.7	29.9	12.3	11.9	14.6	15.4	54.2	10.1	17.4	18.3	21.9	67.7	76.7	87.2
Total sales	2,860.0	2,709.7	633.6	668.7	681.8	1,101.2	3,085.3	761.0	872.6	824.5	1,161.9	3,620.0	3,770.0	4,140.0
YoY evolution														
Sales	-3%	-5%	21%	9%	14%	12%	14%	20%	30%	21%	6%	17%	4%	10%
Selling, G&A	-3%	-7%	10%	10%	15%	12%	13%	18%	37%	13%	7%	17%	2%	9%
EBIT	11%	-7%	94%	27%	46%	24%	35%	29%	24%	57%	4%	21%	7%	13%
PBT	-34%	13%	122%	32%	52%	27%	40%	35%	28%	67%	4%	23%	11%	16%
Net earnings	-34%	20%	165%	19%	27%	31%	39%	26%	33%	70%	1%	21%	11%	16%
EPS Diluted (HSBC)	-25%	21%	156%	16%	25%	30%	39%	39%	56%	92%	9%	25%	5%	16%
Americas	-10%	-11%	22%	8%	9%	10%	12%	19%	25%	17%	-7%	10%	-3%	9%
Japan	4%	-3%	-2%	4%	12%	11%	7%	7%	7%	15%	12%	14%	0%	0%
Asia ex-Japan	10%	20%	50%	21%	24%	25%	29%	37%	29%	36%	30%	38%	22%	18%
Europe	17%	10%	23%	13%	19%	12%	16%	25%	32%	22%	13%	21%	6%	9%
Other	-18%	-55%	76%	61%	274%	-10%	81%	-18%	46%	25%	43%	25%	13%	14%
Total sales	-3%	-5%	21%	9%	14%	12%	14%	20%	30%	21%	6%	17%	4%	10%
Comp store sales														
Americas	-14%	-11%	15%	5%	5%	8%	8%	17%	23%	15%	-9%	9%	-6%	6%
Japan	-10%	-12%	-10%	-7%	-2%	1%	-4%	-3%	8%	5%	5%	4%	0%	0%
Asia ex-Japan	5%	10%	21%	7%	11%	16%	14%	26%	41%	31%	25%	30%	15%	11%
Europe	6%	9%	14%	21%	24%	16%	18%	15%	11%	7%	5%	9%	2%	5%
Total sales	-9%	-7%	10%	5%	7%	9%	8%	15%	22%	15%	1%	12%	0%	6%

*restated for one-offs
Source: company, HSBC estimates

Financials & valuation: Tiffany

Neutral

Financial statements

Year to	01/2011a	01/2012e	01/2013e	01/2014e
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Profit & loss summary (USDm)

Revenue	3,085	3,620	3,770	4,140
EBITDA	743	875	934	1,046
Depreciation & amortisation	-148	-157	-166	-176
Operating profit/EBIT	595	718	767	870
Net interest	-47	-43	-20	0
PBT	547	675	747	870
HSBC PBT	547	675	747	870
Taxation	-179	-230	-254	-296
Net profit	368	446	493	574
HSBC net profit	376	472	493	574

Cash flow summary (USDm)

Cash flow from operations	326	389	543	624
Capex	-127	-250	-226	-248
Cash flow from investment	-127	-250	-226	-248
Dividends	-120	-163	-171	-199
Change in net debt	-21	77	-146	-177
FCF equity	173	112	287	344

Balance sheet summary (USDm)

Intangible fixed assets	0	0	0	0
Tangible fixed assets	666	759	819	891
Current assets	2,643	2,817	3,120	3,467
Cash & others	741	664	810	987
Total assets	3,736	4,003	4,366	4,785
Operating liabilities	870	880	891	902
Gross debt	688	688	688	688
Net debt	-53	24	-122	-299
Shareholders funds	2,177	2,435	2,787	3,195
Invested capital	1,697	2,032	2,238	2,469

Ratio, growth and per share analysis

Year to	01/2011a	01/2012e	01/2013e	01/2014e
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Y-o-y % change

Revenue	13.9	17.3	4.1	9.8
EBITDA	28.1	17.9	6.7	12.1
Operating profit	35.0	20.8	6.8	13.4
PBT	40.4	23.4	10.7	16.4
HSBC EPS	38.6	24.6	4.6	16.4

Ratios (%)

Revenue/IC (x)	1.9	1.9	1.8	1.8
ROIC	25.1	25.4	23.7	24.4
ROE	18.5	20.5	18.9	19.2
ROA	11.1	12.3	12.1	12.6
EBITDA margin	24.1	24.2	24.8	25.3
Operating profit margin	19.3	19.8	20.4	21.0
EBITDA/net interest (x)	15.7	20.4	46.7	
Net debt/equity	-2.4	1.0	-4.4	-9.4
Net debt/EBITDA (x)	-0.1	0.0	-0.1	-0.3
CF from operations/net debt		1617.4		

Per share data (USD)

EPS Rep (fully diluted)	2.87	3.45	3.81	4.44
HSBC EPS (fully diluted)	2.93	3.65	3.81	4.44
DPS	1.00	1.28	1.33	1.55
NAV	17.23	19.07	21.83	25.02

DCF analysis

HSBC assumptions	DCF, comprising		
Risk free rate (%)	3.50	EBIT growth 2011-21e CAGR (%)	8.9
Equity Premium (%)	3.50	EBIT growth 2021-41e CAGR (%)	4.0
Sector beta	1.20	Fading period 2041-47e	
Specific beta	1.20	WACC (%)	8.54

Sensitivity and valuation range

Cost of capital vs fade period	4 years	8 years	12 years
7.5%	79	81	82
8.0%	73	75	76
8.5%	68	69	70
9.0%	63	64	65
9.5%	59	60	61

Valuation data

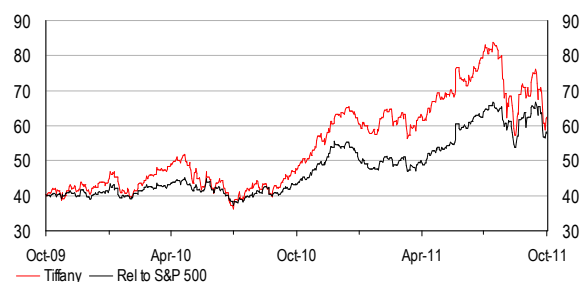
Year to	01/2011a	01/2012e	01/2013e	01/2014e
EV/sales	2.6	2.2	2.1	1.9
EV/EBITDA	10.7	9.1	8.4	7.3
EV/IC	4.7	3.9	3.5	3.1
PE*	21.4	17.2	16.4	14.1
P/NAV	3.6	3.3	2.9	2.5
FCF yield (%)	2.2	1.4	3.6	4.3
Dividend yield (%)	1.6	2.0	2.1	2.5

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (USD)	62.58	Target price (USD)	69.00	Potent'l rtn (%)	10.3
Reuters (Equity)	TIF.N	Bloomberg (Equity)	TIF US		
Market cap (USDm)	7,965	Market cap (USDm)	7,965		
Free float (%)	100	Enterprise value (USDm)	7989		
Country	United States	Sector	Specialty Retail		
Analysts	Antoine Belge	Contact	331 5652 4347		
	Erwan Rambourg	Contact	852 2996 6572		
	Sophie Dargnies	Contact	331 5652 4348		

Price relative



Source: HSBC

Note: price at close of 05 Oct 2011

Tod's

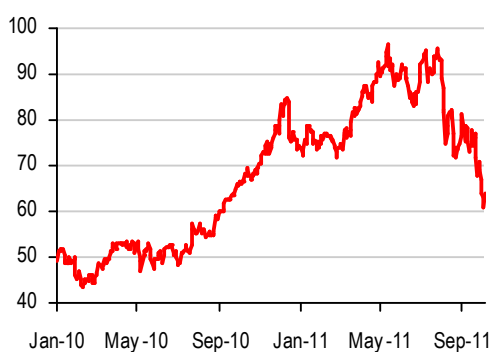
- ▶ Worst share price performer in Q3 2011 (-31%)
- ▶ Distinctive positioning, small exposure to the US more relevant than theoretical threat of high exposure to Europe in our view
- ▶ Remain Overweight, decrease target price to EUR80 (from EUR102) on the back of lower estimates and a higher sector beta

Oversold in our view

Threat of high exposure to Europe overestimated by the market

Last time Tod's published (5 August 2011), the group posted a strong set of H1 results: EBITDA up 28%, EBITDA margin up 230bp (to 26.3%), and 17% organic sales growth. Since then, the group has not talked to the market. But in the light of the numerous threats which have emerged since beginning of August (equity market slump, fears of an economic downturn), Tod's share price was the most impacted in Q3 (down 31% vs -23% for European luxury on average).

Tod's share price from 1 January 2010 (EUR)



Source: Thomson Reuters Datastream

After talking to investors over the last month, it seems some are worried about Tod's geographic split (75% of sales in Europe, of which 54% in Italy) and feel that Tod's should be one of the most impacted if a recession happens. But, in 2009, in spite of a 78% exposure to Europe, Tod's managed to register a flat organic sales growth (only 3 companies in our coverage registered a positive organic sales growth).

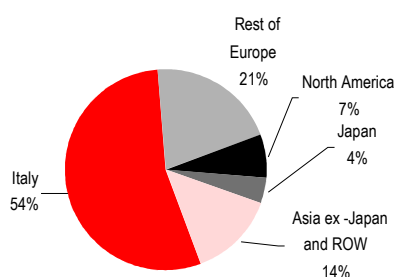
Distinctive positioning key to resilience

As outlined in the thematic section of this report, we believe that the US and Europe are likely to slow down markedly but Asia ex-Japan should continue to boom. In that context, it is worth noting that:

- ▶ **Tod's generated only 7% of its sales in the US** in 2010; although we have factored in -5% in North America in 2012e, this has a limited impact
- ▶ **The Tod's brand has a distinctive positioning** (classic, discreet, comfortable, yet perceived as luxury). In 2008-2009, 'core buyers' of shoes in Italy (women buying up to 10 pairs per year) scaled down their purchases, but continued to buy their pair of Tod's which has no substitute product. Italy only registered one quarter of negative trends (-1% in Q4 09). We thus forecast a flat organic sales growth in Europe (including Italy).

- ▶ **Non Japan Asia (including ROW)** only accounted for 14% of sales in 2010 versus 9% in 2008 (compared to more than 25% on average for the industry), but is growing at one of the fastest rates in the industry (China and Greater China both grew by more than 50% in H1 2011). The group is accelerating the process of opening stores (20 additional stores in 2011e, of which 90% will be in Asia ex-Japan). Tod's brand should have c40 stores in Mainland China by the end of 2011e (vs 26 in 2010), and management expects to have c50 by the end of 2012e and the target is to reach 100 stores in the long-term. For Hogan (80% of sales in Italy), management expects to open one or two stores in Mainland China by the end of 2011. We thus believe that the relative size of the group and the distinctive positioning of its two main brands should enable it to register better organic sales growth rates in Asia ex-Japan than its peers in the next three years. In addition, margins should benefit from the resulting geographic mix effect as in Asia (i) the mark-up is higher (3x-3.5x and even 4.0x for leather goods) vs 2.3x-2.5x in Continental Europe, and 2.6x-2.7x in UK; and (ii) the proportion of leather goods and accessories sales is higher (margins of leather goods and accessories are 500-700bp higher than for shoes).

Tod's sales breakdown by region, 2010



Source: Company data

Earnings, valuation and risks

The last time management spoke to the market (on August 5th ie before the market slump), they were very comfortable with current consensus sales expectations (+12% in euros) as the order backlog for Fall/Winter was up high single digit for wholesale and even higher for own retail. Management considered the 25.8% EBITDA margin consensus achievable.

We nevertheless cut our 2011e-13e EBITDA estimates by 4%, 11% and 15%, respectively on the back of lower US and to a lesser extent Europe sales forecasts. For 2011e, we expect a 13% organic sales growth (16% previously), ie a slowdown in H2 (+10%) vs H1 (+16%). For the FY 2011e, we forecast a 140bp EBITDA improvement to 25.9% (26.2% previously).

For 2012e and 2013e, we forecast organic sales growth of 7% (13%, previously) and 7% (10%, previously), respectively and EBITDA margins of 26.3% (vs 27.2%, previously) and 26.7% (vs 28.2%, previously).

We decrease our DCF-based target price from EUR102 to EUR80 on the back of our estimate decreases (see above) and a higher WACC assumption (9.50% vs 9.0% as we are now using a 1.20 sector beta instead of 1.10). The assumptions used to generate our DCF-derived target price are detailed on page 91.

Tod's, currently trading at 14.1x2012e PE, has lost its premium to the sector. Under our research model, for Europe ex-UK stocks without a volatility indicator, the Neutral band is 5 percentage points above and below the hurdle rate of 8.5%. Based on our target price, Tod's offers a 25.4% potential return. As this is above the range of 3.5-13.5%, we maintain our Overweight rating.

Downside risks to our rating include (i) evidence that there is a limit to growth in Italy; (ii) failure to expand significantly beyond shoes, and (iii) a new sale of shares by the family as the family has repeatedly said it wanted to increase the free float and only have more than 50% (currently, the Della Valle family holds c57%).

Tod's FY results and forecasts

Fiscal year ending December (EURm)	2004a	2005a	2006a	2007a	2008a	2009a	2010a	2011e	2012e	2013e
Net Sales	421	503	573	657	708	713	788	878	936	1,005
Change in percent	13.3%	19.5%	13.9%	14.7%	7.7%	0.8%	10.4%	11.5%	6.6%	7.4%
Total production costs	336	396	445	517	567	570	613	670	709	756
as % of sales	79.8%	78.7%	77.6%	78.7%	80.1%	79.9%	77.9%	76.3%	75.7%	75.2%
Change in percent	8.7%	17.8%	12.4%	16.3%	9.6%	0.6%	7.6%	9.2%	5.8%	6.6%
EBITDA	89	113	137	153	155	159	193	227	246	268
as % of sales	21.1%	22.4%	24.0%	23.3%	22.0%	22.2%	24.5%	25.9%	26.3%	26.7%
Change in percent	15.9%	27.0%	21.8%	11.3%	1.6%	2.0%	21.7%	17.6%	8.4%	9.0%
Amortization and reserves	22	23	24	27	30	32	33	40	43	46
EBIT	67	90	114	126	126	126	160	187	203	222
Percent of revenue	15.9%	17.9%	19.9%	19.3%	17.8%	17.7%	20.3%	21.3%	21.7%	22.1%
Change in percent	53.4%	34.3%	26.3%	11.2%	-0.5%	0.5%	26.5%	16.8%	8.9%	9.4%
Financial Income	0	2	-1	0	-1	0	3	3	3	5
Income before Taxes	67	92	113	127	125	127	163	190	207	227
Percent of revenue	15.9%	18.3%	19.7%	19.3%	17.7%	17.7%	20.7%	21.6%	22.1%	22.6%
Change in percent	44.7%	37.2%	23.2%	11.9%	-1.2%	1.1%	29.1%	16.1%	9.0%	10.0%
Taxes	28	38	46	48	41	40	53	61	66	73
Tax rate	42.1%	41.4%	41.0%	37.8%	33.2%	31.9%	32.2%	32.0%	32.0%	32.0%
Minority interests	0	1	1	1	1	0	2	2	2	2
Consolidated net Profit	38	53	66	77	83	86	109	127	139	153
Percent of revenue	9.1%	10.6%	11.5%	11.8%	11.7%	12.0%	13.8%	14.5%	14.8%	15.2%
Change in percent	49.4%	38.7%	23.8%	17.1%	6.7%	3.8%	27.3%	16.7%	9.1%	10.1%
EPS diluted	1.24	1.68	2.08	2.43	2.66	2.80	3.56	4.16	4.54	4.99
Variation %		36%	24%	17%	9%	5%	27%	17%	9%	10%

Source: Company data, HSBC estimates

Tod's FY sales by segment

Fiscal year ending December (EURm)	2004a	2005a	2006a	2007a	2008a	2009a	2010a	2011e	2012e	2013e	Split in 2004	Split in 2011e	Split in 2013e
Sales by brand													
Tod's	240	289	326	348	357	349	407	475	527	585	57%	54%	58%
Hogan	102	126	155	200	239	257	268	282	285	290	24%	32%	29%
Fay	69	77	82	90	93	92	90	90	87	87	16%	10%	9%
Other	10	11	9	20	19	16	23	31	37	43	2%	4%	4%
Total	421	503	573	657	708	713	788	878	936	1,005			
Sales by product category													
Shoes	268	315	358	427	486	506	565	627	666	703	64%	71%	70%
Leather goods & accessories	85	112	133	139	127	111	123	145	169	197	20%	16%	20%
Apparel	67	75	81	89	95	95	99	106	100	104	16%	12%	10%
Other	1	1	1	1	1	1	1	1	1	1	0%	0%	0%
Total	421	503	573	657	708	713	788	878	936	1,005			
Sales by channel													
DOS	220	259	283	318	336	349	404	463	503	550	52%	53%	55%
Third parties	201	244	290	339	372	364	384	415	433	455	48%	46%	45%
Total	421	503	573	657	708	713	788	878	936	1,005			
Sales by region													
Italy	205	241	280	334	384	405	426	453	456	465	49%	52%	46%
Europe	117	135	145	161	161	151	164	181	183	186	28%	21%	19%
North America	50	57	60	66	59	46	53	57	57	59	12%	7%	6%
Rest of World	50	70	88	97	103	111	145	187	240	295	12%	21%	29%
Total	421	503	573	657	708	713	788	878	936	1,005			

Source: Company data, HSBC estimates

Financials & valuation: TOD'S

Overweight

Financial statements

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Profit & loss summary (EURm)				
Revenue	788	878	936	1,005
EBITDA	193	227	246	268
Depreciation & amortisation	-33	-40	-43	-46
Operating profit/EBIT	160	187	203	222
Net interest	3	3	3	5
PBT	163	190	207	227
HSBC PBT	163	190	207	227
Taxation	-53	-61	-66	-73
Net profit	109	127	139	153
HSBC net profit	109	127	139	153

Cash flow summary (EURm)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Cash flow from operations	166	145	167	379
Capex	-98	-70	-50	-50
Cash flow from investment	-98	-70	-50	-50
Dividends	-153	-107	-73	-80
Change in net debt	81	23	-37	-241
FCF equity	70	77	119	330

Balance sheet summary (EURm)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Intangible fixed assets	189	209	209	209
Tangible fixed assets	174	204	211	216
Current assets	513	534	597	670
Cash & others	172	149	186	426
Total assets	916	987	1,057	1,135
Operating liabilities	182	199	210	223
Gross debt	75	75	75	75
Net debt	-96	-73	-110	-351
Shareholders funds	612	665	724	789
Invested capital	523	600	622	446

Ratio, growth and per share analysis

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Y-o-y % change				
Revenue	10.4	11.5	6.6	7.4
EBITDA	21.7	17.6	8.4	9.0
Operating profit	26.5	16.8	8.9	9.4
PBT	29.1	16.1	9.0	10.0
HSBC EPS	27.3	16.7	9.1	10.1

Ratios (%)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
Revenue/IC (x)	1.6	1.6	1.5	1.9
ROIC	21.5	22.6	22.6	28.3
ROE	17.2	19.9	20.0	20.2
ROA	12.6	13.6	13.8	14.1
EBITDA margin	24.5	25.9	26.3	26.7
Operating profit margin	20.3	21.3	21.7	22.1
EBITDA/net interest (x)				
Net debt/equity	-15.6	-10.9	-15.1	-44.1
Net debt/EBITDA (x)	-0.5	-0.3	-0.4	-1.3
CF from operations/net debt				

Per share data (EUR)

Year to	12/2010a	12/2011e	12/2012e	12/2013e
EPS Rep (fully diluted)	3.56	4.16	4.54	4.99
HSBC EPS (fully diluted)	3.56	4.16	4.54	4.99
DPS	3.50	2.39	2.61	2.88
NAV	20.22	22.00	23.95	26.09

DCF analysis

HSBC assumptions	DCF, comprising		
Risk-free rate (%)	3.50	EBIT growth 2011-21e CAGR (%)	9.6
Equity Premium (%)	5.00	EBIT growth 2021-41e CAGR (%)	4.3
Sector beta	1.20	Fading period 2041-47e	
Specific beta	1.00	WACC (%)	9.50

Sensitivity and valuation range

Cost of capital vs fade period	4 years	8 years	12 years
9.1%	82.8	84.6	86.0
9.3%	80.6	82.2	83.6
9.5%	78.4	80.0	81.3
9.7%	76.4	77.9	79.2
9.9%	74.5	75.8	77.1

Valuation data

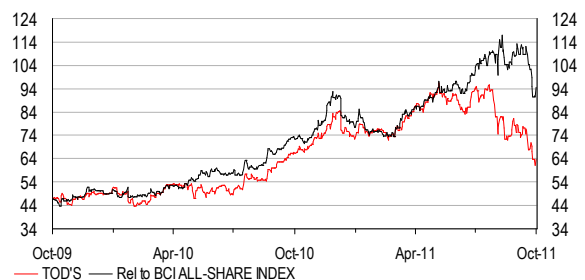
Year to	12/2010a	12/2011e	12/2012e	12/2013e
EV/sales	2.4	2.1	2.0	1.6
EV/EBITDA	9.6	8.3	7.5	6.0
EV/IC	3.6	3.1	3.0	3.6
PE*	17.9	15.3	14.1	12.8
P/NAV	3.2	2.9	2.7	2.4
FCF yield (%)	3.6	3.9	6.1	16.9
Dividend yield (%)	5.5	3.8	4.1	4.5

Note: * = Based on HSBC EPS (fully diluted)

Issuer information

Share price (EUR)	63.80	Target price (EUR)	80.00	Potent'l rtn (%)	25.4
Reuters (Equity)	TOD.MI	Bloomberg (Equity)	TOD IM		
Market cap (USDm)	2,599	Market cap (EURm)	1,953		
Free float (%)	39	Enterprise value (EURm)	1879		
Country	Italy	Sector	Textiles, Apparel & Luxury Goods		
Analyst	Sophie Dargnies	Contact	331 5652 4348		
	Antoine Belge	Contact	331 5652 4347		
	Erwan Rambourg	Contact	852 2996 6572		

Price relative



Source: HSBC

Note: price at close of 05 Oct 2011

Notes

Disclosure appendix

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stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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BURBERRY GROUP	BRBY.L	12.61	10-Oct-2011	4, 7
CHRISTIAN DIOR	DIOR.PA	92.51	10-Oct-2011	6
HERMES	HRMS.PA	234.30	10-Oct-2011	6, 7
LUXOTTICA	LUX.MI	20.23	10-Oct-2011	7
LVMH	LVMH.PA	110.10	10-Oct-2011	1, 2, 5, 6, 7, 11
PPR	PRTP.PA	104.00	10-Oct-2011	1, 2, 5, 6, 7, 11
PRADA SPA	1913.HK	34.75	10-Oct-2011	2, 6, 7
RICHEMONT(CIE FIN)	CFR.VX	46.39	10-Oct-2011	2, 7
SWATCH	UHR.VX	341.50	10-Oct-2011	6
TODS	TOD.MI	102.00	11-Oct-2011	7

Source: HSBC

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