

# RICHEMONT: Revisiting the investment case

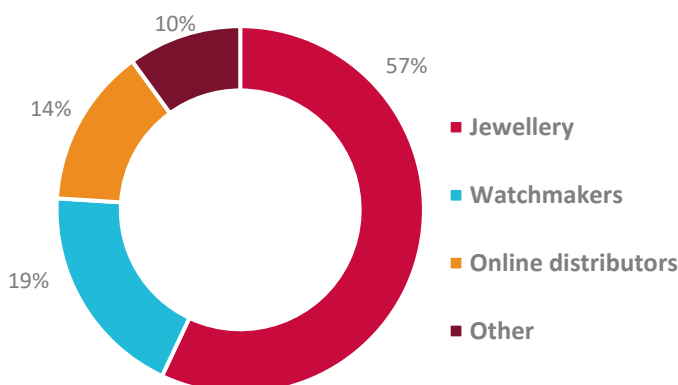


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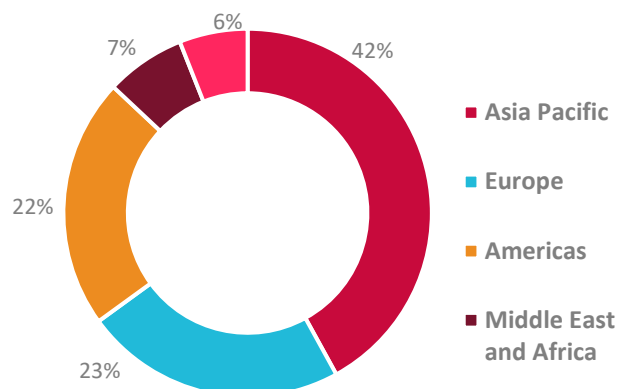
*Richemont’s recent stellar results demonstrate the benefits of the group’s strong position in jewellery and presence in fast-growing emerging markets. However, the underperforming online distribution channel has not only been a capital allocation disaster, but also remains a significant drag on margins and valuations. The announcement of discussions with global luxury platform Farfetch could represent an elegant solution that both brings YNAP to scale and further expands distribution for Richemont’s Maisons.*

Luxury goods holding company Richemont (CFR) has been a long-term position in several of Northstar’s equity funds and is currently a Top 10 holding in the Northstar SCI\* Equity Fund. More than half of group revenue and over 90% of earnings before interest and tax (EBIT) come from jewellery and Richemont has a strong presence in China, where robust medium-term demand for luxury goods is expected.

**Chart 5: Revenue contribution by sector H1 2022**



**Chart 6: Revenue contribution by region H1 2022**



Source: Northstar Asset Management

The group’s news release early in November 2021 about discussions with global luxury platform Farfetch has generated significant interest as it has the potential to catalyse a key aspect of Richemont’s investment case. Jewellery and exceptional brand equity underpin the group’s results.

**The four central aspects of Richemont’s investment case are:**

1. Good medium-term jewellery growth supported by emerging market demand and changing demographics that are likely to see global jewellery outpace other luxury categories through the cycle.
2. The group has significant brand equity in the form of its centuries-old heritage brands, which are difficult to replicate and command significant pricing power, allowing it to further entrench its dominant position as a global jewellery maker.

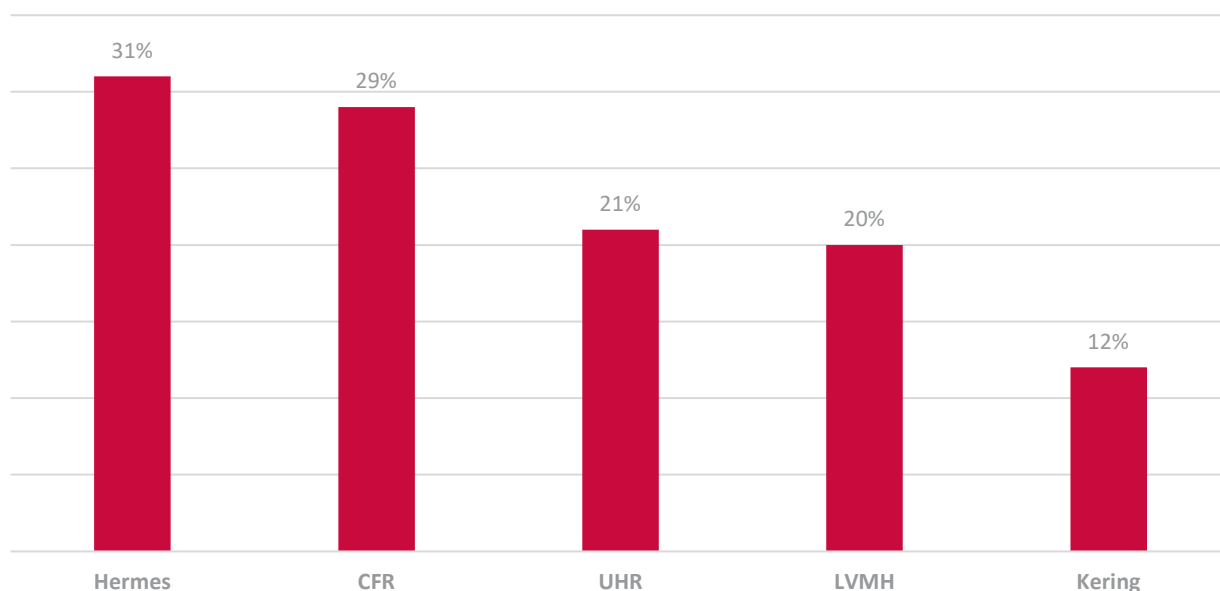
3. Fixing its loss-making online retailer YOOX NET-A-PORTER (YNAP).
4. Demonstrating better capital discipline and improving its ESG characteristics, particularly around management and board structure and composition.

Richemont’s latest results to 30 September 2021 highlight that both the first and second points of CFR’s investment case are intact, showing strong earnings momentum despite Covid-19 disruptions with both sales and earnings handsomely beating consensus and our estimates.

Although the rebound in sales has been broad-based with watch sales and the “Other” category rebounding too, the contribution from jewellery is now even larger (93% of EBIT excluding online distributors) and continues to underpin Richemont’s exceptional brand equity.

Richemont’s rebound in earnings post the Covid lows (+29%) not only exceeded most estimates but also outperformed industry peers such as LVMH and Kering on a constant foreign exchange basis over the past 2 years.

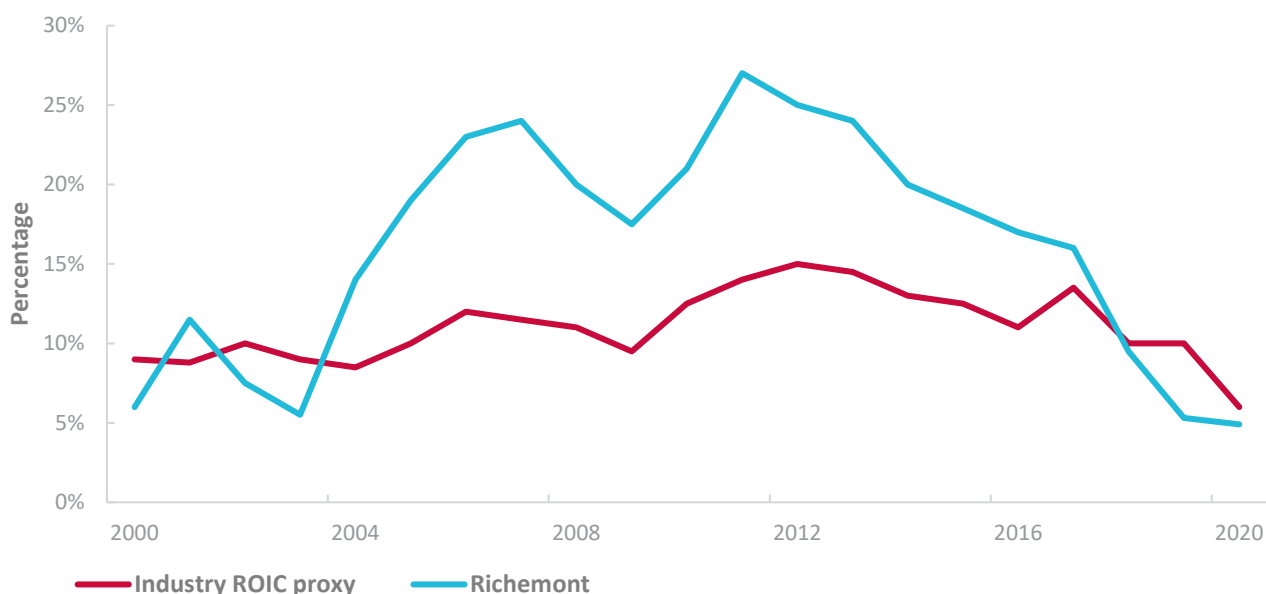
**Chart 7: Constant FX growth by peers, rebased to 100 in 2019**



Source: Company data, SBGS analysis and estimates

**Poor capital allocation has impacted returns**

While we are comfortable that Richemont’s brand equity strength remains intact and medium-term jewellery growth prospects are robust, poor capital allocation decisions over the past 10 years have impacted the group’s return on invested capital (ROIC), resulting in a steady decline since 2012.

**Chart 8: Richemont ROIC vs industry ROIC FY2000-2020**

Source: Company reports, Bernstein analysis

#### The main reasons for this decline are:

1. Bad strategic decisions in the watch business, including price increases and weak innovation, that resulted in subsequent inventory buy-backs, price cuts and wholesale reductions lasting several years. These challenges have now been broadly resolved after significant restructuring and management changes.
2. Poor online strategy and sub-optimal capital decisions relating to YNAP. Despite significant investment, YNAP remains a loss-making unit and contributes less than 5% to total group sales.

#### YNAP – a case study in poor capital allocation

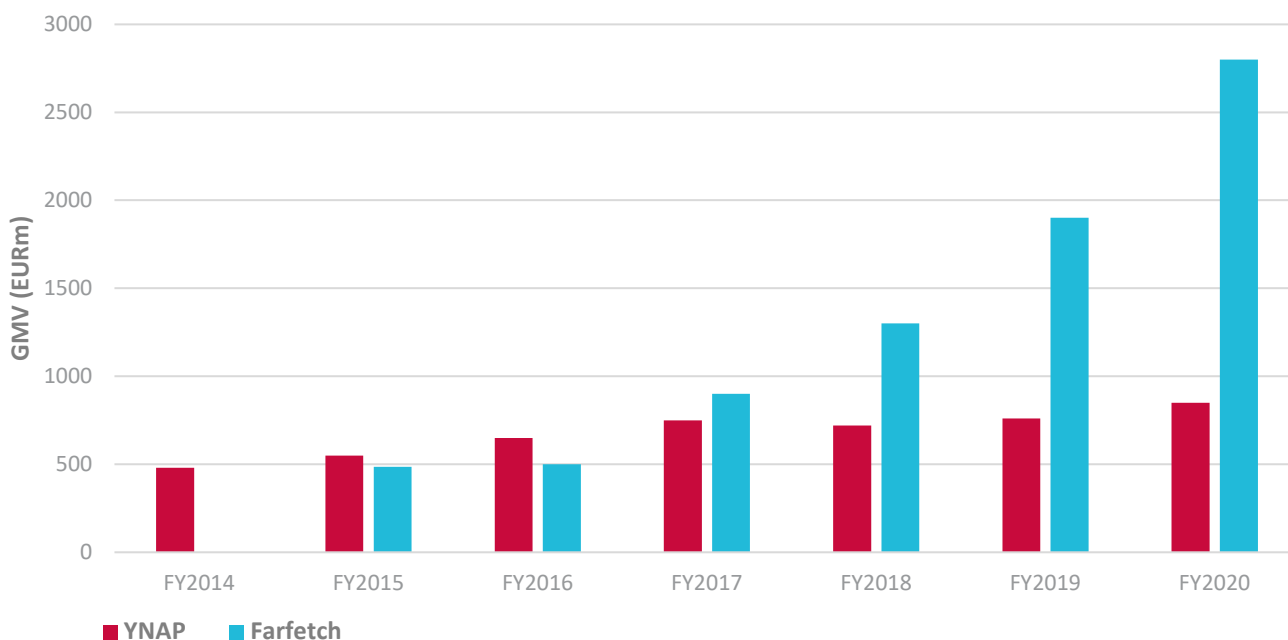
Richemont acquired a 25% stake in London-based e-commerce business Net-a-Porter (NAP) in 2002 to support the group's online distribution strategy. In 2010, Richemont increased its stake to 100% for a consideration of €392mn. In 2015, NAP merged with Italian-based off-price fashion e-retailer Yoox to create YNAP, with Richemont selling 50% of NAP at around €1.2bn.

Having been compelled to invest more capital to fund its losses, revamp the business and improve its tech platforms, in 2018 Richemont acquired 100% of YNAP for €2.8 billion, placing the value of the merged business at €5.3bn.

YNAP has generated cumulative losses of over €1bn and does not appear to be making material advances against industry peers. Despite its relatively small size in the group, its impact on group margins is severe – our calculations indicate that these are currently depressed by 5%. Based on reasonable estimates (capitalising the loss at Richemont's current rating), YNAP may currently be depressing valuation estimates by as much as 25% (Bernstein).

The announced tie-up with Farfetch therefore provides some hope that YNAP can start to realise its full potential without significant further investment, as Farfetch has shown exceptional growth in gross merchandise value (GMV) over the last 5 years.

Chart 9: YNAP vs Farfetch (EU mn)



Source: Company reports

According to Richemont's statement, Farfetch will invest directly into YNAP as a minority shareholder, allowing it to leverage Farfetch Platform Solutions, an end-to-end, multichannel e-commerce solution for luxury fashion brands. Richemont's Maisons will also be able to join Farfetch's marketplace and leverage its technology. The group stated that its ultimate objective is to create a neutral online distribution platform with no controlling shareholders.

#### Fixing YNAP should unlock further value

We believe the cooperation agreement goes a long way to resolve the capital required for YNAP to achieve scale and should accelerate its growth and contribution to group sales as a result of technology inputs and the benefit of network effects from Farfetch.

With Richemont's jewellery business benefiting from strong demand, robust forecast growth and increasing pricing power, the successful execution of a sound medium-term online strategy has the potential to improve margins and returns on capital. While concerns remain around the group's governance structure, at current valuations medium-term prospects remain attractive.

\*SCI refers to Sanlam Collective Investments

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