INTERNATIONAL

The Devil may wear Prada, but should smart investors shun the stock?

| BY ASSIF SHAMEEN |

Forget the *ka-ching, ka-ching* sound that has long been associated with bling. It is time to roast some of the once-high-flying global luxury goods stocks. Actually, Andy Macken, portfolio manager at Montgomery Asset Investment Management in Sydney, says there are now some pretty decent opportunities shorting the stocks of some of the better-known brands. His big short: **Prada**.

How quickly times change. Over the past 10 years, global luxury retailers delivered manna from heaven for investors as they catered to the insatiable appetite of affluent Chinese for bling. Retailers from Prada to **Coach** and **L'Occitane** rushed to list in Hong Kong because their biggest market was next door. Others like Graff Diamonds pulled the plug on their multi-billion dollar listing at the last minute just as the Chinese consumer obsession for luxury was wearing off.

Since last year, however, Beijing's crackdown on corruption, China's slowing economy, a glut of stores and growing inventory have turned the luxury retail sector from one of the most loved to one of the most shunned. Little wonder, then, that luxury retail stocks such as Prada are down 50% from their peak two years ago and many analysts and portfolio managers are betting the bloodletting could last a while.

Prada's huge retail rollout was masking its real problems

Bearish outlook

To be sure, Prada is widely loathed. Even Aaron Fischer, head of consumer and gaming research for CLSA in Hong Kong and one of the region's best-known proponents of luxury stocks, is now extremely bearish on the outlook for global luxury goods makers. China's corruption crackdown has left a trail of destruction in its wake in the sector. "We have seen two golden ages for luxury goods in recent decades," notes Fischer. "The Japanese shoppers in 1980s and early 1990s and the Chinese shoppers over the last decade," he says. Growth in China has slowed dramatically and there is nothing else that can fill that gap. "There is no third golden age in sight. India might be next, but that's at least 10 years away."

The way he sees it, there were two major drivers of growth for luxury retail over the past two years — price increases and an aggressive store rollout across China and other emerging-markets. Much of the sales growth was due to price increases in Asia. Now, with a weaker euro and a stable Chinese renminbi, some of the luxury goods companies are cutting prices rather than increasing them. **Chanel**, Louis Vuitton and others have moved to "harmonise prices" by slashing them in Asia by up to 20% and raising them in Europe by up to 20%. Historically, the price gap was 30% to 35% depending on the brand and what you were buying. That went up to 50% or 60% for some brands. Now, it is down to more like 20%. "It's exactly the same product whether you buy a Prada bag in Milan or Shanghai, so there is no reason why the price differential should be big," says Fischer. Moreover, China has cut tariffs on luxury goods in recent months, closing the gap even further.

The other driver was store expansion, initially in Shanghai and Beijing and in recent years in second- and third-tier cities as brands sought to expand their customer base. The trouble with huge store rollouts is, as the brands move from large cities, where most affluent people live, to smaller cities, affordability declines. Growth in same-store sales for luxury brands in Asia has been negligible; indeed, in many cases it has been declining for years.

The luxury goods sector has undergone dramatic transformation in recent years. The rise and rise of the Chinese consumer has been the key to the extreme makeover of global brands. "Chinese tend to be more adventurous than other shoppers," notes Fischer. "They are also less loyal to brands than the Japanese or Europeans were 20 years or 40 years ago." That means customer retention costs are going up for most brands. "More money needs to be spent on product design and marketing," he says. As the cost of doing business goes up, margins are compressed. Add that to the fact that global brands can no longer sell the same product at a 50% or 60% premium in China and you have an even bigger problem.

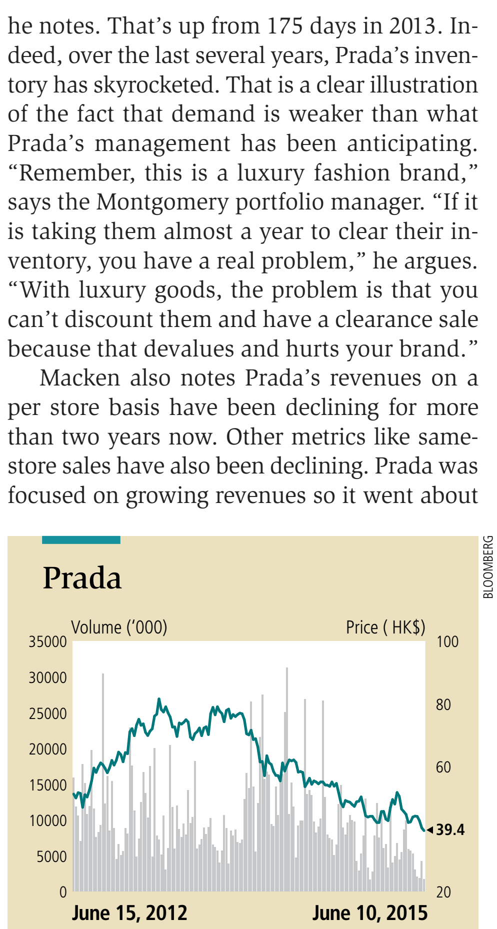
Moreover, the influence of social media in China has had a dramatic impact. "Shoppers are overloaded with information and are looking for the next new thing," Fischer tells *The Edge Singapore.* Ten years ago, anyone buying a luxury watch or handbag went through a small portfolio of brands. "Over the last few years, there has been a proliferation of brands and that's made it difficult to differentiate," he says. Shoppers these days get a lot of information about a brand or a particular handbag on Facebook, Twitter and Pinterest. "We have seen shoppers moving away from brands like Louis Vuitton or Prada to other lower-rung brands because of what they may have seen or read on social media," he adds.

CLSA's veteran luxury goods analyst has a "sell" on Prada even though the stock is already down 52% from its peak in March 2013. "The competitive landscape for luxury goods firms has completely changed and we think Prada will continue to struggle to deliver over the next year or two," he says.

Sydney-based hedge fund manager Macken's case against Prada's stock is simple. President Xi Jinping has embarked on a major crackdown to root out corruption and Beijing mandarins are unlikely to put an end to that campaign in the foreseeable future. "This is a structural, not a cyclical, issue," he argues. "This isn't something that goes away in two or three quarters." The corruption crackdown hurts Prada and other luxury goods makers across the globe because the Chinese now shop in Europe, US, Asia and wherever they travel to.

Just how bad is it? The lack of sufficient new launches, diminishing pricing power in a fiercely competitive marketplace, inflation in its cost base because of an aggressive retail rollout that meant renting expensive real estate, paying higher wages in China, and foreign exchange fluctuations have weighed on Prada over the last two years. But Macken says investors should look no further than the Italian-based Hong Kong-listed firm's inventory numbers. "Prada's inventory is now 240 days," he notes. That's up from 175 days in 2013. Indeed, over the last several years, Prada's inventory has skyrocketed. That is a clear illustration of the fact that demand is weaker than what Prada's management has been anticipating. "Remember, this is a luxury fashion brand," says the Montgomery portfolio manager. "If it is taking them almost a year to clear their inventory, you have a real problem," he argues. "With luxury goods, the problem is that you can't discount them and have a clearance sale because that devalues and hurts your brand."

Macken also notes Prada's revenues on a per store basis have been declining for more than two years now. Other metrics like same-store sales have also been declining. Prada was focused on growing revenues so it went about opening new stores in China. "If you look under the hood, the huge retail rollout was masking their real problems," Macken told *The Edge Singapore* in a phone interview from Sydney. The trouble is that many analysts are giving the firm 80% owned by designer Miuccia Prada and her husband Patrizio Bertelli the benefit of the doubt. "In 2014, we saw both revenue and earnings growth turn negative, but the consensus expectations about future earnings and revenue growth remained positive," he says. "Clearly, the analysts are still way too positive about an early recovery in Prada's revenue and earnings growth when the reality is that their business is still turning down," he says.



The hedge fund manager is betting that the company that operates stores under brands like Prada, Miu Miu, Church's and Car Shoe will announce numbers that are worse than expected when it reports quarterly results next week.He believes the drivers of the company's deteriorating performance in recent quarters like the corruption crackdown, a slowing economy and margin compression are likely to remain in place for a lot longer.

Financial statements

Investors need to step away from its glitzy stores and look closer at its financial statements, says Macken. "Prada is simply not generating enough free cash flow," he argues. "Over the last 12 months, Prada has generated just €113 million ($171.5 million) in free cash flow even though it has a market capitalisation of €12 billion," he notes. "Investors should ask themselves: Do they really want to pay €12 billion for a company that generates only €113 million in free cash flow?"

So, how low could Prada go? Macken refuses to be drawn on where the bottom might be. "I believe it can fall substantially from current levels," he says.

The way he sees it, Prada could be on a slippery slope. Consensus expectations for its earnings, he believes, are likely to come down sharply over the next six months as more analysts wake up to the reality that Prada is a ship that is unlikely to turn around quickly. As expectations are downgraded, Prada's stock price will come down as well, he says.

Macken stresses that he is not suggesting that Prada is going out of business — far from it. "I actually believe Prada is a great business, a good brand," he says. People are still buying stuff from Prada and paying a premium price for the goods, he notes. "What I am asking is: Should investors be paying exorbitant prices for a stock that has no earnings growth to show for and where same-store sales continue to fall?" he says. Prada stock, which has been hovering around HK$39.50, its IPO price four years ago, is trading at 36 times this year's forecast earnings. "The expectations that the stock price implies about future earnings growth in Prada are way too optimistic," says Macken, who used to work for famous short seller Jim Chanos in New York. Chanos, who shorted Enron before its collapse, runs hedge fund outfit Kynikos Associates, which has been bearish on China stocks for years.

What could trigger a big downslide in Prada stock? "We need to see several quarters of Prada failing to meet analyst expectations," he says. Yet, until the earnings miss is so big that investors have no choice but to flee, the stock might just languish. E