Devil wears Prada down but there's still time to bag profit

THE SHORT CUT

with ROGER MONTGOMERY

IT WAS almost a year ago that we picked the Hong Kong-listed global luxury retailer Prada as the world's leading short candidate.

Beijing's crackdown on corruption would hit sales and — when combined with overly bullish analyst expectations and the opening of new stores to boost sales and disguise declining same-stores sales growth — almost all the elements for an opportunity to profit from a declining share price were in place.

The share price has since declined from $HK45 to $HK23.65. The question, of course, is whether the opportunity has now passed.

Before we update the story — and demonstrate whether the opportunity to profit remains — a quick lesson on short selling.

Suppose your neighbour owned a new Toyota Camry with a retail price of $30,000.

Now assume that you knew Toyota would run a 50 per cent-off sale in a month's time. How could you profit from this? Easy.

You could borrow your neighbour's car for a month and promise to return to them a brand new Camry.

After borrowing the car, immediately it sells for $30,000. You now have $30,000 cash and an obligation to return a new Camry to your neighbour in a month's time. When the sale is underway, go buy a new Camry for $15,000 — keeping the remaining $15,000 as profit — and return the just-purchased Camry to your neighbour.

What you have just conducted is a short sale.

Derived from warehousing and inventory management, the trade is called a short sale because you sold stock that you were 'short' in inventory.

The interesting quirk about short selling is that no matter what price you sell a company's share at, the maximum return always remains 100 per cent — if the stock falls to zero.

In other words, even though the share price might have already fallen, the opportunity to profit may not be diminished.

Back to Prada, and it appears the story has not diminished. In the most recent sales update, the company's revenue was flat but a look under the bonnet reveals revenue was down 8 per cent in constant currency terms and down 12 per cent on a same-store sales basis.

The company also confirmed that margins are declining. Earnings before interest and tax fell 28 per cent year on year, cash flow from operations fell 24 per cent year on year and free cash flow is only €30 million ($44.4 million).

Given the market capitalisation of Prada is €6.86 billion, that latter free cash flow number suggests there is arguably still an opportunity to profit from short selling.

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