FUNDS ON FRIDAY
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The Luxury of Winning

Authors: Sam Houlie, Co-CIO: Fundamentals, Differential Capital

Investing is relatively straightforward. As an investor, you want high and continued exposure to winning areas of the market while limiting or avoiding the impact of laggards. This is easier said than done. Consistent execution requires discipline. Global Luxury has been on the winning side of equity markets most recently. High exposure required garnering the correct data, real-time monitoring, a sound decision-making framework and cognitive flexibility.

Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider
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The global luxury sector has experienced wildly fluctuating dynamics leading into and after the Covid pandemic. Going back to 2020, we have seen greater volatility in traditional and correlated data signals. For this reason, the sector provides a perfect example of the fluidity of information and how equity investors could position on the right side of the market. A tumultuous period and a microcosm of modern financial markets.

- We will cover the directional change in data and fundamental signals during October 2023.
- We will highlight the 'pivot' in investor expectations and the upward revisions that followed.
- We will touch on a surprising divergence in mid-December 2023.
- We will elaborate on the resurgence in share prices since mid-January 2024.
- We will postulate on why Richemont is under-represented within domestic funds.
- We will conclude on current expectations for the sector.

A bullish signal

In late October 2023, the confluence of market signals tilted towards bullish. At the time, the prevailing media narrative centred on an imminent Fed interest rate pivot. In reality, certain economic signals in China and the global economy had already turned strongly positive.

Figure 1: OECD China Composite Leading Indicator

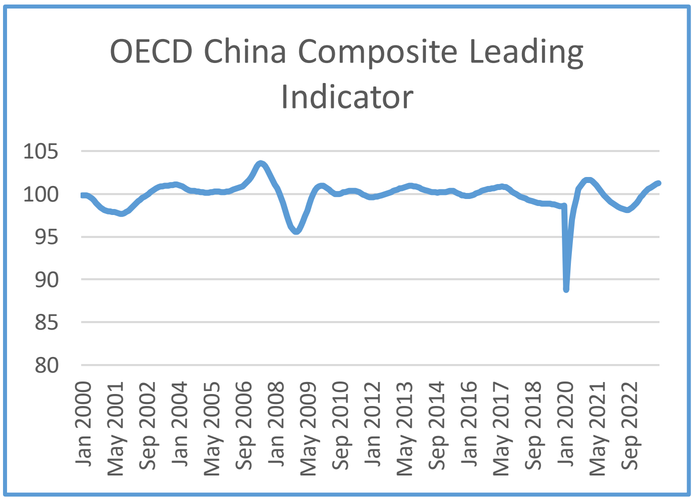
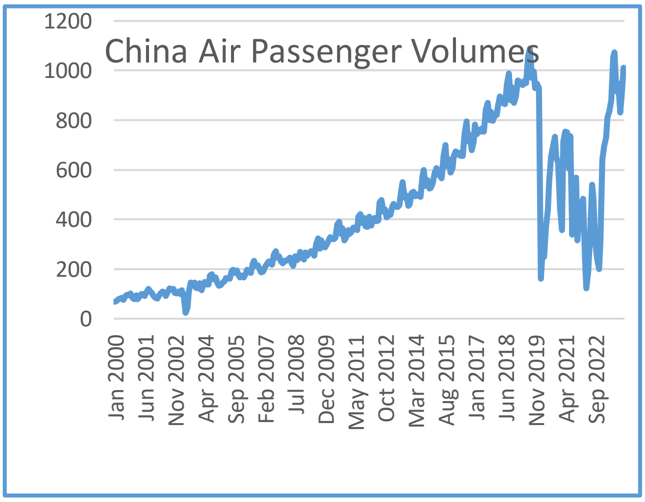
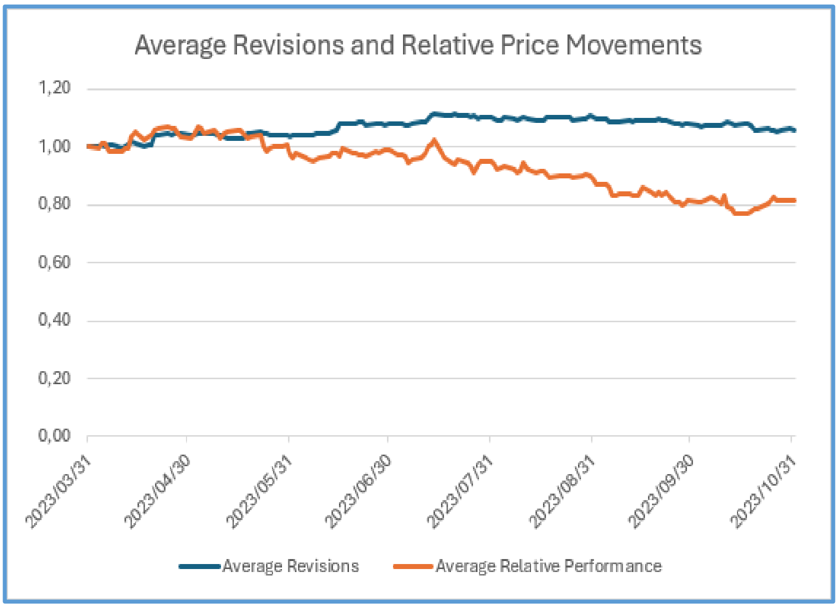


Figure 2: China Air Passenger Volumes



The directional change was conclusive after months of range-bound oscillation. In the preceding six months, the sector had steadily discounted an economic hard landing. Commentators expressed growing expectations of an impending drop in luxury consumer demand.

Figure 3: Average Revisions and Relative Price Movements

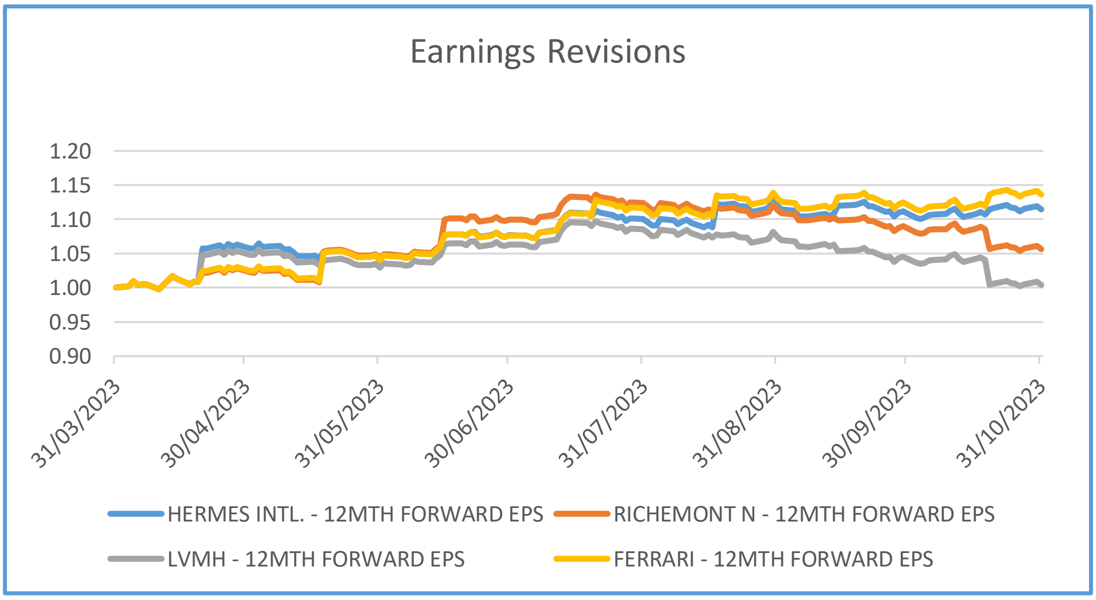


Nobody rang a bell in late October. The positive change in sentiment was abrupt and significant. The reflexivity of market signals and cascading positive revisions caused luxury stocks to lead the market higher. November 2023 was great month for risk-assets in general and luxury stocks were rightfully at the forefront of the rally.

Positive Fundamentals

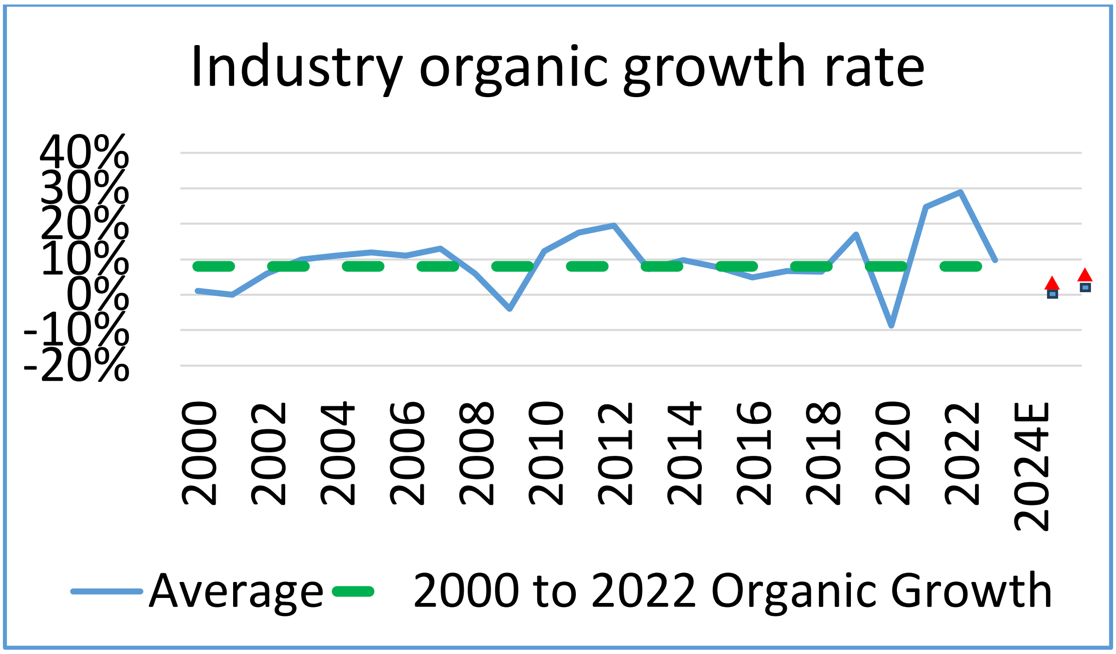
In 2023, market participants seemed to have great difficulty in calibrating the inherent cyclicality of the luxury industry. The previous rally in Luxury stocks (from late 2022 to April 2023) was mostly premised on a post-Pandemic recovery in earnings. Beyond a cyclical earnings peak in 1Q 2023, the market seemed to price in a drop in growth, which was not reflected in a commensurate drop in analyst earnings estimates. In the case of Hermes and Ferrari, earnings estimates continued to advance.

Figure 4: Earnings Revisions



Sanford Bernstein's research shows that medium-term organic growth expectations remained above the long-term industry run rate of 8%. Certainly not the impending doom implied by share price declines.

Figure 5: Industry organic growth rate



Source: Bernstein. Company Reports.

Accordingly, the dramatic sell-off from May to early October 2023 was purely sentiment driven. Subsequent results have proven that analysts were correct in maintaining their earnings expectations.

As a consequence, the explosive rally off the October lows was not speculative. For the global category leaders, the expected drop in consumer demand never occurred. Fundamentals remained strong and were instead being revised higher.

Divergence

Stock market movements can be perplexing at times. Unexpected things happen. In mid-December 2023, the market seemed to inexplicably flip back towards fundamental unbelief. The precipitous decline in share prices that followed suggested that fundamentals were again under pressure. It was a disappointing festive season for global luxury shares, albeit less so for recipients of their exclusive products.

Closer inspection revealed that fundamentals were never truly at risk. Earnings expectations remained high and on track. The moment of truth would come in early 2024 when actual company results would provide a resolution to the growing divergence.

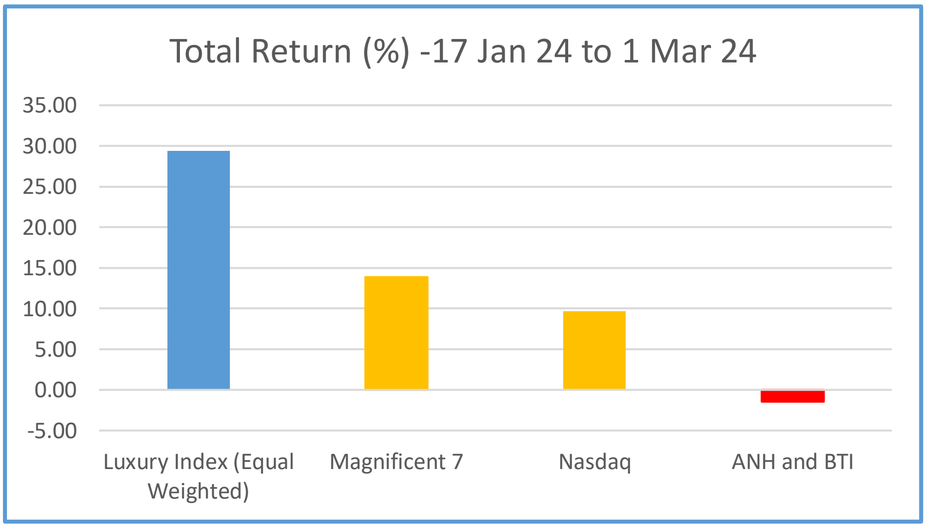
Resurgence

Once again, nobody rang a bell on 17th January 2024. On that day, global luxury shares started reversing their decline.

Richemont was the first large player to provide a trading update a day later. Results were comfortably ahead of expectations. Growth in China was encouraging, and the US acceleration was a positive surprise. Subsequent industry results confirmed that category leaders LVMH, Hermes and Richemont were the undisputed structural winners at this stage of the cycle.

Global luxury shares have led the market since then, performing well ahead of the Nasdaq and keeping in touch with the market favourites. AB Inbev and British American Tobacco Plc, much loved by domestic investors, did not participate in the rally at all.

Figure 6: Total Return %



At the time of writing, global luxury shares remain below their peak in mid-December 2023. While other sectors (like Semiconductors and Technology) remain popular and overbought, luxury has room to rally on improving fundamentals.

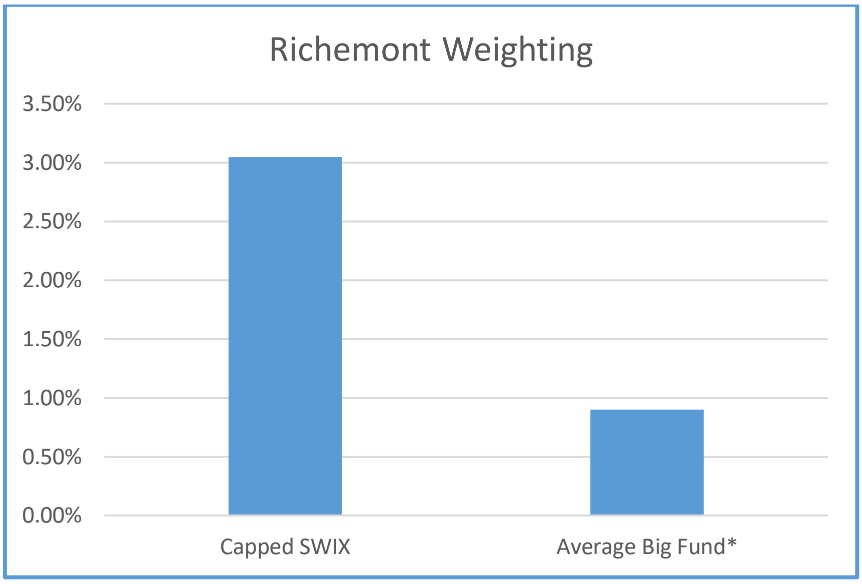
Richemont: Not a crowded trade

Richemont is a unique stock in the South African equity market context. It is the only way for pure domestic equity investors to participate in the global luxury sector. Ironically, domestic investors seem to have a hate-love relationship with the share. Very few have participated in the recent rally, and most appear to have a structural bias against owning the stock.

We cannot explain this fully. However, we do have some observations that may be relevant.

Firstly, it is fascinating that the stock is under-represented in the top holdings of the large Retail Funds in South Africa. We recognise that Reg 28 compliant funds can cast their net wider, including the global luxury sector itself. Richemont is just one of many potential ideas to invest in. The low average exposure is still surprising.

Figure 7: Richemont Weighting



* The average weight within the top 10 holdings of the 7 largest Equity Funds as at 31 December 2023

Secondly, the diversification benefit of holding Richemont seems to be downplayed in favour of other considerations. Relative valuation appears to be the factor that domestic investors struggle with the most. The low PE valuation of the entire SA equity market makes Richemont a glaring outlier. Richemont is considered too expensive to buy, and SA equities are viewed as too cheap to ignore.

It is equally true that Global luxury shares rarely trade at low PE valuations. For that reason, valuation conscious investors have typically missed out on high returns in Richemont (one of the better performing stocks in the SA equity market over time). Beyond valuation and historic returns, there is a strong portfolio diversification argument. It could even be argued that Richemont is the anti-thesis of the average South African share.

Figure 8: Richemont vs Average SA Stock

Richemont		Average South African Stock
Structural growth tailwinds	vs	Structural growth headwinds
Global Reach. Global distribution.	vs	SA only. Local distribution.
Unique Craftmanship. Hard to replicate.	vs	Easy to replicate. Commodity type.
Brand heritage. Pricing Power. Scarcity.	vs	Low Brand equity. Price taker. Abundant supply.
Rand-Hedge	vs	Rand-Centric
High Return on Capital. High Gross Margins.	vs	Low Return on Capital. Highly cyclicality.
Owner-Managed. Exceptional Capital Allocation.	vs	Weak Capital Allocation. Low "Skin-in-the-game".

Strong Balance Sheet. High Cash reserves.	vs	Higher cost of capital. Stretched Balance Sheets.

At the current valuation, an investor in Richemont would have to hold the view that a higher valuation does not necessarily imply overvaluation (and vice versa). Furthermore, if Richemont is held as a source of diversified global growth, an investor would need to view relative valuation as a mere risk factor and not a reason to avoid the share entirely.

Current market expectations: Are they reasonable?

The category leaders (LVMH, Hermes, Richemont & Moncler) are discounting expectations for continued growth in the medium term. The PE ratios for LVMH and Richemont are still below their own history. Hermes and Ferrari are priced in line with their brand exclusivity. Fundamentals are trending in the right direction, and analysts are still upgrading, albeit at a slower pace.

Figure 9: Luxury sector ratios

	P/E Ratio	FwdP/E Ratio	Fwd EV to EBITDA	FwdEV to EBIT
Ferrari	56,9	50,0	30,5	41,7
Hermes	56,1	51,6	33,1	37,1
Moncler	33,9	27,5	14,8	19,5
LVMH	27,9	25,8	14,9	18,7
Richemont	21,7	20,2	11,8	14,8
Kering	17,4	17,6	10,4	14,2
Sector Average	**29,7**	**27,6**	**16,0**	**20,7**

The rally appears sustainable as long as luxury stocks can meet or exceed embedded expectations. As it currently stands, there are no meaningful signs of a slowdown. Lower interest rates and a re-acceleration in the global economy could even usher in a period of higher growth. The industry outlook is bullish.

When to change your mind?

Another benefit to winning is the freedom to change your mind. In December 2023, Richemont announced a change of mind on their sale of YNAP. The facts changed. Market conditions changed. The original deal was struck in 2022, and a year later, they reversed course.

Richemont scraps agreement to sell online retailer YNAP to Farfetch

Reuters

December 18, 2023 6:23 PM GMT+2

The logo of the luxury goods company Richemont is pictured at its headquarters in Bellevue near Geneva, Switzerland, June 2, 2022.

Equity investors can approach the global luxury sector in much the same way. For now, incoming data confirms strong upside fundamentals. Going forward, it comes down to monitoring the relevant incremental data points – if the signal reverses, investors can always change their minds. Richemont did it with YNAP. After all, it is another luxury of winning.

Glacier Research would like to thank Sam Houlie for contributing to this week's *Funds on Friday.*

Sam Houlie
Co-CIO: Fundamentals
Differential Capital

Sam holds the position of Director at Differential Capital and fulfils the role of Co-Chief Investment Officer, overseeing fundamentals. With nearly thirty years of experience as an analyst and portfolio manager in both global and South African financial markets, Sam's career has evolved significantly. In 2022, he made a substantial investment in Differential, an innovative investment manager utilising Data Science, Machine Learning, and AI techniques. A qualified Chartered Accountant and CFA Charter holder, Sam has a rich professional background, having previously contributed to the success of renowned firms such as Allan Gray, Ninety-One, and Counterpoint Asset Management, where he managed award-winning funds across the entire asset class spectrum.