# Fashion & Luxury Insight

INTERNATIONAL FASHION & LUXURY LISTED COMPANIES ANNUAL SURVEY

2009, October

## KEY FINDINGS

- A persisting negative trend. The economic and financial results for FY2008 suggest that the fashion and luxury industry has been underperforming compared to previous years. The most noticeable change compared to FY2007 is the reduction of sales growth rate to just 3.2%, showing an additional contraction in the top line growth from FY2007.
- In addition to the negative trend in sales growth, on average we find a strong contraction in EBITDA (-16.8% from FY2007). On average, EBIT margin faced a strong reduction (-3.6%), in part because of higher operating costs and in part because of an average increase in the reported impairment losses.
- The level of working capital to sales is increased (up to 20.2%), mostly because of a relevant increase in the inventory weight. In line with our expectations from FY2007, we argue that the average company in fashion and luxury has not been able to respond to a deteriorating top line growth with better efficiency and with improvements in the inventory management. The business still proves to be very rigid and longer time to market strongly affects profitability via working capital deterioration.
- Despite the deterioration in the key economic results, most of the players in the industry have not dramatically cut down investments that are still around 5% of total sales. We expect investments to go through a stronger reduction in FY2009 and a concentration on those supporting the core business.
- The opening of new stores (average +8%) is still a relevant part of the investment budget. However, new store openings have confirmed to be unable to contribute to sales growth as they have done in the past. As in FY2007, in FY2008 the growth in the number of stores mostly led to geographical expansion at the expenses of operating efficiency.
- However, the companies that have already achieved a strong retail positioning seem to be able to better fight the slowing down in demand than others. On average, retail-based companies still outperform wholesale-based ones.
- Leather Goods and Fashion Retailers are still the most represented clusters among top performers. On average, the companies in the Leather Goods business have been more successful than the other players to fight the deteriorating top line growth with stronger operating efficiency.
- With respect to market segments, in the Apparel business the Medium segment has been the most heavily affected by the slowing in demand, although it has been the best in defending asset profitability. On the contrary, in the Leather Goods business, the best segment in terms of profitability has been the Mass Market, that has been able to increase the average ROI and to defend the operating margins, even if the deterioration in the top line has affected all the three market segments similarly.

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SDA Bocconi School of Management
Ernst & Young
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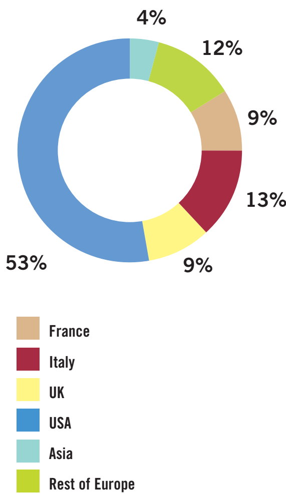
Sample Breakdown
by Nationality
(Based on 2008 Sales)



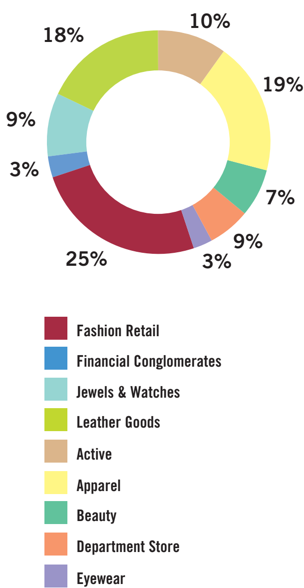

# Introduction

This report analyzes the economic and financial performance of a sample of fashion and luxury firms. We include in the fashion category all those companies manufacturing and/or retailing apparel and personal accessories (leather goods, jewels, eyewear) with a short product life-cycle addressing the current (constantly changing) trend. We include in the luxury category those companies manufacturing and/or retailing apparel and personal accessories competing in the high-end of the market as defined by price and brand image. When possible, the economic performance will be related to company strategies, with the objective to explore the main drivers of financial results.

We include in our analysis the main international players of the fashion and luxury industries. The companies have been identified according to four screening criteria:

1. they have to be listed on the financial market and own internationally renowned brands;
2. their consolidated sales have to be higher than € 200 million (or $ 200 million)[2];
3. their full financial and economic results must be publicly available;
4. they must operate in one or more of the following businesses: Accessories (leather goods, shoes, silk accessories and luggage), Active, Apparel, Beauty, Eyewear, Fashion Retail, Jewels & Watches.

Sample Breakdown
by Cluster
(Based on 2008 Sales)




Total sales of our sample of fashion and luxury companies equal to € 224 billion. We examine consolidated results and analyze company performance with respect to business characteristics, growth process and geographical area.

## OUR MEASURES FOR EVALUATING PERFORMANCE

We take into account different measures of company performance: the average growth in sales and EBITDA, the Return on Investments (ROI), the EBIT and EBITDA margins and Asset Turnover, the operating cash flow capacity and, finally, the average size of investments. We analyze the average growth rates in sales and the EBIT/EBITDA margin to measure the capacity of the companies to increase revenues and together maintain stable margins. The ROI is considered to explore the relationship between the operating results and the amount of assets supporting the business. EBIT and EBITDA margin and Asset Turnover are crucial drivers in this industry to read the economic effects of the business model, which can be based on higher operating margins or on higher asset turnover ratio. The operating cash flow capacity is measured by the ratio of the cash flow generated by the core activity* to sales. In the fashion and luxury industries, this figure is heavily affected by the business model, as the cash absorption from the Operating Working Capital (WC) can display significant changes depending on the main industry the company operates in and the distribution strategy. For this reason, we also provide evidence on the average WC weight by cluster and the average Trade Debtor Days. Finally, we focus on the investment choices of the analyzed companies. We explore both core and total investments, measuring the ratio of core investments to depreciation and the weight of total investments to sales. Core investments include addition to tangible and intangible assets related to the main business of the company, but they do not include any business acquisitions. Total investments are defined as the total cash used in investing activities, therefore including business acquisitions and financial investments.

* The cash flow from core activity or net self financing is the cash flow capacity of the firm after considering the effect of operating Working Capital (WC), and it is calculated as the Potential Cash Flow to Sales (equal to EBIT – Taxes + Depreciation + Amortization) – the changes in WC. The WC is defined as Account Receivables + Inventory – Account Payables.

| Average Exchange Rate | | |
|---|---|---|
| Year | Dollar to € | Yen to € |
| **2005** | 0,8045 | 0,0073 |
| **2006** | 0,8139 | 0,0070 |
| **2007** | 0,7308 | 0,0062 |
| **2008** | 0,6834 | 0,0066 |

The sample considered for the analysis consists of the following 68 companies, grouped according to the identified clusters:

- Active: Adidas, Black Leisure, Columbia Sportswear, Gildan Activewear, K-Swiss, Nike, Quicksilver.
- Apparel: Aeffe, Burberry, Escada, Gerry Weber, G-III Apparel Group, Guess, Jones Apparel, Link Theory Holdings, Liz Claiborne, Perry Ellis, Phillips Van Heusen, Polo Ralph Lauren, VF.
- Beauty: Estée Lauder, Inter Parfums, L'Oréal, Revlon, Shiseido.
- Department Stores: Debenhams, Marks and Spencer, Nordstrom, Saks.
- Eyewear: Luxottica, Safilo.
- Fashion Retail: Abercrombie & Fitch, Alexon, American Eagle Outfitters, Bebe, Benetton, Chico's, Collective Brands, Esprit, Etam, French Connection, Gap, Hennes & Mauritz, Inditex, Limited Brands, Next, Stefanel, Urban Outfitter.
- Financial Conglomerates: Christian Dior, PPR.
- Jewels and Watches: Bulgari, Fossil, Movado, Richemont, Swatch, Tiffany.
- Leather Goods: Coach, Deckers Outdoor, Genesco, Geox, Hermès, Kenneth Cole, Mariella Burani Fashion Group, Skechers, Timberland, Tod's, Weyco, Wolverine World Wide.

Although fashion and luxury companies present very complex business models in terms of vertical integration, diversification, brand and distribution strategies, we group companies on the basis of the industry they originate from (when it still represents the core business), looking for an acceptable level of homogeneity in each of the considered groups. For each cluster we provide the average results: these figures should be referred to as a benchmark for companies within the cluster more than as a measure of comparison among different clusters.

# Overview

In year 2008, the average economic performance of the companies in the sample has been substantially declining, confirming a general negative trend over the past three years (See Exhibit 1). The average increase in sales from previous year is equal to 3.2% (9.4% in FY2007), suggesting that the industry continues to grow but at a considerably lower pace: double-digit is just a memory from the past. In addition, we find a sharp decline in EBITDA margin, which has been dropping by more than 16% over FY2008.
The average ROI of the total sample is about 9.4% (14.2% in FY2007), reducing the average assets profitability from previous years. In addition, the ROE has turned negative (-1.1%) in FY2008: we argue that the negative trend in Net Income has mostly been related to extraordinary impairment losses and negative financial results.
The average EBIT margin is equal to 8.3% (11.9% in FY2007). The average cash flow generation capacity has also been reduced to 8.3% of sales, partially affected by the average increase in the weight of working capital (now equal to 20.2% of sales). The average trade debtor days are substantially stable over time (equal to 41 days).

1. For the purpose of this research, we use a relatively stringent definition of luxury. We exclude categories such as luxury cars, yachts, audio and photo equipment, entertainment and travel.
2. Consolidated sales in € have been calculated on the basis of average annual exchange rates.
3. We group Christian Dior (consolidating LVMH group) and PPR (consolidating Gucci Group) into a special cluster, labelled Financial Conglomerates, because of the very wide scope of activities and brand portfolio.
4. All the results for past years have been calculated on the homogeneous sample.

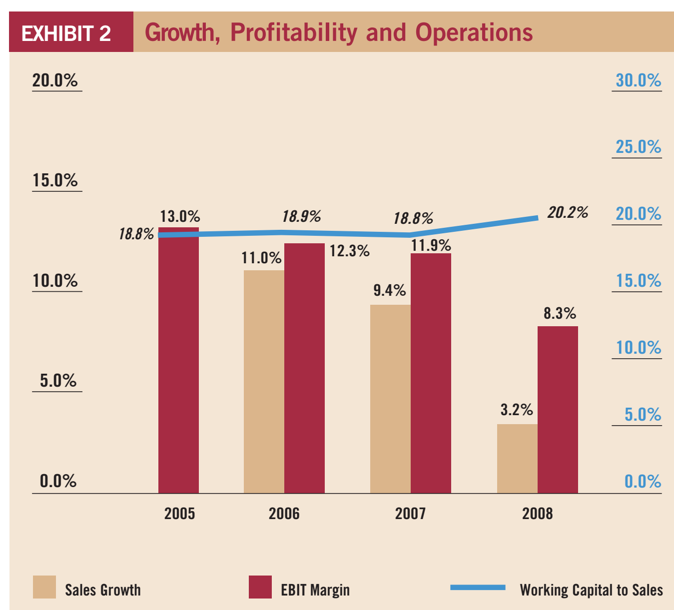
The analyzed companies also show a certain reduction in core investments, now equal to 124.5% on depreciation, and in total investments, now close to 5% of consolidated sales. These figures suggest that the main players in the industry are still investing in the development of the core business and in supporting future growth, even if at a slightly slower pace than in the previous years. With respect to capital structure choices, the analyzed companies have increased their gearing up to 0.7, back to the levels of FY2006. We argue that, unfortunately, the increased use of debt must be related to the covering of increased short term financial needs more than to financing growth.

**EXHIBIT 1** Financial Highlights

| (Overall sample) | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|
| Sales Growth | - | 11.0% | 9.4% | 3.2% |
| EBITDA Growth | - | 33.7% | 18.3% | -16.8% |
| Return on Investments (ROI) | 16.3% | 15.1% | 14.2% | 9.4% |
| Return on Equity (ROE) | 19.3% | 19.4% | 15.7% | -1.1% |
| EBIT Margin | 13.0% | 12.3% | 11.9% | 8.3% |
| Asset Turnover | 1.28 | 1.29 | 1.27 | 1.31 |
| EBITDA Margin | 16.2% | 15.5% | 15.3% | 13.0% |
| Net Cash Flow to Sales | - | 9.9% | 10.3% | 8.3% |
| Gearing | 0.4 | 0.7 | 0.6 | 0.7 |
| Current Ratio | 2.50 | 2.48 | 2.50 | 2.36 |
| Intangible Assets Weight | 17.7% | 17.9% | 17.9% | 16.5% |
| Fixed Assets Weight | 44.2% | 44.7% | 45.0% | 45.2% |
| Working Capital to Sales | 18.8% | 18.9% | 18.8% | 20.2% |
| Trade Debtors Days | 42 | 42 | 42 | 41 |
| Core Investments over Depreciation | 133.9% | 160.0% | 172.4% | 124.5% |
| Total Investments on Sales | 5.8% | 5.7% | 6.0% | 4.9% |

Source: company data

**EXHIBIT 2** Growth, Profitability and Operations




By comparing sales growth and margins with the average investment in working capital over time, we find that the negative trend in sales growth is associated to an average increase in the operating costs of the analyzed companies and to a relevant increase in the level of working capital to sales in FY2008 (See Exhibit 2). We believe that this deteriorating long-time trend must be properly identified as a structural change in the average industry profitability and it cannot simply be identified as the consequence of the 2008 general economic and financial crisis.

On the total sample, size remains a key profitability driver. When segmenting the sample by the average company size (See Exhibit 3), we discover that the companies with sales above € 5 billion achieve higher ROI, EBIT margin and cash flow generation capacity compared to smaller companies. In particular, the companies with average sales below € 1 billion experience the poorest results in the sample with respect to each of the considered profiles.

With respect to sales growth, the medium-sized companies (with consolidated sales between € 1 and 5 billion) exhibit the highest growth rate in FY2008. This results lead to quite interesting insights on the future of many small and medium enterprises in our sample of fashion and luxury players. As a matter of fact, the bigger companies prove to be able to better face a deteriorating economic scenario than the small ones. If so, we might expect big companies to be able to better defend their competitive position also in year FY2009.

**EXHIBIT 3** Segmenting by Average Company Size

| Average Company Size (€bl) | ROI | EBIT Margin | Assets Turnover | Cash Flow to Sales | Total Investments on Sales | CAGR Sales |
|---|---|---|---|---|---|---|
| > 5€B | 14.8% | 12.7% | 1.2 | 12.0% | 5.7% | 3.2% |
| > 1€B and < 5€B | 10.6% | 9.4% | 1.2 | 9.9% | 5.7% | 3.4% |
| < 1€B | 5.1% | 4.8% | 1.4 | 4.7% | 3.6% | 2.9% |

Overall, sales growth and profitability have proved to be strongly correlated in the fashion and luxury business (See Exhibit 4). In general, growth in sales has been followed by significant improvement in return on investments (ROI) in all the years between 2001 and 2007. We have always argued that size is extremely relevant for these companies, thus raising doubts on the sustainability of the business models of niche players.
By comparing FY2008 with previous years, we find support to the evidence that the most of the companies have been struggling with efficiency and maximization of returns, while only few players are still living a phase of intense growth. In FY2008, the trend already identified in FY2007 has been emphasized (See Exhibit 4 and 5). The only companies achieving above the average return on investments have been those that have responded to the average reduction in the industry growth with an increased focus on efficiency.
If in the past the growth in sales has been mostly driven by the opening of new stores, in the last three years the development pace of the distribution network started to decelerate (See Exhibit 6). Our sample shows that, on average, the growth in the number of stores has been equal to 8% in FY2008.

**EXHIBIT 4** Profitability vs Sales Growth (2001-2007)

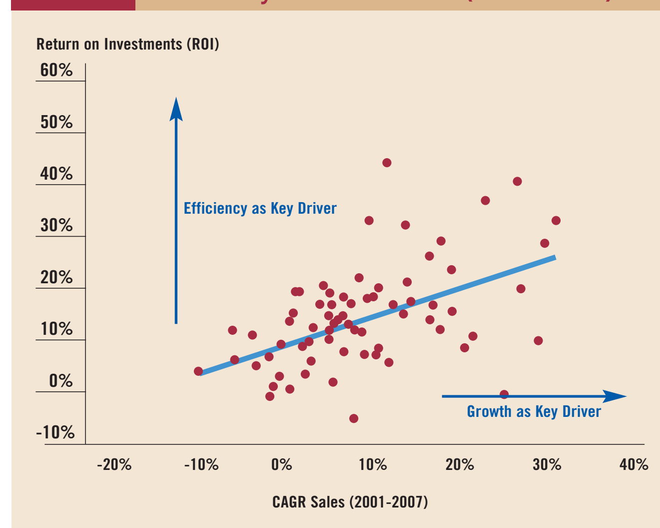
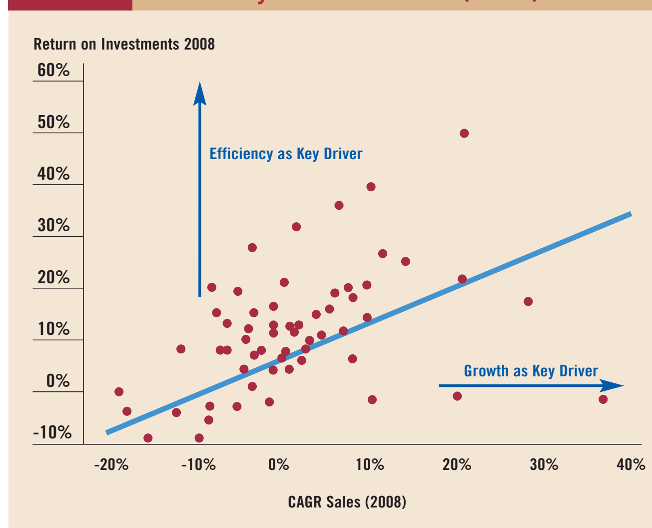



**EXHIBIT 5** Profitability vs Sales Growth (2008)



In the past, the growth in the number of stores has been a crucial driver for sales growth and profitability in this business (See Exhibit 7). Now, as the average growth rate in sales is shrinking, efficiency is becoming increasingly important. On average, in FY2008 the opening of new stores has started to raise new challenges for fashion companies, now struggling more than before to achieve sales in line with their targets (See Exhibit 8).
By analyzing the average growth in investment absolute levels over time, we notice that the total investments have been strongly cut down in FY2008, while the core investments (in tangible and intangible assets) have still been growing, although at a much slower pace than in FY2007 and FY2006 (See Exhibit 9). This suggests that core investments are still a relevant driver in this industry. We expect future investments to be more focused on the core business and organic growth.

**EXHIBIT 6** Average Increase in the Number of Stores (2006-2008)

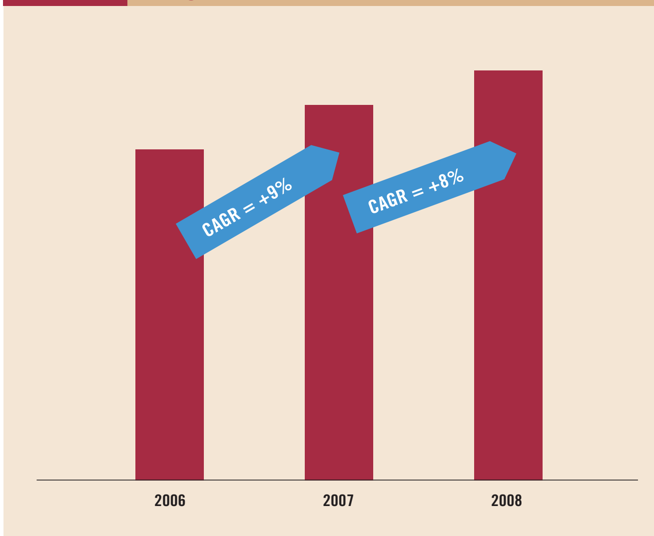



**EXHIBIT 7** Sales Growth vs Retail Development Pace (2001-2007)

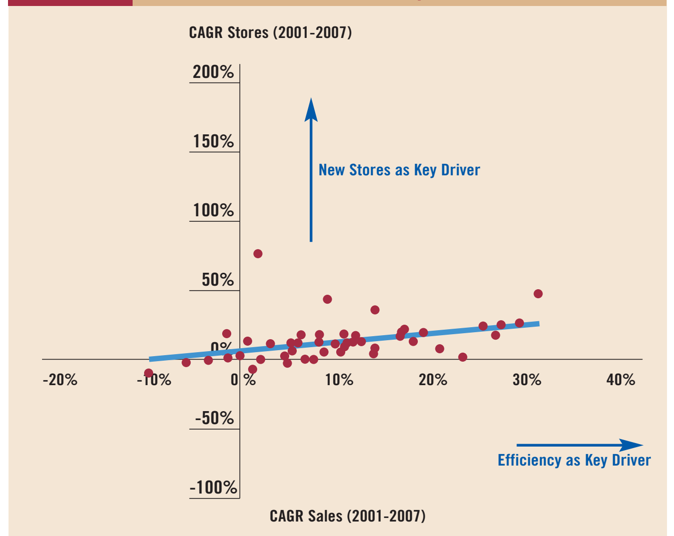



**EXHIBIT 8** Sales Growth vs Retail Development Pace (2008)

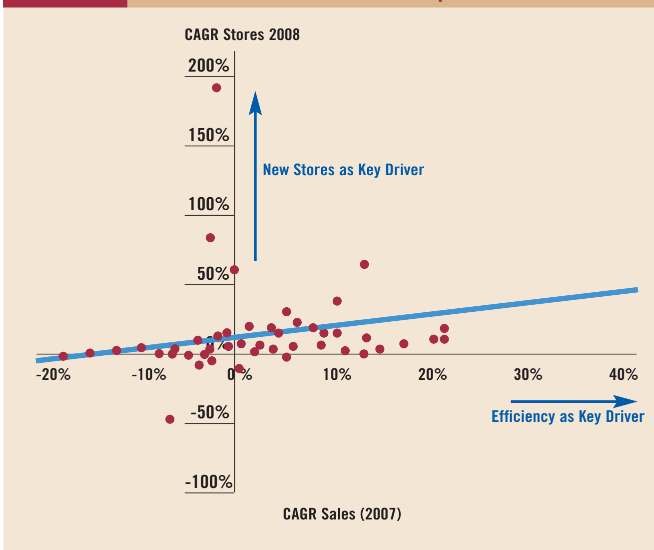
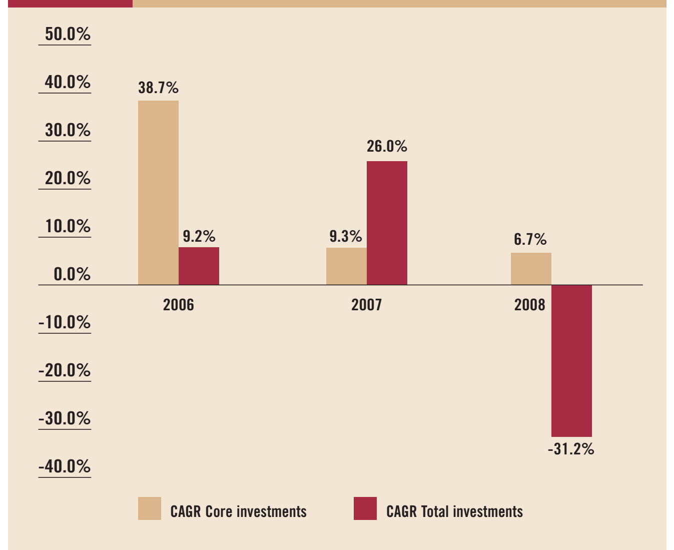



**EXHIBIT 9** Investment Growth over Time (Absolute Values)



In line with previous years, Fashion Retail and Leather Goods are the most represented businesses within the top performers for growth, profitability and cash flow generation (See Exhibit 10 and 11). However, a closer analysis of the strategies implemented by the top performers reveals that additional factors other than the nature of the business they operate in can help in explaining the reasons of such brilliant results. The two keywords in FY2008 have been execution and discipline.

If in fact the conditions in the external economy have affected demand resulting in changes in sales and margins, the best performing companies have reacted putting in place strategies and actions aiming at:

(i) managing inventory turnover;
(ii) enhancing store productivity;
(iii) growing across distribution channels;
(iv) focusing on expanding markets with high growth potential and low penetration.

In line with previous years, the US companies are widely represented among the top performers, as Coach, Deckers Outdoor, Guess and Urban Outfitters exhibit strong performances both in terms of growth and profitability. Not only, but the most of the best performing companies this year achieved above the average results in FY2007 as well. This evidence confirms that the strong presence on the local market and vertical integration in the retail business represent two main drivers for success for fashion and luxury companies.

Once again, Geox is the only Italian company within the best performers. The company shows extraordinary results, both in terms of profitability and growth. Its innovative product concept and business model are proving to be successful in the long run and able to resist to major economic downturns. With respect to the average return on investments, the top performers are those companies that are able to achieve both very high operating margin (above 17% on sales) and high asset turnover (which, on average, is one of the more stable figures on our sample in FY2008). On average, these players have been able to achieve an average +24% growth in consolidated sales in FY2008. As an additional note, it is interesting to observe that, in line with the past few years, no pure luxury High End player appears among top performing companies, except for the EBIT margin profile. This evidence suggests that the investments to support the High End positioning of a brand are becoming less and less profitable compared to those in the Medium and Mass Market segments.

5. Since the absolute level of investments are extremely volatile from one year to another and strongly company dependent, the average growth in investments over time has been calculated using a trimmed average at the 95% level.
6. We have analyzed the key actions and strategic choices emerging from the Management's Discussions reported in the Annual Reports for all the best performing companies.

EXHIBIT 10

## Top ten Performers by Sales Growth

| Company | Country | Cluster | Sales growth |
|---|---|---|---|
| Deckers Outdoor | US | Leather Goods | 54% |
| G-III Apparel Group | US | Apparel | 37% |
| Gildan Activewear | Canada | Active | 30% |
| Coach | US | Leather Goods | 22% |
| Urban Outfitter | US | Fashion Retail | 22% |
| Burberry | UK | Apparel | 21% |
| Geox | Italy | Leather Goods | 16% |
| Guess | US | Apparel | 14% |
| Hennes & Mauritz | Sweden | Fashion Retail | 13% |
| Collective brands | US | Fashion Retail | 13% |

## Top ten Performers by ROI

| Company | Country | Cluster | ROI |
|---|---|---|---|
| Coach | US | Leather Goods | 50% |
| Hennes & Mauritz | Sweden | Fashion Retail | 39% |
| Esprit | Asia | Fashion Retail | 35% |
| Genesco | US | Leather Goods | 32% |
| Next | UK | Fashion Retail | 27% |
| Guess | US | Apparel | 26% |
| Geox | Italy | Leather Goods | 26% |
| Deckers Outdoor | US | Leather Goods | 24% |
| Urban Outfitters | US | Fashion Retail | 23% |
| Wolverine World Wide | US | Leather Goods | 21% |

## Top ten Performers by EBIT Margin

| Company | Country | Cluster | EBIT margin |
|---|---|---|---|
| Coach | US | Leather Goods | 36% |
| Hermès | France | Leather Goods | 25% |
| Esprit | Asia | Fashion Retail | 24% |
| Hennes & Mauritz | Sweden | Fashion Retail | 23% |
| Swatch | Swiss | Jewels & Watches | 21% |
| Dior | France | Financial Congl | 19% |
| Geox | Italy | Leather Goods | 19% |
| Richemont | Swiss | Jewels & Watches | 18% |
| Tod's | Italy | Leather Goods | 18% |
| Genesco | US | Leather Goods | 17% |

## Top ten Performers by Cash Generation

| Company | Country | Cluster | Cash flow to sales |
|---|---|---|---|
| Coach | US | Leather Goods | 25% |
| Revlon | US | Beauty | 20% |
| Hennes & Mauritz | Sweden | Fashion Retail | 18% |
| Esprit | Asia | Fashion Retail | 17% |
| Inditex | Spain | Fashion Retail | 16% |
| Luxottica | Italy | Eyewear | 16% |
| L'Oréal | France | Beauty | 15% |
| Swatch | Swiss | Jewels & Watches | 15% |
| Hermés | France | Leather Goods | 15% |
| Debenhams | UK | Department Store | 14% |

EXHIBIT 11 Top five Performers by Sales Growth (controlling for size)

### Average Company Size > 5€B

| Company | Country | Cluster | Sales growth |
|---|---|---|---|
| Hennes & Mauritz | Sweden | Fashion Retail | 13% |
| Estée Lauder | US | Beauty | 12% |
| Inditex | Spain | Fashion Retail | 10% |
| VF | US | Apparel | 6% |
| Adidas | Germany | Active | 5% |

### Average Company Size > 1€B and < 5€B

| Company | Country | Cluster | Sales growth |
|---|---|---|---|
| Coach | US | Leather Goods | 22% |
| Urban Outfitter | US | Fashion Retail | 22% |
| Burberry | UK | Apparel | 21% |
| Guess | US | Apparel | 14% |
| Collective brands | US | Fashion Retail | 13% |

### Average Company Size < 1€B

| Company | Country | Cluster | Sales growth |
|---|---|---|---|
| Deckers outdoor | US | Leather Goods | 54% |
| G-III Apparel Group | US | Apparel | 37% |
| Gildan Activewear | Canada | Active | 30% |
| Geox | Italy | Leather Goods | 16% |
| Gerry Weber | Germany | Apparel | 12% |

# Performance analysis by geographical area

When looking at the sample by nationality, in FY2008 Italian companies show average growth in sales lower than companies from the rest of Europe and even the US (See Exhibit 12). More in details, Italy is showing a dramatic trend, considering the drop in the sales growth rate from 16% in FY2006 and 10% in FY2007 to just 1.6% in FY2008. The US companies also display a similar contraction, with growth rates falling from 10% in FY2006 and FY2007 to just 2.8% in FY2008.
With respect to profitability, we find that US and French companies have performed better than companies from Italy and the rest of Europe (See Exhibit 13). In fact Italian and other European companies show similar contraction in profitability (in both cases ROI has been quite stable over time and then reduces of about 3% over FY2008). Profitability of French companies has been only marginally affected by the economic downturn, as on average their ROI reduces by 1%. On the contrary, US firms exhibit a substantial fall in profitability, with ROI dropping from average 15% in FY2007 to less than 10% in FY2008.

**EXHIBIT 12** Growth in Sales by Nationality

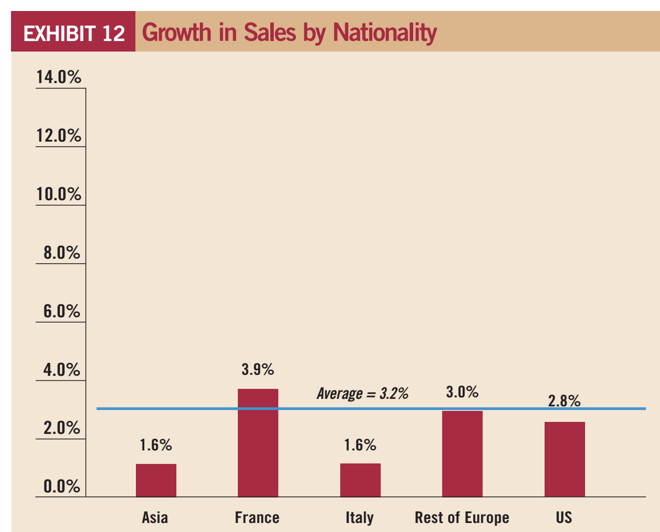
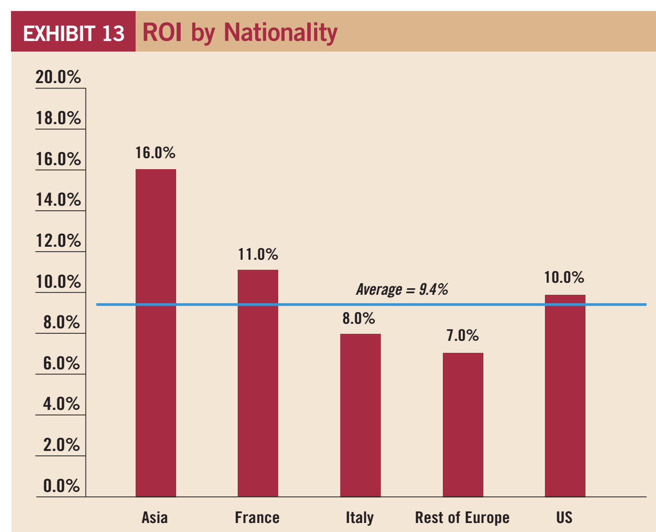



**EXHIBIT 13** ROI by Nationality

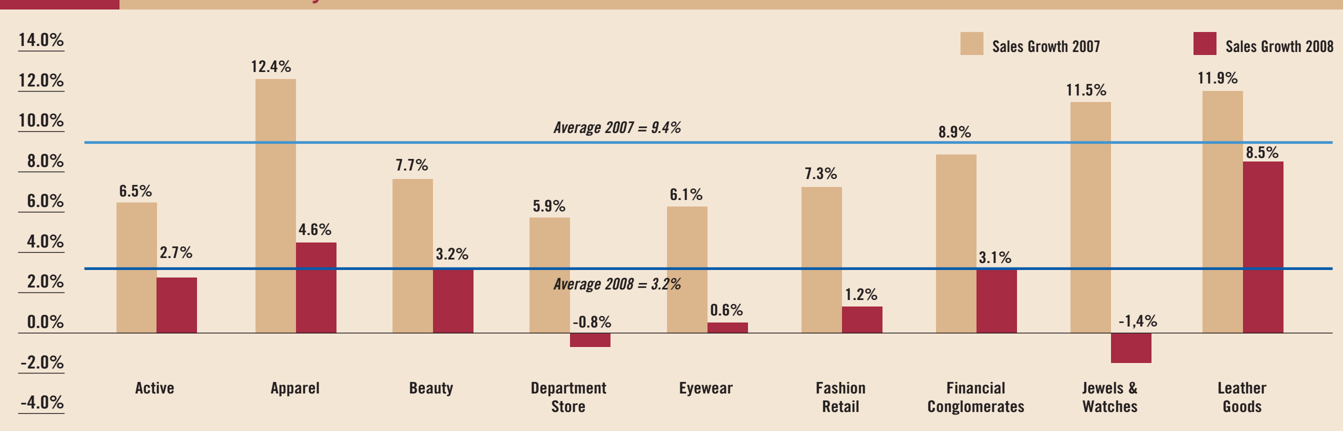


# Performance analysis by cluster

## Sales growth by cluster

In line with previous years, in FY2008 the average growth rates in sales are very different across clusters (See Exhibit 14). Not surprisingly, all the clusters experienced a substantial reduction in the average sales growth rates. The growth rate in sales is well above the average for both Apparel and Leather Goods companies. On the contrary, Fashion Retail and Eyewear show really poor sales growth figures, just close to 1%. Jewels & Watches and Department Stores are the only clusters with an average reduction in sales from FY2007: on average, the companies in these clusters lost 1.4% and 0.8% of their consolidated sales in FY2008, respectively. Not only, but these clusters are also among those that have been facing the strongest drop in sales over time, together with the Apparel business. In fact, in FY2007 the average growth rate in sales was equal to 12.4% for Apparel companies, to 5.9% for Department Stores and to 11.5% for companies operating in the Jewels & Watches business.

**EXHIBIT 14** Growth in Sales by Cluster




## Return on investments by cluster

With respect to the return on investments, Leather Goods, Jewels & Watches, Beauty and Fashion Retail are the best performing clusters (See Exhibit 15 and 16). The companies operating in Leather Goods exhibit the highest average ROI, equal to 18%, followed by Beauty (with ROI equal to 14%) and then by companies in the Jewels & Watches and Fashion Retail business (with ROI equal to 12 and 10%, respectively). The other clusters underperform compared to the average company in the fashion and luxury business (whose ROI equals to 9.4%). However, on a relative basis, it is important to notice that the only cluster showing an average increase in ROI is Beauty (with average ROI from 13 to 14%). Leather goods companies have succeeded in keeping ROI almost constant (equal to 18%, in line with FY2007), and Financial Conglomerates show a minor contraction in the average ROI (-1% from FY2007). Apart from these cases, the other clusters have been all facing a striking decrease in the average asset profitability.

In line with the past, the Fashion Retail cluster exhibits the highest average Asset turnover of the sample (equal to 1.51), confirming that the direct control over the consumer demand

and the supply chain associated to vertical integration in retail helps in maximizing volumes and company efficiency. Surprisingly, companies in the Apparel also show quite good asset turnover ratio (1.46), although their average EBIT margin is really low (2%), thus getting very poor average ROI (close to 1%). The companies in the Leather Goods cluster achieve outstanding results in profitability (ROI = 18%) thanks to well above the average EBIT margin (13%) and high asset turnover ratio (1.35).

**EXHIBIT 15** ROI by Cluster

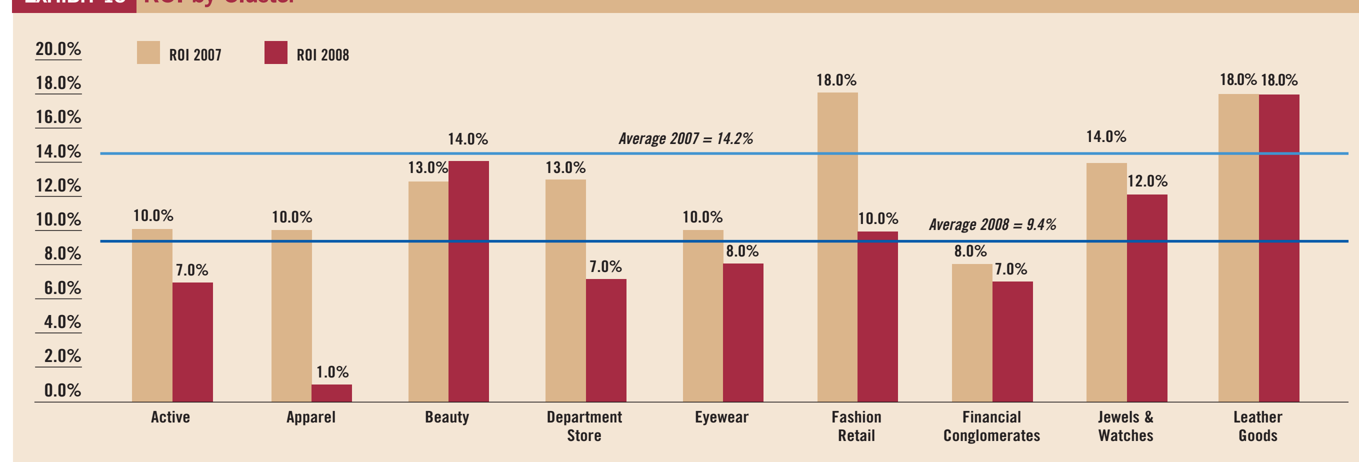


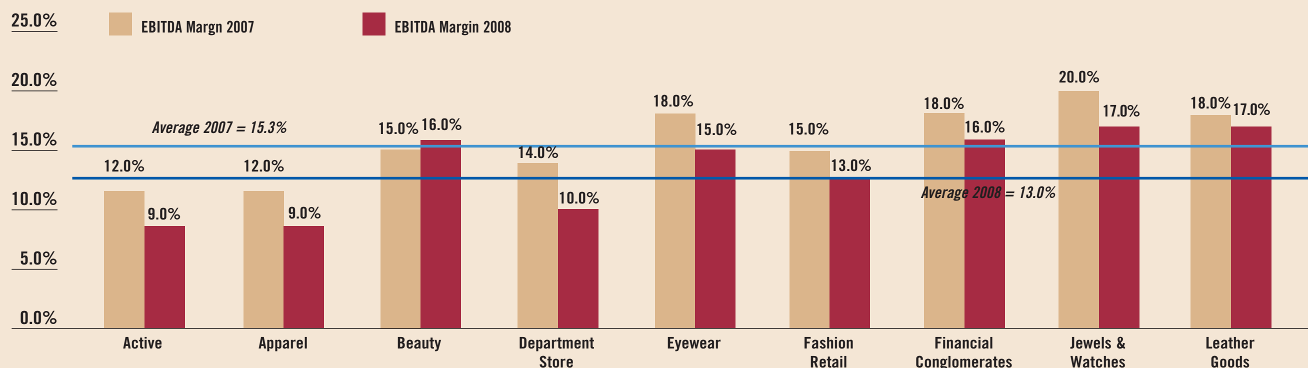

**EXHIBIT 16** ROI Drivers by Cluster

| Cluster | EBIT Margin 2007 | EBIT Margin 2008 | Asset Turnover 2007 | Asset Turnover 2008 |
|---|---|---|---|---|
| Active | 9.0% | 6.0% | 1.23 | 1.25 |
| Apparel | 8.0% | 2.0% | 1.34 | 1.46 |
| Beauty | 12.0% | 11.0% | 1.20 | 1.23 |
| Department Store | 10.0% | 6.0% | 1.27 | 1.29 |
| Eyewear | 14.0% | 11.0% | 0.68 | 0.67 |
| Fashion Retail | 12.0% | 8.0% | 1.51 | 1.51 |
| Financial Conglomerates | 15.0% | 13.0% | 0.60 | 0.63 |
| Jewels & Watches | 16.0% | 13.0% | 0.89 | 0.91 |
| Leather Goods | 15.0% | 13.0% | 1.32 | 1.35 |

## EBITDA Margin by cluster

In FY2008, the companies from the fashion and luxury industries show EBITDA margins equal to 13.0% (See Exhibit 17). The general trend is descending, with EBITDA margins reducing in each cluster except than Beauty, where the operating results before depreciation and amortization increased by 1% in FY2008.
The best performing clusters are Leather Goods (17.0%) and Jewels & Watches (17%), followed by Beauty and Financial Conglomerates (both with EBITDA margin equal to 16%), and then by Eyewear (15%). In line with previous years, Apparel margins are well below those of companies in Leather Goods, confirming that higher business complexity leads to lower operating margins. Similarly, margins for Department Stores are substantially lower that those of Fashion Retail.

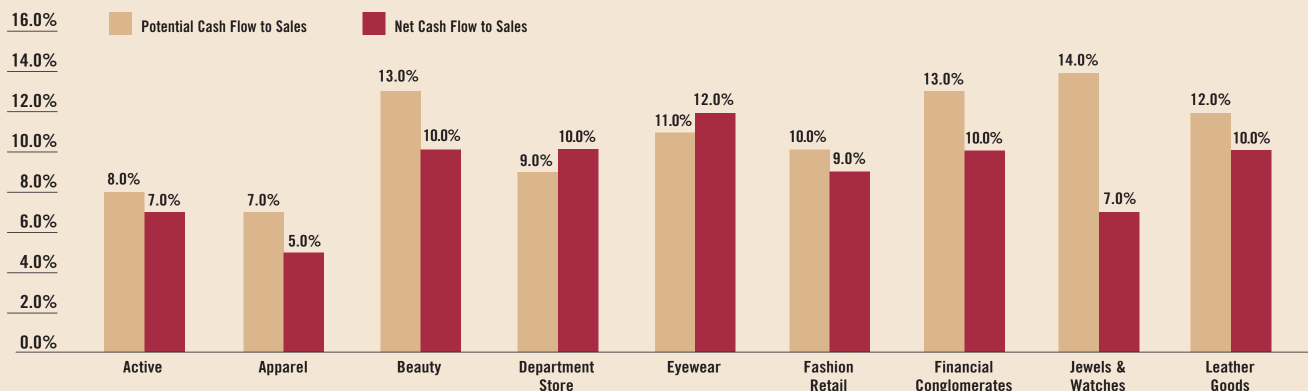
**EXHIBIT 17** EBITDA Margin by Cluster




## Cash flow and working capital by cluster

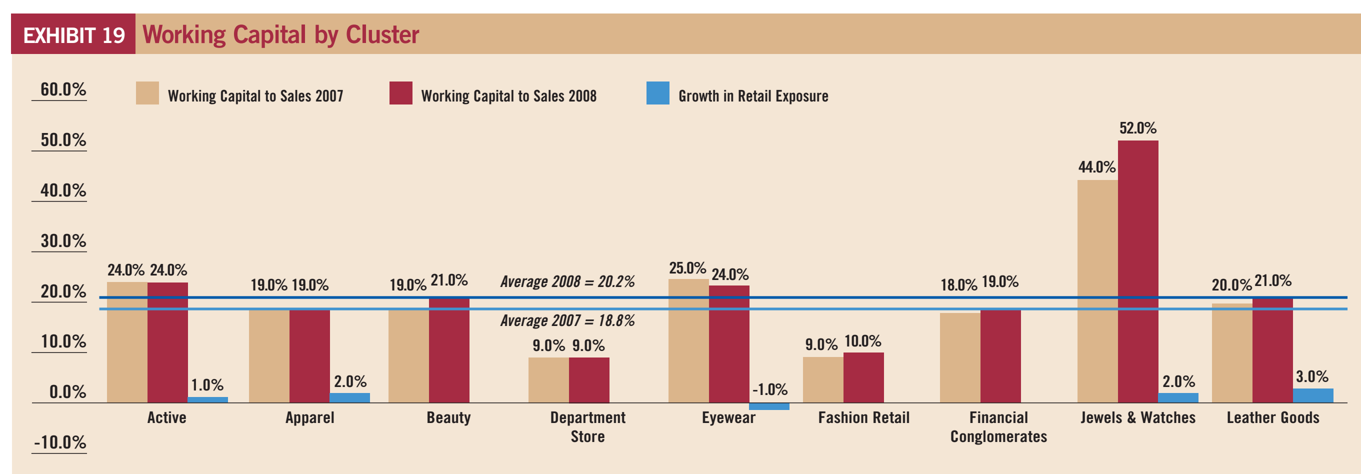
The companies in the sample generate potential cash flow equal to 10.1% of sales and net cash flow of 8.3% of sales (See Exhibit 18). This means that, on average, WC changes absorb cash for about 2% of sales, pretty much in line with evidence from previous years. However, the average weight of WC to sales has increased up to 20.2%, suggesting that some of the players might have been heavily affected by working capital dynamics. Many companies in fashion and luxury have not been able to respond to a deteriorating top line growth with better efficiency and with improvements in the inventory management. The business still proves to be very rigid and longer time to market strongly affects profitability via working capital deterioration.
In general the cash flow generation capacity of the players in fashion and luxury shows a declining trend. However, Department Stores and companies in the Eyewear business have on average been able to increase the cash flow to sales ratio, from 7 to 10% and from 10 to 12%, respectively. Companies in the Leather Goods business keep their average cash flow ratio substantially unchanged (and equal to 10%). All the other clusters exhibit a reduction in the ratio between consolidated sales and cash flows.
Eyewear is the most cash generating cluster, with cash flow generation capacity equal to 12%. Right after this, the companies in Beauty and Leather Goods, together with Financial

**EXHIBIT 18** Cash Flow Generation by Cluster



Conglomerates and Department Stores transform into cash around 10% of their consolidated sales, closely followed by Fashion Retailers (9%). The companies in Active, Jewels & Watches and Apparel transform into cash just 7 and 5% of their sales, well below the industry average. However, it's important to state once again that, since the cash generation capacity is strongly company-dependent, the net cash flow to sales ratios show quite broad dispersion within each cluster. For example, in the Apparel, some of the companies, like Guess, Polo Ralph Lauren and VF exhibit well above the average cash flow to sales ratios (equal to 12.6, 12.1 and 11.5%, respectively). Among the companies in Leather Goods, Coach and Hermès show uncommon capacity to generate cash flow (with cash flow to sales ratios equal to 25.4 and 14.7%, respectively).

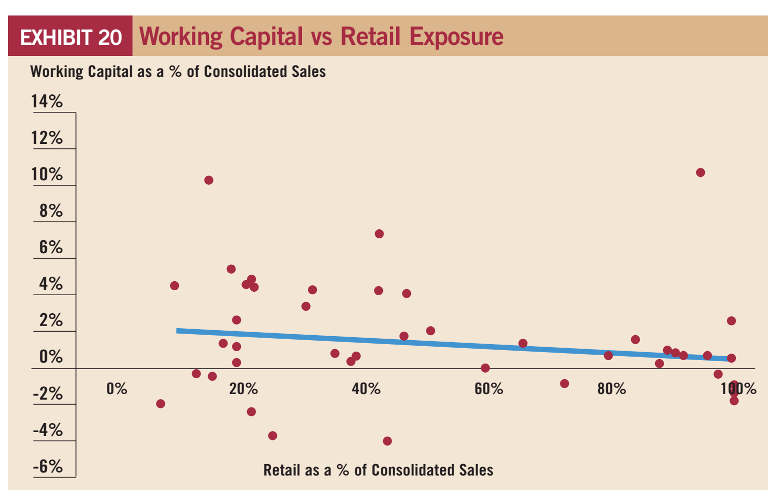
**EXHIBIT 19** Working Capital by Cluster




Evidence from the sample suggests that the weight of WC over sales remains strongly cluster depending (See Exhibit 19). However, in FY2008 we find that the retail exposure does not represent a key driver in determining average working capital performance (See Exhibit 20). This suggests that no matter what the distribution choices have been, on average the companies in this industry are having troubles in the working capital management area.

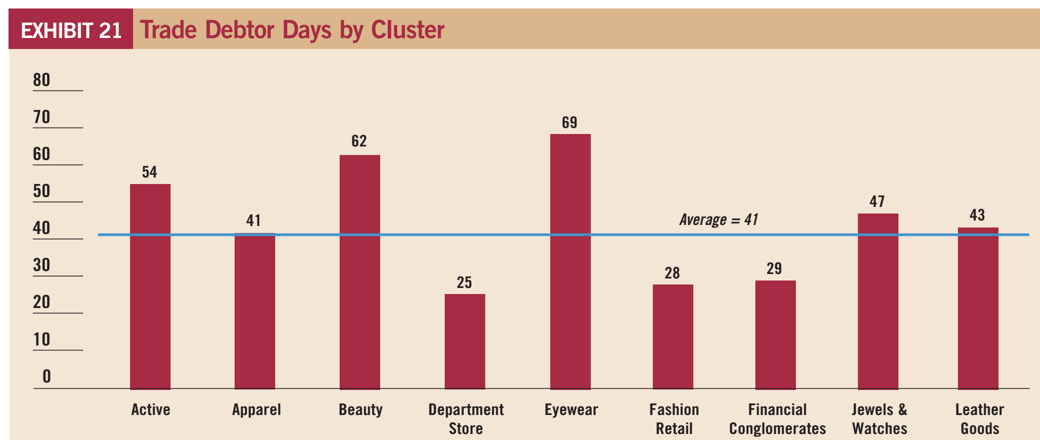
The companies in the Jewels & Watches business have an average WC to sales of 52%, mostly driven by the very high value of inventory (47% of sales). In line with previous years, this helps to explain the substantial gap between potential and net cash flow to sales in this sub-sample (from 14 to 7%). However, companies in this cluster show the highest increase in the weight of WC and inventory on sales from FY2007 (+12 and 11% respectively).
Of the other clusters, Active, Apparel, Department Stores and Eyewear show stable or improved WC ratios, while all the remaining ones show an average increase in the weight of working capital on sales.

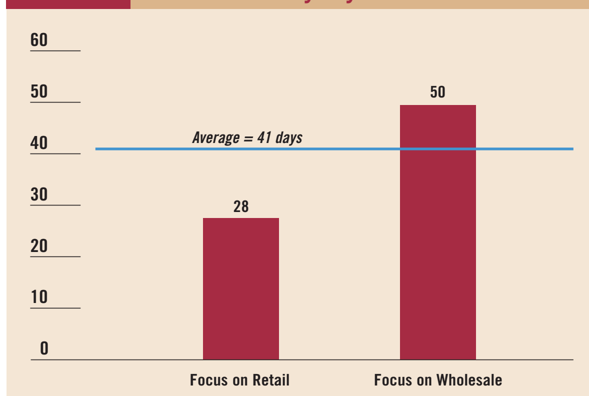
**EXHIBIT 20** Working Capital vs Retail Exposure




* The average retail exposure is available for a limited portion of the total sample (44 out of 68).

## Average trade debtor days by cluster




Evidence from FY2008 suggest that no substantial changes in the average company credit policy occurred in the fashion and luxury business (See Exhibit 21). The average trade debtor days haven't changed from FY2007 for Department Stores and companies in Leather Goods. Fashion Retailers face a little increase in the average figure (from 25 to 28 days). On the contrary, in FY2008 it took on average two days less than in the past to collect money from customers for the players in all the other clusters.

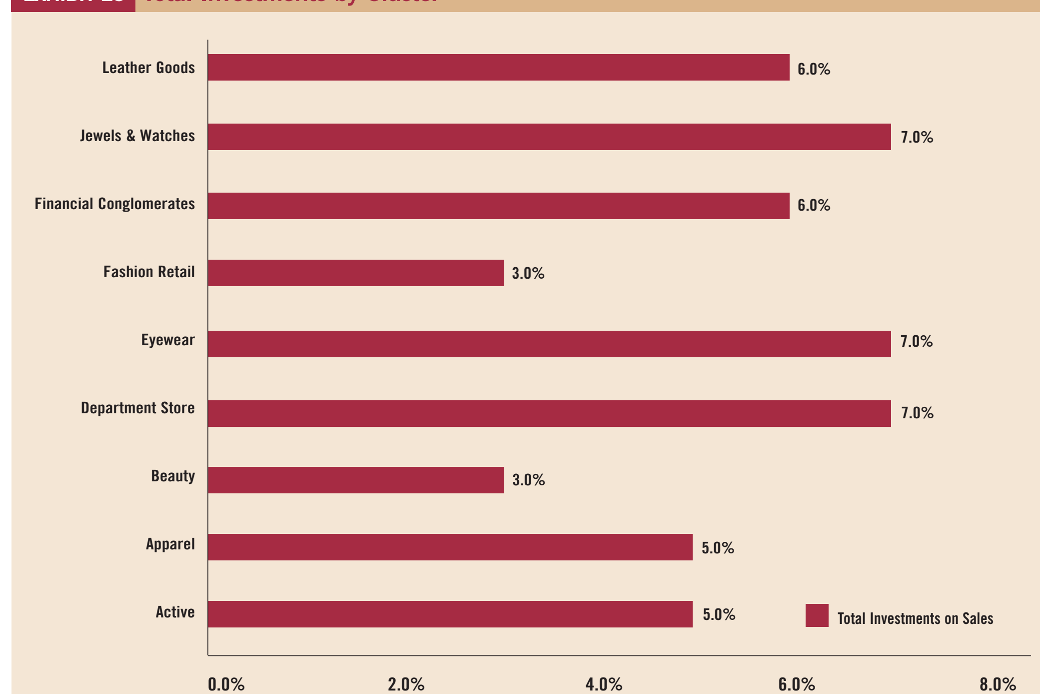
In line with previous years, the companies with a primary focus on retail distribution have to wait on average 28 days before collecting money from their customers, while those focused on wholesale distribution need 22 more days to do that (See Exhibit 22).

## Investments by cluster

In the previous editions of this paper, we spent time on discussing that fashion and luxury has become a capital intensive business. Although the average growth rate of the industry has been slowing down since a couple of years, fashion and luxury companies keep supporting quite an aggressive investment policy until FY2007. In FY2008, the average core investment ratios started to decrease. The level of core investments on depreciation has in fact been reduced quite sharply from previous years. However, the investment ratio of 124.5% on depreciation is an indicator of a more moderate but still positive growth. Quite surprisingly, the reduction in the level of total investments to sales has not been so evident at a first analysis: the average ratio in FY2008 has been equal to 4.9%, just -1.1% from FY2007. This suggests that, despite the deterioration in the key economic results, the most of the players in the industry have not dramatically cut down investments: around 25% of the companies of our sample have performed acquisitions in FY2008.

When trying to identify the main types of investments carried out during FY2008, we still note that a substantial part of these investments is represented by the opening of new stores. This suggests that, despite the slowing down of the top line, many firms have decided not to postpone planned investments in their retail network.

**EXHIBIT 23** Total Investments by Cluster




Leather Goods and Active are the clusters with the highest average growth rate of stores, equal to 17 and 13%, respectively. After them, we find Apparel and Jewels & Watches, both with +11% in stores.

## PERFORMANCE ANALYSIS BY MARKET SEGMENT

We are introducing a market segment analysis, focused on Apparel and Leather Goods (the only clusters with a meaningful number of companies operating in different market segments). Defining and identifying market segments in fashion and luxury is extremely complicated, because fashion and luxury companies are very often multi-brand, multi-business and multi-segment players. Detailed information on brands, businesses and segments are not available in public reports, and on top of that the positioning of a brand can vary from a geographical area to another. Nevertheless we defined market segments for the two clusters mentioned above considering the following criteria: assortments and prices available on companies web-sites; presence of well known designers in the brand portfolio; weight of different segments on the total consolidated sales (when available). Experts' interviews have grounded our opinions on market segments definition.
The resulting segmentation is as follows:

- **Apparel:**
  - High End: Aeffe, Burberry, Escada, Polo Ralph Lauren;
  - Medium: Gerry Weber, Guess, Link Theory Holdings, Liz Claiborne, Phillips Van Heusen;
  - Mass Market: G-III Apparel Group, Jones Apparel, Perry Ellis, VF.
- **Leather Goods:**
  - High End: Hermès, Tod's;
  - Medium: Coach, Geox, Kenneth Cole, Mariella Burani Fashion Group, Timberland;
  - Mass Market: Deckers Outdoor, Genesco, Skechers, Weyco, Wolverine World Wide.

Segment specific evidence is discussed in the comparative within-cluster analysis.

# Comparative within-cluster analysis

## Focus on the Apparel industry

In FY2008, the general declining trend in profitability for the companies in the Apparel business continues and gets worse (See Exhibit 24). In addition, a sharp decline in ROI (from 10 to 1%) is the consequence of a relevant contraction in the EBIT margin (from 8 to 2%) that a significant average increase in the asset turnover ratio (from 1.34 to 1.46) has not been able to overcome.

**EXHIBIT 24** Apparel

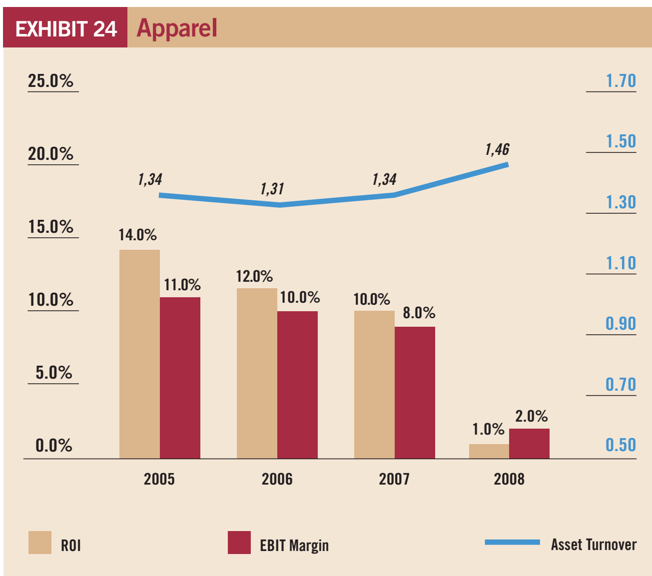



**EXHIBIT 25** Apparel

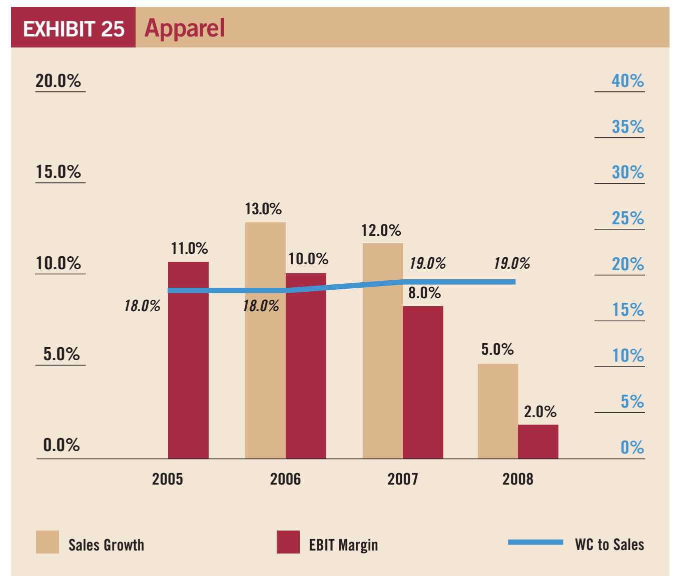
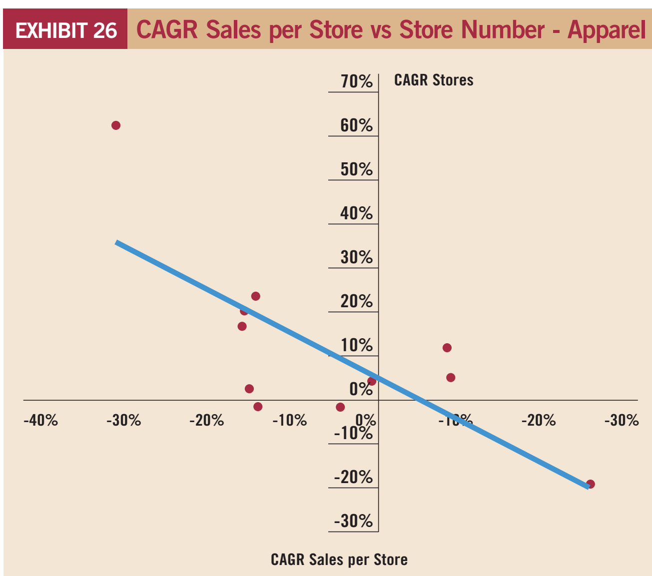



**EXHIBIT 26** CAGR Sales per Store vs Store Number - Apparel




By comparing sales growth and margins with the average investment in working capital over time (See Exhibit 25), we find that the negative trend in sales growth (-7% in FY2008) is followed by an increase in the average operating costs of the analyzed companies. In particular, we detect a relevant increase in the weight of Depreciation & Amortisation and in related impairment losses, which spreads the gap between EBIT and EBITDA margin to 7% (4% in FY2007 and 2% both in FY2006 and 2005). On the same line, we find that no improvement has been achieved by these players as for the weight of working capital to sales: this suggests that they haven't gained any efficiency in operations through their retail strategy.
Although strongly reduced from previous years, the growth rate in the number of stores continues to be double digit (11%). Despite the boost in the retail network, the increase in the weight of retail on consolidated sales is just about

2%, meaning that the new stores have not been performing in line with expectations in terms of contribution to the top line. Exhibit 26 shows that the increase in the number of stores hasn't turned into an increase in sales.
In FY2008, we find that the positive relationship between retail exposure and profitability reduces significantly (See Exhibit 27 and 28).

**EXHIBIT 27** Profitability vs Retail Exposure - Apparel (2007)

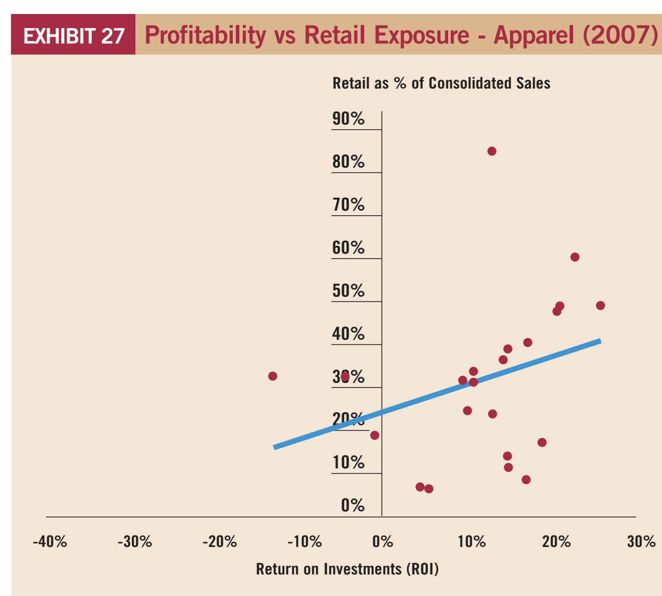
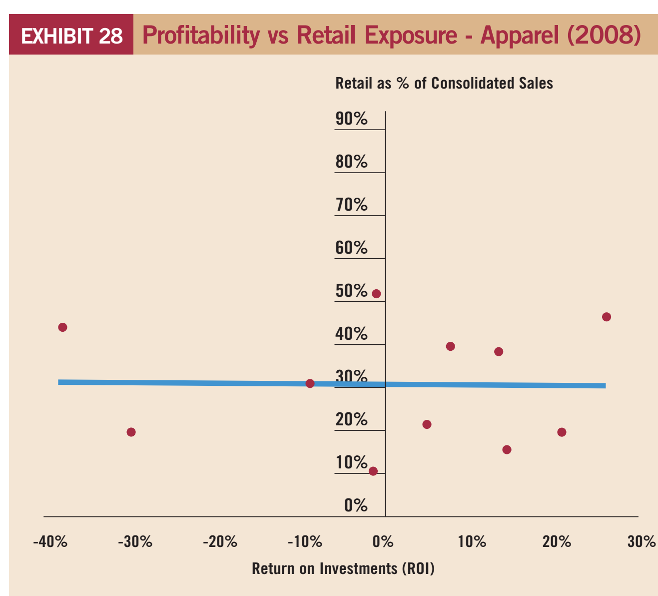



**EXHIBIT 28** Profitability vs Retail Exposure - Apparel (2008)




As shown in Exhibit 29, the reduction in the sales growth rate has been associated to a reduction in profitability, as measured by the ROI (-9% in FY2008). However, the companies in this cluster have not reduced their investments rate, still in line with FY2007 (+2% in FY2008).
In line with the evidence on the entire industry, we find that size proves to be a key factor in explaining company profitability in the Apparel business (See Exhibit 30). When segmenting the sample by the average company size, we discover that the companies with sales above € 5 billion achieve higher ROI, EBIT margin and sales growth compared to smaller companies. These results confirm that bigger financial budgets and larger investment capacity are key factors to face the deteriorating economic scenario that these companies have been experiencing lately.

**EXHIBIT 29** Apparel

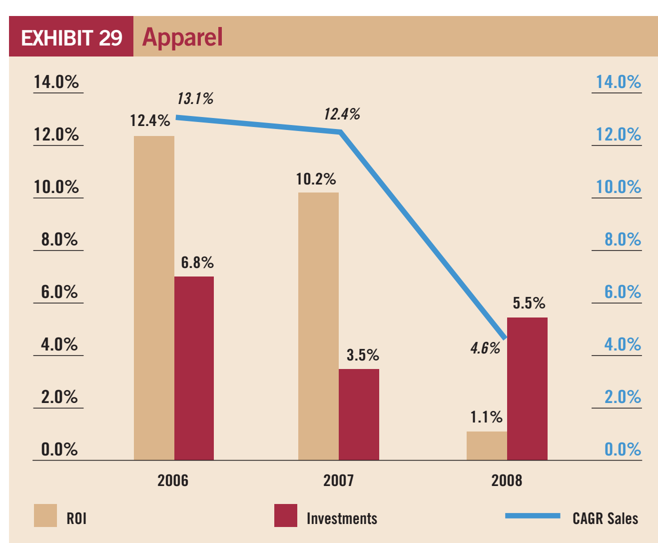



**EXHIBIT 30** Segmenting by Average Company Size - Apparel

| Average Company Size (€bl) | ROI | EBIT Margin | Asset Turnover | Cash Flow to Sales | Total Investment on Sales | CAGR Sales |
|---|---|---|---|---|---|---|
| > 5€B | 14.6% | 12.4% | 1.2 | 11.5% | 2.9% | 5.9% |
| > 1€B and < 5€B | -3.6% | -0.5% | 1.4 | 7.4% | 6.2% | 3.4% |
| < 1€B | 3.6% | 2.6% | 1.6 | 2.0% | 5.1% | 5.7% |

When segmenting the companies operating in the Apparel industry by market segment, we can find additional insights on the performance of these players (See Exhibit 31-37). In the Apparel industry, the companies from the Medium segment have been strongly hit by the slowing in demand, with sales growth down to 3.1% in FY2008 (from 20.1% in FY2007). Similarly, High End companies have experienced a strong deceleration in sales growth, now equal to 2.3% (from 10.2% in FY2007). The sales growth for the Mass Market players has been the highest in the cluster (8.8% in FY2008), suggesting a recovery from FY2007, when sales growth has been equal to 5.0%.

**EXHIBIT 31** Financial Highlights Apparel

| **High End** | **2005** | **2006** | **2007** | **2008** |
|---|---|---|---|---|
| Sales Growth | - | 11.5% | 10.2% | 2.3% |
| EBIT Margin | 12.9% | 12.6% | 11.7% | 3.2% |
| Working Capital to Sales | 18.6% | 16.1% | 19.1% | 21.1% |
| Retail as % of Consolidated Sales | - | 36.4% | 35.9% | 36.0% |
| ROI | 14.3% | 13.7% | 11.6% | 2.3% |
| Investments | 8.6% | 5.3% | 5.4% | 7.0% |
| G Stores | - | -0.4% | 21.8% | 4.9% |
| Trade Debtor Days | 47 | 44 | 45 | 44 |
| Inventory to Sales | 17.6% | 16.7% | 18.6% | 19.9% |
| Intangible Assets Weight | 25.7% | 25.6% | 24.8% | 20.7% |
| CF to Sales | - | 12.2% | 7.1% | 3.1% |
| Asset Turnover | 1.13 | 1.13 | 1.11 | 1.07 |

| **Medium** | **2005** | **2006** | **2007** | **2008** |
|---|---|---|---|---|
| Sales Growth | - | 18.2% | 20.1% | 3.1% |
| EBIT Margin | 11.0% | 11.0% | 6.8% | 4.1% |
| Working Capital to Sales | 15.2% | 16.9% | 16.2% | 16.1% |
| Retail as % of Consolidated Sales | - | 29.3% | 34.2% | 37.7% |
| ROI | 14.8% | 14.1% | 9.5% | 4.4% |
| Investments | 4.9% | 12.9% | 5.3% | 4.3% |
| G Stores | - | 11.0% | 19.3% | 14.1% |
| Trade Debtor Days | 32 | 35 | 39 | 37 |
| Inventory to Sales | 12.6% | 14.5% | 12.8% | 12.1% |
| Intangible Assets Weight | 23.1% | 27.1% | 24.0% | 19.6% |
| CF to Sales | - | 5.5% | 7.2% | 7.5% |
| Asset Turnover | 1.38 | 1.28 | 1.41 | 1.61 |

| **Mass Market** | **2005** | **2006** | **2007** | **2008** |
|---|---|---|---|---|
| Sales Growth | - | 8.2% | 5.0% | 8.8% |
| EBIT Margin | 8.9% | 5.9% | 6.6% | -2.0% |
| Working Capital to Sales | 21.4% | 22.3% | 21.4% | 21.6% |
| Retail as % of Consolidated Sales | - | 22.2% | 16.8% | 15.7% |
| ROI | 12.0% | 9.2% | 9.6% | -4.0% |
| Investments | 6.7% | 0.6% | -0.7% | 5.3% |
| G Stores | - | 11.9% | 39.5% | 13.0% |
| Trade Debtor Days | 48 | 50 | 47 | 44 |
| Inventory to Sales | 13.3% | 13.8% | 14.4% | 15.7% |
| Intangible Assets Weight | 38.4% | 35.2% | 35.5% | 31.3% |
| CF to Sales | - | 3.9% | 8.1% | 4.5% |
| Asset Turnover | 1.50 | 1.55 | 1.47 | 1.66 |

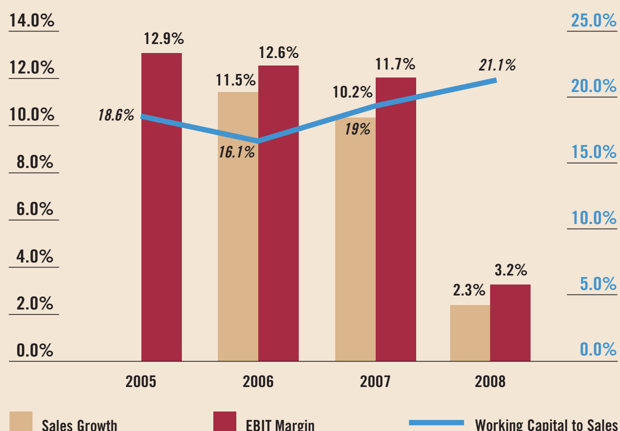


EXHIBIT 32 Growth, Profitability and Operations - High End
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
12.9%
11.5%
12.6%
10.2%
11.7%
21.1%
18.6%
16.1%
19%
2.3%
3.2%
2005
2006
2007
2008
Sales Growth
EBIT Margin
Working Capital to Sales

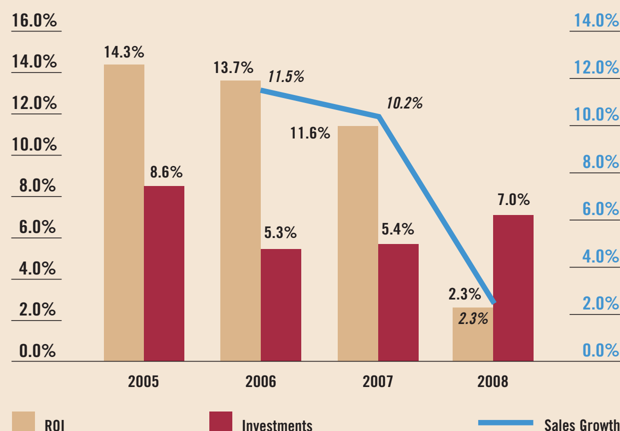


EXHIBIT 33 Growth, Profitability and Investments - High End
16.0%
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
14.3%
8.6%
13.7%
11.5%
5.3%
11.6%
10.2%
5.4%
2.3%
2.3%
7.0%
2005
2006
2007
2008
ROI
Investments
Sales Growth

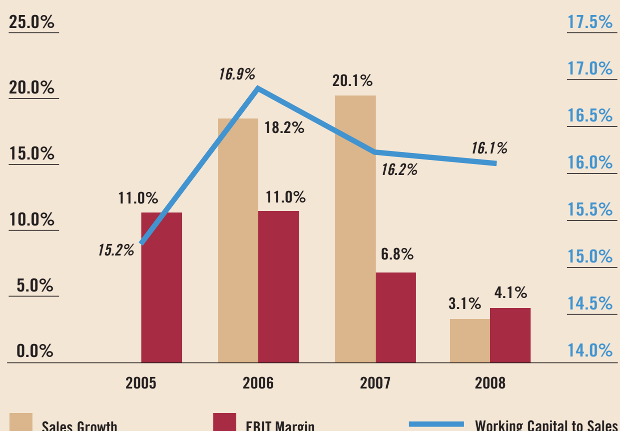


EXHIBIT 34 Growth, Profitability and Operations - Medium
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
17.5%
17.0%
16.5%
16.0%
15.5%
15.0%
14.5%
14.0%
11.0%
15.2%
16.9%
18.2%
11.0%
20.1%
16.2%
6.8%
16.1%
3.1%
4.1%
2005
2006
2007
2008
Sales Growth
EBIT Margin
Working Capital to Sales

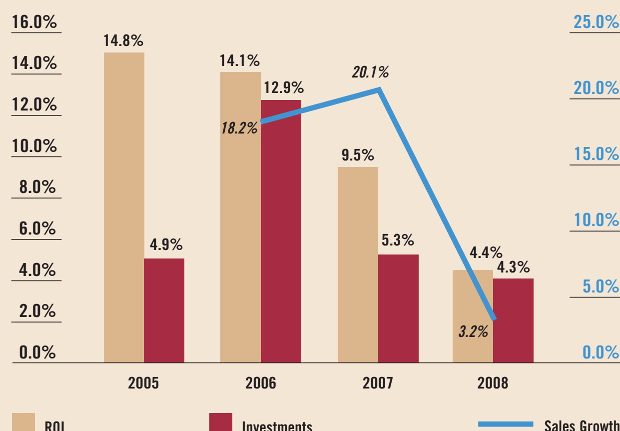


EXHIBIT 35 Growth, Profitability and Investments - High End
16.0%
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
14.8%
4.9%
14.1%
12.9%
18.2%
20.1%
9.5%
5.3%
4.4%
4.3%
3.2%
2005
2006
2007
2008
ROI
Investments
Sales Growth

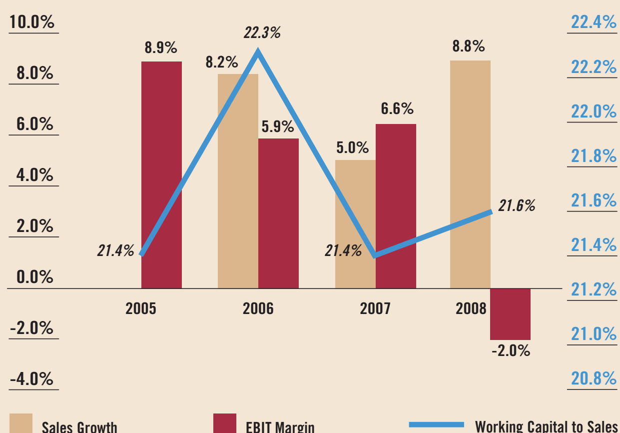


EXHIBIT 36 Growth, Profitability and Operations - Mass Market
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
22.4%
22.2%
22.0%
21.8%
21.6%
21.4%
21.2%
21.0%
20.8%
8.9%
21.4%
8.2%
22.3%
5.9%
5.0%
6.6%
21.4%
8.8%
21.6%
-2.0%
2005
2006
2007
2008
Sales Growth
EBIT Margin
Working Capital to Sales

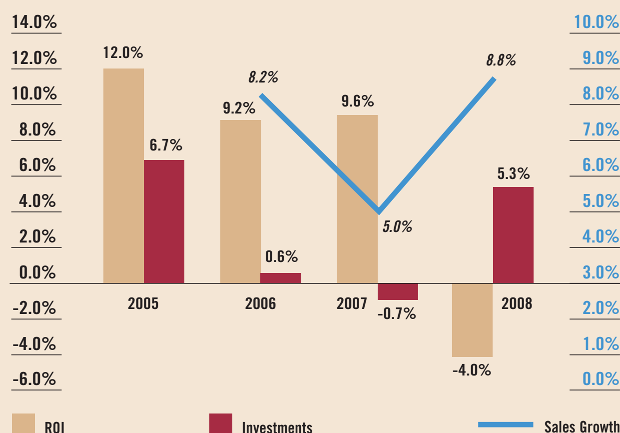


EXHIBIT 37 Growth, Profitability and Investments - Mass Market
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
10.0%
9.0%
8.0%
7.0%
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
12.0%
6.7%
8.2%
9.2%
0.6%
9.6%
5.0%
-0.7%
8.8%
5.3%
-4.0%
2005
2006
2007
2008
ROI
Investments
Sales Growth

Each of the three segments has experienced a strong contraction in profitability as measured by ROI and EBIT margin, more pronounced in the Mass Market, where the ROI turned negative in FY2008 (-4.0%), and despite an average increase in asset turnover. Overall, the Medium segment seems to be the best performing in terms of cash flow generation.
With respect to the growth of the retail network, in the past three years, the Medium segment is the one that faced the strongest increase in the weight of retail sales on consolidated revenues (from 34.2% in FY2006 to 37.7% in FY2008), with a lasting and aggressive strategy based on double-digit growth in the number of stores. The High End and Mass Market segments have expanded significantly their retail network as well, but with a less smooth development pace over time and with less clear results in terms of retail contribution to the top line.
In conclusion, the Mass Market is the segment that suffers the most in the Apparel business in FY2008, with very bad results in terms of profitability and the store network expansion proving not to be able at all to contribute to consolidated growth.

## Focus on the Leather Goods industry

Although not immune to the overall negative trend, the companies from the Leather Goods cluster show good average results over FY2008 (See Exhibit 38). The ROI remains in line with FY2007 (equal to 18%), thanks to a small average increase in the asset turnover ratio (from 1.32 to 1.35) and despite the contraction in the EBIT margin (from 15 to 13%). Although we cannot say that the profitability of Leather Goods companies is not threatened by the current market conditions, on a systematic basis this business is still more profitable than Apparel and still delivering satisfactory results.
The negative trend in sales growth (-3% in the growth rate between FY2007 and FY2008) has been followed by a certain deterioration in the EBIT margin (-2% between FY2007 and FY2008) and by a small increase in the working capital to sales weight (21%), as shown in Exhibit 39. However, the path is less pronounced than in the Apparel business, thus we argue that, on average, the companies in the Leather Goods business have been, at least partially, able to responding to a deteriorating top line growth with stronger focus on mark-ups or efficiency and with improvements in the inventory management.
Despite the relevant reduction in the sales growth rate, the average investment rate has been substantially in line with previous years (-0.6% in FY2008), and the average profitability has

**EXHIBIT 38** Leather Goods

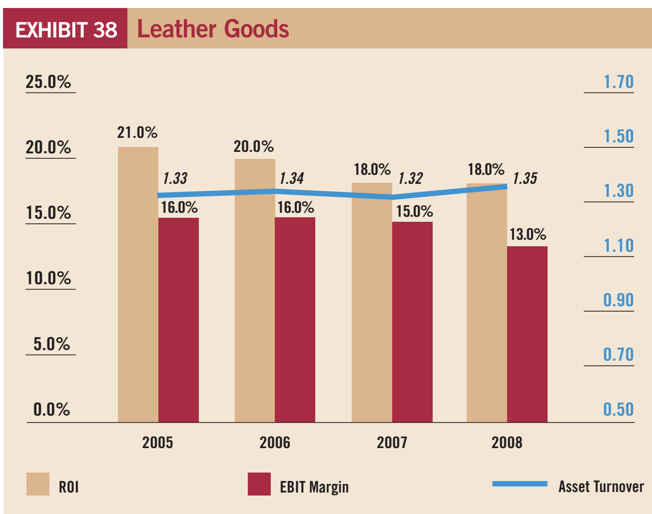
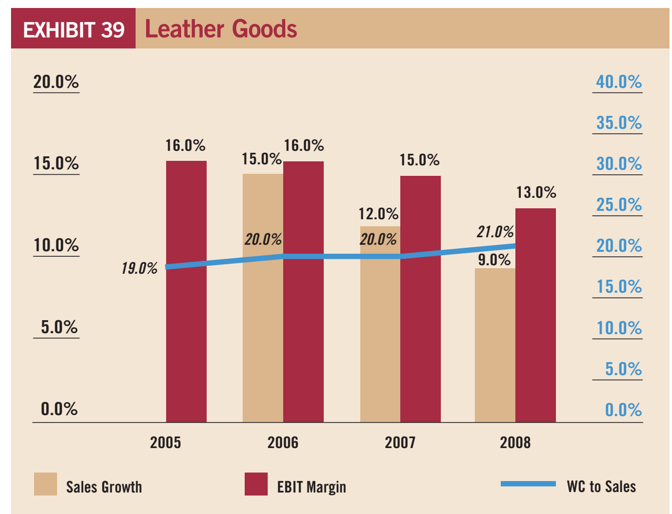



**EXHIBIT 39** Leather Goods



been quite stable if compared to other clusters (See Exhibit 40). This suggests that on average the companies in the Leather Goods business have decided to keep fighting the slowing of demand with new investments.
By splitting the companies operating in the Leather Goods business on the basis of the weight of retail sales on consolidated revenues (See Exhibit 41) we find that the companies with more than 50% of their sales generated by direct distribution show higher profitability and cash generation capacity. The average ROI is equal to 34% for the companies focused on retail and only to 12% for the companies focused on wholesale.
More in detail, operating margins are substantially different (26.2 vs. 8.8%, respectively), while the asset turnover is essentially stable. The companies focused on retail also generate a much higher cash flow from the core activity (18.0 vs. 7.3%). In the past five years, the growth rates in sales have been very similar for the two groups of companies: this proves that accessories are still living a very favourable momentum and are not affected as sharply as the Apparel business in the current market condition. However, in FY2008 the consolidated sales of the companies with a focus on retail has increased by 11.2% and the sales of the companies still focused on wholesale only by 7.7%. This confirms retail as a key driver for growth and profitability in challenging macro-economic conditions, at least for the leather goods business.

**EXHIBIT 40** Leather Goods

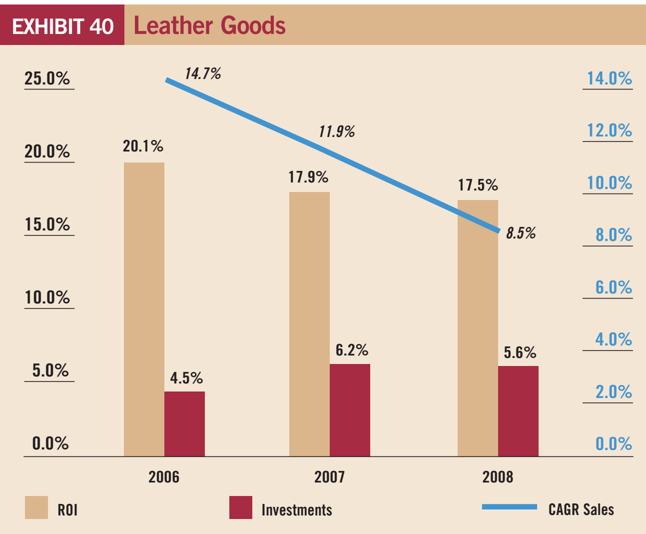



**EXHIBIT 41** Leather Goods: Results by Distribution Structure

| Distribution | ROI | EBIT Margin | Asset Turnover | Cash Flow to Sales | WC to Sales | CAGR Sales | CAGR Stores |
|---|---|---|---|---|---|---|---|
| Focus on retail | 34.0% | 26.2% | 1.4 | 18.0% | 17.6% | 11.2% | 7.3% |
| Focus on wholesale | 12.0% | 8.8% | 1.3 | 7,3% | 22.6% | 7.7% | 20.8% |

This evidence is even stronger if we take into account that, because of their business model, retail based companies should have been more dramatically hit by the September 2008 crisis. It is also interesting to notice that evidence from FY2008 confirms retail as a dominant distribution model in the Leather Goods business: if retail based companies still open new stores at quite relevant pace (+7.3% from FY2007), the wholesale based players have increased their number of stores by more than 20% in FY2008.
In line with that, we find that the correlation between the percentage of consolidated sales generated by retail and the ROI has increased up to 67% in FY2008, from 35% in FY2007 (See Exhibit 42).
However, the opening of new stores in FY2008 has not been able to generate sufficient increase in sales. In fact, in line with what found in other clusters, the correlation between the growth in the number of stores in FY2008 and the growth in the sales per store has been strongly

**EXHIBIT 42** Profitability vs Retail Exposure - Leather Goods

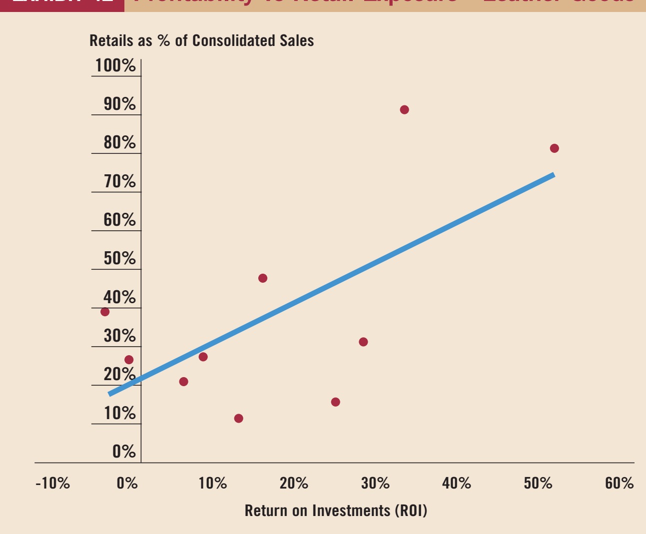
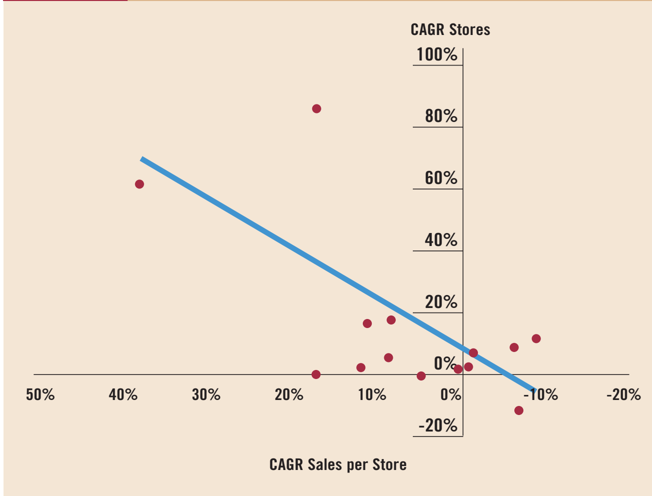


**EXHIBIT 43** CAGR Sales per Store vs CAGR Store Number - Leather Goods




negative (-72%). This means that new store openings have not performed in line with previous ones (See Exhibit 43). Retail distribution is a key factor to achieve satisfactory economic performance, but new openings are not a short-cut to this result, at least in FY2008, as they seem to not have been able to perform in line with expectations.

In line with the total sample, we find that the larger companies in this cluster achieve higher ROI and EBIT margin and generate higher cash flows compared to smaller companies[7] (See Exhibit 44). Once again, larger companies are able to better survive market turmoil, suggesting that economies of scale (for example in sourcing) represent a relevant driver to support profitability and cash flow capacity. When segmenting the companies operating in the Leather Goods business by market segment, we can find additional insights on the performance of these players (See Exhibit 45-51).

**EXHIBIT 44** Segmenting by Average Company Size - Leather Goods

| Average Company Size (€bl) | ROI | EBIT Margin | Asset Turnover | Cash Flow to Sales | Total Investment on Sales | CAGR Sales |
|---|---|---|---|---|---|---|
| > 5€B | na | na | na | na | na | na |
| > 1€B and < 5€B | 34.0% | 26.2% | 1.4 | 18.0% | 9.0% | 11.2% |
| < 1€B | 5.2% | 4.9% | 1.4 | 6.8% | 4.1% | 4.5% |

In line with what found in the Apparel business, players from the Leather Goods show different results depending on the market segment they operate in. The slowing in demand hit all the three segments similarly, although the final outcome is quite different for the three market segments. The companies in the Mass Market and in the High End over perform companies in the Medium segment with respect to growth in sales (equal to 11.4, 8.1 and 5.8%, respectively).

In terms of profitability, the Mass Market segment still exhibits an impressive average ROI, equal to 19.4% (up of about 2% from FY2007). The companies in the High End still show very positive return on assets too, with average ROI equal to 17.5%, down 1% from FY2007. The players operating in the Medium segment are those most heavily affected by the economic meltdown, with average ROI down of about 2.4% from FY2007, now equal to 15.6%.

These results can once again be analyzed in terms of volumes and margins. Each of the three segments in fact shows quite stable average asset turnover over time: in the High End, asset turnover ratios are stable below one (equal to 0.82 in both FY2007 and FY2008); in the Medium and Mass Market segment turnover is well above one (and equal to 1.31 and 1.59, respectively). It is also interesting to note that, despite the slowing down in the economy, the Mass Market segment exhibits a positive long term trend in the asset turnover ratio over the last three years.

With respect to EBIT margins, the High End and Mass Market seem to have been able to defend their average profitability over time, being only marginally affected in terms of reduction in operating margins. On the contrary, the Medium segment suffers from a substantial drop in the EBIT margin, down to 10.8% from 15.6% in 2007. With respect to the growth of the retail network, the cluster experienced quite an increase in the number of stores in the past few years. Surprisingly, the number of stores kept growing double-digit also in FY2008. Although the growth

7. However, no company in the Leather Goods cluster has sales above 5 billion.

in consolidated sales has not been proportional, on average this strategy translated into an increase in the weight of retail on total revenues, especially for the Medium and Mass-market segments.
We conclude that High End and Mass Market show substantially different characteristics. The High End is the most retail oriented segment and it proves to be still able to grow, but growth seems to happen at the expense of operating margins and asset profitability. On the contrary, the Mass Market segment is less retail oriented (and it is investing in this direction), but it shows higher growth rates and quite stable margins and asset profitability. We believe the upcoming months will be helpful in understanding if this evidence has to be related to the current macro-economic scenario or a structural feature of different market segments.

**EXHIBIT 45** Financial Highlights Leather Goods

| **High End** | **2005** | **2006** | **2007** | **2008** |
|---|---|---|---|---|
| Sales Growth | - | 10.0% | 11.0% | 8.1% |
| EBIT Margin | 22.4% | 23.6% | 22.7% | 21.7% |
| Working Capital to Sales | 21.6% | 24.4% | 27.0% | 30.0% |
| Retail as % of Consolidated Sales | - | 49.4% | 48.4% | 47.4% |
| ROI | 17.1% | 18.7% | 18.5% | 17.5% |
| Investments | 7.1% | 5.7% | 7.6% | 7.7% |
| G Stores | - | 8.5% | 7.3% | 12.3% |
| Trade Debtor Days | 37 | 41 | 45 | 43 |
| Inventory to Sales | 25.7% | 27.6% | 29.9% | 31.9% |
| Intangible Assets Weight | 16.3% | 14.1% | 14.7% | 14.0% |
| CF to Sales | - | 13.9% | 13.1% | 13.4% |
| Asset Turnover | 0.77 | 0.79 | 0.82 | 0.82 |
| **Medium** | **2005** | **2006** | **2007** | **2008** |
| Sales Growth | - | 19.0% | 9.0% | 5.8% |
| EBIT Margin | 17.8% | 17.6% | 15.6% | 10.8% |
| Working Capital to Sales | 16.4% | 16.1% | 17.0% | 16.1% |
| Retail as % of Consolidated Sales | - | 39.6% | 37.0% | 39.8% |
| ROI | 24.4% | 23.1% | 18.0% | 15.6% |
| Investments | 9.6% | -0.3% | 5.9% | 6.4% |
| G Stores | - | 17.4% | 5.9% | 15.5% |
| Trade Debtor Days | 43 | 40 | 43 | 45 |
| Inventory to Sales | 19.0% | 16.5% | 16.4% | 16.0% |
| Intangible Assets Weight | 15.0% | 13.7% | 12.9% | 14.9% |
| CF to Sales | - | 12.4% | 11.9% | 12.4% |
| Asset Turnover | 1.34 | 1.36 | 1.27 | 1.31 |
| **Mass Market** | **2005** | **2006** | **2007** | **2008** |
| Sales Growth | - | 12.3% | 15.2% | 11.4% |
| EBIT Margin | 12.2% | 12.1% | 12.2% | 12.1% |
| Working Capital to Sales | 20.8% | 22.0% | 21.1% | 23.2% |
| Retail as % of Consolidated Sales | - | 15.2% | 32.1% | 35.3% |
| ROI | 18.0% | 17.7% | 17.5% | 19.4% |
| Investments | 2.9% | 8.7% | 5.8% | 4.0% |
| G Stores | - | 13.3% | 15.6% | 21.5% |
| Trade Debtor Days | 42 | 43 | 43 | 41 |
| Inventory to Sales | 15.5% | 16.9% | 15.8% | 17.7% |
| Intangible Assets Weight | 13.7% | 11.4% | 9.6% | 7.6% |
| CF to Sales | - | 5.9% | 7.5% | 6.1% |
| Asset Turnover | 1.55 | 1.54 | 1.57 | 1.59 |

**EXHIBIT 46** Growth, Profitability and Operations - High End

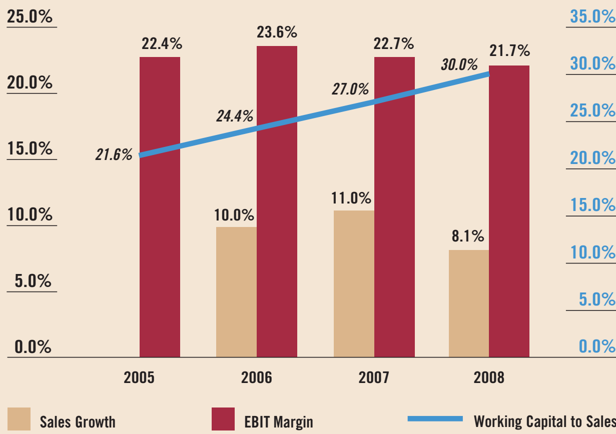



**EXHIBIT 47** Growth, Profitability and Investments - High End

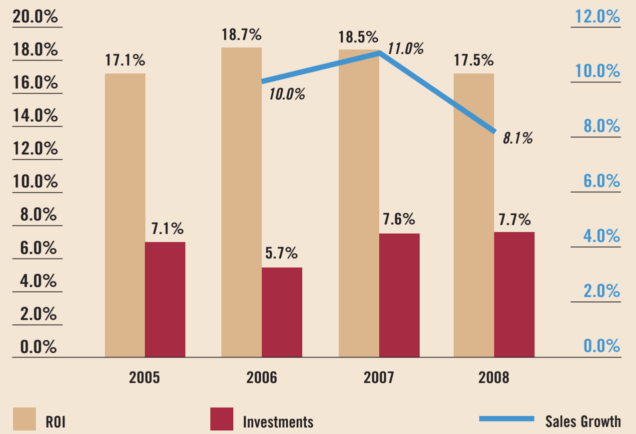



**EXHIBIT 48** Growth, Profitability and Operations - Medium

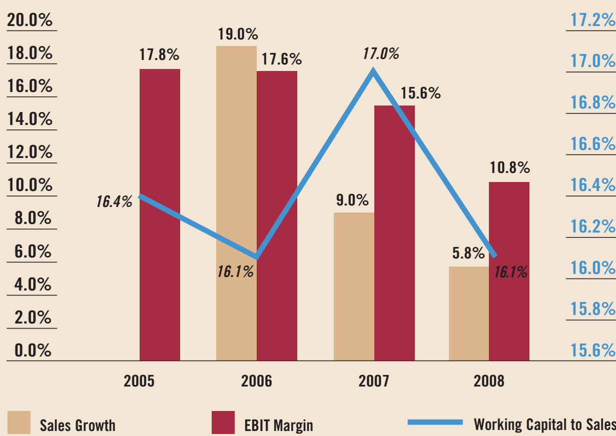



**EXHIBIT 49** Growth, Profitability and Investments - Medium

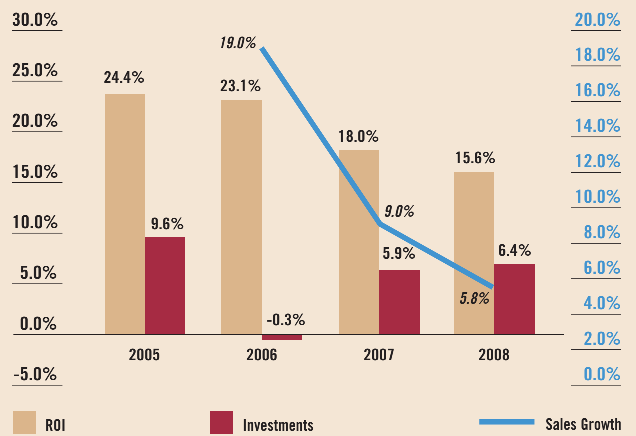



**EXHIBIT 50** Growth, Profitability and Operations - Mass Market

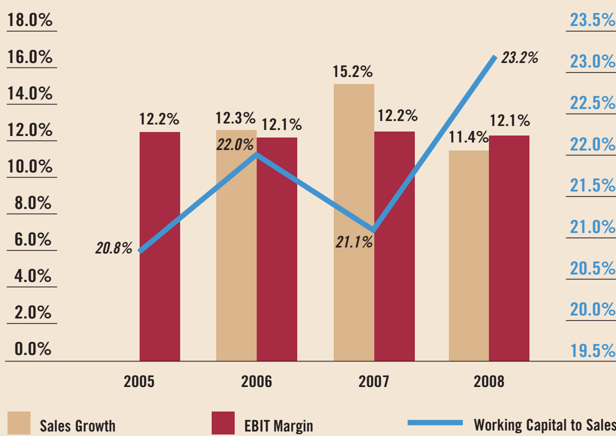
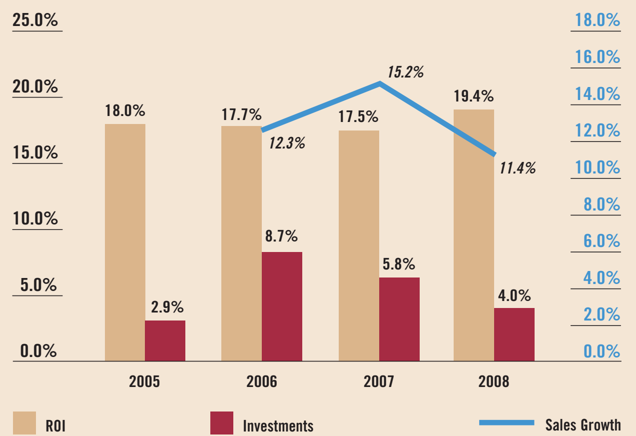



**EXHIBIT 51** Growth, Profitability and Investments - Mass Market



## Focus on Department Stores

If between FY2005 and FY2007 the average performance of Department Stores has been extremely stable, in FY2008 these players have experienced a substantial drop in the EBIT margin that has caused a sharp reduction in ROI despite stable asset turnover ratios (See Exhibit 52).
Sales shrink by 1% in FY2008 and the working capital is stable despite a 1% decrease in the average level of inventory (See Exhibit 53). The EBIT margin shows a decrease of about 4%. We also find that the reduction in the sales growth rate has translated into a reduction in profitability, as measured by the ROI (-6% in FY2008). However, as for the other companies in fashion and luxury, the average investment rate has not decreased from FY2007 (+0.9% in FY2008, as shown in Exhibit 54). This suggests that, on average, companies in this cluster have decided to contrast the slowing of demand by avoiding cutting new investments.
With respect to the relationship between new store openings and sales contribution, we find

**EXHIBIT 52** Department Stores

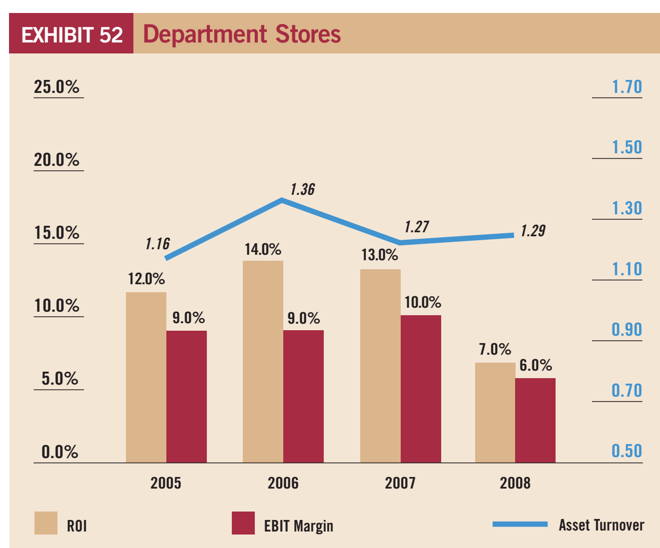



**EXHIBIT 53** Department Stores

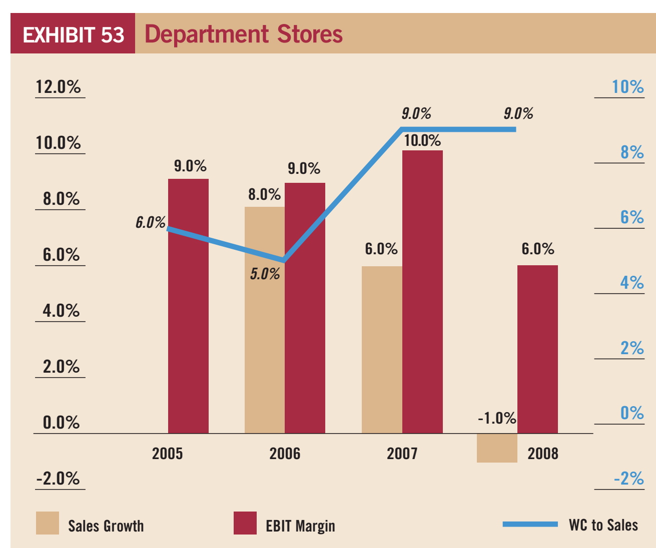



**EXHIBIT 54** Department Stores

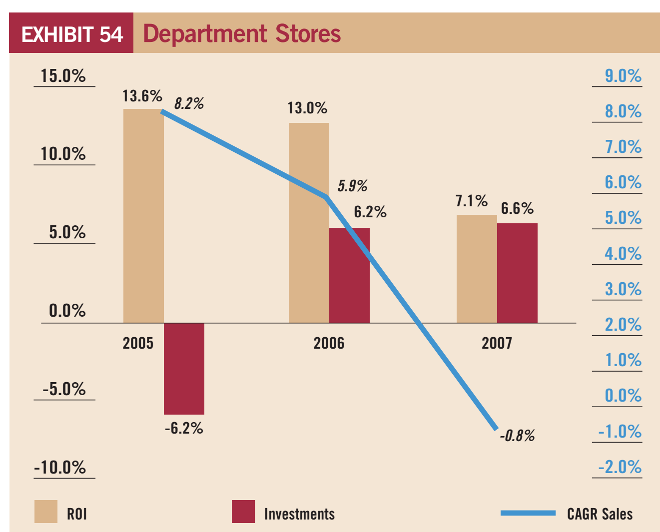
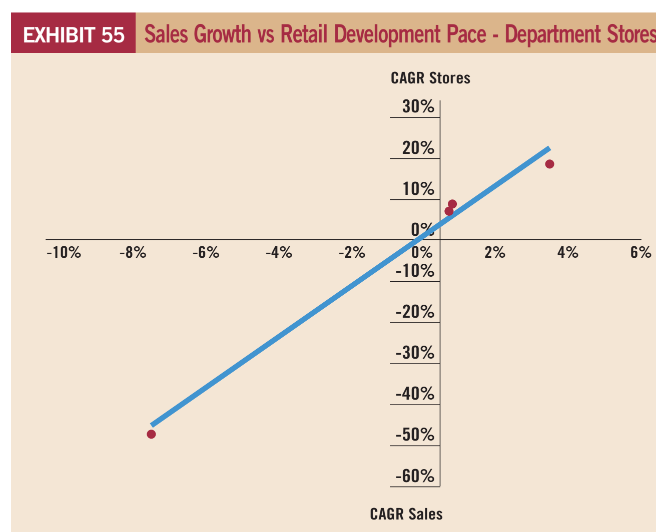



**EXHIBIT 55** Sales Growth vs Retail Development Pace - Department Stores



| EXHIBIT 56 Segmenting by Average Company Size - Department Stores | | | | | | |
|---|---|---|---|---|---|---|
| Average Company Size (€bl) | ROI | EBIT margin | Asset Turnover | Cash Flow to Sales | Total Investment on Sales | CAGR Sales |
| > 5€B | 12.9% | 9.2% | 1.4 | 10.5% | 7.8% | 0.5% |
| > 1€B and < 5€B | 1.3% | 2.6% | 1.2 | 8.5% | 5.5% | -2.0% |
| < 1€B | na | na | na | na | na | na |

that in FY2008 the new stores have not been able to generate sufficient increase in sales (See Exhibit 55). This evidence is in line with what found with respect to the other clusters. Finally, we observe that performance in Department Stores is strongly dependent on their average size (See Exhibit 56). We argue that the higher negotiating power associated to higher market share continues to be a crucial driver of performance in business with a structural low level of vertical integration.

## Focus on Fashion Retailers

Over the last three years, the companies operating in this cluster have shown extraordinary performance. The Fashion Retailers have been considered one of the best performing clusters in the fashion and luxury business. However, the negative trend of the period 2005-2007 has continued in 2008 (See Exhibit 57). On average, the ROI decreases from 18 to 10%, in line with the EBIT margin (from 12 to 8%) and despite stable asset turnover ratio. Nevertheless, there are some notable exceptions, as some of the best performing companies in fashion and luxury are players from this cluster (i.e: Esprit, H&M and Urban Outfitter).
The negative trend in sales growth (-6% in the growth rate between FY2007 and FY2008) has been followed by a deterioration in the EBIT margin (-4% between FY2007 and FY2008) and by a slight increase in the weight of working capital to sales (+1%), as shown in Exhibit 58. We fear that fashion retailers are, at least partially, loosing their ability to respond to growth reduction in the top line with stronger focus on mark-ups and/or efficiency and improvements in the inventory management. The level of inventory on sales

**EXHIBIT 57** Fashion Retail

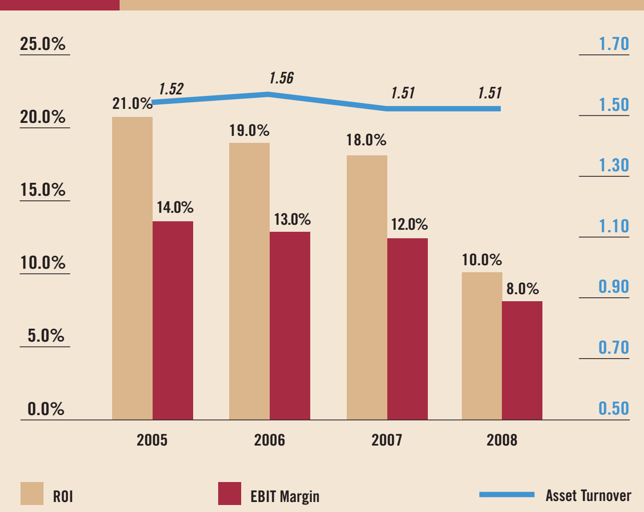



**EXHIBIT 58** Fashion Retail

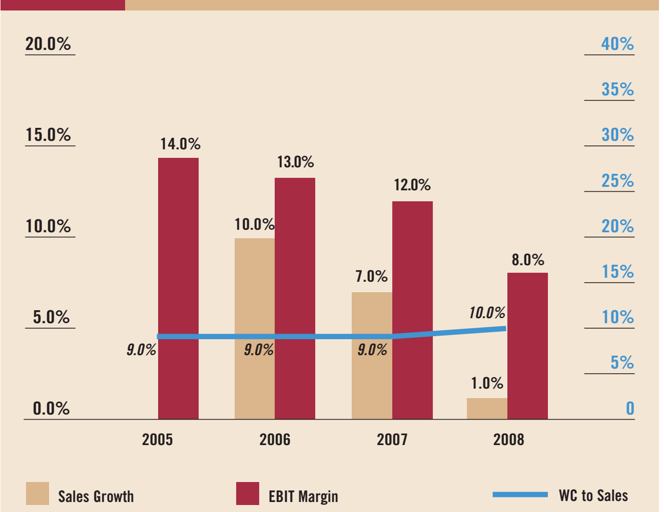


**EXHIBIT 59** Fashion Retail

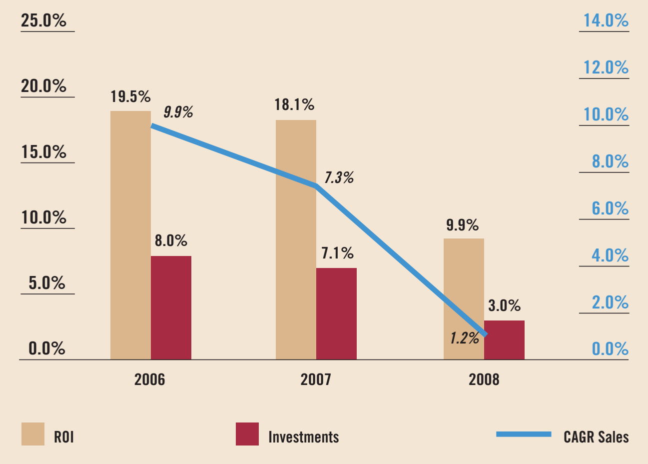
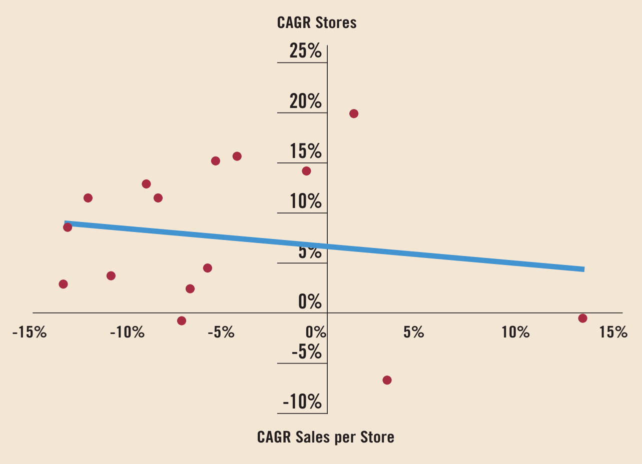



**EXHIBIT 60** CAGR Sales per Store vs CAGR Store Number - Fashion Ret.



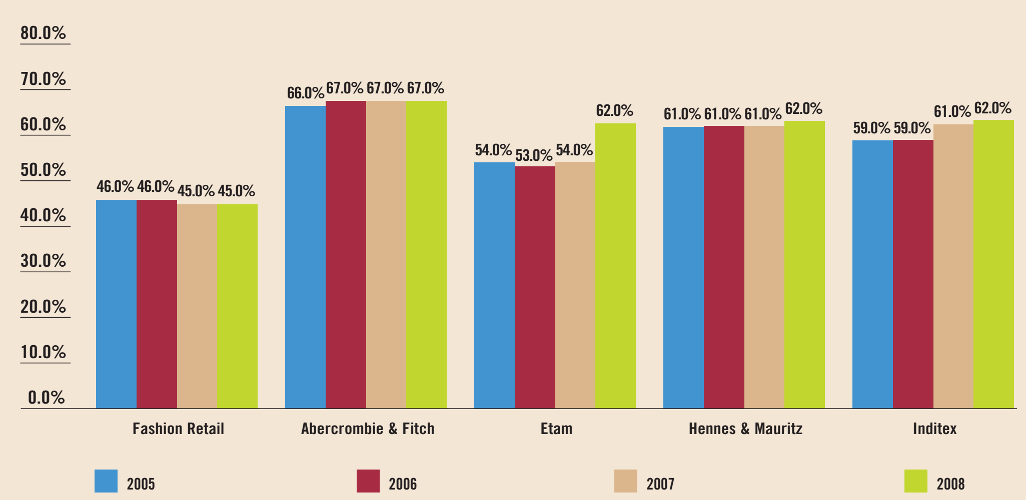

has increased by 2% in FY2008 (up to 12%).
It must be worth noting that the strong reduction in the sales growth rate has translated into a sharp reduction in profitability, as measured by the ROI (-8.2% in FY2008). In the same period, the average investment rate decreased (-4.1% in FY2008), as shown in Exhibit 59. This suggests that, on average, fashion retailers have recently been adopting a more conservative investment strategy.

**EXHIBIT 61** Financial Highlights

| (Fashion Retail cluster) | FY2008 |
|---|---|
| Consolidated Sales Growth | 1.2% |
| Per-Store Sales Growth | -5.2% |
| Growth of Stores | 7.7% |

As for the other clusters in our sample, the opening of new stores in FY2008 has not been able to generate sufficient increase in sales (See Exhibit 60). However, the number of stores for Fashion Retailers has still increased by 8% in FY2008. This has generated a negative impact on the average store efficiency, as the average per-store sales growth has been largely negative (See Exhibit 61). Only few players are able to generate sales development both through efficiency and store network growth.

**EXHIBIT 62** Gross Margin to Sales over Time - Fashion Retail



In line with FY2007, the negative trend over time persists when exploring the cluster profitability through the gross margin. Even if the gross margin trend is still better than the EBIT trend (-0.5 vs -3.7%), these figures are getting worse over time, except for a few best performing players (See Exhibit 62).
It might also be interesting to observe that in FY2008, on average, the growth in sales is not associated any more to average reduction in the weight of working capital (see Exhibit 63 and 64). This suggests that the companies in this business are suffering from lower operational efficiency in FY2008. The nature of the fashion retail business should call for performance improvement mainly focused on inventory management. This has always been true in the past, but is not persisting in FY2008 (see Exhibit 65 and 66), suggesting that the expected growth in consolidated sales was higher: lack of performance in sales generated increase in the average inventory level.
On average, the cluster shows a significant worsening in inventory management in FY2008, as we find an average increase in the level of per-store inventory (See Exhibit 67 and 68). Some

**EXHIBIT 63** Working Capital vs Sales Growth - Fashion Retail

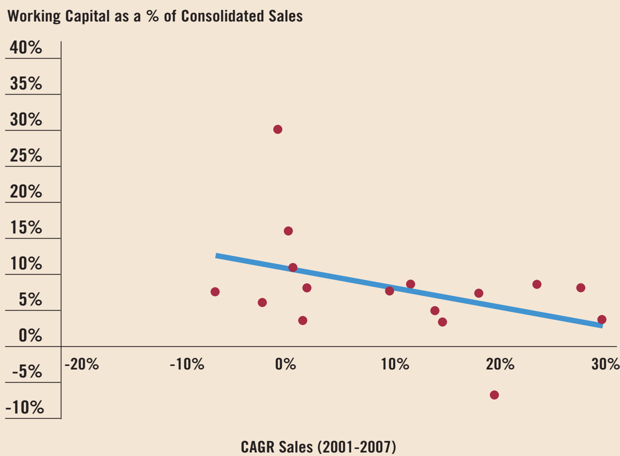



**EXHIBIT 64** Working Capital vs Sales Growth - Fashion Retail

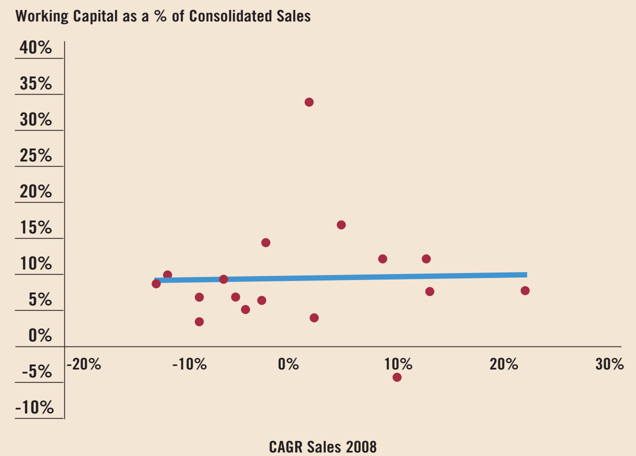



**EXHIBIT 65** Inventory Level vs Sales Growth - Fashion Retail

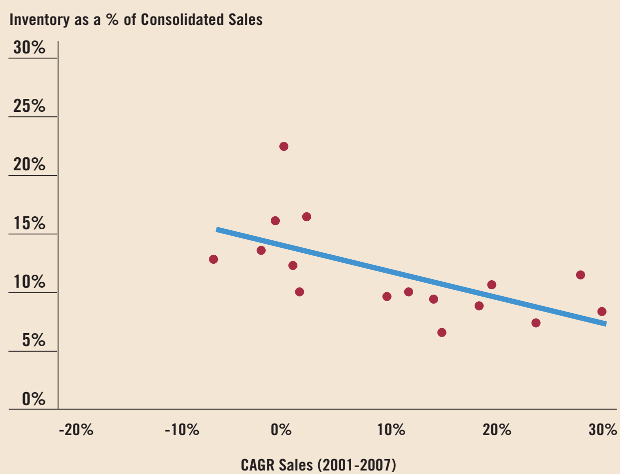



**EXHIBIT 66** Inventory Level vs Sales Growth - Fashion Retail

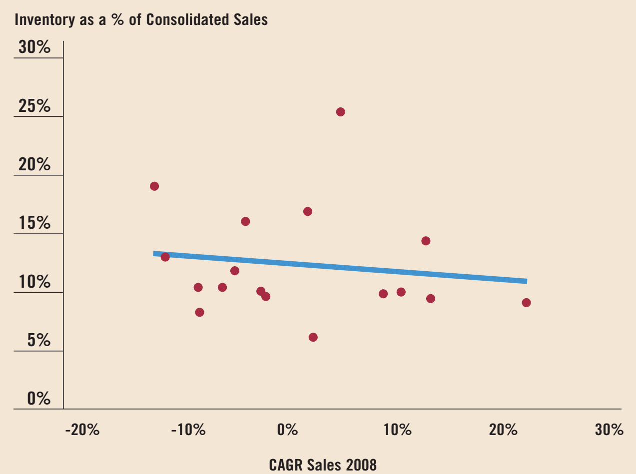
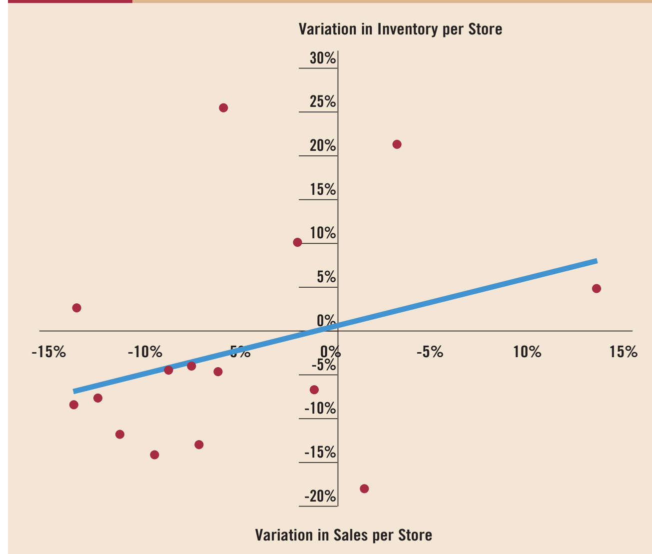


**EXHIBIT 67** Highlights

| (Fashion Retail cluster) | FY2008 |
|---|---|
| Per-Store Sales Growth | -5.2% |
| Per-Store Sales Growth (excluding outlier) | -6.4% |
| Variation in Per-Stores Inventory | 2.0% |

**EXHIBIT 68** Per-Store Sales vs Per-Store Inventory - Fashion Retail




players in the cluster, such as Alexon, Bebe, Chico's, Gap, Limited Brands and Urban Outfitter, achieve remarkable performance with respect to this profile, with an average reduction in the level of inventory per store of about 4%.

Even in this cluster, bigger companies achieve higher ROI and EBIT margin and generate higher cash flows compared to smaller companies (See Exhibit 69). However, the companies that show the highest growth in sales are the ones in the medium size range (between € 1 and 5 billion). This evidence supports the relevance of sales volumes in improving operating margins and asset profitability.

**EXHIBIT 69** Segmenting by Average Company Size - Fashion Retail

| Average Company Size (€bl) | ROI | EBIT Margin | Asset Turnover | Cash Flow to Sales | Total Investment on Sales | CAGR Sales |
|---|---|---|---|---|---|---|
| > 5€B | 22.2% | 13.8% | 1.6 | 14.2% | 3.9% | 1.2% |
| > 1€B and < 5€B | 14.9% | 10.7% | 1.4 | 10.2% | 3.8% | 3.5% |
| < 1€B | -8.1% | -1.4% | 1.7 | 2.8% | 1.2% | -2.5% |

## Focus on Jewels & Watches

The companies operating in the Jewels & Watches business show quite positive average results in FY2008 in absolute terms, although they are not immune from the negative general trend affecting the industry. FY2008 represents a stop to the previous growth pattern in the average profitability: the ROI decreases by 2% (to 12% average) and the EBIT margin reduces by 3% (to 13% average), as shown in Exhibit 70.

The consolidated sales have suddenly stopped growing, and now the business is experiencing a contraction in sales of about 1% (See Exhibit 71). Compared to this sharp reduction (-12% in FY2008), the 3% decline in EBIT margin seems quite good news. However, the weight of working capital to sales has also started to increase, mostly because of a strong deterioration in inventory management: the level of inventory to sales has increased by 9% in FY2008.

Despite the strong reduction in the sales growth rate, profitability is still good in absolute terms and the companies in this cluster have also being maintaining a relevant investment ratio, equal to 7% of consolidated sales (See Exhibit 72).

**EXHIBIT 70** Jewels & Watches

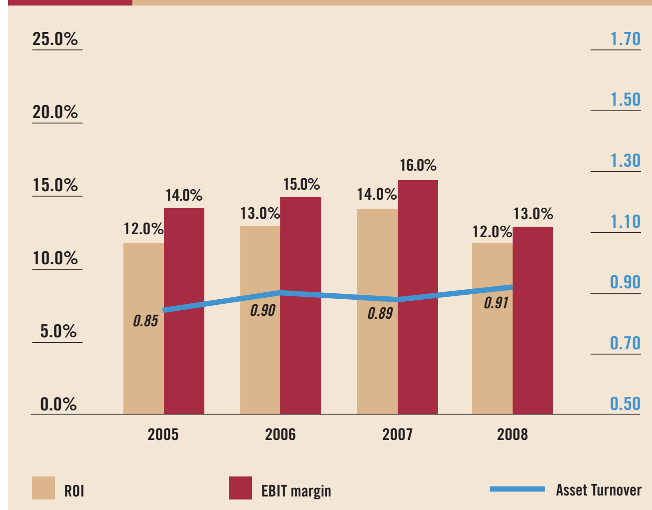


**EXHIBIT 71** Jewels & Watches

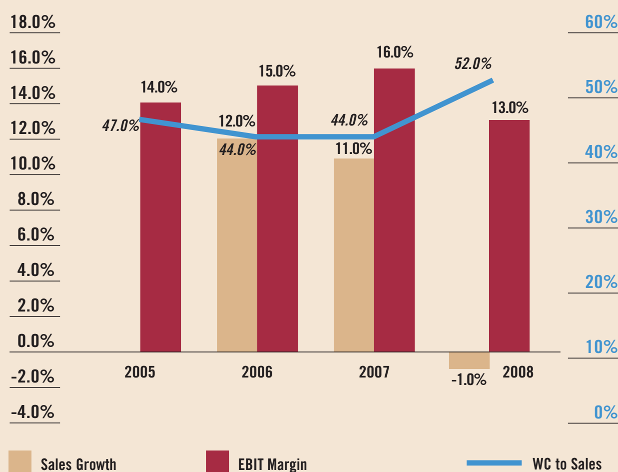
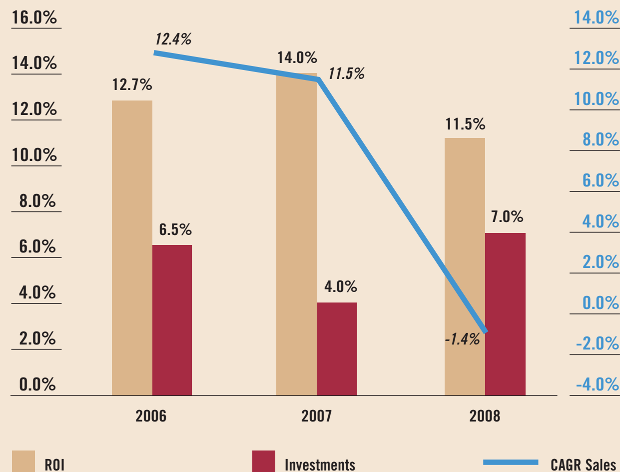



**EXHIBIT 72** Jewel & Watches




By splitting the companies operating in the Jewels & Watches business on the basis of the weight of retail sales on consolidated revenues (See Exhibit 73) we find that the companies with more than 50% of their sales generated by direct distribution show higher profitability, in line with what found in the Leather Goods cluster, but they show lower cash flow generation capacity. The average ROI is equal to 12.1% for the companies focused on retail and to 10.9% for the companies focused on wholesale. However, the cash flow to sales ratio is lower for retail-based companies (2.6 vs 7.1%): this result can be explained by the higher level of working capital typical of retail oriented companies in Jewels & Watches. In addition, players with a focus on retail have been more penalized in terms of sales growth (-2.7% vs -1.7%). This suggests that retail might be a costly strategy for players in Jewels & Watches in challenging macro-economic conditions. In line with what found in Leather Goods, both retail and wholesale based companies still open new stores at quite relevant pace (+12% from FY2007).

**EXHIBIT 73** Jewel & Watches: Results by Distribution Structure

| Distribution | ROI | EBIT Margin | Asset Turnover | Cash Flow to Sales | WC to Sales | CAGR Sales | CAGR Stores |
|---|---|---|---|---|---|---|---|
| Focus on retail | 12.1% | 13.1% | 0.9 | 2.6% | 53.9% | -2.7% | 12.0% |
| Focus on wholesale | 10.9% | 10.6% | 1.0 | 7.1% | 44.8% | -1.7% | 11.9% |

The average company size seems to be affecting firm profitability and performance also in Jewels & Watches (See Exhibit 74). Similarly to what detected in the other clusters of the sample, bigger companies in this cluster achieve higher EBIT margin and Cash flow capacity and tend to invest more than smaller companies.

**EXHIBIT 74** Segmenting by Average Company Size - Jewels & Watches

| Average Company Size (€bl) | ROI | EBIT Margin | Asset Turnover | Cash Flow to Sales | Total Investment on Sales | CAGR Sales |
|---|---|---|---|---|---|---|
| > 5€B | 13.3% | 18.1% | 0.7 | 12.4% | 8.5% | 2.2% |
| > 1€B and < 5€B | 13.8% | 14.4% | 1.0 | 7.4% | 7.2% | 1.7% |
| < 1€B | 0.6% | 0.7% | 0.8 | -0.6% | 4.9% | -17.6% |

## DISCLOSURES

**General disclosures:**
This survey is intended to provide management teams of fashion and luxury companies with relevant information about the average results of the main players in the business. This report does not constitute an investment recommendation, is not addressed towards investors and does not give investment suggestions. This publication has been carefully prepared but it necessarily contains information in a summarized form. It is therefore intended for general guidance only, and is not intended to be a substitute for detailed research or the exercise of professional judgment. SDA Bocconi, Altagamma, and E&Y can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. We update our research every twelve months, consistent with the disclosure of the main economic results by the selected companies. Our research is disseminated primarily electronically, and, in some cases, in printed form.

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