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Sweet smell of money

Evan Lorenz writes:

There's lots to like about the high-end beauty business, and Mr. Market knows it. And because he knows it, companies like L'Oréal S.A. trade at prices that never tempt the Graham and Dodd faithful.

Thanks to a disadvantageous listing, a limited float and messy recent results, however, one such company does so make the valuation grade. In preview, *Grant's* is bullish on L'Occitane International S.A. (973 on the Hong Kong Stock Exchange).

The L'Occitane en Provence brand was founded in 1976 when Olivier Baussan made an inspired purchase of a corroded still from a French farmer for the price of its scrap copper. The 23-year-old university student extracted essential oils from local rosemary and sold the derived products at nearby farmers' markets. The scent was divine.

Customers cottoned to the natural ingredients sourced from Provence, but Baussan couldn't generate profitable growth. Neither could Natural, the French private equity firm to which he sold his majority stake in 1992. The v.c. team made changes, including firing Baussan, but achieved a scale no greater than 10 domestic L'Occitane retail stores.

This is where Reinold Geiger enters the story. Geiger founded AMS Packing S.A., a maker of containers and boxes for high-end perfumes and cosmetics. He met Baussan in the early 1990s. In a series of transactions between 1994 and 1996, Geiger bought a majority stake in L'Occitane. He brought back Baussan as a creative director and raised his sights on growth.

Under Geiger, L'Occitane indeed grew rapidly, to €612.2 million in sales generated by 1,541 stores worldwide in the fiscal year ended March 31, 2010. It was the year the company completed an initial public offering, raising $787 million. But the novelty of online shopping was going mainstream, and all that brick and mortar proved financially burdensome.

L'Occitane's sales, after doubling between fiscal 2010 and 2017, to €1.3 billion, dipped slightly in 2018. In the same year, operating margins plunged to 10.7% from 18.5% in 2010. A turnaround strategy was in order, and management promptly unveiled one. They called it "Pulse."

Pulse was a grand design to restore growth and margins. Management empowered and incentivized regional managers. It took steps to boost online sales and revamp L'Occitane's digital storefronts. It summoned new products into existence to attract and retain new customers.

The call for a new iconic product was quickly answered with the late-2018 debut of Immortelle Overnight Reset Oil-in-Serum. In the 12 months ended March 31, 2020, the bubble-infused elixir sold 1 million units.

Then came Covid, a nightmare for the beauty industry. The home-bound clientele, with few to primp for, had little need for L'Occitane's creams, serums, essences, fragrances, oils, balms, foams, masks or butters.

However, for L'Occitane, at least, there was a silver lining. Management used the fiscal 2021 slump to throw its U.S. subsidiary into voluntary bankruptcy, thereby shedding underperforming stores and leases.

While fixing the problems within its legacy business, L'Occitane acquired two faster-growing businesses: Elemis, a British skincare purveyor, for $900 million in 2019, and an 83% stake in Sol de Janeiro, an American body-care company, at a $450 million valuation in 2021.

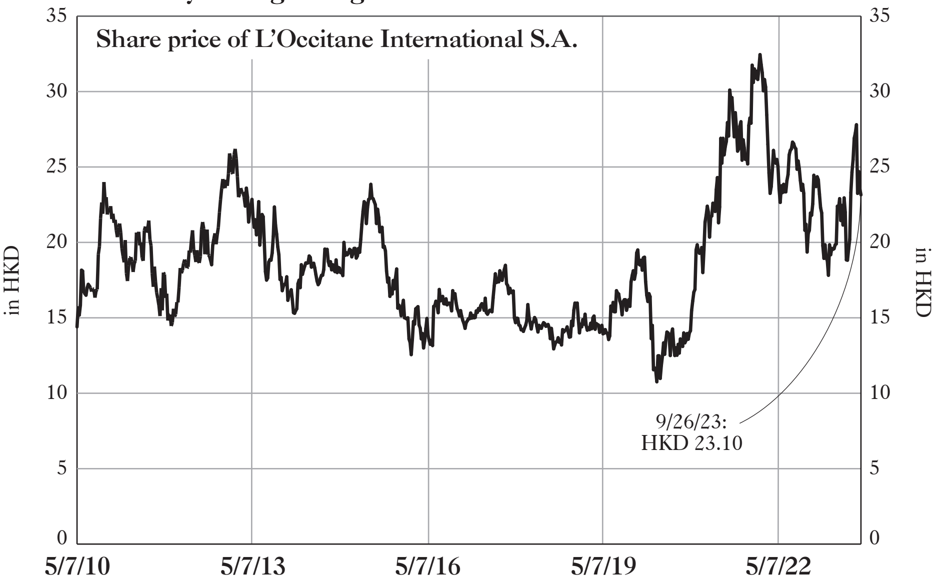
Today, L'Occitane is a multi-branded beauty-products company with over 3,000 retail locations in more than 90 countries. In the 12 months ended June 30, the business generated €2.2 billion in revenue across Asia Pacific (40.7% of trailing sales), the Americas (34.5%) and Europe, the Middle East and Africa (24.8%). In the fiscal year ended March 31, America was the single biggest end market (27.2% of sales) followed by China (14%) and Japan (8.5%).

The L'Occitane en Provence brand, still the company's largest (64% of trailing sales), is best known for its body- and hand-care products. Almond Supple Skin Oil, at $52 for a 3.3 ounce bottle, and Shea Butter Hand Cream, at $30 for a 5.2 ounce tube, illustrate the affordable side of the luxury brand.

The Sol de Janeiro brand (15% of trailing sales) is wildly popular with Generation Z, though you wouldn't suppose that the young folk would need Bum Bum Cream, the Brazilian-inspired skin-tightener. Elemis (12%), a high-end skin-care company, fashions its Pro-Collagen Marine Cream from seaweed extracts.

Five other brands account for the remaining 9% of sales: Melvita, a vendor of eye and lip oils derived from organic

But why Hong Kong?



source: The Bloomberg

ingredients; LimeLife, which enlists social influencers to sell its makeup; Erborian, a Korean-inspired skincare brand; Grown Alchemist, a purveyor of antiaging creams; and L'Occitane au Brésil, which markets beauty products in Brazil made from local ingredients. "Natural and organic" is the common thread.

In the three months ended June 30, company-wide sales showed year-over-year growth of 24.5%, with the L'Occitane brand itself expanding by 4.4%, Elemis by 23.6% and Sol de Janeiro by an astounding 171% (figures are adjusted for currency movements). The Americas region is leading the top line, with sales increasing by 57.5% in the June quarter versus growth of 6.4% in EMEA and 11.2% in Asia Pacific.

L'Occitane's large retail footprint condemns its legacy brand to a lower tier of profitability than the brands of the more rapidly expanding acquisitions. Last year, L'Occitane en Provence generated a 14.6% operating margin, compared with 20.2% for Elemis and 24.6% for Sol. As Elemis and Sol grow to deliver a larger proportion of overall sales, they stand to lift the parent's margins.

Travel-related sales offer another potential channel for growth. L'Occitane and its stable of brands are underrepresented at airports and other tax-free points of sale. "Until a couple of years ago, we were still a mono-brand company," Janis Lai, L'Occitane's director of investor relations, tells me. "When you negotiate with duty-free operators, there is a marked advantage when you're representing 20 brands as a global group as opposed to L'Occitane, where we really had only one brand."

North America provides Sol with around two-thirds of its sales; North America and the U.K. provide a similar proportion for Elemis. Each company could profit from a push to other markets. "To be honest, when we first acquired Sol de Janeiro, we didn't know if it would resonate outside of North America," says Lai. "The scents are on the heavier side.... But when we presented the brand internally and with our partners, we had overwhelmingly [positive] feedback."

While L'Occitane en Provence is a mature brand, face care makes up only about one-fifth of its sales. "When we look at the brand rankings in premium body and premium hair," Lai continues, "we are either No. 1 or No. 2, but the overall brand ranking is somewhere between Nos. 15 and 20." Continued strength in Immortelle sales would go far to close the disparity.

To capitalize on such opportunities, L'Occitane is investing an incremental €100 million in operating expenses this year, primarily in China-directed marketing. The outlay spells lower operating margins, on the order of 12% for the 2024 fiscal year verus an adjusted operating margin of 15.8% in fiscal 2023. Investors wouldn't mind, of course, if such spending bore immediate fruit, but they seem to be asking, What if it doesn't? Also, What about the here and now?

There can be no guarantee, as it almost goes without saying, that L'Occitane will continue its rapid expansion. A recession in the United States would put the brake on Sol, and a global slowdown would ding the group's top line. Then, again, management has the option to toggle back marketing outlays if the expected incremental revenues do not materialize.

It's a little concerning that China, with its deflating property bubble and burgeoning municipal-debt crisis, is a land of hope for all three of L'Occitane's major brands (*Grant's*, Sept. 1). Then, again, allure is always in style, and Japan remained a vibrant beauty market even after the twin collapses of its property and stock market

L'Occitane International S.A. at a glance
all figures in € mns except per share data

	FY-23*	FY-22	FY-21	FY-20	FY-19
sales	€2,134.7	€1,781.4	€1,537.8	€1,644.1	€1,426.9
operating income	239.1	310.7	198.9	187.3	150.7
net income	115.1	242.0	154.6	116.3	118.2
earnings per share	0.08	0.16	0.11	0.08	0.08
shares outstanding	1,473.6	1,473.2	1,470.8	1,464.5	1,465.9
cash	147.3	360.9	421.2	166.3	144.4
debt	518.9	670.9	522.1	475.0	577.9
total assets	2,816.4	3,009.1	2,496.9	2,408.4	1,964.0

* Fiscal year ends March 31.

source: company reports

bubbles three-plus decades ago. If not cycle-proof, the beauty business has shown itself to be cycle-resistant.

Whether L'Occitane's recent messy results are the prelude to deeper problems is the hovering question. In the last fiscal year, the profit-and-loss statement absorbed €75.4 million in impairment charges on underperforming brands Melvita and LimeLife as well as €50.3 million in expenses from shuttering operations in Russia. A decision to reduce sales to a U.K. partner that had sold Elemis products at heavily discounted prices—the case of an insult to "brand equity"—inflicted further damage. All in all, Elemis's revenues rose by 8.9% last year, though they roared back to 23.6% growth in the three months ended June.

Melvita has been the red-headed stepchild of the group since its 2008 acquisition. If the organic-only tike got lost in the corporate shuffle, the recent decision to assign Melvita a management team of its own (it had shared one with its preoccupied parent) could make a constructive difference.

In contrast, the 2018 purchase of a controlling interest in LimeLife was a hit right out of the gate. "During the first year of Covid," says Lai, "they were our only growing brand." The problems came after lockdowns ended. Notable was a new Facebook algorithm whose purpose was to marginalize the very influencers who were selling the likes of LimeLife.

Now a new management team is working to diversify the brand's distribution. "[Chairman] Reinold has made it very clear to the LimeLife management and to the market that we don't have infinite patience," as Lai puts it to me.

To capitalize on its rapid growth in Asia, L'Occitane chose to list on the Hong Kong market in 2010. Management little foresaw President Xi Jinping's unfriending of capitalism or the attack of the Chinese Communist Party on the historic liberties of Hong Kong. In any case, that listing is now an albatross around the necks of the shareholders.

"In our view," Anne Ling et al., analysts with Jefferies Financial Group, Inc., noted at the end of July, "international companies listed in HK might seek dual primary listing or listing elsewhere to 1) explore higher valuation in other markets, 2) increase liquidity and 3) avoid Sino-U.S. tension, which impacts sentiment in the overall HK equity market."

After reporting results on June 26, which included plans for that €100 million ad campaign, L'Occitane's stock slumped. By July 6, it hit to HKD 18.32, down about 25% on the year. "Maybe it was our delivery or presentation," says Lai, "but, at the end of the day, we felt that this was the right strategy to take for the long term while the market was looking for margin expansion year after year."

In late July, rumors began to circulate that Geiger would buy out the 27.3% of shares he did not already control with an eye to relisting shares in the United States or Europe. Up went the stock price to a high of HKD 27.80 on Aug. 31, as the company confirmed that any potential offer from Geiger would be at least HKD 26 per share. In response, minority shareholders floated a price tag of HKD 35 in the local press. It was too rich for Geiger, and he cancelled the takeover process on Sept. 4.

At a price of HKD 23.10 today, L'Occitane trades below the minimum bid that Geiger supposedly contemplated last month. To be sure, the entrepreneur has committed to no further bid, but it's nice to know (if the rumors were true) that he contemplated one. Adjusting for the aforementioned impairment charges as well as for the costs to shutter the Russia operations, the stock trades at 20.5 times trailing earnings and 13.9 times the estimate for the fiscal year ending March 31, 2025. It looks like a bargain compared to Estée Lauder Cos., Inc., e.l.f. Beauty, Inc. and L'Oréal S.A., which trade at an average of 44.7 times trailing earnings and 37.9 times the estimate for the year ending Dec. 31, 2024.

As of March 31, the balance sheet of unrated L'Occitane showed a net debt balance of €371.6 million, against which one might compare consensus estimates of €472 million in Ebitda in fiscal 2024. In the last fiscal year, operating profit, adjusted for the impairment charges for underperforming brands and the exit from Russia, covered interest expense by 26.3 times.

Of the dozen analysts who cover L'Occitane, 10 say buy and none says sell. While management has neither bought nor sold a single share in the past 12 months, the chairman and controlling shareholder did almost—according to the aforementioned whispers—take the company private.

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