

# Investment Theme

## Luxury Q&A – an industry sure to feel the slowdown

# Luxury goods

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**Asset Class: Equity**

### At a glance

Based on our regular interviews of industry leaders and our ongoing analyses, we address the questions most frequently asked by our clients about the luxury goods industry today and tomorrow.

#### Is now a good time to invest in luxury goods companies?

In general, shares of luxury goods companies outperform in prosperous times and underperform in difficult market environments. Thus, the unfolding global economic slowdown makes us generally reluctant to invest at this stage and we have a moderate underweight on the luxury subsector. While valuation already anticipates weaker consumption ahead, we think there is more room for decline as we expect near-term earnings pressure.

#### Are luxury goods companies immune to economic downturns?

No. Luxury goods, like other discretionary consumer expenditure, are not immune to an economic downturn. The global financial storm and the deteriorating consumption environment threaten luxury sales as well as consumers' income and wealth. After years of strong growth, we think sales and earnings growth for luxury goods companies face a difficult near-term future.

#### Are there any attractive investment possibilities right now?

Even in an economic downturn, we do see above-average growth potential for some luxury goods companies, particularly those with high-end products, strong brands, high margins and promising growth potential. By these criteria, we favor Hermes, LVMH, Richemont and Swatch. We think long-term trends in wealth accumulation, tourism, demographics and emerging markets should ensure strong margins and cash generation, also for the future.

#### What drives earnings in the sector?

Strong brands are vital to the EUR 140bn-a-year global luxury goods market, since the brand determines pricing power. In general, entry barriers are high and demand is relatively stable as luxury customers tend to spend from their above-average incomes and the sector's long-term growth outlook is good, despite the recent downturn. Luxury goods sales are driven by brand power and its ability to evoke a "feel-good" factor. The industry generally enjoys high profitability, strong cash flow generation and healthy balance sheets.

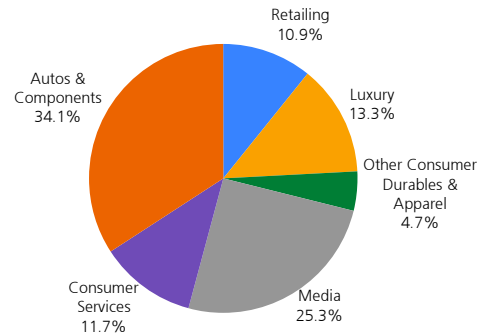
### Luxury and its appeal

Today, customers are often pursued either with a price argument or with a product's luxury attributes. Price is a straightforward concept, but luxury is a bit harder to define, whether the term is applied to a car, a handbag or a service. In order to invest wisely, we think it is important to understand the term properly.

In this report, we focus on luxury goods like apparel, accessories, leather goods, watches and jewelry and perfumes. We do not consider

### Fig. 1: MSCI Europe Consumer Discretionary

Consumer Discretionary: 8% of the MSCI Europe Index

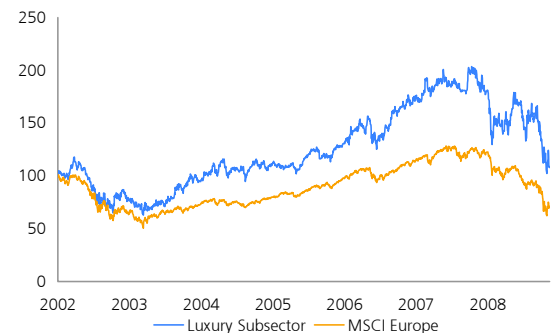


Source: MSCI, October 2008

Note: The Consumer Durables & Apparel subsector is split into Luxury and Other Consumer Durables & Apparel

### Fig. 2: Sector price performance

Luxury subsector vs. MSCI Europe



Source: FactSet, 10 November 2008

### Fig. 3: Recommendations (selection)

Company	Price	EFVR	WMR Rating
Hermès	EUR 101.3	80-100	Hold/Outperform
LVMH	EUR 49.31	52-58	Hold/Outperform
Richemont	CHF 23.42	35-40.5	Buy/Outperform
Swatch	CHF 167	360-440	Buy/Outperform

Source: UBS WMR, 10 November 2008

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automobiles, services or other kinds of consumer products.

Our several product categories have some particular characteristics that we think are common to all luxury products and services. The most obvious one is high price, which is often explained by the quality of materials, sophisticated design, durability and exclusivity. Higher prices result in higher margins for luxury goods, closer to the Pharma sector's margins than to other Consumer Discretionary sub-sectors (see Fig. 4).

Advertising is important to luxury brands. It aims at establishing and reinforcing the brand's image, often building on history, authentic quality, exclusivity and tradition. It is vital to represent these characteristics in the best way, exploiting the brand's power to evoke a "feel-good" factor and make its products desirable for potential customers.

The global luxury goods sector has grown by about 8% annually since 2000. Bain & Co. estimates its value at EUR 141bn in 2007, which is the most widely accepted assessment of the market's size (see Fig. 5). We estimate that the luxury goods market comprises 10% apparel, and 35% accessories and leather, mainly handbags and shoes, with around 35% in "hard" products, including watches and jewelry. The remaining 20% consists of perfume, cosmetics and other products (see Fig. 6).

Luxury goods attract a customer segment that is generally well-educated and disposes of an above-average income. In particular, the junior luxury consumer is often unmarried, life-style-oriented and fashion-aware and prefers apparel, accessories and low-end luxury goods. The older luxury consumers, age 50 and above, are wealthier and have less financial obligations to their families. They prefer high-end luxury goods with superior quality and durable value, such as watches.

The market is dominated by large international conglomerates that own many individual brands, as well as by some strong single-brand houses (see Fig. 7). Some companies are listed while others are privately held. The goods are distributed via wholesale customers – boutiques and department stores – and directly-owned, branded retail stores. In general, watches, beverages, perfumes and cosmetics are sold wholesale.

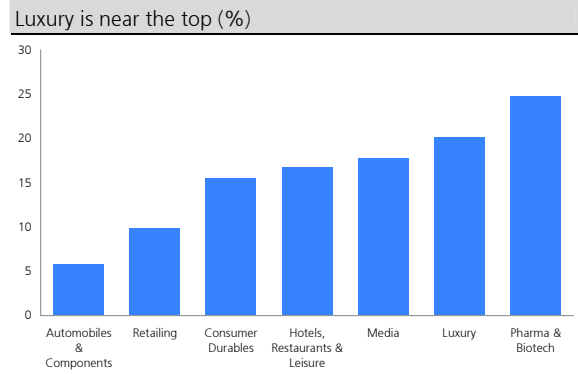
The wholesale channel generally involves low investment risks, lower fix costs, an easier local market access, higher customer traffic and lesser administrative effort. On the other hand, directly-owned retail distribution enables better price and brand control, even higher margins, better inventory management and the chance to respond to consumer demand directly. That is why watch manufacturers have also started to establish their own retail stores, achieving about 500-600 bps higher EBIT margins, in our estimates.

**Long-term earnings drivers for luxury companies**

Brand power is vital to luxury goods companies. The necessity of an established brand serves as a high entry barrier for newcomers. It makes the industry highly profitable and generates healthy cash flow. The brand is crucial to evoke a "feel-good" factor and cement customer loyalty, which strengthens demand and ensures strong pricing power. Successful luxury goods companies often enjoy the advantages of vertical supply, production and distribution networks and are less vulnerable to cost inflation in these areas.

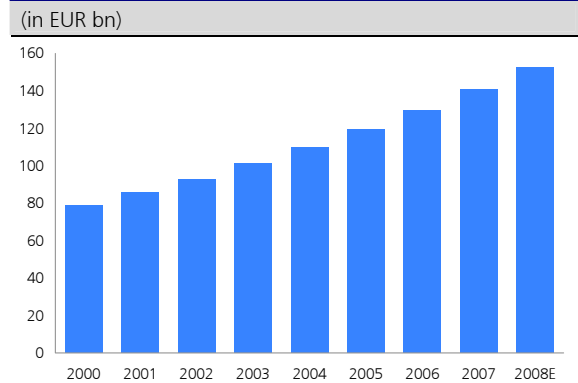
The luxury goods industry has benefited from the considerable increase in wealth, and therefore in potential customers, globally over

**Fig. 4: 2007 EBIT margins compared by sector**



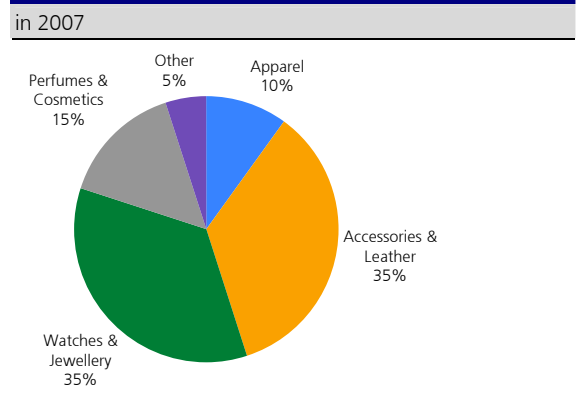
Source: UBS Investment Bank

**Fig. 5: Global luxury goods market**



Source: UBS WMR, Bain & Co., 2007

**Fig. 6: Estimated market share by product sales**



Source: UBS Investment Bank

the past decade and more. First of all, the existing and the potential customer segments are getting richer. In particular, the number of individuals worldwide who hold at least USD 1 million in financial assets, so-called High Net Worth Individuals (HNWIs), should increase in the coming years (see Fig. 8).

Nonetheless, we expect wealth to grow at a slower pace in the near-term given the recent financial turmoil. At the same time, the aging demographic points to growth in the wealthier senior segment, which is important in more saturated developed markets. In emerging markets, on the other hand, real incomes are increasing. We believe that emerging economies should repeat the development patterns of developed countries, and we expect people in emerging economies to spend more on discretionary purchases in future.

These fast-growing markets offer a growing population of newly wealthy customers. In recent years, demand for luxury goods, which depends on high levels of income, has seen revenues grow about five times the pace of GDP growth in the US, Europe, Japan and Asia-ex Japan, according to our data. We expect the potential high-growth markets in the Middle East, Russia, India and China to account for a significantly larger share of global luxury goods sales in future (see Fig. 9).

Finally, as a result of increasing global wealth, we expect to see continuing growth in tourism (see Fig. 10). This is significant for luxury goods as we estimate over a third of global luxury goods revenues are generated by travelers who buy when they are abroad.

**Short-term risks**

We consider an economic slowdown as the most significant market risk, eroding the consumer's general confidence, income, wealth and changing his or her spending behavior.

We recognize that the current global financial turmoil and uncertainty have dampened consumer sentiment. This is apparent in the European consumer confidence index, which declined sharply during the downturn after the turn of the millennium and slipped even more so lately (see Fig. 11). The financial crisis has spurred losses in the stock, bond and real estate markets recently. Meanwhile, layoffs and lower compensation, not only in the financial industry, are certain to hurt the luxury goods market and growth in the wealth of HNWIs globally.

As a result, we expect reduced levels of consumption that will also reflect the tighter consumer credit environment of the credit crunch. As our 2009 and 2010 economic growth forecasts for the most important luxury markets – Europe, the US, Japan and China – have been lowered considerably (see Fig. 12), we expect that the relevant consumer confidence indicators and the purchasing power in these markets will also slide.

None of this is good news for luxury goods companies. Ignoring, for the moment, the impact of currency movements, we expect revenue to decline by about 5% for the luxury industry in 2009. We calculate that this should result in net profits falling by about 15%. As the global economy slows, we expect tourism's growth also to sputter in the near term. And we do not ignore the risk that an event like a terrorist attack or a pandemic outbreak could also dampen consumer behavior and travel trends.

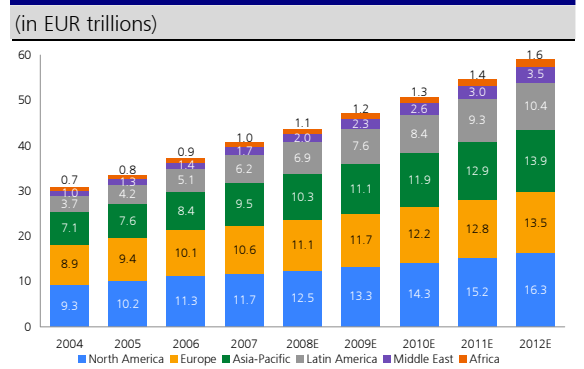
We also see particular risks in currency movements. Because European luxury goods companies are highly exposed to the US, Japan and dol-

**Fig. 7: Single- and multi-brand luxury firms**

Single-brand	Multi-brand
Bulgari	LVMH: Louis Vuitton, Marc Jacobs, Kenzo, Tag Heuer, Zenith, Moët & Chandon, Dom Perignon, Hennessy
Burberry	
Hermès	
Hugo Boss	
Rolax	PPR: Gucci, Bottega Veneta, Yves Saint Laurent
Tod's	

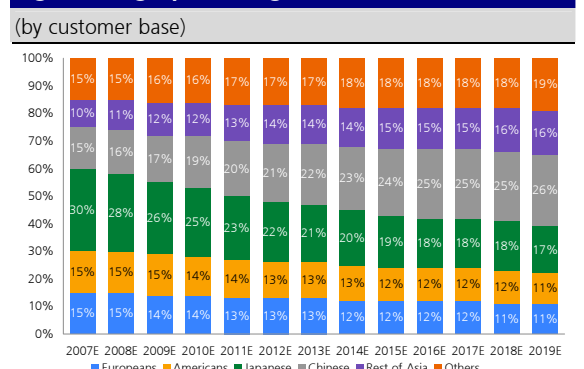
Source: UBS WMR, Company reports

**Fig. 8: Global growth trends for HNWI**



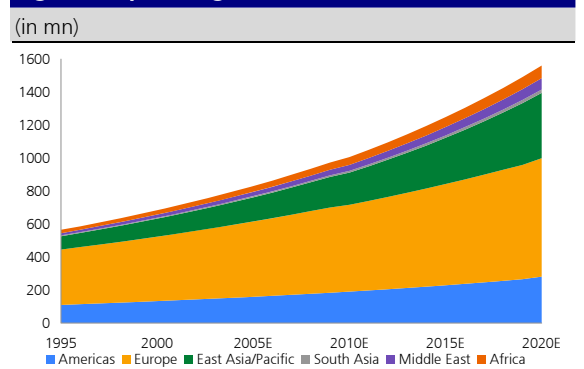
Source: UBS WMR, Merrill Lynch, Cap Gemini, 2008

**Fig. 9: Geographical segmentation of sales**



Source: UBS WMR, Goldman Sachs Global Investment Research, 2008

**Fig. 10: Expected growth in tourist arrivals**



Source: UBS WMR, World Tourism Organization

lar-linked Asian countries, this could have a significant impact on reported sales and profits.

And there is always the risk that companies miss fashion trends. In addition, failure to meet consumer's expectations for quality could also damage brand value and lower earnings expectations.

**Is this the time to invest in luxury goods companies?**

Considering the current global financial storm and the increasing macroeconomic weakness, waning consumer confidence and softening emerging markets, we are generally reluctant to invest at this stage. We consider the luxury sector less defensive than other consumer sectors, which also makes us more cautious on the luxury sector in the short term, given its cyclical nature.

Hence, we prefer a selective stance and have a moderate underweight on the luxury subsector, which includes Bulgari (not covered), Burberry, Hermes, Hugo Boss, LVMH, Swatch and Richemont. Moreover, we cover the PPR Group but do not include PPR in our luxury subsector because of its significant share in non-luxury-related retail business, which accounts for more than 50% of its sales.

Since 2002, luxury shares outperformed the MSCI Europe index by about 37%. This is an example of luxury's outperformance during prosperous times. In today's more turbulent environment, the luxury sub-sector shows a valuation premium of about 36% for next year, still a high level, in our view (see Fig. 13). While we think the sector valuation already anticipates some deterioration in the consumption environment, we think there may be more downturn potential than is currently perceived by many market observers. In the near term, we believe that earnings should come under considerable pressure. As Fig. 2 shows, the industry's shares usually outperform in prosperous times and underperform in a difficult market environment.

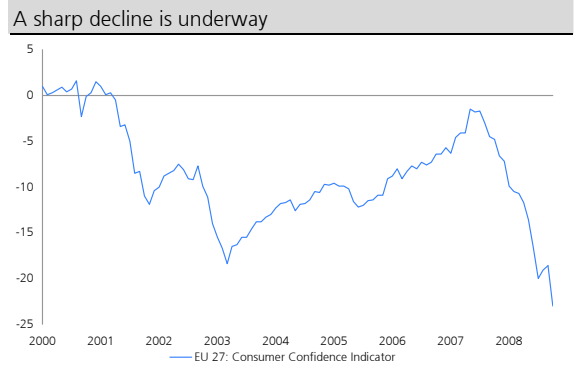
In the near future, we expect more earnings estimates downgrades than upgrades from analysts. As the October figures show, more than 20% of analysts lowered their earnings expectations (see Fig. 4), which could have a further negative impact on share prices, in our view.

**Investment possibilities**

While the short-term outlook remains gloomy, we still see above-average growth potential for many luxury goods companies. This is mainly due to strong company fundamentals, healthy balance sheets, good geographic and product diversification. In addition, we think promising long-term growth drivers such as increasing wealth, demographic changes and opportunities in emerging markets should support strong margins and cash generation.

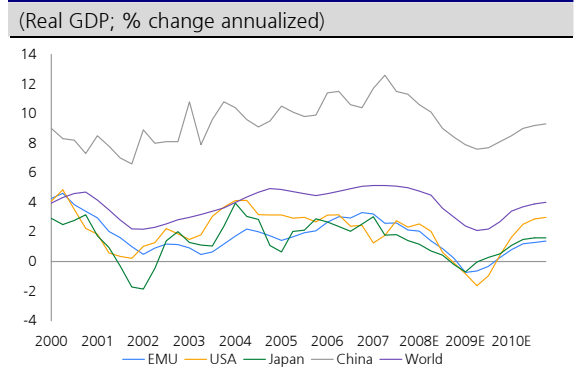
For less risk-averse investors, we focus on solid companies with high-end products, strong brands, high margins and promising growth potential. Therefore, we recommend companies such as Hermes, LVMH, Richemont and Swatch, which we think should be less affected by an economic downturn than sector peers (see page 5).

**Fig. 11: European consumer confidence indicator**



Source: UBS WMR, Eurostat

**Fig. 12: Economic growth forecasts**



Source: UBS WMR

**Fig. 13: MSCI Europe Consumer Discretionary**

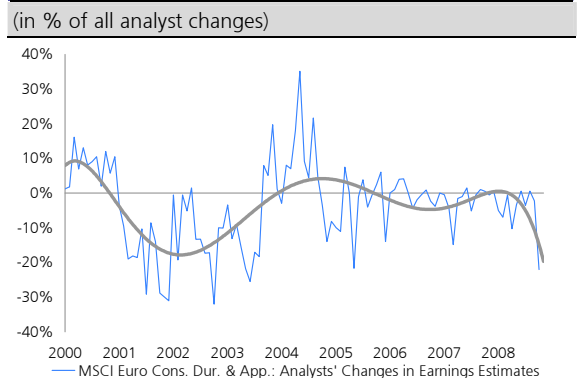
P/E comparison

Sector	2008E	2009E	2010E	2011E
Luxury subsector	13.0	12.8	11.8	11.0
Autos & Comp.	5.9	7.9	7.9	9.3
Retailing	8.0	8.3	7.2	7.8
MSCI Europe	10.2	9.4	8.6	8.1
MSCI World	13.9	17.8	11.1	9.6

Source: UBS WMR, FactSet, 10 November 2008

Note: Consensus mean

**Fig. 14: Analysts' changes in earnings estimates**



Source: MSCI I/B/E/S, 27 October 2008

Note: positive % indicates increased estimates; negative % reduced

**Recommendations (selection)**  
Europe

**Hermes: YTD: 22.6%; one-year total return: 30%**  
Hermes' brand stands for high-quality craftsmanship and classic rather than fashion-driven design. It offers leather goods, ties and scarves, ready-to-wear, home furnishings, shoes, watches and jewelry, and has very high price points compared with other luxury houses. Historically, Hermes has always traded at a significant valuation premium to the luxury sector due to its superior earnings stability, even during economic slowdowns. Without a drop in reported EPS for more than 15 years, we believe Hermes should be able to maintain its track record.

**LVMH: YTD: -45.8%; one-year total return: -44%**  
LVMH is a global leading luxury group. Its brand portfolio includes Louis Vuitton leather goods, Moët & Chandon champagne, Hennessy cognac, TAG Heuer watches, fashion, and jewelry. We believe LVMH's strong portfolio diversification offers significantly better earnings predictability and better quality of EPS growth compared to many of its peers. We think that this can be demonstrated particularly in a challenging market environment. Furthermore, we believe emerging market growth opportunities should remain in place in the long term.

**Swatch: YTD: -58.2%; one-year total return: -55.4%**  
The Swatch Group is one of the two leading Swiss luxury watch manufacturers. The company's portfolio of luxury brands (Omega, Breguet, Glashütte) and its component production are considerable advantages. Of the luxury watch groups, Swatch is better-positioned in the booming high-end watch segment and in fast-growing Asian economies, and is less vulnerable to the US market. The solid demand for luxury Swiss watches in an environment of limited production and highly utilized production capacity should be favorable for Swatch's margins. The ongoing share buyback program should further support the shares, in our view.

**Richemont: YTD: -47.1%; one-year total return: -41.8%**  
Richemont is the second-biggest luxury company in the world and has some of the leading high-end luxury watch brands (Cartier, Jaeger le-Coultre, Lange & Söhne and IWC). The company is well-diversified geographically, with a significant presence in fast-growing markets like Asia-Pacific, the Middle East and Russia. It also benefits from strong demand for high-end watches. Richemont's valuation factors in a significant economic downturn but we think it fails to reflect the group's strong balance sheet (net cash position of EUR 900mn), the ongoing strength in trading and its better positioning versus than in downturns given its more flexible cost base and more diversified end-markets.

Source: WMR, 10 November 2008

**Fig. 15: Luxury industry SWOT analysis**

- Strengths**
- strong pricing power
  - high entry barriers (brand value)
  - strong revenue growth (5x GDP)
  - high margins & cash flow generation
  - healthy balance sheets
- Weaknesses**
- frequent design cycles are part of the business
- Opportunities**
- diverging wealth distribution
  - expansion into high growing markets
  - continuous rise in tourism
  - demographic trend
  - changing lifestyle
  - M&A activity
  - FX movements (appreciation of USD and JPY)
- Threats**
- macroeconomic downturn
  - declining consumer confidence/spending
  - decreasing travelling flows
  - fashion risk
  - diminishing brand value
  - FX movements (depreciation of USD and JPY)

Source: WMR

**WMR Strategy – Consumer Discretionary**

Global	
Consumer Discretionary	underweight
Cons., Durab. & Apparel	moderate underweight
<b>Luxury subsector</b>	n.a.
US	
Consumer Discretionary	strong underweight
Cons., Durab. & Apparel	moderate underweight
<b>Luxury subsector</b>	n.a.
EMU	
Consumer Discretionary	underweight
Cons., Durab. & Apparel	moderate underweight
<b>Luxury subsector</b>	<b>moderate underweight</b>
UK	
Consumer Discretionary	strong underweight
Cons., Durab. & Apparel	n.a.
<b>Luxury subsector</b>	n.a.
Switzerland	
Consumer Discretionary	moderate overweight
Cons., Durab. & Apparel	n.a.
<b>Luxury subsector</b>	n.a.

Source: WMR, November 2008

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**Statement of Risk**

Past performance is no indication of future performance. The market prices provided are closing prices on the respective principle stock exchange. This applies to all performance charts and tables in this publication.

As our recommendations may change over time, we advise investors to always check on our individual stock ratings.

## Appendix

Terms and Abbreviations		Terms and Abbreviations	
Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
1H, 2H, etc. or 1H07, 2H07, etc.	First half, second half, etc. or first half 2007, second half 2007, etc.	Interest Coverage	Ratio that expresses the number of times interest expenses are covered by earnings
1Q, 2Q, etc. or 1Q07, 2Q07, etc.	First quarter, second quarter, etc. or first quarter 2007, second quarter 2007, etc.	Interest exp	Interest expense
2007E, 2008E, etc.	2007 estimate, 2008 estimate, etc.	ISIN	International securities identification number
ADR	American depositary receipt	LLP/Net Int Inc (%)	Loan loss provisions divided by net interest income
AUM	Assets under management = total value of own and third-party assets managed	LLR/Gross Loans (%)	Loan loss reserves divided by gross loans
bn	Billion (10 <sup>9</sup> )	m/m	Month-over-month; month on month
bp or bps	Basis point or basis points (100 bps = 1 percentage point)	mn	Million (10 <sup>6</sup> )
BVPS	Book value per share = shareholders' equity divided by the number of shares	n.a. or NA	Not available or not applicable
CAGR	Compound annual growth rate	NAV	Net asset value
Cant Inc/Capita	Cantonal income per capita (Switzerland only)	Net Debt	Short- and long-term interest-bearing debt minus cash and cash equivalents
Capex	Capital expenditures	Net Int Margin (%)	Net interest income divided by average interest-bearing assets
CFO	1) Cash flow from operations 2) Chief financial officer	Net Margin (%)	Net income divided by revenues
CFPS	Cash flow per share	n.m. or NM	Not meaningful
Cost/Inc Ratio (%)	Costs as a percentage of income	NPL	Non-performing loans
CPI	Consumer price index	Op Margin (%)	Operating income divided by revenues
CR	Combined ratio = ratio of claims and expenses as a percentage of premiums (for insurance companies)	p.a.	Per annum (per year)
CY	Calendar year	P/BV	Price to book value
DCF	Discounted cash flow	P/CFPS	Price/Cash flow per share
DDM	Dividend discount model	P/E	Price to earnings
Dividend Yield (%)	Dividend per share divided by price per share	P/E Relative	P/E relative to the market
DPS	Dividend per share	P/EmV	Price to embedded value
EBIT	Earnings before interest and taxes	PEG Ratio	P/E ratio divided by earnings growth
EBIT Margin (%)	EBIT divided by revenues	PPI	Producer price index
EBIT(D)A	Earnings before interest, taxes, (depreciation) and amortization	Prim Bal/Cur Rev (%)	Primary balance divided by current revenue (total revenue minus capital revenue)
EBITDA Margin (%)	EBITDA divided by revenues	Profit Margin (%)	Net income divided by revenues
EBITDA/Net Interest	EBITDA divided by net interest expense	q/q	Quarter-over-quarter; quarter on quarter
EBITDAR	Earnings before interest, taxes, depreciation, amortization and rental expense	ROA (%)	Return on assets
EFVR	Estimated fair value range	ROCE (%)	Return on capital employed = EBIT divided by difference between total assets & current liabilities
EmV	Embedded value = net asset value + present value of forecasted future profits (for life insurers)	ROE (%)	Return on equity
EPS	Earnings per share	ROAE (%)	Return on average equity
Equity Ratio (%)	Shareholders' equity divided by total assets	ROIC (%)	Return on invested capital
EV	Enterprise value = market value of equity, preferred equity, outstanding net debt and minorities	Solvency Ratio (%)	Ratio of shareholders' equity to net premiums written (for insurance companies)
FCF	Free cash flow = cash a company generates above outlays required to maintain/expand its asset base	Tax Burden Index	Swiss tax index; 100 = average tax burden of all cantons
FCF Yield (%)	Free cash flow divided by market capitalization	Tier 1 Ratio (%)	Tier 1 capital divided by risk-weighted assets; describes a bank's capital adequacy
FFO	Funds from operations	tn	Trillion (10 <sup>12</sup> )
FY	Fiscal year / financial year	Valor	Swiss company identifier
GDP	Gross domestic product	WACC	Weighted average cost of capital
GF	Grandfathered status	UBS WMR	UBS Wealth Management Research
Gross Margin (%)	Gross profit divided by revenues	y/y	Year-over-year; year on year
h/h	Half-year over half-year; half on half	YTD	Year-to-date
Interbank Ratio	Interbank deposits due from banks divided by interbank deposits due to banks		

## Appendix

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Any price of securities written in this publication is taken as at the close of business on the main market of listing on the date shown unless otherwise stated.

#### Disclosures (10 November 2008)

Burberry 1, LVMH 2, 3, PPR 4, 5, 6, 7, Richemont 1, 5, 6, 8, Swatch Group 5, 6, 7, Hermès International: No Disclosures for this Company

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## Appendix

### Stock Recommendation System

Analysts provide two ratings: an absolute rating and a relative rating. The absolute rating is based on the current Estimated Fair Value Range (EFVR) for the stock and the stock's recent trading price. The relative rating is based on the stock's total return potential against the total estimated return of the appropriate sector benchmark over the next year.

The EFVR is the price range within which the analyst estimates the stock to be fairly valued. The estimation of the EFVR is based on methods such as a discounted cash flow valuation or a valuation multiples comparison. In the definition of the EFVR, analysts take into account the risk profile (predictability) of the stock.

#### Absolute Stock Rating System

##### Buy

We believe the stock is undervalued relative to current market prices.

##### Hold

We believe the stock's current market valuation is within a fair range.

##### Sell

We believe the stock is overvalued relative to current market prices.

##### Under review

Upon special events that require further analysis, the stock rating may be flagged as "Under review" by the analyst.

##### Suspended

If data is not valid anymore, the stock rating may be flagged as "Suspended" by the analyst.

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#### Industry Sector Relative Stock View

Outperform (OUT)	Expected to outperform the benchmark
Marketperform (MKT)	Expected performance in line with the benchmark
Underperform (UND)	Expected to underperform the benchmark

#### Current WMR Global Rating Distribution (as of last month-end)

Buy	27%** (52%*)	Outperform***	31% (51%*)
Hold	63%** (55%*)	Marketperform***	49% (48%*)
Sell	2%** (35%*)	Underperform***	11% (41%*)

\* Percentage of companies within this rating for which investment banking services were provided by UBS AG or UBS Securities LLC or its affiliates within the past 12 months. Source: UBS WMR, as of 10 November 2008

\*\* At present, not all securities in WMR's global coverage universe have been assigned an Absolute Stock Rating in a Corporate Report. The Absolute Stock Rating distribution calculation includes only securities that have been assigned an Absolute Stock Rating as of the last month-end.

\*\*\* Under our Industry Sector Relative Stock View system, "Outperform" most closely corresponds with a "Buy" recommendation, "Marketperform" most closely corresponds with a "Hold" recommendation, and "Underperform" most closely corresponds with a "Sell" recommendation

## Appendix

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