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Investment Project

Richemont (CFR) Company Overview:

Compagnie Financiere Richemont SA, also known as Richemont (CFR), is a luxury goods company based in Switzerland. It was founded in 1988 by South African businessman Johann Rupert. He spun it off of the international assets of Rembrandt Group Ltd., which was a South African based company founded by Rupert's Father, Anton. As of 2014, Richemont is the second largest luxury goods company in the world after LVMH.

Through its subsidiaries, Richemont is responsible for designing, manufacturing, and selling luxury goods that include jewelry, watches, and leather goods amongst other items. Richemont has organized its business into the following three categories: Jewelry Maisons, Specialist Watchmakers, and Other Businesses. Richemont owns the famous jewelry brands Cartier, Van Cleef & Arpels, as well as Piaget. Richemont's goal is for long term growth through investments in all Maisons, as well as to maintain high product quality and creative management.

Richemont is a publicly traded company listed as CFR on the SIX Swiss Exchange and the JSE Securities Exchange. Richemont is headquartered in Geneva, Switzerland. The largest shareholder of Richemont is Compagnie Financiere Rupert, a Swiss company that holds and controls Johann Rupert's shares. Johann Rupert is the Chairman of Richemont and was first appointed to the board in 1988.

Competition:

The Luxury segment is highly consolidated as just six companies own over forty brands: LVMH, Kering, Richemont, PUIG, Labelux and OTB. Out of the six, only the first three are public companies that we could use as competitors for this analysis. As a result, we include Tiffany & Co. as well, which is a smaller and less diverse company, but will help with positioning the valuation of Richemont.

Competitor	**Company Description**	**Implications for Richemont**
Tiffany & Co. (TIF)	Luxury jewelry and specialty retailer headquartered in NYC. ~11,900 employees, Almost 150 stores globally. Market cap: 13.6 billion	Strong competitor in luxury goods market, selling jewelry, watches, handbags. Tiffany and Cartier (subsidiary of CFR) are major competitors. Both companies are "leaders" among digital competency.
LVMH Moet Hennessy Louis Vuitton SE (LVMH)	French multinational luxury goods conglomerate headquartered in Paris. 120,000 employees. Controls 60 subsidiaries that each manage small number of luxurious brands.	Greatest competitor for Richemont. E-commerce competition with Lyst (LVMH) and Net-A-Porter/YOOX (CFR).

	Market cap: 151 billion	Partnerships with celebrities (Rihanna). Has wine and spirits whereas CFR does not.
Kering S.A. (KER)	International luxury group based in France. 44,000 employees. Newer company (1963). Selective group of luxury designers; dropped Puma in 2018 to become 100% luxury goods company. Market cap: 47 billion	Smaller company, not as strong of a competitor for CFR compared to LVMH. Commitment to sustainability; top sustainable luxury goods corporation in 2018.

Financials:

Income Statement

When looking at Richemont's income statement from last fiscal year, we can see that the sales increased from €10,647M in 2017 to €10,979M in 2018. This is an increase of 7% at a constant rate (which is excluding inventory buybacks in FY17 and FY18) and highlights a strong retail performance. This is most likely attributed to the acquisition of YOOX Net-A-Porter, as well as strong performance by Cartier globally. The gross profit also increased by 5% from €6,799M in 2017 to €7,150M in 2018 with the gross margin at 65.1% and up 120 basis points. This increase can be attributed to the significant decrease in other operating expenses (€143M in 2017 to €59M in 2018) as well as lower watch inventory buy-backs compared to FY17. Additionally, there was 40 basis points of negative currency impact. The operating profit of €1,844M in FY18 shows the operating margin of 16.8% vs. 16.6% in 2017 (€1,764M). However, the profit for the year for 2017 was €1,210M and in 2018 was €1,221M—only up by 1%—which indicates that although they made an additionally 300M in sales, and although the cost of sales decreased, there were places in which they either spent more or profited less than in the previous year. However, there was an overall increase in operating profit and also a higher effective tax rate which differed from FY17.

Consolidated statement of comprehensive income

for the year ended 31 March

	Notes	2018 €m	2017 €m
Sales	5	**10 979**	10 647
Cost of sales		**(3 829)**	(3 848)
Gross profit		**7 150**	6 799
Selling and distribution expenses		**(3 094)**	(3 044)
Communication expenses		**(1 106)**	(1 119)
Administrative expenses		**(1 047)**	(1 015)
Other operating (expense)/income	24	**(59)**	143
Operating profit		**1 844**	1 764
Finance costs	27	**(335)**	(233)
Finance income	27	**185**	73
Share of post-tax results of equity-accounted investments	10	**(41)**	(34)
Profit before taxation		**1 653**	1 570
Taxation	11	**(432)**	(360)
Profit for the year		**1 221**	1 210
Other comprehensive income:			
Items that will never be reclassified to profit or loss			
Defined benefit plan actuarial gain/(losses)	20	**32**	(99)
Tax on defined benefit plan actuarial losses	11	**(7)**	(20)
Share of other comprehensive income of equity-accounted investments	10	**–**	–
		25	(119)
Items that are or may be reclassified subsequently to profit or loss			
Currency translation adjustments			
– movement in the year		**(1 063)**	279
– reclassification to profit or loss		**(49)**	–
Loss on cash flow hedge	33	**(53)**	–
Tax on cash flow hedge		**9**	–
Share of other comprehensive income of equity-accounted investments	10	**(10)**	–
		(1 166)	279
Other comprehensive income, net of tax		**(1 141)**	160
Total comprehensive income		**80**	1 370
Profit attributable to:			
Owners of the parent company		**1 221**	1 210
Non-controlling interests		**–**	–
		1 221	1 210
Total comprehensive income attributable to:			
Owners of the parent company		**80**	1 370
Non-controlling interests		**–**	–
		80	1 370
Earnings per A share/10 B shares attributable to owners of the parent company during the year (expressed in € per share)			
From profit for the year			
Basic	28	**2.164**	2.145
Diluted	28	**2.158**	2.141

The notes on pages 66 to 116 are an integral part of these consolidated financial statements.

Balance Sheet

Richemont's balance sheet shows that its assets have increased from FY17 to FY18. Total assets at the end of FY17 were €19,436M vs. €24,954M at the end of FY18; assets were even greater during mid FY19 with €28,203M. This reflects Richemont's efforts to expand globally and also expand into the ecommerce market. Additionally, from the end of FY17 to the end of FY18, Richemont decreased its total inventories from €5,302M to €4,928M. Richemont bought back much of their watch inventory in order to protect the brands' reputation and value, which explains the decrease in inventory during this period.

Interim Balance Sheet	09/30/2018 EUR	03/31/2018 EUR	09/30/2017 EUR restated	09/30/2017 EUR original	03/31/2017 EUR	09/30/2016 EUR
Assets						
Cash & ST Investments	10,709.00	13,476.00	-	7,022.00	7,951.00	7,560.00
Receivables (Net)	1,558.00	995.00	1,208.00	1,208.00	996.00	1,176.00
Total Inventories	6,014.00	4,943.00	4,928.00	4,928.00	5,302.00	5,390.00
Prepaid Expenses	-	151.00	168.00	168.00	163.00	175.00
Other Current Assets	0.00	19.00	4.00	4.00	21.00	179.00
Current Assets - Total	**18,281.00**	**19,584.00**	**13,330.00**	**13,330.00**	**14,433.00**	**14,480.00**
Investment In Unconsolidated Subsidiaries	178.00	1,308.00	-	1,338.00	1,307.00	1,267.00
Property Plant & Equipment - Net	2,506.00	2,325.00	2,288.00	2,288.00	2,558.00	2,469.00
Property Plant & Equipment - Gross	-	4,995.00	-	-	5,206.00	-
Less: Accumulated Depreciation	-	-	-	-	-	-
Other Assets	7,238.00	1,737.00	1,672.00	1,672.00	1,138.00	1,144.00
Intangible Assets	6,120.00	667.00	673.00	673.00	689.00	697.00
Total Assets	**28,203.00**	**24,954.00**	**18,628.00**	**18,628.00**	**19,436.00**	**19,360.00**
Liabilities						
Accounts Payable	-	-	-	-	-	-
ST Debt & Current Portion of LT Debt	4,644.00	3,901.00	2,006.00	2,006.00	1,738.00	2,603.00
Other Accrued Expense	-	-	-	-	-	-
Income Tax	-	-	-	-	-	-
Other Current Liabilities	310.00	1,625.00	237.00	237.00	1,389.00	303.00
Current Liabilities - Total	**7,437.00**	**6,315.00**	**3,938.00**	**3,938.00**	**3,900.00**	**4,555.00**
Long Term Debt	4,440.00	4,288.00	381.00	381.00	402.00	384.00
LT Debt Excl Capitalized Leases	4,440.00	4,263.00	381.00	381.00	374.00	384.00
Capitalized Lease Obligations	-	25.00	-	-	28.00	-
Deferred Taxes	(223.00)	(596.00)	(630.00)	(630.00)	(716.00)	(742.00)
Deferred Taxes - Credit	358.00	8.00	-	7.00	8.00	17.00
Deferred Taxes - Debit	581.00	604.00	-	637.00	724.00	759.00
Other Liabilities	332.00	309.00	261.00	261.00	321.00	518.00
Liabilities - Total	**11,986.00**	**10,316.00**	**3,950.00**	**3,950.00**	**3,907.00**	**4,715.00**
Shareholders' Equity						
Non-Equity Reserves	0.00	0.00	0.00	0.00	0.00	0.00
Minority Interest	86.00	7.00	1.00	1.00	0.00	0.00
Preferred Stock	0.00	0.00	0.00	0.00	0.00	0.00
Preferred Stock Non-Redeemable	0.00	0.00	0.00	0.00	0.00	0.00
Preferred Stock Redeemable	0.00	0.00	0.00	0.00	0.00	0.00
Common Equity	16,131.00	14,631.00	14,677.00	14,677.00	15,529.00	14,645.00
Common Stock	334.00	334.00	334.00	334.00	334.00	334.00
Capital Surplus	0.00	0.00	-	0.00	0.00	0.00
Other Appropriated Reserves	-	-	-	-	-	-
Retained Earnings	14,074.00	12,925.00	12,719.00	12,719.00	12,623.00	12,020.00
Less: Treasury Stock	560.00	520.00	522.00	522.00	432.00	458.00
Total Shareholders Equity	**16,131.00**	**14,631.00**	**14,677.00**	**14,677.00**	**15,529.00**	**14,645.00**
Total Liabilities & Shareholders Equity	**28,203.00**	**24,954.00**	**18,628.00**	**18,628.00**	**19,436.00**	**19,360.00**
Common Shares Outstanding	564.60	564.60	564.48	564.48	564.80	563.92

Statement of Cash Flows

Looking at the statement of cash flows we can see that the net cash from operating activities has increased from €1,619M in 2017 to €2,384M in 2018. In 2018, the cash flow generated from operations and taxation paid both increased, which could account for the differences. Net cash used in investing activities also sharply increased from €475M to €3,299M from 2017 to 2018. Their proceeds from disposal of subsidiary undertakings decreased from €370M in 2017 to €14M in 2018; however, their acquisition of investment property of non-current assets/investments increased from €0 to €213M and €36M to €631M from 2017 to 2018, respectively. The net cashed generated from financing activities also increased from €958M to €2.853B. Proceeds from borrowings increased greatly from €101M to €3.992B from 2017 to 2018. Cash and cash equivalents at the end of the year increased from €2.765B in 2017 to €4.504B in 2018. This is most directly attributable to the cash flows from investing activities, which more than quadrupled from 2017 to 2018, and more specifically from the acquisition of Dufry stake and investment properties.

Interim Cash Flow Statement	09/30/2018 EUR	03/31/2018 EUR	09/30/2017 EUR restated	09/30/2017 EUR original	03/31/2017 EUR	09/30/2016 EUR
Operations						
Net Income / Starting Line	1,130.00	1,844.00	1,166.00	1,166.00	1,764.00	798.00
Depreciation, Depletion & Amortization	-	-	265.00	-	-	-
Depreciation & Depletion	234.00	454.00	225.00	225.00	467.00	224.00
Amortization of Intangible Assets	150.00	83.00	40.00	40.00	94.00	46.00
Deferred Income Taxes	-	-	-	-	-	-
Other Cash Flow	(30.00)	(299.00)	(111.00)	(111.00)	(677.00)	(195.00)
Funds From Operations	1,484.00	2,082.00	1,320.00	1,320.00	1,648.00	873.00
Extraordinary Items	0.00	0.00	0.00	0.00	0.00	0.00
Funds From/For Other Operating Activities	(837.00)	302.00	(360.00)	(360.00)	(29.00)	(417.00)
Dec(Inc) In Receivables	(181.00)	16.00	(244.00)	(244.00)	42.00	(127.00)
Dec(Inc) In Inventories	(195.00)	68.00	110.00	110.00	123.00	(31.00)
Inc(Dec) In Accounts Payable	-	-	-	-	-	-
Inc(Dec) In Income Taxes Payable	-	-	-	-	-	-
Inc(Dec) In Other Accruals	-	-	-	-	-	-
Dec(Inc) In Other Assets/Liabilities	(461.00)	218.00	(226.00)	(226.00)	(194.00)	(259.00)
Net Cash Flow - Operating Activities	**647.00**	**2,384.00**	**960.00**	**960.00**	**1,619.00**	**456.00**
Investing						
Capital Expenditures (Addition to Fixed Assets)	(212.00)	(444.00)	(139.00)	(139.00)	(536.00)	(220.00)
Net Assets From Acquisitions	(2,687.00)	(108.00)	(122.00)	(122.00)	312.00	(26.00)
Increase In Investments	(3,546.00)	(7,109.00)	(2,686.00)	(2,686.00)	(4,183.00)	(2,742.00)
Decrease In Investments	4,539.00	4,999.00	2,682.00	2,682.00	3,988.00	2,575.00
Disposal of Fixed Assets	11.00	8.00	3.00	3.00	15.00	10.00
Other Uses - Investing	(25.00)	(631.00)	(601.00)	(601.00)	(36.00)	(18.00)
Other Sources - Investing	16.00	29.00	7.00	7.00	28.00	21.00
Net Cash Flow - Investing	**(1,971.00)**	**(3,299.00)**	**(878.00)**	**(878.00)**	**(475.00)**	**(431.00)**
Financing						
Net Proceeds From Sale/Issue of Com & Pref	106.00	70.00	-	69.00	47.00	28.00
Proceeds From Stock Options	0.00	0.00	0.00	0.00	0.00	0.00
Other Proceeds From Sale/Issuance of Stock	106.00	70.00	69.00	69.00	47.00	28.00
Com/Pfd Purchased	(180.00)	(141.00)	(141.00)	(141.00)	(95.00)	(95.00)
Long Term Borrowings	56.00	3,992.00	51.00	51.00	101.00	89.00
Reduction In Long Term Debt	(49.00)	(84.00)	(80.00)	(80.00)	(133.00)	(84.00)
Inc(Dec) In Short Term Borrowings	-	-	-	-	-	-
Cash Dividends Paid - Total	(926.00)	(918.00)	(918.00)	(918.00)	(878.00)	(878.00)
Other Sources - Financing	57.00	6.00	0.00	0.00	0.00	0.00
Other Uses - Financing	(195.00)	(72.00)	0.00	0.00	0.00	0.00
Net Cash Flow - Financing	**(1,131.00)**	**2,853.00**	**(1,019.00)**	**(1,019.00)**	**(958.00)**	**(940.00)**
Effect of Exchange Rate On Cash	52.00	(199.00)	(190.00)	(190.00)	31.00	(21.00)
Inc(Dec) In Cash & Short Term Investments	**(2,403.00)**	**1,739.00**	**(1,127.00)**	**(1,127.00)**	**217.00**	**(936.00)**

Valuation

Compared to its competitors, Richemont seems expensive today as it generates lower ROE from its businesses, although the acquisition of YNAP is expected to improve equity returns. However, the analyst consensus is that while the ROE will improve, it will lag behind its peers.

Fiscal Year Ending	Mar-18	Mar-19	Mar-20	Mar-21
Revenue (million EUR)	10,979	13,907	14,606	15,620
P/E	30.0x	19.8x	19.0x	18.0x
EV/Revenue	3.3x	2.0x	1.9x	1.8x
Dividend Yield	2.3%	3.0%	3.0%	3.2%
ROE	8.9%	11.4%	11.5%	11.5%

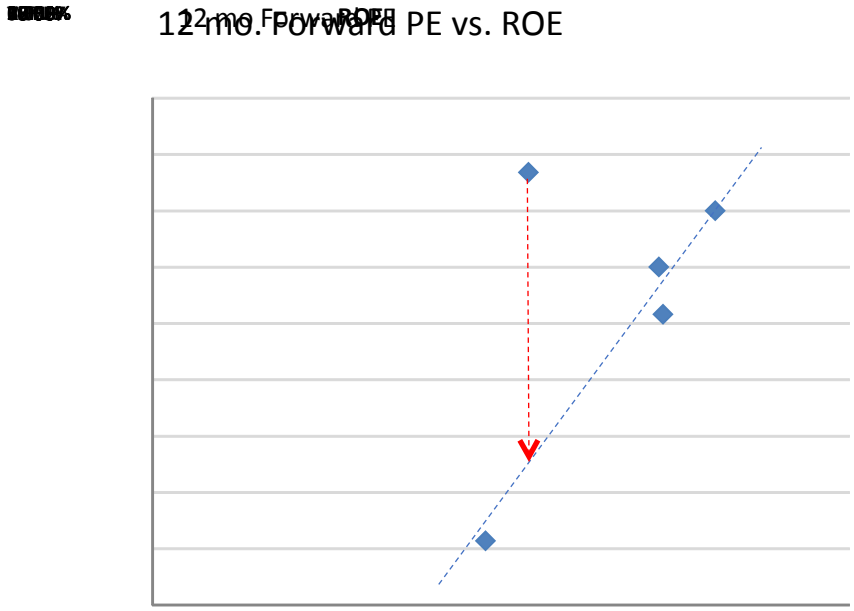
Source: Morgan Stanley

An additional valuation "wrinkle" is whether we are looking at Richemont in EUR, CHF, or USD – the P/E in USD reflects the translation of financials to USD, while the volatility with respect to the S&P 500 is considerably higher in USD than in EUR.

Company	Symbol (Yahoo)	Last Price (€, £, $)	Beta (3 years)	Price/Book	Price/Sales	Forward P/E	ROE	Trailing P/E	Market Cap (Billion €, £, $)
Richemont (France)	RITN.F	60.04	0.54	2.10	2.82	19.84	16.18%	25.49	34.29
Richemont OTC	CFRUY	6.825	0.84	2.05	2.76		16.18%	13.25	39.16
LVMH (France)	MC.PA	258.3	0.81	4.33	2.84	18.58	21.97%	21.67	129.73
KERING (France)	KER.PA	405.9	1.26	5.56	3.03	19.00	21.79%	15.4	51.07
Burberry (London)	BURBY.L	22.77	1.48	5.43	2.66	19.50	24.23%	21.79	9.42
Tiffany (NYSE)	TIF.N	85.82	1.62	3.48	2.35	16.57	14.34%	23.99	10.46

Source: Yahoo Finance

Richemont seems to be valued differently than its peers when we look at the P/E ratio as a function of the ROE:



Investment Opportunities

Acquisition of YOOX Net-A-Porter Group (YNAP)

In June 2018 Richemont acquired 98% of YOOX Net-a-Porter (YNAP) group's shares, offering €38 per share and valuing it at €5.3B; this acquisition will add more than €2B to Richemont's consolidated top line. YNAP owns Milan-based YOOX and British online retailers Mr Porter, the Outnet, and Net-A-Porter. Along with all of the YNAP ecommerce platforms, Richemont will also soon own Watchfinder, a specialist in buying and selling pre-owned watches online and through a small network of shops in the UK. As the world's largest luxury online presence, YNAP would provide a robust ecommerce platform for most of Richemont's product lines and brands. Richemont intends to grow YNAP in existing and new geographies, as well as increasing product availability and range. Through ecommerce, Richemont will be able to reduce their real estate footprint, which for Cartier, is the costliest operating expense. Additionally, given that Richemont profits have been fickle for years, the acquisition of the remaining 75 percent of YNAP stock should expand Richemont's sales' pipelines and stabilize sales. Also, YNAP's return policy spans 28 days after purchase date and covers the cost of return shipping; such an easy return policy helps instill consumer confidence in the brand and lessens perceived purchase risk, which likely helps increase sales.

Lower Priced Goods

In California in May 2018, Richemont Group launched Baume, a watch company marketed towards millennials. The watches range from $450 - $1000 and are based off of one of Richemont's original watch companies, Baume & Mercier. Richemont's goal is to appeal to the younger generation, since millennials typically cannot afford brands such as Cartier right out of college or during their first job.

Digital Expansion in China
In 2018, Richemont formed a joint venture with Chinese ecommerce giant Alibaba, a sign of how the combined forces of China and online retail are reshaping the global luxury goods market. The deal is a significant shift for the luxury goods market, which has been hesitant on embracing online retail and has especially regarded Chinese ecommerce with suspicion amid concerns it fosters counterfeiting. The global luxury market has more than tripled in size since 1996; the industry is now will be worth €280B and will rise to a total of €390B by 2025. This growth has been fueled greatly by Chinese shoppers, both at home and abroad. Alibaba will provide the technology, payment, and marketing support for Chinese consumers shopping at home and abroad to invest in the growing online luxury goods market. This will greatly benefit Richemont since there has been a huge surge in sales in the past two years from Chinese millennials who shop online. Millennials overall now account for 40 – 60% of global sales for big brands, such as Richemont's Cartier.

Investment Risks

Declining Wholesale Watch Sales
Due to a recent jewelry boom and subsequent slump in the wholesale watch business, jewelry sales have surpassed watch wholesale sales for Richemont. The lagging watch wholesale sales have thus spurred Richemont's evolution into a watch retailer. In FY18, the wholesale network accounted for only 37% of total sales. However, Richemont's own retail channel increased three points to 63% of sales while sales in the wholesale channel were down €909M in two years to €4.06B. This is the result of a boutique-building and the launch of ecommerce sites in the watch sector by some brands. However, watch sales in Richemont's retail network are performing just fine; in fact, they were up by double-digits in FY18. Richemont's main problem is the wholesale watch network and given Richemont's goal to become an omnichannel player, this trend is certain to continue.

Foreign Exchange Risk
Richemont is a global business with global sales which, as a result, come in different currencies. With the majority of Richemont's subsidiaries manufacturing their goods primarily in Europe, most of the workers' expenses are therefore in euros. However, Richemont's headquarters are in Switzerland, where the main form of currency is the Swiss franc. Therefore, when you buy CFRUY stock, you are essentially buying a EUR stock, converting it to USD (with all the F/X volatility), which means that the price fluctuations you see have an F/X component on top of the stock volatility. Therefore, using USD metrics to calculate P/E ratios in USD is meaningless because your price in USD reflects the USD/EUR volatility and Richemont's competitors trade differently. Competitors in the United States, such as Tiffany's, trade at different valuation metrics given the different environment rates and accounting differences.

An example of the risk associated with investing in CFRUY is the Swiss franc shock of January 2015, when the Swiss National Bank suddenly removed the artificial peg to the euro it had imposed to stop the franc from strengthening. Overnight, the franc jumped 15% against the dollar and the euro, causing chaos in export markets.

Buyback of Goods
In order to protect the brands from "grey market" discounted sales, Richemont spends millions every year buying back excess stocks of goods produced, such as watches; this takes a major hit on annual profits. In 2018, shares fell when Richemont reported that annual profits were hit by over €200M that were spent in order to buyback watches. Richemont's concern revolves primarily around wholesale distributers selling to third-party retailers, which are usually websites that sell the goods at bargain prices, in turn threatening the brand's image and exclusivity that is so sought after.

Watches and Technology
More and more fashion houses are introducing smart watches as a way maintain relevance in today's increasingly technology-driven market. Michael Kors, for example, has its own collection of smart watches and Cartier's competitor, Hermes, has partnered with Apple to create Apple Watches with Hermes Leather. A majority of Richemont's subsidiaries are watch companies or rely on their watch sales to generate revenue; by not adapting to the new standard of watches, the companies are missing out on a large group of consumers who will ultimately now go to Richemont's competitors in order to acquire the product that is more modern and relevant.

Vulnerable during Difficult Global Economic Conditions Resulting in Lowered Consumer Confidence
Overall business conditions, political uncertainties/developments, changes in the market value of real estate, inflation, interest rates, and expectations of future economic conditions all affect consumer confidence. During economic hardships, people first eliminate luxury goods; with the exception Baume, all of Richemont's subsidiaries are luxury brands with goods easily starting in the thousands of dollars. As a result, when consumers' confidence falls, they typically spend less money on luxury (discretionary) goods, which negatively affects Richemont's companies. Additionally, since almost, if not all, of Richemont's subsidiaries do not engage in price promotional activity, when other competitors react to such conditions by altering or prices and running promotions, Richemont can suffer. Also, since a majority of Richemont consumers are from China, any decrease in the Chinese economy would have a negative impact on sales and profitability in stores in China, as well as the other markets that serve Chinese tourists.

Increases in Costs of Gemstones and Precious Metals
Increases in costs of gemstones (such as diamonds) and precious metals (such as gold), or reduced availability of these supplies, could negatively impact Richemont's jewelry companies—which in FY18 generated the majority of Richemont's profit—by impacting the companies' abilities to produce and thus sell the products at the desired profit margins.

Investment Recommendation
Richemont is trying to improve its business metrics through one more brand acquisition (YNAP), yet the analyst consensus is for modest improvement in EBIT and ROE. China is also a big question since the economy is "stalling," but for Richemont, Asia/Pacific represents 37% of sales and highest growth (11%) was in China. Finally, for a USD investor, the stock in USD brings additional risks in the form of volatility and valuation caused by the volatile USD/EUR exchange rate. Therefore, I would not buy CFR (or CFRUY).