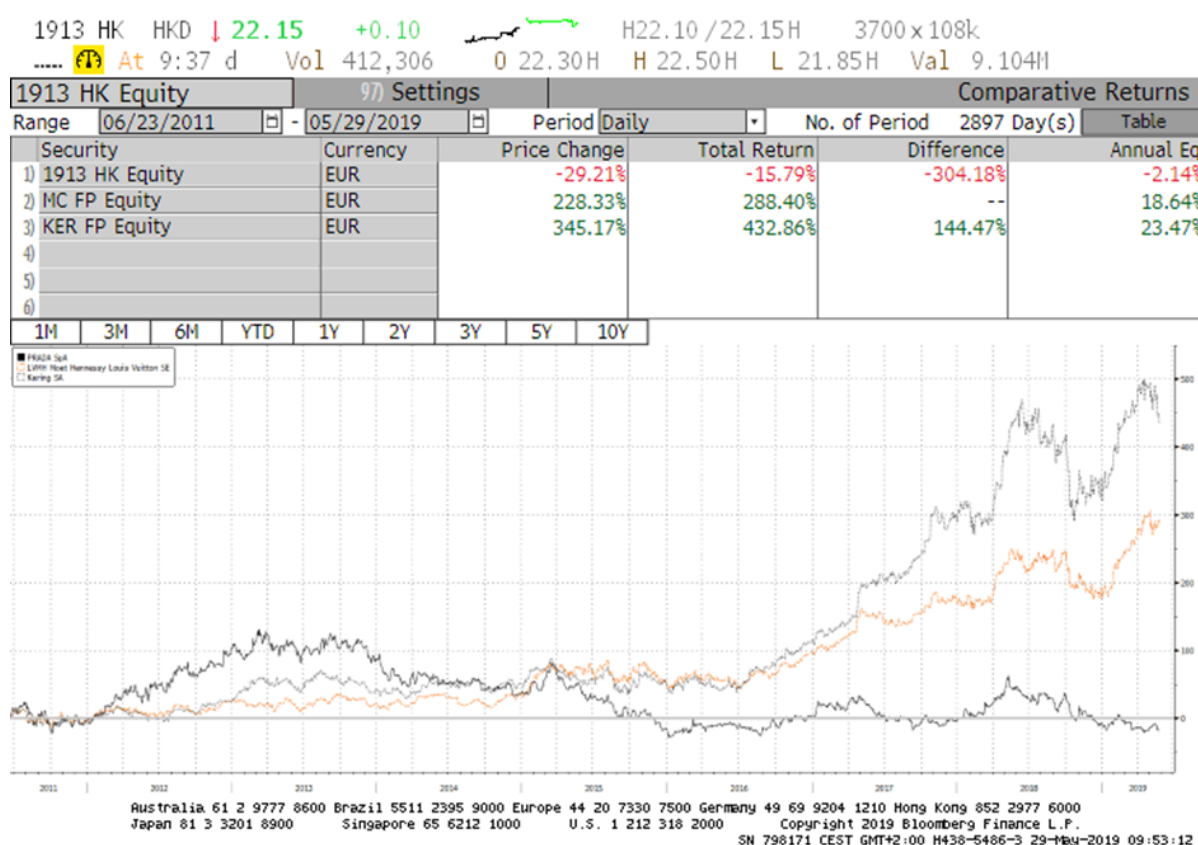




## Friday Morning Coffee

### Nr. 59 — The devil wears Prada

In the 2006 movie "The devil wears Prada", Meryl Streep plays an autocratic editor as chief of a prestigious fashion magazine featuring Anne Hathaway who struggles in her first job as a co-assistant. 5 years after the movie premiered, the iconic fashion brand Prada was IPOed in Hong Kong as the founding family opened its capital to outside investors. The stock price evolution that followed the listing looked more like a hell's ride than a graceful walk on the catwalk. The initial offer price of Prada in June 2011 was 39.5 HKD and the stock closed at 22.15 HKD as of this Thursday morning. Indeed after a short good start as a public company, Prada underperformed its main peers, such as LVMH and Kering, as illustrated below :



Source: Bloomberg (all stock prices in EUR)

Investors voted with their feet on Prada as its organic growth rates slowed, in some periods it recorded a negative growth too, when the closest peers were thriving. Prada, still 80% family owned, stayed true to its DNA and has not taken easy ways to re-fuel the brand. Instead it embarked on to a costly multi-year expansion plan that brought its store base up from c. 400 in 2012 to c. 670 in 6 years while profitability of the business was in free fall: the operating (EBIT) margin went from 26% in 2014 to 11% last year.



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**As value investors we like so-called moats, meaning the competitive advantages that enable companies to generate superior returns and shield them from competitors, at least partly. In our opinion with its 100 year old Prada brand, Miu Miu and the Church's shoes the company owns in our opinion superior brand assets.** The problems in the business are internal: low operating margins due to low store density and heavy investments after a multi-year investment program. Prada has maintained the pricing power of its products, as the gross margins are above 72%, which is amongst the highest in the industry. We would expect that the margins will improve going forward as the expansion plan comes to an end and sales density increases.

In the meantime, Prada continues to create shareholder value as the returns on tangible capital remains significantly above cost of capital even at current margins. Balance sheet is sound with the company almost debt free ( excl. leasing debt ) and the cash flow generative business is paying a healthy dividend.

Valuation looks compelling for us as value investors at an enterprise value to sales ratio of 2 times compared to 3.4 times for LVMH or 4.3 times for Kering. The current valuation of Prada resembles indeed more to the through valuations seen in the luxury industry during the financial crisis.

It will take some nerves for the investor in Prada as the current operating environment is far from easy. However, for an investor point of view with a four to five year horizon, the current environment may prove an excellent entry point into a quality business.

**In the "The devil wears Prada" the main character tells her friend at one stage " I am one stomach flu away from my ideal weight." In our value investment framework "we are a solid margin of safety away from our fair value" in Prada justifying us to take a hell's ride.**

The disclaimer is at the same time our conclusion of today's morning coffee : we are long Prada.

I wish you a nice weekend,

**Léon Kirch, CFA**  
*Partner & Chief Investment Officer*  
May 31<sup>st</sup>, 2019

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