Bulls Eye

IIM BANGALORE

Exploring Inorganic Growth Opportunities for LuxCo:

Acquisition of Salvatore Ferragamo

Contents

Executive Summary

Industry & Company Landscape:

LuxCo is a leading global player in growing personal luxury goods industry

Evaluation of Targets:

Preparation of an exhaustive list of parameters to critically evaluate potential target brands

Review & Valuation of Ferragamo:

Strategic & Financial fit assessment of Ferragamo to arrive at fair valuation

Synergies & Expected Impact:

Project the positive impact of the deal on LuxCo’s critical KPIs and group valuation

Risks & Challenges:

Be prudent to chalk out potential roadblocks as a part of M&A activity

Future perspective & considerations:

Look into the future to establish a clear path to sustainable market dominance

As-is Industry Overview

A birds-eye view of the global luxury goods market chalking out key statistics & trends

USD 252 Billion

Agg. luxury goods sales, 2020

1.8% CAGR

FY 2017-2020 growth in sales

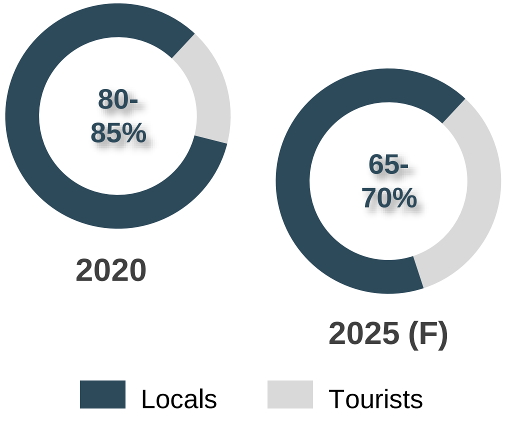
5.1% Net Profit

Composite industry PAT margin

Growth Drivers

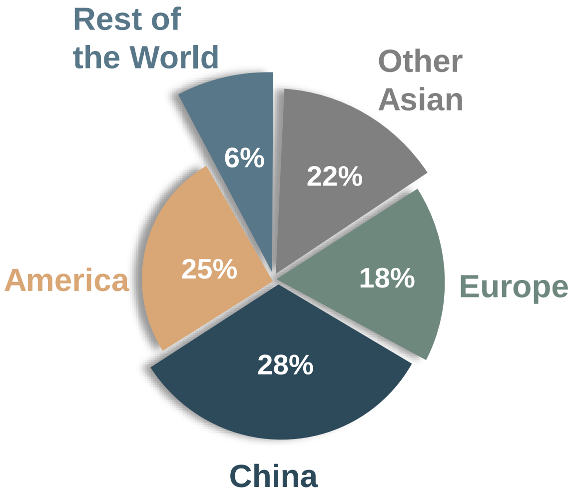
- ☐ Increasing **disposable income** in **emerging markets**
- ☐ Expanding **tourism sector**, especially in the **Middle East**
- ☐ Rise in **social media marketing** & **celebrity endorsements**

Local vs Tourist Demand



Demand from **locals expected to decrease**, **Tourist** share to be **1/3rd** by **2025**

Geographical Market Split



Top 10 Luxury Good Companies by sales (2020)

LVMH
MOËT HENNESSY• LOUIS VUITTON

KERING

PVH
PHILLIPS-VAN HEUSEN CORPORATION

L'ORÉAL
LUXE

ESTĒE LAUDER
COMPANIES

RICHEMONT

周大福
CHOW TAI FOOK

CHANEL

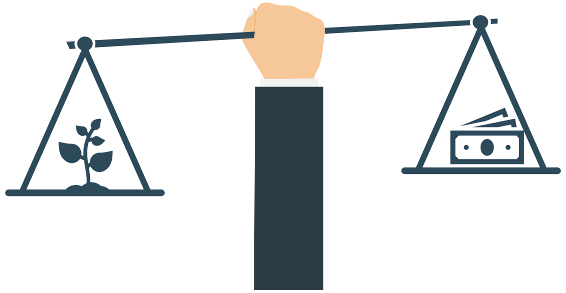
ESSILORLUXOTTICA

HERMÈS
PARIS

Key Trends moving forward from the COVID-19 pandemic

- ☐ **Digitalization** driving **Fashion-Tech investments** in the industry
- ☐ **Bio-materials** gaining traction as players **embrace circular economy**
- ☐ **High consolidation – Top 15** players have **>60%** of **sales**, to increase further
- ☐ Increasing focus on **younger customers** & **emerging markets**

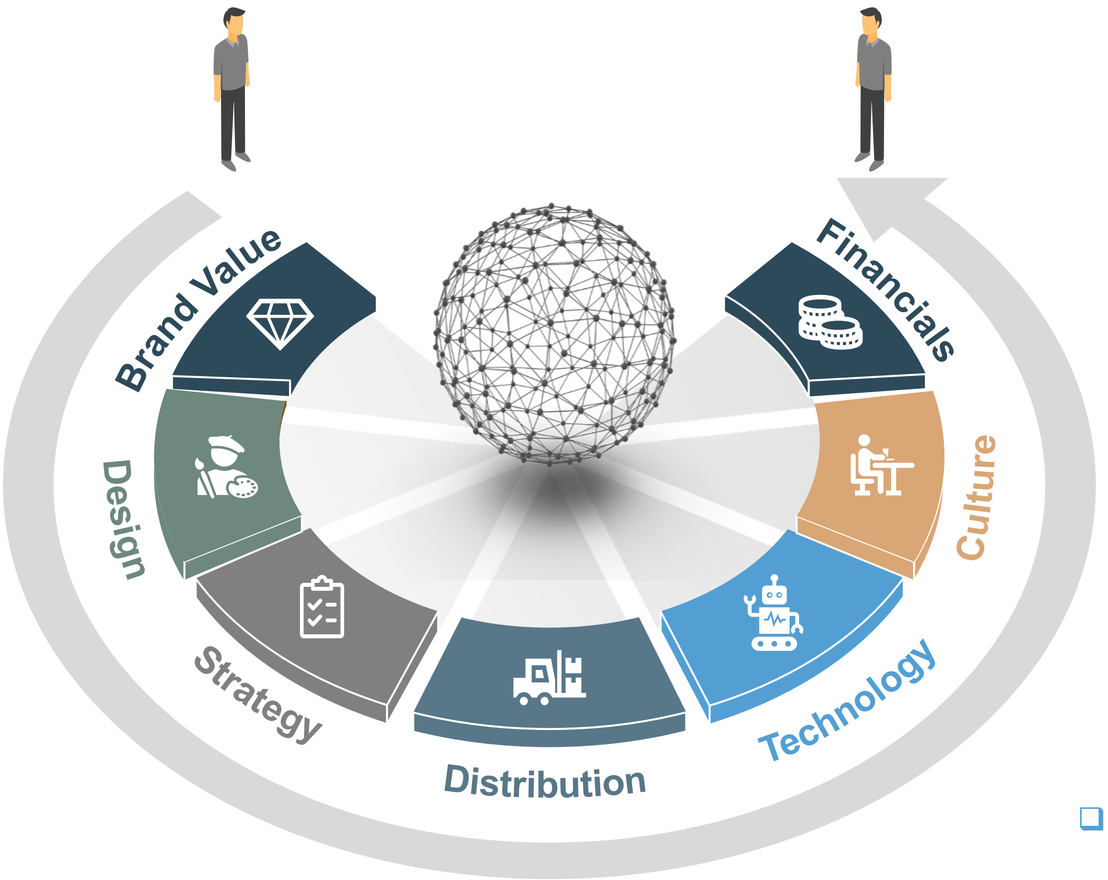
Strong call for **Sustainable Fashion** from **stakeholders** – balance between **profitability and responsibility**



Source: Delloite. (2021). Global Powers of Luxury Goods, Breakthrough Luxury; Bain. (2020). The Future of Luxury: Bouncing back from Covid-19;LuxCo. (2020).

Parameters for Evaluation of Target

A broad framework of parameters considered for evaluating the best target brand for acquisition



- ☐ **Pedigree:** Brand symbolism coming from its history, heritage, tradition
- ☐ **Paucity:** Sense of ‘limited’ supply, rarity & enhanced customer perception
- ☐ **Persona:** Image & positioning of target brand relative to customer persona

- ☐ **Uniqueness:** Own style of products establishing a certain identity in the market
- ☐ **Similarity:** Index of similarity with existing brands to limit sales cannibalization
- ☐ **Trend Setting:** Leading fashion waves & adaptability to market trends

- ☐ **Mission, Vision, Values:** Organizational alignment with LuxCo’s strategy
- ☐ **Market Positioning:** Pure luxury vs diluted positioning in different segments
- ☐ **Future plans:** Brand goals & ambition in the medium term & convergence of scope

- ☐ **Geographic presence:** Access to international markets
- ☐ **Retail footprint:** # of stores, distribution centers, strategic locations & proximity advantage
- ☐ **Digital sales channel:** Share of digital presence & efficiency in customer traction, sales

- ☐ **Capital efficiency:** Cash conversion cycle & related operating metrics
- ☐ **Cost structure:** Underlying unit economics & margin generating capacity
- ☐ **Growth prospects:** Future financial outlook & estimated topline growth

- ☐ **Talent management:** People policies & practices like evaluation, compensation, career growth, succession, etc.
- ☐ **Org Structure & Hierarchy:** New Operating model with clear reporting relationships & pre-defined decision making powers
- ☐ **Employee demographics:** Cultural integration & fusion among different nationalities

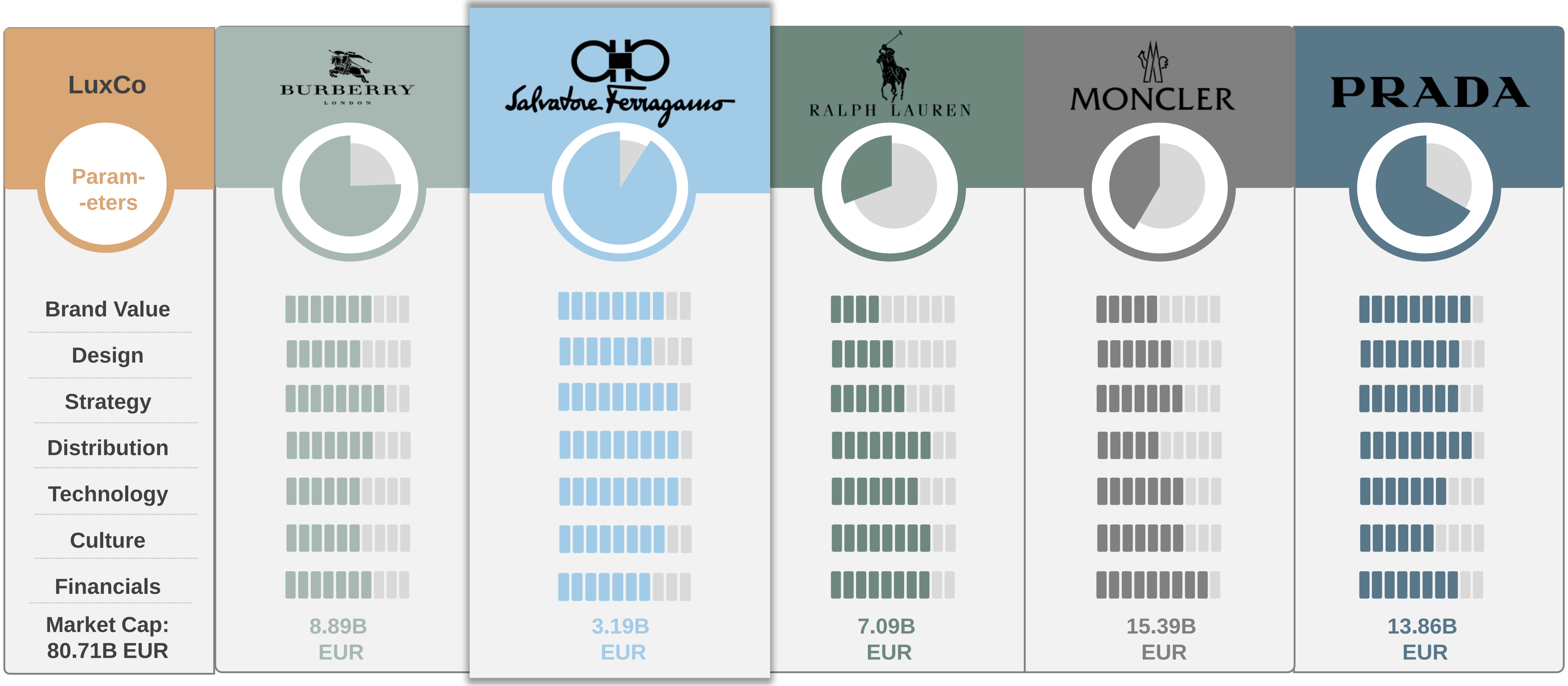
- ☐ **Infrastructure:** Tech infra to augment the LuxCo’s competencies, data collected & analyzed
- ☐ **Innovation Capabilities:** Use of new age tech; R&D efforts in emerging spaces like AI, ML, etc.
- ☐ **Customer engagement:** Leveraging technology for superior service, security, information

Source: Team analysis

Evaluation of Potential Targets

A comparison of potential targets based on the identified parameters

Salvatore Ferragamo emerges as the best fit for LuxCo's acquisition, driven by high strategic fit, and tech capabilities



LuxCo	BURBERRY LONDON	Salvatore Ferragamo	RALPH LAUREN	MONCLER	PRADA
Param- -eters					
Brand Value	7	8	4	5	9
Design	6	7	5	6	8
Strategy	8	9	6	7	8
Distribution	7	9	8	5	9
Technology	6	9	7	7	7
Culture	6	8	8	7	6
Financials	7	7	8	9	8
Market Cap: 80.71B EUR	8.89B EUR	3.19B EUR	7.09B EUR	15.39B EUR	13.86B EUR

Note: Currency exchange rates used as on 28/01/2022; Parameter wise scores derived from critical assessment – qualitative & quantitative of sub-parameters

Source: Bloomberg; Company Annual Reports; Customer reviews; Team analysis

Strategic Review of Target

A deep-dive into the parameters for critical evaluation of identified target brand

Salvatore Ferragamo

Established in 1927 as "shoemaker of the stars", in Florence. Made in Italy brand, with diversified presence in 90 countries

① Brand Value

- ❑ **Pedigree:** Ferragamo has 54-year-old legacy of being in Italian luxury, "Shoemaker of the stars"
- ❑ **Paucity:** Only 644 stores present across the world, known for immersive experience
- ❑ **Persona:** Elegance, comfort and exclusive craftmanship, with more accessibility

② Design

- ❑ **Uniqueness:** Patchwork and vibrant, attention to detail and reaching out to younger generations
- ❑ **Consistency:** Product mix of Ferragamo in line with LuxCo's existing brands
- ❑ **Trend Setting:** Accessible pricing, identifying trends from comfortable footwear to rise of sneakers

③ Strategy

- ❑ **Mission, Vision, Values: Market Positioning:** Pure luxury brand with diversified portfolio. Focus on inclusivity, vibrance and innovation
- ❑ **Future plans:** Aim to be the largest global luxury brand, by dominating the shoe and accessory business

④ Distribution

- ❑ **Geographic presence:** Large presence in Asia-pacific markets, 262/644 stores, generating 41.6% of sales
- ❑ **Retail footprint:** 395 DOS, 264 TOPS. 69.6% sales from retail, 29.4% from wholesale
- ❑ **Digital sales channel:** Increased digital presence with new website

Financials ⑤

- ❑ **Capital efficiency:** Good liquidity positions
- ❑ **Cost structure:** Operating cost is high and inventory turnover is declining
- ❑ **Growth prospects:** Focus on digitization and expansion to Asian markets point to healthy growth

Culture ⑥

- ❑ **Talent management:** Family-owned business, 4000+ employee base, focus on inclusion
- ❑ **Org Structure & Hierarchy:** Geographical HQs reporting to group head, country wise subsidiaries
- ❑ **Employee demographics:** Focus on inclusion. 60% female in senior mgmnt, 45% under 30s fresh recruit

Technology ⑦

- ❑ **Infrastructure:** Contemporary website with AI/ML integration for real store experience. Hevolus as tech partner
- ❑ **Innovation Capabilities:** Partnership with Microsoft to leverage mixed reality.
- ❑ **Customer engagement:** Digital transformation to engage customers and give them in store experience virtually

Note: DOS – Directly Operated Stores TOPS – Third-Party Operated Stores

Source: MarketLine. (Sep, 2021). Salvatore Ferragamo SpA. "https://advantage.marketline.com/Company/Summary/salvatore-ferragamo-s-p-a-2545776_2229877"

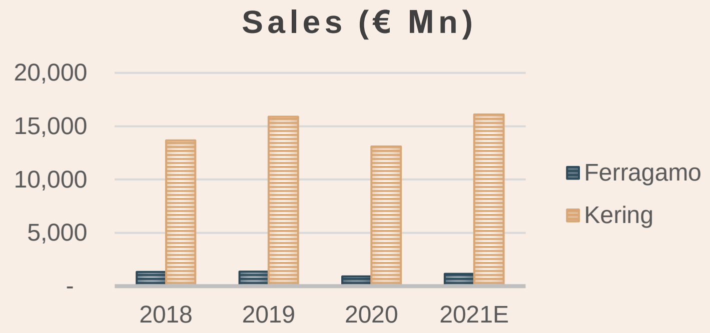
Financial Review of Target

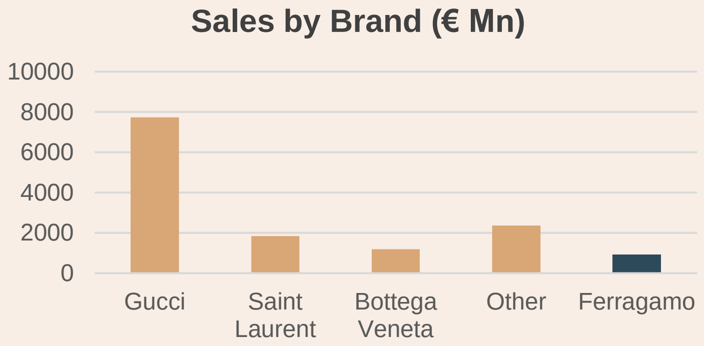
A deep-dive analysis of Ferragamo's financials

Scale

Ferragamo in comparison to LuxCo

- ❖ Ferragamo in **terms of scale** is **much smaller** than LuxCo
- ❖ But in comparison to other brands under LuxCo, Ferragamo has **significant contribution**

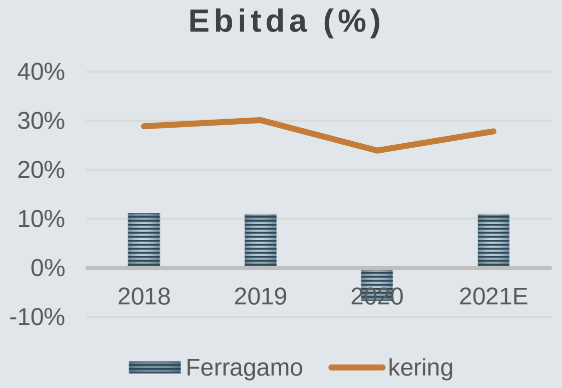




Operating Metrices

EBITDA & Operating Margin

- ❖ Operating margin of Ferragamo is **lower in %age** of sales terms as compared to LuxCo's
- ❖ During covid, both **EBITDA and ROE** even **turned negative**, due to dip in sales.
- ❖ This points to possible operational inefficiencies & offers **scope** for a **strong turnaround**



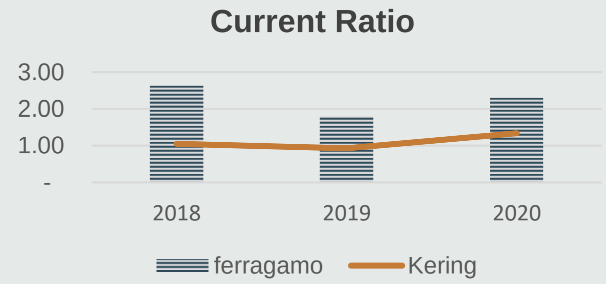
Recovery in 2021

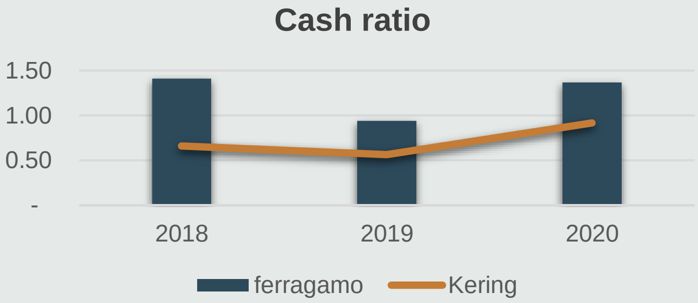
- ❖ Estimates suggest **Ferragamo's recovery** in 2021, comparable to **pre-pandemic levels**.

Liquidity

Cash Rich

- ❖ Ferragamo has **healthy liquidity** with minimal debt indicating a strong financial position
- ❖ **Current and cash ratio** better compared to LuxCo
- ❖ This will add to LuxCo's **future ability** of **investments** and **acquisitions**.





Source: Ferragamo and LuxCo Annual reports; Retrieved 25th Jan, 2022, from https://www.statista.com/statistics/267494/global-revenue-share-of-the-LuxCo-groups-luxury-division-by-brand/

Valuation of Salvatore Ferragamo

Proposed valuation of target with detailed methodology, rationale & assumptions

Methodology & Key metrics | **Rationale** | **Remarks** | **Implied Valuation**

1 Discounted Cash Flows

WACC: 8.5%

Terminal growth: 3.0%

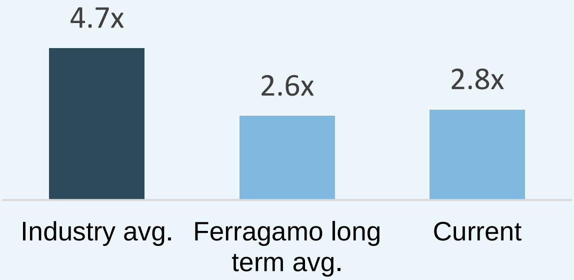
- ☐ WACC and terminal growth rates are sourced from broker reports
- ☐ Terminal growth rate in line with long-term growth rate of industry

- ☐ DCF valuation based on **5-year projections** (until 2026E)
- ☐ **8% sales CAGR** assumed
- ☐ EBIT **margin expansion of 4%** (exit margin 15%) built into projections to capture **brand potential** & prospects

2 Sales multiple

Multiple: 2.7x

FY22E Sales: €1,245Mn

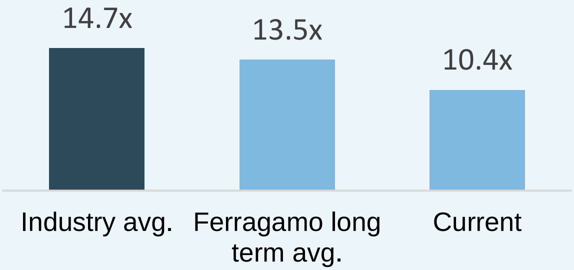


- ☐ Ferragamo trades at discount to industry due to **high proportion of wholesale sales** (30%+) and low marketing focus
- ☐ **Sales growth** has been **below industry** historically

3 EBITDA multiple

Multiple: 12.0x

FY22E EBITDA: €279Mn



- ☐ Ferragamo trades at discount due to **lower margins vs peers**
- ☐ The margin gap has further widened in the industry in recent times resulting in **pressure on multiples**

Implied Enterprise Value	€ Mn
DCF	2,399
NTM EV/Sales	3,360
NTM EV/EBITDA	3,345
Average	**3,035**
Net debt	-360
Implied equity value	**3,395**

Estimated equity value of target

Note: Valuation as of today for illustrative purposes. Numbers need to be rolled forward based on transaction timeline.

Source: Broker reports, Bloomberg, Factset, Team analysis

Transaction Considerations

Analysis of estimated transaction size and funding requirements

Transaction pricing and size

Key considerations

❑ **Acquisition stake** - **51%** (Proposed)
Balances LuxCo's need for control with promoter family's ownership interests

❑ **Control premium** - **25%**
In line with past M&A trends to incentivize sale by promoters

Net requirement of funds

Figures in € Mn	
Estimated equity value	3,395
Control premium	*25%*
Acquisition value	**4,244**
Premium to CMP	*36.9%*
Stake to be acquired	**51%**
Total cash consideration	**2,164**

Evaluation of funding alternatives

Balancing internal accruals and Debt

❑ **Trade-off** between liquidity, returns and credit position

❑ LuxCo benefits from a **strong credit rating** (A-) and **low cost of debt**

❑ **Strong credit position** indicates ample room for debt funded acquisition
  - ○ Net debt/equity **- 0.2x**
  - ○ Interest coverage ratio **- 34.2x**

❖ LuxCo's debt position (As of Dec'20)

❑ **Cash balance -** €3,443Mn

❑ **Existing debt -** €5,592Mn

❑ **Cost of debt –** 2.5%
  - ○ Based on interest rate of LuxCo's outstanding bonds

❑ **Preference for liquidity** to tackle any business surprises due to Covid

Sensitivity of key parameters to debt funding in proposed acquisition

		RoE	Int. Coverage ratio	Cash ratio
Debt (%)	*0%*	20.4%	53.1	0.83
	50%	20.3%	44.7	0.93
	100%	20.2%	38.6	1.01

Note: LHS: Premium calculated based on market capitalization as of 28 Jan'2022; RHS: Values shown are for combined entity and immediately post transaction close (i.e.) they do not capture impact of synergies to be realized over time

Source: Annual reports; Team analysis

Post-Acquisition Integration

Imperative considerations for successful post-acquisition integration to maximize value creation

Direction alignment

Defining the company **goals & aspirations** to be aligned on the **Mission, Vision, Values** and **Morals** as one business entity

Organizational design

Set up the **Target Operating model** & establish clear reporting structure; absorb **Ferragamo subsidiaries** & shed off unnecessary **layers of hierarchy**

Talent Management

Selecting, retaining & **developing** the best people; awareness & **training sessions** for **exchange of ideas** and better **interaction** between both sets of employees

Workforce integration

Senior leadership being **committed, credible & transparent**; Ferragamo employees **identifying** themselves as a part of the **LuxCo family**

Customer involvement

Actively **involve customers** in the integration process & willingly **share information** to generate **positive publicity** in the market

Location mapping

Identify strategic locations like **warehouses & distribution hubs** to leverage & **integrate supply chain** operations; map acquired stores and accordingly plan future stores using **revised proximity index**

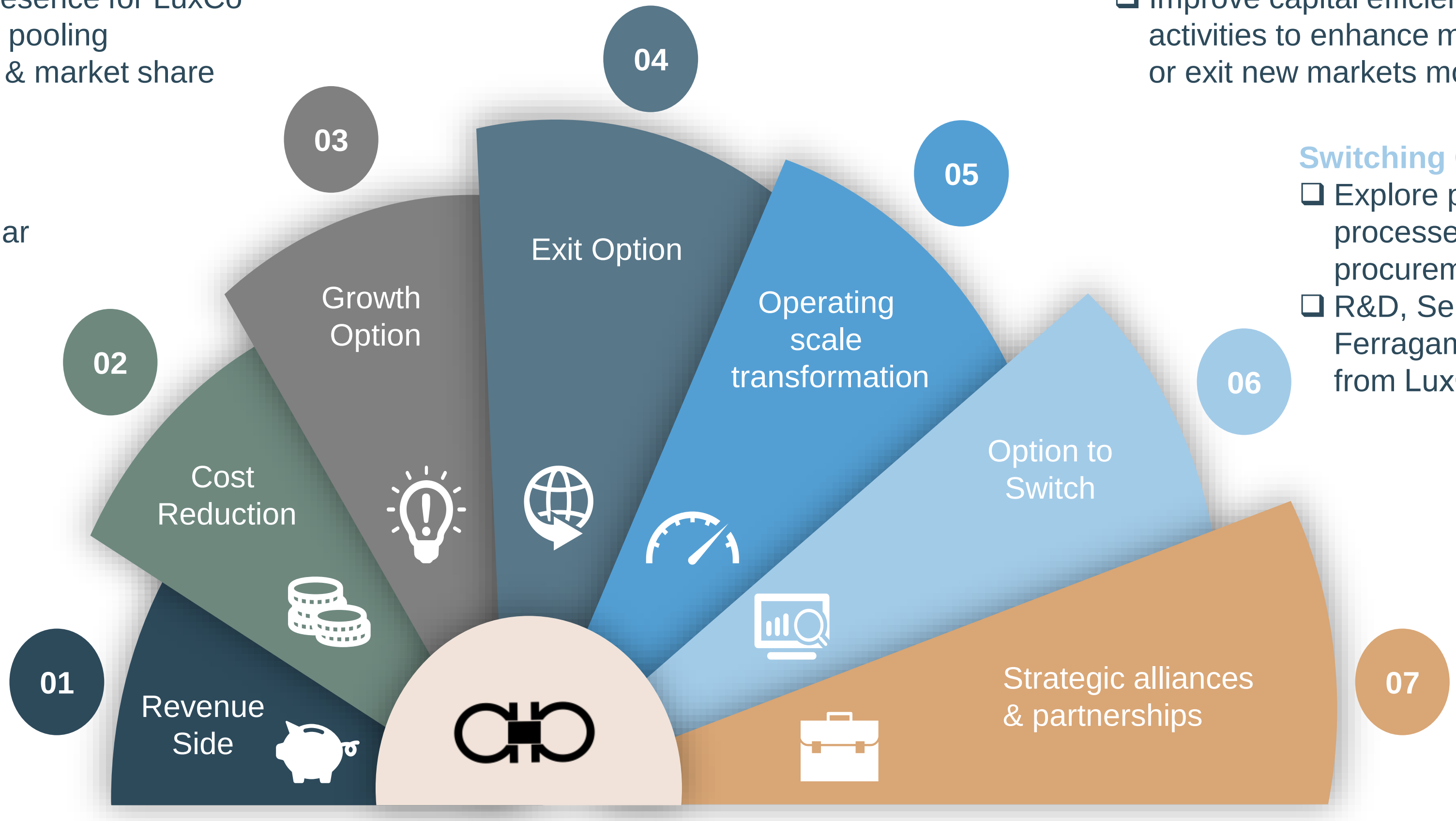
System Infrastructure

Decide early on the management of **IT systems** & back end infra to ensure **common platform**, smooth functioning & enhanced visibility cutting down lead time in **decision making** and **improving flexibility**

Source: Team analysis; BCG capabilities: M&A, Transactions & PMI

Expected Synergies for LuxCo

Assessment of the potential synergies to be realized after the acquisition of Salvatore Ferragamo



Revenue Side Synergies

- ☐ Complementarity of offers, cross-learning of selling techniques, exploitation of sales channels
- ☐ Access to a larger customer base, digital integration into multi-brand e-tail stores

Cost Reduction Synergies

- ☐ Exploit economies of scale, combine sourcing & other similar backend activities to exercise higher bargaining power
- ☐ Know-how & Best practices shared to improve processes and reduce operating costs

Growth Option Synergies

- ☐ Both LuxCo & Ferragamo have resources & experience to enter new markets
- ☐ Enlarging current industry presence for LuxCo becomes easier as resource pooling exponentially affects returns & market share

Exit Option Synergies

- ☐ Better flexibility to adapt to industry changes & transitions, more equipped to handle turbulence
- ☐ Less path dependence as Ferragamo brings in competence in newer product lines such as footwear

Operating Scale Transformation Synergies

- ☐ Opportunity to optimize the operations of Ferragamo using the LuxCo expertise
- ☐ Improve capital efficiency and cut down duplicate activities to enhance margins and gain agility to enter or exit new markets more freely

Switching Option Synergies

- ☐ Explore possibility in switching input processes to streamline & centralize procurement related activities
- ☐ R&D, Services & inventory policies of Ferragamo can be altered to gain benefit from LuxCo's global expertise

Strategic Alliances Synergies

- ☐ Build on partnerships of Ferragamo for the greater benefit of LuxCo's brands
- ☐ Use collaborative in-house identification of newer tech capabilities to foster innovation & creativity

Source: Team analysis; Sant'Elia, Bozzolan (2017), M&As in Luxury industry, LUISS

Projected Impact on LuxCo KPIs

Assessment of the potential synergies to be realized after acquisition of Salvatore Ferragamo

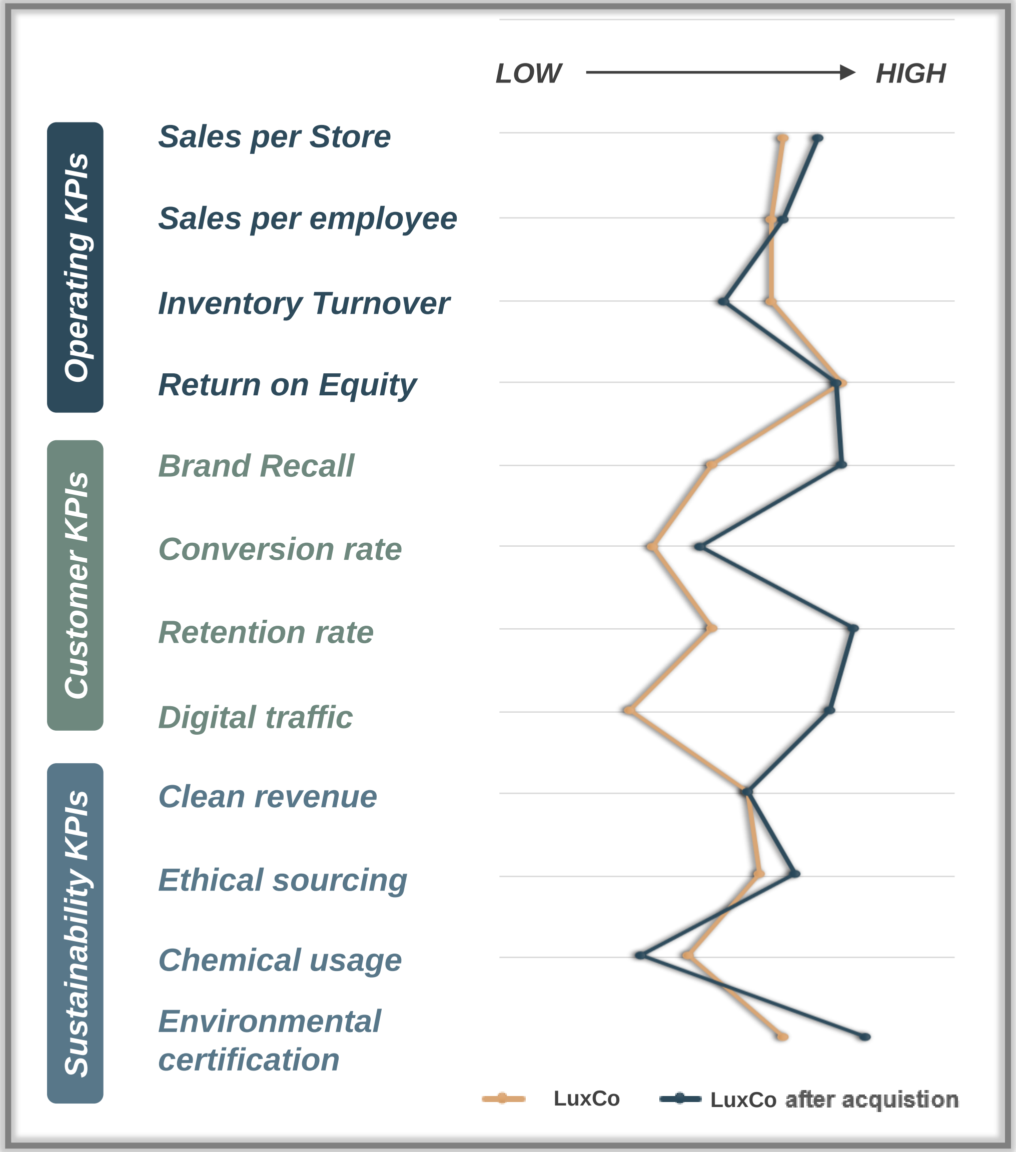
Adding Ferragamo will substantially improve the **brand recall** – bringing in a **new customer cohort** primarily preferring **luxury footwear**

Ferragamo indicators will have **limited impact** on LuxCo's operating performance owing to its strong brand portfolio **diminishing impact to 1/10th**

Lagging behind on **customer service**, Ferragamo will benefit from **LuxCo's expertise** in its stores worldwide

Digital capabilities brought in by Ferragamo will augment LuxCo's vision of a **multi-brand online retail** platform

Ferragamo is heavily invested in **sustainability & responsibility** metrics which serves as an important area for the **stakeholders of LuxCo** – thereby building confidence and approval for the acquisition



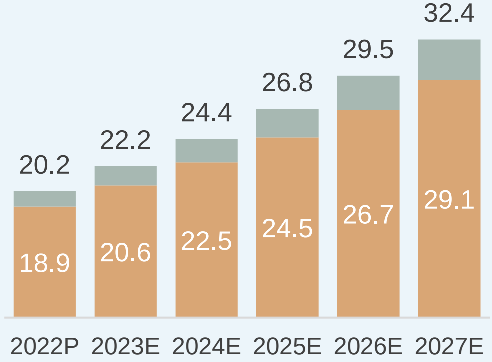
Note: Low-High Ratings based on synergy calculations & qualitative assessment by the Team
Source: Sustainability Report 2019,Salvatore Ferragamo Group; Annual Reports; Team analysis

Impact on LuxCo Group Financials & Valuation

Projected Impact on LuxCo Group financial metrics and valuation post acquisition of Ferragamo

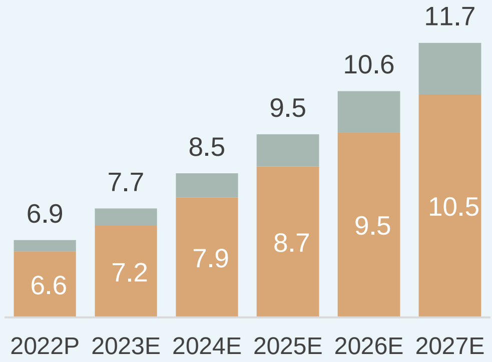
Sales & Profitability

Sales (€ Bn)



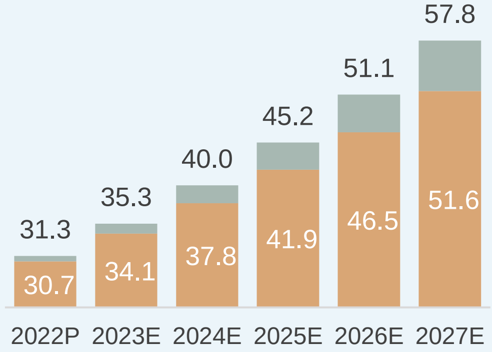
Marketing expertise of LuxCo + **Access to customer base** & **digital presence** of Ferragamo to drive superior topline growth

EBITDA (€ Bn)



Integration with LuxCo to **reduce operational inefficiencies** & drive **margin expansion** at Ferragamo

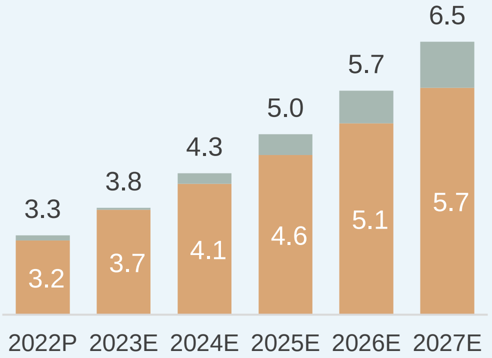
EPS (€)



Transaction is **EPS accretive**

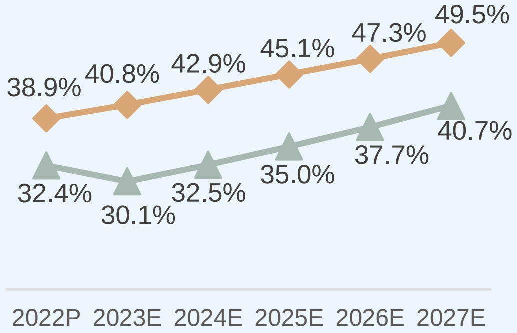
Cashflow & Returns

FCFF (€ Bn)



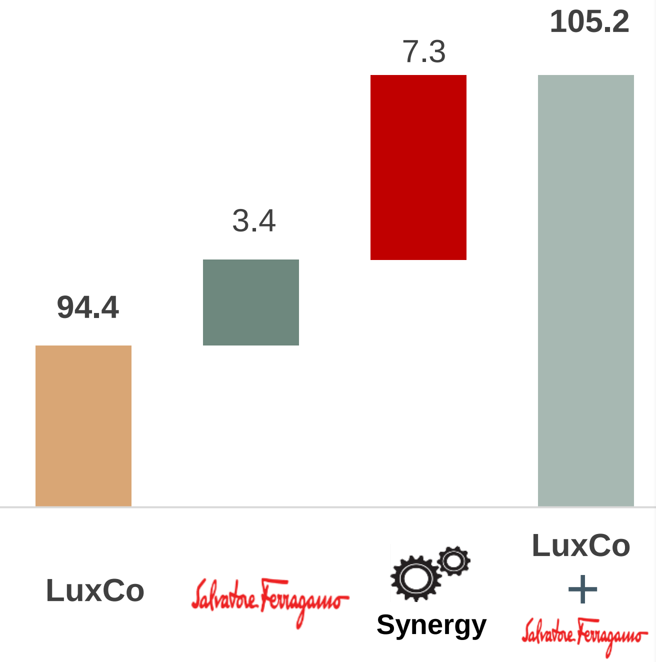
Incremental **growth** and **margin expansion** to **enhance cashflow** generation

RoCE (%)



Return ratios **fall slightly** due to **capital inefficient** Ferragamo business. Gap to **shrink over time**

Group Valuation (€ Bn)



- ☐ Valuation based on **DCF** and **trading multiples** for LuxCo
- ☐ Value calculated as of 2026 using **comps** and NTM financials (2027E) and **discounted back** to allow for **synergies to build into the financials**

Note: Transaction assumed to close end of 2022.
Financials are projected for combined entity for 5 years post transaction close (i.e.) 2027E to reflect synergies in the group valuation.
Source: Broker reports, Team analysis

🟧 LuxCo 🟩 LuxCo + Ferragamo

Anticipated Risks & Challenges

Risks and challenges associated with the acquisition and the industry in general

Factors Specific to the acquisition of Ferragamo

Cannibalization

01

- Chances of increased competition with other brands of LuxCo portfolio.
- Similarities in terms of product portfolio and geographical segment, leather goods and shoes with Gucci and assortment of jewelry and eyewear.

Trendiness and Adaptability of Ferragamo

02

- Ferragamo has been around since 1927, now for its class & craftmanship, it may find it difficult to adjust to a more vibrant taste of other markets.
- Its pricing is also on the more affordable side, possible brand dilution for LuxCo

Family ownership and control issues

03

- Ferragamo being a family-owned fashion house, hard to negotiate controlling stakes and even doubts on willingness to sell.
- Hard to ensure effective management in case of sluggish performance.

Financial Dyssynergies

04

- Ferragamo’s operational inefficiencies likely to drag down group return in the short term. Operating margin is ~11% compared to ~30% of LuxCo
- Low ROE is also a risk and will require input from LuxCo resources to improve

Conflicts of Interest & Pushback from Italian design houses

05

- Uncertainty around willingness to share knowledge with other portfolio brands.
- The recent speculation of an Italian luxury conglomerate formation could be a roadblock to this acquisition.

Macro Factors

Fast pacing change in trends

LuxCo while chasing growth needs to be mindful of the **transient nature** of fashion trends and **geographical variation** in taste.

Technological risks

Covid and subsequent push on **digitalization** is a major concern for most fashion houses. With higher growth, **channel management** will become paramount..

Focus on Sustainability

Rising wave of more **eco-aware** customers looking for **sustainable brands.** Each brand should resonate with this philosophy.

Industry paradigm shift

There is a rise of **anti-elitist culture** in developed nations, pushing back on luxury. Accompanied by rising **Chinese home-grown luxury** houses .

Source: Lectra. (June, 2021). Ferragamo’s strategy: more accessible pricing to target younger generations?. https://www.lectra.com/Businesswire. (Feb, 2021). Salvatore Ferragamo and Medallia Together Amplify the Customer Experience

Path to the Future for Luxury Retail

Chalking out a future plan to stay profitable & dominating in the medium to long term

5 Long term sustainability

- Sustainable luxury – promoting **environment**, social responsibility, circular economy & **waste minimization**
- Focus on **ethical** fashion methods (production), **slow** fashion (sharing, renting), **conscious** fashion (green)

4 Targeting Gen alpha through alternate models like NFTs and Gaming:

- Expected to be **~2B consumer base** globally by mid 2020s, building a **strong recall** today to benefit tomorrow
- Involvement in **Non-Fungible Token** (NFTs) and **Gaming** markets to target “customers of the future”

3 Riding the e-commerce trend:

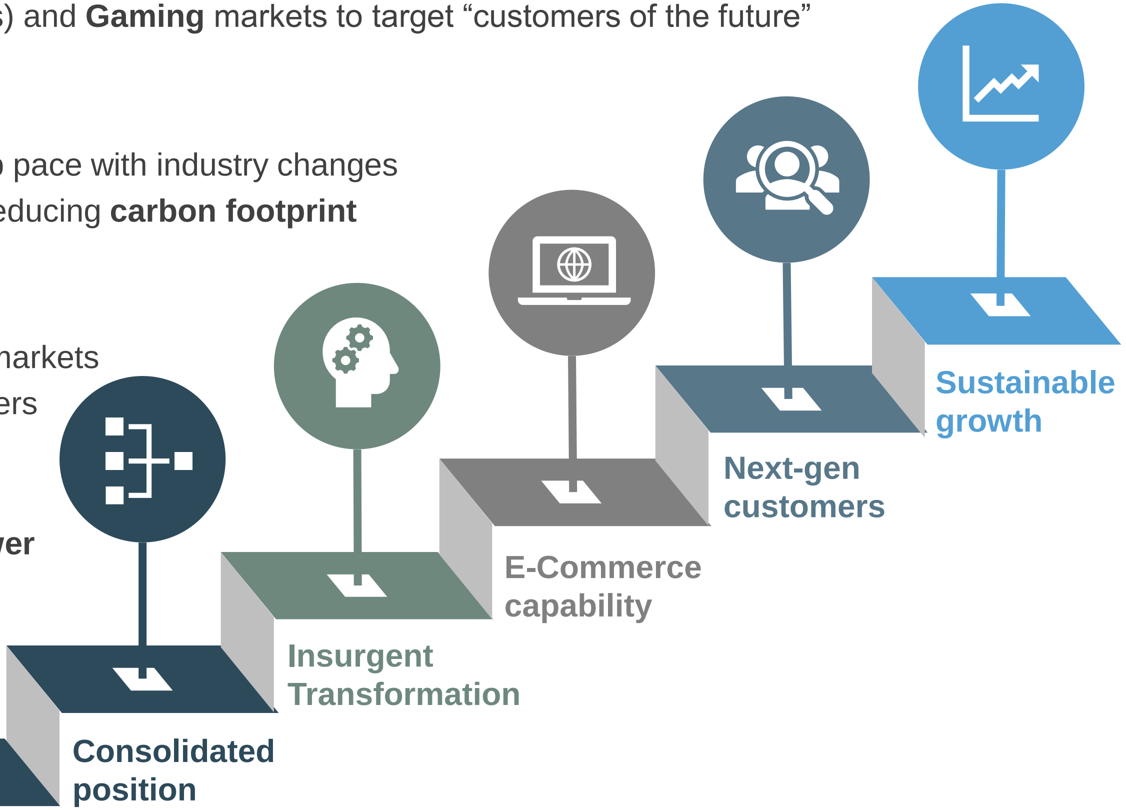
- Strategic partnerships with **digital players** for keeping up pace with industry changes
- Virtual **design** & **try-on tech** increasing engagement & reducing **carbon footprint**

2 Operational and insurgent transformation:

- **Cultural excellence** & **creative mindset** will be the key to win major markets
- Strong emphasis on **diversity & inclusion** to appeal to young customers

1 Consolidating position for Market power:

- Ongoing trend of **M&A** in the luxury industry – attain scale for higher **bargaining power**
- Leverage **cross-brand synergies** & leaner operations for **competitive advantage**



Source: Delloite. (2021). Global Powers of Luxury Goods, Breakthrough Luxury; Bain. (2020). The Future of Luxury: Bouncing back from Covid-19;LuxCo. (2020)