

Is a hand-made Hermès bag a **better** **long-term investment** than its stock?



Valuation Master Class

CASE  STUDY
VALUATION MASTER CLASS
by
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RESEARCH

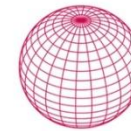


What's interesting
about Hermès is that
it is **still owned by the
family** (now in 6th
generation)



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Is a hand-made Hermès bag a better long-term investment than its stock?



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Sector: Cons. Disc.



Family-controlled 185 years old luxury manufacturer specialized in leather goods and lifestyle accessories

Our estimate:

EUR811

(Downside 29%)

SELL



3 things to know about this company

- ★ Competitive moat allows for sustainable high margins
- ★ Intended scarcity creates excess demand
- ★ Asia is a vital market for luxury brands to realize growth

Key statistics

Analyst consensus (19)

EUR1,300

(Upside 14%)

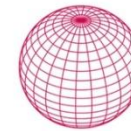
BUY

PE ratio (21A)

45x

Dividend yield

0.7%



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Risks



Leather goods & saddlery (46%)

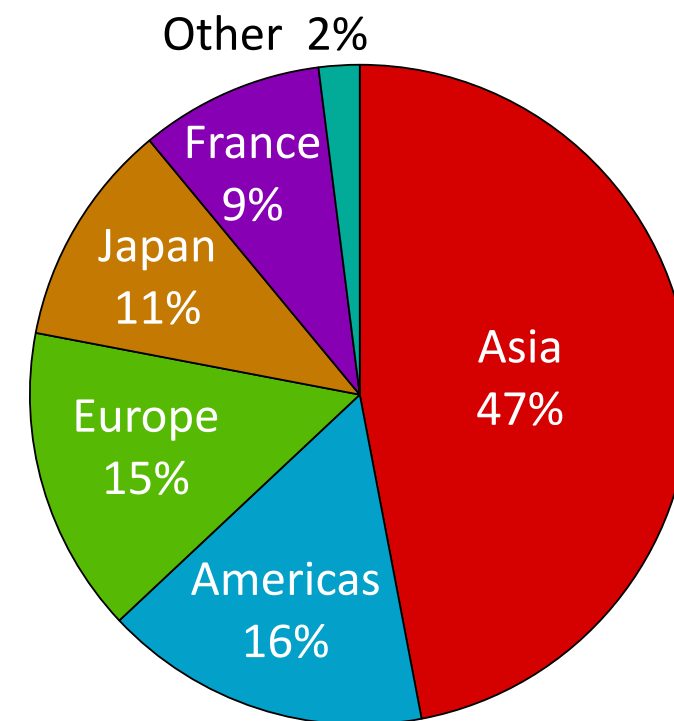


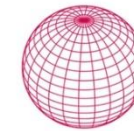
Silk, textiles, beauty, watches, other (29%)

Ready-to-wear accessories (25%)



Breakdown by region





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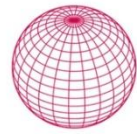
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Risks

Income statement	Global: All cos. ex Real Est. sector	Global: All Cons. Disc. cos.	Hermes International SCA
%	18-yr avg	18-yr avg	3-yr avg
Revenue	100.0	100.0	100.0
Cost of goods & ser.	(71.3)	(72.9)	(30.3)
Gross profit	28.7	27.1	69.7
SG&A	(15.3)	(17.4)	(29.2)
Other operating exp.	(3.9)	(2.7)	(5.5)
EBIT	9.5	7.0	35.0
Other items	(3.8)	(2.5)	(12.4)
Net profit	5.7	4.5	22.6
<i>Avg. # of cos.</i>	11,656	2,099	1

- ★ Hermès has consistently delivered a massive gross margin over time
 - It is almost 3x higher than the average Consumer Discretionary company

The company follows a differentiation strategy



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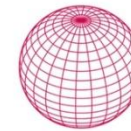
Risks

UNIQUENESS AND PERFORMANCE OF THE CRAFTSMANSHIP MODEL

Hermès leverages its craftsmanship activities, the first pillar of its strategy, with nearly 5,200 craftsmen in France. A House of over 180 years, backed by a rich history shaped by six generations of craftsmen, Hermès draws from its past through its *savoir-faire*, and is geared to the future through its values that address the concerns of our modern societies. Hermès moves with its times, but always respecting tradition, transmission and innovation. The quest for **excellence** and **quality**, the search for **precision** and elegance are the values that guide its action. It is over this long period of time that the House has forged its **savoir-faire** and its values, and that the Hermès strategic vision has developed.

- ★ HMRS has developed a vision of developing high quality products
 - **It only manufactures its products in France**
- ★ Hermès can operate in price categories where customer sensitivity is relatively low
 - **Its luxury collections provide high sustainable margins with high pricing power**

2 Intended scarcity creates excess demand



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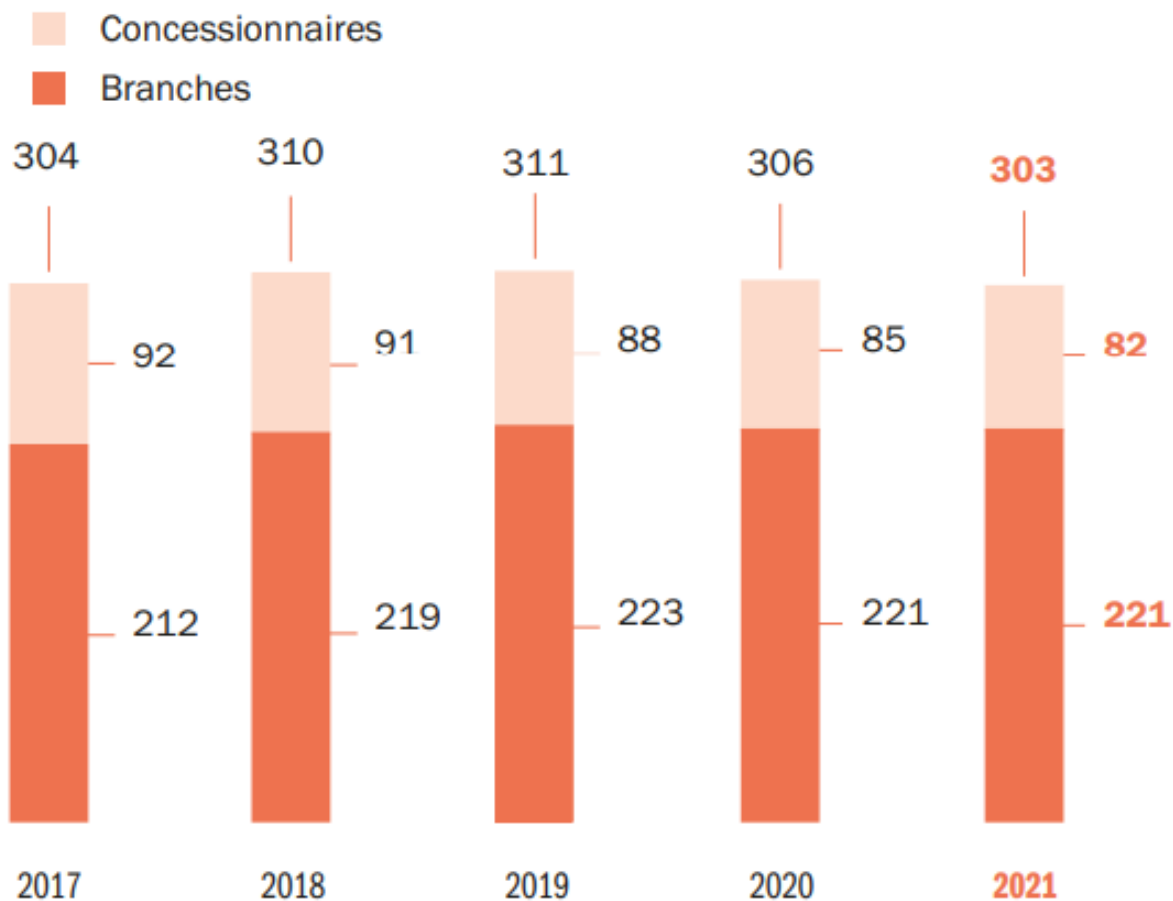
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Risks



- ★ As of 2021, Hermès operates only 303 stores globally, which is less than in the past
 - **For comparison, LVMH has more than 5,500 stores**
- ★ Exclusivity and difficult access to its products make the brand so desirable
 - **It creates intended scarcity and has long waiting lists of several years for its bags**
 - **The higher the price, the higher the demand**

Increasing price to increase demand sounds very odd

- For the majority of goods, we observe that overall demand decreases when price increases
 - People tend to switch to cheaper variants or look for substitute products
- However, there are a few products where the law of demand does not hold
 - Economists call them “**Veblen goods**”
 - If luxury products become cheap, they lose the premium status as more people can afford it
 - Raising the price helps to keep exclusivity



Ask
Ajarn
Andrew

Low marketing costs compared to competitors



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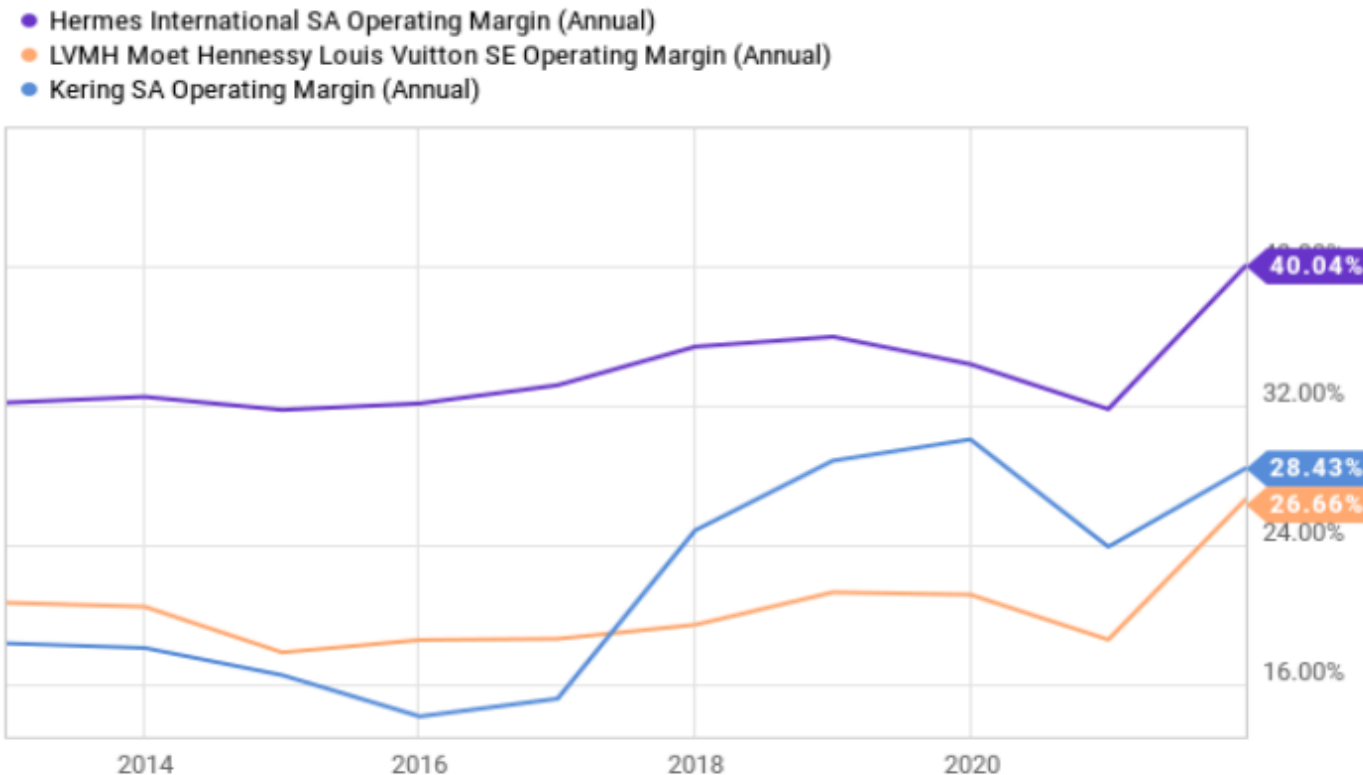
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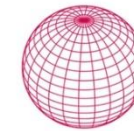
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Risks



★ Unlike its competitors LVMH (Louis Vuitton) and Kering Group (Balenciaga, Gucci, Yves Saint Laurent), Hermès has much lower SG&A and marketing costs

- The difference is that Hermès does not rely on brand ambassadors or celebrities promoting the brand
- For its competitors, such ambassadors is key for its marketing, but also very expensive



Sales

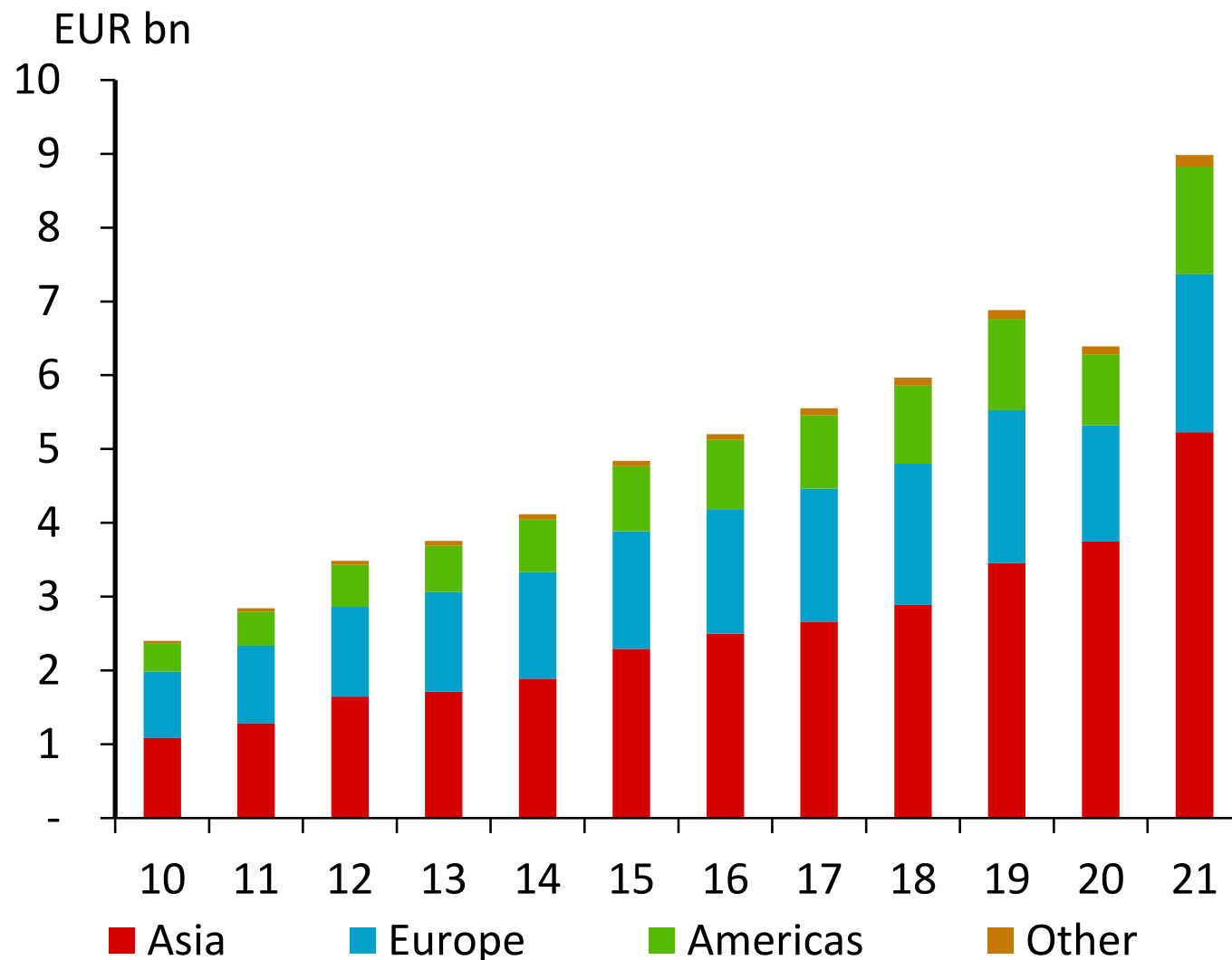
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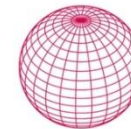
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Risks



- ★ Between 2010 and 2021, revenue from Asia has increased 5x
 - Its home market Europe only increased 2x over the same horizon
- ★ Luxury products in Asia are a representation of high status
 - Craftsmanship and artistry are widely associated with the upper class
 - It's the main market for Hermès to focus on to continue realizing growth

Consensus is divided



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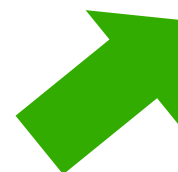
Risks

Analyst consensus valuation

Recommendation	Apr-22	May-22	Jun-22	Current
Strong buy	2	3	3	3
Buy	5	4	5	5
Hold	12	12	11	11
Sell	2	3	3	3
Strong sell	1	-	-	-
Average score	2.8	2.7	2.6	2.6

Price target	Mar-22	Apr-22	May-22	Current
Median	1,377	1,345	1,311	1,300
Mean	1,375	1,372	1,329	1,273

19
analysts

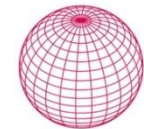


Upside: 43%

- ★ The majority of analysts stays on HOLD, as current share price might be too high
- ★ Analysts predict strong margins to continue as Hermès has a high pricing power

Analyst consensus 3-year forecast

(%)	19	20	21	22E	23E	24E
Revenue growth	15.4	(7.2)	40.6	17.6	10.2	9.5
Gross margin	63.2	61.2	65.6	67.2	67.0	66.5
EBIT margin	34.1	31.3	39.5	37.2	37.5	38.0
Net margin	22.2	21.7	27.2	25.7	26.1	26.4



(YE Dec, € m)	2020A	2021A	2022E	2023E
Revenue	6,389	8,982	10,419	11,148
Cost of goods & services	(2,481)	(3,092)	(3,751)	(4,013)
Gross profit	3,908	5,890	6,668	7,135
SG&A	(1,834)	(2,277)	(2,761)	(2,954)
Other operating (exp)/inc	(39)	(18)	(18)	(18)
EBIT	2,036	3,595	3,889	4,163
Interest expense (net)	(19)	(20)	(20)	(18)
Other non-operating inc/(exp)	(19)	(29)	(29)	(29)
Earnings before taxes (EBT)	1,998	3,546	3,841	4,116
Income tax	(613)	(1,015)	(1,152)	(1,235)
Earnings after taxes (EAT)	1,385	2,531	2,688	2,881
Equity income/Minority interest	12	26	32	34
Earnings from cont. operations	1,397	2,557	2,720	2,915
Forex/Exceptionals before tax	(11)	(112)	-	-
Net profit	1,385	2,445	2,720	2,915

★ Net profit could stay on heightened levels as it record strong demand growth for its products



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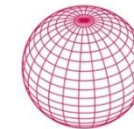
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Risks

(YE Dec, € m)	2020A	2021A	2022E	2023E
Cash & short-term investments	4,733	6,696	7,895	9,486
Accounts receivable	443	590	695	743
Inventories	1,289	1,449	1,719	1,839
Other current assets	185	110	125	134
Total current assets	6,650	8,845	10,433	12,202
Long-term investments	417	668	708	751
Net fixed assets	3,166	3,407	3,553	3,713
Intangible assets	221	258	283	310
Goodwill	42	42	42	42
Other long-term assets	555	627	721	829
Total assets	11,051	13,847	15,740	17,848

- ★ Hermès has a strong cash position as it generates huge cash flows on an annual basis

Balance sheet - liabilities



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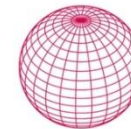
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Risks

(YE Dec, € m)	2020A	2021A	2022E	2023E
Overdrafts & short-term loans	220	249	241	248
Accounts payable	373	450	500	535
Other current liabilities	1,246	1,876	1,875	2,007
Total current liabilities	1,839	2,575	2,617	2,790
Long-term debt	1,466	1,553	1,614	1,662
Other long-term liabilities	355	307	310	313
Total liabilities	3,660	4,435	4,541	4,766
Minority interest	11	12	20	29
Paid-up capital - Common shares	103	104	104	104
Paid-up capital - Preferred shares	-	-	-	-
Retained earnings	1,385	2,445	4,487	6,676
Revaluation/Forex/Others	5,891	6,851	6,587	6,274
Total equity	7,380	9,400	11,179	13,053
Total liab & shareholders' equity	11,051	13,847	15,740	17,848

- ★ Hermès has low leverage with a liabilities-to-assets of 30%



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(YE Dec)	2020A	2021A	2022E	2023E
General growth (YoY, %)				
Revenue	(7.2)	40.6	16.0	7.0
Assets	11.8	25.3	13.7	13.4
Gross profit	(10.2)	50.7	13.2	7.0
Operating profit	(14.0)	76.6	8.2	7.0
Attributable profit	(9.3)	76.5	11.3	7.1
EPS	(9.5)	76.1	11.3	7.3
Recurring EPS	(11.7)	81.0	7.9	7.3
Du Pont analysis (%)				
Net profit margin	21.7	27.2	26.1	26.1
Revenue per €100 of assets	61.1	72.2	70.4	66.4
Assets/equity (x)	1.5	1.5	1.4	1.4
Return on equity	19.9	29.1	26.4	24.1
Others (%)				
Effective tax rate	30.9	29.6	30.0	30.0
Dividend payout ratio	34.2	33.3	25.0	25.0

★ Strong bottom line ensures consistent high profitability measured by ROE



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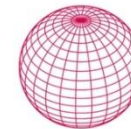
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(YE Dec)	2020A	2021A	2022E	2023E
Internal liquidity (x)				
Current ratio	3.6	3.4	4.0	4.4
Quick, or acid test ratio	2.9	2.9	3.3	3.7
Working cap. mgmt (Days)				
Inventory conversion period	176	159	152	160
Receivables collection period	27	21	22	23
Days from raw mat to coll	203	180	174	183
Payables deferral period	56	48	46	46
Cash conversion cycle	146	132	129	136
Profitability ratios (%)				
Gross profit margin	61.2	65.6	64.0	64.0
EBIT margin	31.9	40.0	37.3	37.3
EBIT return on avg assets	19.5	28.9	26.3	24.8
Return on average assets	13.2	19.6	18.4	17.4
Financial risk (x)				
Liabilities-to-assets (%)	33.1	32.0	28.8	26.7
Debt-to-equity	0.2	0.2	0.2	0.1
Net debt-to-equity	(0.4)	(0.5)	(0.5)	(0.6)
Times-interest-earned	85.3	129.9	136.4	142.6
Effective interest rate (%)	2.1	1.8	1.8	1.8

★ Cash conversion cycle is very long but is not a risk given the strong cash position and cash flow generation ability



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Risks

(YE Dec, € m)	2020A	2021A	2022E	2023E
EBIT	2,036	3,595	3,889	4,163
<i>Est tax rate (%)</i>	<i>31</i>	<i>30</i>	<i>30</i>	<i>30</i>
NOPAT	1,407	2,532	2,722	2,914
Add: Depre & amort	514	563	602	670
Less: CAPEX	(437)	(523)	(676)	(749)
Chg in A/R	74	(147)	(105)	(49)
Chg in inventory	(157)	(160)	(270)	(120)
Chg in oth curr assets	(128)	75	(15)	(9)
Chg in A/P	(33)	77	50	35
Chg in oth curr liabs	(156)	630	(1)	131
Less: Chg in working cap	(400)	475	(340)	(11)
Less: Chg in invest cap				
Free cash flow to firm	1,085	3,048	2,308	2,823

- ★ CAPEX requirements are relatively low as it does not expand aggressively in physical stores



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Risks

Forecast assumptions		
3-year average	Consensus	My assumptions
Revenue growth (CAGR)	12.4	9.9
Gross margin	66.9	64.0
EBIT margin	37.6	37.3
Net margin	26.1	26.3

My valuation method	
Market: France	
Market risk-free rate	2.5
Market equity risk premium	7.0
Market return	9.5
Company beta (x)	0.8
COE	7.8
WACC	7.3
Terminal growth rate	4.0

Valuation Method:
FCFF

- ★ I am a bit more cautious about the revenue growth prospects are China’s demand might be lower than expected
- ★ I value the company by using FCFF and a terminal growth rate of 4%



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Ratios

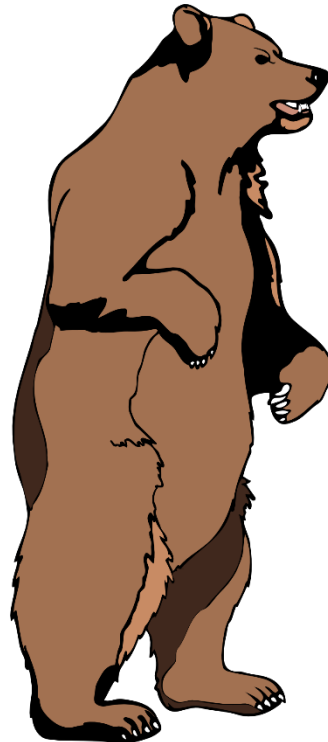
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Risks

Bear

EUR758

(Downside 33%)



Base

EUR811

(Downside 29%)



Bull

EUR877

(Downside 23%)





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Risks

- ★ Failure to adopt to changing consumer demands
- ★ Mean reversion of temporary heightened margins
- ★ Failure to comply with growing ESG standards could lead to reputational damage

CONCLUSION

- Competitive moat delivers best-in-class margin
- Asia continues to provide ample growth opportunities
- Lucrative company but at an expensive price

