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TRABAJO FIN DE GRADO

LUXURY SECTOR. PROFITABILITY FOR YEARS?

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ABSTRACT

To understand the unique characteristics of one of the most special sectors that exist, the luxury sector, we conduct a qualitative analysis of the whole sector and of four of its most representative companies: LVMH, Hermès, Kering, and Moncler. In the study, we analyze how it has evolved throughout history, the emotions its products evoke in people, the unique features of luxury goods, as well as the perspectives and options for their future. All of this is reflected in the financial figures of the four selected companies, which are also analyzed to determine how good and profitable these types of businesses are in the long term. As a final result, we compare the performance of these four companies in the stock market against a benchmark (the S&P 500) and see if all these qualities are truly effective in achieving good long-term returns.

KEY WORDS

Lindy Effect, Antifragility, Veblen Goods, Brand Awareness, Intrinsic necessities.

RESUMEN EJECUTIVO

Para entender las características únicas de uno de los sectores más especiales que existen, el sector del lujo, realizamos un análisis cualitativo de todo el sector y de cuatro de sus empresas más representativas: LVMH, Hermès, Kering y Moncler. En el estudio, analizamos cómo ha evolucionado a lo largo de la historia, las emociones que sus productos evocan en las personas, las características únicas de los bienes de lujo, así como las perspectivas y opciones para su futuro. Todo esto se refleja en las cifras financieras de las cuatro empresas seleccionadas, que también se analizan para determinar qué tan buenos y rentables son este tipo de negocios a largo plazo. Como resultado final, comparamos el rendimiento de estas cuatro empresas en el mercado de valores frente a un benchmark (el S&P 500) y observamos si todas estas cualidades son realmente efectivas para lograr buenos rendimientos a largo plazo.

PALABRAS CLAVE

Efecto Lindy, Antifragilidad, Bienes Veblen, Conciencia de Marca, Necesidades Intrínsecas

Content

1. INTRODUCTION

In the tireless search for the best sectors and business models that quality investors face, there are many unique characteristics of some sectors or businesses that make them different, and often better than the rest. These series of characteristics are inevitably linked to the business model and the industry in general, often achieved over many years of effort by the investors and founders of these companies.

If we talk about the principles of investment and its long-term success, one of the maxims is to avoid a permanent loss of capital, understood as an irrecoverable loss of the money invested, often due to poor performance of the company or a fundamental change in the business. It is the job of investors to avoid these permanent capital losses and, many times, the best way to do so is to find sectors and companies that enjoy underlying macro trends, and one of them, to which dedicate this project, is the luxury sector. As a private investor who has been doing research the financial markets for almost 4 years and in the luxury sector since 2021, I came to the conclusion that this is one of the best sectors that investors can buy for the long term. That is why, throughout the project, many personal opinions and ideas that I have come up during the past three years will be expressed.

My objective with this project is none other than to demonstrate the benefits of one of the most special and lucrative sectors in the world. That is why the first part of the project (section 2) aims to show all these unique characteristics and create a mental framework and understanding, before reaching a more quantitative part focused on the financial aspects of the four most representative companies in the sector that will be analyzed in more detail. In this way, in the last section (4.5) we will see, in practice, whether certain hypotheses are met and whether, as we said at the beginning, the luxury sector represents a good long-term equity investment strategy.

My personal implications would go directly to future investors and creators of luxury companies. The difficulty of creating a luxury brand is extreme, because not only does the available capital depend on it, but to a large extent, it requires the most scarce asset in the world, time. That is why, if you thought of some of the greatest businessmen and entrepreneurs in history and you gave them a sufficient amount of capital to create a global luxury brand, they would probably fail in the attempt and it would be impossible for them to compete against more established companies, as we will see throughout the project. Some examples are precisely, the four companies under analysis: LVMH, Hermés, Kering and Moncler. Two of these companies were founded more than 150 years ago and their success lies in achieving good brand image management over many decades.

Furthermore, economic principles and unique characteristics that apply to almost no other company in the world apply to all of these companies. Some of these are the Lindy Effect or Veblen Goods. This creates competitive advantages that make this sector one of the most resilient over time, which in turn makes them more "antifragile", a concept that we will delve into further later. All of this can be seen in a much more objective way in the excellent financial fundamentals that these companies enjoy and that make them so attractive for long-term investment. Although future profitability is never assured, the empirical results obtained in the past, thanks to the study of the four companies, can make us think that it is very likely that they will be able to compound capital and returns on the stock market in the long term.

2. IMPORTANT ASPECTS ABOUT LUXURY SECTOR

2.1 LUXURY SECTOR

The luxury sector is a huge market valued at 1,384 billion euros, in which we can differentiate nine different segments with different importance, size, and characteristics, as figure 1 shows. The growth rates from 2019–2022, despite having passed the pandemic, which heavily impacted the results of many companies, have been healthy, around 8%–10% compound annual growth rates.

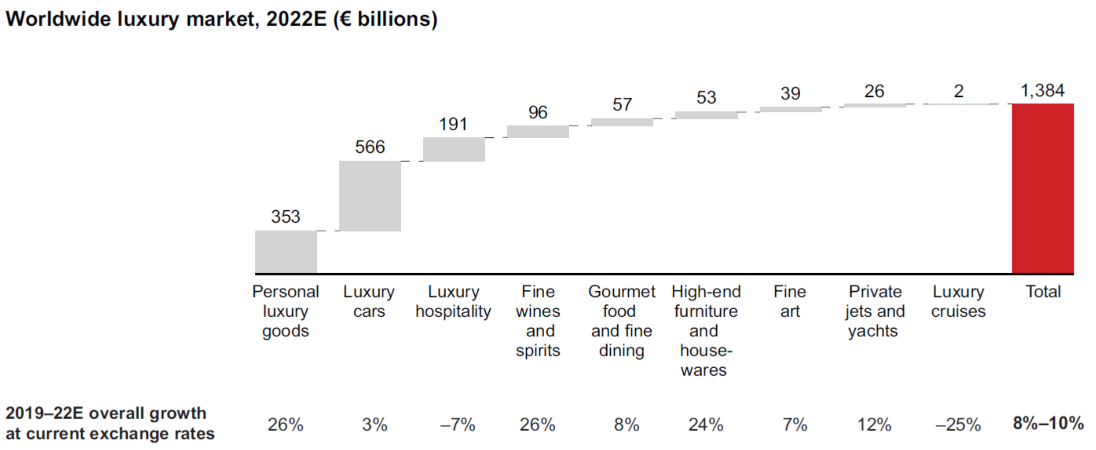

Figure 1. Source: (Bain & Company, 2022)

The biggest segment of the sector is the Luxury Cars one, with a size of 566B€, containing worldwide known brands such as Ferrari or Lamborghini. However for the purpose of this project, I will focus on the Personal Luxury Goods segment (353B€) formed by iconic brands and conglomerates, such as Louis Vuitton (from now on LVMH) Hermès, Kering and Moncler. There are several reasons for this, as there are more firms to compare with each other, the readers might be more familiar with these kind of products and they offer the most appealing investment option for the years to come.

There are different categories in this segment of the overall market, with "Leather" being the most important (80B€) and "Jewelry" (28B€) the least. According to figure 2, all of them have grown at high double digits in 2019-2022 and have surpassed the market sizes of 2019, before COVID-19 impacted.

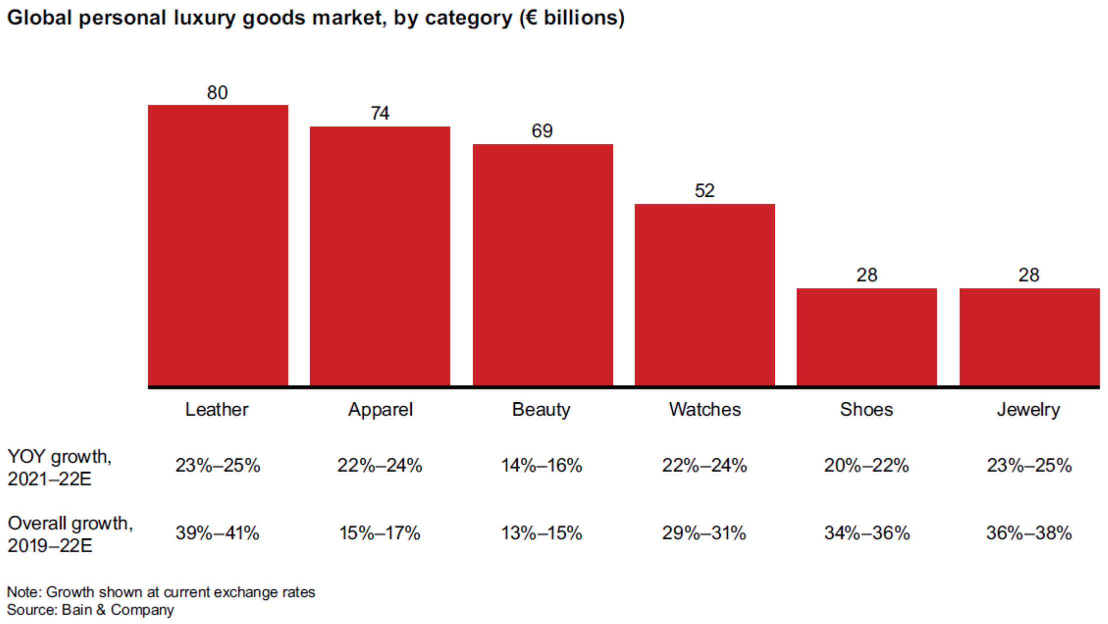

Figure 2. Source: (Bain & Company, 2022)

2.2 TIME PLAYS IN THEIR FAVOR

Unlike most industries in the world, the luxury sector benefits from pass of time. Taking their years of foundation as a reference, such as LVMH in 1987 (LVMH, s. f.), Hermès 1837(Hermès, s. f.), Kering 1963(*Kering*, s. f.), Moncler 1952,(Moncler s. f.), we can infer that strong brand reputations are built over many years and need time to occupy a place in mind of consumers. It is the story behind a brand or a company, that builds an emotional or logical connection with customers.

This aspect can also be explained by the "Lindy Effect" which states that the future life expectancy of any non-perishable object is a direct function of its past survival. (González-Sicilia, 2023) So if we take into account that some of these companies have more than a century of history, and that the risk of disruption is very low compared to many other industries we can infer that there are higher chances that these brands will last in the decades to come extending their Lindy Effect even more.

The final explanation of this fact is that many of these firms are family-owned businesses. There are many examples of family-operated firms in this sector, such as LVMH, Hermès, L'Oréal, and Estée Lauder. These kinds of managers have longer-term thinking, take actions to preserve the value of the brand and the firm, and instill their corporate culture in the employees and their descendants, as in the future they will probably take charge of the business.

Figure 3 shows the superior performance of these kinds of firms (the image is a basket of many different industries companies) compared to a non-family universe.

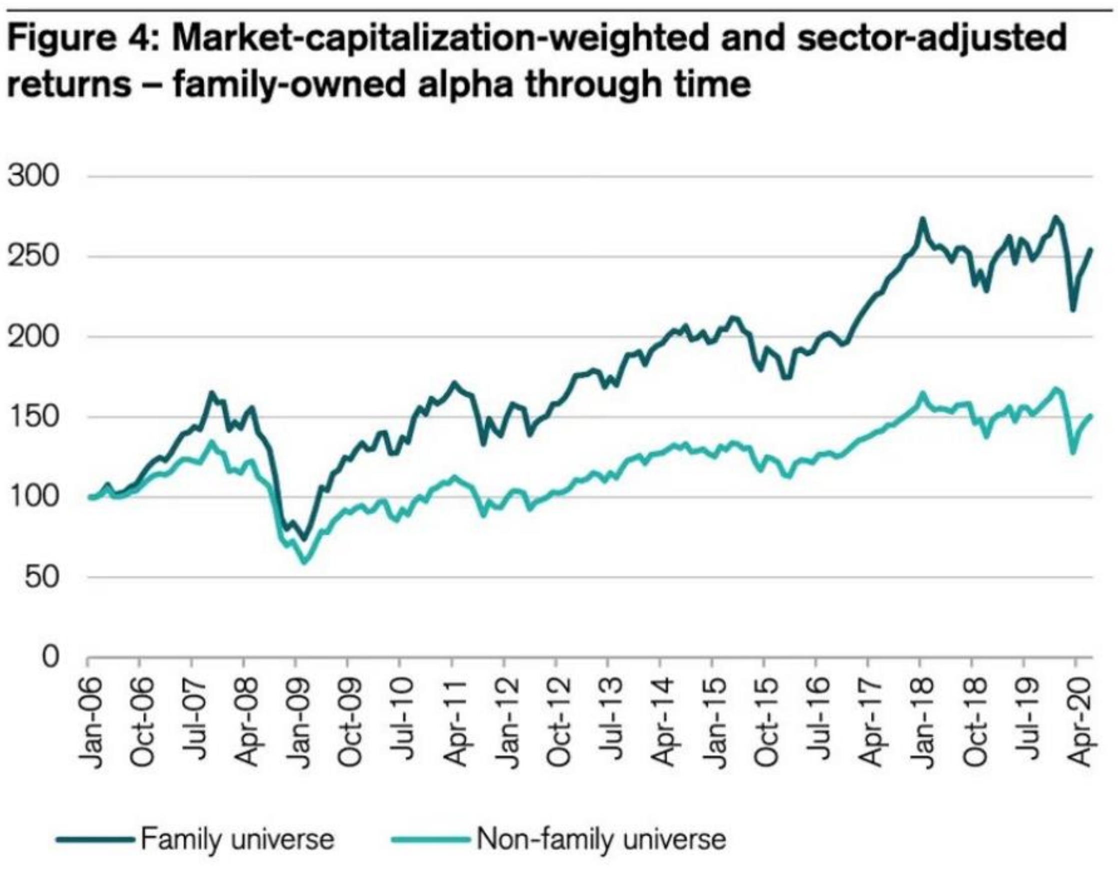

Figure 3. Source: (Family-Owned Businesses Show Resilience through Pandemic, 2020)

2.3 VEBLEN GOODS

A Veblen good is a good for which demand increases as the price increases due to its exclusive nature and appeal as a status symbol. (Chen, 2023) Unlike normal goods, luxury ones might be the only items in the world for which raises in prices are perceived as positive, as this increase their exclusivity and their desire. Unlike technological assets, which are deflationary by nature, as they reduce the demand for labor and increases productivity, luxury goods are inflationary as annual raises in prices are a must in this sector. Depending on the brand power and positioning, managers are able to raise them more than others, but normally all firms are able to increase prices at least, at the rate of inflation.

In figure 4, we can see the difference between Veblen goods, for which the higher the price, the higher the quantity demanded, while for normal goods, the opposite happens. As mentioned before, few goods in the world can achieve this unusual phenomenon, while most assets behave just the opposite way (normal goods): the higher the price, the lower the quantity demanded. This is one of the first theories taught in economics, but, as in almost any aspect of this matter, there are never absolute truths, and Veblen goods are the exception to the laws of demand.

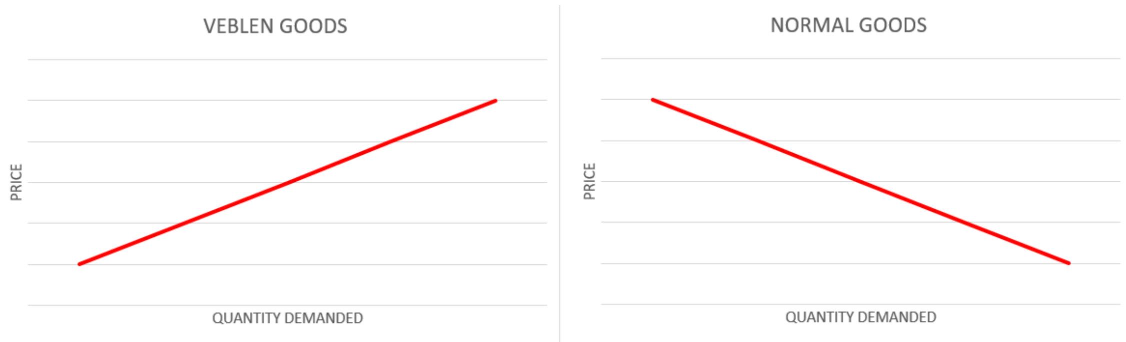

Figure 4. Veblen and Normal goods demand. Source: Own elaboration

2.4 GROWTH VS EXCLUSIVITY

The growth vs. exclusivity dilemma is one of the most challenging aspects faced by luxury companies (especially the newest ones) face. In order to preserve the value of the brand and create a feeling of scarcity, firms must control their supply of goods (volumes), so there is always a higher demand than the products offered. This is partially explained because many of the goods are handmade, so the production process is longer and much more complicated, but higher quality is ensured. By not outsourcing the production of their goods, companies are reinforcing their brand image and values. If not, these kinds of companies face the risk of becoming a premium good and not a luxury one anymore.

The difference between premium and luxury goods is that in premium goods, customers try to find a good balance between price and technical specs (functionalities, shapes, colors…), while in luxury goods, technological specs are not taken into account as much as the status that the good provides, the feelings of belonging, and the superior quality of the product. An example of this could be the Apple Watch, which is a premium good that offers an appropriate value and amount of functionalities for the price paid, compared to an Hermès watch, whose quality is really high while their specs or functionalities do not go beyond providing the time and date. One way to solve this dilemma could be the release of new product lines. For example, Ferrari launched its SUV model, the Purosangue, last year. This completely opens a new business line for the firm, as it escapes from the traditional sports cars that Ferrari has always been known for. With this new model, new customers are targeted: those interested in having a bigger and more durable car while preserving the essence of a Ferrari. In my opinion, this decision does not affect the brands' perceived value or exclusivity, as despite having more cars and models in circulation, the highest-end cars will still be very scarce and expensive, while having the possibility of selling higher volumes of cars at the end of the year without a negative impact on exclusivity. Other brands, such as Hermès or Louis Vuitton, have progressively broadened their offerings beyond exclusive collections of high-priced handbags and travel accessories to include ready-to-wear clothing and sunglasses. From my point of view, alcoholic beverages and spirits as well as fragrances and cosmetics are goods more suitable to carry out this strategy, as the product life is finite compared to a bag that can last forever with good preservation. Following this reasoning, releasing a higher number of fragrances or drinks does not impact the brand that much. In the case of companies without exposure to these segments, such as Moncler, their following path should be releasing new product lines (clothes) with limited supply and also limiting the supply of the rest of the product lines so that the brand image is not diluted that much. This evolution is not solely dependent on substantial research and development budgets but rather on the capability to leverage the full potential of their existing brands.

2.5 INTRINSIC TO THE HUMAN BEING

Since the beginning of our time, the human being has been attracted by exclusivity, status, precious objects, or exclusive experiences. Examples of this are the novelty parties and meetings of the Roman Empire, the treasures found in Egyptian mummies, or even weapons with precious stones from cave-age times. These kinds of goods or experiences fulfilled two intrinsic necessities of human beings: the feeling of belonging to a group and the desire to be better than others. In the times of the first men, this usually translated into higher chances of surviving (tribes were created to protect each other) and also higher chances of procreating (the same happens in the animal world). The strongest tend to mate easier.

A curious aspect also occurs in the luxury sector. Famous people purchase and show their clothes or goods at important events. Normally, influencers and celebrities live off promoting products. Companies pay these people to show the products on their social media or to wear them at important events. The brand power of some luxury firms is so strong that the most famous celebrities are willing to collect their products, such as some Hermès bags or Ferrari cars, and show them in public as if they were trophies, just as a sample of their power and privileges. In fact, in these two exact examples, companies have the power to choose their clients and force them to buy different items from their catalogs just to have the option of having access to the most exclusive brand goods. For example, the Ferrari models LaFerrari, Enzo, F12 TDF, Monza SP1, and Monza SP2 (Juárez, 2020) or the Birkin Hermès bags.

Despite all these aspects, sales and marketing expenses have an important impact on the P&L of the companies. Generally, marketing spending ranges around 20% and 40% of sales, with the exception of Hermés, which is a single brand and tries to be the most luxurious one. The table below represents the sales and marketing expenses of the four companies that I have chosen for the project. But if we take them in absolute terms, the investment passes a couple of billions on all occasions. This level of spending is impossible for smaller players and only illustrates the importance of economies of scale.

	2016	2017	2018	2019	2020	2021	2022
LVMH	39%	38%	38%	38%	38%	35%	36%
HERMÈS	5%	5%	5%	8%	10%	7%	6%
KERING	48%	46%	46%	44%	49%	46%	47%
MONCLER	22%	37%	22%	28%	30%	30%	28%

Table 1. Marketing expenses by company and year. Source: Own elaboration from data extracted from Tikr.

2.6 AN ANTIFRAGILE SECTOR

A relevant question could be whether the luxury sector is anticyclical or not. This can be argued, as normally, people who buy luxury products tend to have higher purchasing power, so they are less affected by economic downturns. We can argue that this is not something anticyclical, but just a safer sector than others with higher exposition to the economic cycle. This, at least, happens in the highest luxury brands (Hermès, Ferrari, Rolex, etc.) that tend to have waiting lists for some of their products, while in others of not so high status (Nike), the purchasing experience is more affordable and democratized, targeting a wider range of customers without that much economic power, making the spending behaviors more cyclical. Previously in this research, we explained the difference between premium and luxury goods. The premium consumption is much more discretionary, and therefore it tends to be reduced in tough economic times, while the luxury consumption suffers less and has more resiliency.

Table 2 shows the performance in terms of revenues and EPS during the Lehman Brothers crisis of 3 of the companies (Moncler was not a public company in those times) showing the resiliency of this sector during difficult times. (If Kering is more affected is because during those times, it was a much more diversified conglomerate having more exposure to economic cycles)

REVENUES	2007	2008	2009	2010
LVMH	16.481 €	17.193 €	17.053 €	20.320 €
YoY Growth		*4,32%*	*-0,81%*	*19,16%*
HERMÉS	1.625 €	1.765 €	1.914 €	2.401 €
YoY Growth		*8,58%*	*8,48%*	*25,41%*
KERING	19.098 €	17.207 €	13.584 €	11.008 €
YoY Growth		*-9,90%*	*-21,05%*	*-18,97%*

EPSs	2007	2008	2009	2010
LVMH	4,22 €	4,26 €	3,70 €	6,32 €
YoY Growth		*0,95%*	*-13,15%*	*70,81%*
HERMÉS	2,71 €	2,76 €	2,74 €	4,00 €
YoY Growth		*1,85%*	*-0,72%*	*45,99%*
KERING	7,54 €	2,63 €	2,26 €	5,60 €
YoY Growth		*-65,12%*	*-14,07%*	*147,79%*

Table 2. Revenues and EPS during the 2008 financial crisis. Source: Own elaboration with data extracted from Tikr.

This could prove that the luxury sector is more or less defensive, but in my opinion, this sector is antifragile. Antifragility is a term created by Nassib Taleb to explain how some people or companies (in this case) can get stronger through difficult times. (Street, 2014)

For example, before pandemic, online sales was a lacking segment for this luxury companies, while now and after having been locked at home for some months, represent 21% approx. of luxury companies revenues (75B€ out of a retail market of 353B$) *(Bain & Company, 2022*) Before 2020, 88% of the revenue came from retail and wholesale stores *(Bain & Company, 2022)*, and most of them were closed due to the pandemic restriction. In Table 3, the performance in terms of revenues and EPS during the COVID-19 crisis of the four chosen companies.

REVENUES	2019	2020	2021	2022
LVMH	53.670 €	44.651 €	64.215 €	79.184 €
YoY Growth		*-16,80%*	*43,82%*	*23,31%*
HERMÉS	6.883 €	6.389 €	8.982 €	11.602 €
YoY Growth		*-7,18%*	*40,59%*	*29,17%*
KERING	15.884 €	13.100 €	17.645 €	20.351 €
YoY Growth		*-17,52%*	*34,69%*	*15,34%*
MONCLER	1.628 €	1.440 €	2.046 €	2.603 €
YoY Growth		*-11,51%*	*42,05%*	*27,21%*

EPSs	2019	2020	2021	2022
LVMH	14,23 €	9,32 €	23,89 €	28,03 €
YoY Growth		*-34,50%*	*156,33%*	*17,33%*
HERMÉS	14,55 €	13,21 €	23,30 €	32,09 €
YoY Growth		*-9,21%*	*76,38%*	*37,73%*
KERING	17,40 €	17,28 €	25,40 €	29,30 €
YoY Growth		*-0,69%*	*46,99%*	*15,35%*
MONCLER	1,42 €	1,18 €	1,47 €	2,26 €
YoY Growth		*-16,90%*	*24,58%*	*53,74%*

Table 3. Revenues and EPS during the COVID-19 financial crisis Source: Own elaboration with data extracted from Tikr.

Both metrics suffered more than in the previous crisis while having strong rebounds in 2021, but online commerce was boosted thanks to this and now represents another pilar of their omnichannel.

Another advantage of this sector is the absence of technological disruption. A fundamental part of luxury consumption is the shopping experience. The individual and sophisticated treatment that workers provide to customers is a distinctive aspect of retail stores operated by the brands themselves. The owned retail stores now represent 50% of the total stores in the sector in general, compared to 28% in 2010. Moreover, these retail stores are strategically located in important cities and neighborhoods, all placed close to each other to create positive synergies, such as Paris Champs Elysees or Serrano Street in Madrid. This is explained because these are not excludable goods; people can buy a bag at Hermès and a t-shirt at Moncler the same day, and it will not be the same if a firm uses an specific accounting software; probably, it will not use another accounting software for doing the same tasks, as the necessity is covered with the first one.

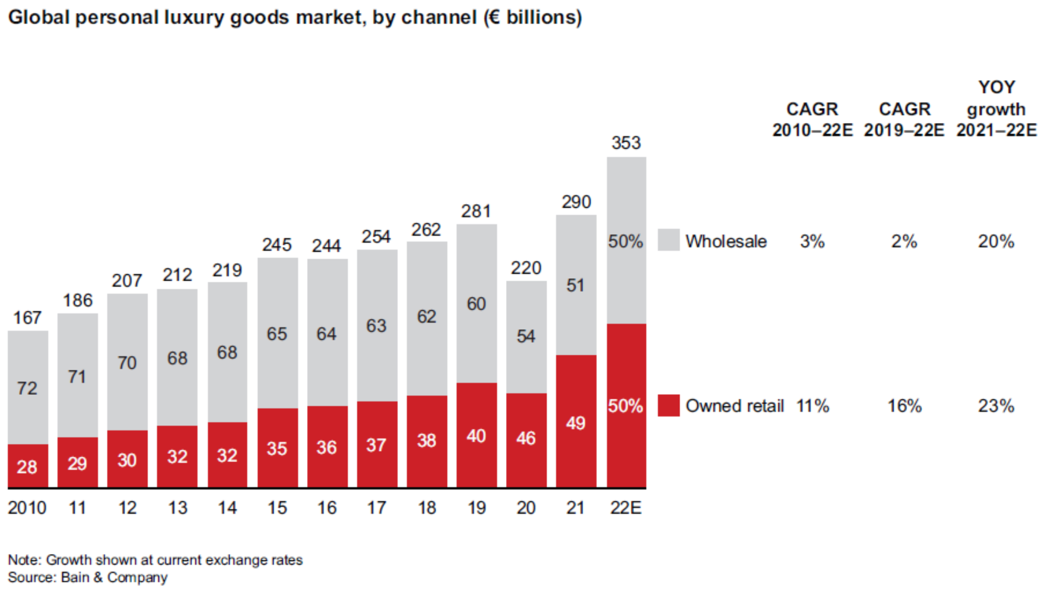

Figure 5. Source: (Bain & Company, 2022)

These experiences are part of the essence of luxury, and companies know this. That is why they are increasing their efforts to open own-operated shops and close wholesale shops in order to increase the perceived value of the brands, have better control over inventories and working capital, and provide a better customer experience. An example of this could be the Moncler and Stone Island stores, characterized by their original and changing interiors and designs. Another positive aspect of owning the stores is that all this real estate is protected against inflation thanks to its privileged locations, so probably, the real value of these assets is much higher than that shown on the balance sheet. They avoid lease payments, which can be increased with each contract renewal, and firms can make better management decisions about inventories and shop personnel, improving customer relationships.

Figure 6: Interiors of two Moncler stores. Source: (Stocks, 2023)

This fact completely eradicates the technological disruption from retail players such as Amazon or even specialized e-commerce luxury platforms such as Farftech, which are not allowed to sell top-notch brands like LVMH or Hermès. In fact, brands are more vulnerable when novelty and fast-changing technologies are the main advantages of the sector. In the luxury world, the opposite happens: tradition, history, and own operations are more valued than technological advantages. These firms operated their own online channels, increasing the scarcity and perceived value of their products. The monobrand sites follow the same positive trend as the own-operated stores.

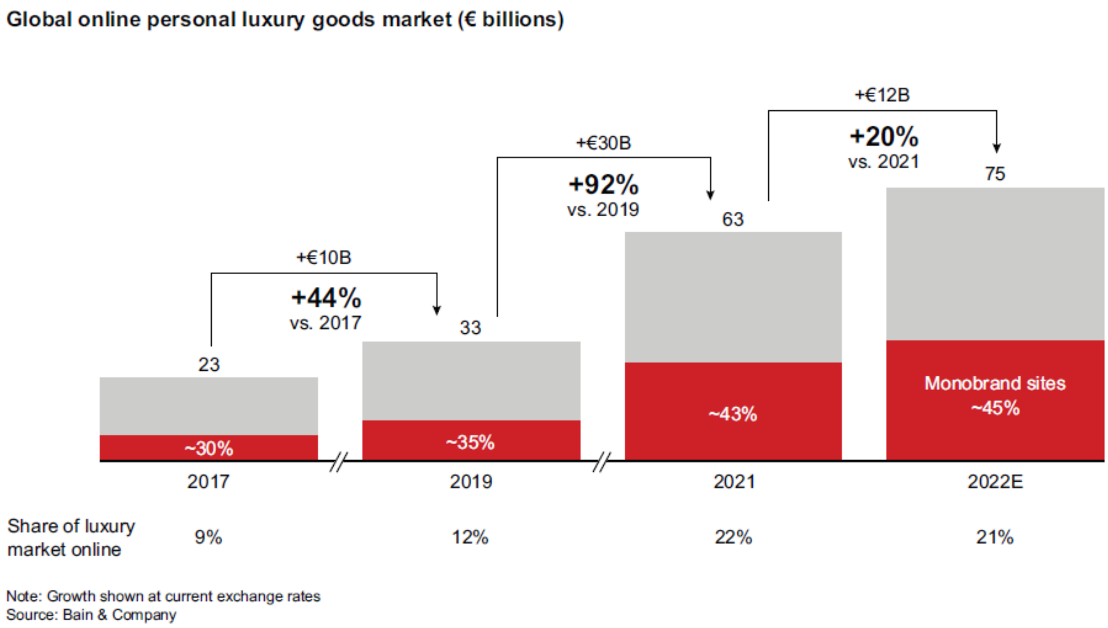

Figure 7. Source: (Bain & Company, 2022)

In addition to all this, the biggest luxury companies are fully vertically integrated, which means that they control each step of the value chain, from the acquisition of raw materials until the control of the marketing and sales channels. This ensures the highest quality in every one of their products, making it more difficult for other brands to match their value proposition. All this is only possible thanks to their economies of scale, which allow them to have financial muscle to face high expenditures such as marketing or manufacturing facilities while being able to reinforce their brand image.

2.7 GROWTH AND MACRO PROSPECTS

Until now, we have only talked about past aspects and characteristics, but the future of the sector is also a crucial matter. "Past performance does not ensure future profitability"(*Russell Investments*, s. f.), but thanks to the intrinsic characteristics of the sector and other factors such as the Lindy Effect, the confidence in its future is really high.

If we take a look at the expected pace of growth of the overall retail sector, 5% to 7% compound annual growth rates (CAGRs) are expected until 2030. It has a rate of growth well above the world GDP (2%) and a targeted inflation rate objective of 2%, which makes it an appealing place to invest. Moreover, in my opinion, the best companies in the sector that possess the strongest brands will enjoy higher growth rates in both their top and bottom lines of the P&L, thanks to their brand power, their more optimized cost structure thanks to the economies of scale and vertical integration and the higher advertising power spending.

Figure 18: Solid market fundamentals should lead to a positive medium-term trajectory for personal luxury goods (with potential bumps along the way)

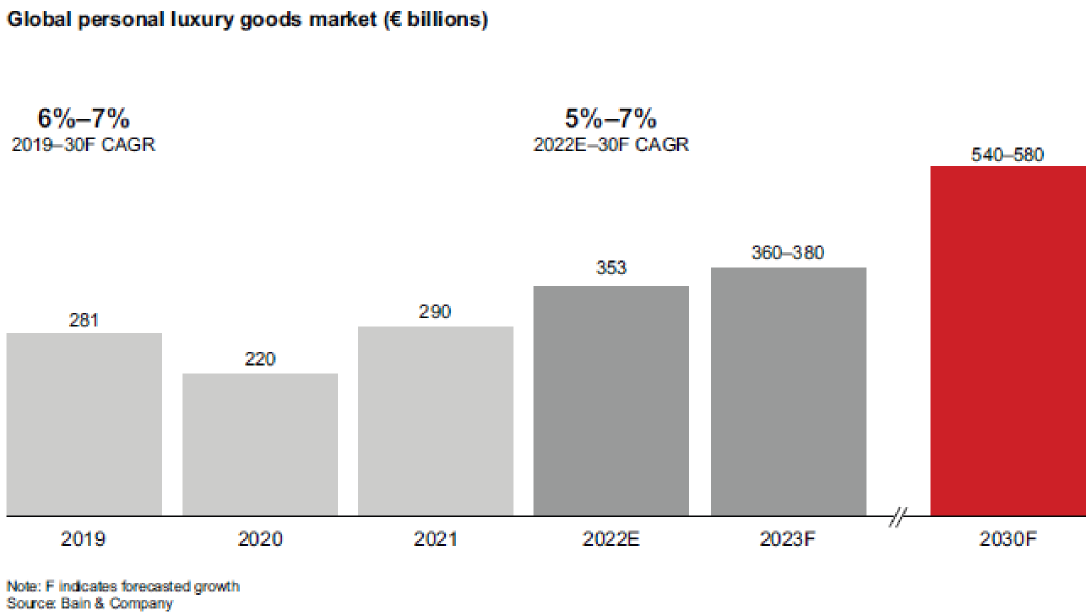

Figure 8. Source: (Bain & Company, 2022)

There are several factors explaining this growth rate for the next decade. The most important one resides in the Chinese market's expansion. In 2022, just the Chinese region accounted for 17% of the overall market expenditure. This market share is expected to grow to 25%–27% in 2030, thanks to the increase in the Chinese middle class and the liberalization of its market. Companies are aware of this, and they are focusing their efforts in the Asian region with the opening of R&D and innovation centers (like Estée Lauder) and more retail shops (like Moncler) to try to capture a higher market share in the fastest region in the world. But not only the Chinese market is important; Chinese consumers are even more important, as they are estimated to have a market share of around 38%–40%, thanks to their consumption overseas. Many times, China is confused between its importance and its dependence. China is important, but not completely dependent. Just to show the importance of the Asian country, in the year 2021, 11 out of the 100 biggest luxury companies in the world will be Chinese.

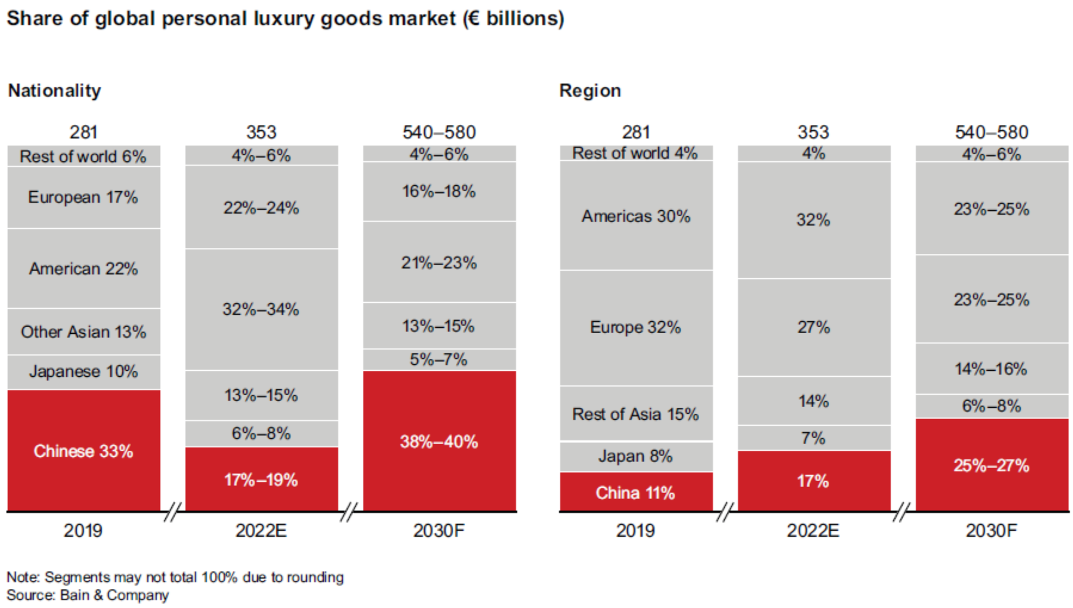

Figure 9. Source: (Bain & Company, 2022)

Another source of growth will be targeting the youngest generations, such as the Millennials or Z Generation, which are expected to grow three times faster than other populations of similar ages, becoming around 30% of the overall market. (Bain & Company, 2022) The continued engagement in social media reinforced this trend, with the continuous desire to pretend to have more than you have or try to impress their followers. Creating habits in these kinds of young generations is very important, as they have not reached their total income peak yet, so once this happens, the consumption patterns of luxury items must already be integrated so brands can benefit from this secular trend.

2.8 NFT WORLD. THE HIDDEN VALUE?

This might be the most technical and less familiar part of the project, but I think it is important to include it, as it could represent a future positive option for adding extra sources of revenue to these kinds of companies. It is a non-tangible way of diversifying product categories. NFTs, or non-fungible tokens, are digital assets certified using blockchain technology. The cryptography of these tokens is what makes them unique; no two of them are alike, and they cannot be exchanged for each other. This allows you to prove that the person who bought it, is its sole owner. Non-fungible goods are not replaceable or consumed when "used". (NFT, 2022) And customers can prove their property through "smart contracts," which are self-executing digital contracts utilized to govern non-fungible tokens (NFTs). These contracts consist of executable lines of code that respond to specific conditions outlined in IF/THEN scenarios. Similar to the digital assets they encapsulate, these contracts reside on a blockchain, rendering them decentralized, transparent, and unalterable. (Dilmegani, 2023)

Thanks to the NFT, scarcity and exclusivity for future digital products are ensured. The ownership and authenticity are easily checkable thanks to the smart contract, and they are asset-light products (the capital expenditures for releasing these kinds of products for companies are minimal), which means that they have really high margins. Moreover, the creator of the NFT (luxury firms in this case) will gain a percentage on each transaction (when the NFT is traded) in the form of a royalty.

The NFT world is a whole new industry and world of possibilities, but it is really difficult to quantify its potential. According to Bain & Company 2022 luxury report, there will be a potential market of about 60B$-120B$ by 2030, related to the Metavers, NFTs, brand communities and exclusive events. But as this segment will never be the main source of income for luxury companies (just a complement) I consider it an optionality. The possibilities are wide, for example, private communities for NFTs holders, NFTs can be issued in order to have exclusive access to some events or rare clothes drops just for owners of the NFT. Imagine a collaboration between the Louvre Museum and LVMH. They can drop 10 Mona Lissa's with a LVMH bag NFTs, and buyers could be the sole owners of one of the ten items. How valuable is this? They would be like non-tangible pieces of art that can provide extra benefits, such as exclusive access to a private event in the museum for the 10 NFT owners. There are already several brands that have used NFTs for different purposes, such as: Gucci, LVMH, Balmain, Prada… (Van Rijmenam, 2022) All the things mentioned above would help to create long-lasting relationships between customers and brands and boost the sense of belonging and identity with companies. In my opinion, there are only advantages as the operational risk is very small, and NFTs are products that perfectly fit the scarce and exclusive nature of luxury companies while creating alternative sources of income with asset-light products for the companies.

The NFT and Metaverse flow of income should be included in the terminal growth rate of the company and not on actual cash flows as a valuation matter (Using Discounted Cash Flow-DCF models). The fact that all these luxury companies have a high terminal value, would make the Lindy Effect even bigger and stronger and can give decades of extra growth for the companies sources of income. The sector is more anti-fragile with the past of time.

3. RETAIL COMPANIES PRESENTATION

In order to dig deeper into the personal luxury goods segment, we will focus on the 4 biggest exponents of the market. LVMH, Hermès, Kering and Moncler. Before starting to compare them with each other on a simultaneous way in different quantitative aspects, a brief description of each company will be provided, in order to have clearer concepts before trying to determine which one is the best.

3.1 LVMH

Louis Vuitton (LVMH) is the biggest luxury conglomerate in the world. It was founded in 1987 through the merger of two French companies, Louis Vuitton (founded in 1854) and Moët Hennessy (created in 1971).(*LVMH, World Leader in High-Quality Products*, s. f.)

FIRM	LOUIS VUITTON		
TICKER	LVMH	FOUNDATION	1987
ENTERPRISE VALUE IN	441,467B€	EXPECTED g	10%
DIVIDEND	12,00 €	DIV YIELD	1,40%
FCF YIELD	2,91%	FCF/EBITDA	48%
PRICE	860	AV. 7Y	

Table 4. Important data about LVMH. Source: own elaboration from company fillings

The group is formed by more than 75 companies from different segments. The company segments its revenue as shown in the figure 10 attached below. In my opinion, the combination of a diversified and extended portfolio, with good execution and implementation on the company's portfolio of new acquisitions, taking advantage of the group's expertise and scale, might be the strongest point of LVMH from a corporate and investment point of view. This encourages cross-selling among the different products in the group and reduces the risk of product failure.

Figure 10. LVMH revenue by region and business group. Source: (LVMH 2022 annual report)

The most important segment is "fashion and leather goods", which represents 49% of the group's revenue and 74% of the operating profit. (LVMH 2022 annual report) But thanks to its wide diversification, we can invest in LVMH as if it were an ETF, having exposure to all the segments of personal luxury goods, with brands above average, and outstanding management. Just to give some examples, inside the "fashion & leather goods" segment, we can find brands such as Dior, Versace, Givenchy,... In "Wines and Spirit," they control Moet Chandon and Hennessy. In "Perfumes and Cosmetics", the group owns Fendi and Loewe, among others. In the segment "Watches and Jewelry" (my second favorite segment), there are brands like Tag Heuer, Bulgari, and their last acquisition, Tiffany & Co. (LVMH 2022 annual report). And finally, its "Selective Retailing" segment, which includes all the locations of the brand, Sephora. The company is fully vertically integrated, owning all of its retail locations, which carries all the benefits explained in part 1 of the project. This vertical integration has been crucial for maintaining its level of profitability while price for many raw materials went up due to increasing demand and Ukrainian war pressures.

The CEO of LVMH is Bernard Arnault, one of the richest people in the world. He and his family group own 48.2% of the company and 65% of the voting rights. (LVMH Investor relations, 2023) So all the decisions of the group are under his power. In my humble opinion, I consider him, if not the best, one of the best CEOs in the world. Moreover, the five heirs of Mr. Arnault are working for the company. Delphine's appointment at the head of Dior was preceded by the appointment of her brother Antoine Arnault, age 45, as head of the LVMH conglomerate. The other three brothers also occupy prominent positions in this emporium: Alexandre Arnault, 30, is head of products and communication at Tiffany; Frederic Arnault, 28, is CEO of Tag Heuer; and Jean Arnault, 24, is the head of marketing and product development for Louis Vuitton's watch division. (BBC News, 2023)

Another important part of LVMH's growth strategy is the continuous acquisition and integration into the company structure of luxury brands from all of its different segments. The last one was Tiffany’s in 2021, but there are many other examples, like Bulgari in 2011 or Sephora in 1997 (*Acquisitions by LVMH*). The strategy is clear: they acquire companies with renowned brands that have temporary problems and are not at their full potential. Although Bernard himself has stated on many occasions that the main goal of the group is to grow organically, this organic growth can come in the form of higher prices, higher volumes, or a mix of both. Finding the equilibrium between the two, as mentioned in the first part of the analysis, is key to maintaining the terminal value of a company. In my opinion, what LVMH does with the combination of acquisitions and organic growth (despite the operational risk of the acquisitions or the price paid for them) is the best strategy for creating positive synergies between brands and taking advantage of the scale and financial strength of the company.

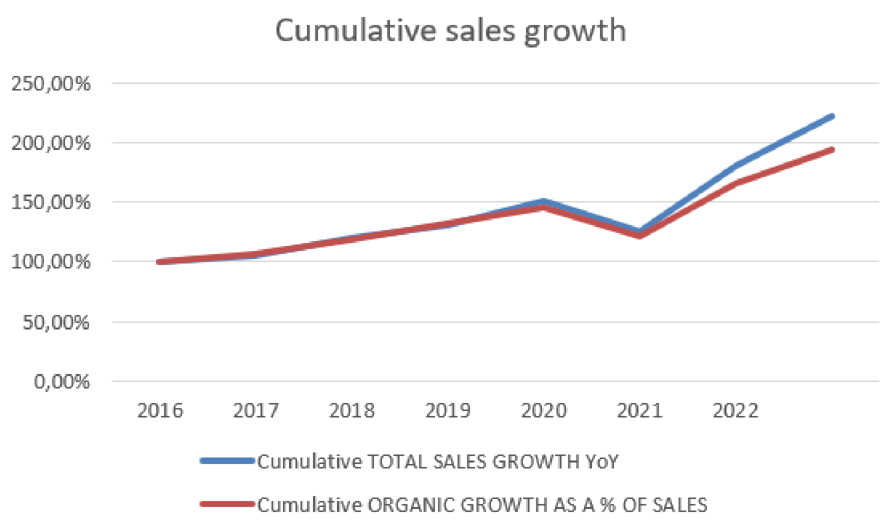

Figure 11. Source: own elaboration with data extracted from Tikr

As a conclusion, figure 12 shows the growth in revenues and net income in the last 7 years.

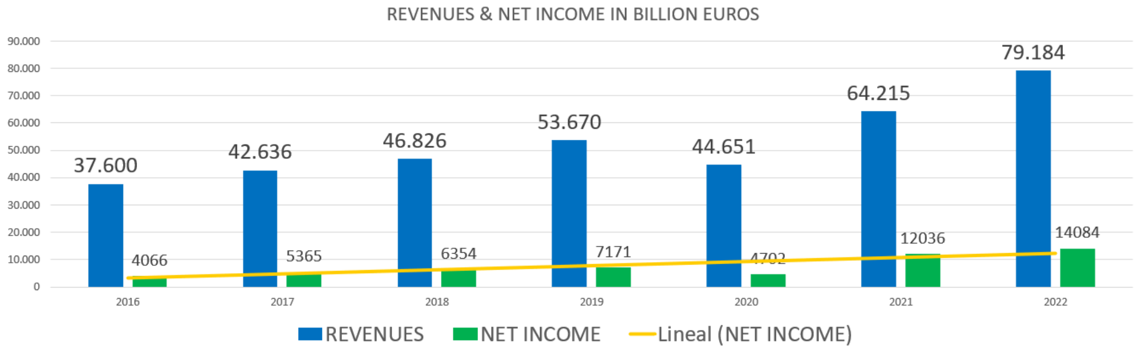

Figure 12. Source: own elaboration with data obtained from Tikr.

3.2 HERMÉS

Hermès might be the highest luxury expression in the personal luxury goods segment. Founded in Paris in 1837 by Thierry Hermès, initially the brand was dedicated mainly to the manufacture of harnesses and leather goods for horses. The brands' (Birkin and Kelly are the maximum exponents) bags are so famous because the creator began to make them for his wife with the same materials that he used to make the horse saddles. At first, they were designed to actually transport them, not for everyday use. Then he began to sell them, but not in masse, since they were craft-made. (Colino, 2009)

FIRM		HERMÉS	
TICKER	RMS	FOUNDATION	1837
ENTERPRISE VALUE	190.414	EXPECTED g	15%
DIVIDEND	$13,00	DIV YIELD	0,68%
FCF YIELD	1,52%	FCF/EBITDA	49%
PRICE	1901	AV. 7Y	

Table 5. Important data about Hermes. Source: own elaboration

Hermès operates under a single brand. It is widely diversified in terms of products and geographies, as shown in figure 13. This gives the company more resiliency towards economic downturns in some of its regions or products.

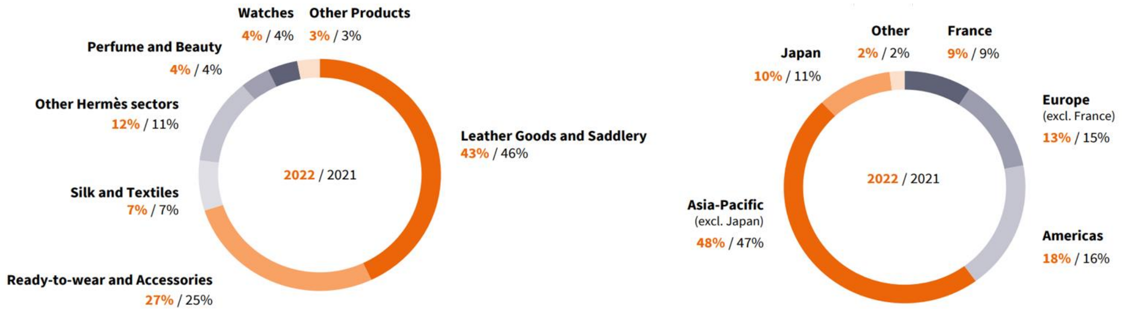

Figure 13.Hermés revenues by business segment and geography Source: (Hermès - 2022 Universal Registration Document, 2022)

Hermès is one of the most singular companies in the world, not only due to its almost two centuries of history and six generations of legacy but also because of its way of doing business. When buying at Hermes, there are no preorders, no waiting lists, no returns, and no guarantees. The firm refuses to increase inventory or mass manufacture, so its products are extremely scarce and expensive, as well as suffering price appreciation over time. Its flagship product is the Birkin bag, which is worldwide known because it was initially made and inspired by the singer and actress Jane Birkin, who happened to be traveling next to Jean-Louis Dumas (president of the company) (Colino, 2009). The average production time for a Birkin Bag can be between 25 and 40 hours, made by expert craft makers at a unitary cost of around €500. Hermes is able to sell them for more than €40,000. They have to be perfect, or else they are burned. The craftsman must have been with the company for 10 years. The most expensive are those made with alpine crocodile skin from the Himalayas. The most expensive in history was sold at a Hong Kong auction in 2017 for 340 thousand dollars (Monterrubio, 2022). The buying process is also complex, but as a summary, the buyer has to collect other items of the brand and buy them in the same store until they earn the right to be on a waiting list for months to be able to buy them. (Rebloom, 2020). If buyers want to avoid all this, they can always buy them on secondary markets, where they are sold at much higher prices. A strong secondary market can lead to more repeat purchases. The difficult access to products and a strong secondary market mean that luxury comes to be seen as an investment (the same can be applied to Rolex). All Birkin's are worth more secondhand than brand new, giving the illusion that it is not a purchase but an investment.

The company has always paid special attention to the quality of its products. That is why artisans are trained for years in a vocational school and enroll in a Hermes school, followed by 18 months of training with a journeyman artisan. In fact, many of their production locations and labor force are French. The global footprint of stores is also very limited (303), and Hermès only sells through its direct online channels. All these just increase the quality, value perception, scarcity, and brand power of the firm and, in my opinion, place it at the same level as Ferrari or Rolex as the maximum expressions of luxury. In addition to this, and as it happened with LVMH, Hermès is fully vertically integrated, having control from raw materials until the distribution channels.

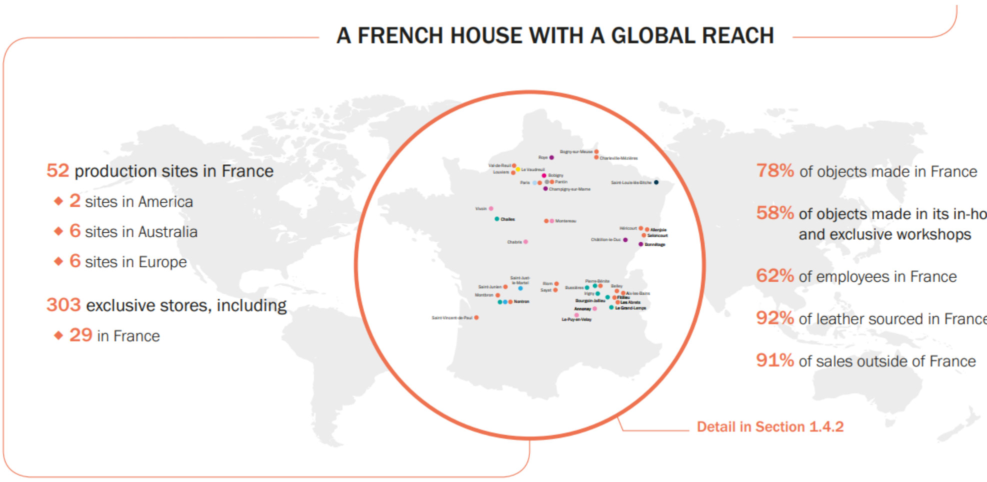

Figure 14. Source: (Hermès - 2022 Universal Registration Document, 2022)

The Hermés family owns 66.59% of the company. It is one of the only luxury brands that has never been sold to a conglomerate, even though some competitors like LVMH have tried to buy it in the past. (La Información, 2014) Unlike any of its competitors, Hermès has never purchased any other company, and their capital management is very conservative. The company does not repurchase shares; it shares dividends at a small payout ratio of 36%. (TIKR, 2023) and has a net cash position of 9B€ (TIKR, 2023). The capital allocation is oriented towards organic growth rather than through mergers and acquisitions, which implies a higher operational risk. All this is backed up by its corporate culture, which is focused not only on the quality of the product but also on the well-being of their employees and the training they received through their stay with the company. This is a very difficult to replicate and cumulative know-how, not easy to value from an investment point of view, and that can be seen as a hidden asset inside the operational capability of the company. The company usually shares its success with the employees by giving them bonuses every year. In 2023, they will give a bonus of €4,000 to each employee. (Hermès Universal Registration Document, 2022)

Savoir-faire and corporate culture	Roll out operational and managerial training	83 trainers covering the leather *métiers* for 22 leather goods workshops
	Cultivate internal *savoir-faire*	423,317 hours of training provided worldwide, i.e. 8% more than in 2020
	Spreading the corporate culture	6,855 leather craftspeople trained in 10 years
		Creation of an Apprentice Training Centre for leather goods (State diploma)
		23 Meilleurs Ouvriers de France (Best Craftspeople in France)
		100% of employees receive training in the Hermès culture

Figure 15. Hermés employees compensation. Source: (Hermès - 2022 Universal Registration Document, 2022)

As a conclusion, figure 16 shows the growth in revenues and net income in the last 7 years.

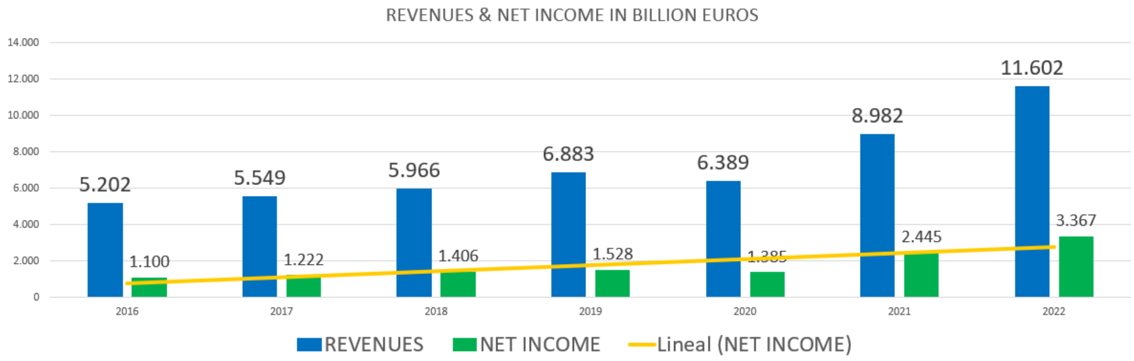

Figure 16. Source: own elaboration with data obtained from Tikr.

3.3 KERING

Kering is a conglomerate of luxury houses founded in 1963 and managed by François Pinault (current CEO). It is formed by worldwide-known brands such as Gucci, Yves Saint Laurent (YSL), Bottega Benetta, and many others. The biggest shareholder of the company is the Pinault family, with 42% of the outstanding shares held. (*TIKR*, s. f.).

KERING

FIRM		KERING	
TICKER	KER	FOUNDATION	1963
ENTERPRISE VALUE	64.879	EXPECTED g	8%
DIVIDEND	$14,00	DIV YIELD	2,80%
FCF YIELD	5,02%	FCF/EBITDA	65%
PRICE	500	AV. 7Y	

Table 6. . Important data about Kering. Source: own elaboration

Figure 17 shows how Kering splits is revenue. Kering has a high revenue concentration in Gucci but is well diversified on a geographic scale.

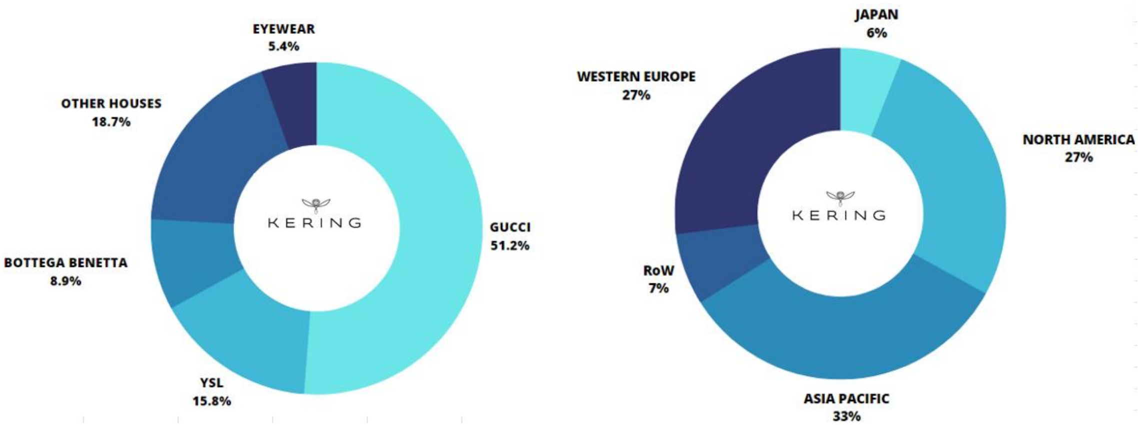

Figure 17. Kering revenues by business segment and geography. Source: Own elaboration with data extracted from 2022 full year results presentation

Before becoming Kering in the year 2013, it was known as PPR (Pinault Printemps Redoute). In the year 2009, the group started its transition towards the luxury sector by making several splits, such as Fnac and Conforama (Modaes, 2009). These past decisions have helped the group become a much more profitable company, with a stronger balance sheet and less discretionary demand.

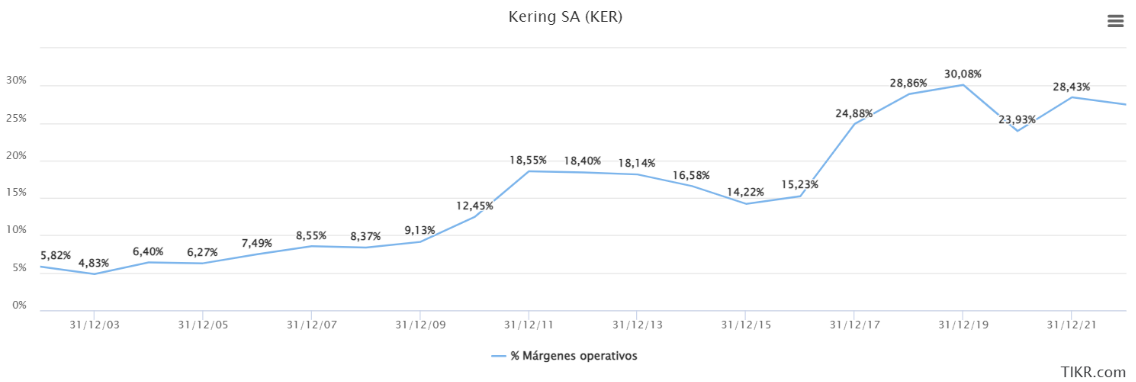

Figure 18. Kering operating profit evolution since 2003. Source: (TIKR, s. f.)

The market particularly dislikes Gucci's flattening growth and a persistent weakness in China due to its highly concentrated portfolio and more volatile returns, and this is reflected in the historic multiples applied to the company compared to others in the sector.

MULTIPLES OF VALUATION	PE RATIO	EV/FCF	EV/EBIT	EV/EBITDA
KERING	16X	14.5X	12X	9X
LVMH	23X	24X	17X	14X
HERMÈS	47X	48X	31X	30X
MONCLER	24X	21X	17X	13X

Table 7. Multiples of valuation of the four companies .Source: own elaboration with data extracted from Tikr.

In terms of Kering's total sales, its thee biggest brands are responsible for about 75% (just Gucci represents 50%), while the rest of the brands account for only 20%. The remaining 5% is derived from Kering's eyewear and general corporate activities. In fact, Kering is the only true luxury company in the sector that is committed to the eyewear segment. The biggest player in this market is Essilor Luxottica (75 billion in market capitalization) trading in Euronext Paris.

When we talked in the first part of the research about the importance of time and good execution from the management in terms of finding a good balance between growth and exclusivity, I was referring to what Kering has done with YSL during the last few years. Thanks to good management of volumes offered and brand reinforcements, Kering Group has been able to convert a brand that in 2009 had negative margins and profitability into its second most important part of the business and one of the most iconic brands in the world. The rest of the houses have also experienced really good performances.

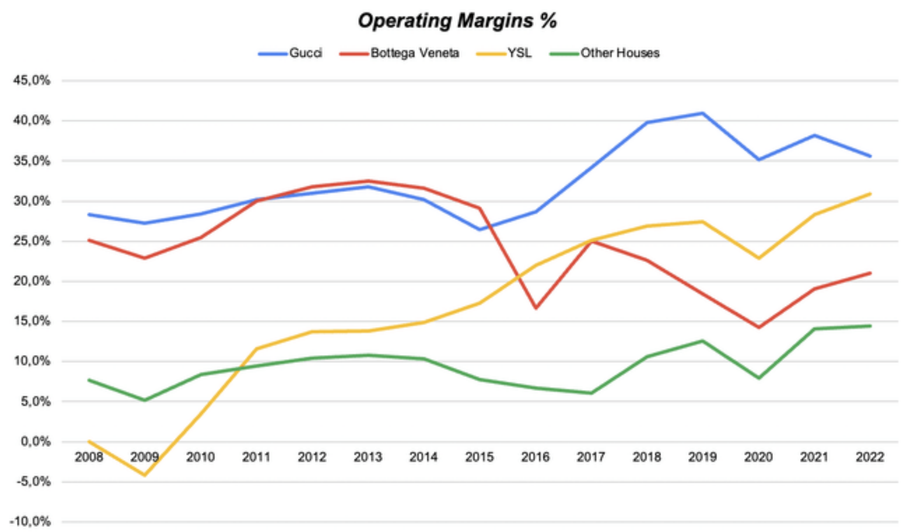

Figure 19. Kering operating margins by segment. Source: (Ramirez, 2023)

Management and capital allocation are two of the most important things (if not the most) for any company, and in this sector, where the brand image and the value shared with customers are crucial, they gain even more importance. In my opinion, one of the only ways in which a company can be disrupted in this sector is by tarnishing the brand image, and this is what Balenciaga, one of the brands included in the "Other Houses" segments, did in November last year with the marketing campaign that showed two girls posing with fetishistic teddy bears *(Carcedo, 2022)*. The firm had to delete the photos and product collection and apologize for it. Despite being just a fraction of the revenue of Kering, the reputational damage is something difficult to fix, and many investors are seeing this as another reason for not investing in the company or penalizing it against its direct rivals on a valuation matter.

As a conclusion, figure 20 shows the growth in revenues and net income in the last 7 years.

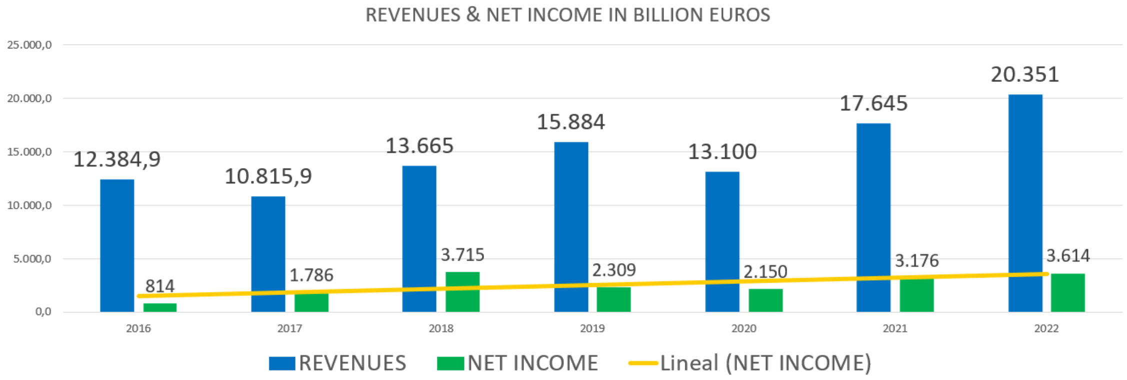

Figure 20. Source: own elaboration with data obtained from Tikr.

3.4 MONCLER

Moncler is an Italian luxury fashion brand known primarily for its ski wear. Founded in 1952 by René Ramillon and André Vincent, Moncler took its name from the abbreviation of Monestier-de-Clermont, an alpine town near Grenoble, France. It is formed by the iconic Moncler brand and the recently acquired Stone Island, leaving a catalog concentrated on just two brands but more diversified in a few clothing items than prior to the acquisition. The current CEO is Remo Ruffini, who acquired the company in 2003 and owns 22.3% of the shares outstanding. (TIKR, 2023). He has been responsible for Moncler´s transition towards a much more desired brand. Thanks to its focus on building customer relations, it has increased its perceived value by transforming it into a more exclusive and expensive brand and giving a higher importance to sustainable materials and production steps in order to share behavioral values with younger generations. In addition to this, the acquisition of Stone Island and its future transformation is, in my opinion, a master move to decrease the group’s sales seasonality and value creation throughout the diversification of its brand portfolio. Moncler is also focusing on increasing their portfolio of products, entering new segments like footwear with the Trailgrip GRX and Gaia Pocket Mid. They are also investing in the release of fragrances and eyewear, trying to follow the successful steps of the bigger players.

FIRM	MONCLER		
TICKER	MONC	FOUNDATION	1952
ENTERPRISE VALUE	15.449	EXPECTED g	15%
DIVIDEND	$1,12	DIV YIELD	1,75%
FCF YIELD	3,40%	FCF/EBITDA	70%
PRICE	64	AV. 7Y	

Table 8. . Important data about Moncler. Source: own elaboration

As we have mentioned before, building a new brand from scratch could take several decades, and positive results are not guaranteed. Therefore, doing M&A is often a good way to grow in this sector, but potential targets are limited. Moncler can be a good example of this, thanks to its recent acquisition of Stone Island in 2021 for 1,150 million euros (Rivetti, s. f.). Due to its smaller size than, for example, LVMH, the pool of companies susceptible to being acquired by Moncler is considerably smaller. Stone Island now represents 15.40% of the group revenue (compared to 10.84% in 2021) (Poggioli, 2022) which means that it is growing faster than Moncler brands, and this can be because of the strategic transformation that the management is executing. The geographical and channel representations of Moncler and Stone Island are shown in figure 21 (Moncler in blue and Stone Island in green).

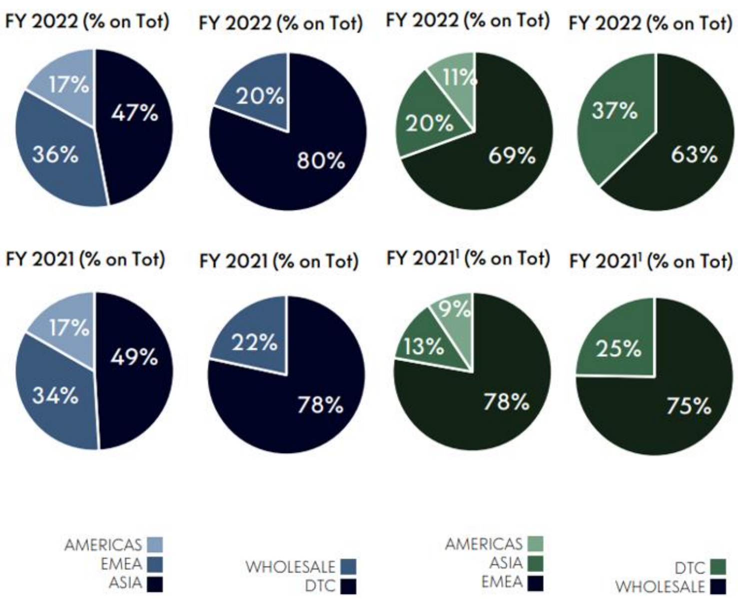

Figure 21. Moncler revenues by geography and segment. Source: (Poggioli, 2022)

In the image, we can see two patterns that we mentioned in the first part of the research. First, the large and growing exposure to China and the importance of the Direct-to-Consumers (DTC) segment, which are the own-operated stores, compared to the gradually less important wholesale Even though Moncler and Stone Island are not perceived as luxurious brands as LVMH or Hermès, they are making their best efforts to correct this and make the transition towards a higher-end market. Moreover, with the acquisition of Stone Island, the group is being able to decrease its winter seasonality, as Moncler is well known for its high-end ski clothes, such as the famous Moncler coats, with prices over 1,000€.

Moncler Group is the smallest company in this research, which is why their shop foot print is not as big as that of their competitors. But Moncler´s management is really competent, and they are making strategic openings of their own directed stores in important locations in the biggest cities in the world while maintaining or even decreasing the number of wholesale stores. The most aggressive expansion is taking place in Asia, a region in which, for example, Stone Island has opened 40 DTC shops during 2022 from the only 4 managed in 2021. This is part of the strategic transition that is being carried out by the management, which aims to increase the value perceived by both brands.

	2017	2018	2019	2020	2021	2022
MONCLER DTC SHOPS	181	193	209	219	237	251
MONCLER WHOLESALE	46	55	64	63	64	63
STONE ISLAND DTC SHOPS					30	72
STONE ISLAND WHOLESALE					58	19

Table 9. Moncler and Stone Island number of shops. Source: own elaboration with data obtained from annual reports.

Following the path of increasing exclusivity and brand desire, management has displayed astute decision-making in the creation of "Moncler Genius," a distinctive clothing line consisting solely of exclusive collaborations. By adopting this approach, they have generated excitement and intrigue around their diverse range of clothing products, leveraging scarcity to enhance the marketing of their apparel. (Research, 2023)

As a conclusion, figure 22 shows the growth in revenues and net income in the last 7 years.

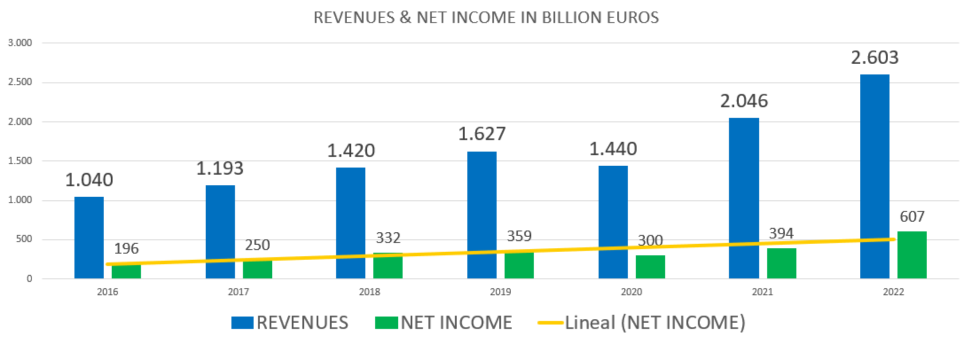

Figure 22. Source: own elaboration with data obtained from Tikr.

4. QUANTITATIVE COMPARISION

Once we have talked about the qualitative aspects of the companies and the sector in general, it is time to address another important matter when researching a company: its quantitative aspects. In this section, we will discuss different metrics and financial figures that I personally use when investing in any kind of company, and I will make a simultaneous comparison between the four companies discussed throughout the project. All these numbers will be based on Tikr Methodology, a payment database based on data extracted from Capital IQ (S&P Global Inc.)

4.1 SALES AND PROFITS

Despite not being the most important aspect of a company, earnings and sales may be the first things to look at in depth in order to have a quantitative framework for a deeper analysis of other financial metrics. From table 10, we can infer which company is the largest, at least in terms of sales and profits. But these numbers, just by themselves, do not tell us much about the profitability or financial performance of the firms while table 11 does.

2022 Financials	HERMES	LVMH	KERING	MONCLER
SALES	€ 11.602	€ 37.600	€ 20.351	€ 2.603
EBITDA	€ 5.304	€ 8.273	€ 7.255	€ 880
EBIT	€ 4.697	€ 6.999	€ 5.589	€ 775
NET INCOME	€ 3.367	€ 14.084	€ 3.614	€ 607
EPS	€ 32.09	€ 28.03	€ 30.42	€ 2.24
FCF	€ 2.896	€ 10.940	€ 3.257	€ 525

Table 10. 2022 financials comparison between the four companies. Source: Own elaboration from data extracted from Tikr. Everything is displayed in millions of € except "EPS" which is expressed in €.

Table 11 displays the compound annual growth rates of different financial metrics for the four companies. In green, the fastest section is painted. The size of the firm plays an important role in these aspects, as it is assumed that the smaller the firm, (if it executes well), the faster it should grow. In this case, this principle only applies to Moncler sales (14% CAGR), while the rest of the aspects, except for FCF, for which Hermés has been the fastest grower (15.3% CAGR), are applied to Kering. LVMH is not the best in any of the six metrics, but neither the worse, something that is encouraging despite being at least two times bigger than its next competitor (Hermés) in terms of market capitalization.

Acquisitions and different price strategies have contributed differently depending on the company, but, in this section, we can tell that Kering is the winner.

I think no explanations are needed for why sustainable growth in sales and profits is important. Warren Buffet, who is considered by many the best investor in history, states in his book "Buffetology" (Buffet, 1997) that these facts are two of his musts for investing in a company. A positive CAGR in all the different metrics confirms this fact. Moreover, if we take into account that normally the worldwide GDP growth is around 3% and that all growth percentages in the table are greater than this number, we can state that the growths are healthy (McKinsey & Company Inc., 2020).

If I had to choose one of the metrics displayed below, I would choose free cash flow (FCF) growth, which can be calculated as Operating Cash Flow – Capital Expenditures. Free cash flow represents the cash that a company generates after accounting for cash outflows to support operations and maintain its capital assets. (Free Cash Flow (FCF), s. f.) Unlike net profit, which can be inflated by accounting tricks, free cash flow is, in essence, the purest form of profit for a company (McKinsey & Company Inc., 2020). There are several uses that a company can make of its cash flows, and the quality of their use will depend on the quality of management. Normally, the FCF can be used for repurchasing their own stocks, sharing dividends with their shareholders, paying out debt, doing M&A, and reinvesting in the company. This last option should be the priority of any management, and has a lot to do with the ROIC. In this metric, Kering is clearly lagging compared to its peers.

CAGRs	HERMES	LVMH	KERING	MONCLER
SALES	12.1%	11.2%	7.4%	14.0%
EBITDA	15.7%	18.6%	18.2%	14.8%
EBIT	15.5%	17.0%	16.8%	14.7%
NET INCOME	17.3%	19.4%	23.7%	16.3%
EPS	17.4%	19.5%	24.5%	16.3%
FCF	15.3%	13.5%	4.9%	11.7%

Table 11. CAGRs comparison between the four companies. Source: own elaboration.

4.2 COMPANY RETURNS

Many analysts agree that ratios of return are one of the most important aspects of a company. Returns are measured using Return Over Equity (ROE) and Return Over Invested Capital (ROIC), which are metrics that show how much profit companies generate using their own equity or their own invested capital. My personal favorite is the ROIC, because it does not take into account the capital structure of a company, which is why it excludes interest payments from its calculation (Net Operating Profits After Taxes/(Total Debt+Equity+Capital Leases+Goodwill-Marketable Securities)). This metric is heavily impacted by impairments, as goodwill is taken into account in the equation, so companies more likely to make acquisitions may have worse ROICs. One important aspect of returns is that they should be incremental over time. In the short run, they can be impacted by new investments, such as the construction of a new plant, by acquisitions and impairments, or by a decrease in profits due to temporary weakness. But, over the long term, it might be the healthiest sign of a company executing its operational business well.(McKinsey & Company Inc., 2020)

Out of the 4 companies we are comparing, the one that shows better returns is Hermés. This can be explained because Hermés does not have debt; it does not make acquisitions, so impairments in case of a bad acquisition would not impact ROIC, and it is the one that can set higher prices for its products, thanks to its higher luxury perception. The other 3 are very stable and show good results. Charly Munger and Pat Dorsey stated that in the long term, the stock performance of a company should not mismatch much from their returns, as these are the paces at which they can compound capital without making any M&A. In order to check if this applies to our companies, I am going to compare the ROICs with the stock performance over the last 10 years. It may be a big coincidence, but the data are almost identical except for LVMH, whose performance (22%, 10-year compound annual growth rate) has been superior to its ROIC (17%). But, as we have mentioned before, impairments due to acquisitions affect ROIC a lot. One good aspect of this sector, in general, are the outstanding management teams leading the companies, so acquisition tends to create value and are not susceptible to any impairment. If we exclude Goodwill from calculations, LVMH's ROIC is 23%, almost the same. So with this, we can support my initial opinion that it is one of the most important metrics in a company, as in the long term, stock performance will tend to converge to ROIC.

RETURNS	HERMES	LVMH	KERING	MONCLER
ROE	27%	25%	24%	21%
ROIC	23%	17%	15%	16%
10y CAGR	**23%**	**22%**	**15%**	**16%**

Table 12. Returns comparison between the four companies . Source: own elaboration with data obtained from Tikr and Stratosphere.io.

Nevertheless, just by itself is not enough to infer which company is better than another (although many times this coincides). The ROIC is just a component of a "machine" (an important one), but we have to support it with other components to have a better clue of why something happens. For the next example, we should focus not only on the ROIC of the company but also on the CAGRs of their metrics. This discovery is not applicable to all companies, despite the apparent success of our initial assumption.

For this purpose, a premium brand (not a luxury one), such as Nike, has been chosen for making a direct comparison against a pure luxury one, Hermés. In table 13, we can see all the important financials of both companies. If we look only at the ratio that we are discussing in this section (ROIC), we will be surprised to know that Nike's ROIC is greater than Hermés's ROIC, despite being a premium company and having given a total return to shareholders of 12.8% CAGR over the last 10 years, compared to 25.1% of its ROIC. How is this possible?

As I mentioned in the previous section, a number does not tell us much on its own if we do not understand the context of the company and look at other important figures. The important thing to understand here is that ROIC must be matched with high growth rates in order to create more value than with slower ones. (McKinsey & Company Inc., 2020) We can see clear differences in the last part of the table, in which Hermés CAGRs are much better than Nike ones. So despite having similar ROICs, Hermés total return for shareholders (22.8% 10Y CAGR) has been much better compared to that of Nike (12.8% 10Y CAGR). This is just the combination of both effects and the greater capacity for reinvestment in the company itself, taking advantage of the high returns over invested capital (ROIC) (McKinsey & Company Inc., 2020).

	NIKE		HERMÉS	
MARGINS 2022	2022	7Y AVERAGE	2022	7Y AVERAGE
GROSS MARGIN	43,0%		71,0%	
EBITDA MARGIN	14,0%	14,6%	45,7%	41,2%
EBIT MARGIN	12,7%	12,8%	40,5%	35,6%
NET INCOME MARGIN	2,6%	10,1%	17,3%	23,8%
FCF MARGIN	6,5%	9,1%	25,0%	20,2%
EBITDA TO FCF	46,2%	61,1%	54,6%	48,9%
RETURNS 2022	2022	7Y AVERAGE	2022	7Y AVERAGE
ROE	36,2%	35,8%	27,0%	24,3%
ROIC	25,1%	26,6%	23,3%	22,9%
DEBT RATIOS 2022	2022		2022	
CURRENT RATIO	2,72		3,94	
NET DEBT/EBITDA	-0,24		-1,73	
NET DEBT/EQUITY	-0,12		-0,74	
OTHER RATIOS 2022	2022	7Y AVERAGE	2022	7Y AVERAGE
CAPEX/SALES	1,4%	1,7%	5,2%	5,8%
WORKING CAPITAL/SALES	19,0%		11,9%	
INVENTORY DAYS	60		56	
7Y CAGRs 2022	2022		2022	
SALES	5,9%		12,1%	
EBITDA	4,0%		15,7%	
EBIT	4,6%		15,5%	
NET INCOME	2,6%		17,3%	
EPS	3,7%		17,4%	
FCF	2,7%		15,3%	
10Y CAGR Total Return	12,8%		22,8%	
PER	26X		46X	

Table 13. Nike vs. Hermés financials comparison . Source: own elaboration with data obtained from Tikr and Stratosphere.

4.3 MARGINS

It is well known that luxury companies can enjoy margins well above average thanks to their pricing power and cost management as a result of their vertical integration. According to Warren Buffet, a company with gross margins over 40% shows some kind of competitive advantage (Buffet, 2009). In the case of these four companies, their gross margins are almost double that. This is primarily thanks to their ability to set high markups on their prices. In fact, luxury companies have margins pretty similar to Software As A Service (SAAS) companies, which operate asset-light business models and enjoy high switching costs and pricing power thanks to their subscription revenue model and the crucial nature of the service provided, for example, an accounting software in the case of Intuit. Luxury companies, despite being in a much more capital-intensive and less profitable sector by nature (retail sector), are able to match their margins thanks to the reasons stated above.

As in the case of returns, the best companies are those that can increase margins over time. This is not always possible, as, for example, mature companies reach a point in which costs cannot be better optimized and price increases in their products cannot be very aggressive due to the risk of losing customers. But in the case of the luxury sector, I think this is far from over. If we take a look at our companies, again, Hermès shows the best results in almost all the metrics, followed by Moncler in almost any of the rest. This is explained because Hermès operates under a single brand, so its pricing power is higher; for example, Kering or LVMH have lower-perceived brands in their portfolios, so the pricing power is not that strong overall. On the other hand, Moncler also shows good results because their product catalog is not as diversified as the others, so they are focused on higher-margin products, such as clothes, without having exposure to lower-margin ones, such as perfumes or cosmetics. While this could be seen as an advantage from a margins point of view, it could also represent a lack of diversification (which may be a risk, at least in terms of products), causing more seasonality and more economic impact from different demand shocks. Either way, I do not consider these factors highly risky.

Despite all the positive aspects that have been said about companies' margins, I believe that they could become even higher if operating expenses (OPEX) are capitalized in the same way that capital expenses (CAPEX) are. Some examples of these operating expenses would be marketing expenses, which I consider to be an investment that produces long-term returns, but which are computed as an expense in the Income Statement. In this way, the companies' margins and returns would be even higher. (Palepu, 2020)

MARGINS 2022	HERMES	LVMH	KERING	MONCLER
GROSS MARGIN	71%	69%	74%	76%
EBITDA MARGIN	46%	34%	36%	34%
EBIT MARGIN	40%	27%	27%	30%
NET INCOME MARGIN	29%	18%	18%	23%
FCF MARGIN	25%	14%	16%	20%

Table 14. Margins comparison between the four companies. Source: own elaboration with data obtained from Tikr.

4.4 DEBT

One of the few aspects that can make a company go bankrupt is high balance sheet debt. To make sure that the companies in which I invest do not have high debt risks, I use the three ratios shown in the image below.

Current Ratio: calculated as (current assets/current liabilities), it is a good way to check whether a company could have financial problems paying its short-term liabilities. Any ratio above 1 is already positive. Except for Kering, the rest have it over 2, which is an excellent sign.

Net Debt/EBITDA: Net debt is calculated as (Total Debt minus Cash and Equivalents minus Marketable Securities)/EBITDA. EBITDA stands for Earnings Before Interest, Taxes, Depreciation, and Amortization. EBITDA is a measure of a company's operating performance and profitability. It provides an indication of the company's ability to generate earnings from its core operations before accounting for non-operating expenses and non-cash items. A negative ratio means a negative net debt (net cash position); only Hermès and Moncler hold this, or a negative EBITDA, which is not the case for any of the four companies selected.

The net debt/EBITDA ratio is primarily used to assess a company's ability to manage its debt obligations relative to its earnings. A higher ratio indicates higher levels of debt compared to the company's earnings, which can suggest higher financial risk and potential difficulties in servicing the debt. Conversely, a lower ratio implies a lower level of debt relative to earnings and can indicate a healthier financial position. Personally, this is my favorite ratio out of the three, as it can be used for comparing companies in different sectors and with different capital structures, so it is more versatile.

Net Debt/Equity: The net debt/equity ratio provides insights into the capital structure and financial risk of a company. It helps evaluate the proportion of debt and equity used to finance a company's operations and investments. A higher ratio indicates a higher level of debt relative to equity, suggesting that the company relies more on borrowed funds to finance its activities. This can indicate higher financial risk and potential difficulties in meeting debt obligations. A negative ratio could mean a net cash position (Hermès and Moncler) or a negative equity position (none of the four).

Among the three, Hermès emerges victorious once more. However, all four exhibit a lack of debt risk, reaffirming the robustness and antifragility inherent in the sector..

DEBT RATIOS	HERMES	LVMH	KERING	MONCLER
CURRENT RATIO	3.94	3.01	1.37	2.07
NET DEBT/EBITDA	-1.73	0.33	0.33	-0.84
NET DEBT/EQUITY	-0.74	0.16	0.16	-0.26

Table 15. Source: own elaboration with data obtained from Tikr.

4.5 OPERATING WORKING CAPITAL AND CAPITAL EXPENDITURES

These last financial metrics need to be reviewed due to the nature of the sector that these companies operate in. In other kinds of business models, such as SAAS (mentioned before), these metrics are not that important because they are usually asset-light businesses (low capex, below 2% normally) and they do not hold inventories, so their operating working capital needs are not that high. This is just the opposite that happens to the retail sector, so both metrics must be taken into account for assessing which is the best company among the four of them.

Operating working capital indicates the company's ability to meet its short-term financial obligations and fund its day-to-day operations. I calculate it as: inventory + account receivables - accounts payable. The lower the ratio, the better, as it means that the company needs a small amount of operating working capital to carry on its core operational activities. It has to do a lot with inventory days. The less time, the better, as this means that products have a smaller risk of being outdated and that inventory turnover is higher, incurring smaller inventory costs as well.

Contrary to many analysts opinions, I do consider high capex/sales a competitive advantage, as they elevate the barriers to entry against other players and benefit from economies of scale. Either way, it will depend on the sector, but for evaluating the one in which we are interested, this theory applies. Capital expenditures (capex) are money invested by a company to acquire or upgrade fixed, physical, or non-consumable assets. (What Is Capex?, s. f.) High capital expenditures are the reason why these 4 companies are highly vertically integrated, controlling all the value steps inside the value chain, something crucial for ensuring the quality of the products and achieving a higher cost efficiency that will help boost margins and have a smaller negative impact when negative shocks occur. The same applies to other companies in different industries, such as Texas Instruments (semiconductors) and Pepsi (non-alcoholic beverages). It is another proof of financial strength and economies of scale.

OTHER RATIOS	HERMES	LVMH	KERING	MONCLER
CAPEX/SALES	5%	8%	8%	4%
WORKING CAPITAL/SALES	12%	20%	17%	6%
INVENTORY DAYS	56	94	80	37

Table 16. Source: own elaboration with data obtained from Tikr.

4.6 VALUATION AND TOTAL RETURN

This might be the most subjective part of the project. The valuation of a company is not a universal truth, and given that we are trying to predict an uncertain future, mistakes and unexpected events (black swans) can affect our valuation model. What I will try to do in this section is make reasonable assumptions about the future growth prospects of the earnings per share (EPS) of the companies and apply a multiple of valuation (PE multiple) so we can get a possible price target in 5 years. Although this is not my favorite valuation method, as I prefer inverse discounted cash flow models, it is evident that it is the easiest one and the one with the smallest number of assumptions we have to make. Before starting with the valuation model, I will explain why inverse DCF and conventional DCF are better ways to perform company valuations.

The main answer to this question is the terminal value. Terminal value (TV) determines a company's value in perpetuity beyond a set forecast period—usually three to five years. (Ganti, 2023) After projecting the company's cash flows for a number of years (3, 5, 10, etc.), we will assume that the company will grow at a fixed terminal growth rate for the remainder of its life. Normally, this terminal growth rate tends to be between 2% and 3%, as is the pace of growth in the world economy. This is the most common way of valuing companies, but the point here is that quality companies (as the ones we are analyzing) tend to grow at faster rates than the terminal value once the 5- to 10-year period is completed. So growth rates over 3% may not be that rare in these kinds of models. This is the best way to capture, and try not to penalize excessively, a company that has proven to remain profitable and resilient over long periods of time. Here, the Lindy Effect plays an important role again. As an example, imagine having performed a DCF in 1980 for Hermés. After year 10 of projected cash flows, a terminal growth rate should have been assumed, but as we have seen in section 4.1, "Sales and Profits," the compound annual growth rates of the company FCF these past 7 years have been much higher than this rate. Therefore, our valuation model would have given us a completely biased fair value, compared to the current value of the firm nowadays. That is why quality companies are said to be eternally undervalued. Nevertheless, this is the only way to capture this terminal value in a valuation model. Multiples, on the other hand, give no merit to this power against capitalism's rules.

After this brief explanation, I will begin with the valuation of the companies. In order to simplify the methodology, I will get the projected growth rates that analysts estimate for the company's EPS. As we have seen before, EPS can grow faster than sales thanks to the effect of share repurchases or margin expansions. Price to Earnings multiples will be the 10-year average for each of the companies. This number may be higher or smaller than the actual multiple of valuation, but we will try to be conservative, despite companies being better than 10 years ago and therefore requiring a higher multiple. 2027' prices are shown below, as well as the last 10 years average PE multiple for the 4 companies.

COMPANY	2022 EPS	2023' EPS	2024' EPS	2025' EPS	2026' EPS	2027' EPS	Growth rate	PE MULTIPLE	2027' PRICE	ACTUAL PRICE
LVMH	€ 28.03	€ 32.80	€ 38.37	€ 44.89	€ 52.53	€ 61.45	17.00%	23	€ 1,413.45	
HERMÉS	€ 32.09	€ 36.94	€ 42.51	€ 48.93	€ 56.32	€ 64.83	15.10%	41	€ 2,657.85	
KERING	€ 30.42	€ 35.17	€ 40.65	€ 46.99	€ 54.32	€ 62.80	15.60%	19	€ 1,193.17	
MONCLER	€ 2.24	€ 2.53	€ 2.87	€ 3.24	€ 3.67	€ 4.15	13.10%	27	€ 111.92	

Table 17. Valuation table for the four companies. Source: own elaboration with data obtained from Tikr.

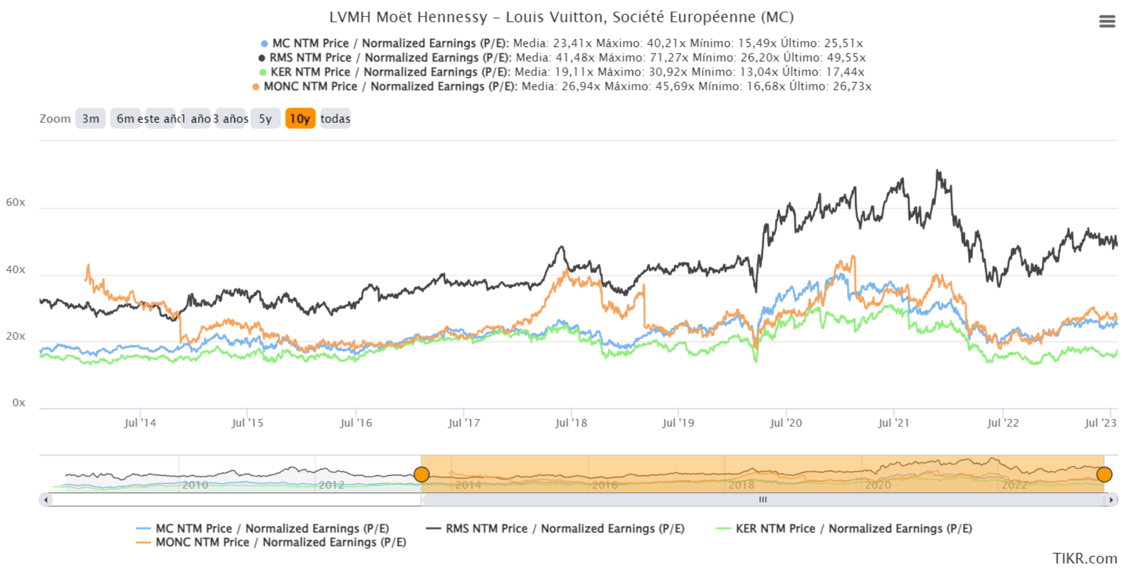

Figure 23. PE multiples for the four companies. Source: Tikr

But in order to be fair and have a better idea of the possible return we may obtain from these companies, dividends should be taken into account. I will assume the same growth as the expected EPS growth rate. New prices would look like this.

COMPANY	2022 DIV	2023' DIV	2024' DIV	2025' DIV	2026' DIV	2027' DIV	Growth rate	SUM	2027' PRICE	ACTUAL PRICE
LVMH	€ 12.00	€ 14.04	€ 16.43	€ 19.22	€ 22.49	€ 26.31	17.00%	€ 98.48	**€ 1,511.93**	
HERMÉS	€ 13.00	€ 14.96	€ 17.22	€ 19.82	€ 22.82	€ 26.26	15.10%	€ 101.09	**€ 2,758.93**	
KERING	€ 30.42	€ 35.17	€ 40.65	€ 46.99	€ 54.32	€ 62.80	15.60%	€ 239.93	**€ 1,433.10**	
MONCLER	€ 1.12	€ 1.27	€ 1.43	€ 1.62	€ 1.83	€ 2.07	13.10%	€ 8.22	**€ 120.15**	

Table 18. Valuation table for the four companies including dividends. Source: own elaboration with data obtained from Tikr.

As I have mentioned before, this is a simple way of valuing a company. We are not even making our own assumptions, but for this, I would need a whole thesis for each company, so by using this method, we have simplified the process while obtaining possible results with reasonable assumptions (at least those expected by analysts). As we can see, the expected returns are appealing (some more than others) and there are high chances of beating the market in the years to come.

In order to conclude this part, figure 24 the total return of the four companies over the last 10 years compared to the S&P 500 index. All of them have beaten the market and given double-digit returns to their investors. I expect this to continue, although future returns will depend on the company's valuation at the time of purchase and the execution of its core business.

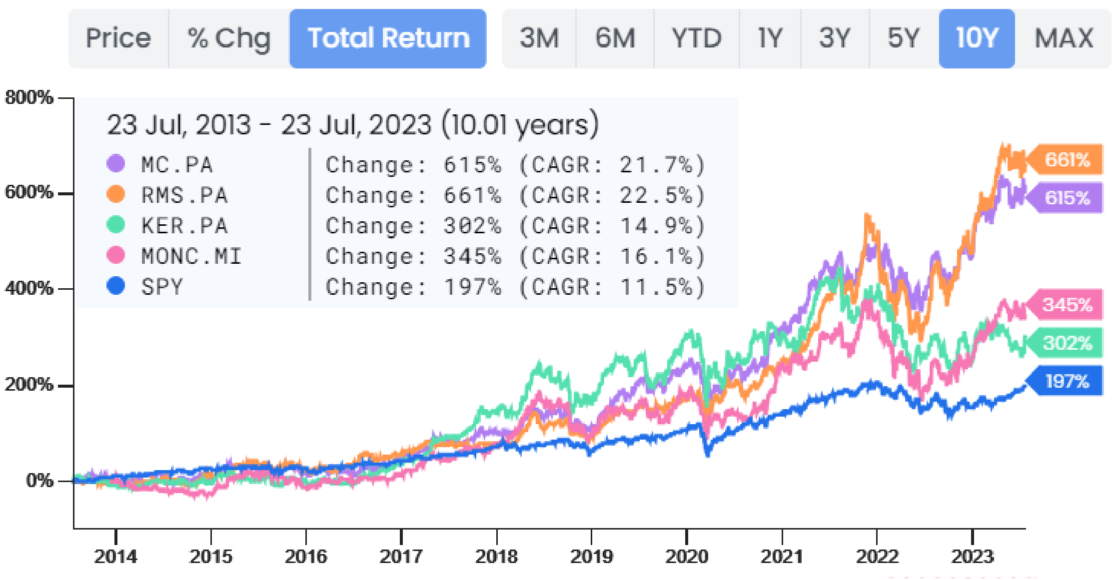

Figure 24. 10 year total returns for the four companies. Source: stratosphere.io

5. CONCLUSION

In this work, both qualitative and quantitative aspects of the luxury sector and, more specifically, of the four selected companies have been thoroughly investigated, for the reasons specified in point 2.1. As has been demonstrated, these types of characteristics, many of them intrinsic and difficult to replicate, occur in all successful companies in the sector, a fact that has contributed to their financial performance, even in times of crisis, where they have managed to come out stronger.

The results obtained both numerically and applied to the stocks have been satisfactory and in line with the hypotheses of the beginning. The luxury sector has proven to be a good place for long-term investment in the past and due to its unique characteristics, underlying macro trends and its low risk of technological disruption by other players or less established brands, I consider that these 4 companies will continue to be long-term winners in the future. If I had to choose one, it would be Hermés or LVMH.

Finally, and for anyone who wants to keep track of the sector or companies, where they should most dedicate their efforts is to understand the different value propositions that these types of companies offer (not very tangible needs and desires of human beings). Another factor would be the development of the middle class in both China and India, key markets for the future thesis of this sector to be fulfilled. We have already seen that this can be a double-bladed sword, where their biggest future opportunity can also be their biggest risk. Finally, I believe that the only way these companies can be disrupted is through an internal execution failure, as happened to Kering with Balenciaga. The care given to the brand image, its values, the binomial of exclusivity vs. growth… all this is what makes a brand successful in the long term and those in charge of building this are the company management. Having confidence in their good work is crucial.

EXHIBIT

KEY WORDS

Lindy Effect: States that the future life expectancy of any non-perishable object is a direct function of its past survival.

Antifragility: How something or someone can get stronger, even in difficult times.

Veblen Goods: a good for which demand increases as the price increases due to its exclusive nature and appeal as a status symbol.

Brand Awareness: the extent to which consumers are familiar with the qualities or image of a particular brand of goods or services. It has to do with the history, values and exclusivity of the brand.

Intrinsic necessities: of human beings: the feeling of belonging to a group and the desire to be better than others.

Figures

Tables

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