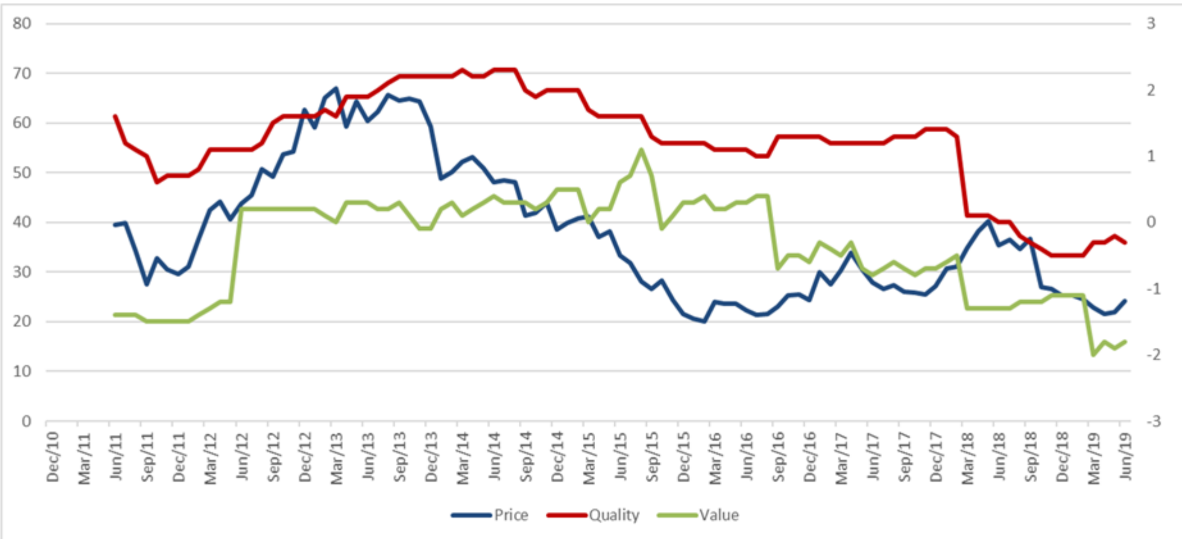
Friday Morning Coffee

European Capital Partners

Nr. 130 — “The devil wears Prada again”

This week we thought of revisiting Friday Morning Coffee Nr. 59 — “The devil wears Prada” that we wrote in May 2019. Back then our musing came forth on the back of our investment into Prada. Just like any other investment case this was not an easy call given the then prevailing circumstances; Sino-China trade war at its peak with the potential for further escalations, talks of repositioning of Global supply chains, market pundits foreseeing death of brick and mortar retailers and un-synchronised growth rates around world economies. On top of it what made this case unique in its nature was an absence of quarterly earning disclosures, although being a long-term investor we are not big advocates of quarterly earnings, but in restructuring stories like these the lower frequencies of trade disclosures can work against the share price.

To summarise our thesis at the time of entering into the investment: Prada is a global luxury brand with strong consumer appeal, it has big chunk of revenue coming from leather goods segment compared to peers, Prada has higher exposure fast growing Asia-Pacific markets especially China and Japan, it has industry leading gross margins underlying its pricing power and lastly, the founding family is a majority owner in the company. And what was not going in favour of the stock price? Well, lets look at our proprietary Quality-Value framework at the time.



As can be seen from the graph above, the quality score was gradually trending down since its peak in 2014. Until 2018, when it took a nose dive and interestingly enough, market participants were ahead of the curve on this case. Having identified positive attributes of the case as mentioned earlier, we begun our root cause analysis of the stock price debacle.

- First thing we noticed is that although the gross margin was declining slightly, it was still at industry leading level. In the non-food retailer businesses, the discounting, which companies regularly engage in to either bring in some volumes or clear out old stock, is one of the major factors amongst other that can pressure gross margins and we found out that in the recent past the company management has regularly engaged in discounting.
- Secondly, Prada had one of the worst sales densities in the industry. The reason behind could either be declining brand appeal or over expansion or both. Our analysis made us believe that in case of Prada, its over expansion which is hurting its sales densities more badly.
- Thirdly, Prada had developed a massive negative operating jaw which means if the things were to normalize, we have a potential for significant operating leverage to kick in.
- Fourth, proportion of sales from wholesale segment has gone up significantly higher, which is a perfect recipe for brand value dilution if left unchecked.
- And lastly, Prada had under monetised its brand as compared to peers.

All the issues we identified with Prada were internal and which were easily rectifiable. Higher exposure to leather goods means Prada had lower chances of falling out of favour with consumers as compared to pure apparel retailers, where the industry dynamics have changed to such an extreme that overnight we see one hero brand that goes to zero brand the next day. Let us thank e-commerce, fintech and fast-fashion for that. Having followed some of the M&A activities in the sector, we were convinced that at such a distress valuation a global luxury brand such as Prada would definitely attract raiders. Not to mention the management at Prada had already started addressing issues that we mentioned earlier, in addition to investing more in marketing.

Fast forward to November 2020, the management at Prada continues to walk in the direction we hoped for. Although we will not be able to provide like for like comparison due to extraordinary situation of Covid-19 that we are witnessing, but whatever scarce data we are observing adds to our confidence in the case. Take for example retail sales growth in the month of January this year were already in mid double digit as compared to negative growth recorded for first half of last year. Wholesale revenue has reduced to just 9% of the group sales compared to 15% in 2019. Apart from this, the online channel is showing solid take-up, management is delivering on cost savings at the same time it is continuing to invest in brand value.

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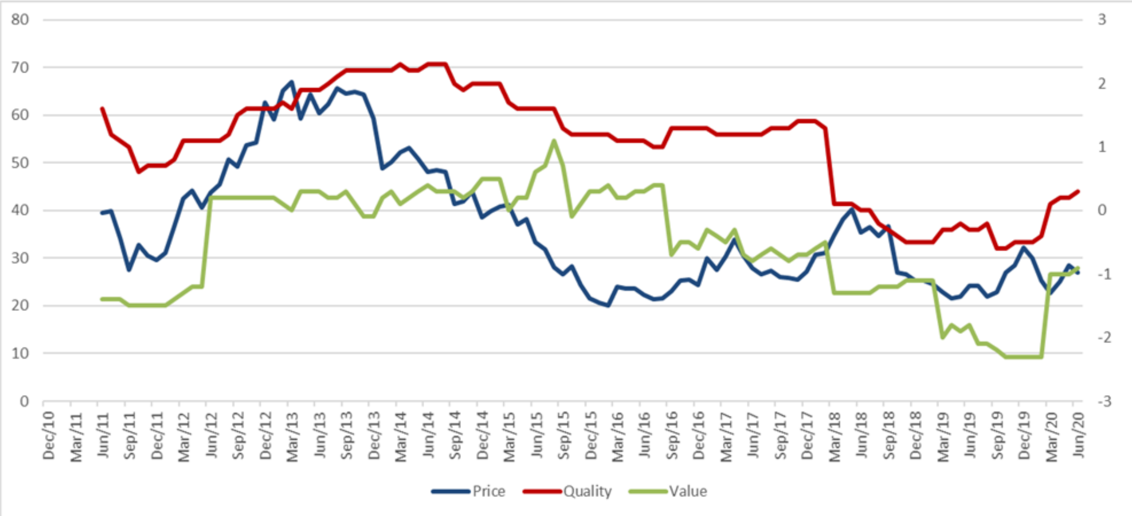

More importantly, in times like these we turn to our Quality-Value model which compares companies' performance on relative basis and thereby the score it gives is less polluted by Covid-19 effect than the financial statements of the company. And as shown below, the quality score has improved and so has the share price.

I wish you very nice weekend,

The Team of ECP

November 27th, 2020