

LTS Challenge 2023

Empyreo

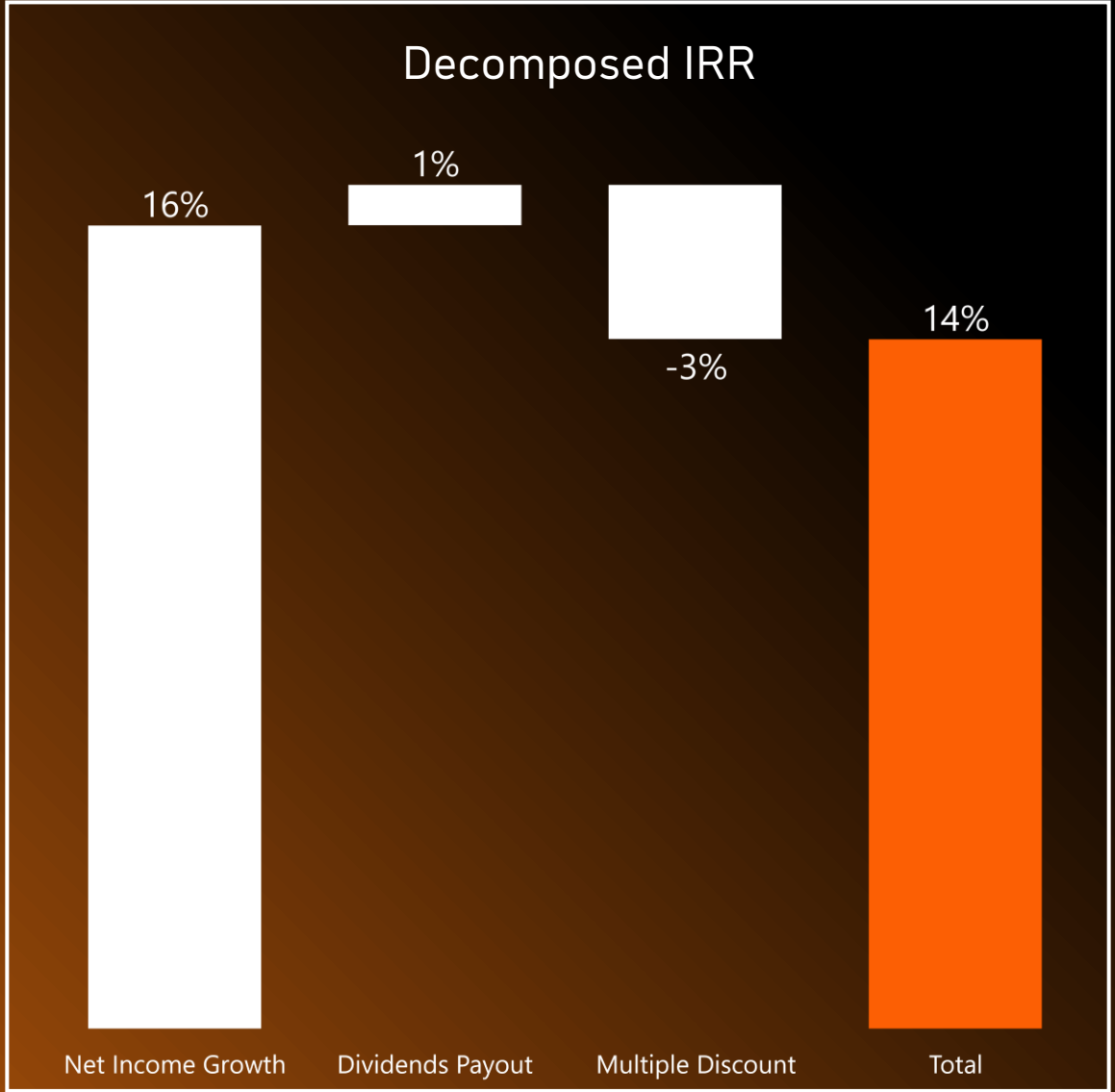
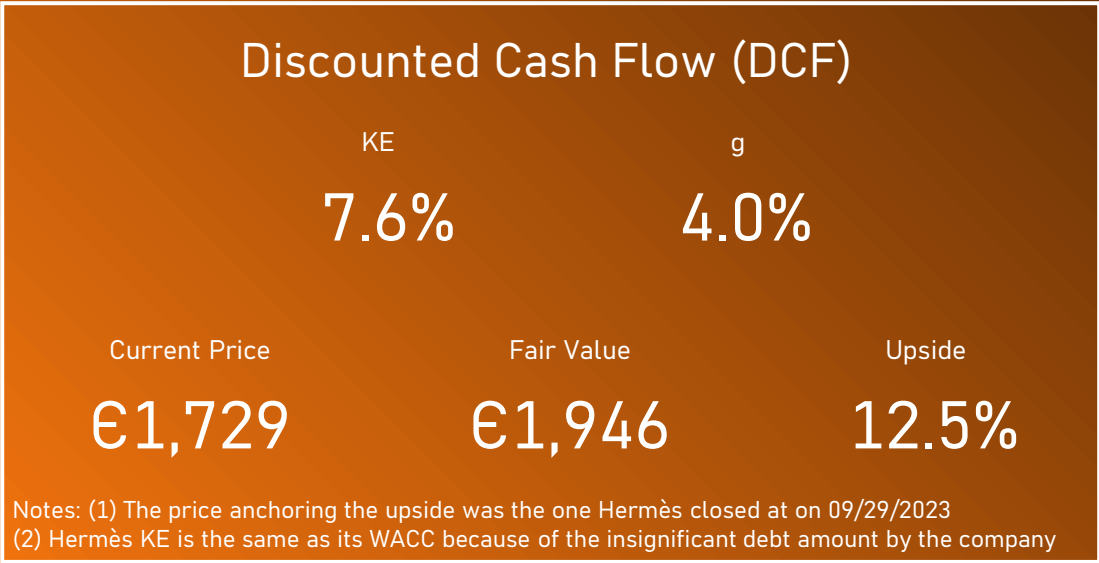
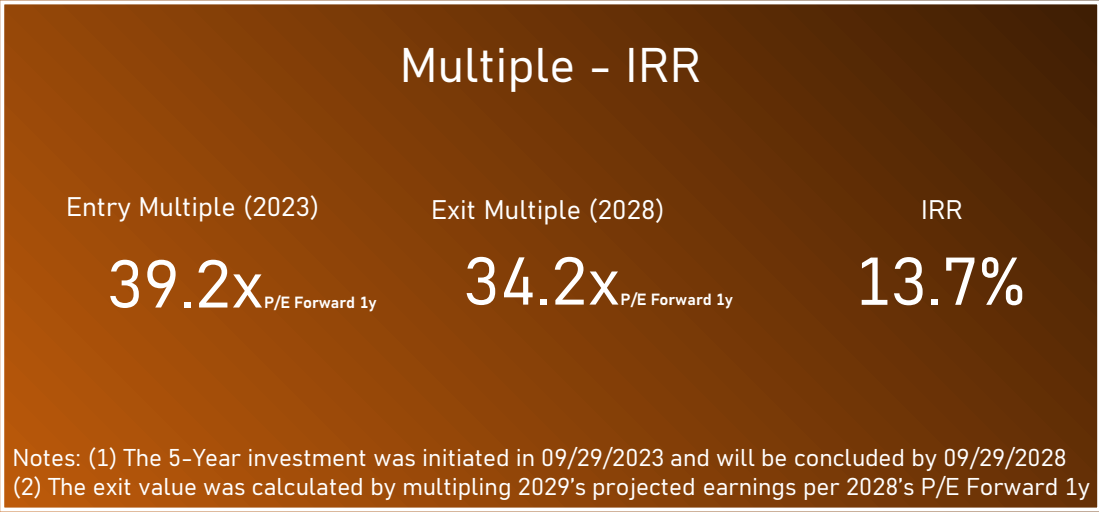
HERMÈS
PARIS

 InFinance
Célula de Finanças | Insper



Hermès – Buy Recommendation

Based on deep analysis of the company, we recommend a "buy" position. Our decision is supported by both multiples and DCF analyses. The focus lies on the multiples analysis due to Hermès trading at a premium not precisely captured by the DCF



Investment Thesis - Based on 3 Main Pillars

HERMÈS
PARIS

1

Irreplicable brand that involves the consumer's loyalty, generates competitive advantages, and increases the company's pricing power and returns

2

Growth driven by wealth increase, Hermès' strong global positioning and product mix

3

An impeccable management structure that is fundamental to the resilience and solidity of the company

Hermès at a Glance

A unique brand with an irreplicable business model

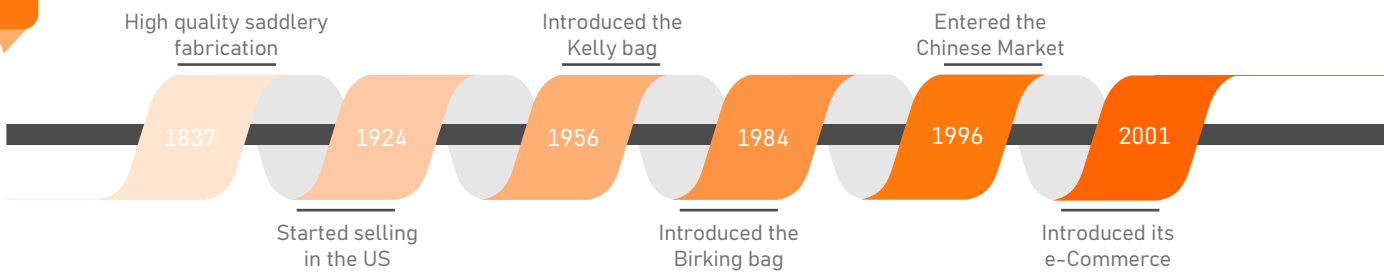
HERMÈS PARIS

Hermès was founded in 1837, by Thierry Hermes. The company designs, produces, and distributes personal luxury accessories and apparel. It sells items such as leather products, scarves, men's clothes, ties, women's fashions, perfume, watches, shoes, hats, gloves and jewelry

Hermès is perceived as one of the most luxurious brands in the world and is known for its traditional craftsmanship, and superior manufacturing

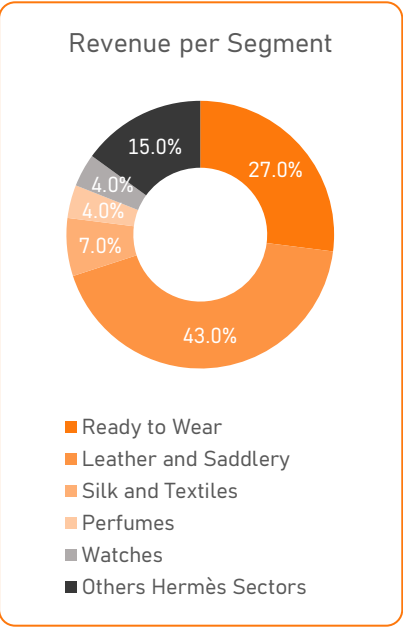
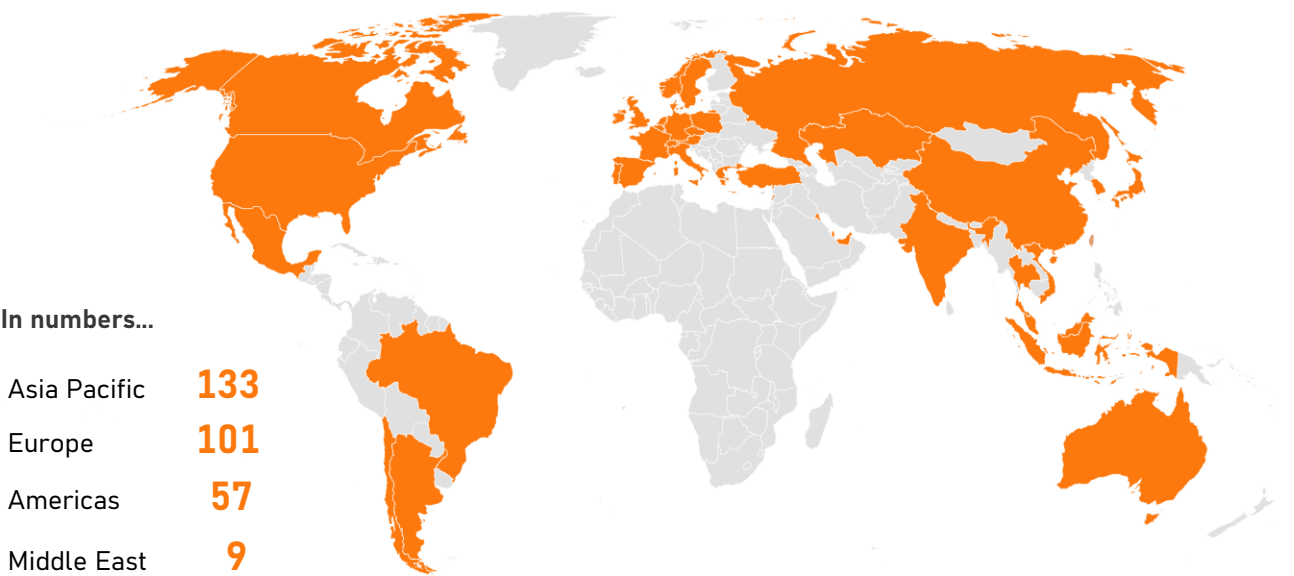
Key Financials

In EUR	
Revenue	11.6 bn
Market Cap	184 bn
Number of stores	303
Number of employees	20,607



The company boasts a robust geographic footprint, actively seeking prime locations for its operations to fulfill its global demand

Hermès Stores Global Distribution



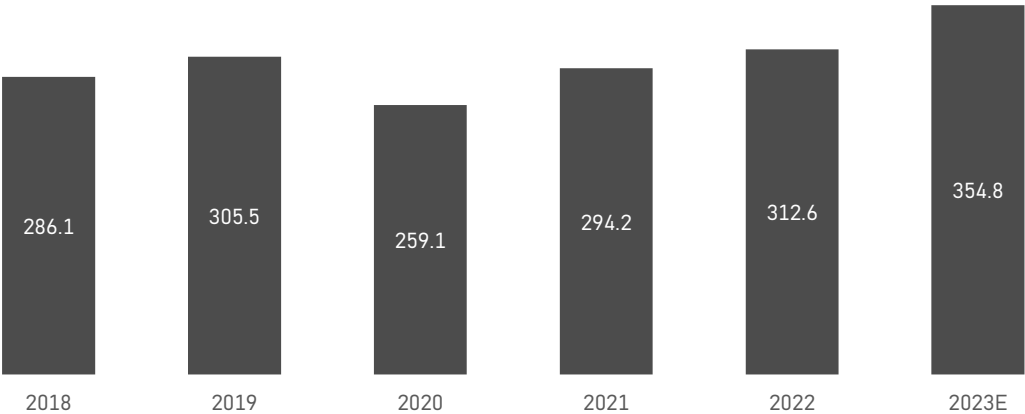
- ### Main Informations
- Managed by the Hermès Family's sixth generation
 - 222 exclusive stores
 - 76% of the production is located in France
 - 68 production and training sights
 - 55% of production in its in-house and exclusive workshops

Understanding how the company is positioned in the industry

Hermès is one of the most iconic brands in the world, being on the top of the luxury pyramid

The Luxury sector grew from US\$286 to US\$312 billions between 2018 and 2022 at a CAGR of 2.24%. Globally, the industry is predominantly concentrated in Asia and in the United States, with a diverse range of subsegments. Those include fashion, leather goods, watches and jewelry, fragrances and cosmetics, as well as eyewear

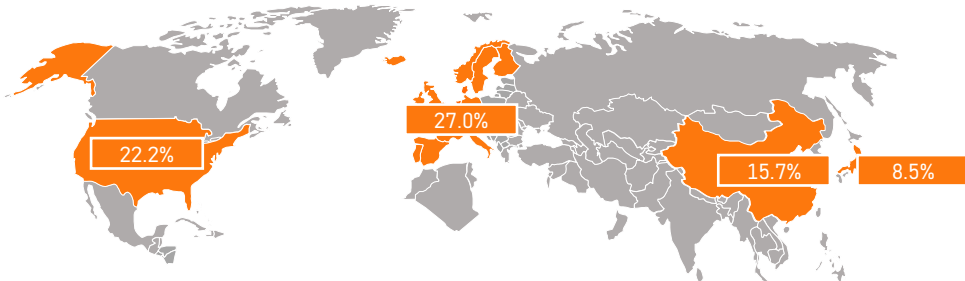
Global Revenue Luxury Goods (US\$ Bn)



Luxury Goods Market Share (2022)



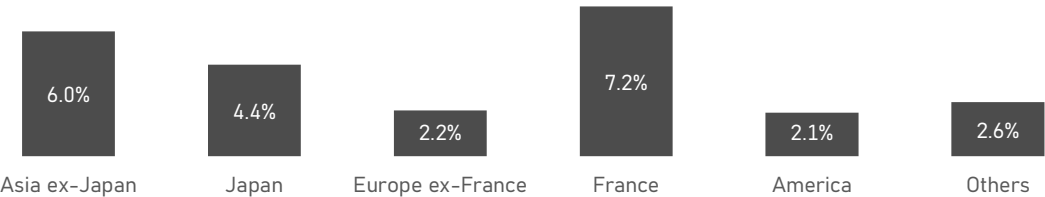
Global Luxury Goods Market Revenue % (2022)



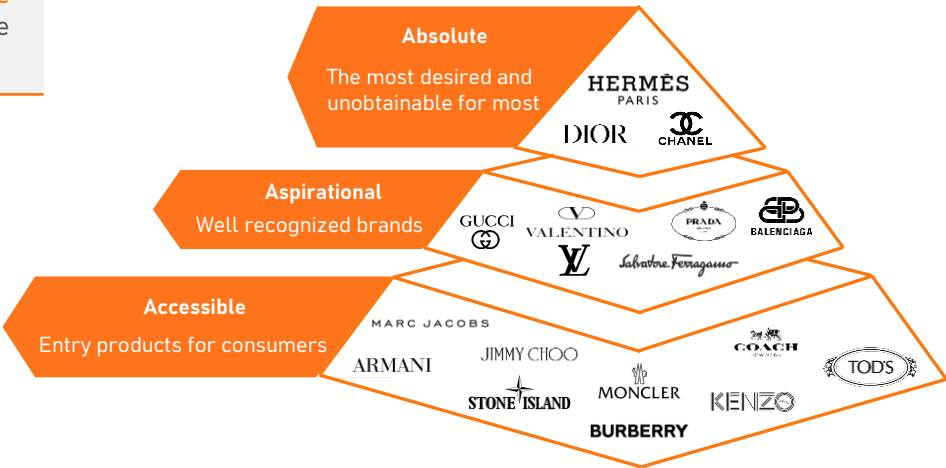
Despite its small market share across the world, Hermès is one of the most important companies in the industry. The company maintains its image through scarcity rather than volume, and has the most exclusive brand among all luxury goods businesses

Hermès has never focused on manufacturing its products in large quantities. Their goal is to preserve the scarcity of its products and assign to them values beyond beauty and quality. This strategy alludes to the company's brand awareness and positions its brand as one of the strongest and most exclusive in the industry

Hermès Market Share per Region



Soft Luxury Brands Pyramid

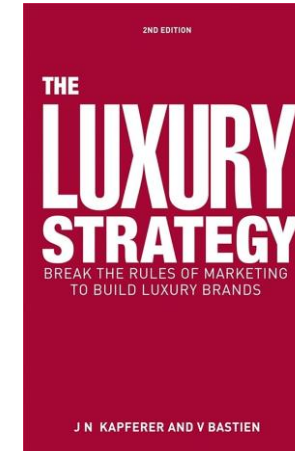
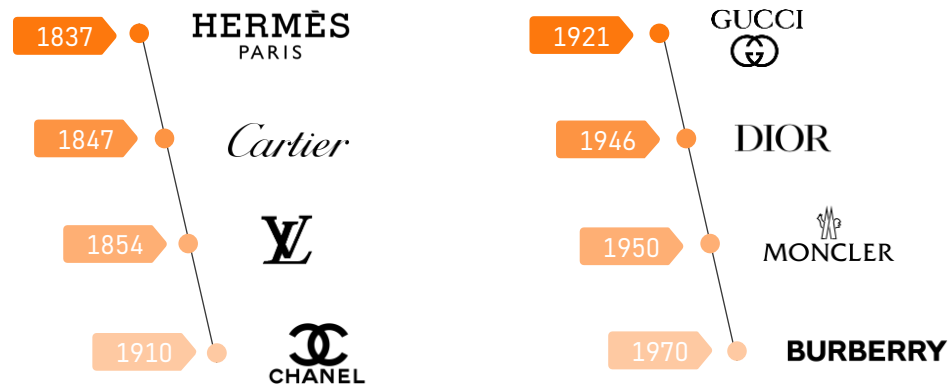


Why is Hermès' Brand Irreplicable?

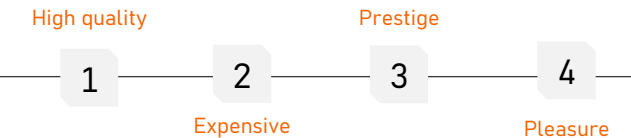
With over 180 years of history, Hermès has built an irreplicable brand through a unique business model

The luxury goods sector presents very **few newcomers** over time. In this regard, companies with a longer brand and history stand out. Through literature, we analyzed what constitutes a strong brand in the Luxury segment. With a solid positioning in pillars such as product quality, brand exclusiveness and brand awareness, Hermès has built strong reputation in the industry

Main Luxury Brands Foundation Date

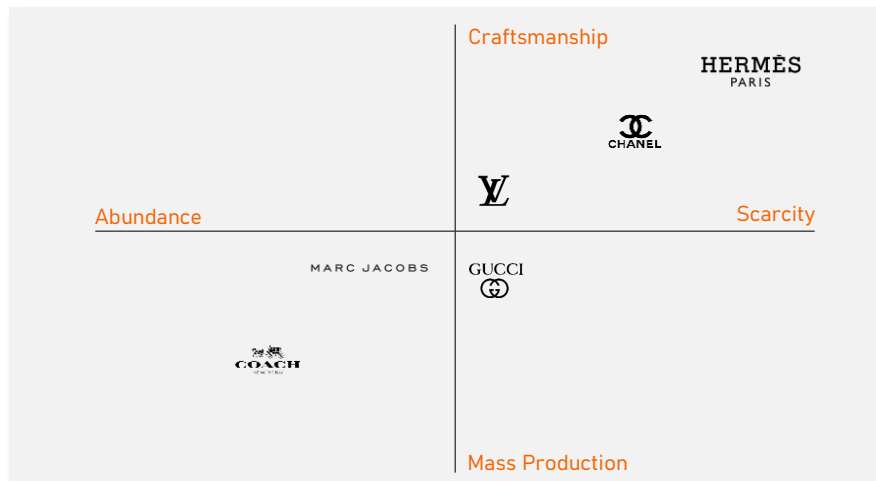


What luxury means for its clients in the six major luxury markets

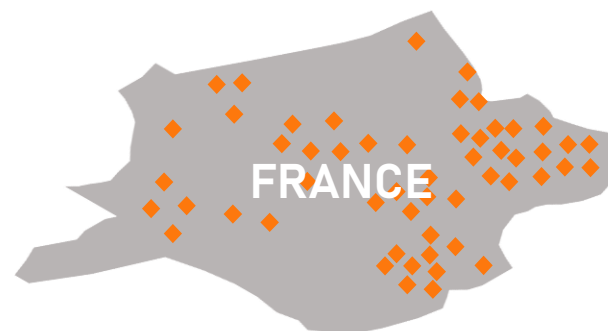


"People learn about what **constitutes luxury** not from their parents or families but from the **brands themselves**, which are **pervasive**, with **highly visible** stores and communications."
J N Kapferer and V Bastien, The Luxury Strategy

Since its foundation in 1837, **excellence in manufacturing** is one of Hermès main concerns. It is for these very principles that the company has always shunned mass production, manufacturing lines and outsourcing. This makes Hermès business far ahead from its competitors in terms of quality and irreplaceability of the products



Hermès Production and Training Sites in France



Hermès has **68** fully owned production and training sites. With production mainly located in France, they certify the qualification of artisans to maintain the impeccable quality of their products

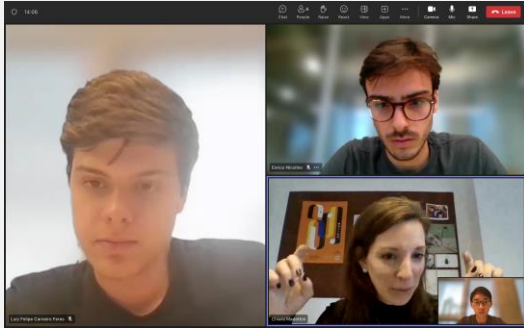
2-year training

There is a mandatory 2-year training for a craftsman before he or she can start working on putting together any leather product in the Hermès portfolio.

Why is Hermès' Brand Irreplicable?

With over 180 years of history, Hermès has built an irreplicable brand through a unique business model

Through conversations with Chiara Mariottini, Director of Hermès Brazil, we analyzed what sets the company apart from other brands and makes it so unique. A series of strategies place Hermès products as the most desirable in the industry



Chiara Mariottini
General Manager at Hermès

“Hermès has **never changed** its path, even in **economic crises** when it can be necessary to **change the path** to increase demand. Hermès has been pursuing **quality, scarcity and uniqueness** throughout its journey

That approach creates a great **identity** which is **difficult to replicate**, since its competitors has always been “**fashion oriented**”, making **different** approaches when facing demand problems

”

Hermès is notorious for its practice of **burning imperfect** Birkin Bags, showcasing its **dedication to the finest quality**

When a product starts selling excessively, Hermès cuts production to **preserve their exclusivity**

Two-bag rule: Individuals are limited to purchasing a maximum of two Hermès bags per year, enabling the brand to uphold its exclusivity

Exclusive and carefully chosen customers patiently wait in line for up to **two years** to purchase a Birkin bag

Other companies have attempted to match Hermès' product quality and pricing capability. In the realm of leather goods, for instance, Chanel aimed to reach that level, which is a **nearly impossible feat**. Through **vertical integration**, Hermès holds the **most qualified** raw materials and cuts off production to maintain the essence of its products and create exclusivity

Case Study: Bag Price War

No brand has ever priced their bags at the level that Hermès does with their Birkin and Kelly Bags.

The situation has evolved, with Chanel increasing its prices. As of 2023, the brand has priced its Timeless Bag at the same level as Hermès' Birkin 25 bag.

Bag Prices (2023)



Hermès' Birkin 25 Bag

\$10,400



Chanel's Timeless Bag

\$10,200

So is Chanel at Hermès' level?

NO!

When it comes to the segment of leather goods (responsible for **43%** of Hermès' revenue), the Orange Brand has **77%** of its production verticalized

This way, they have **greater control of the quality of their products** and are willing to do anything to preserve it. Due to this fact, Hermès has 5 out of the 7 most expensive handbags in the world

Besides performing quality control, Hermès also engages in supply management to sustain desirability.

Patrick Thomas
Former Hermès CEO

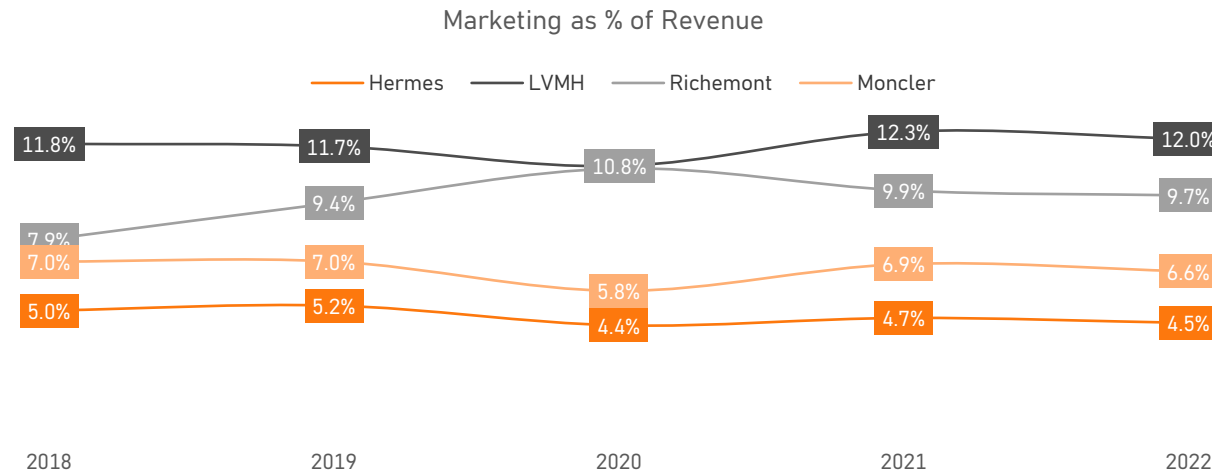


“When a product sells too much, we stop producing it... it should always be necessary to wait to possess a luxury item”

Why is Hermès' Brand Irreplicable?

With over 180 years of history, Hermès has built an irreplicable brand through a unique business model

The capacity of Hermès to convey all the opulence of its products, combined with a production control that generates scarcity, allows the company to have **very low marketing expenses and significant pricing power**



Case Study: Bag Price Evolution (USD)

Hermès' Birkin 35 Bag



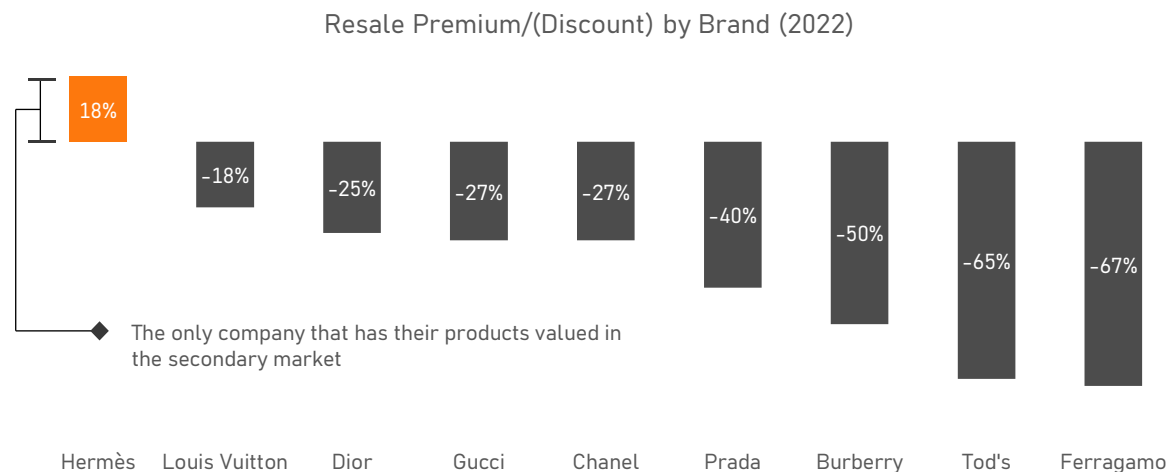
2000	2014	2020	CAGR (2000-2020)
\$4,000	\$11,000	\$12,100	5.69%

Louis Vuitton's Speedy 30 Bag



2000	2014	2020	CAGR (2000-2020)
\$400	\$850	\$1,000	5.19%

Thus, Hermès products **appreciate** over time in both the **primary and secondary markets** compared to their main peers. This gives the company **irreplicable** capabilities, which characterize a strong **competitive advantage**



Mark Urquhart

Partner at Baillie Gifford, investing in Hermès for **20+ years**

"People have tried hundreds of different strategies to compete with Hermès ... They tried pricing at the same level, but they're not substitutes"

Bruce Greenwald
Author of All Strategy is Local

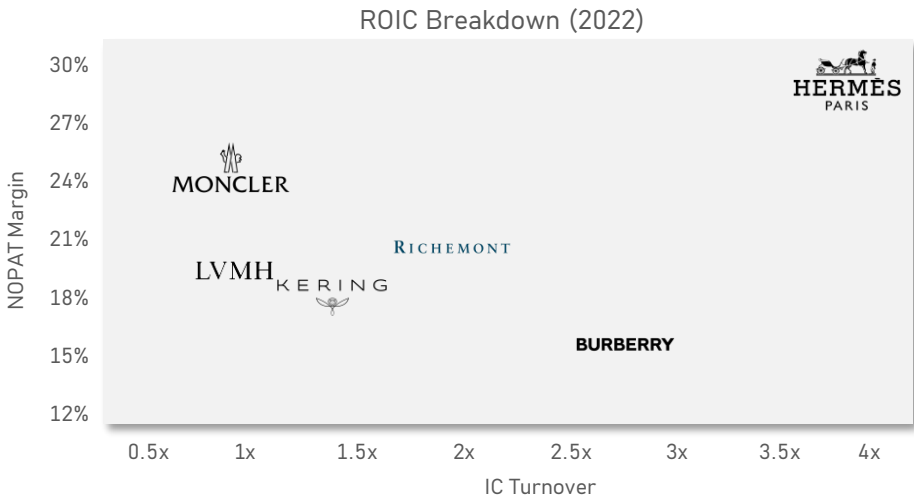
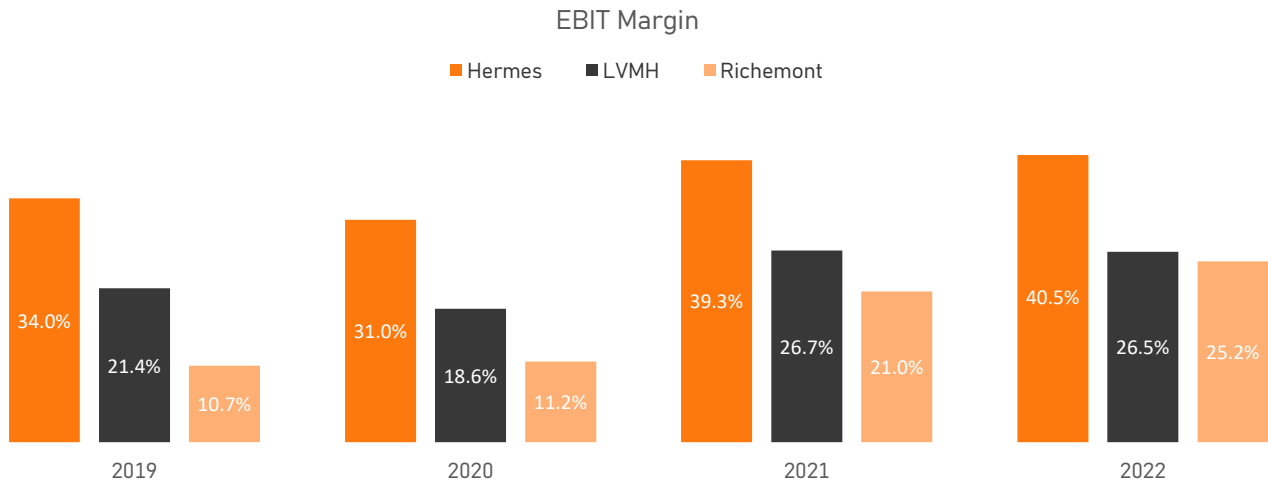


"A competitive advantage is something a firm can do that rivals cannot match" – All Strategy is Local

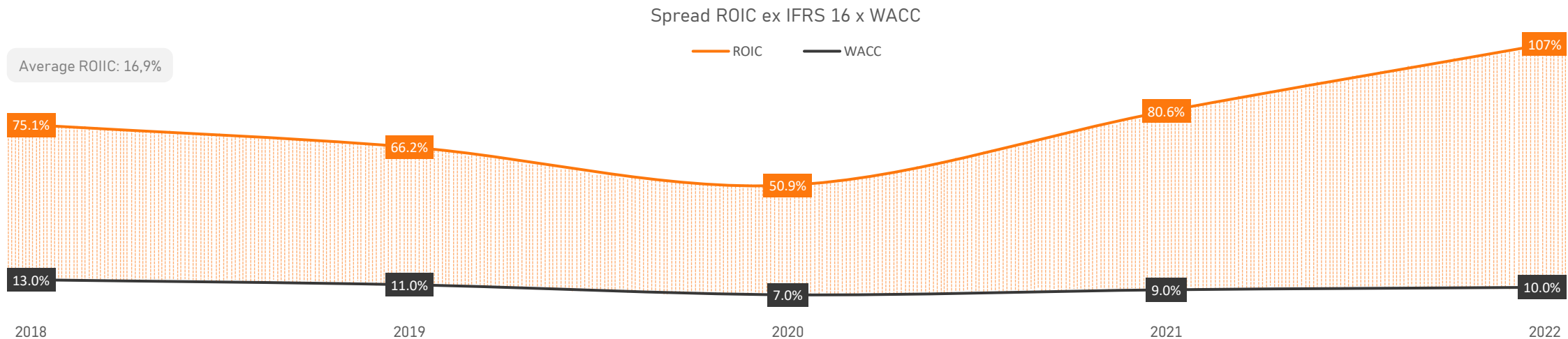
Why is Hermès' Brand Irreplicable?

With over 180 years of history, Hermès has built an irreplicable brand through a unique business model

The clear competitive advantage that the Hermès brand provides to the company results in an **impeccable operational performance** over time and a **Return on Invested Capital well above the industry average**, driven by high NOPAT margin and IC turnover



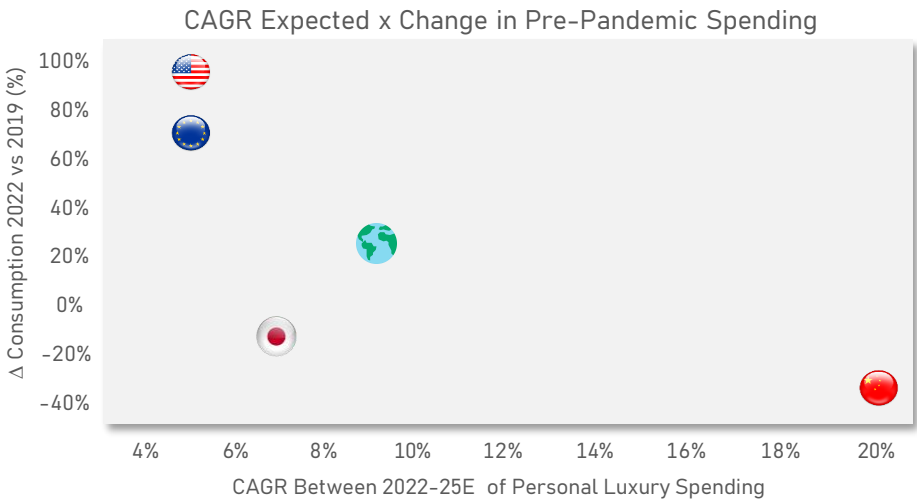
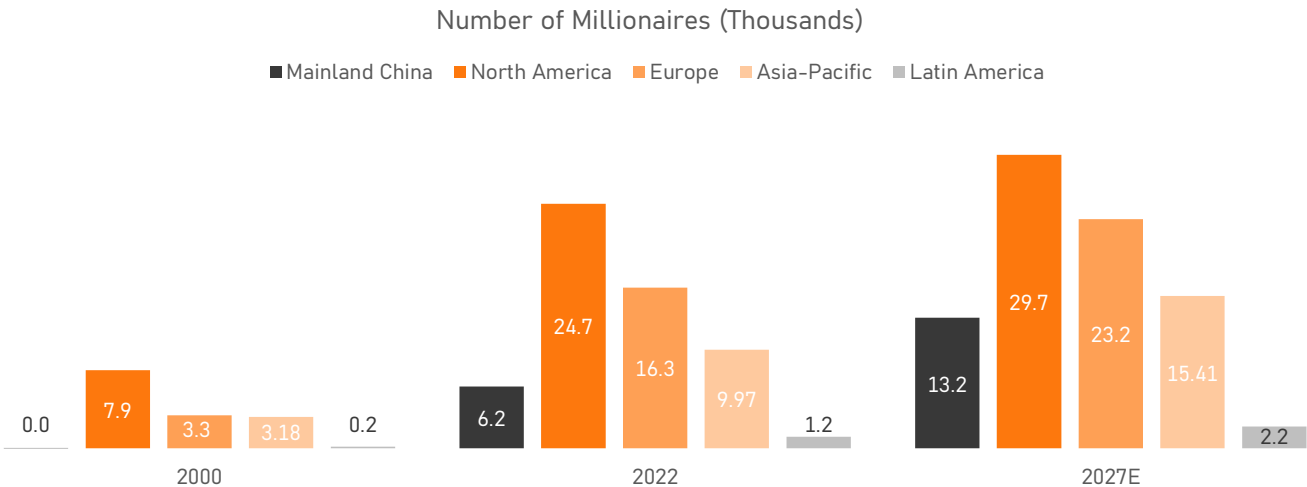
These very high operational margins and Return on Invested Capital drive the company to generate **increasing value over time**, represented by a growing **ROIC-WACC spread** and a positive **ROIIC average** throughout the years



Global Industry Growth as a Tailwind for Hermès

Not only due to the gap generated by the pandemic but mainly due to wealth growth and domestic drivers

Regarding growth, the global wealth reflected in the number of millionaires indicates the **potential for increased spending**. However, it's noteworthy that Chinese and Japanese consumption **has yet to recover to pre-pandemic levels**. This, in conjunction with the growth in wealth, presents a significant opportunity for Hermès **to expand its presence worldwide**



Spending by **Asian consumers**, both domestic and overseas, can be one of the **main drivers** to Hermès. Analyzing how **big** is this market, it is notable to see that a lot of **subsegments** can be explored. Hermès has been doing it successfully, with emphasis in **China**

HERMÈS IN ASIA



Hermès can have great opportunities in underpenetrated categories, such as watches, jewelry and home goods. This mix of products has been growing with the creation of brand lifestyle, through physical stores which create a serendipitous discover.
(Forbes Magazine – “The ‘I didn’t know Hermès made that’ phenomenon”)

Chinese and Korean shoppers are increasingly favoring brands with the highest price points, which they view as status symbols, while cutting on the less expensive, more fashion-oriented or “aspirational” brands favored by Western shoppers.
(Morgan Stanley Research – Chinese Buyers to Boost Luxury Goods Sector)

1st in Hermès Revenue **1st** in Hermès Growth **1st** in Hermès Stores

Zooming in on China

- Chinese domestic consumption has been increasing since COVID-19. In 2018, domestic consumption accounted for 27% of the total consumption, and it is projected to increase to 55% by 2025
- The price gap between China and Europe has been declining. The price difference between China and Europe has been decreasing. In 2017, according to a luxury analysis, it averaged over 50%, whereas in 2022, it had reduced to 23%
- Market Size of Segments in China (2023E):
 - Watches and Jewellery:** US\$ 24.6 Bn
 - Ready to Wear:** US\$ 10.7 Bn
 - Leather Goods:** US\$ 9.1 Bn

Hermès has been successfully increasing its growth and penetration in all segments

Global Industry Growth as a Tailwind for Hermès

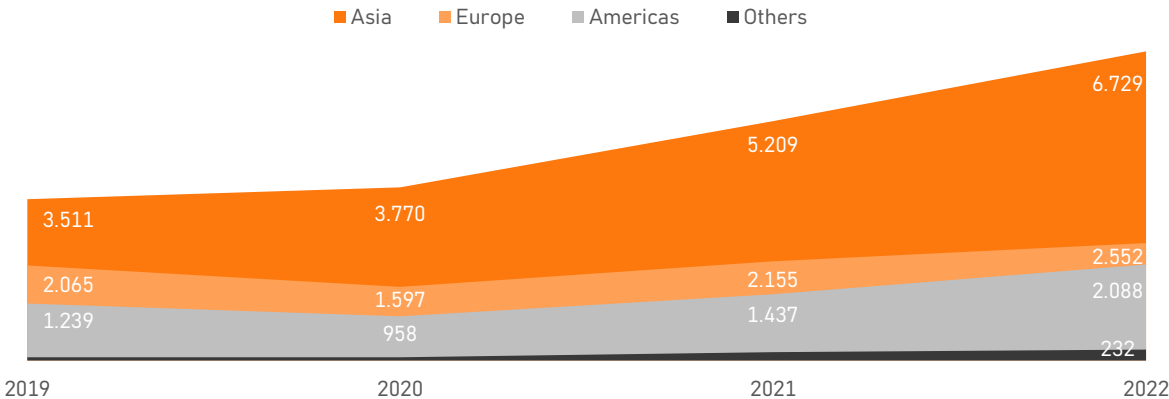
Not only due to the gap generated by the pandemic but mainly due to wealth growth and domestic drivers

By the mentioned global drivers, Hermès is increasingly managing to **capture the growth** in luxury's alternative segments such as watches, jewelry and others. The company's positioning reflects the rise in its revenue across Asia, Europe, the Americas, and other regions

Hermès x Global Market Product Mix CAGR (2017-2022)

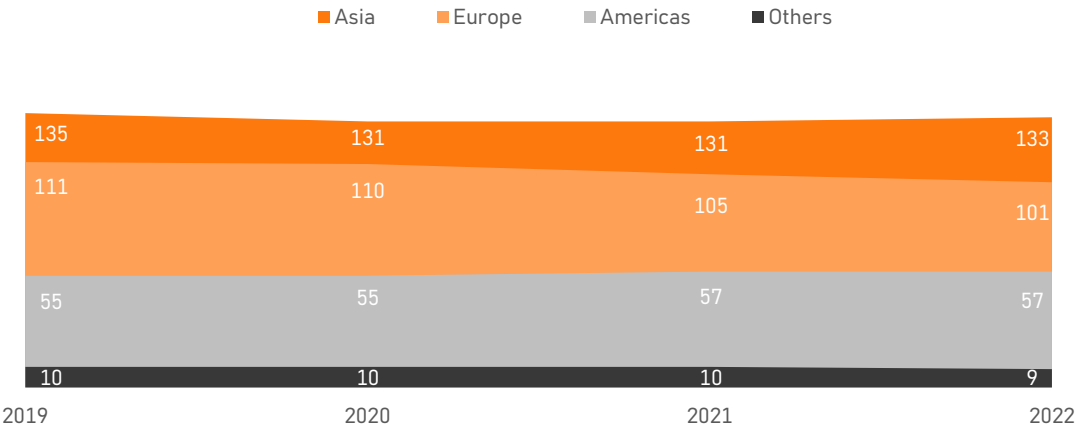
Luxury Segments	Hermès Revenue CAGR	Global Market CAGR	Market Size
Fashion	18.4%	4.7%	102 Bn in EUR
Leather Goods	12.1%	9.4%	80 Bn in EUR
Perfume and Cosmetics	9.3%	5.0%	69 Bn in EUR
Watches	26.9%	4.4%	52 Bn in EUR
Others (jewelry and home goods)	23.3%	14.9%	50 Bn in EUR

Hermès Revenue per Region (EUR Mn)

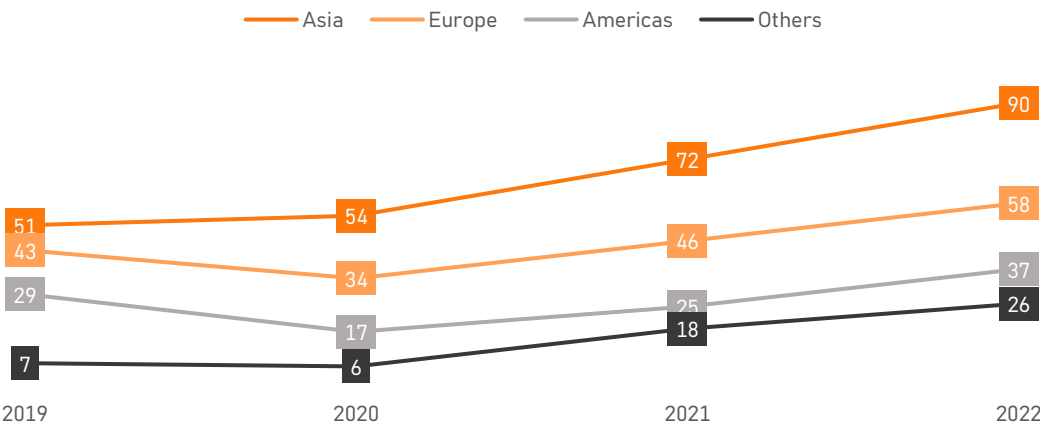


This company's growth is not necessarily due to the opening of new stores, but rather the **increase in revenue per store**, which has grown at a CAGR of 16.2% in recent years, and is the highest in the industry in absolute values

Hermès Number of Stores




Hermès Revenue per Store per Region (EUR Mn)



A Management that Keeps the Gears in Motion

Despite excellent growth and rentability plans, a competent management is essential to guarantee resilience and results

The current CEO, **Axel Dumas**, is a member of the Hermès family and has been in the company for **over 20 years**, where he has built a valuable track record. **Trained in-house**, the current CEO knows Hermès like few others, validating what is pointed out in the book 'The Investment Checklist' by highlighting the success of managements formed in-house



Axel Dumas
Hermès CEO

Assumed the role of Director of the Jewelry Division

Assumed the role of CEO

2003

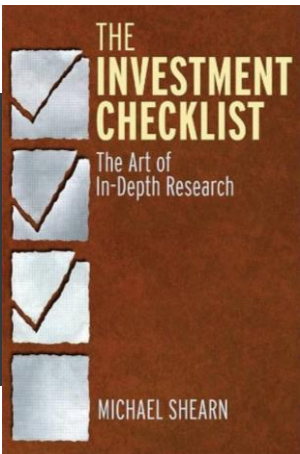
Left Paribas and served as Director of Sales in France

2006

2008

Assumed the role of Director of the Leather Goods Division

2013



“ You want to get a sense of the manager’s understanding of all the divisions and functions of the business. Ideally, a manager would have experienced in multiple positions.


A manager with a lot of organization-specific knowledge is critical to generating long-term growth at a business.

”

The Investment Checklist book also notes that companies with **long-serving CEOs tend to perform better**. Hermès is a notable example, not just in terms of CEOs longevity but also of the company's controllers. The Hermès family, now in its sixth generation, retains more than 60% of the company' shares, showcasing a **strong sense of ownership and a long-term outlook**


Analysis of The Time Served of the Last 3 CEOs

Jean-Louis Dumas




Served for 25 years
(1978-2003)

Patrick Thomas



Served for 10 years
(2003-2013)

Axel Dumas



Served for 10+ years
(2013-Present)

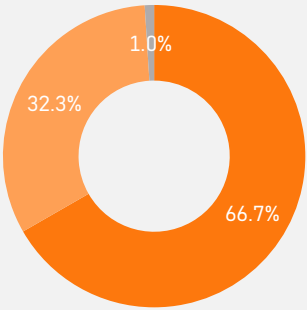
Axel Dumas is the representative of **the sixth generation** of the Hermès-Dumas family. He has guided the company with unwavering dedication through challenging periods, upholding the values of **craftsmanship, quality, and authenticity**

A defining moment of his tenure was **LVMH's hostile takeover attempt**. Ultimately, the Dumas family united to protect the company's independence by establishing a holding company named **H51**, which holds a 51 percent stake and enforces a **20-year restriction** on share sales

Citing Dumas: "It was a big commitment for them to say 'I will put all my net worth there and not sell it for 20 years'. But they did it"

Breakdown of Shareholders

■ Hermès family group ■ Free-Float ■ Treasury Shares



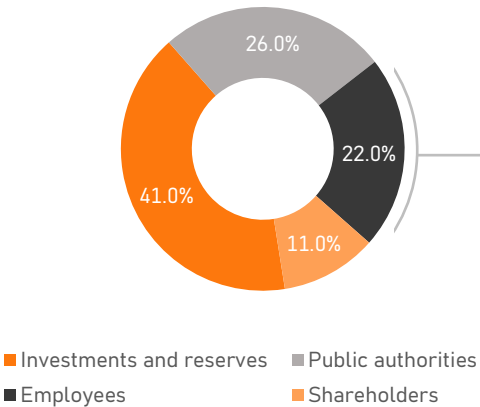
Shareholder Type	Percentage
Hermès family group	66.7%
Free-Float	32.3%
Treasury Shares	1.0%

A Management that Keeps the Gears in Motion

Despite excellent growth and rentability plans, a competent management is essential to guarantee resilience and results

Not only in management and within the Hermès family, but the **sense of ownership** is also very well **conveyed to the company's employees**. With an extensive incentive structure, profound appreciation for craftsmen, and a portion of compensation in stocks, there is a shared commitment among the employees to make today's Hermès even better than yesterday's

Sharing Added Value



Employees

- ◆ €1.5 billion of payroll costs in 2022
- ◆ €4,000 exceptional bonus paid to all employees in 2023 in respect of 2022
- ◆ More than 11,000 employee shareholders
- ◆ Employee shareholding represented 0.98% of the share capital, i.e. over €1.49 billion (Dec. 2022)

Chiara Mariottini talking about Hermès' culture



There is a **very close proximity** between the employees and the headquarters of Hermès in France

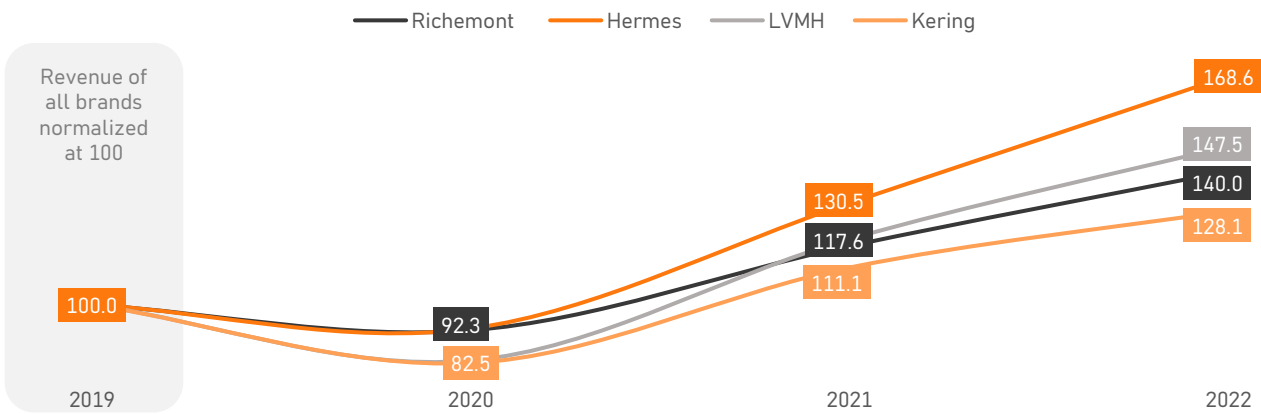
This horizontal relationship among different levels of the company **enriches the culture of ownership** at Hermès, which is very different from other places I have worked

This has greatly helped us to have **resilience during periods of crisis** and to achieve excellent results

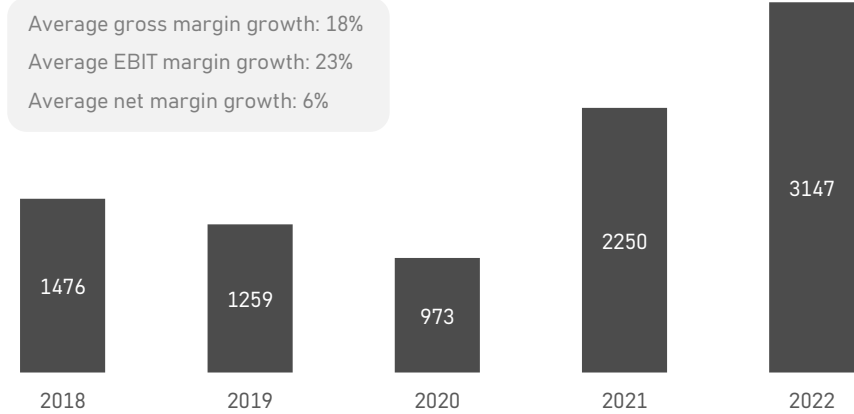
Chiara Mariottini
During our video conversation

All this commitment from the company's management and the culture of ownership present at Hermès employees have led to resilience in periods of crises and to profitable growth. This is evidenced by **Hermès' sales surpassing its peers** and a **consistent generation of Free Cash Flow to the Firm (FCFF)** with **increasing margins** during past years

Companies Sales Evolution



Hermès FCFF Generation ex IFRS 16



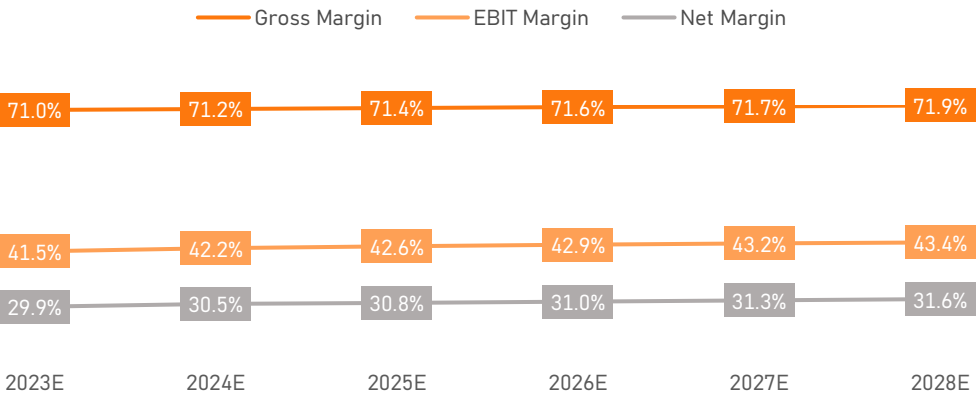
Average gross margin growth: 18%
Average EBIT margin growth: 23%
Average net margin growth: 6%

How is Everything Translated into Future Numbers?

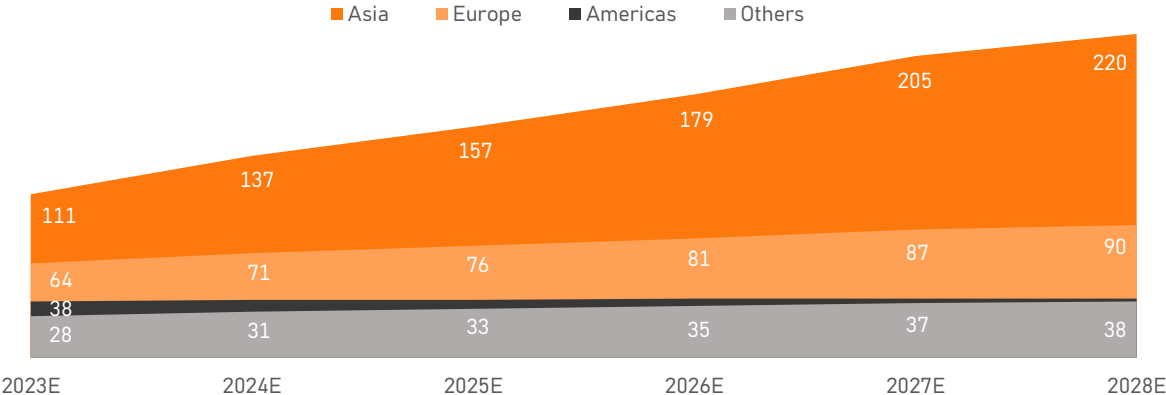
We projected an increase in gross margin through pricing power and a growth segmented by region

We calculated an **average pricing above inflation** for Hermès products, which resulted in a **gross margin increase**. The other operating margins remained in line with the company's historical performance. Regarding revenue, we considered **growth segmented by region**, taking into account the mentioned global drivers and product mix for each region

Hermès Margins Projections

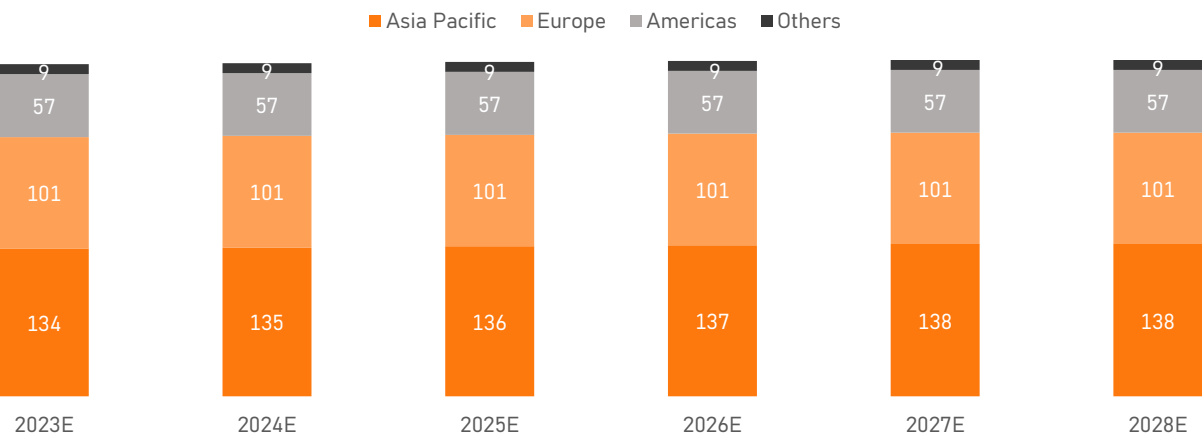


Projection of Revenue per Store per Region (EUR Mn)

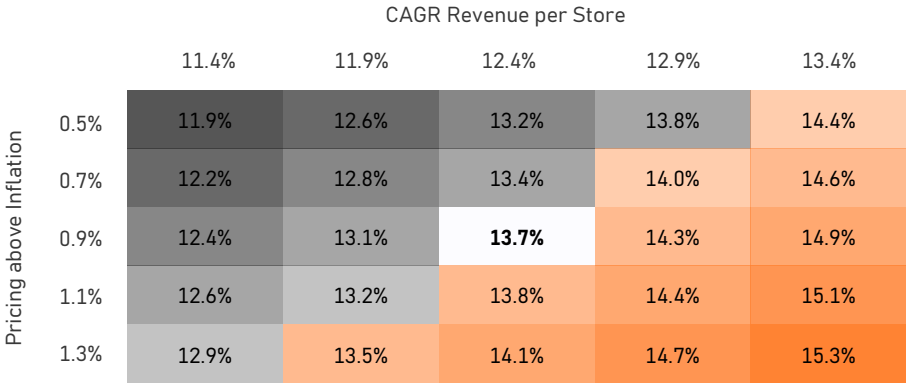


Considering the expected growth of millionaires in Asia and the maintenance of the company's image through exclusivity and scarcity, we **predicted a conservative increase in the number of stores**, all of them opening in **Asia**. Beyond that, we sensitize the two main variables that impact our IRR: **the revenue per store CAGR and the capacity of Hermès pricing above inflation**

Projection of Number of Stores



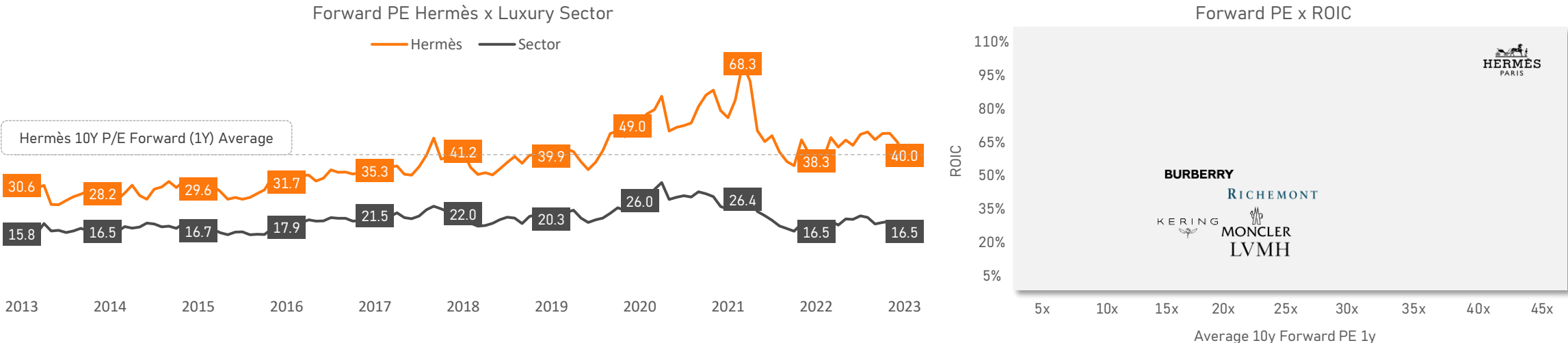
Sensitivity Analysis of IRR



Multiple Analysis

Hermès trades at a premium in its multiples that may decline, but will never converge to the industry average

A football field analysis comparing multiples of Hermès to its competitors and to past transactions would be **invalid**, considering that the company has a much higher multiple than the **industry average** due to its **high ROIC and growth prospects**. Therefore, the use of the **forward PE** aims to value the company based on its **future profit's market perspective**



Over 10-year windows, Hermès has yielded an **average annual return of 20%**, consistently **trading at multiples much higher** than its competitors. This demonstrates that, despite appearing expensive, the company **generates solid returns** for its shareholders. This way, it is **unlikely** that Hermès will have its **multiples decreased** to the market average

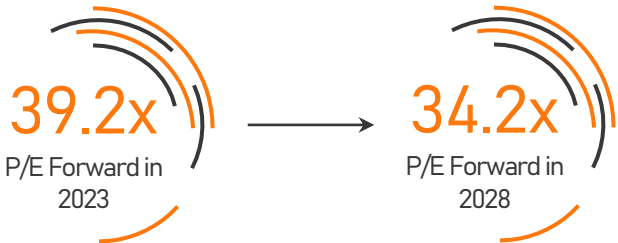
Annualized Return of Luxury Companies

Periods	Hermès	LVMH	Richemont	Kering
1993-2003	26%	23%	12%	21%
2003-2013	20%	16%	24%	13%
2013-2023	22%	19%	7%	15%

When analyzing the performance of these companies over the past three decades and segmenting the data into 10-year intervals, it becomes evident that Hermès is the sole firm that has **consistently delivered approximately a 20% return rate**

Considering all the aforementioned factors, the group holds the view that the valuation multiple at which Hermès is currently traded is **unlikely to reach sector-level lows**. However, we anticipate a **slight decrease in the multiple** as the company's growth potential approaches its **market-assessed limit**

Current multiple at which the company trades at and the multiple used on our exit



Thesis Scenarios and Risks

Group projected scenarios and concerns about the 5-year investment at Hermès

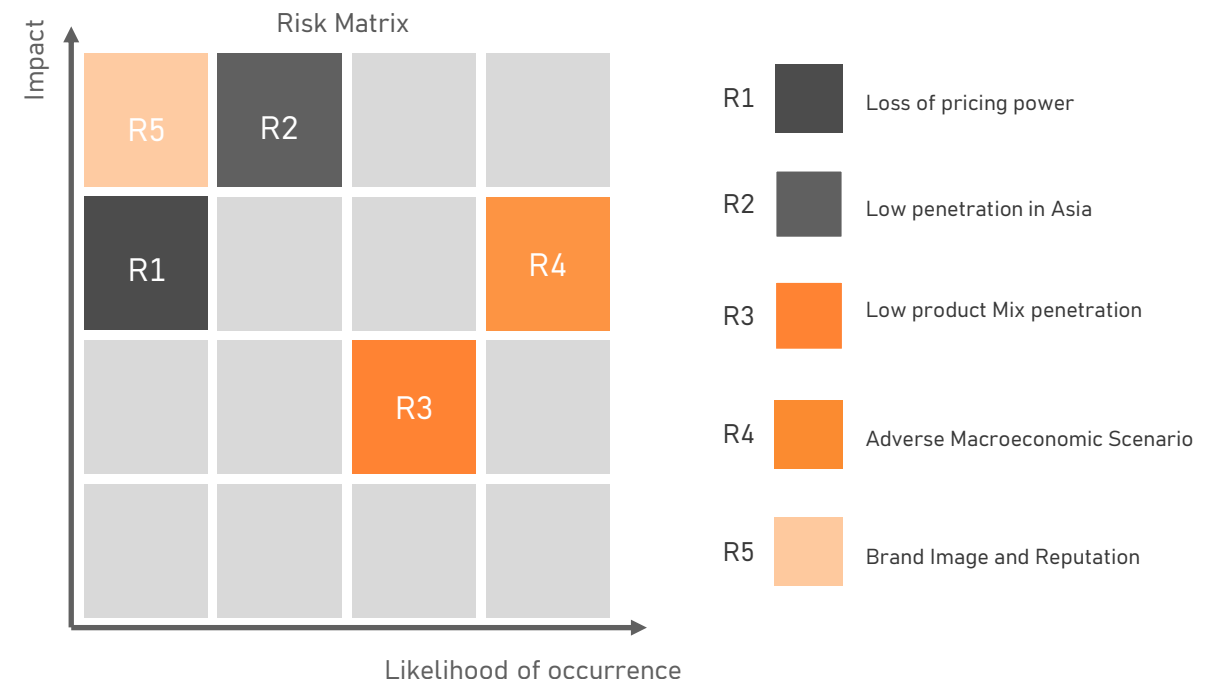
The group considered 3 different scenarios based on different operational assumptions. The base scenario showed an IRR of 13.7% and an upside of 12%. Additionally, the pessimistic and optimistic scenarios considered the occurrence or non-occurrence of possible risks to the thesis. In this sense, we have listed points to be monitored throughout the investment

Scenarios IRR	Bear	Base	Bull
Average Store Opening	0.5	1	1.5
Revenue per Store CAGR	10.0%	12.4%	15.0%
Pricing Above Inflation	0.50%	0.94%	1.20%
Multiple	31.7	34.2	36.7
Payout	28%	28%	35%
IRR	8.8%	13.7%	19.6%

Scenarios DCF	Bear	Base	Bull
Average Store Opening	0.5	1	1.5
Revenue per Store CAGR	10.0%	12.4%	15.0%
Pricing Above Inflation	0.50%	0.94%	1.20%
Perpetuity Growth	3.5%	4.0%	4.5%
Upside	-1.3%	12.3%	27.9%

Following Up the Investment

1. Is Hermès maintaining its pricing power through increasing margins?
2. Is Hermès' Revenue per store in Asia doing well?
3. Is Hermès' mix of products increasing its share in the revenue?
4. Is Management lined up with its employees, strategies and social questions?
5. Will Hermès' sales still be resilient during an adverse economic scenario?
6. How are Millennials and Gen Z spending their money in luxury goods?
7. Will the consumers in emerging countries start saving money because of the current economic forecast?





Thank you!

Empyreo | *LTS Challenge 2023*

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