BRYAN, GARNIER & CO

**INDEPENDENT RESEARCH**

2nd June 2017

# Optical & Eyewear Sector

## Review of the situation after the "big-bang"

Optical & Eyewear Sector

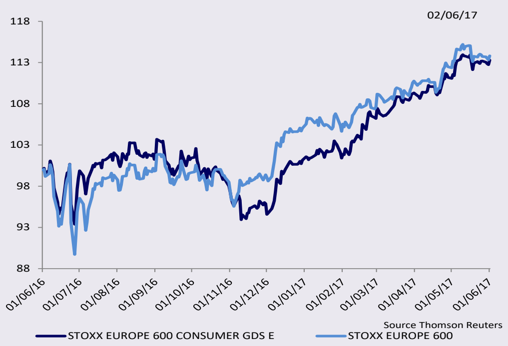
| ESSILOR | | BUY | FV EUR138 vs. 123 |
|---|---|---|---|
| Bloomberg | EF FP | Reuters | ESSI.PA |
| Price | EUR118.75 | High/Low | 123.45/95.63 |
| Market cap. | EUR25,938m | Enterprise Val | EUR27,684m |
| PE (2017e) | 28.1x | EV/EBIT (2017e) | 20.4x |

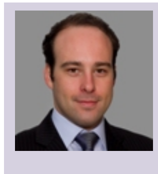
| GRANDVISION | | BUY | FV EUR26.5 vs. 27 |
|---|---|---|---|
| Bloomberg | GVNV NA | Reuters | GVNV AS |
| Price | EUR23.34 | High/Low | 26.13/18.8 |
| Market Cap. | EUR5,939m | Enterprise Val | EUR6,603m |
| PE (2017e) | 22.9x | EV/EBIT (2017e) | 16.7x |

| LUXOTTICA | | BUY vs. NEUTRAL | FV EUR64 vs. 52 |
|---|---|---|---|
| Bloomberg | LUX IM | Reuters | LUX.MI |
| Price | EUR53.9 | High/Low | 55.1/40.55 |
| Market Cap. | EUR26,112m | Enterprise Val | EUR27,048m |
| PE (2017e) | 26.8x | EV/EBIT (2017e) | 17.5x |

| SAFILO | | NEUTRAL | FV EUR6.5 |
|---|---|---|---|
| Bloomberg | SFL IM | Reuters | SFLG.MI |
| Price | EUR6.73 | High/Low | 9.915/6.24 |
| Market Cap. | EUR422m | Enterprise Val | EUR464m |
| PE (2017e) | 35.1x | EV/EBIT (2017e) | NS |

Prices as at close of 30th May





**The EssilorLuxottica operation has reshuffled the cards in the optical sector prompting all players to position themselves in terms of vertical integration issues and control of the value chain, while Kering and LVMH are gradually bringing their eyewear businesses back in-house. We analyse the outlook for the four groups in our sample in this new context and review the situation in the US market.**

- **EssilorLuxottica: the new sector giant.** The combined entity is set to become the most vertically integrated player in the sector with full control of the value chain, very complementary products and brands, and the opportunity of creating a unique omnichannel strategy in the industry thanks to Luxottica's ~8,000 stores. In this report, we set out our synergy estimates (EUR508m in 2021 vs. the official target for EUR400-600m, leading us to a CAGR in adjusted EPS of 12% over 2018-21 (excluding additional D&A of EUR508m).

- **GVNV + SFL: the next major deal?** SFL could be weakened by the risk of departure of the five LVMH licences as they expire (around 27% of total sales). HAL, which owns 77% of GVNV and 42% of SFL could be tempted to merge the two in order to create a mini-Luxottica. While this seems attractive on paper (19% boost to 2019e EPS at GVNV), we explain why the deal has little chance of materialising (opposing strategies and positioning, urge to remain independent for both groups etc.).

- **The US – 37% of the global market – Back in the Game!** In 2016, the leading global market suddenly slowed during H1, taking a toll on the sector's operating and stockmarket performances. The US market showed signs of a recovery in Q1 whereas a large number of initiatives undertaken by the groups are gradually set to pay off throughout 2017. The US market is becoming a positive catalyst for the industry again.

- **Multiples are underpinned by the gradual improvement in fundamentals and the merger of EI-LUX.** Excluding SFL, our three stocks have 2018e PEG ratios of 2.5-2.8x whilst EI-LUX trades at 2x. Note that the 12m forward P/E of our three optical stocks totals 1.67x whereas the average of the past five years was 1.9x.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# 1. The EssilorLuxottica "big-bang" shuffles the cards in the optical sector

Since the announcement of the merger on 16th January and our report of 18th January, a few milestones have been crossed in the project. In this section, we review some of the major points of the operation and try to anticipate what the implications could be for other groups in our sample.

## 1.1. No merger… at least in the short term

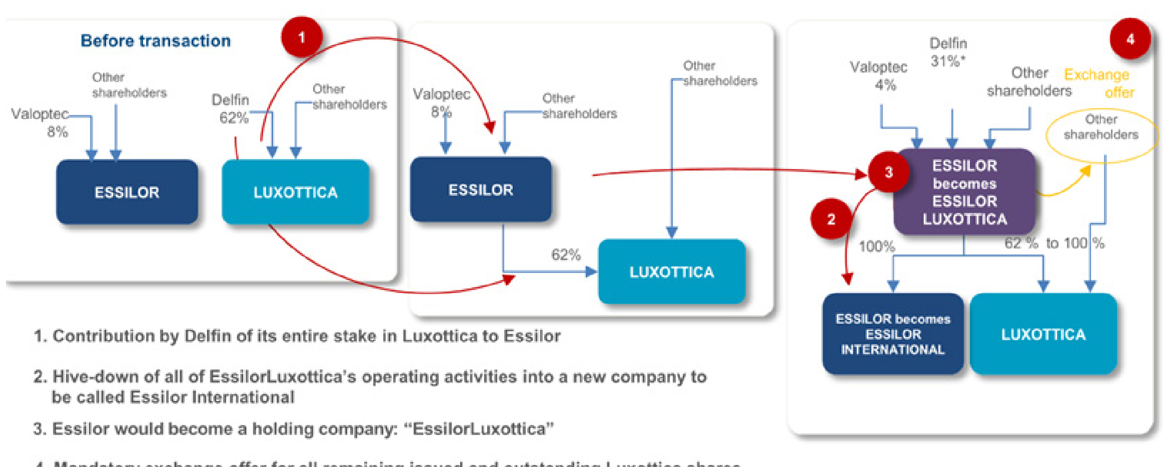
### 1.1.1. Legally: Essilor is acquiring Luxottica…

Following the operation, Essilor will legally be turned into a listed holding company (on the Paris bourse) and renamed EssilorLuxottica, which will hold a 100% stake in Essilor (newly created to house the operating activities) and between 62% and 100% of Luxottica depending on the success of the minorities buy-out operation:

- **EssilorLuxottica** is to be co-managed by Leonardo Del Vecchio and Hubert Sagnières with the backing of a Board of Directors made up of 16 members (eight from Essilor and eight from Luxottica). The holding company is also set to welcome an Integration Committee responsible for executing the synergies plan, the integration process and defining the two-group's targets.
- **Essilor** and **Luxottica** are to remain two separate groups with a distinct organisation and management. In our view, Laurent Vacherot (Essilor) and Massimo Vian (Luxottica) will head up operating management.

This form can be explained by the relatively cautious synergies target (EUR400-600m over four/five years), since there is no genuine merger, but we therefore expect this to **limit the integration risk** that we feared especially since the two companies have a relatively strong corporate culture.

**Fig. 1: Main stages and structure of the new pairing post-operation:**




*Source: Essilor*

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### 1.1.2. … but from an accounting stance, the opposite is happening

In the reference document concerning the issue of new Essilor shares aimed at remunerating the contribution from Delfin (published on 7th April), **it is stated that from an accounting perspective, "*Luxottica is deemed to acquire Essilor*"**, a situation similar to that of a reverse takeover.

The table below sets out the stakes of each of the two entities based on this accounting nuance. This also has an impact on the valuation of the counterparty transferred (Essilor in this case), which is based on the price of the Luxottica share on 31st March 2017 (EUR51.75) as well as on the exchange parity, which remains at 0.461 Essilor shares for one Luxottica share.

In addition, the accounting process implies a revaluation of intangible assets (EUR6.8bn net of book value) rather than those of Luxottica, resulting in pro-forma preliminary goodwill of EUR12.6bn.

**Fig. 2: Valuation of counterparty transferred (= Essilor):**

| As of March 31, 2017 | Full conversion of LUX shares (Contribution + 100% of minority interest) | Partial conversion of LUX shares (Contribution + 0% of minority interest) |
|---|---|---|
| Number of Luxottica outstanding shares (m) | 477.0 | 298.1 |
| Exchange ratio (x) | 0.461 | 0.461 |
| Equivalent in Essilor shares (m) | 219.9 | 137.4 |
| Number of Essilor outstanding shares (m) | 216.5 | 216.5 |
| **Percentage shareholding of Essilor in combined group** | **49.6%** | **61.2%** |
| **Theoretical value of Essilor (EURm)** * | **24,299** | **24,299** |
| Theoretical share price | 112.2 | 112.2 |
| Current share price (as of May 30, 2017) | 118.8 | 118.8 |

** = EI existing shares **x** (LUX share price as of 31st March EUR51.75 / Exchange ratio) = EI existing shares x EI implied share price*

** Source: Company Data; Bryan, Garnier & Co ests*

Although Essilor has provided any reasoning for this accounting process (Luxottica acquiring Essilor), we believe there are two possible explanations: **1/** the fact that Leonardo Del Vecchio is to become the key shareholder in EssilorLuxottica (31-38% of capital) and **2/** the revaluation of Essilor's intangible assets is less complicated than it would have been to revaluate Luxottica's given the numerous brands/banners that are still valued at their historical cost, but which have enjoyed excellent operating performances since their takeover. This fact is particularly true for Ray-Ban, acquired for USD640m in 1999 and fully amortised after 2018.

Based on the figures set out above, **the merger is set to prompt additional depreciation and amortisation of at least EUR580m.** Note that 2017 EBITDA for the two groups combined, before integrating these new impacts, was expected to total around EUR3.9bn.

We therefore understand that Luxottica's reporting method could be adopted by EssilorLuxottica since Essilor's R&D expenses were reclassified into COGS rather than in operating expenses as was the case at Essilor until now.

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## 1.2. Obvious complementary factors

The two charts below illustrate the significant complementary factors existing between the global leaders in ophthalmic lenses (Essilor) and frames/sunglasses (Luxottica), in terms of both categories and distribution channels. This is why around 50% of the synergies planned for the MT (EUR400-600) are due to stem from revenue synergies.

**Fig. 3: Complementary categories and distribution circuits:**

| | Key success factors | ESSILOR | LUXOTTICA |
|---|---|---|---|
| Ophthalmic Lenses | R&D / Brands / Supply chain | +++++ | + |
| Sunglasses/ Frames | R&D / Brands / Supply chain | + | +++++ |
| Distribution | Scale / Diversified channels | ++ (online) | ++++ (retail + online) |

*Source: Company Data*

This symbiosis is naturally found in the portfolio of brands where the future group is set to combine highly reputed corrective lens brands with the Italian's group's premium and luxury names. The combination of the two portfolios will provide an opportunity to offer customers combined solutions (frame plus lenses), thereby helping to drive up the value of the optical market.

**Fig. 4: An unrivalled brand portfolio:**

*Source: Company Data*

Three examples of complementary aspects already stand out:

**(i)** **The US market:** schematically, Essilor should be able to increase penetration of its brands within the major Luxottica chains, while Luxottica should make the most of Essilor's high density among independents.

**(ii)** **Sunglasses:** with the exception of Costa, Essilor's portfolio of sunglass brands is only made up of readers and mid-scale brands whereas the Italian group only has premium & luxury brands, an ideal situation to start a multi-network strategy.

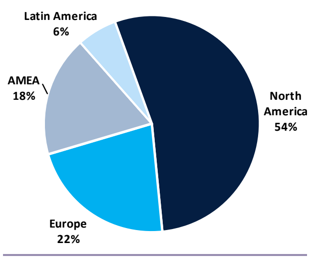
**(iii)** **Omnichannel:** the online circuit is rapidly expanding. Like other consumer segments, especially clothing, the convergence of Essilor's online platforms with Luxottica's stores is set to create a huge competitive edge!

Please see the section headed "Important information" on the back page of this report.

# 1.3. Example no. 1: the US market

## 1.3.1. Sharing the supply chain in ophthalmic lenses

Breakdown of EssilorLuxottica sales:




Source: Company Data

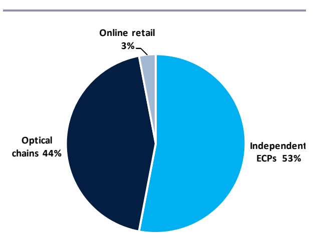
The US market is already by far the leading market for both Luxottica and Essilor (respectively 56% and 47% of sales) and naturally set to remain so since the merger has been ratified given that North America is set to account for 54% of the new pairing's sales (*see chart opposite*).

As the chart below shows, the US ophthalmic market is characterised by the presence of prescription labs, which are the virtually unavoidable intermediaries between opticians and lens manufacturers. Essilor dominates this wholesale distribution with almost 125 labs throughout the US, whereas Luxottica has completed construction of its mega-lab in Atlanta. This initially aims to cover lens requirements for LensCrafters (@ Macy's, followed by those of other stores, in order to eliminate the in-store labs further out.

**In our view, sharing the supply chain between the two groups should generate efficiency and productivity gains:** for example, the labs will be able to assemble glasses faster thanks to a shared inventory management in real time for frames and lenses, while lens volumes for the various Luxottica chains will probably be directed as a priority to the combined entity's labs (=> economies of scale).

## 1.3.2. Cross-selling opportunities in optical distribution

Breakdown of US ophthalmic market (2015, %):

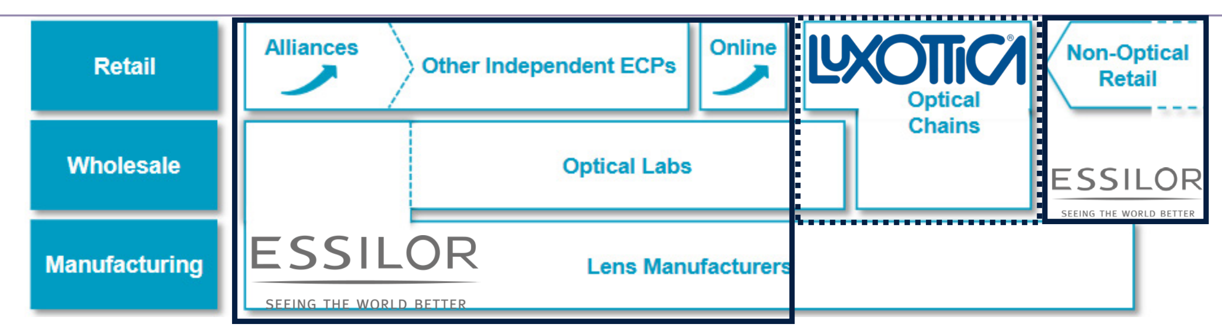



Source: VisionWatch

Within the US ophthalmic market, the positions held by the main chains and independent players are well balanced (*see chart opposite*) even though independent players have managed to increase their market share over the past decade (+3 points to 53%). However, as the chart below again highlights, the two groups share very complementary aspects: **Luxottica** has clearly focused on its four optical chains whereas **Essilor** boasts good coverage of independent opticians/optometrists, especially following the acquisitions of several independent cooperative optometrists (Vision Source, PERC/IVA, etc.). Note that **Essilor** also addresses major chains such as Walmart and Costco which were not customers of the Italian group.

**As such, we detect genuine cross-selling opportunities:** Essilor can increase penetration of its brands within the Luxottica chains and move its existing offer upscale, especially at LensCrafters, which buys around 30% of its lens volumes at Essilor group brands, but essentially in the mid-range. Luxottica will have better access to the circuit of independent opticians and optometrists for the sale of its frames and sunglasses.

**Fig. 5: US market: complementary distribution networks:**




Source: Company Data; Bryan, Garnier & Co ests

Please see the section headed "Important information" on the back page of this report.

## 1.4. Example no. 2: developing the product mix and the multi-network strategy in solar

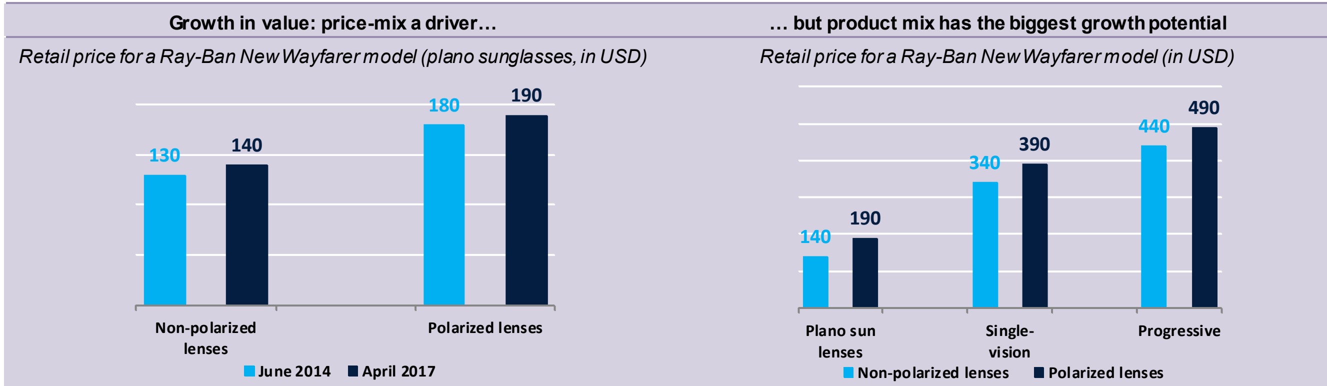
### 1.4.1. Developing the prescription sunglass category

The prescription sunglasses category remains largely under-developed since **just 10% of prescription glasses wearers also have a pair of prescription sunglasses** whereas Essilor estimates **potential in this category at around 50%.** This under-penetration was explained either by a complicated purchase experience (limited choice of frames/designs) and by a lack of specialisation at the opticians (opticians and chains either specialised in prescription or sunglasses).

Before even benefiting from Essilor's expertise in prescription lenses, Luxottica's management recently revealed that **prescription sunglasses already represented around 50% of total prescription sales for the Ray-Ban brand!**

The charts below show the **dominant role of the product-mix** in the sunglasses category: the consumer craze for polarised lens technology implies an average premium of 35% relative to standard sunglasses (*see Fig. 6 left-hand chart*). The mix is even more favourable concerning prescription sunglasses (*see right-hand chart*) with a relation of 1-2.5-3x between plano lenses and prescription sun lenses.

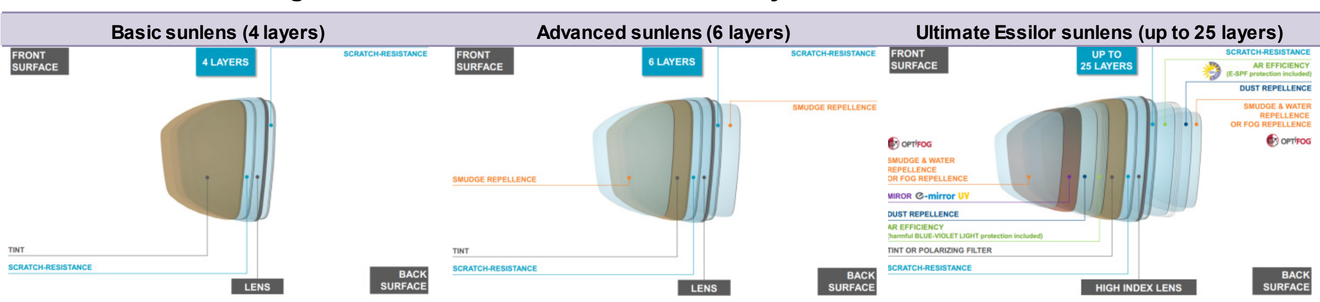
**Fig. 6: Prescription sunglasses: a still under-exploited category**




*Source: Ray-Ban.com (US), Bryan, Garnier & Co ests*

The premium in favour of this niche category is justified in particular by the value added and complex nature of the lenses. Strengthened by its expertise in prescription lenses, Essilor can superpose up to 25 layers/additional treatments (*see chart below*) compared with four levels for a standard lens. **Note that prescription sunglasses are one of the most profitable categories on the market and their development at EssilorLuxottica should therefore boost margins for the combined entity.**

**Fig. 7: Essilor: innovation and multilayers to increase value:**




*Source: Company Data*

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### 1.4.2. Heading for a Luxottica frames + Essilor lens offer?

Launched at end-2016 in Italy and gradually deployed in Europe, the new Ray-Ban frame and lens offer includes prescription lenses carrying the Ray-Ban signature logo (*see image below*) and manufactured by the new production unit in Sedico (Italy), whereas until now, the majority of the banner's lenses (plano and prescription) were produced externally.

**These combined offers present several advantages for opticians: (i)** an easier order process since only one interface is required in which the correction and the customer's measures can be entered at the same time (pupil distance and height), **(ii)** delivery times are fairly rapid (six days maximum), **(iii)** there is no need for in-store stocks (= better WCR management) and **(iv)** consumers are more receptive to "branded" lenses.

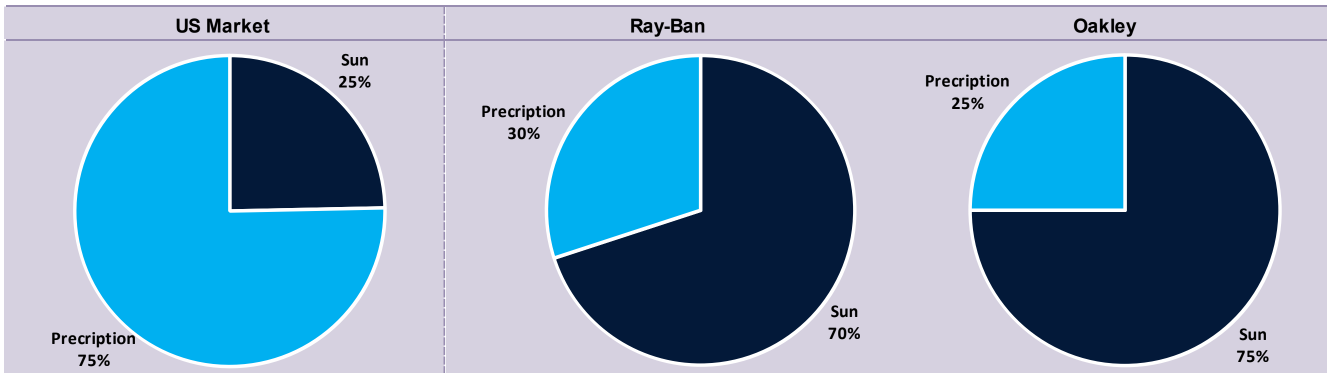
The new partnership therefore suggests future combined offers are on the cards with Essilor lens brands, whether prescription or even non-prescription sunglasses since Essilor owns a number of significant players (Polycore, Intercast, Polinelli, etc.), and even a *"Made in Italy"* label thanks to Intercast. For example, a future Ray-Ban + Varilux offer would help drive two categories at the same time: prescription glasses and prescription sunglasses.

**Fig. 8: The new combined Ray-Ban offer (frames and lenses) and tomorrow Essilor lenses?**

*Source: Ray-Ban*

**The Essilor ophthalmic brands also strengthen the legitimacy of the Ray-Ban and Oakely prescription range,** which only account for 30% and 25% of sales respectively, whereas this category represents around 70% of the global market (around 30% sunglasses), or even 75% in the case of the US market, as shown in the chart below.

**Fig. 9: Ray-Ban/Oakley: weight of sun and prescription categories:**




*Source: Company Data; VisionWatch, Bryan, Garnier & Co ests*

### 1.4.3. Heading for a multi-network strategy full of opportunities in the US and the world

On the one hand, Luxottica boasts the most attractive portfolio of premium and luxury brands in the industry, while on the other Essilor has the largest range of readers (FGX, Stylemark) and mid-range brands, often with a domestic/regional anchoring such as Bolon, Molsion or Prosun (China) and Ossé in Turkey. Note that Essilor also owns the US sunglass brand Costa, which targets a different customer base than that targeted by Oakley, more generalist and slightly older.

These complementary aspects should therefore be made the most of to create a genuine multi-network strategy, which has already proved successful in corrective lenses at Essilor. As the right-hand chart shows (*see Fig. 10*), EssilorLuxottica covers all price segments, from readers (USD15-20) to "Atelier" brands (>USD300), with the majority of brands positioned in the luxury-premium segment (USD100-300).

The Essilor brands should be an asset for the new pairing, whether in emerging markets or the US where the value segment (>USD30) represents 73% of solar market volumes (~31% in value terms), as shown by the two charts in Fig 10. Note that in the US, almost 77% of sunglasses are still sold in the mass retail sector, hence the strategic interest of the partnerships maintained between Essilor and groups such as Walmart, Dollar General and Costco.

**Fig. 10: The brand portfolio will now cover all price segments:**

Price range of main sunglasses brands (retail price, in USD):

1 000
900
800
700
600
500
400
300
200
100
0
Foster Grant *
Oakley
Ray-Ban
Costa *
Persol
Prada
Chanel

US sunglass market by volumes (2016, in units):

$30-50 7%
Over $50 20%
Up to $30 73%

US sunglass market by price category (2016, in dollars):

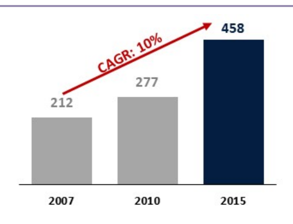
Over $50 69%
$30-50 7%
Up to $30 24%

* Sunglass brands owned by Essilor

*Source: SunglassHut.com, FramesDirect.com, Brand websites; Bryan, Garnier & Co ests.*

### 1.4.4. Capitalising on Luxottica's know-how to develop Foster Grant internationally

Change in Foster Grant sales (2007-15, USDm):




*Source: Company Data*

In the Essilor fold since the takeover of FGXI in 2009, Foster Grant is the leading US sunglass brand in volume terms ahead of Oakley and Ray-Ban. It has expanded rapidly in recent years (2007-15 CAGR of 10% in sales) as distribution has been extended and via a gradual premiumisation strategy, partly driven by the innovations provided by Essilor.

This expansion is set to continue since FG recently penetrated the higher price segment (>USD30 vs. core range at USD10-30), while models now exist of up to USD85. In our view, **FG could make the most of the expertise of the Ray-Ban and Oakley teams in terms of brand-building and international development to strengthen its brand image and extend its footprint outside the US** since Foster Grant is currently only present in 15 markets.

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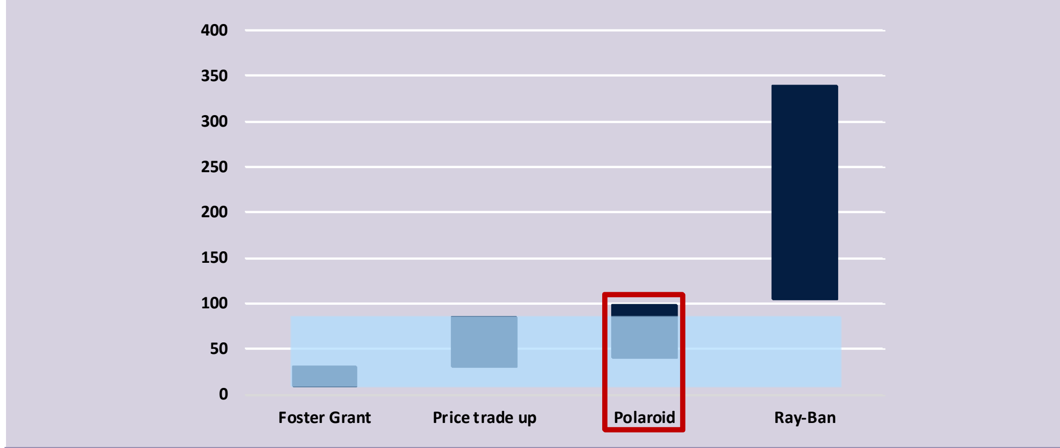
With the ongoing moves upscale, Foster Grant should be present in the majority of the price segments occupied by Polaroid, one of the most well-known brands in the "mass-cool" segment, as indicated in Fig. 11. Although Polaroid is not very well developed in the US and targets independents mostly (vs. major chains for Foster Grant), we believe Foster Grant could become a serious rival to Polaroid (Safilo) within a few years.

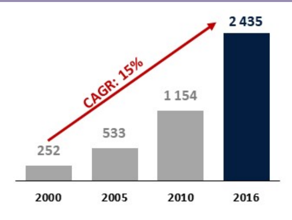
**Fig. 11: Premiumisation of Foster Grant could rival Polaroid (Safilo) further out:**




*Source: SunglassHut.com, Brand websites; Bryan, Garnier & Co ests.*

**Foster Grant would like to replicate the Ray-Ban success story**

Change in Ray-Ban sales (2000-16, EURm):




*Source: Company Data, Bryan, Garnier & Co ests*

Ray-Ban is currently the world's highest selling glasses brand with sales of more than EUR2.4bn at end-2016. It is clearly THE success story in the sector over the past decade, as shown by the CAGR of 15% in sales between 2000 and 2016. When Luxottica bought Ray-Ban from Bausch & Lomb in 1999 (USD640m), its brand image was clearly deteriorated, it had no pricing power, an exclusively mass market distribution (local stores, petrol stations) and an average price of USD19. The Italian group then turned around Ray-Ban in two main stages:

**(i) Increasing quality and distribution:** the brand's US production was brought back in-house at the Italian plants, which already manufactured for Chanel and Georgio Armani, having an instant effect on the quality of frames. Luxottica has not hesitated in cutting almost 13,000 mass sales points to replace them with department stores and specialised retailers such as Sunglass Hut. As such, the average price-tag rose by almost 60% between 2000 and 2010. The brand even inaugurated flagship stores such as those in New York (465m²) and China (~70 stores), thereby strengthening the positioning and reputation of Ray-Ban.

**(ii) Globalising the brand and extending the offer:** Ray-Ban is the standard-bearer for Luxottica when it penetrates a new market, explaining why the brand is the most present internationally at the Italian group. It has also expanded in prescription sunglasses (30% of sales vs. 0% in 2000) and in personalisation, with Ray-Ban Remix now accounting for 40% of the brand's internet sales.

As mentioned previously, Foster Grant has a similar strategy: it has just invested in a higher price segment (>USD30), backed by innovation and new distribution circuits (especially independents). Further out, FG could also reflect on bringing frame production back in house (to Luxottica's Chinese plants?). In our view, Ray-Ban should above all help FG in terms of brand-building and international expansion.

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## 1.5. Example no. 3: launch of a genuine omnichannel strategy

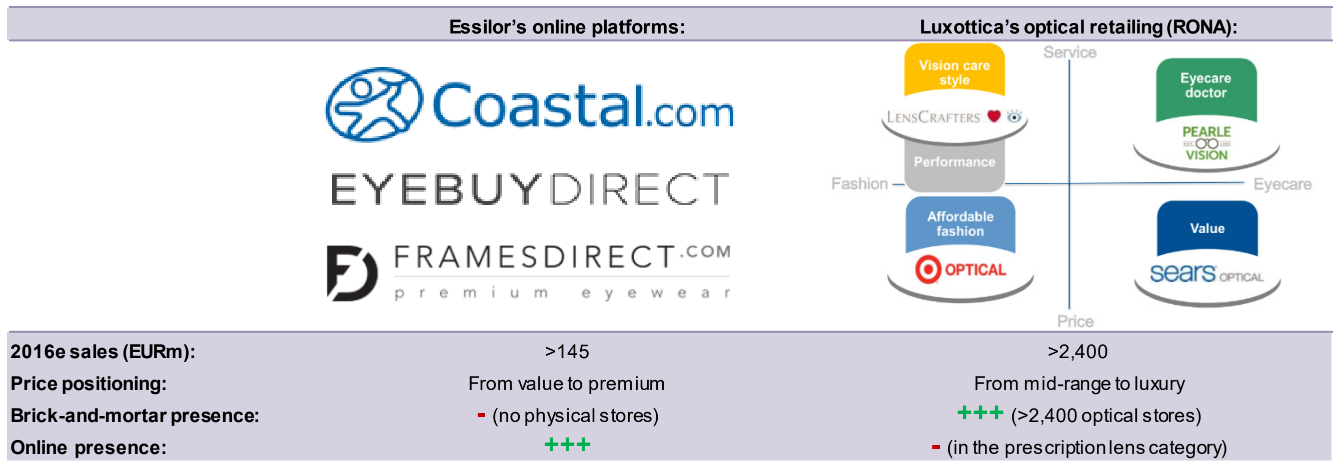
Even though the online circuit only accounts for around 4% of the US optical market (vs. around 30% for textiles/accessories purchase), the market itself is growing at an average annual pace of more than 10% and is already significant for contact lenses (market share of around 20%) and sunglasses (around 10-15%).

In many sectors, examples of the omnichannel strategy are multiplying (Apple, Inditex, adidas etc.) and this could be a perfectly answer for the optical sector since a lot of consumers are indeed reluctant to purchase corrective lenses on the internet. The rapid development of omnichannel players such as **Warby Parker** in the US, **Mister Spex** and **Brillen.de** in Europe, testify to this difficulty in being a pure online player.

The table below shows that the complementary features between Essilor and Luxottica are ideal to implement this omnichannel strategy:

- **Essilor is the leader in online distribution:** sales in North America were in excess of EUR145m via three main platforms. In our view, the French group could provide its expertise in terms of optical product sales on internet (supply chain, big data, segmentation of offer, etc.) since Luxottica's online presence remains restricted to sunglasses above all (ray-ban.com, oakley.com and sunglasshut.com).
- **Luxottica dominates physical distribution:** the group has more than 2,400 optical stores in North America (excluding Sunglass Hut), which could become as many additional contact points to reach US consumers. The roll-out of a gateway between the Essilor websites and its stores would be an ideal solution since its customers would benefit from human intervention at the end of the chain to check that the glasses are mounted properly and that the lenses fit the prescription.

**Fig. 12: EssilorLuxottica: an opportunity to roll out an omnichannel strategy:**




| | Essilor's online platforms: | Luxottica's optical retailing (RONA): |
|---|---|---|
| 2016e sales (EURm): | >145 | >2,400 |
| Price positioning: | From value to premium | From mid-range to luxury |
| Brick-and-mortar presence: | - (no physical stores) | +++ (>2,400 optical stores) |
| Online presence: | +++ | - (in the prescription lens category) |

*Source: Essilor, Luxottica*

Please see the section headed "Important information" on the back page of this report.

### 1.5.1. The omnichannel stance benefits technological innovations

Thanks to the increasingly sophisticated cameras embedded in smartphones, a number of players are developing portable autorefractors based on applications that work with classic smartphones. This innovation is also favoured by the lack of ophthalmologists and waiting times that are quite long even for a simple refraction test (= measure of the extent of the eye's optical default).

Self-measuring device for sight and inter-pupillary distance Netra:

*Source: EyeNetra*

This is the case of US start-up **Eyenetra**, which develops a range of portable devices working on smartphones. These devices test virtually all visual troubles (myopia, presbyopia, etc.) with the same precision as autorefractometers used by ophthalmologists but at a far more affordable price (around USD1,000-2,300 vs. USD45,000 for the most advanced autorefractometers). Thanks to this portable device, ophthalmologists/optometrists can undertake refractory tests in people's homes or in the workplace.

This example of technological programmes, without mentioning 3D (or virtual) mirrors, is increasingly encouraging consumers to order their glasses online while benefiting from the advice of an optometrist who works either on behalf of LensCrafters, Pearle Vision, etc., or an independent referenced by the cooperatives owned by Essilor (Vision Source, PERC/IVA, etc.). During the final stage of the purchase process, the customer can even choose to go and collect their glasses from a store for a physical check by a sales person.

This is why an omnichannel strategy needs to be implemented, combining internet platforms (virtually unlimited offer available 24/7, practical etc.) and a network of optical stores (quality of advice, checking of measures and final quality of the frame, proximity).

**Fig. 13: An example of the future omnichannel/digital circuit in optical:**



*Source: Eyenetra, Bryan, Garnier & Co*

### 1.5.2. Other optical chains are gradually getting going

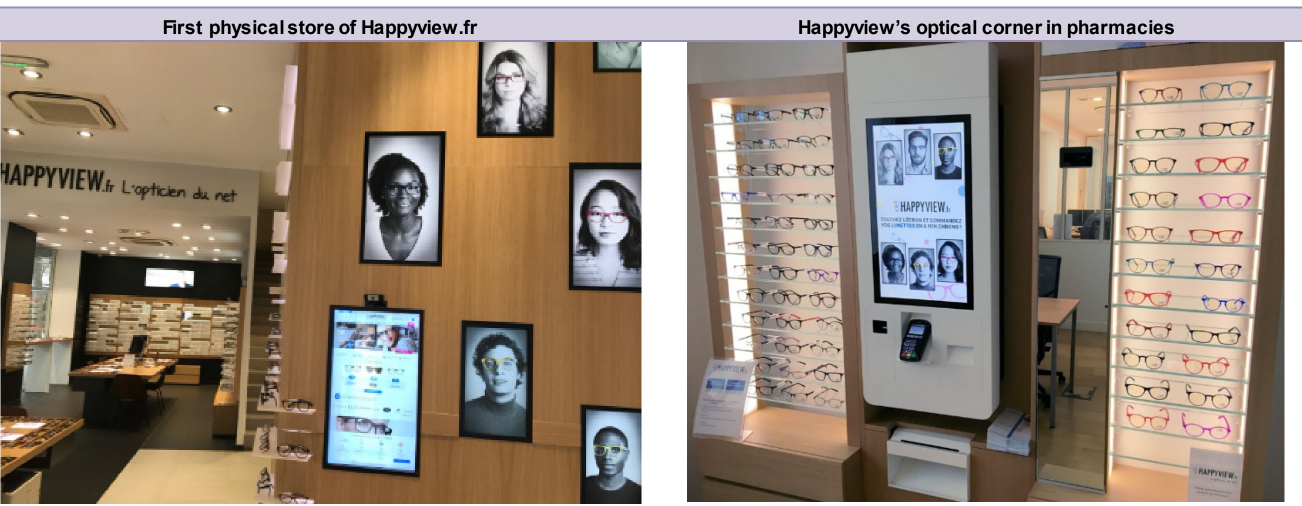
Last August, **GrandVision** announced that its German brand **Apollo Optik** had launched its omnichannel platform in order to facilitate its customer purchase experience (appointments made on the website, online profile etc.) especially since the German leader Fielmann does not believe in the future of online sales for the eyewear segment. Management pointed out that the first results were promising, with a rise in in-store traffic and new consumers captured thanks to this platform.

Last October, **Alain Afflelou** bought two websites (Happyview.fr and Malentille.com) in order to step up its presence in digital, which represents barely 1% of the retailer's sales at present. With this operation, the group is acquiring know-how (Happyview founder Marc Adamowicz heads up Digital Strategy at AF) and the platforms to implement its omnichannel strategy:

**(i)** **Opening of physical stores:** like the main pure internet players (Warby Parker, Brillen.de, Mister Spex, Sensee, etc.), Happyview opened its first store in Paris in November 2016 using numerous digital tools such as trying out frames using augmented reality (*see left-hand photo below*).

**(ii)** **Order terminals in pharmacies:** even more original is Happview's plan to install interactive optical corners in chemists enabling customers to order their glasses by themselves: **1/** a choice of around 50 frames exposed in the optical corner is offered (unifocal or progressive lenses), **2/** the terminal then scans the customer's prescription and takes their measurements. According to Happyview, rental and maintenance fees for the terminal total EUR340/month and only two sales per month are required to reach the profitability threshold. The site plans to roll-out machines until 2017-18.

**Fig. 14: Happyview implementing its physital strategy:**




*Source: Happyview*

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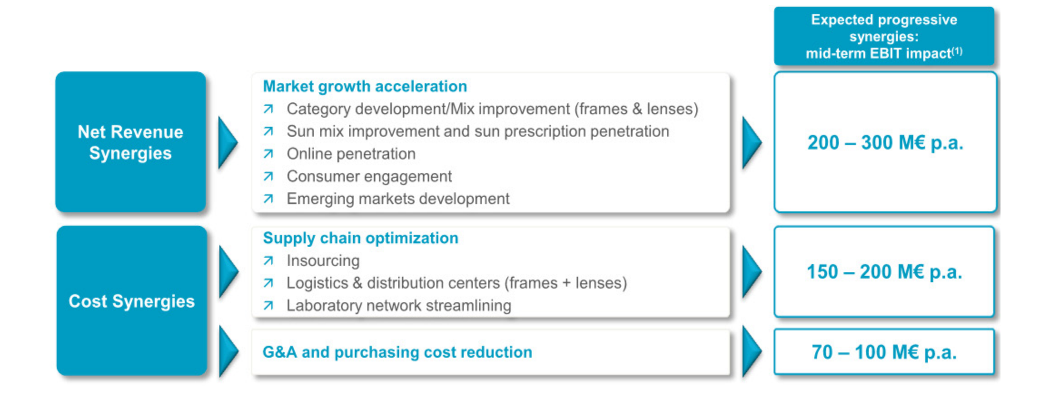
## 1.6. EssilorLuxottica P&L

**We are forecasting an overall amount of synergies of EUR508m out to 2021, i.e. in the mid range of the target announced by Essilor (around EUR400-600m),** as set out in the chart below.

### Fig. 15: Synergies targets by category:




*Source: Company Data*

**Cost synergies target (EUR220-300m) seems fairly conservative…**

As mentioned previously, despite the lack of an effective merger between Essilor and Luxottica, we believe the group will exceed its cost synergies target since the upper-end of the range (EUR300m) only represents 2% of the combined cost structure.

In our view, **savings on lens purchases** by Luxottica (est. BG: ~EUR150m in 2021) and **the optimisation of the lab network in the US** (~EUR50m) will be the main synergy sources. Optimising the lab network should help Essilor focus its volumes on a small number of labs whereas the closure of in-store labs will have a positive impact on rental and wage costs at Luxottica.

### Fig. 16: Our cost synergy estimates (net impact on 2018-21e EBIT):

| EURm | 2018e | 2019e | 2020e | 2021e |
|---|---|---|---|---|
| Lens Insourcing | 38 | 75 | 113 | 150 |
| Supply chain optimisation and Rx lab streamlining | 11 | 23 | 47 | 52 |
| Sourcing & purchasing gains | 16 | 20 | 35 | 53 |
| G&A synergies | 17 | 20 | 21 | 22 |
| **Total cost synergies** | **82** | **138** | **216** | **277** |

*Source: Bryan, Garnier & Co ests.*

**… However, potential revenue synergies (EUR200-300m) are more complicated to estimate**

Some of these synergies will depend on the smooth execution of joint projects presented above (for example Ray-Ban + Varilux lenses, omnichannel strategy etc.), but above all, the ability of the new group to convince its customers that this merger is advantageous for them in several ways:

**(i)** **A reduction in delivery times:** the shared management of lens and frame stocks, assembly of the full frame and the lab centralisation trend are set to reduce delivery times and simplify customer relations given that only one intermediary is involved.

**(ii)** **A huge choice of brands:** cross-selling and complementary distribution channels should provide customers a wider choice. For example, the alliance groups owned by Essilor, are

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little covered by Luxottica and will have easier access to the Italian group's sunglass and frame brands.

**(iii)** **More attractive commercial offers:** this argument is key for proving to customers (and antitrust authorities) that EssilorLuxottica is not closing the optical market, but quite the contrary. We believe that some of the efficiency and productivity gains associated with optimising the supply chain could be reinvested in attractive packages (for example, Vogue frames + Kodak or Shamir lenses, Ray-Ban frame + Varilux lenses) for customers and consumers.

Since these revenue synergies are by nature more difficult to estimate, we have deliberately positioned ourselves at the low-end of the range (around EUR231m vs. the target of EUR200-330m). Despite our relative caution, we believe that the most attractive potential naturally lies in the complementary **optical + sunglass duo** (combined offers between Essilor and Luxottica, sharing of stocks etc.) as well as the **diverse nature of distribution channels** (optical chains, optometrist cooperatives, e-commerce etc.).

**Fig. 17: Our revenue estimates (net impact on 2018-21e EBIT):**

| EURm | 2018e | 2019e | 2020e | 2021e |
|---|---|---|---|---|
| Pooling of lens & frames inventory management | 14 | 24 | 35 | 50 |
| Cross-selling opportunities in the US market | 13 | 22 | 32 | 44 |
| Sun/Rx mix improvement at Ray-Ban & Oakley | 8 | 23 | 37 | 54 |
| Global roll-out of Essilor's sunglass brands | 3 | 12 | 21 | 32 |
| Emerging Markets (Asia for LUX/ LatAm for EI) | 6 | 14 | 25 | 37 |
| Online penetration + omnichannel opportunities | 5 | 7 | 11 | 14 |
| **Total cost synergies** | **49** | **102** | **161** | **231** |

*Source: Bryan, Garnier & Co ests.*

**Update to our P&L following the publication of Document E**

In combined sales, we have adjusted for **intra-group sales** (EUR350m in 2016) and have added to this the additional sales stemming from revenue synergies.

Like the accounting practices used by Luxottica, Essilor's **R&D** expenses (EUR214m in 2016) will now be booked under COGS (vs operating expenses previously). We include **additional depreciation and amortisation** of EUR580m prompted by the revaluation of Essilor's intangible assets. Give its significant impact, we have calculated net profit adjusted for this "exceptional" expense over 2018-21. Finally, we have added our synergies estimates as presented in Fig. 16 and Fig. 17.

Please see the section headed "Important information" on the back page of this report.

**Fig. 18: P&L EssilorLuxottica after taking into account synergies (2018-21e):**

| EURm | 2018e | 2019e | 2020e | 2021e |
|---|---|---|---|---|
| **Combined revenue after restatements & synergies** | **18 374** | **19 723** | **21 236** | **22 612** |
| *% change* | *7,6* | *7,3* | *7,7* | *6,5* |
| | | | | |
| **Total EBITDA** | **4 241** | **4 684** | **5 024** | **5 461** |
| % of sales | 23,1 | 23,7 | 23,7 | 24,2 |
| | | | | |
| **Total EBIT before synergies** | **2 553** | **2 861** | **3 192** | **3 481** |
| % of sales | 14,1 | 14,9 | 15,7 | 16,2 |
| Revenue synergies | 49 | 102 | 161 | 231 |
| Cost synergies | 82 | 138 | 216 | 277 |
| **Total EBIT post synergies** | **2 683** | **3 101** | **3 568** | **3 989** |
| % of sales | 14,6 | 15,7 | 16,8 | 17,6 |
| Financial result | -95 | -75 | -48 | -28 |
| **Profit before tax** | **2 588** | **3 026** | **3 520** | **3 960** |
| IS | -777 | -908 | -1 056 | -1 188 |
| Tax rate (%) | 30,0 | 30,0 | 30,0 | 30,0 |
| Minorities | -81 | -87 | -92 | -96 |
| **Net profit** | **1 731** | **2 031** | **2 372** | **2 676** |
| **Adjusted net profit** * | **2 137** | **2 412** | **2 729** | **3 007** |

** Adjusted for the EUR580m amortisation charge from the FV adjustment made to Essilor's intangible assets (7th April)*

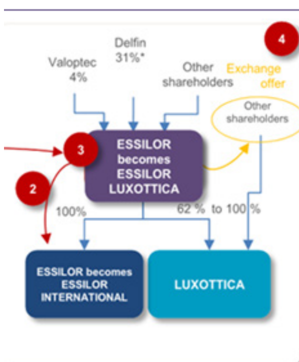
*Source: Bryan, Garnier & Co ests.*

# 1.7. Risk factors concerning the operation

## 1.7.1. Integration risk

When the merger deal was announced on 16th January, we were above all wary of integration risk since we initially believed that the two groups would merge as soon as the operation was completed. This assumption gave rise to two main questions: 1/ what about governance, bearing in mind that this crucial question was at the root of the failed Publicis-Omnicom merger and complicated negotiations between Lafarge and Holcim, as well as those between Essilor and Luxottica during past attempts to reach an agreement, 2/ how to combine two very strong and distinct corporate cultures?

EssilorLuxottica will own Essilor and Luxottica:




*Source: Company Data*

**Governance: the roles seem to be clearly shared**

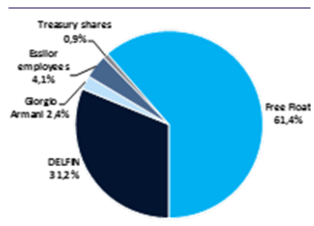
As mentioned in section 1.1.1, the organisation of the new group (*see chart opposite*) seems capable of reducing governance risks (e.g. disagreements over the division of management positions).

- **EssilorLuxottica** is to be co-directed by **Leonardo Del Vecchio** and **Hubert Sagnières** with the backing of a Board of Directors made up of 16 members (eight from Essilor and eight from Luxottica). The holding company will also house an Integration Committee responsible for executing the synergies plan and the integration process and of defining the aims of the two groups:

- **Essilor** and **Luxottica** will remain two separate groups with distinct organisations and management teams. In our view, **Laurent Vacheron** (Essilor) and **Massimo Vian** (Luxottica) will be responsible for operating management.


Please see the section headed "Important information" on the back page of this report.

Essilor-Luxottica shareholding structure (%):*




** assuming that 100% of minorities accept the offer*

*Source: Company Data*

**Is Mr Del Vecchio a risk?**

Apart from the fact that this merger mostly solves the succession problems, Mr Del Vecchio (82 on 22nd May) will become the key shareholder of EssilorLuxottica with a stake of between 31% and 38% of the capital. This situation has prompted fears for certain investors who still have in mind the role played by the founder of Luxottica in the departures of three CEOs between September 2014 and February 2016.

We believe this "nuisance risk" is exaggerated for four main reasons:

- **(i)** **The balance of powers at EssilorLuxottica:** even though Leonardo Del Vecchio is set to be the future EssilorLuxottica CEO, Hubert Sagnières, who will be Deputy CEO, will have the same powers. This two-headed direction is to be rounded out by a Board of Directors evenly balanced between Essilor and Luxottica members.
- **(ii)** **Mr Del Vecchio's voting rights are statutorily limited to 31%** irrespective of his final stake (from 31-38% of the capital) and therefore cannot form a blocking minority within EssilorLuxottica.
- **(iii)** **One single mandate?** In several interviews, Mr Del Vecchio confirmed that after his three-year mandate, the decision of its renewal would be submitted to shareholders.
- **(iv)** **Mr Del Vecchio will not have control of operating management,** which will above all be in the hands of Laurent Vacherot and Massimo Vian. In addition, the EssilorLuxottica head offices will be in Paris such that Mr Del Vecchio could be less present than in Milan where Luxottica's head offices are.

**How can two strong corporate cultures co-exist?**

The two management teams evidently insist on "their joint passion for the product", their joint aim to improve eyesight throughout the world and the common points of their growth strategy (vertical integration, M&A etc.). These numerous similarities should not mask the very strong *affectio societatis* within each company, characterised by employee shareholders at Essilor (around 8.4% of the capital) and by a strong identification (and admiration) of Luxottica's employees relative to Leonardo Del Vecchio, the founder of Luxottica.

Schematically and in a simplified manner, the values of **Essilor** still rely mostly on its "medtech" heritage, which is explained by its mission (to improve eye-sight), implying a medical aspect (protect, correct and prevent visual troubles). Indeed, Hubert Sagnières has often repeated that "vision is not fashion". In contrast, at **Luxottica,** which has built itself on the manufacturing of glasses frames and brand management, this medical aspect is less present and a far larger focus is set on design (frames) and marketing, which are vital since glasses have become a genuine fashion accessory.

These complementary aspects are precisely what motivated the merger, but the Integration Committee at EssilorLuxottica and both groups' management teams will have to avoid this "culture shock" and ensure that the teams at both groups share the same values and aims.

Please see the section headed "Important information" on the back page of this report.

## 1.7.2. Synergy risks

**The mid-range valued at around EUR5.1bn**

To calculate NPV, we have obviously started with our synergy forecasts presented in Fig. 16 and Fig. 17. Note that we expect a total amount of synergies of EUR508m out to 2021, or the middle of the target range announced by Essilor (EUR400-600m). Our assumptions, set out in the table below are the following: WACC of 6.5% (vs. 6.3% for Essilor and 6.9% for Luxottica), a growth rate to infinity of 1% and a tax rate of 30%. **Our NPV therefore works out to EUR5.1bn.**

EssilorLuxottica may not unlock revenue synergies in the event of a slower and/or more complicated integration, difficulties in executing joint projects, negative reactions from important clients etc. **In the fairly unlikely event (in our view) of no revenue synergies being unlocked, NPV would only stand at EUR2.6bn.**

**Fig. 19: NPV estimated at almost EUR5.1bn:**

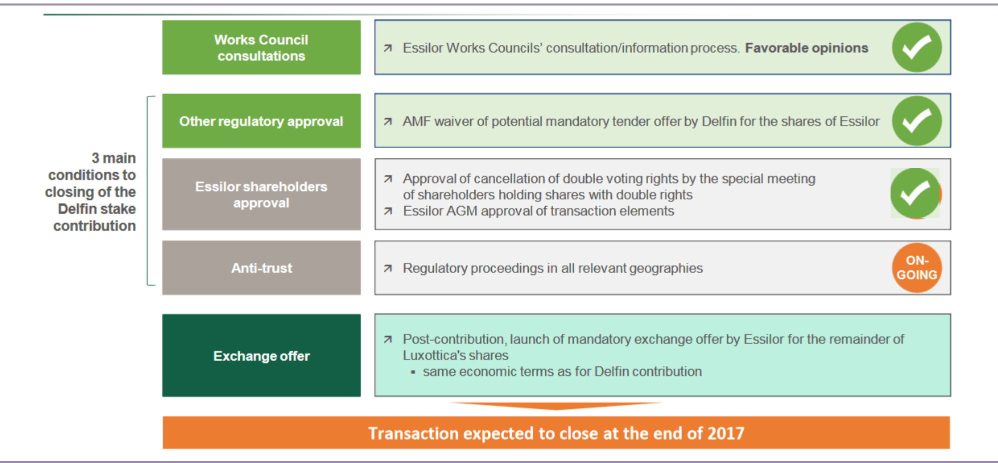
| EURm | Revenue Synergies | Cost Synergies | Total Synergies | Post-tax (30%) | PV |
|---|---|---|---|---|---|
| 2018e | 49 | 82 | 130 | 91 | **80** |
| 2019e | 102 | 138 | 240 | 168 | **139** |
| 2020e | 161 | 216 | 377 | 264 | **205** |
| 2021e | 231 | 277 | 508 | 355 | **259** |
| WACC | 6.5% | | | | |
| LT growth | 1.0% | | | | |
| **NPV** | **5,157** | | | | |

*Source: Bryan, Garnier & Co ests.*

## 1.7.3. Is there a risk for Luxottica's minorities?

At the AGM on 11th May, Essilor shareholders provided huge support for the resolutions concerning the merger project with Luxottica. As the time-frame below shows, the vote on these resolutions will now enable the group to issue new shares destined to pay for the stake tendered by DELFIN, as well the minorities of the Italian group under the framework of the obligatory share swap offer due to be initiated in coming weeks. Apart from DELFIN, we expect Mr Giorgio Armani to tender his stake in Luxottica (around 4.7%).

**Fig. 20: Key stages of the operation:**




*Source: Company Data; Bryan, Garnier & Co ests.*

Please see the section headed "Important information" on the back page of this report.

There is naturally a risk that Essilor does not obtain all of the shares held by minority interests, with some deciding to wait to play an eventual hike in the offer price by Essilor (a cash sweetener?).

Looking at the chart below, the market and arbitrage players do not seem to want to play this scenario given that since the operation was announced on 16th January, **the Luxottica/Essilor share price ratio remains very similar to the exchange parity set on 16th January** (0.461 Luxottica shares for one Essilor share).

Note that in Italy, the obligatory squeeze out is possible once Essilor recovers 95% of voting rights, whereas the sell-out clause can be activated by minorities as of a threshold of 90% in certain cases.

**Fig. 21: EI and LUX shares relative to exchange parity**



*Source: Datastream; Bryan, Garnier & Co ests.*

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# 2. LVMH-Marcolin came like a thunderbolt to Safilo

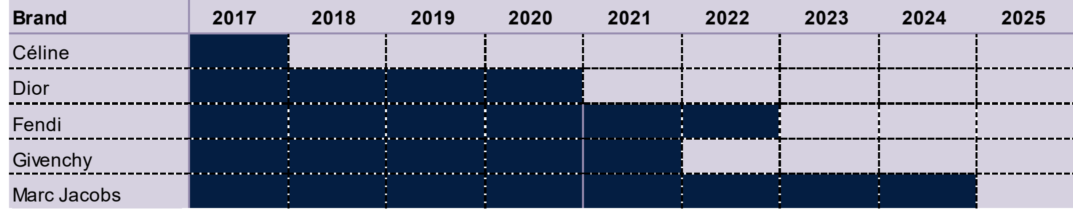
Two weeks after EssilorLuxottica, the second major announcement in the sector came from Marcolin which made official its partnership with LVMH, taking the form of a 10% stake in Marcolin and the creation of a joint venture to manage the eyewear business for the LVMH brands. LVMH is to own 51% of the joint venture, which is due to start in 2018 with Céline and above all Louis Vuitton, and is then destined to gradually welcome the luxury group's other brands.

After Kering (September 2014), which decided to bring back in-house eyewear distribution for its brands, this strategic decision made by LVMH has revived fears in view of licence activities, beyond even eyewear since players such as Interparfums (perfumes) or YNAP (e-commerce), which are also exposed to the licence business, have been the object of uncertainty on the part of investors.

## 2.1. What licences are concerned?

**Safilo is clearly in the front line and the main player affected by this announcement** since the global no. 2 was LVMH's privileged partner with five licence agreements (see table below) for sales of around EUR340m. In contrast, **the scenario of a sudden halt to the partnership between LVMH and Safilo seems to be ruled out,** as Safilo's CEO confirmed recently in a few interviews. This is fairly good news for Safilo since Kering advanced the expiry of its licence agreements in return for the sum of EUR90m.

**Fig. 22: Main LVMH licence expiry dates at Safilo:**




*Source: Company Data*

As the following table shows, **Luxottica** handles the design, production and distribution of Bulgari, but this represents less than 1% of total sales. The impact should be all the more limited in that the Luxottica chains (LensCrafters, Sunglass Hut mainly) will probably continue to sell the Bulgari collections in their stores, enabling the Italian group to maintain at least its distribution margin. The fact of owning the chains is again, a clear advantage!

**Fig. 23: Bulgari expiry dates at Luxottica:**

| Brand | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|---|---|
| Bulgari | | | | | | | | | |

*Source: Company Data*

Please see the section headed "Important information" on the back page of this report.

## 2.2. What differences with Kering Eyewear

The creation of the JV co-managed by LVMH and Marcolin is part of the same logic as Kering's decision to bring back in-house its eyewear business (September 2014). In our view, there are nevertheless three main differences in their approaches:

- **Difference no. 1:** Kering created a specific division (Kering Eyewear) within the group to manage eyewear for 12 brands (out of 22) that are present in eyewear. In contrast, LVMH is to manage this business from its joint venture, which would imply less pressure on margins (additional opex and capex).
- **Difference no. 2:** In January 2015, Kering and Safilo signed an agreement ratifying an early halt to the licences in return for a compensation payment of EUR90m. From the Marcolin press release, we understand that the move to bring the business back in-house will be gradual at LVMH, as the licences expire at Safilo and Luxottica. Safilo's CEO also brought up this scenario in various interviews.
- **Difference no. 3:** as indicated in the table below, Kering has no frame manufacturing plant and continues to outsource production to Safilo (Gucci licence at least until December 2020) and to other third-parties located in Italy and Japan. In contrast, the LVMH brands are clearly set to benefit from Marcolin's production capacities, enabling them to internalise this stage.

However, this difference could soon be eliminated thanks to the **agreement signed between Maisons Cartier and Kering Eyewear** in March. Cartier, which was the only luxury brand to have its own eyewear, is set to transfer its factory (located in Sucy-en-Brie, near Paris) and in return, Richemont is set to take a 30% stake in Kering Eyewear. In our view, **this factory could enable it to insource production of certain luxury brands in the portfolio**, especially Gucci after 2020.

**Fig. 24: The eyewear business value chain:**

| Brand | Design | Production | Distribution |
|---|---|---|---|
| Kering Eyewear | [internalised] | *Currently outsourced but gradual insourcing in the MT?* | [internalised] |
| LVMH-Marcolin | [internalised] | [internalised] | [internalised] |
| [internalised] | = internalised process | | |

*Source: Bryan, Garnier & Co*

Please see the section headed "Important information" on the back page of this report.

## 2.3. Bringing eyewear back in-house: the meaning of the story for major groups

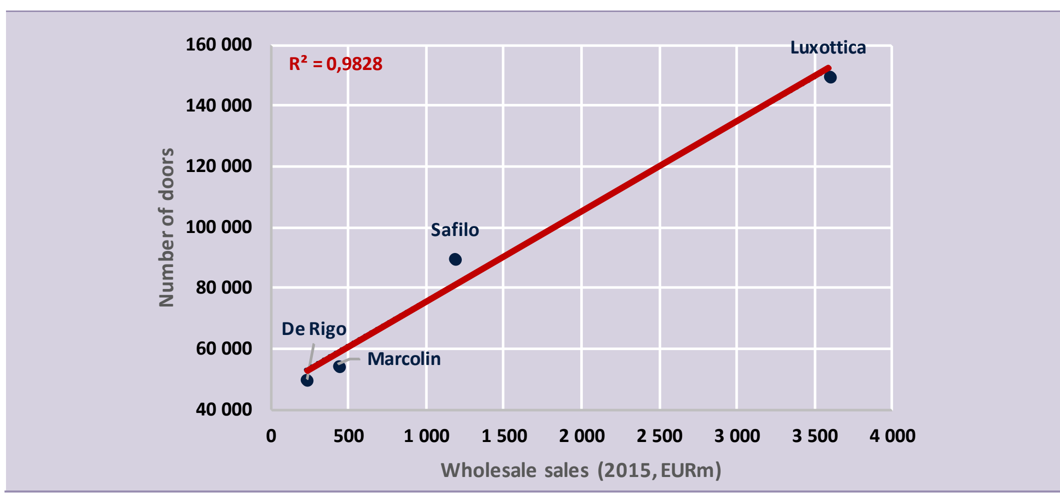
For several years, luxury brands have been carrying out vertical integration in both directions in order to increase their credibility in the eyes of consumers: upstream, they have aimed to secure supply and their know-how in terms of production, while downstream, they have strengthened control of their distribution by opening directly-operated stores and increasingly distancing themselves from department stores and other multi-brand sales points.

The integration of the eyewear business comes under the upstream vertical integration given its increasing importance for many luxury brands, as we discussed in our sector report of June 2015. This strategy enables brands to perfectly align design, collections and schedules for all of the categories (ready-to-wear, leather goods, eyewear etc.).

**Rolling-out the distribution network remains the top difficulty**

We have always considered that the main entry barrier to the optical industry is controlling the distribution network and the supply chain. This complexity is due to the extreme high capillarity of the network since tens of thousands of independent opticians need to be addressed as well as the major chains (optical, sun, generalists). As the chart below shows, at least 50,000 wholesale sales points need to be covered to rank among the top 4 in the world and there is naturally a correlation between the size of the distribution network and the volume of sales generated.

**Fig. 25: Wholesale network of four main eyewear manufacturers:**




*Source: Company Data; Bryan, Garnier & Co ests*

However, a luxury group that decides to insource eyewear must build this distribution network, which has very few synergies with its core business (only around 10% of eyewear sales are generated in the brand's directly-operated stores), thereby requiring long and costly investments. In an interview published at the start of the year, Safilo's former CEO and the current head of Kering Eyewear (Roberto Vedovotto) confirmed that setting up this network had been one of his priorities since Kering Eyewear was founded in September 2014 and we also believe that his network continues to lag Safilo's, partly due to the slightly more exclusive positioning than previously.

Please see the section headed "Important information" on the back page of this report.

### 2.3.1. Only LVMH and Kering have the critical mass to make this insourcing profitable…

Bringing design, production (if necessary) and distribution back in-house, implies significant investment spending as shown by the operating losses incurred by Kering Eyewear in 2016 (EUR61.5m), especially due to start-up costs. Business volumes need to be sufficiently high if there is any hope of generating attractive ROI and being able to amortise operating costs fairly rapidly.

In our view, only Kering and LVMH boast the critical mass necessary thanks to their extensive brand portfolios. Indeed, Kering Eyewear already regroups 12 group brands (including Gucci as of 1st January 2017) and is set to extend its portfolio with the arrival of Cartier (estimated sales of around EUR150m) at the end of the year. LVMH has at least seven brands presented in the eyewear business, including LV which was not under licence. During its full-year results, Kering unveiled that Kering Eyewear generated sales of EUR340m whereas we estimate that the seven LVMH brands generated around EUR400-500m.

### 2.3.2. … More difficult for single brand groups

In our view, the decision by Cartier to join forces with Kering Eyewear testifies to the difficulties of leveraging production and distribution costs when a brand is alone and does not have critical mass. In addition, this agreement is clearly an opportunity for Kering Eyewear, which is rounding out its portfolio with a prestigious brand and will amortise its cost base more easily.

Other main licences in the sector (sales ≥ EUR200m) are at Luxottica, namely **Prada** (-> 2025), **Giorgio Armani** (-> 2022) and **Dolce & Gabbana** (-> 2025). Given the size of these groups and the fact that their brand portfolios are not as wide-ranging as those of the two French players (making cost leverage more difficult), we believe that insourcing will not concern them in the short term. Note that Prada did try to control this business by creating a joint venture with De Rigo in 1999, but this was not a success and the JV was sold to Luxottica in 2013. Finally, note that Prada and Dolce & Gabbana renewed their licence agreement in 2015.

**Fig. 26: Main sunglass brands (house or licences) in volumes:**

| | Volumes (in millions of pairs) |
|---|---|
| Ray-Ban (**H**, Luxottica) | >25 |
| Foster Grant (**H**, Essilor) | >12 |
| Oakley (**H**, Luxottica) | ~10 |
| Maui Jim (**H**, independent) | ~4 |
| Bolon (**H**, Essilor), **Armani** (**L**, Luxottica) | >2.5 |
| Chili Beans (**H**, independent) | ~2.5 |
| Polaroid (**H**, Safilo), Gucci (**H**, Kering Eyewear), Carrera (**H**, Safilo), **Dolce & Gabbana** (**L**, Luxottica), **Prada** (**L**, Luxottica), Police (**H**, De Rigo), Dior (**L**, Safilo), Costa (**H**, Essilor), Molsion (**H**, Essilor) | 1 to 2 |
| ***H** = House brand – **L** = licensing agreement* | |

*Source: Essilor; Bryan, Garnier & Co ests*

Please see the section headed "Important information" on the back page of this report.

## 2.4. What future for Safilo?

Safilo needs to stand up to the merger operation by Essilor-Luxottica and the ensuing race for critical mass that is set to cause a near 27% loss in sales further out (LVMH licences). These two successive announcements have naturally revived rumours of operations surrounding Safilo.

**Did LVMH approach Safilo before Marcolin?**

This question is worth asking since it would have been easier for LVMH to join forces with Safilo since it produces and distributes five eyewear licences and since the two groups have worked together for more than 20 years. However, we believe that there could have been two stumbling blocks to a partnership: **(i)** Safilo would not have agreed on the structure of the operation (= creation of a joint venture majority-owned by LVMH) and **(ii)** the world no. 2 and/or its key shareholder HAL, which owns 42% would have opposed the entry of LVMH into the capital. The Italian group's CEO has also insisted on numerous occasions that he intended to remain an independent player.

### 2.4.1. Alliance with another producer?

Apart from Luxottica, the majority of Safilo's rivals are owned by families or non-listed groups. As in the luxury sector, for all M&A operations the aim is therefore firstly to know whether or not these shareholders would be sellers before looking at potential buyers. In addition, the recent statements made by Luisa Delgado do not invite mergers with Safilo, but it is nevertheless interesting to present them since a number of players could well have to join forces in order to better resist the future mega-group EssilorLuxottica:

**(i)** **De Rigo:** the group remains owned by the De Rigo family and would be an ideal partner since it has a successful house brand (Police, >30% of sales). Furthermore, De Rigo is a mini-Luxottica since it also owns a retail business (around 46% of sales) made up of the no. 1 optical chain in Spain (General Optica which partners Essilor), the no. 2 eyewear retailer in Turkey (Opmar Optik) and a large Portuguese chain (Mais Optica). Note also that De Rigo has 42% of Boots Optical, the second-largest optical chain in the UK. The limits to this merger are: **1/** the De Rigo family does not seem to want to sell off control of its company and **2/** we doubt that HAL would agree to Safilo teaming up with a player that owns rival chains to its own.

**(ii)** **Marcolin:** the Italian manufacturer has the third-largest portfolio in the industry, with attractive brands such as Tom Ford, Moncler, Tod's, Montblanc, etc. However, this merger would not allow Safilo to reduce its exposure to licences since the majority of Marcolin's sales stem from this business. In our view, PAI Partners fund, which bought 78% of Marcolin in 2012 (EUR207m), could prepare its withdrawal over the medium term, helped by the partnership that has just been signed with LVMH, which is taking 10% in the Italian group's capital. This operation is likely to limit the chances of a merger with another player.

**(iii)** **Marchon Eyewear:** This manufacturer was bought by the leading US eye care insurance group VSP (rival to EyeMed at Luxottica) in 2008 for USD735m. On our estimates, it has sales of around EUR700m. A merger would have a number of advantages for Safilo: **1/** low overlap in Europe while the Italian group would benefit from the US structure of VPS/Marchon for its affordable/mass brand segment (Lacoste, Calvin Klein, Nike, etc.) in which Safilo is strengthening its presence. However, we do not believe that VSP is interested in selling off this asset.

### 2.4.2. Is a merger with GrandVision possible?

GrandVision and Safilo share the same key shareholder since they are 77% and 42%-owned respectively by Dutch investment fund HAL, limited under the name of HAL Trust in Amsterdam.

**Fig. 27: HAL stakes in GrandVision and Safilo:**

GrandVision

HAL 77%
GV Management 0%
Treasury shares 1%
Free Float 22%

Safilo

HAL 42%
Only 3T 9%
BDL Capital Management 7%
Free Float 42%

*Source: Company Data; Bryan, Garnier & Co ests*

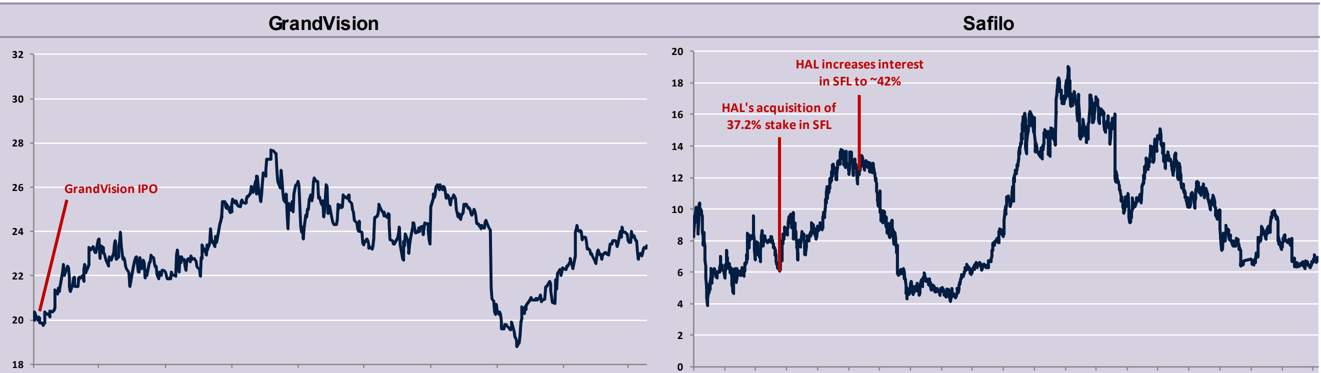
The investment timeframe is very long since the fund started to invest in optical chains in 1996. **GrandVision** was created in 2011 from the merger of the two major chains owned by HAL: Pearle Europe and Grand Vision. HAL finally floated slightly more than 20% of GrandVision in February 2015 at a price of EUR20.

Its stake in Safilo was built in two stages:

**(i)** **A first stake of 37.2%** was bought in March 2010, representing a total investment of around EUR222m.

**(ii)** **The stake was lifted to 42.2% in April 2012** via a reserved rights issue (EUR44.3m or EUR9/share), destined at financing part of the Polaroid acquisition.

**Fig. 28: Change in GrandVision and Safilo share prices:**




*Source: Datastream, Bryan, Garnier & Co ests*

### 2.4.3. A tempting scenario for HAL on paper…

Although the two groups share the same shareholder, the synergies between GrandVision and Safilo are far from optimal, with HAL managing its two assets independently. Safilo's management has often stated that its brands were not the object of special treatment by GrandVision concerning brand referencing. **Today, we estimate that GrandVision accounts for around 5% of Safilo's sales.**

Safilo needs to face the risk of finding itself isolated up against the EssilorLuxottica giant and increased competition from the LVMH-Marcolin joint venture and Kering Eyewear. These operations have also relaunched the issue of vertical integration, especially better control of distribution. Note that in the retail segment, GrandVision faces a number of rivals that have been integrated vertically, such as Luxottica and Fielmann. The market could therefore start playing the merger scenario again given that this would have a few advantages for both groups:

**(i)** **Vertical integration for GrandVision:** the rise in profitability was notably driven by the ability to better negotiate sourcing conditions with suppliers, especially thanks to tender procedures. Safilo is its third-largest supplier of frames and sunglasses, and its integration could therefore enable it to: **1/** secure supply, **2/** unlock additional synergies and **3/** benefit from Safilo's expertise in sunglasses, a category currently enjoying sharp growth at GrandVision.

**(ii)** **Finally, a controlled distribution network for Safilo:** this asset enabled Luxottica to widen the gap over all its rivals over the past decade. With the GrandVision chains, Safilo would have a significant outlet for its production and would strengthen its negotiating clout relative to brands, either to attract new ones, or to hang onto existing ones. Finally, Safilo could better anticipate market trends.

**(iii)** **HAL: optimising assets in the optical segment:** the combination of GrandVision's retail business and Safilo's wholesale would result in the creation of a “mini-Luxottica” and a perfectly vertically integrated group. Fears concerning Safilo's isolation would be resolved and HAL's optical assets would therefore be grouped together in a single listed group bigger in size.

Assuming a merger would take place, we have therefore imagined three possible scenarios with the theoretical calculation of the accretive impact based in particular on the following estimates:

- **Intra-group sales:** on our estimates, Safilo derives 5% of its overall sales from all of the chains owned by GrandVision. This share should even fall slightly in 2017 with the departure of Gucci.
- **Amount of synergies:** potential synergies would total 3% of the total cost structure of Safilo in 2018 and 5% in 2019. This estimate may seem cautious but note that there is little overlap between the two groups and GrandVision has no plant. Cost synergies would therefore be limited to central costs (+IT) and eventually a small amount in sourcing, but in our view, synergies would above all stem from additional revenues, although this potential is always difficult to estimate.

Please see the section headed “Important information” on the back page of this report.

### Fig. 29: Our 2017 & 2018 forecasts for GrandVision and Safilo:

| GrandVision P&L (EURm) | 2018e | 2019e |
|---|---|---|
| Sales | 3,484 | 3,649 |
| Adj. EBITDA | 573 | 614 |
| % of sales | 16.5 | 16.8 |
| Adj. EBIT | 434 | 466 |
| % of sales | 11.9 | 12.2 |
| Adj. Net income | 282 | 306 |
| Adj. EPS (EUR) | 1.12 | 1.21 |
| **Safilo P&L (EURm)** | **2018e** | **2019e** |
| Sales (before elimination of intra-group sales) | 1,191 | 1,248 |
| Adj. EBITDA | 84 | 87 |
| % of sales | 7.4 | 7.4 |
| Adj. EBIT | 42 | 44 |
| % of sales | 3.7 | 3.7 |
| Adj. Net income | 26 | 29 |
| Adj. EPS (EUR) | 0.42 | 0.47 |

*Source: Bryan, Garnier & Co ests*

**Scenario no. 1: GrandVision bid for Safilo**

Given its healthy balance sheet, GrandVision would have no trouble offering a 50% premium to the current share price (adjusted 2017e ND/EBTIDA of 1.9x) while respecting its internal limit (adjusted ND/EBITDA of 2x) and its covenant (adjusted ND/EBITDA of 3.25x).

### Fig. 30: Terms of a GrandVision takeover of Safilo:

| | |
|---|---|
| Safilo's share price on May 30 (EUR) | 6.7 |
| Premium to share price | 50% |
| **Price offered per share (EUR)** | **10.1** |
| Number of shares (m) | 62.8 |
| Value of 100% equity (EURm) | 634 |
| Net debt and end-2017e (EURm) | 43 |
| **Total EV (EURm)** | **676** |
| Cost of debt (pre-tax) | 3% |
| Tax rate | 30% |

*Source: Bryan, Garnier & Co ests*

### Fig. 31: Theoretical accretive impact in the event of a bid:

| GrandVision + Safilo P&L (EURm) | 2018e | 2019e |
|---|---|---|
| Sales excl. intra-group sales | 4,780 | 5,005 |
| Adj. EBITDA | 698 | 741 |
| % of sales | 14.6 | 14.8 |
| Adj. EBIT pre-synergies | 476 | 510 |
| % of sales | 10.0 | 10.2 |
| Synergies | 35 | 60 |
| Adj. EBIT after synergies | 511 | 570 |
| % of sales | 10.7 | 11.4 |
| After-tax synergies | 24 | 42 |
| After-tax additional cost of debt | -14 | -14 |
| Adj. net income | 319 | 363 |
| Number of shares (m) | 252.6 | 252.6 |

Please see the section headed "Important information" on the back page of this report.

| | | |
|---|---|---|
| **Adj. EPS (EUR)** | **1.26** | **1.44** |
| **Theoretical accretion (%)** | **13%** | **19%** |

*Source: Bryan, Garnier & Co ests*

**<u>Scenario no. 2:</u> mixed public offering in shares and cash (42-58%)**

Given the respective sizes of the two groups (market capitalisation of around EUR6bn for GrandVision and EUR430m for Safilo), a share exchange offer is not vital for the Dutch group, since the structuring would be more complicated and the theoretical accretive impact ultimately less attractive than a takeover bid. Consequently, a mixed operation seems less likely to us.

**Fig. 32: Terms of a mixed offer by Grandvision for Safilo:**

| Partial share offer (42%)... | | ... and 58% in cash | |
|---|---|---|---|
| Safilo's market cap (EURm) | 423 | Safilo's share price on May 30 (EUR) | 6.7 |
| Premium to share price | 50% | Premium to share price | 50% |
| **SFL: value of 100% equity (EURm)** | **634** | **Price offered per share (EUR)** | **10.1** |
| **GVNV: value of 100% equity (EURm)** | **5,896** | | |
| | | Value of 100% equity (EURm) | 634 |
| SFL: number of shares (m) | 62.8 | Net debt and end-2017e (EURm) | 43 |
| GVNV: number of shares (m) | 252.6 | **Total EV (EURm)** | **676** |
| | | **Total investment for GVNV (EURm)** | **391** |
| **Exchange ratio (x)** | **0.433** | | |
| **New GVNV shares to acquire 42% stake in SFL (m)** | **11.5** | Cost of debt (pre-tax) | 3% |
| | | Tax rate | 30% |

*Source: Bryan, Garnier & Co ests*

**Fig. 33: Theoretical accretive impact in the event of a takeover bid:**

| GrandVision + Safilo P&L (EURm) | 2018e | 2019e |
|---|---|---|
| Sales excl. intra-group sales | 4,780 | 5,005 |
| Adj. EBITDA | 698 | 741 |
| % of sales | 14.6 | 14.8 |
| Adj. EBIT pre-synergies | 476 | 510 |
| % of sales | 10.0 | 10.2 |
| Synergies | 35 | 60 |
| Adj. EBIT after synergies | 511 | 570 |
| % of sales | 10.7 | 11.4 |
| After-tax synergies | 24 | 42 |
| After-tax additional cost of debt | -8 | -8 |
| Adj. net income | 325 | 369 |
| Number of shares (m) | 264.1 | 264.1 |
| **Adj. EPS (EUR)** | **1.23** | **1.40** |
| **Theoretical accretion (%)** | **10%** | **15%** |

*Source: Bryan, Garnier & Co ests*

**Scenario no. 3: share exchange offer**

Like scenario no. 2, a share exchange offer is not vital for GrandVision since Safilo is modest in size relative to the Dutch group. In addition, the eventual accretive impact would also be the least attractive of the three possible scenarios.

### Fig. 34: Terms of a GrandVision share exchange offer for Safilo:

| | |
|---|---|
| Safilo's market cap (EURm) | 423 |
| Premium to share price | 50% |
| **SFL: value of 100% equity (EURm)** | **634** |
| **GVNV: value of 100% equity (EURm)** | **5,896** |
| SFL: number of shares (m) | 62.8 |
| GVNV: number of shares (m) | 252.6 |
| **Exchange ratio (x)** | **0.433** |
| **New GVNV shares to acquire 100%stake in SFL (m)** | **27.2** |

*Source: Bryan, Garnier & Co ests*

### Fig. 35: Theoretical accretive impact of a share exchange offer:

| GrandVision + Safilo P&L (EURm) | 2018e | 2019e |
|---|---|---|
| Sales excl. intra-group sales | 4,780 | 5,005 |
| Adj. EBITDA | 698 | 741 |
| % of sales | 14.6 | 14.8 |
| Adj. EBIT pre-synergies | 476 | 510 |
| % of sales | 10.0 | 10.2 |
| Synergies | 35 | 60 |
| Adj. EBIT after synergies | 511 | 570 |
| % of sales | 10.7 | 11.4 |
| After-tax synergies | 24 | 42 |
| After-tax additional cost of debt | 0 | 0 |
| Adj. net income | 333 | 378 |
| Number of shares (m) | 279.8 | 279.8 |
| **Adj. EPS (EUR)** | **1.19** | **1.35** |
| **Theoretical accretion (%)** | **7%** | **11%** |

*Source: Bryan, Garnier & Co ests*

### 2.4.4. … However, the two groups have different strategies and this makes an eventual merger more complicated

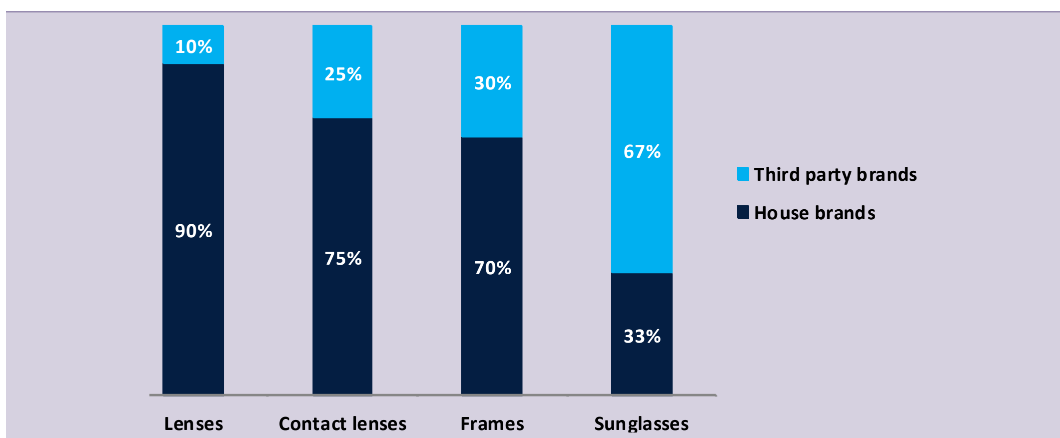
**GrandVision: priority on exclusive brands**

Like all retailers, GrandVision's interest is to push its own brands in order to raise its profitability and stand out from rivals. This strategy is justified particularly since the Dutch group operates in the mass segment where consumers are less attracted by brands and focus more on the price/quality ratio.

GrandVision has successfully managed to develop its own brands as shown by the chart below: **the majority of its own brands total 90% for corrective lenses, 75% for contact lenses and even 70% for frames.**

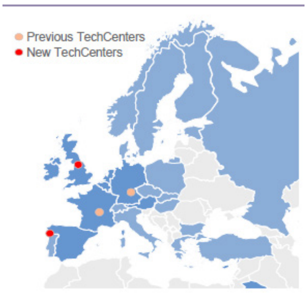
Even though the house brands only account for 33% of sunglasses, **this global strategy of pushing own brands is the opposite to that of Safilo, which relies on its brand portfolio ranging from mass to luxury segments.** As such, there is little chance that GrandVision and Safilo could develop significant sales synergies such as those existing at Luxottica, bearing in mind that the Italian brands represent respectively 95% and 60% of sales at Sunglass Hut and LensCrafters.

**Fig. 36: Weight of GrandVision house brands by category (volumes):**




*Source: Company Data, Bryan, Garnier & Co ests*

The four GrandVision TechCenters:




*Source: Company Data*

**GrandVision: little interest in maximum vertical integration..**

During the conference call on 2016 earnings, the group's CEO again reminded that the Dutch group did not intend to insource its production, contrary to players such as Fielmann and Luxottica, to maintain maximum flexibility in the choice of products and suppliers. As such, GrandVision does not seem interested in acquiring a lens or frame manufacturer over the medium-term.

Upstream integration is currently limited to the stage of lens mounting (prescription lab), in order to play on the group's critical mass by concentrating volumes as far as possible in specialised centres, known as TechCenters (TC). So far, GrandVision has four centres, all located in Europe: **1/** Germany (1988), **2/** France (2009), **3/** Portugal (2014) and **4/** the UK (2014). This rise in momentum was one of the main catalysts behind the hike in the group's margins, especially in the G4 segment (adjusted EBITDA margin over 2012-16 up 240bp to 21.5%). **In 2016, these centres cut and mounted around 67% of total lens sales sold by the group.**

Please see the section headed "Important information" on the back page of this report.

**… preferring to focus on suppliers to make the most of its critical mass**

In order to maintain its competitiveness, GrandVision still ensures it can benefit from the best sourcing conditions possible thanks to two initiatives: **(i)** concentration of purchases for the group's 34 banners is key in order to make the most of the critical mass effect (like a purchasing centre) and **(ii)** the regular launch of tenders (every three years on average) to play on competition, without compromising the quality of its products.

The table below sets out the group's three main suppliers by category. While the presence of **Luxottica** and **Safilo** is no surprise given the low share of exclusive brands in sunglasses, note that GrandVision has not used Essilor since H2 2015, since it uses a different strategy: **1/** it does not accept the sale of lenses in own brands and **2/** it is more implicated in the supply chain of its clients (logistics, stock and assortment management etc.) as shown by the partnerships with Alain Afflelou, Boots (UK) and General Optica (Espagne).

**Fig. 37: Main suppliers by category:**

| Category | Top 3 suppliers… | … and their share of value (%) |
|---|---|---|
| Lenses | Hoya, Rodenstock, Seiko | 82 |
| Contact lenses | Alcon, Cooper Vision, Johnson & Johnson | 85 |
| Frames & Sunglasses | **Luxottica**, Marchon, **Safilo** | 72 |

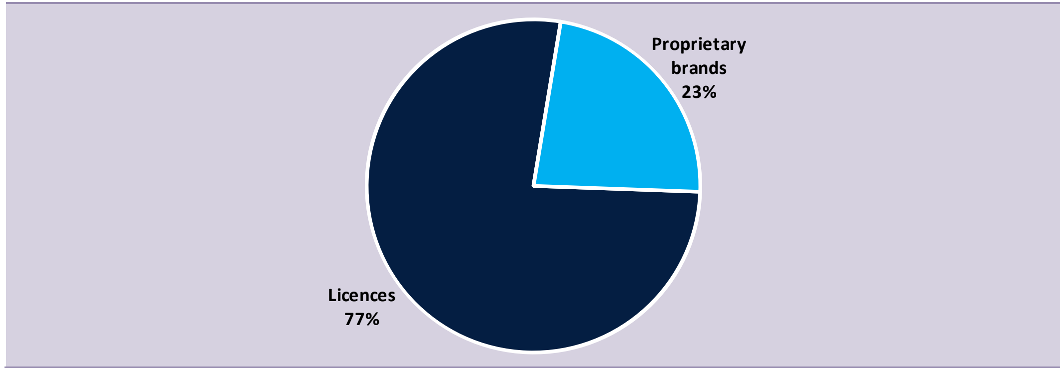
*Source: Company Data*

### 2.4.5. If Safilo wants to remain independent, it will have to reduce its exposure to licences

Despite the prospect of losing the LVMH licences further out, Safilo's CEO has often stated that the group would like to remain independent, suggesting that a possible merger with GrandVision was not on the agenda at the Italian group either. This aim to remain independent is only possible if Safilo manages to make its growth sustainable, implying a reduction in its exposure to licences (BG estimate: around 77% of sales at end-2016).

However, since the launch of the 2020 Strategic Plan in March 2015, the portfolio of own-brands (primarily Carrera, Polaroid and Smith) has underperformed that of licences (excluding the negative impact caused by the departure of Gucci). **Carrera** is still struggling to restore growth after its repositioning but more surprising, **Polaroid's** sales dropped slightly last year due to a more intense competitive backdrop at the end of the year. Only **Smith** posted a rise in its online sales (~30% of North American sales at Smith), which helped overcome the difficulties in the sporting goods channel.

**Fig. 38: Breakdown of 2016 sales between proprietary brands and licences:**




*Source: Bryan, Garnier & Co ests.*

Please see the section headed "Important information" on the back page of this report.

**2017: A key year for shaking up the portfolio of house brands**

Despite these two years of underperformance, the group's CEO reiterated his aim to generate around 40% of sales from proprietary brands by 2020. This year should therefore be key and this is why numerous initiatives are planned at the group's five brands, some of which are set out in the table below.

In all, Safilo needs to apply the same measures that already work with the portfolio of licences, namely launching collections that are loyal to each brand's positioning and DNA, capitalising on the very dense circuit of independents and ensuring perfect execution.

**Fig. 39: The main sources of leverage to growth in Safilo's proprietary brands:**

| Smith | Carrera | Polaroid | Safilo | Oxydo |
|---|---|---|---|---|
| SMITH | CARRERA EYEWEAR SINCE 1956 | Polaroid | SAFILO | OXYDO |
| ~8% of total sales | ~7% of total sales | ~7% of total sales | ~1% of total sales | <1% of total sales |
| • Penetrate new sport categories & develop lifestyle<br>• Continue geographical expansion (Europe)<br>• E-commerce (already ~30% of NA sales) | • Well-differentiated brand design and image<br>• Enlarge geographical footprint<br>• Improved quality of sun lenses<br>• Increased communication efforts | • Three new collections launched per year vs. one<br>• Expand distribution, esp. outside Europe<br>• Focus on digital marketing | • Main brand to expand the prescription category (only 35% of sales)<br>• Target: premium & high end price segment | • New brand in the Atelier segment<br>• Display Safilo's high degree of craftsmanship |

*Source: Bryan, Garnier & Co ests*

**M&A remains an opportunity that should not be neglected**

Even if Safilo wants to or must succeed firstly in boosting organic growth for all of its proprietary brands, the group could also consider taking over a number of independent brands (*see table Fig. 40 below*). Via an acquisition, Safilo would kill two birds with one stone: **(i)** the weight of the house brands would rise faster, and **(ii)** Safilo would increase its presence in prescription (around 35% of sales), a category that is larger and less cyclical than sunglasses.

As the table below shows, the majority of these brands are relatively small in size (average sales: around EUR20m) since they have more of an upscale positioning, with a fairly selective distribution network. In addition, the timing would be ideal since we do not believe that Luxottica would make acquisitions just as the antitrust authorities are examining the merger with Essilor.

**Fig. 40: A few examples of independent brands:**

| Brand | Country | Est. Sales (EURm) | Comments |
|---|---|---|---|
| Bevel | U.S | 10-20 | High-end eyewear and sunglasses, hand-made in Japan |
| Cutler & Gross | U.K | ~30-40 | Hand-made in Italy (2 plants), production: ~96k frames per year |
| Gold & Wood | Luxembourg | ~5 | Production: ~27-30k per year, 75% Rx / 25% sun, 8 flagship sores, very high-end positioning |
| Lindberg | Denmark | ~30-40 | High end eyewear and sunglasses, known for its titanium frames |
| Morgenthal Frederics | U.S | 10-20 | 11 stores, belongs to Luxury Optical Holdings (optical retailer) |

*Source: Bryan, Garnier & Co ests*

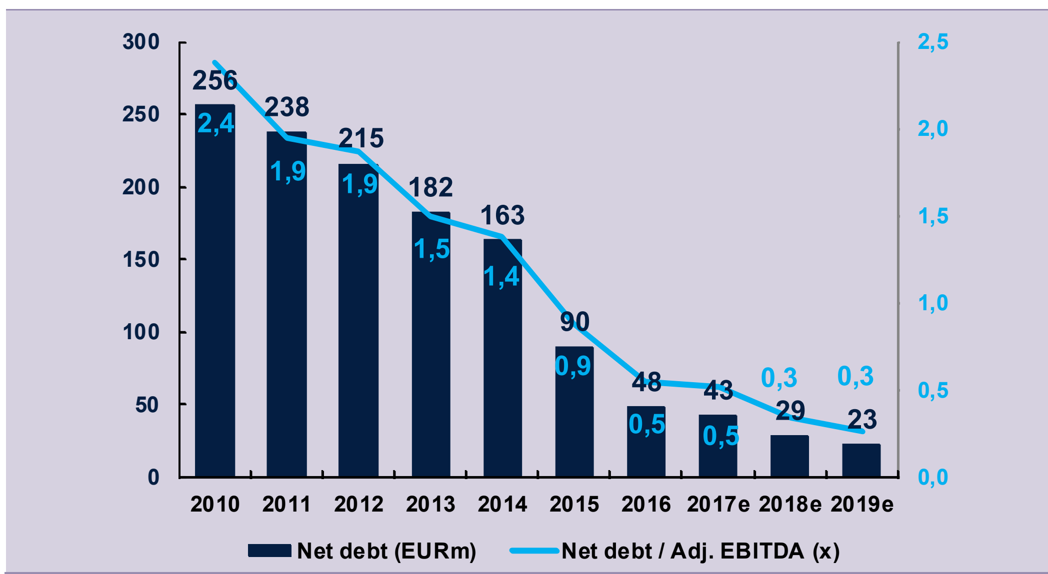
Please see the section headed "Important information" on the back page of this report.

**Safilo could at least make a medium-sized acquisition**

Given the latest major transactions in the sector (EV/sales of 1.4x for the acquisitions of Alain Mikli and Polaroid), we believe that these brands are clearly within Safilo's reach, especially since the group should be close to the net cash position as of 2019, as the chart below shows.

In the event of a larger acquisition, we cannot rule out the prospect of backing from HAL, which could take part in the financing as it did for the takeover of Polaroid: the Dutch fund contributed EUR44m via a reserved rights issue out of a total cost of EUR65m.

**Fig. 41: Safilo net debt and adjusted ND/EBITDA ratio (2010-19e):**




*Source: Company Data; Bryan, Garnier & Co ests.*

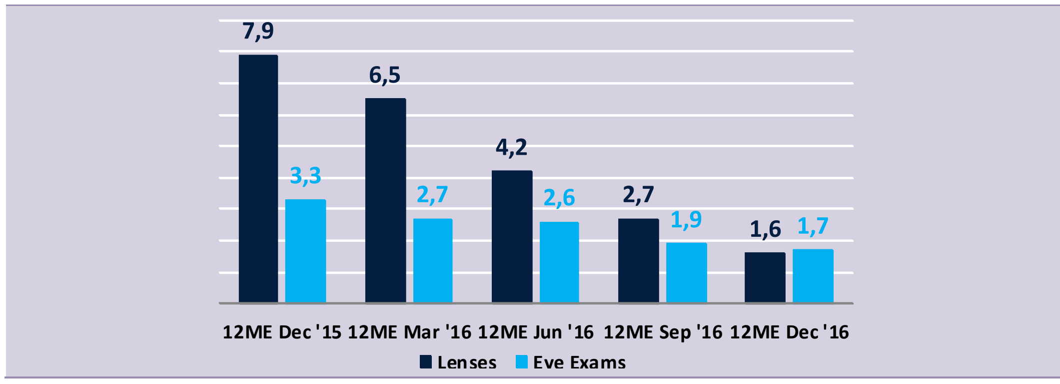
# 3. US market: is the 2016 slowdown behind us?

## 3.1. Corrective lenses were the most affected

The category was indeed the worst affected, as shown by the chart below: after a very dynamic year in 2015 (+7.9% over 12m yoy), growth in **corrective lenses** slowed constantly, ending with a rise of just 1.6% at end-December. **Eye tests** also slowed over the period, with growth of just 1.7% at end-December (12m yoy) vs. +3.3% at end-December 2015.

Analysis of **eye tests** is also interesting since it is a prior stage to the purchase or replacement of lenses, especially in the US, where these tests are primarily undertaken by independent optometrists or those affiliated with optical chains (e.g. Walmart, LensCrafter, Pearler Vision etc). These eyesight tests therefore play an essential role in the conversion rate for optical stores and the slowdown shown by the eye tests category could suggest a wait-and-see attitude by US consumers who are delaying the replacement of their lenses in the short term.

***Fig. 42:*** **Corrective lens sales and eye tests have slowed clearly *(change in value terms over 12m rolling, sell-out figures):***




*Source: Vision Council*

## 3.2. Are there other wait-and-see factors to explain this temporary slowdown?

Apart from this postponement effect by US consumers (= weak end demand, hence volumes), many feared that the slowdown in the US optical market was associated with eventual pressure on prices and/or the ramp-up in the online channel, which are threats facing virtually all ready-to-wear brands in the US market at present. In our view, the impacts of these challenges remain limited and are not the main reasons behind this temporary slowdown.

### 3.2.1. Internet: sales are growing but market share remains confidential

At end-December 2016, **online sales of optical products rose by 8%, or a performance slightly below that of the past five years** (CAGR of 10-15%), but which should be seen in relation to the anaemic growth in the overall corrective lens market (+0.6% in volumes). This momentum could prompt certain investors to believe that the decline in traffic in optical stores is due to competition from internet, similar to trends witnessed by traditional clothing retailers (e.g.: department stores).

In our view, this is not the case. As the left-hand chart below shows, **the internet circuit only accounted for 4% of the US optical market whereas more than 30% of clothing and shoe sales are made online** (see right-hand chart). While the online circuit is becoming significant for contact lens sales (around 15-20%) and sunglasses (10%), it remains very marginal for lens sales, especially for complex lenses (e.g. progressive lenses) and the upscale segment, since consumers prefer to maintain a "real" relation in this category.

**Fig. 43: Internet only accounts for 4% of the optical market vs. 31% for clothing:**

**Rx frames e-commerce penetration (% of total US market):**

| Y/E Dec '12 | Y/E Dec '13 | Y/E Dec '14 | Y/E Dec '15 | Y/E Dec '16 |
|---|---|---|---|---|
| 2,9% | 3,2% | 3,4% | 3,9% | 4,2% |

**Online sales penetration rate by category (%):**

| Category | % |
|---|---|
| Travel Leisure Flights | 83% |
| Music | 81% |
| Travel Hotel Stays | 61% |
| IT Devices | 32% |
| Clothing & Footwear | 31% |
| Home Furnishings | 28% |
| Car Insurance | 28% |
| Mobile Phones | 24% |
| Home Appliances | 17% |
| TV Sets | 15% |
| Make-up | 15% |
| Optical & Eyewear | 4% |

*Source: Vision Council, Ecommerce Foundation, Bryan, Garnier & Co ests*

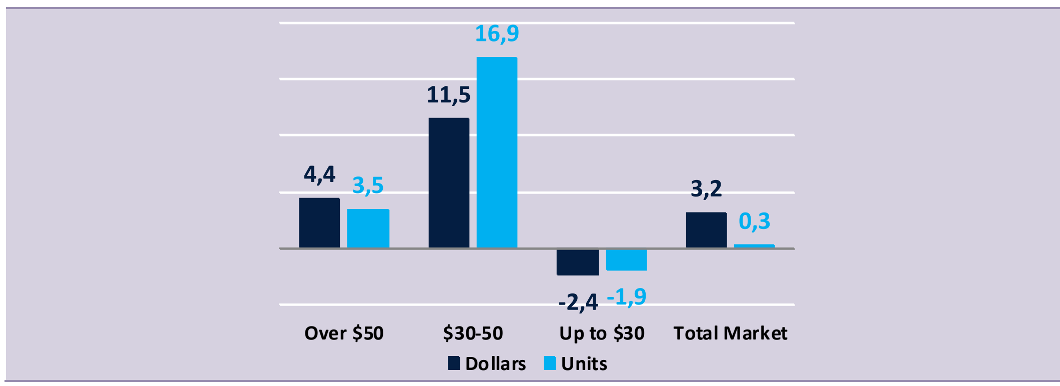
### 3.2.2. Sunglasses: no trading down and low price pressure

The 2016 sunglass season was also more sluggish since growth only stood at 3.2% vs. 5.1% in 2015. This weakness was mostly caused by a lack of sunshine during the most important quarter of the year (Q2 2016), leading to low volume growth (+0.3% vs. +3.2% in 2015) as shown in the chart on the following page.

This chart also shows **that there was no trading down by consumers** since the segment above (retail price above USD50) gained more than 4% whereas the value segment (<USD30) narrowed by almost 2%. In contrast, a premiumisation effect was even noted in favour of the mid-range segment (USD30-50) as already pointed out by **Essilor**. This trend helps better understand the reasons for the ramp-up of its Foster Grant brand (readers) in the up to USD50 price category (vs. <USD30 previously) and why **Safilo** is stepping up its development in the segment that it qualifies as mass/cool (USD50-90).

Admittedly in sunglasses, **the price backdrop remains beneficial for brands** since retailers (independents opticians, specialised chains such as SGH) maintain greater discipline in their prices than those operating in clothing. These market conditions also probably helped **Ray-Ban** (Luxottica) to clean up the grey market and reduce the average discount rate (e.g. <6% at the start of 2017 vs. ~37% in April 2016 on Amazon Marketplace).

**Fig. 44: Growth in volumes and value in the sunglass category (12m yoy at end-December 2016, in %):**



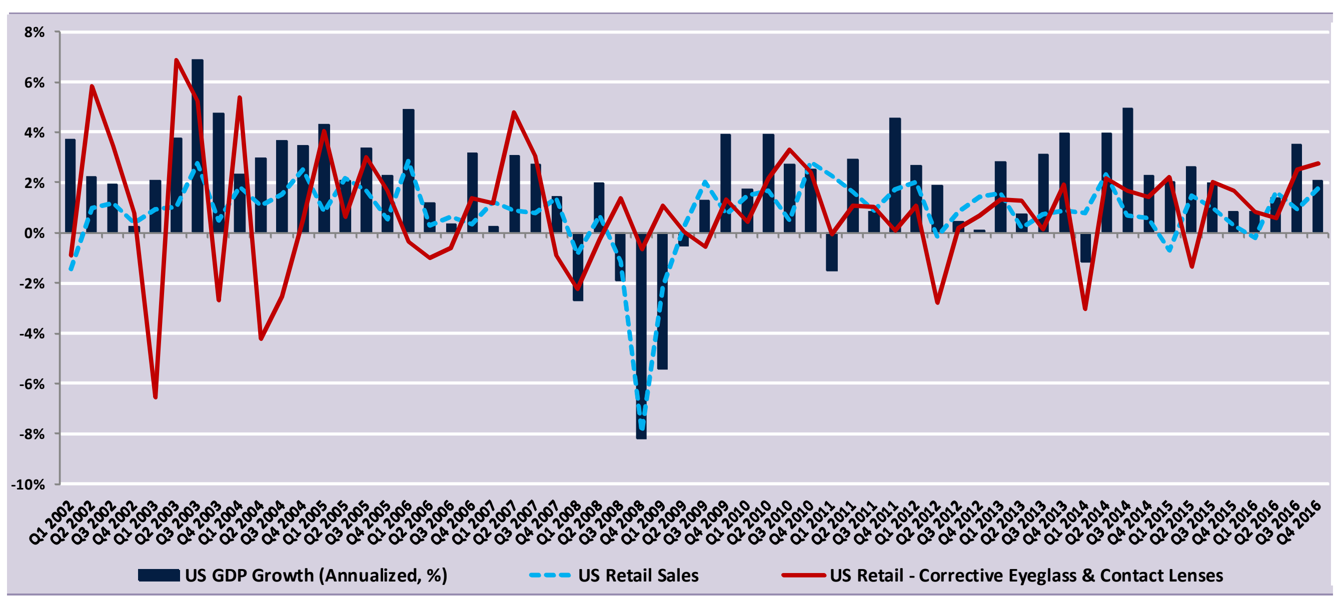

*Source: Vision Council, Bryan, Garnier & Co ests*

## 3.3. The US in 2017: heading for a rebound?

### 3.3.1. US macro indicators remain beneficial

Change in the US optical market is historically correlated to that of US GDP growth, as shown by the chart below. The rise in retail sales of optical products ran out of steam over the majority of 2016 (red line), but picked up again as of Q4 2016, confirming statements by the groups, who noted a bubbling in activity following the US elections.

**Fig. 45: Change in GDP growth and retail sales (qoq, % change):**




*Source: Datastream*

Please see the section headed "Important information" on the back page of this report.

The recovery in the optical market could be driven by the constant improvement in the consumer confidence index, which has remained above the pre-subprime crisis levels for several months (117.9 in May).

**Fig. 46: Conference Board US consumer confidence index:**

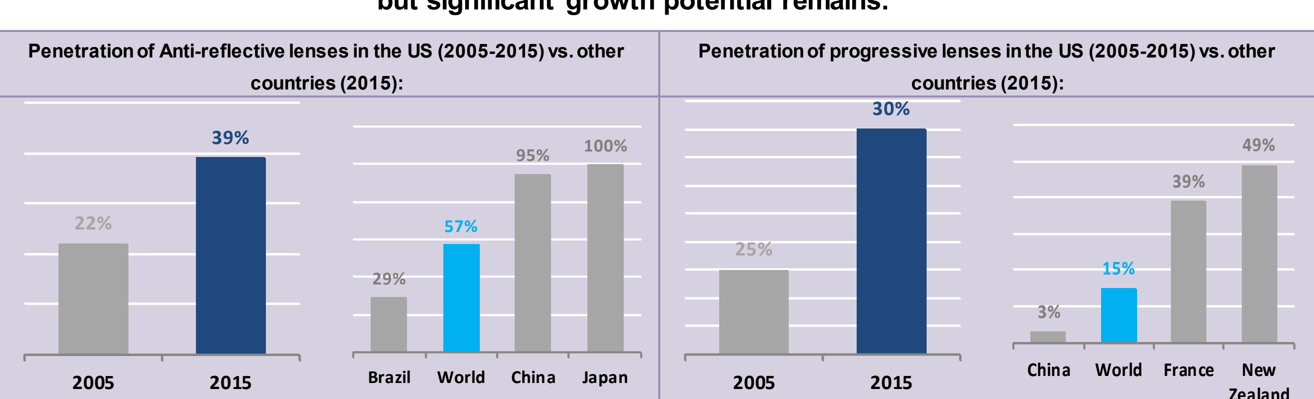
*Source: Conference Board*

### 3.3.2. MT/LT growth opportunities remain considerable

Although the US accounts for a little less than 40% of the global optical market and is the main market for Essilor, Luxottica and Safilo, all players agree in highlighting that growth prospects remain very attractive, thanks to buoyant demographical trends, but above all, a value potential given the technological lag relative to Europe.

If we take the two examples set out in the tables below, to show that the US market remains under-developed in terms of value-added lenses: **(i)** despite 17 points of growth between 2005 and 2015, only 39% of lenses have **anti-reflection treatments** compared with the global average of 57% and **(ii) progressive lenses** have market share close to 30%, which is double the global average, but nevertheless remains below levels in several western markets. Note also that the US is lagging in terms of **high indices** (= thin lenses), with a penetration rate of just 5% vs. 15% on average in the world.

**Fig. 47: Value-added lenses gained momentum in the US between 2005 and 2015 but significant growth potential remains:**




*Source: Essilor; Bryan, Garnier & Co ests*

Please see the section headed "Important information" on the back page of this report.

### 3.3.3. The same goes for the sunglass category

The lag in value terms also concerns the sunglasses market given that at end-September 2016, although three pairs of sunglasses out of four sold in the US were sold for less than USD30 (*see left-hand chart below*). The predominance of value is explained by:

**(i)** **The success of sunglass readers (average price: around USD15-20)**, a segment widely dominated by FGX (Essilor) and which is not very well developed beyond anglo-US markets. Note interestingly that readers are also concerned by premiumisation thanks to the innovation contributed by Essilor and FGX, such as polarised lenses.

**(ii)** **Distribution majority controlled by mass retailers** (Walmart, Costco, Dollar General, etc.) who have a market share of 39.4% in volume terms (17.6% in value) and which therefore implies a lower average selling price.

To make the most of this catching up effect, the solutions to adopt are virtually identical to those in the ophthalmic segment: manufacturers and associations such as Vision Council must: **(i)** train independent opticians better so that they can convince their customers to move upscale and attract new customers, **(ii)** extend the network of specialised banners (e.g. Sunglass Hut, Solstice, etc.) to improve the shopping experience, and **(iii)** communicate on the benefits of innovations such as polarised lenses, new lens tints for specific uses (driving, outdoor sports etc.) and new materials concerning frames.

Consumer education is also a significant catalyst since according to a survey undertaken in the US by Vision Council, almost 30% of people questioned do not wear sunglasses to protect their eyesight, and more importantly, 65% of these people were not aware that the lack of protection from UV rays implied a significant risk of cataracts and age-related macular degeneration.

**Fig. 48: Sunglasses: distribution still dominated by the mass segment:**

US Sunglass Market by Segment (Units)

<$30 73%

>$50 20%

Mass ($30-50) 7%

US Sunglass Market by Channel (Units)

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| Independent ECP & optical chains | 2,5% | 2,5% | 2,5% |
| Sunglass Specialty | 12,1% | 12,3% | 12,7% |
| Sporting Goods Store | 2,7% | 2,7% | 2,7% |
| Department Stores | 4,5% | 4,5% | 4,6% |
| Mass Chains | 39,1% | 39,5% | 39,2% |
| Other | 39,1% | 38,5% | 38,4% |

*Source: Vision Council; Bryan, Garnier & Co ests*

Please see the section headed "Important information" on the back page of this report.

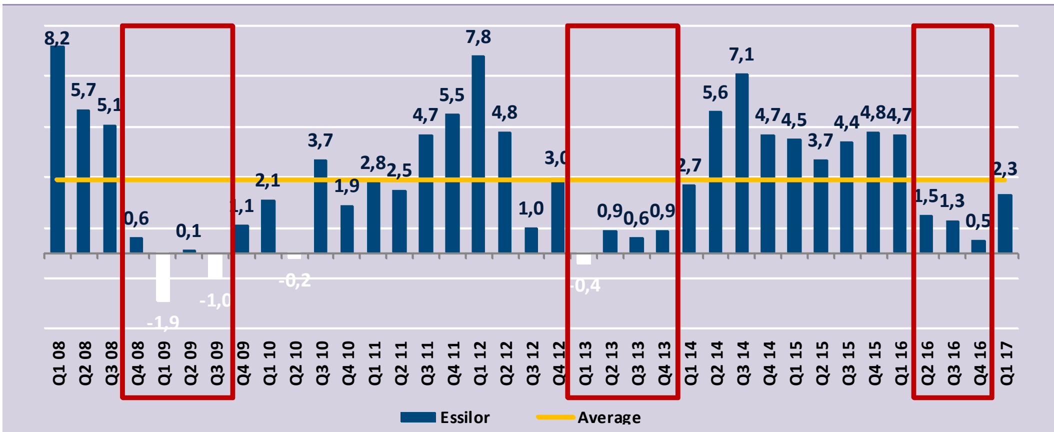
## 3.4. Recovery taking shape at the beginning of the year

### 3.4.1. Essilor (stand-alone) can count on several sources of leverage

**1/ A more beneficial market thanks to the end of the "postponement effect"**

As the chart below highlights, wait-and-see phases such as that affecting the US market and Essilor in H2 2016, generally last three to four quarters since consumers cannot delay their lens purchases/replacement indefinitely. This fact seems to be confirmed again since Essilor showed a rebound in organic growth in North American in Q1 2017 (+2.3%), despite business still partly penalised by the loss of a few Medicare/Medicaid contracts.

**Fig. 49: Change in Essilor lfl growth in North America (%) and the last three periods affected by this postponement effect:**



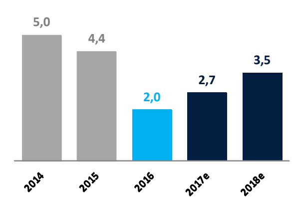

*Source: Company Data*

**2/ Essilor catalysts to pick up again in 2017**

Apart from a better ophthalmic market, Essilor could also focus on reversing a few negative trends that dented growth in the region in 2016:

**(i)** **Coastal is faring better:** in 2016, the site's sales (around EUD100m in the region) suffered a mid -ingle-digit decline given the difficult repositioning. In Q1, sales had only "fallen slightly" thanks to the new commercial offering launched at the end of the year, suggesting business could stabilise in 2017.

Growth forecasts in North America (2014-18e, lfl in %):




*Source: Company Data, Bryan, Garnier & Co ests*

**(ii)** **Action plan to shake up Transitions (+4% in Q1):** the rise in sales in Essilor networks is still too low to offset the decline in shippings to third parties (-10%). The group has rolled out a task force combining a sales force and a marketing offer exclusively dedicated to the brand, in order to boost sales within the Essilor network. The aim is to deliver like-for-like growth of at least 7% over the medium term.

**(iii)** **Varilux X to arrive in September:** the launch of the new generation of progressive lenses is strategic given the weight of the brand (around 15-20% of total sales). This new lens, which primarily targets the X generation (born between 1965 and 1980) meets the requirements of these highly connected consumers, especially by fluidifying and extending "arm's length" vision (= reading and using smartphones).

**(iv)** **A number of one-off items should no longer weigh on H2 2017:** note indeed that the group was penalised by the loss of very specific contracts (US Department of Veterans

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Affairs and Medicaid/Medicare contracts in the US). These should no longer weigh on organic growth in the region after the end of H1 2017.

### 3.4.2. Luxottica: initiatives are starting to pay off

The numerous projects launched in 2016 in North America (Minimum Advertised Price or MAP at **Ray-Ban**, integration and reorganisation of **Oakley**, digitalisation of **LensCrafters** stores etc.) have taken a toll on the Italian group's performance. While the MAP turned out to be more of a handicap than expected, the effects of this reorganisation were exacerbated by poor sunshine in Q2 (sunglasses = 56% of the group's sales) and the difficulties encountered by a number of sports articles distributors who were Oakley clients (e.g. bankruptcy of Sports Authority with 450 stores).

**The MAP rapidly helped limit promotional campaigns at Ray-Ban**

Although the MAP led to a plunge in online sales to third parties in the US (-50 to -60%), and in US wholesale sales (-3%) in 2016, the fact that the **Italian group rapidly succeeded in weeding out the grey market and reducing the average promotional rate (>6% over the start of the year vs. ~6% in October 2016 and above all ~37% in April 2016) is excellent news.** As mentioned previously, these first promising results from the MAP were facilitated by the discipline of distributors who did not start a price war as in clothing. **However, Ray-Ban's appeal also played since sales on the Ray-Ban.com website increased in double-digits while sales in the group's stores also rose**, proving that consumer appetite for this brand remains strong.

Ray-Ban: New Wayfarer model (polarised lenses) sold for USD190 on the Ray-Ban.com website:

*Source: Ray-Ban.com*

The screenshot below indeed shows that apart from one site offering a promotional deal (probably authorised by Ray-Ban), the prices proposed by Amazon and Amazon Marketplace are identical to those on the brand's website (see example opposite of the New Wayfarer model). In addition, the sites that have pledge to respect the brand's commercial policy have also received the "Authorized Retailer Agreement" stamp and highlight it on the website (see red boxes).

**Fig. 50: Price of New Wayfarer model (polarised) on the Amazon US site:**

| Price + Shipping | Condition (Learn more) | Delivery | Seller Information |
|---|---|---|---|
| $161.50 Prime & FREE Shipping Details | New | FULFILLMENT BY AMAZON • Want it delivered Tuesday, May 2? Order it in the next 5 hours and 46 minutes, and choose One-Day Shipping at checkout. See details • Shipping rates and return policy. | Genuine Eyewear 97% positive over the past 12 months. (837 total ratings) |
| $190.00 Prime & FREE Shipping Details | New | FULFILLMENT BY AMAZON • Want it delivered Tuesday, May 2? Order it in the next 8 hours and 31 minutes, and choose One-Day Shipping at checkout. See details • Shipping rates and return policy. | Designer Iwear 99% positive over the past 12 months. (1,568 total ratings) |
| $190.00 Prime & FREE Shipping Details | New | FULFILLMENT BY AMAZON • Want it delivered Tuesday, May 2? Order it in the next 5 hours and 46 minutes, and choose One-Day Shipping at checkout. See details • Shipping rates and return policy. | Green Room: Surf Skate Snow Sand SUP 99% positive over the past 12 months. (21,805 total ratings) |
| $190.00 Prime & FREE Shipping Details | New | FULFILLMENT BY AMAZON • Want it delivered Tuesday, May 2? Order it in the next 8 hours and 31 minutes, and choose One-Day Shipping at checkout. See details • Shipping rates and return policy. | Frame Center 100% positive over the past 12 months. (149 total ratings) |
| $190.00 Prime & FREE Shipping Details | New | FULFILLMENT BY AMAZON • Want it delivered Tuesday, May 2? Order it in the next 3 hours and 16 minutes, and choose One-Day Shipping at checkout. See details • Shipping rates and return policy. | Designer Optics 93% positive over the past 12 months. (1,722 total ratings) |
| $190.00 & FREE Shipping | New | • Arrives between May 5-10. • Want it delivered Monday, May 8? Choose Expedited Shipping at checkout. • Shipping rates and return policy. | Luxury Ottica 95% positive over the past 12 months. (45 total ratings) |

*Source: Amazon.com (US website)*

### US retail: reorganisations underway still taking a harsh toll on performance

Optical chain sales dropped 2.3% on a constant-currency (cc) basis in Q1 2017. This renewed downturn was primarily explained by a poor same-store performance (*see left-hand chart below*): **1/ LensCrafters** is continuing its digitalisation and the roll-out of a new store concept, which has prompted upsets in sales, **2/ Sunglass Hut** has suffered a plunge in traffic given the decline in promotional offerings as well as the ramp-up of the brand's online sales.

**SGH** therefore optimised its store network with the closure of 160 sales points in Q1, whereas **Sears Optical** also reduced its density (-88 stores vs. Q1 2016 to 477 stores) given the huge difficulties encountered by the host chain Sears. The impact of these closures was offset by the opening of sales points at **LensCrafters** (+86 to 1,012 stores) and at **Target Optical** (+88 to 477 stores), in line with the plan unveiled last year.

For the moment, these initiatives therefore mask the improvement in underlying trends but management was keen to state that this negative impact was in line with its expectations (and those of the consensus) and that it expects a gradual improvement as of Q2. This scenario has been factored into FY 2017 guidance (see elsewhere).

**Fig. 51: Quarterly growth of US retail:**

Optical NA and SGH US comparable store sales (%):

Retail North America (FX-n growth):

*Source: Company Data; Bryan, Garnier & Co ests*

### Oakley (around 11% of total sales): reorganisation of the sports division underway

The unsatisfactory integration of Oakley, which was nevertheless bought back in 2007, was one of the main reasons mentioned by Leonardo Del Vecchio to explain his return in February 2016. The optical side of the eyewear business (around 25% of sales) was merged into the Italian group's sales force last year. Apart from R&D and production, which is still managed by the brand, the other functions are currently being integrated, as shown by the table below:

**Fig. 52: Oakley: heading for a more in-depth integration:**

| Function | Now Reports to… |
|---|---|
| R&D | Oakley's HQ (California) |
| Production | Oakley's HQ (California) – Production capacity was reinforced in 2015 |
| Retail Operations | Luxottica's North American Retail offices in Mason (Ohio) |
| Wholesale | Luxottica's North American Wholesale office in NY |
| Marketing | Luxottica's HQ in Milan |

*Source: Company Data; Bryan, Garnier & Co ests.*

The other major project at Oakley for 2017 is the relaunch of its Apparel, Footwear and Accessories business (AFA - around 15% of Oakley's sales on our estimates). The brand is notably set to clean up its number of references in apparel (-70%) and ensure that the design and products in this category are coherent with eyewear. CEO Massimo Vian stated that this reorganisation would be visible as of the spring/summer 2017 collection.

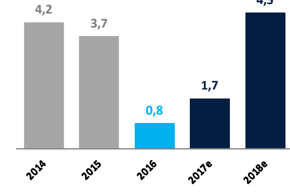
**An example of possible synergies thanks to the full integration of Oakley:** the group has just opened a store in Times Square in New York, housing its two main brands for the first time (see picture below). In 2017, this format should be deployed in other US cities.

**Fig. 53: New Ray-Ban/Oakley store in New York:**

*Source: Bryan, Garnier & Co*

**2017 US guidance: cautious, but still expecting an improvement as of Q2**

Our growth forecasts in North America (2014-18e, FX-n %):

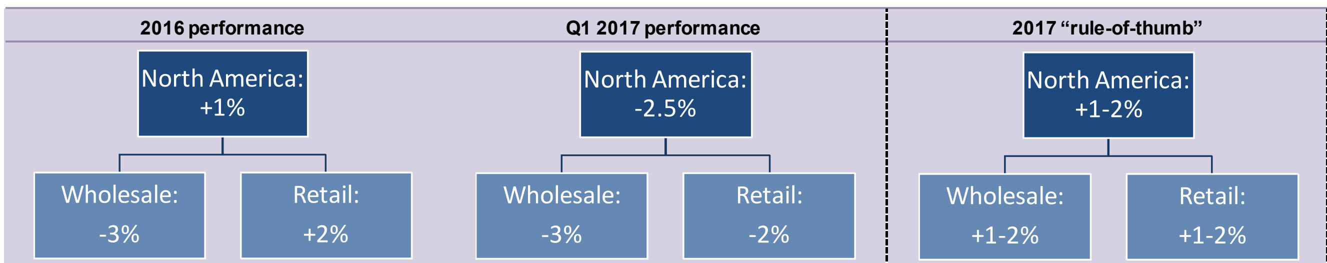



*Source: Company Data, Bryan, Garnier & Co ests*

In view of the Q1 2017 performance in North America, the Italian group is set to post average growth of almost 3% over the next three quarters to reach the middle of the range of its 2017 target (+1-2% FX-n). By distribution circuit, this would imply an average rise of 3.4% in wholesale and 2.7% in retail over the rest of the year.

Since management stated that H2 would be dynamic, this implies that the improvement will be sequential, but with a Q2 already showing signs of a recovery. This is likely to be more pronounced in **wholesale** thanks to the annualisation of the MAP effect (as of Q2) and more advantageous comparison with the year-earlier period. Unsurprisingly, guidance remains more cautious in **retail** since the rebound is set to depend mostly on the speed of execution of the numerous initiatives (e.g. digitalisation at LensCrafters, omnichannel strategy, centralisation of the lab segment, standardisation of store network management etc.).

**Fig. 54: 2017 growth targets in North America (FX-n):**




*Source: Company Data*

Please see the section headed "Important information" on the back page of this report.

### 3.4.3. Safilo penalised by its Solstice chain

In Q1 2017, Safilo's US wholesale business gained 2.6% adj. FX-n (excluding the Gucci licence), driven by an excellent winter season for **Smith** (ski helmets and masks), but also by **Kate Spade** (licence) and more recently, by **Carrera** whose new collections went down well with press editorials and customers. Its repositioning seems to be easier in this region where the brand is still fairly unknown whereas it still needs to be accepted by historical customers in Europe.

In contrast, **Solstice**, the only chain still owned by Safilo and a rival to Sunglass Hut, reported a plunge in sales (-22.6% FX-n). This was above all due to the plunge in same-store growth (-17.4%), as well as the store closure plan, in line with the stimulus plan. As such, Solstice now only has 105 stores vs. 121 at end-March 2016.

The poor start to the year for SGH and Solstice shows that the retail environment remains difficult in solar, but we also believe that the Safilo chain suffers from two main handicaps:

**(i)** **Lack of critical mass:** Solstice now only has 105 stores vs 1,700 sales points for Sunglass Hut. The rapid development in the online circuit for the sun division no longer requires such a huge network of stores as SGH, which closed more than 160 sales points in Q1, although the Solstice network remains too low to impose itself as an obvious choice for buying sunglasses in the eyes of consumers and for attracting brands outside Safilo (especially foreign ones) given its low reach in the US market. Note that in order to be efficient, an omnichannel strategy needs to include a fairly dense network of physical stores to play the advantage of proximity and service.

**(ii)** **No real development strategy:** in recent years, the group has long stated that Solstice was not aiming to expand, since the chain serves as a showcase for Safilo's know-how, but also to have a direct link with US consumers. However, the Italian group's wait-and-see attitude seems to have ended since CEO Luisa Delgado has suggested that a development plan could be rolled out once restructuring is completed.

**Fig. 55: Quarterly growth in North America by circuit (FX-n, %):**

* *"Going forward brand portfolio = excl. Kering licenses*

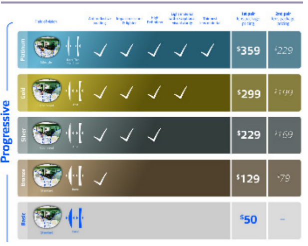
*Source: Company Data; Bryan, Garnier & Co ests.*

Please see the section headed "Important information" on the back page of this report.

### 3.4.4. What about GrandVision? The start of the American story

GrandVision is the last player in our sample to penetrate the US market, with the acquisition of the optical chain For Eyes in December 2015. This company has sales of around USD100m with 116 stores across the east coast (Chicago, Boston, Philadelphia, Miami, etc.) and California. As such, the US only accounts for around 3% of the Dutch group's sales, which is still very clearly European (87% of sales).

Price range for progressive lenses (USD50-359):

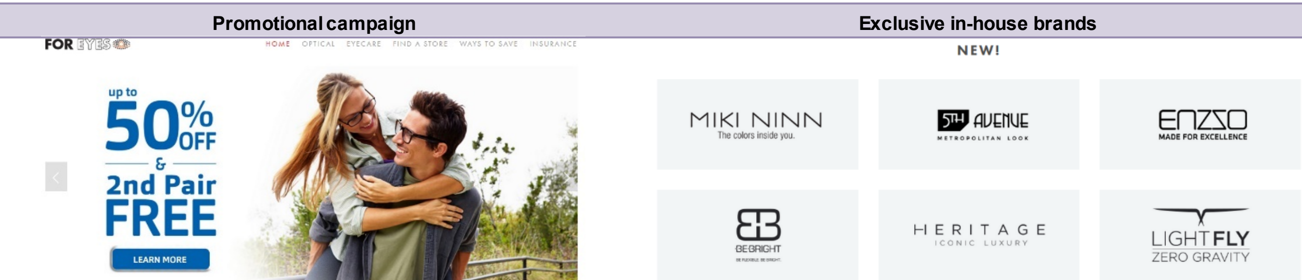



Source: Foreyes.com

Faithful to its strategy to standardise the offer, GrandVision rapidly launched its main house brands (*see Fig. 56 below*), which are present in the vast majority of the 34 banners throughout the world. As the left-hand chart shows, the brand offers promotional campaigns regularly in order to step up footfall in its stores, while the logo is also aligned with GrandVision's visual identity.

The group's price policy is coherent with its overall positioning in the mid-range, even if the various options proposed to consumers (antireflection, HD, high index etc.) means it can occupy a wide price range from USD79 to USD219 for simple lenses and USD359 for progressive lenses (see price grid opposite).

**Fig. 56: The For Eyes offer is fully aligned with GrandVision's offer:**




Source: Foreyes.com

**Other acquisitions once the integration of For Eyes is complete?**

We indeed believe that once GrandVision has completed the integration of For Eyes, the group will look for other targets. However, it will make sure that future acquisitions can easily integrate the US platform (in terms of complementary geographical, human and logistical aspects) in order to avoid the same difficulties encountered in Italy in 2015-16 between Avanzi and Optissimo that had just been bought. In our view, the group could have at least three main reasons to continue expanding in the US:

(i) **Strengthening its positions in the world's leading optical market:** since GrandVision is already the world no. 1 in ophthalmic distribution (= excluding sunglasses) the group needs to be present in the US, which represents 45% of the global optical market

(ii) **A primarily mid-range and fragmented market:** indeed, the value and mid-range segments represent respectively 23% and 53% of the corrective lens category (>USD150 for simple lenses) in line with GrandVision's positioning. Finally, distribution remains fragmented.

(iii) **Leveraging the For Eyes prescription lab:** this chain had the specific feature of owning its own prescription laboratory, which could also handle lens volumes for the next chains acquired by GrandVision. This TechCenter could represent potential operating level and productivity gains.

# 4. 2017-18 outlook

## 4.1. Essilor reigniting growth engines

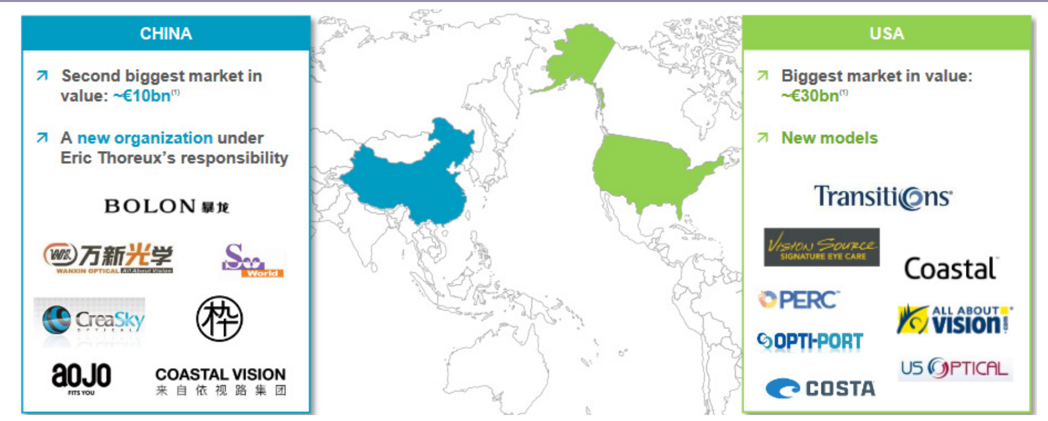
### 4.1.1. US and China should be more dynamic…

In 2016, performances in **North America** (around 47% of sales), **China** (8-9%) and **Brazil** (4%) were lower than expected, which clearly took a toll on Essilor's global growth (+3.6% vs. the initial target of around 5%). Apart from the slight drop expected in Brazil in 2017, Essilor can count on better market conditions as well as its multi-network/multi-brand strategy, as shown in the chart below:

- **In North America:** even though all the distribution channels are already well covered in prescription, Essilor is set to make a **special effort for the independent channel** by strengthening penetration of its brands at independent optometrist cooperatives and by improving service levels. For example, Framedream (delivery of lenses and frames) is set to cover more than 1,000 independents by the end of 2017 vs. 250 last year. The **online business** should also be more dynamic with the relaunch of Coastal.

- **Acceleration in sunglasses in China:** as expected, growth in domestic sales at Bolon were low in Q1 (mid single digit) due to the opening of the new plant although a sharp rebound is expected as of Q2. In the sunglass category, the multi-network strategy has been implemented since the acquisition of **MJS** in 2016: whereas **Bolon** occupies the upper end of the mid-range and is above all distributed by opticians, MJS is distributed in its own franchised stores (around 1,000 sales points), which are located primarily in shopping malls. The price positioning is slightly lower than at Bolon.

**Fig. 57: Essilor set to strengthen its presence in the US and China:**




*Source: Company Data*

### 4.1.2. … to offset the return to normal in Europe

Note that during the Investor Day in June 2014, the group communicated on average lfl growth of 0-1% over the medium term. This target was beaten in 2015 and 2016, with rises of 4% and 3.4% respectively, clearly outperforming the European optical market (around 1%e.).

Despite the good start to the year (+2% lfl vs. 1.5% expected), the consensus and ourselves expected a return to normal in this growth over 2017 given high comparison bases and a macro-environment

Please see the section headed "Important information" on the back page of this report.

that it still fragile. However, we believe that Essilor will continue to outperform the European market (*see Fig. 58 below*) and will remain above its MT guidance by continuing the same strategy:

**(i)** **Innovation:** the new generation of progressive lenses (Varilux X) is due to be launched in Europe in Q2 and should provide a significant catalyst given the weight of the brand (around 15-20% of sales on our estimates). Launches in other important brands (Crizal, Transitions, Eyezen) are also planned and this should stimulate renewal demand.

**(ii)** **Ramp-up in online circuit:** the integration of two major acquisitions in 2016 (Vision Direct in February, with sales of around EUR45m, and MyOptique Group in August, with sales of around EUR65m). With annualised sales of around EUR190m, the online channel is set to account for around 10% of total sales, and this should have an accretive impact on organic growth (but dilutive on profitability), and strengthen the group's multi-network strategy in this region.

**(iii)** **Key contracts:** Essilor has signed a new key contract this year with Synsam the leading optical chain in Nordic countries (sales of around EUR310m), enabling it to increase the penetration of its brands in the region and create long-term relations with this retailer. Those signed with Boots (UK) and General Optica (Spain) in recent years were significant catalysts.

**Fig. 58: Our lfl growth estimates in Europe (%):**

| MT guidance | 2014 | 2015 | 2016 | 2017e | 2018e |
|---|---|---|---|---|---|
| 0-1% | 0,1 | 4,0 | 3,4 | 1,7 | 1,5 |

*Source: Company Data; Bryan, Garnier & Co ests*

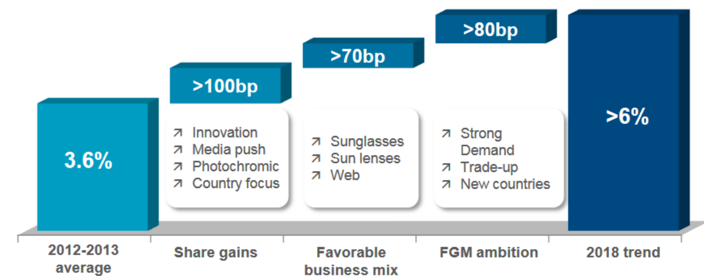
### 4.1.3. Despite the merger, 2018 targets remain intact

In June 2014, Essilor set the target of moving towards organic growth of 6% in around 2018, as shown by Fig. 59 on the following page. Unfortunately, a number of growth engines did not deliver as much as was hoped for (e.g. transitions, certain emerging markets) and macro-economic conditions were less buoyant, as shown by the weakness of the US market in 2016.

However, management confirmed during its various roadshows at the start of the year, that the 2018 roadmap remains intact and that the merger with Luxottica does not undermine these targets, on the contrary. Indeed, revenue synergies generated by the operation should help deliver this growth target.

Please see the section headed "Important information" on the back page of this report.

**Fig. 59: Initial levers contributing to the acceleration in lfl growth:**




*Source: Company Data (CMD June 2014)*

By category, the table below shows that the group seems to be lagging its guidance in emerging markets (China and Brazil in particular) and to a lesser extent, the online circuit given the difficulties at Coastal and Transitions (photochromic lenses).

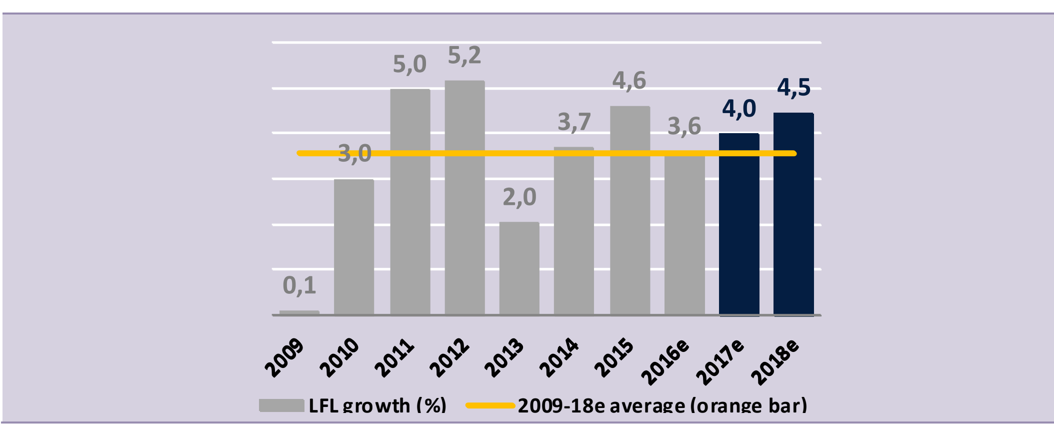
**Fig. 60: 2018 targets by category (sales, EURm):**

| Category | 2016 Revenue (BG ests) | 2018 Guidance | Implied 2016-18 CAGR (%) |
|---|---|---|---|
| Clear Lens | ~5,500 | ~5,800 | **3** |
| Sunwear | ~880 | ~1,100 | **12** |
| Online | ~325 | 400-500 | **11 to 24** |
| Fast-Growing Markets | ~1,641 | ~2,800 | **31** |
| **Total Group** | **7,115** | **~8,200** | **7** |

*Source: Company Data; Bryan, Garnier & Co ests.*

Our organic growth forecasts for Essilor stand-alone (+4%e in 2017 and +4.5%e in 2018) indeed show that we are below Essilor's 2018 target, but we would point out that since its presentation in June 2014, we and the consensus have always had more cautious estimates than those communicated by Essilor.

**Fig. 61: Our lfl growth estimates for 2016-18e:**




*Source: Company Data; Bryan, Garnier & Co ests*

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## 4.2. Luxottica on the runway before a take-off in 2018?

Whereas Luxottica is likely to be the main beneficiary of a more robust US market (around 56% of sales), the Italian group remained quite cautious in its 2017 targets, for two main reasons in our view: **(i)** management has learnt the lesson from the downward revisions to 2016 targets, and **(ii)** it is aware that the numerous initiatives underway limit visibility this year, but that their completion will depend on the acceleration expected in 2018.

Upstream of the alliance project planned for the end of the year, or early 2018, the two groups are bringing their growth paths together, as shown by the table below and will try and avoid overly complicated comparison bases that could limit the potential upswing in 2018.

**Fig. 62: Quite similar 2017 targets:**

| | Luxottica | Essilor |
|---|---|---|
| Sales | Low to mid-single digit at cc | +3-5% LFL and +6-8% at cc |
| Contribution margin / Adj. EBIT margin | 0.8-1x sales growth<br>=> Slight decline or stable margin | "Around 18.5%"<br>=> Slight decline vs. 2016 (18.7%) |

*Source: Company Data*

### 4.2.1. The many US initiatives limit visibility in the short-term

**Wholesale division: all eyes on Ray-Ban and Oakley**

During the Q1 conference call, management confirmed that the negative effects of the MAP at **Ray-Ban** would gradually fade since the brand has succeeded in rapidly cleaning up the US market and that the impact of the MAP is set to be annualised as of Q2. As mentioned above, the results of restructuring at **Oakley** will come later in 2017, but the first signs could already be visible in the optical category of the US market. The left-hand chart below shows that the division is set to benefit from very advantageous comparison with the year-earlier period in 2017. Finally, growth could also benefit from the new **Valentino** licence.

Note that at end-December, Luxottica announced the extension of the licence agreement with **Ralph Lauren** (BG est: around 2% of total sales) until 31st March 2027, which is good news given the weight of this brand in the US. We believe the Italian group should also announce the prolongation of the licence agreement with **Tiffany** (due to expire on 31st December 2017) during the year.

**Retail division: further store openings**

Two optical brands are set to continue their development in the US market: **LensCrafters** (at Macy's) and **Target Optical**. Even if LensCrafters could open slightly fewer sales points at Macy's given its closure plan, the eyewear banner should have at least 150 new stores by the end of 2017 (and a further 150-200 more in 2018), whereas **Target Optical** is set to increase its network to 180 new stores between 2016 and 2018. These store-openings are therefore a significant catalyst helping to offset: **1/** the closure of sales points at SGH and **2/** low lfl growth at LensCrafters due to the deployment of the new store concept.

It is also interesting to note that **this expansion is based on a host store format,** implying the opening of sales points within a department store rather than an autonomous store. This strategy has a number of advantages: **(i)** the sales point benefits from natural footfall at the host banner, **(ii)** the

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cost structure is far more flexible (smaller surface area, fewer staff, cheaper rents) and **(iii)** the entire sales surface is focused on sales (no prescription lab or storage space). This host store format has already started to be rolled out abroad, like the partnership with SGH and Galeries Lafayette in France.

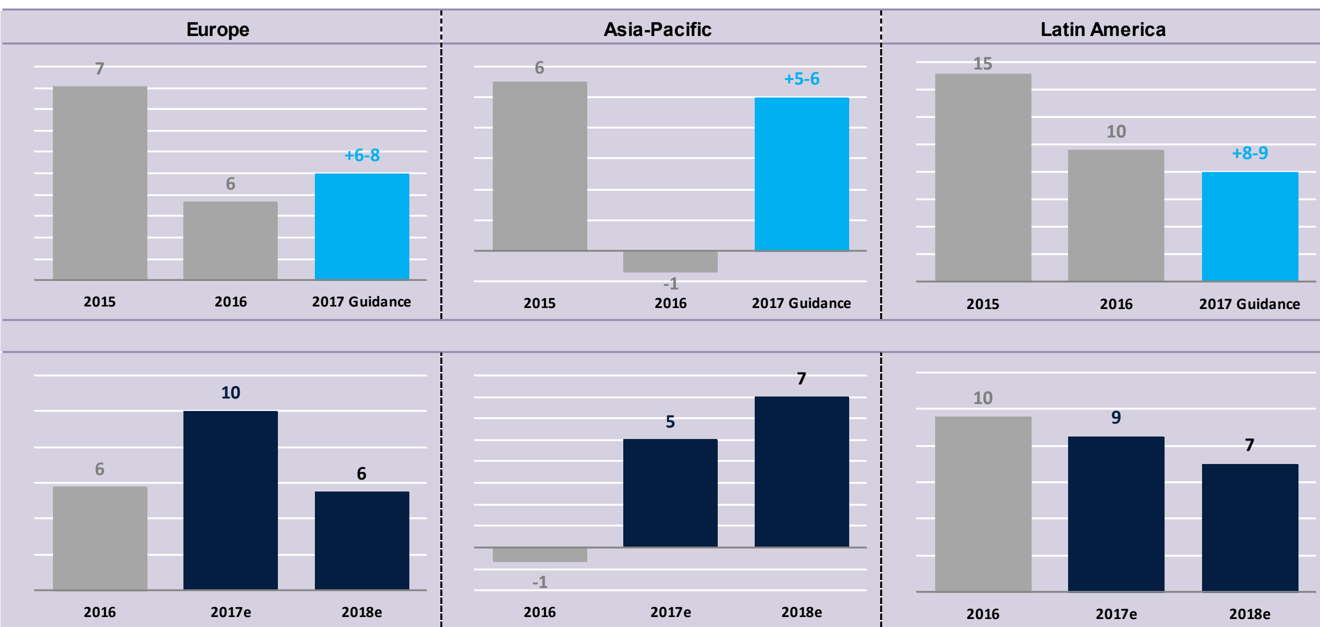
### 4.2.2. Greater confidence in other regions?

This is notably the case in **Asia-Pacific** (+5-6% FX-n) after a particularly disappointing year in 2016 (-0.7% FX-n), handicapped by robust sales growth in Hong Kong (optical category) and the reorganisation of the distribution network in continental China, which consists of ending contracts with around 60 Chinese wholesalers and installing direct distribution. For 2017, the acceleration is set to be driven by: **1/** the deployment of the **Ray-Ban stores** (~100 DOS by the end of the year vs. 50 at end-2016), **2/** further momentum in **Australia** and **3/** a gradual improvement in **Greater China** (~2-3% of total sales).

At first glance, Luxottica is expecting a slowdown in **Latin America** (guidance: +8-9%) although we should take account of the two years in a row of high growth (+15.1% in 2015 and 9.6% in 2016) and the economic crisis in **Brazil** (around 4% of total sales), partly made up for by the integration of the Oticas Carol chain (sales of around EUR70-80m) as of Q2 2017. Growth of 8-9% FX-n would therefore be an excellent performance given these negative factors.

**In contrast, we believe the group is extremely cautious concerning Europe (+8-9%e)** since this objective includes the Italian chain Salmoiraghi & Vigano whose contribution should total ~8-9 points over the year! The Q1 performance testified to this with sales up 17.4% FX-n while pure organic (= excluding S&V) was mid to high single-digit according to CFO Stefano Grassi, i.e. a scope effect of 8-9% in line with our estimates. **We therefore expect Luxottica to exceed its guidance and are forecasting +10% FX-n.**

**Fig. 63: 2017 FX-n growth guidance and our estimates by region:**




*Source: Company Data; Bryan, Garnier & Co ests*

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### 4.2.3. Upside potential for US margins

**The centralisation of prescription labs should provide hefty synergies**

The three giant labs built in 2016 are up and running and should ramp-up in the near future: **1/** in Atlanta to cover North America, **2/** in China to address the LensCrafters stores in China and in Hong Kong, and **3/** in Sedico (Italy) to serve the stores in Europe (including Salmoiraghi & Vigano). They will not be running at cruising speed this year and the closure of in-store labs is only just starting, but we believe that this initial phase could already have a slightly accretive impact as of 2017.

**This aim to centralise the prescription lab functions** (cutting, mounting and even assembly of eyewear in certain cases) **is also shared by Essilor and GrandVision**, as shown by the charts below. As such, the start of streamlining to the number of labs at **Essilor** in the region is the consequence of the concentration of volumes and the ramp-up in export labs (especially in Mexico), whereas **GrandVision** has generated significant efficiency and productivity gains thanks to the industrialisation of the mounting phase and by concentrating volumes in only four sites in Europe.

**Fig. 64: Essilor and GrandVision concentrating business volumes in their labs:**

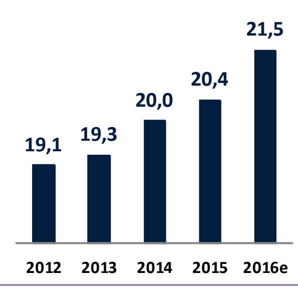
| Essilor's Rx labs in North America (2009-15): | GrandVision's four "TechCenters" in Europe: |
|---|---|

| 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|
| 180 | 190 | 166 | 163 | 174 | 169 | 168 | 162 |

Previous TechCenters
New TechCenters

*Source: Essilor, GrandVision*

Adjusted EBITDA margin in the G4 region at GrandVision (% of total sales):




*Source: Company Data; Bryan, Garnier & Co ests*

The surge in margins in GrandVision's G4 region, as shown in the chart opposite coincides exactly with the ramp-up in its TechCenters, which currently process approx. 70% of lens volumes sold in the region. At Luxottica, this centralisation is set to procure two main advantages further out:

**(i)** **Efficiency gains in the supply chain:** the densification in volumes is set to imply a rise in profitability, shorter processing timeframes and an improvement in quality (=> fewer returns) which are set to play favourably on the gross margin rate.

**(ii)** **Increasing retail profitability:** in a first phase, the central lab will cover the LensCrafters@Macy's sales points, but further out, we believe the other LensCrafters stores will close their internal labs, helping to reduce the size of stores (cost savings in terms of rents and staff costs). LensCrafters US (EBIT margin current at 16-18%e on our estimates) is above all set to benefit to start with.

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### 4.2.4. Other potential catalysts for profitability

Despite weak organic growth (+1.9%) and numerous projects (MAP, integration of Oakley, reorganisation in the US retail division etc.), adjusted EBIT margin only narrowed by 20bp to 15.8%, partly aided by cost cutting moves. In 2017, certain negative effects from these projects should gradually come to a halt:

(i) **MAP:** the impact of the MAP is due to be annualised as of Q2 and since Ray-Ban has managed to weed out the discount market (average promotional rate: <6% at the start of the year vs. ~37% in April 2016), pressure on profitability should be less penalising, especially if the brand restores slight growth in sunglasses in the US in 2017.

(ii) **Integration/reorganisation of Oakley:** the integration of Oakely's eyewear business already helped unlock the first synergies in 2016, with these even set to gain momentum in 2017 with the reorganisation of the AFA category.

(iii) **Rebound in Asia-Pacific:** the recovery in organic growth expected in 2017 (+5-6% vs. -0.7% in 2016) should have a beneficial impact on the geographical mix, especially with better momentum in Greater China.

(iv) **US retail:** store closures at SGH and Sears Optical are set to generate restructuring costs in the short term (no impact on our adjusted margin forecast), but should then have a positive effect on profitability since the closures concern less profitable sales points.

**Our 2017-18 profitability forecasts**

The timeframe for a number of major initiatives (digitalisation of LensCrafters, ramp-up in new stores etc.) remains vague, thereby limiting visibility and partly explaining the cautious EBIT guidance for 2017 (growth of 0.8-1x sales).

However, the good progress made in other projects (MAP, Oakley, Asia-Pacific) prompts lower pressure on profitability, especially since the slight acceleration in organic growth is set to imply higher operating leverage this year. We are slightly more optimistic than the top-end of the guidance range, with a slight increase in adjusted EBIT margin (+10bp to 15.9%).

**Fig. 65: Change in adjusted EBIT margin (2015-2018e in %):**

| 2015 | 2016 | 2017e | 2018e |
|---|---|---|---|
| 16,0 | 15,8 | 15,9 | 16,3 |

*Source: Company Data; Bryan, Garnier & Co ests.*

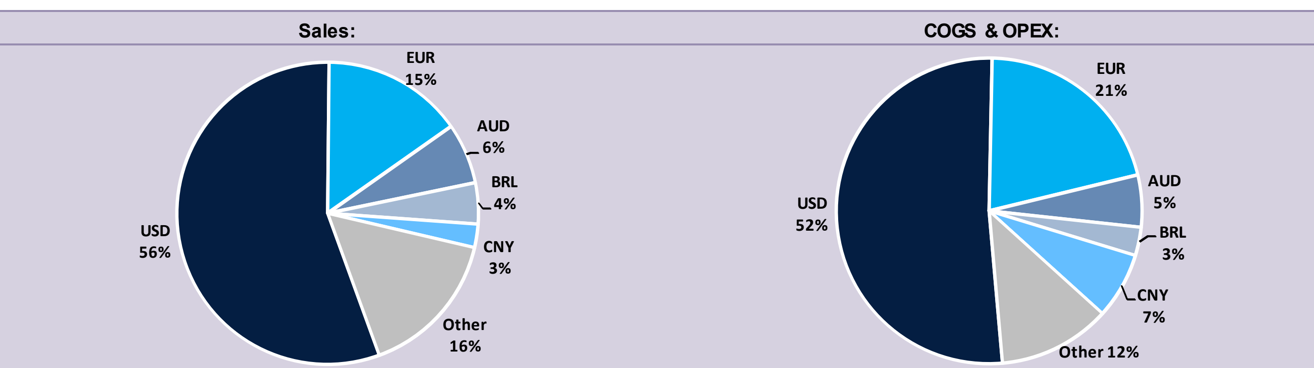
Please see the section headed "Important information" on the back page of this report.

**A more beneficial FX effect than in 2016**

A rise in the USD naturally benefits Luxottica, which generates around 56% of sales in the currency, thereby implying a slightly positive transactional impact. In addition, the decline in the CNY (~7% of costs vs. ~3% of sales) also prompts a beneficial effect on profitability. The other dollar currencies (AUD, CAD) were either stable, or slightly stronger relative to last year, whereas the BRL surged by more than 10% relative to the 2016 average.

Note that contrary to luxury groups that also benefit from the rise in the dollar, Luxottica does not hedge the forex impact, thereby implying an immediate transactional impact (positive on current trends) and the lack of forex losses/gains.

**Fig. 66: Main currencies at Luxottica (2016):**




*Source: Company Data; Bryan, Garnier & Co ests*

## 4.3. GrandVision: all lights at green

### 4.3.1. The group is launching omnichannel services

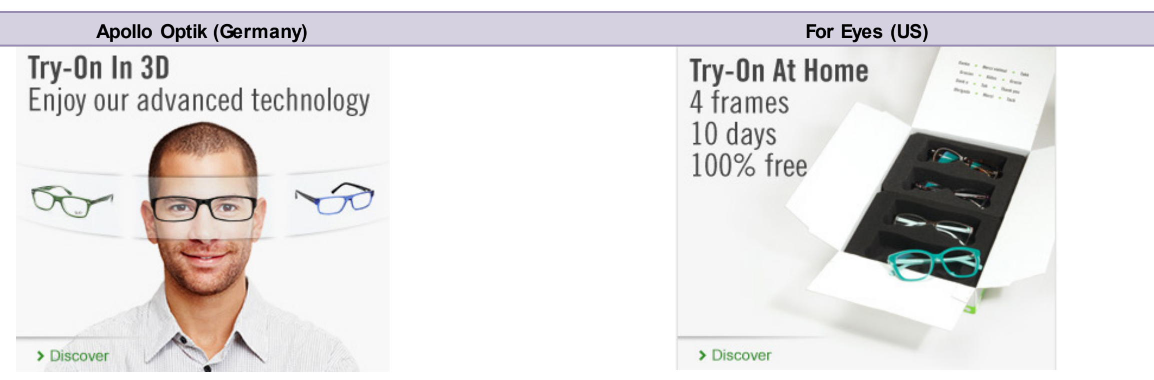
At the start of H2 2016, Apollo Optik, the German no. 2 behind Fielmann launched its website, which is also aimed at encouraging omnichannel sales and footfall in stores (appointments can be made for eye tests, delivery at home or to stores etc.).

Germany is therefore a test market for GrandVision and in our view, this is no coincidence since: **1/** Fielmann does not believe in the online circuit in eyewear and this could provide a genuine competitive edge for Apollo if successful, and **2/** hybrid players such as **Mr Spex** (sales of around EUR90m) and **Brillen.de** (sales of around EUR50m) have rapidly expanded in Germany by playing on the combination of the online offer + the network of referenced independent opticians + a few directly managed physical stores opened recently.

Mr Spex uses the latest technological tools, in particular the **3-D virtual mirror** (see left-hand photo on following page), which also serves as a measure tool and a decision aid (comparison of several pairs of glasses at the same time, inter-pupillary distance, photo sharing on social networks etc.). This technology acts positively on conversion rates (online purchases and footfall in stores), improves the customer experience and reduces the return rate (=> savings). As for pure players in fashion (Zalando, ASOS, etc.), Mr Spex delivers up to four pairs of glasses free of charge and offers a free trial period of 10 days (right-hand photo). These services help gradually develop the online optical market.

Please see the section headed "Important information" on the back page of this report.

## Fig. 67: Examples of services offered by Mister Spex:

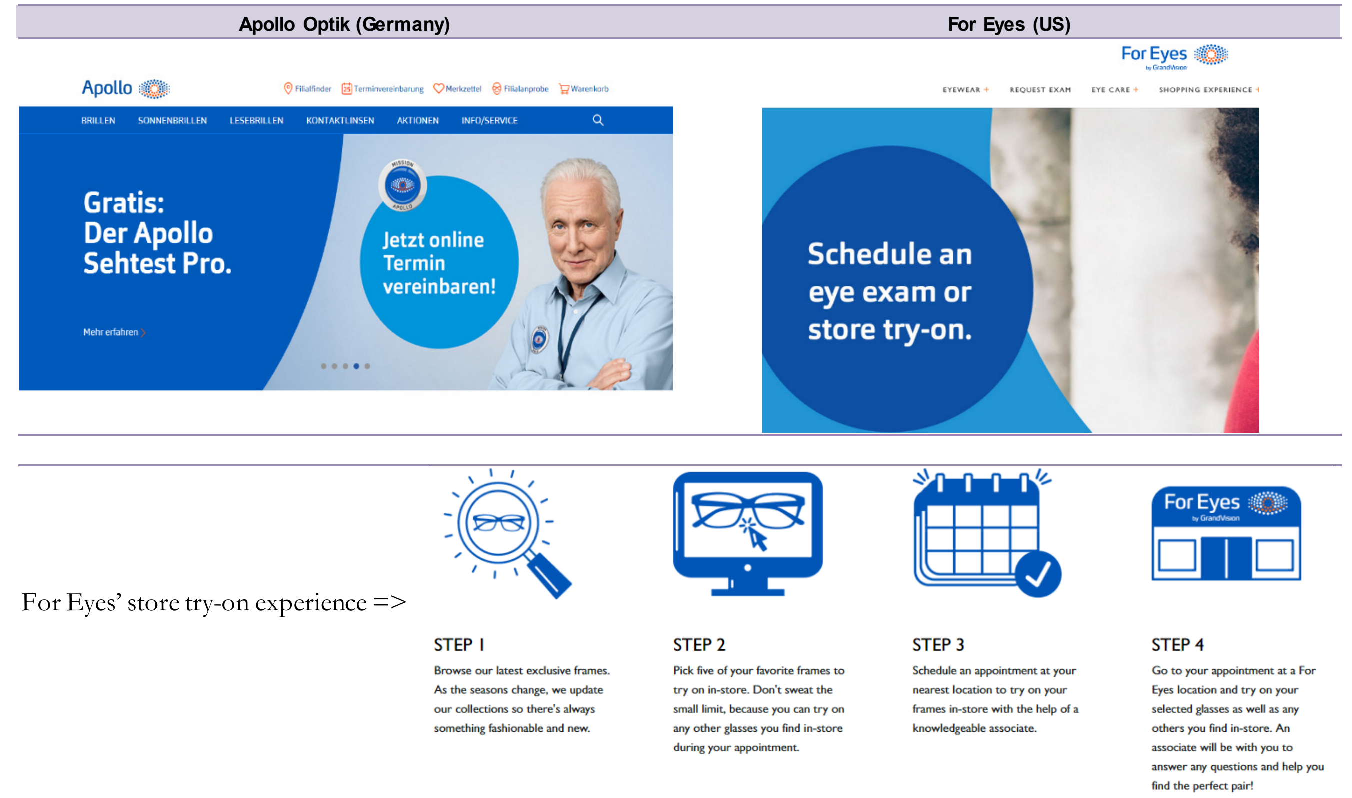



*Source: Mister Spex*

As well as offering the same services, **Apollo Optik highlights its network of more than 800 stores to make the most of the proximity advantage.** This is particularly beneficial for booking appointments for eye tests and to enable customers to come and collect their glasses in the store nearest to them while benefitting from the advice of a sales person to check the measurements and mounting. For two quarters, **Apollo Optik has noted a rise in footfall in its stores, partly driven by new customers that visited the website previously.**

In our view, **GrandVision should roll out this omnichannel strategy in its main markets very soon** (UK, France, etc.), but also in the US. Indeed, the For Eyes chain already has a website and offers services to book an appointment for an eye test and/or to try out frames in the store.

## Fig. 68: GrandVision banners moving into omnichannel:




*Source: Company Data; Bryan, Garnier & Co ests*

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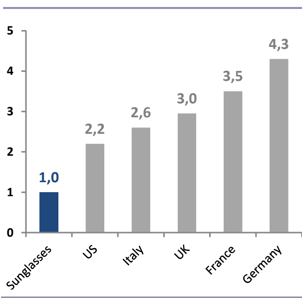
### 4.3.2. Development in sunglasses continuing

GrandVision is continuing to expand in the sunglass category to which it remains under-exposed (around 12% of sales vs. 15% of the global market). This expansion is based on its specialised banner Solaris. Rather than open stores solely dedicated to sunglasses, Solaris is opening corners in existing optical stores (*see right-hand photo below*), in order to encourage those buying prescription glasses or contact lenses to also purchase a pair of sunglasses, whether adapted to their eyesight or not. This strategy has several advantages:

Average renewal rate for sunglasses vs prescription glasses (no. of years):




*Source: Company Data, Bryan, Garnier & Co ests.*

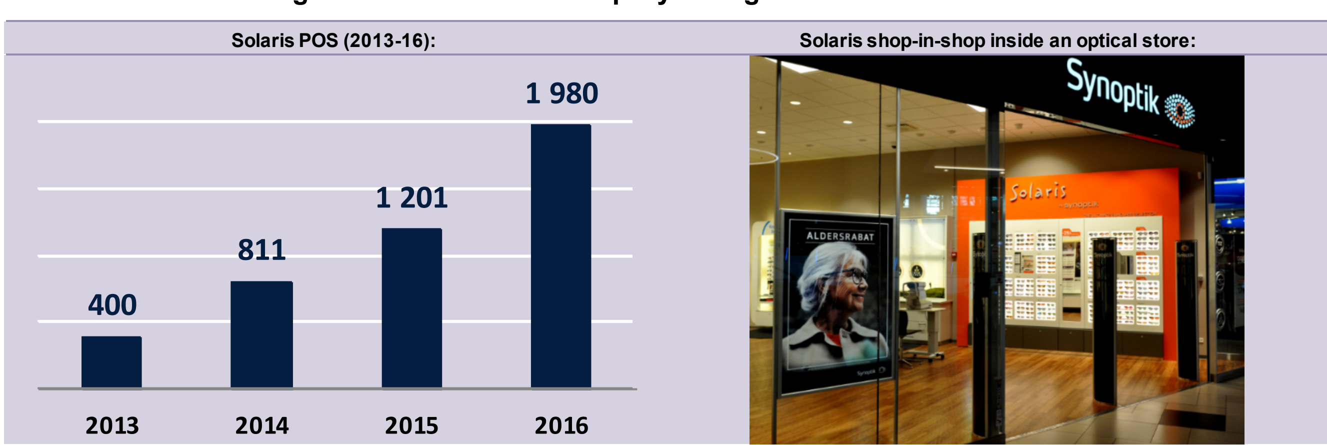
**(i) A significant driver behind footfall:** given the shorter renewal rate of around one year on average (see chart opposite), the presence of a sunglass corner attracts additional footfall and especially customers who do not yet wear prescription glasses.

**(ii) Cross selling opportunities**: since only 10% of people with corrective lenses have a pair of prescription sunglasses. Being able to offer two types of expertise (prescription and sunglasses) in the same store is a means of directing customers towards the purchase of a second pair.

**(iii) Rapid expansion:** this retail format requires few operating expenses and capex and can therefore be rolled out rapidly as shown by the opening of more than 700 new corners in 2016 (*see left-hand chart below*). GrandVision's management pointed out that all of the group's stores (6,551 at end-March 2017) could theoretically welcome a Solaris corner.

**(iv) Attractive sales per square metre:** whereas the sales surface areas remain unchanged, GrandVision has the possibility of increasing its sales volumes on the back of a new customer base and thanks to the rise in the sales index (= average number of articles bought per transaction) stemming from already existing customers.

**Fig. 69: GrandVision is rapidly rolling out Solaris:**




*Source: Company Data*

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### 4.3.3. M&A activity still on the cards

Via its UK banner Vision Express, in May GrandVision bought 290 **Tesco Opticians** sales points with sales of around GBP90m (EUR105m). The price-tag for the deal was not unveiled but we estimate that the EV/sales multiple stood at around 1x. This was the first sizeable acquisitions (3-point scope effect on an annualised basis) since the acquisition of the For Eyes chain in October 2015.

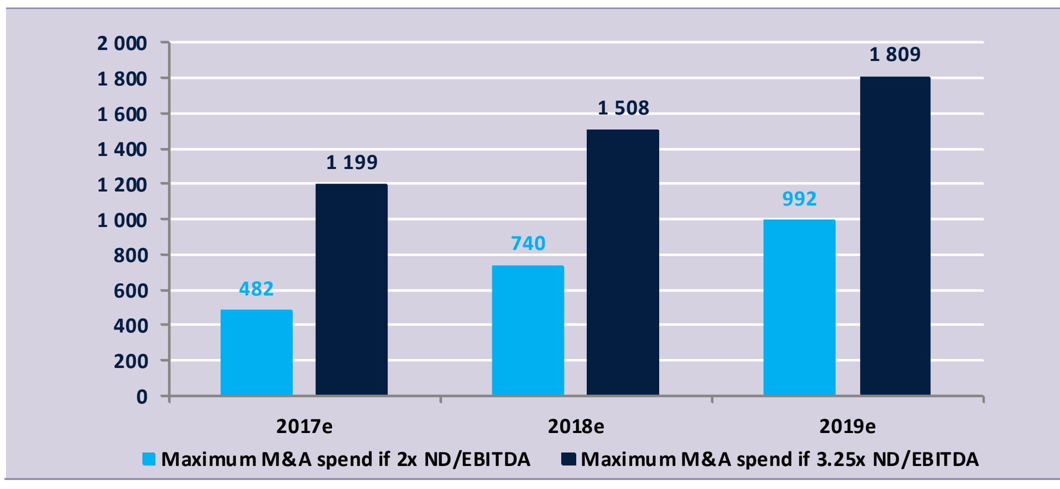
The Tesco corners acquired are naturally located in the chain's stores, with points of sales that are therefore complementary to those of Vision Express, which are freestanding stores in town centres. In our view, the integration process should be identical to previous acquisitions, namely the Tesco Opticians sales points will be rebranded as Vision Express and the commercial proposition aligned with the group's.

Thanks to this acquisition, Vision Express is clearly set to bolster its presence in the UK, with a network set to rise from 389 stores at present to 598. The banner will thereby consolidate its no. 3 position in the UK optical market (market share of 7-8%) and make up some of the ground lying between itself and the two leading players Specsavers (~41%) and Boots Opticians (~12-13%).

**GrandVision still has considerable firepower for a sizeable acquisition**

The Dutch group continues to improve its financial structure, even after the Tesco Opticians deal (2017e ND/EBITDA of 1.2x vs. 1.4x in 2016), enabling it to maintain considerable firepower to undertake other acquisitions if necessary. During the IPO, management stated it would like to maintain financial leverage of 2x ND/EBITDA, or almost EUR480m, which could be focused on other operations in 2017. GrandVision could even mobilise up to EUR1.2bn while respecting its covenant for ND/EBITDA of 3.25x.

**Fig. 70: Financial means that could be mobilised for M&A:**




*Source: Bryan, Garnier & Co ests.*

### 4.3.4. 2017 outlook: heading for less volatility?

While the group's operating performances were among the best in the optical sector (*see Fig. 71 below*), the share price nevertheless corrected by 24% in 2016. Even though same-store growth in 2016 was slightly lower than expected, this plunge was mostly unmerited in our view, triggered by an insufficiently prepared consensus in terms the various technical factors that led to sharp volatility depending on the quarter. Furthermore, downward revisions to Essilor and Luxottica targets also acted negatively, with the whole lot exacerbated by the low free float of 21%, which amplifies share price movements.

**Fig. 71: Change in cc sales and adjusted net profit (2016, change in %):**

| FX-n Sales Growth (%) | | Adjusted Net Income Growth (%): | |
|---|---|---|---|
| EI | 7,6 | GVNV | 12,0 |
| GVNV | 6,5 | EI | 7,4 |
| SFL * | 3,6 | LUX | 3,3 |
| LUX | 1,9 | SFL | NS |

* SFL = "Going-forward portfolio" Source: Bryan, Garnier & Co ests

**Heading for brighter skies in 2017**

The share has nevertheless fared better since the beginning of the year (+13%) thanks to healthy publications (2016 and Q1 2017 earnings). Aware that investors had not sufficiently integrated technical factors (timing of promotions, integration difficulties Italy, comparison bases), GrandVision **stepped up efforts in financial communication** by organising a conference call after every publication instead of two per year previously, and issuing warnings about the technical factors that could influence the following quarter.

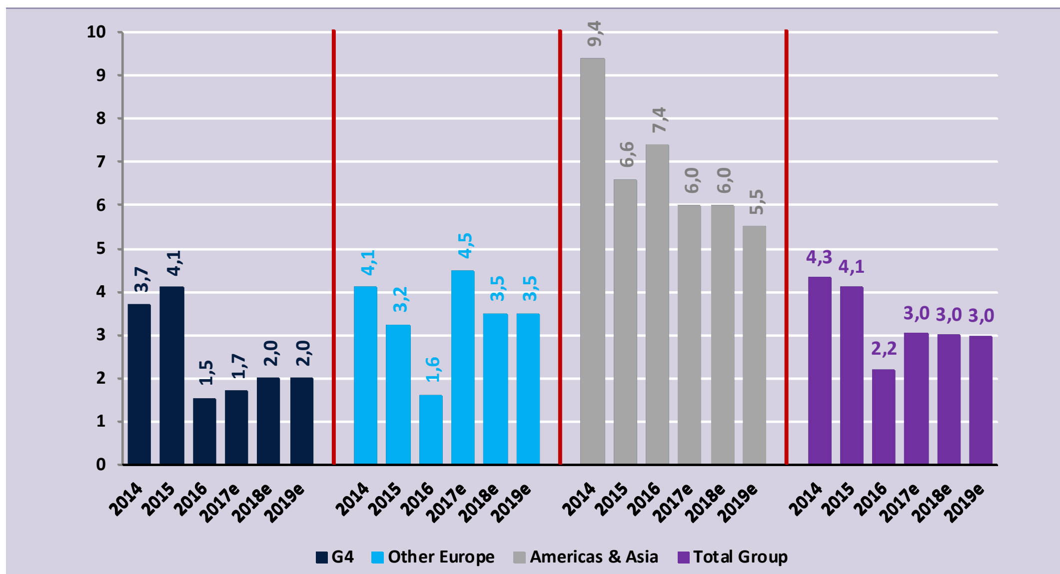
For 2017, we believe that the negative effects of two out of three main technical factors described above should gradually fade, if not reverse during 2017, suggesting the year could be better:

- **(i)** **Easier comparison with the year-earlier period in G4 (~61% of total sales):** although a few markets remain fragile (e.g. France in Q1), the group is set to face easier comparison bases (SSSG: +1.5% in 2016 vs. +4.1% in 2015) while Germany should be more dynamic thanks to the first beneficial effects of Apollo Optik's omnichannel strategy.
- **(ii)** **Acceleration in Italy (around 20% of Others Europe sales):** the region picked up considerably in the past two quarters (Q4 2016: +7% and Q1 2017 +6.5%), confirming that the integration of two chains in Italy was complete and suggesting a far more robust year in the country.

**In this context, we are forecasting a rebound in same-store sales growth (SSSG) of around 3%, which is the group's implied medium-term target:** at least +5% cc excluding any strategic acquisitions, or +3% on a same-store basis, +1% from a sales surface area effect, and +1% from scope effects following small acquisitions.

Please see the section headed "Important information" on the back page of this report.

**Fig. 72: SSSG forecasts (%):**




*Source: Company Data; Bryan, Garnier & Co ests.*

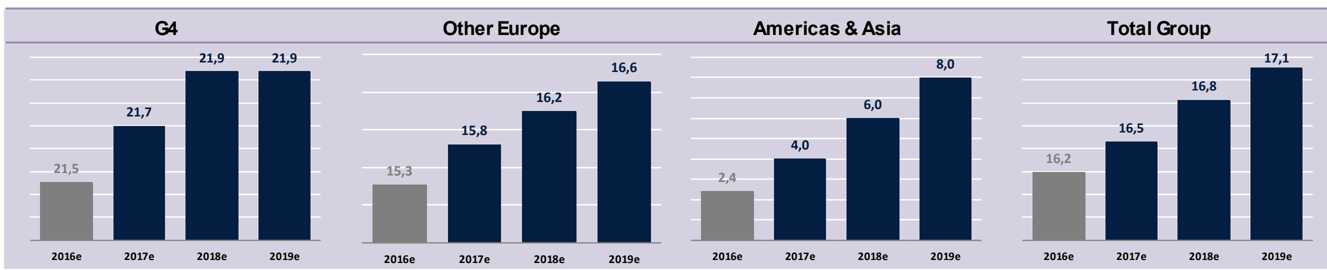
**Margin widening potential remains high**

Same-store sales growth remains the main catalyst for margin widening in the medium term, although the beneficial effects of critical mass prompted by the centralised organisation and the group's unique platform are also significant. In Q1 2017, despite same-store growth of "just" 1.5%, adjusted EBITDA margin in the G4 region widened by 90bp to 21.2% thanks to **advantageous sourcing conditions** and **efficiency and productivity gains** which coincided with the ramp-up in **TechCenters**. The rise in the share of house brands has also helped improve profitability.

Despite this record profitability, management confirmed that margin improvement potential remains high in line with growth in volumes handled by TechCenters and the share of exclusive brands. As the charts below show, profitability in the **Other Europe** and **Americas & Asia** divisions is far lower than that of G4 since the group has yet to reach critical mass or even the same level of vertical integration. This margin differential with other zones should therefore narrow gradually.

However, we should not forget the **risk of dilution due to acquisitions**, since GrandVision generally buys less profitable chains. It generally takes 12-18 months for the integration to be completed and the majority of the profitability gap to be reabsorbed.

**Fig. 73: Adjusted EBITDA margin estimates by segment (% of total sales):**




*Source: Company Data; Bryan, Garnier & Co ests.*

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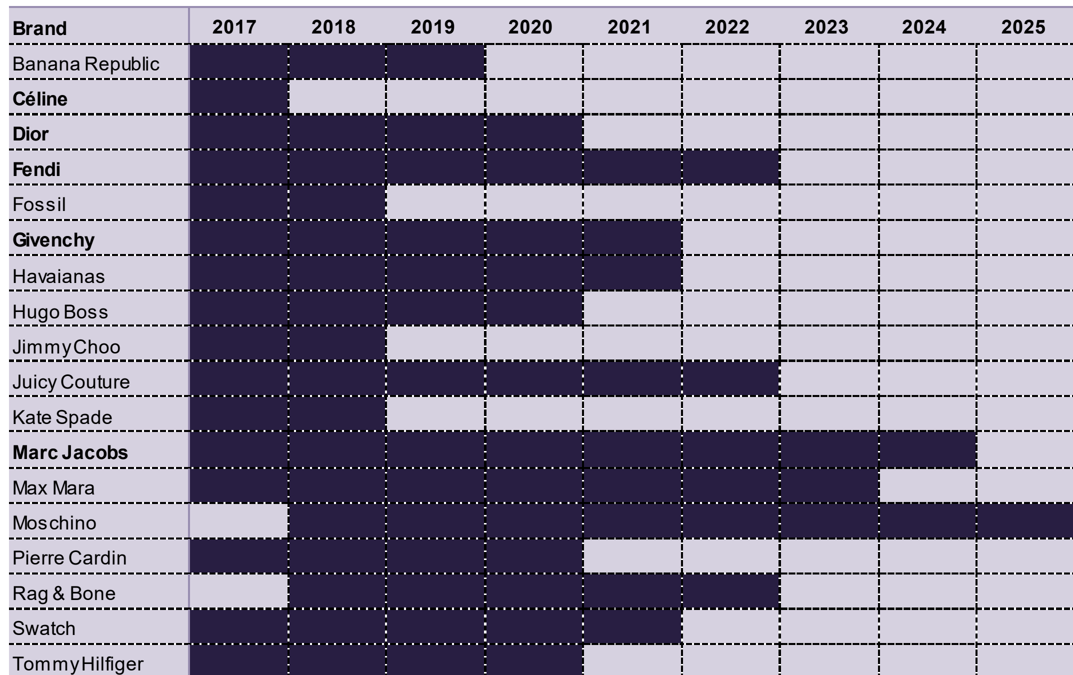
# 4.4. Safilo: succeeding the Gucci transition… and preparing for that of LVMH

## 4.4.1. The outlook for the licence portfolio has darkened with the LVMH-Marcolin partnership

As discussed in Chapter 2, Safilo is the main player affected by this partnership between LVMH and Marcolin, since the world no. 2 was LVMH's favoured partner with five licence agreements generating sales of EUR340m. The only fairly positive point is that LVMH seems to have chosen to gradually integrate its licences as they expire. As such, Safilo has until end-2020 to prepare for the withdrawal of its largest licence Dior (around 15% of total sales).

Before this bad news, 2016 was quite positive for the licence portfolio with mid to high single-digit growth (+5.2% FX-n in all excluding retail) and the addition of two new licences that are due to start up in January 2018: the Italian upscale fashion brand **Moschino** (->2025) and the US fashion brand **Rag & Bone** (->2022).

**Fig. 74: Expiry dates for main Safilo licences:**




*Source: Company Data; Bryan, Garnier & Co ests*

**Heading for a rebound in the portfolio of house brands in 2017**

Since the group's CEO reiterated the target to generate around 40% of sales from the house brands by 2020, the rebound in the own-brand portfolio is vital this year. Each of the five brands is set to benefit from numerous initiatives (*see table on the following page*) that are already tried-and-tested in the licence portfolio: collections loyal to the positioning and DNA of each brand, capitalising on the density of the independents circuit and ensuring perfect execution.

Please see the section headed "Important information" on the back page of this report.

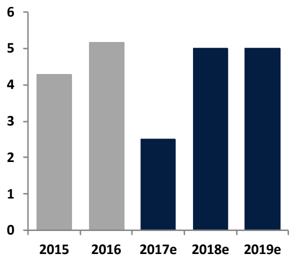
Even though it is still too early to draw any conclusions, the Q1 2017 performance showed a few positive trends at **Smith** (excellent winter season for ski masks/helmets) and **Carrera** in the US, for which the new collection includes some of the initiatives set out in the table below. Note also the relaunch of the **Safilo** brand, which should enable the group to increase its presence in the optical category (around 35% of group sales).

**Fig. 75: Main sources of leverage to growth for Safilo's own-brands:**

| Smith | Carrera | Polaroid | Safilo | Oxydo |
|---|---|---|---|---|
| SMITH | CARRERA EYEWEAR SINCE 1956 | Polaroid | SAFILO | OXYDO |
| ~8% of total sales | ~7% of total sales | ~7% of total sales | ~1% of total sales | <1% of total sales |
| • Penetrate new sport categories & develop lifestyle<br>• Continue geographical expansion (Europe)<br>• E-commerce (already ~30% of NA sales) | • Well-differentiated brand design and image<br>• Enlarge geographical footprint<br>• Improved quality of sun lenses<br>• Increased communication efforts | • Three new collections launched per year vs. one<br>• Expand distribution, esp. outside Europe<br>• Focus on digital marketing | • Main brand to expand the prescription category (only 35% of sales)<br>• Target: premium & high end price segment | • New brand in the Atelier segment<br>• Display Safilo's high degree of craftsmanship |

*Source: Bryan, Garnier & Co ests*

Organic growth in wholesale sales excl. Kering licences (lfl, %):




*Source: Company Data; Bryan, Garnier & Co ests*

**Our 2017-18 organic growth forecasts for Wholesale**

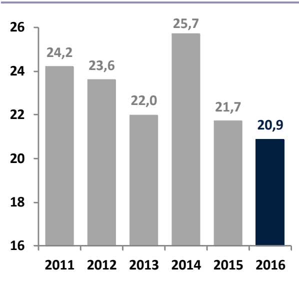
Excluding the impact of Gucci, we are forecasting adjusted organic growth of 2.5%. This caution for 2017 is justified by the plunge in Q1 sales (-14.5% adj. FX-n) due to the automation of the Padua distribution centre, causing a halt to orders and shipments during the quarter (one million pairs of glasses waiting to be shipped at end-March). North America was spared somewhat by this upheaval, contrary to other regions.

With the distribution centre now operational, Safilo will make sure that it delivers orders that are late and honours new ones. A catching-up effect could take place in Q2, thereby reducing the impact of the disruption over the full-year.

## 4.4.2. The many supply chain projects are progressing

It is clearly complicated to note the progress made in view of the difficulties encountered during the automation of the distribution centre, but this project clearly illustrates the need for the group to make up its technology lag and solve the structural handicaps it has been facing in its logistical chain.

Safilo WCR (2011-16e, as % of sales):




*Source: Company Data; Bryan, Garnier & Co ests*

This issue had already been raised during the 2020 Strategic Plan in March 2015 by the management team who was aware that these handicaps and poor execution had caused the loss of a few strategic licences over the past decade (Ralph Lauren, Giorgio Armani). The Italian group therefore launched the huge EYEWAY programme (*see chart on following page*) aimed at gaining in agility and reactivity, above all with the ramp-up in the online circuit.

Since the launch of EYEWAY, a few signs of improvement have already been noted:

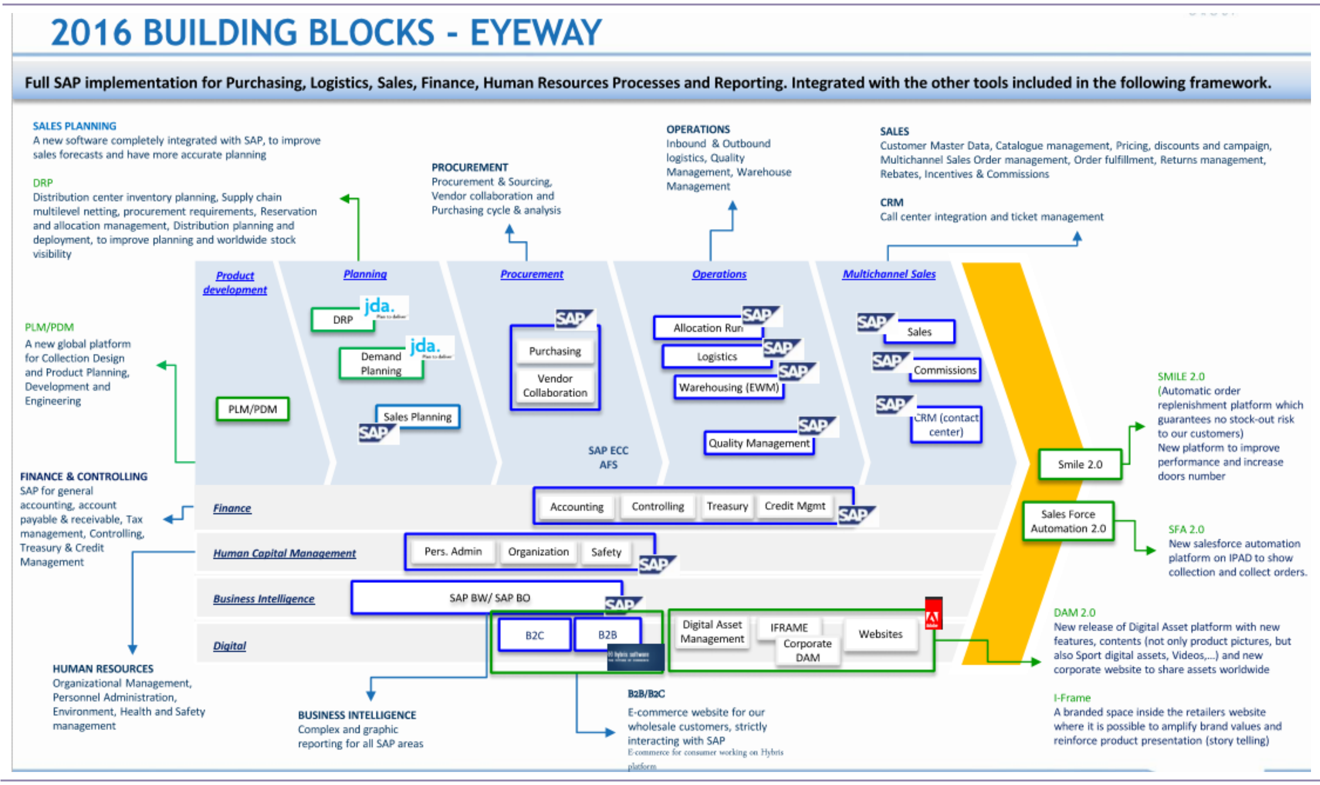
**(i) Improvement in WCR:** as shown in the chart opposite, optimisation of stock management (SAP, ERP) has enabled a clear improvement in Safilo's WCR (-330bp over 2011-16), even though obsolescence costs went up in 2016 and should increase again in 2017 due to the departure of Gucci.

Please see the section headed "Important information" on the back page of this report.

**(ii) Shorter production timeframes:** at end-2015, lead times for finished products had been reduced by five days to 40 days and the group is confident it can reach the 2020 target of 12 days.

**(iii) Productivity gains:** restructuring and the simplification plan already generated cost savings during 2016 and these should increase in 2017-18. We believe that Safilo could exceed its target for EUR25-30m in combined cost savings for end-2019.

**Fig. 76: Numerous IT projects as part of the EYEWAY programme:**




*Source: Company Data*

### 4.4.3. Visibility on changes in profitability remains poor

In **2017**, CFO Gerd Graehsler confirmed that the compensation paid by Kering and booked by Safilo (around EUR43m over the full-year) should make up for the lost earnings caused by the departure of Gucci this year. The reading of Q1 earnings confirms this forecast. At the same time, adjusted EBITDA margin growth is set to depend on three other factors:

**(i) The reabsorption of disruption caused by the distribution centre:** a rapid return to normal would imply a less negative volume impact over the full year.

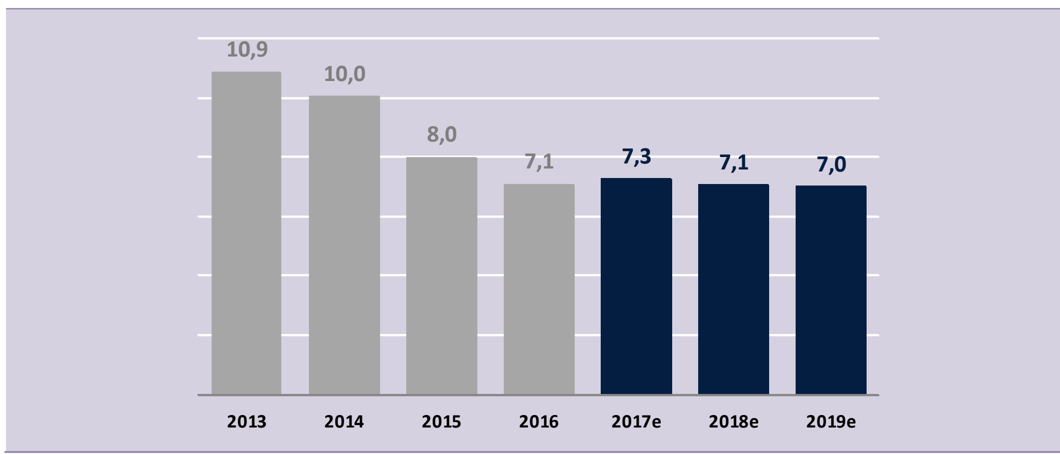
**(ii) The relaunch of own-brands:** this will have an impact on the group's overall organic growth. In terms of margins, obsolescence should be lower (fewer unsold goods), and the beneficial impact of operating leverage should be higher in view of higher organic growth.

**(iii) Restructuring of Solstice:** the underperformance and reorganisation of the chain had a further dilutive impact of 40-50bp in Q1. In our view, the stimulus plan is unlikely to deliver significant results this year, but the dilutive effect should narrow on the back of more advantageous comparison bases during the year.

Please see the section headed "Important information" on the back page of this report.

The overall dilutive impact remains difficult to establish since visibility on the deadlines for these factors is low, thereby limiting our potential margin rebound at present. In our view, a stabilisation after the constant decline since 2013 would initially be reassuring for investors.

**Fig. 77: Our forecasts for adjusted EBITDA margin (2013-19e, in %):**




*Source: Company Data; Bryan, Garnier & Co ests.*

Please see the section headed "Important information" on the back page of this report.

# 5. Valuation

## 5.1. YTD performance is satisfactory

After enjoying a perfect alignment of the planets in **2015**, combining robust operating performances with a strong dollar, shares in the sector had a more chaotic ride during **2016**. Indeed, disappointing organic growth, disruptive reorganisations at certain groups and a disadvantageous currency backdrop were all reasons behind the sector's de-rating.

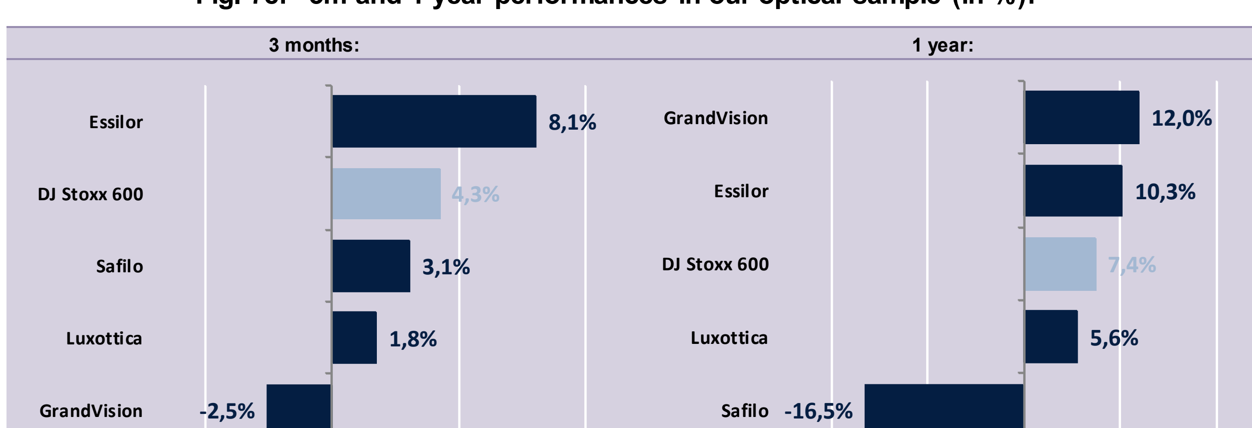
Since the beginning of the year, share price performances in the sector have outstripped that of the DJ Stoxx 600, with the exception of Safilo (-16.5%), which suffered from the announcement of the strategic partnership between LVMH and Marcolin. The sample has indeed benefited from three main sources of support:

**(i)** **Momentum is gradually improving**, driven by the rebound in the US (around 37% of the global optical market) and China (around 10%), as well as the first effects of initiatives taken by players to relaunch growth. **Note that momentum at Essilor and Luxottica has initially improved for the top line, while the benefits to margins are only likely to be felt in 2018**, profitability is only set to notch up at Luxottica (we are slightly more optimistic than the guidance), but should be high at GrandVision. **Note that organic growth is the main catalyst in the sector.**

**(ii)** **Essilor-Luxottica in sight:** after a period of calm to digest the news of the merger announcement, the two shares have picked up again on the back of the expected acceleration in momentum following a Q1 performance in line with estimates, but above all in order to play the success of the operation, which offers significant growth prospects as discussed in Section 1 of this report.

**(iii)** **Structural catalysts in the sector remain intact.** Although certain categories/countries could witness a temporary slowdown, underlying trends in the optical market remain structurally very buoyant such as demography (eyesight problems, ageing populations etc.) constant innovation and the consolidation of a highly-fragmented market. As such, questions concerning the sustainability of robust medium/long-term momentum are less present than in other consumer segments (food, retail, fashion and apparel etc.).

**Fig. 78: 3m and 1 year performances in our optical sample (in %):**




*Source: Bryan, Garnier & Co*

Please see the section headed "Important information" on the back page of this report.

## 5.2. Valuation/growth multiples

In an optical sector benefiting from solid catalysts and in view of the growth profile of our sample, it seems relevant to look at changes in the valuation/growth ratio. The two tables below show that these multiples have improved hugely since the share price correction witnessed after Q3 2016 on the back of the widespread gains on stockmarket indices as well as the merger operation between Essilor and Luxottica.

This was notably the case for **Luxottica** and **Essilor**, which are trading on EV/EBIT to growth multiples of respectively 2.3x and 2.2x. These high levels stem from the fact that the merger operation went down well with the market whereas EBIT growth is set to lag sales growth at Essilor but slightly outstrip sales growth at Luxottica (we are slightly more optimistic than the consensus). In contrast, **GrandVision's** profitability should improve further this year, offering a far more attractive valuation than its German peer Fielmann (2.2x vs. 3.1x).

**Fig. 79: EV/EBIT to growth:**

| Companies | Market Cap (EURm) | 2017e EV/EBIT (x) | 2018e EV/EBIT (x) | EBIT CAGR 2016-2019e (%) | EV/EBIT to growth 2017e (x) | EV/EBIT to growth 2018e (x) |
|---|---|---|---|---|---|---|
| Essilor | 25,938 | 20.5 | 18.6 | 9.1 | 2.3 | 2.0 |
| Fielmann | 6,017 | 22.9 | 21.5 | 7.4 | 3.1 | 2.9 |
| GrandVision* | 5,896 | 16.4 | 14.7 | 7.2 | 2.2 | 2.0 |
| Luxottica* | 26,113 | 17.4 | 15.9 | 8.1 | 2.1 | 2.0 |
| Safilo* | 423 | 9.6 | 16.5 | 0.1 | NS | NS |

** Adjusted EBIT*

*Source: Bryan, Garnier & Co ests*

The lack of robust EBIT momentum is naturally reflected in our EPS estimates, thereby explaining why PEG ratios are all close to 3x, with the exception of **Fielmann** (4.2x) and **Safilo** (1.4x).

**Fig. 80: PEG multiples:**

| Companies | Market Cap (EURm) | 2017e P/E (x) | 2018e P/E (x) | EPS CAGR 2016-2019e (%) | PEG ratio 2017e (x) | PEG ratio 2018e (x) |
|---|---|---|---|---|---|---|
| Essilor | 25,938 | 28.1 | 25.8 | 10.0 | 2.8 | 2.6 |
| Fielmann | 6,017 | 34.4 | 32.2 | 7.3 | 4.7 | 4.4 |
| GrandVision* | 5,896 | 22.9 | 20.9 | 8.0 | 2.8 | 2.5 |
| Luxottica* | 26,113 | 26.8 | 24.8 | 9.1 | 3.0 | 2.8 |
| Safilo* | 423 | 35.1 | 15.9 | 24.0 | 1.5 | 0.7 |

** Adjusted EPS*

*Source: Bryan, Garnier & Co ests*

Since the market has already started to play the merger, the Essilor and Luxottica shares are trading on high stand-alone multiples, although **the theoretical valuation of EssilorLuxottica,** after taking into account our synergy estimates (revenue and cost) and the exceptional costs caused by additional depreciation and amortisation of EUR580m, **seem far more attractive, with a PEG multiple not exceeding 2x in 2018.**

**Fig. 81: Theoretical PEG multiples at EssilorLuxottica (after synergies):**

| Companies | Market Cap (EURm) | 2018e P/E (x) | 2019e P/E (x) | EPS CAGR 2017-2020e (%) | PEG ratio 2018e (x) | PEG ratio 2019e (x) |
|---|---|---|---|---|---|---|
| EssilorLuxottica* | 51,904 | 24.3 | 21.5 | 12.1 | 2.0 | 1.8 |

** Adjusted EPS*

*Source: Bryan, Garnier & Co ests*

Please see the section headed "Important information" on the back page of this report.

## 5.3. What valuation relative to the indices?

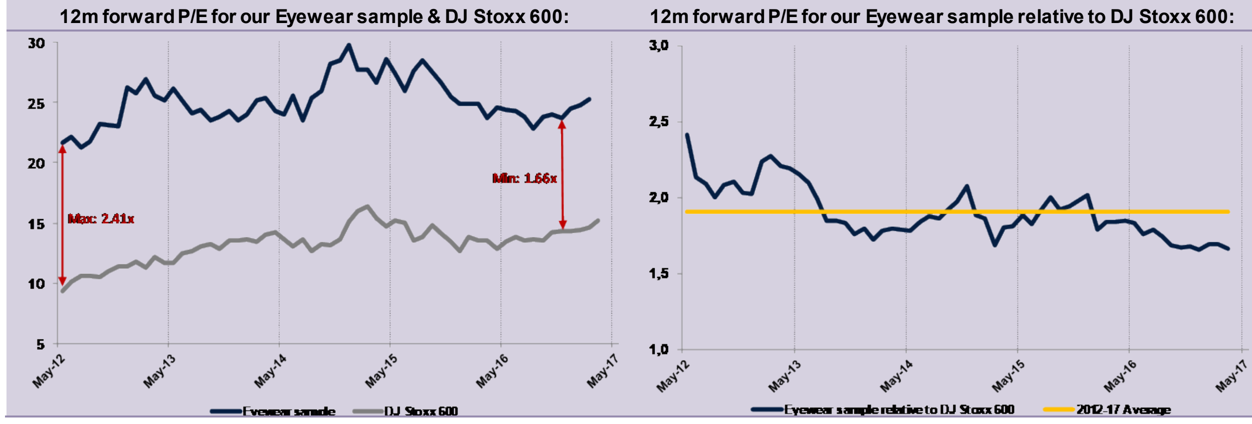
Admittedly, share prices and absolute valuations have risen in recent months, but what about the rest of the market?

The left-hand chart below retraces the change in 12m forward P/E in our eyewear sample (Essilor, Luxottica and GrandVision but not Safilo), relative to the DJ Stoxx 600. At present, our three stocks are trading at an average of 25.3x vs. 15.2x for the index.

The right-hand chart shows that in relative terms, the 12m forward P/E of our three optical stocks totals 1.67x whereas the average of the past five years was 1.9x, suggesting a fairly attractive entry point. The decline in this differential is not surprising in a bullish phase since investors have been looking more at cyclical sectors recently (e.g. bank stocks).

**What catalysts could contribute to a hike in relative P/E? 1/** An acceleration in organic growth is set to be the main catalyst at least for Essilor, Luxottica and Safilo since momentum at GrandVision was better than expected in Q1 and will probably be slightly lower in Q2 given the disadvantageous technical factors in play (shift in Easter weekend, comparison with the year-earlier period) as management pointed out during the Q1 conference call, **2/** investors are set to play Essilor (or Luxottica) as the operation's completion deadline approaches and antitrust risk is removed, and **3/** an upgrade to margin estimates once the first effects of projects/initiatives become visible.

**Fig. 82: The sector's relative valuation is discounted relative to its five-year average:**




*Source: Datastream, Bryan, Garnier & Co*

## 5.4. Our valuation of EssilorLuxottica

We are forecasting high single-digit sales growth over 2018-20, driven by average growth in the optical market of 3-4%, better momentum at Luxottica thanks to the initiatives currently put in place and finally, the revenue synergies unlocked by the merger. As for all our DCF forecasts, we then gradually reduce the rise in sales to move towards our growth rate to infinity of 2.5%.

Our EBIT estimates are above all based on a normative margin as of 18.5% for Essilor (as of 2020) and 17.6% for Luxottica (as of 2021). We then factor in our synergies estimates as set out in section 1.6 of this report (around EUR508m out to 2021).

Please see the section headed "Important information" on the back page of this report.

**Our BP assumptions:**

- **A normative tax rate of 30%:** note that at end-2016, a differential of more than 10 points existed between the Essilor tax rate (24.5% and that of the Italian group (around 35.5%). In the short-term, Luxottica should benefit from the decline in the corporate tax rate in Italy and potentially the Patent Box regime. Even without these advantages, the two management teams agree in saying that there are opportunities to optimise the Luxottica tax rate.

- **Capex:** we have simply added together the investment levels expected for Essilor (normal average of 4% of sales as of 2020) and Luxottica (normal average rate of 5% as of 2020). The merger and certain projects concerning the supply chain could lead to a reduction in investment spending further out, but at this stage, the groups have not communicated on the subject.

- **WCR:** whereas the two groups are both aiming to reduce lead times, the merger should probably enable better stock management (e.g. pooling of inventories for frames and lenses, lab sharing etc.). In our view, the change in WCR should not total more than 0.6% of sales.

We calculate WACC of 6.5%, which breaks down into a cost of equity of 6.9% (risk-free rate of 1.6%, risk premium of 7% and beta of 0.75x) and a cost of debt of 3%.

**Fig. 83: DCF valuation:**

| EURm | 2017e | 2018e | 2019e | 2020e | 2021e | 2022e | 2023e | 2024e | 2025e | 2026e |
|---|---|---|---|---|---|---|---|---|---|---|
| **Net sales** | **17 083** | **18 374** | **19 723** | **21 236** | **22 612** | **23 667** | **24 646** | **25 432** | **26 191** | **26 974** |
| *% change* | *-* | *8* | *7* | *8* | *6* | *5* | *4* | *3* | *3* | *3* |
| EBIT | 2 320 | 2 683 | 3 101 | 3 568 | 3 989 | 4 257 | 4 497 | 4 703 | 4 905 | 5 109 |
| EBIT margin (%) | 13.6 | 14.6 | 15.7 | 16.8 | 17.6 | 18.0 | 18.2 | 18.5 | 18.7 | 18.9 |
| Income taxes | -663 | -777 | -908 | -1 071 | -1 197 | -1 277 | -1 349 | -1 411 | -1 472 | -1 533 |
| Tax rate (%) | 30.0 | 30.0 | 30.0 | 30.0 | 30.0 | 30.0 | 30.0 | 30.0 | 30.0 | 30.0 |
| **Operating profit after taxes** | **1 657** | **1 906** | **2 193** | **2 498** | **2 792** | **2 980** | **3 148** | **3 292** | **3 434** | **3 577** |
| + Depreciations | 965 | 978 | 1 039 | 946 | 999 | 1 049 | 1 109 | 1 144 | 1 179 | 1 214 |
| - Change in WCR | 175 | 150 | 157 | 136 | 145 | 151 | 158 | 163 | 168 | 173 |
| - Investments in fixed assets | 988 | 889 | 890 | 946 | 1 018 | 1 065 | 1 109 | 1 144 | 1 179 | 1 214 |
| **Operating cash flow** | **1 459** | **1 846** | **2 184** | **2 362** | **2 629** | **2 813** | **2 990** | **3 129** | **3 266** | **3 404** |

| | |
|---|---|
| PV of terminal value | 46,467 |
| +PV of future cash flows (2017-26) | 17,970 |
| **= Enterprise Value** | **64,436** |
| Net debt (2017e) | 2,682 |
| Other liabilities | 1,063 |
| Minority interest | 372 |
| Financial assets | 133 |
| **Theoretical value of equity** | **60,453** |
| Number of shares (m) | 436 |
| **Theoretical FV per share (EUR)** | **138** |

*Source: Bryan, Garnier & Co ests*

**We therefore reach a FV of EUR138 for EssilorLuxottica.**

**Given this new FV, we have adjusted our FV for Luxottica (EUR64 vs. EUR52) and upgraded our recommendation from Neutral to Buy.** In our view, Luxottica shareholders can play three catalysts:

**(i)** **The gradual improvement in Luxottica stand-alone,** especially in terms of sales growth.

**(ii) The success of the merger operation** since the Luxottica shares are later set to be converted into EssilorLuxottica shares.

**(iii) Playing a possible increase in the offer amount** (cash complement?) in the event that Essilor does not manage to obtain sufficient Luxottica shares from minority interests.

## 5.5. GrandVision valuation

**We are temporarily ruling out the peer comparison method (EUR31)**

As pointed out in section 5.1, the merger operation has started to influence the Essilor and Luxottica share prices and this effect is likely to amplify as the operation's closing deadline approaches (H2 2017? early 2018?). Consequently, we have decided to temporarily exclude the peer comparison method in our FV calculation for GrandVision.

Via this method, **we obtain a theoretical FV of EUR31** stemming from the weighted average for each of the 2017 and 2018 multiples (EV/EBITDA, EV/EBIT and P/E) between:

- **The two eyewear distribution players = 75% of the weighted average:** Fielmann (100% of sales from retail) and Luxottica (61% of sales), which share the same distribution activity with GrandVision, hence a weight of 75% in the end average.
- **Essilor = 25% of the weighted average:** although Essilor is a lens manufacturer with low retail presence (only online), GrandVision and the French group benefit from the same catalysts in the optical market (ageing population, innovation effect, penetration of emerging markets etc.) and also have one global leadership position, which should be reflected in GrandVision's valuation.

**Fig. 84: GrandVision optical sector peers (price on May 30):**

| (x) | EV/EBITDA | | EV/EBIT | | P/E | |
|---|---|---|---|---|---|---|
| | 2017e | 2018e | 2017e | 2018e | 2017e | 2018e |
| **1/ Players with optical retail = 75%** | | | | | | |
| Fielmann | 19.6 | 18.5 | 22.9 | 21.5 | 34.4 | 32.2 |
| Luxottica | 12.9 | 11.9 | 17.4 | 15.9 | 26.8 | 24.8 |
| **Average** | **16.2** | **15.2** | **20.1** | **18.7** | **30.6** | **28.5** |
| **2/ B2B optical player = 25%** | | | | | | |
| Essilor | 15.6 | 14.5 | 20.5 | 18.6 | 28.1 | 25.8 |
| **Weighted average (75% / 25%)** | **16.1** | **15.0** | **20.2** | **18.7** | **30.0** | **27.8** |
| **GrandVision (adjusted)** | **11.4** | **10.4** | **16.4** | **14.7** | **22.9** | **20.9** |

*Source: Bryan, Garnier & Co ests, Thomson Reuters*

Please see the section headed "Important information" on the back page of this report.

**DCF valuation: EUR26.5**

Concerning sales, we have assumed a CAGR of 4.5-5% over 2017-21, slightly below the medium-term guidance set by GrandVision's management (at least +5%cc), especially since our forecasts include no acquisitions as often used by the group in its development strategy, as shown by the recent acquisition of Tesco Opticians. As of 2022, this growth is set to fall gradually to move into line with our growth rate to infinity of 2.5%.

The CAGR in EBIT is close to 8% over 2017-21, in line with the group's medium-term target (high single-digit growth). This improvement in profitability is set to stem from the ramp-up in the unique platform (critical mass effect), the increasing weight of own-brands and wider margins in emerging markets. We have assumed a normative EBIT margin of 13% as of 2022 (+220bp vs. 2016), which we consider as cautious since it remains below the current level of profitability in **Luxottica's** retail division (13.7% despite projects currently weighing on EBIT margin) and at **Fielmann** (18.1% but fully integrated).

We have assumed a cost of equity of 7.6% (risk-free rate of 1.6%, risk-premium of 7% and beta of 0.85) and a cost of debt of 3%, which leads us to a WACC of 7.1%.

**Fig. 85: DCF valuation:**

| EURm | 2017e | 2018e | 2019e | 2020e | 2021e | 2022e | 2023e | 2024e | 2025e | 2026e |
|---|---|---|---|---|---|---|---|---|---|---|
| **Net Sales** | **3 484** | **3 649** | **3 819** | **3 991** | **4 171** | **4 338** | **4 468** | **4 580** | **4 694** | **4 811** |
| *% change* | *5.0%* | *4.8%* | *4.7%* | *4.5%* | *4.5%* | *4.0%* | *3.0%* | *2.5%* | *2.5%* | *2.5%* |
| EBIT | 396 | 429 | 461 | 499 | 534 | 564 | 581 | 595 | 610 | 625 |
| EBIT margin (%) | 11.4% | 11.7% | 12.1% | 12.5% | 12.8% | 13.0% | 13.0% | 13.0% | 13.0% | 13.0% |
| Income taxes | -113 | -123 | -133 | -152 | -163 | -172 | -177 | -182 | -186 | -191 |
| Tax rate (%) | 29.0% | 29.0% | 29.0% | 30.5% | 30.5% | 30.5% | 30.5% | 30.5% | 30.5% | 30.5% |
| **Operating profit after taxes** | **283** | **305** | **328** | **347** | **371** | **392** | **404** | **414** | **424** | **435** |
| + Depreciations | 172 | 180 | 188 | 180 | 188 | 195 | 201 | 206 | 211 | 217 |
| - Change in WCR | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| - Investments in fixed assets | 174 | 164 | 172 | 180 | 188 | 195 | 201 | 206 | 211 | 217 |
| **Operating cash flow** | **281** | **322** | **343** | **347** | **371** | **392** | **404** | **414** | **424** | **435** |

| | |
|---|---|
| PV of terminal value | 4,905 |
| +PV of future cash flows (2017-26) | 2,548 |
| **= Enterprise Value** | **7,453** |
| Net debt (2017e) | 665 |
| Other liabilities | 106 |
| Minority interest | 60 |
| Financial assets | 111 |
| **Theoretical value of equity** | **6,734** |
| Number of shares (m) | 253 |
| **Theoretical FV per share (EUR)** | **26.5** |

*Source: Bryan, Garnier & Co ests*

**Since we are only taking into account the DCF valuation, we have notched down our FV for GrandVision from EUR27 to EUR26.5 Our Buy recommendation is naturally maintained.**

**Note that by using the average of the two valuation methods (peer comparison of EUR31 and DCF of EUR26.5) our FV would work out to EUR29.**

Please see the section headed "Important information" on the back page of this report.

## 5.6. Valuation of Safilo

Concerning sales, our forecasts include underlying growth of 5-5.5%, as well as the negative impact associated with the non-renewal of five LVMH licences: **Céline** (-> 2017), **Dior** (-> 2020), **Givenchy** (-> 2021), **Fendi** (-> 2022) and **Marc Jacobs** (-> 2024). Indeed, we do not expect the production agreement with **Gucci** to be renewed (-> 2020).

Adjusted EBIT over 2017-19 takes into account the compensation payment from Kering, although afterwards visibility on the normative margin level admittedly remains poor due to the lack of clear top-line trends (operating leverage) as well as future measures taken by Safilo to offset the programmed end to LVMH licences.

We have assumed a cost of equity of 9.3% (risk-free rate of 1.6%, risk premium of 7% and beta of 1.1) and a cost of debt of 4.5%, leading us to a WACC of 8.8%.

**Fig. 86: DCF valuation:**

| EURm | 2017e | 2018e | 2019e | 2020e | 2021e | 2022e | 2023e | 2024e | 2025e | 2026e |
|---|---|---|---|---|---|---|---|---|---|---|
| **Net Sales** | **1 137** | **1 191** | **1 248** | **1 317** | **1 149** | **1 183** | **1 224** | **1 279** | **1 263** | **1 301** |
| *% change* | *-9.2* | *4.7* | *4.9* | *5.5* | *-12.7* | *2.9* | *3.5* | *4.5* | *-1.2* | *3.0* |
| Adjusted EBIT | 49 | 42 | 44 | 66 | 46 | 59 | 67 | 77 | 76 | 78 |
| Adj. EBIT margin (%) | 4.3% | 3.6% | 3.5% | 5.0% | 4.0% | 5.0% | 5.5% | 6.0% | 6.0% | 6.0% |
| Income taxes | -12 | -10 | -17 | -24 | -16 | -21 | -24 | -27 | -27 | -27 |
| Tax rate (%) | 24.7% | 24.2% | 38.6% | 36.5% | 35.0% | 35.0% | 35.0% | 35.0% | 35.0% | 35.0% |
| **Operating profit after taxes** | **37** | **32** | **27** | **42** | **30** | **38** | **44** | **50** | **49** | **51** |
| + Depreciations | 34 | 42 | 44 | 40 | 34 | 35 | 37 | 38 | 38 | 39 |
| - Change in WCR | -24 | 11 | 12 | 13 | 11 | 12 | 12 | 13 | 13 | 13 |
| - Investments in fixed assets | 49 | 48 | 47 | 40 | 34 | 35 | 37 | 38 | 38 | 39 |
| **Operating cash flow** | **46** | **15** | **11** | **29** | **18** | **27** | **32** | **37** | **37** | **38** |

| | |
|---|---|
| PV of terminal value | 263 |
| +PV of future cash flows (2017-26) | 182 |
| **= Enterprise Value** | **444** |
| Net debt (2017e) | 43 |
| Other liabilities | 92 |
| Minority interest | 0 |
| Financial assets | 97 |
| **Theoretical value of equity** | **406** |
| Number of shares (m) | 63 |
| **Theoretical FV per share (EUR)** | **6.5** |

*Source: Bryan, Garnier & Co ests*

**We are maintaining our FV of EUR6.5 as well as our Neutral recommendation as long as visibility on momentum has not improved (rebound in portfolio of own-brands, new licences, stabilisation in profitability).**

Please see the section headed "Important information" on the back page of this report.

## 5.7. Overview of our investment cases

The table below sets out the main catalysts and arguments underlying our recommendation for the four stocks in our Eyewear sample:

### Fig. 87: Our four investment cases:

| Stock | Recommendation | FV | Comments |
|---|---|---|---|
| **Essilor** | Buy | **EUR138** vs. EUR123 | * **Trends in Essilor's two main markets are improving:** more favourable market conditions in the US (~47% of sales) and in China {~8-9% of sales) will be key catalysts for top-line acceleration.<br>* **Strong top-line momentum** as early as Q2, the lower end of the LFL guidance (+3-5%) implies 3-3.5% growth over the rest of the year<br>* **Clear roadmap to EssilorLuxottica:** although we expect synergies of EUR508m by 2021, the mid-point of the group's EUR400-600m target, we believe that execution/integration risks are low and the potential for synergies could be higher than expected, particularly with regard to cost synergies.<br>* **Essilor is less sensitive to FX fluctuations:** despite its significant exposure to the USD, the group benefits from natural hedging, hence FX has no material impact on profitability. |
| **Luxottica** | Buy vs. Hold | **EUR64** vs. EUR52 | * **Cautious FY targets and risks are now well priced in…** We see little downside risk as CS expectations are now aligned with Luxottica's cautious guidance. More advantageous market conditions and a faster implementation of turnaround initiatives might lead to a better-than-expected operating performance this year<br>* **Play the successful alliance…** as for Essilor, we believe that execution/integration risks are low and that EssilorLuxottica could beat its EUR400-600 synergy target by 2021.<br>* **… and a higher offer from Essilor?** The French group could raise its buyout offer to convince minority shareholders in Luxottica and reach the squeeze-out threshold. |
| **GrandVision** | Buy | **EUR26.5** vs. EUR27 | * **Visibility on top-line growth is good…** Q1 results beat expectations and although some technical factors could partly hamper Q2 growth, we believe that GrandVision will deliver FY sales growth fairly in line with LT guidance ("at least 5% cc"), excluding a contribution from strategic acquisitions.<br>* **… as well as profitability improvement:** In 2016, the Dutch group was the only player to improve its profitability and we anticipate a 30bp-increase in adj. EBITDA margin to 16.5% in 2017, before a possible dilutive impact from M&A (i.e. Tesco Opticians).<br>* **A global leader in optical retailing:** GrandVision benefits from its critical mass to win market share in a very fragmented optical distribution market. The EssilorLuxottica deal could favour a faster optical retail consolidation, hence favourable market conditions for GrandVision.<br>* **Attractive valuation:** The GrandVision share is trading at 16.4x 2017e EV/EBIT (adj.), representing discounts of respectively 11% and 28% to its 2015-17 historical average and to Fielmann's multiples (22.9x). |
| **Safilo** | Hold | EUR6.5 | * **Safilo has valuable assets…** the Italian group still has the second-largest brand portfolio in the eyewear industry, including own brands which harbour some (untapped) growth potential.<br>* **… but faced a major setback with the LVMH-Marcolin deal:** Safilo will gradually lose the five LVMH licenses (~EUR340m), highlighting its overly large exposure to licenses (~77%e of sales).<br>* **Fragile top-line & earnings momentum:** despite an expected catch-up effect in Q2, the "SAP impact" took a harsh toll on Q1 (-14.9% adj. FX-n) and is set to weigh on the FY top-line and earnings performance (limited operating leverage).<br>* **Upside risk: 1/** speculation concerning a possible merger with GrandVision, which shares the same shareholder (HAL owns 77% of GrandVision and 42% of Safilo), **2/** strong rebound in adj. cc sales growth in Q2 (catch-up effect) and **3/ an** acceleration in momentum for the own-brand portfolio. |

*Source: Company Data, Bryan, Garnier & Co*

Please see the section headed "Important information" on the back page of this report.

**BRYAN, GARNIER & CO**

# INDEPENDENT RESEARCH UPDATE

2nd June 2017

Luxury & Consumer Goods

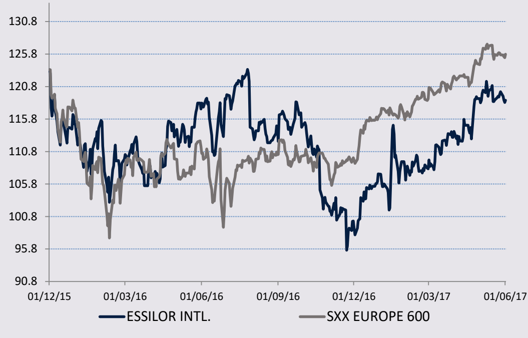
# Essilor

## Succeeding the operation to dazzle the crowds in 2018!

**Fair Value EUR138 vs. EUR123** (price EUR118.75) **BUY**

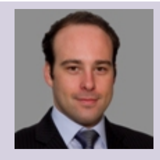
| | |
|---|---|
| Bloomberg | EF FP |
| Reuters | ESSI.PA |
| 12-month High / Low (EUR) | 123.5 / 95.6 |
| Market capitalisation (EURm) | 25,938 |
| Enterprise Value (BG estimates EURm) | 27,684 |
| Avg. 6m daily volume ('000 shares) | 579.2 |
| Free Float | 90.4% |
| 3y EPS CAGR | 10.0% |
| Gearing (12/16) | 30% |
| Dividend yield (12/17e) | 1.18% |

| YE December | 12/16 | 12/17e | 12/18e | 12/19e |
|---|---|---|---|---|
| Revenue (€m) | 7,115 | 7,754 | 8,255 | 8,796 |
| EBIT (€m) | 1,230 | 1,357 | 1,472 | 1,596 |
| Basic EPS (€) | 3.71 | 4.14 | 4.51 | 4.93 |
| Diluted EPS (€) | 3.79 | 4.22 | 4.60 | 5.04 |
| EV/Sales | 3.94x | 3.57x | 3.30x | 3.04x |
| EV/EBITDA | 21.2x | 19.2x | 17.5x | 16.0x |
| EV/EBIT | 22.8x | 20.4x | 18.5x | 16.7x |
| P/E | 31.3x | 28.1x | 25.8x | 23.6x |
| ROCE | 18.0 | 18.9 | 19.5 | 20.1 |



**After taking into account the information provided in document E on the issue of shares as compensation for DELFIN's contribution, as well as our synergy estimates for 2018-21 stemming from the partnership with Luxottica, we have raised our FV on Essilor from EUR123 to EUR138, and are maintaining our Buy recommendation.**

- **Essilor stand-alone is benefitting from advantageous trends.** Two of its main markets (US: 47% of sales, China: 8-9%) slowed temporarily in 2016, but EI has gradually restored better momentum in these countries since the beginning of the year. In addition, new catalysts (launch of Varilux X, integration of US optometrist cooperatives, relaunch of Coastal) are set to boost organic growth. As such, we believe EI is capable of delivering an average increase of at least 3.5% over the next three quarters (after 2.4% lfl growth in Q1 (FY guidance: +3-5% lfl).
- **An historical and promising deal!** Our cost synergies assumption is at the top-end of the group's fairly cautious target range (EUR277m vs. EUR220-300m). In contrast, we are more measured in our forecast for revenue synergies (EUR231m vs. EUR200-300m), which are always more difficult to unlock. Despite everything, **our synergy estimates (EUR508m in 2021 vs the group's target of EUR400-600m) lead to a CAGR in adjusted EI-LUX EPS of 12% over 2018-21,** excluding the impact of additional depreciation & amortisation of EUR580m prompted by the revaluation of Essilor's intangible assets.
- **Three major risks … that nevertheless seems to be well priced in. Integration risk** is what we feared most, but since the two groups are not merging, the risk of clashes seems lower. **Execution risk** also exists on **revenue synergies,** which are generally difficult to generate. Our forecast is at the low end of the target range and takes account of this risk despite clear complementary aspects in terms of products, distribution and geography.
- **The share price already reflects some of the market's (positive) expectations:** Essilor stand-alone is trading on 2018 PEG of 2.6x whereas that of EI-LUX would total 1.8x.

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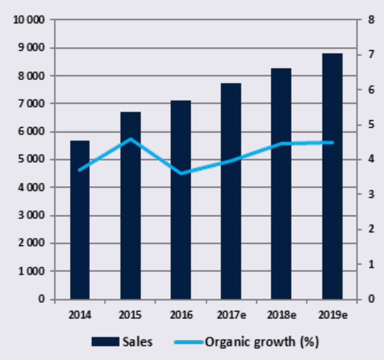
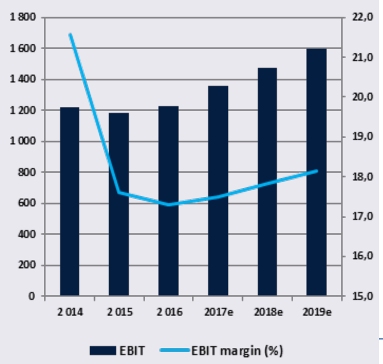
Please see the section headed "Important information" on the back page of this report.




**Company description**

With 2016 sales of EUR7.1bn, Essilor is the global leader in ophthalmic lenses and instruments (~87% of sales). This activity benefits from strong structural drivers such as the under-equipment in emerging markets, ageing population and innovation (trade-up). The group still derives 77% of sales from mature countries (o/w 47% in North America). Emerging markets currently account for about 23% of sales. Essilor is listed in Paris and is in the CAC40 index. With free float of c.90%, the group has no key shareholders, although its employees nevertheless own 8.3% of the capital.

| **Income Statement (EURm)** | **2014** | **2015** | **2016** | **2017e** | **2018e** | **2019e** |
|---|---|---|---|---|---|---|
| Revenue | 5,670 | 6,716 | 7,115 | 7,754 | 8,255 | 8,796 |
| *Change (%)* | *12.0%* | *18.4%* | *6.0%* | *9.0%* | *6.5%* | *6.6%* |
| Gross Profit | 3,315 | 4,012 | 4,181 | 4,583 | 4,904 | 5,242 |
| Contribution from operations | 1,043 | 1,263 | 1,321 | 1,442 | 1,552 | 1,671 |
| EBIT | 1,222 | 1,183 | 1,230 | 1,357 | 1,472 | 1,596 |
| *Change (%)* | *45.0%* | *-3.2%* | *4.0%* | *10.3%* | *8.5%* | *8.4%* |
| Financial results | (46.0) | (62.0) | (66.0) | (50.0) | (40.0) | (30.0) |
| Profits from associates | 3.0 | 0.0 | 1.0 | 0.0 | 0.0 | 0.0 |
| Pre-Tax profits | 1,179 | 1,121 | 1,165 | 1,307 | 1,432 | 1,566 |
| Tax | (193) | (308) | (285) | (327) | (365) | (399) |
| Minority interests | (57.0) | (55.5) | (67.0) | (73.7) | (79.2) | (85.2) |
| Net profit | 929 | 757 | 813 | 907 | 988 | 1,082 |
| *Change (%)* | *56.7%* | *-18.5%* | *7.4%* | *11.5%* | *8.9%* | *9.5%* |
| **Cash Flow Statement (EURm)** | | | | | | |
| Operating cash flows | 1,022 | 1,245 | 1,272 | 1,407 | 1,480 | 1,607 |
| Change in working capital | (10.0) | 51.0 | 8.0 | 118 | 92.3 | 99.6 |
| Capex, net | 232 | 327 | 294 | 310 | 330 | 352 |
| Financial investments, net | 1,836 | 780 | 706 | 310 | 289 | 308 |
| Dividends | 228 | 251 | 119 | 322 | 300 | 333 |
| Other | 188 | 128 | 125 | 0.0 | 0.0 | 0.0 |
| Net debt | 1,821 | 2,113 | 2,093 | 1,746 | 1,278 | 763 |
| Free Cash flow | 800 | 867 | 970 | 979 | 1,057 | 1,155 |
| **Balance sheet (EURm)** | | | | | | |
| Cash & liquid assets | 626 | 466 | 517 | 864 | 1,332 | 1,847 |
| Other current assets | 2,536 | 2,806 | 2,992 | 3,241 | 3,436 | 3,647 |
| Tangible fixed assets | 1,154 | 1,200 | 1,214 | 1,524 | 1,854 | 2,206 |
| Intangible assets | 4,668 | 5,295 | 6,191 | 6,191 | 6,191 | 6,191 |
| Other assets | 1,805 | 2,204 | 2,249 | 2,249 | 2,249 | 2,249 |
| Total assets | 10,789 | 11,971 | 13,163 | 14,069 | 15,063 | 16,140 |
| LT & ST debt | 2,447 | 2,579 | 2,610 | 2,610 | 2,610 | 2,610 |
| Other liabilities | 3,082 | 3,300 | 3,499 | 3,779 | 3,998 | 4,235 |
| Shareholders' funds | 5,260 | 6,092 | 7,054 | 7,681 | 8,454 | 9,295 |
| Total liabilities | 10,789 | 11,971 | 13,163 | 14,069 | 15,063 | 16,140 |
| Capital employed | 7,195 | 8,067 | 9,131 | 9,559 | 9,981 | 10,433 |
| **Financial Ratios** | | | | | | |
| Contribution margin (% of sales) | 18.40 | 18.80 | 18.57 | 18.60 | 18.80 | 19.00 |
| EBIT margin (% of sales) | 21.56 | 17.61 | 17.29 | 17.50 | 17.83 | 18.15 |
| Tax rate | 16.37 | 27.48 | 24.46 | 25.00 | 25.50 | 25.50 |
| Net margin | 16.39 | 11.27 | 11.43 | 11.69 | 11.96 | 12.30 |
| ROE (after tax) | 18.91 | 13.27 | 12.16 | 12.40 | 12.21 | 12.11 |
| ROCE (after tax) | 16.88 | 19.95 | 18.01 | 18.86 | 19.51 | 20.10 |
| Gearing | 34.62 | 34.68 | 29.67 | 22.73 | 15.12 | 8.21 |
| Pay out ratio | 34.43 | 31.11 | 39.58 | 33.14 | 33.68 | 33.73 |
| Number of shares, diluted | 214,820 | 216,583 | 219,203 | 219,203 | 219,203 | 219,203 |
| **Per share data (EUR)** | | | | | | |
| EPS | 4.32 | 3.50 | 3.71 | 4.14 | 4.51 | 4.93 |
| Restated EPS | 3.05 | 3.57 | 3.79 | 4.22 | 4.60 | 5.04 |
| *% change* | *6.2%* | *17.0%* | *6.2%* | *11.5%* | *8.9%* | *9.5%* |
| BVPS | 11.01 | 10.92 | 10.79 | 10.79 | 10.79 | 10.79 |
| Operating cash flows | 4.76 | 5.75 | 5.80 | 6.42 | 6.75 | 7.33 |
| FCF | 3.72 | 4.00 | 4.42 | 4.47 | 4.82 | 5.27 |
| Net dividend | 1.05 | 1.11 | 1.50 | 1.40 | 1.55 | 1.70 |

*Source: Company Data; Bryan, Garnier & Co ests.*

BRYAN, GARNIER & CO

INDEPENDENT RESEARCH UPDATE

2nd June 2017

Luxury & Consumer Goods

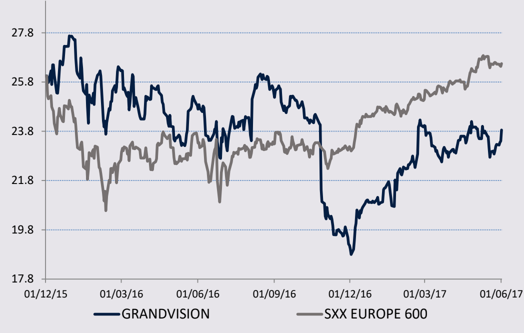
# Grandvision

## Critical mass available on shelves now

**Fair Value EUR26,5 vs. EUR27** (price EUR23.34) **BUY**

| | |
|---|---|
| Bloomberg | GVNV NA |
| Reuters | GVNV AS |
| 12-month High / Low (EUR) | 26.1 / 18.8 |
| Market capitalisation (EURm) | 5,939 |
| Enterprise Value (BG estimates EURm) | 6,603 |
| Avg. 6m daily volume ('000 shares) | 100.7 |
| Free Float | 21.0% |
| 3y EPS CAGR | 8.0% |
| Gearing (12/16) | 75% |
| Dividend yield (12/17e) | 1.53% |

| YE December | 12/16 | 12/17e | 12/18e | 12/19e |
|---|---|---|---|---|
| Revenue (EURm) | 3,316 | 3,484 | 3,649 | 3,819 |
| EBIT (EURm) | 358.22 | 396.26 | 428.79 | 460.98 |
| Basic EPS (EUR) | 0.92 | 1.01 | 1.10 | 1.20 |
| Diluted EPS (EUR) | 0.96 | 1.02 | 1.12 | 1.21 |
| EV/Sales | 2.02x | 1.90x | 1.76x | 1.64x |
| EV/EBITDA | 12.5x | 11.5x | 10.5x | 9.6x |
| EV/EBIT | 18.7x | 16.4x | 14.7x | 13.3x |
| P/E | 24.3x | 22.9x | 20.9x | 19.3x |
| ROCE | 19.5 | 21.0 | 23.0 | 24.9 |



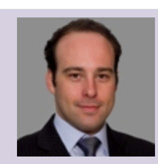
**The excellent start to the year highlighted the qualities of the global leader in eyewear: 1/ robust SSSG even in difficult markets, 2/ rise in profitability thanks to the positive effects of critical mass and 3/ M&A to round out its density. GrandVision could also be a good alternative for investors not keen on playing the EI-LUX operation and those fearing a decline in the dollar (around 3% of sales vs. 87% of sales in Europe).**

- **Robust momentum expected in 2017.** Although management preferred to warn the market about negative technical factors in Q2 (comparison bases, shift in Easter holidays), GVNV should at least deliver its MT guidance (mid single-digit constant currency sales growth, high-single digit growth in adjusted EBITDA excluding acquisitions). Note that GVNV is likely to be the only player in our sample to post wider margins in 2017 (adj. EBITDA margin of +30bp).

- **A retailer that knows how to play critical mass.** The group's centralised organisation provides it a number of competitive advantages: **(i)** a very competitive offering (around 20% cheaper than the competition) thanks to optimised sourcing and its own-brand offer, **(ii)** efficiency gains and operating leverage, **(iii)** capex under control (around 4.5-5%e of sales over 2017-19) favouring FCF generation (around EUR280-345m a year over 2017-19).

- **A consolidating role.** A merger with SFL looks tempting at first glance but we do not favour this scenario given the two groups' opposing strategies. In contrast, GVNV, which dominates European distribution with "just" 14-15% market share, is set to benefit from the highly fragmented nature of optical distribution to continue to make acquisitions. In April, the group bought Tesco Opticians in the UK (sales of around EUR105m, 290 stores) and we believe that operations in the US are very likely in the future.

- **Attractively values.** The slight adjustment to our FV (EUR26.5 vs. EUR27) stems only from the fact that we have decided to temporarily exclude a valuation by peer comparison (EUR31) since share prices in our sample are affected by the merger operation. Apart from SFL, GVNV is the most affordable share in the sector in terms of 2017e EV/EBIT (16.4x), implying a discount of around 19% relative to Fielmann!

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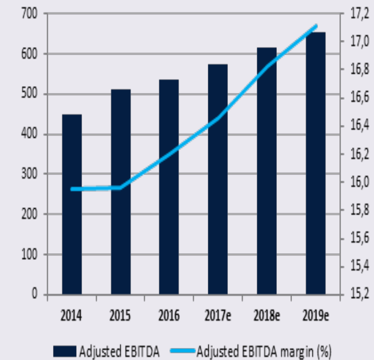
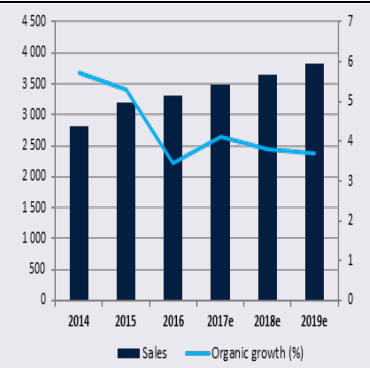



**Company description**

Investment fund HAL started to invest in optical distribution in 1996 before going on to buy a number of chains in Europe and the rest of the world over the years. GrandVision was born in 2011 from the merger of the main chains owned by HAL: Pearle Europe and Grand Vision. GrandVision's leadership is based on a network of 34 banners present in 44 countries, representing over 6,500 stores. In 2016, the group had sales of more than EUR3.3bn. Europe clearly remains the centre of gravity for GrandVision since it accounts for 87% of sales and 98% of adjusted EBITDA (before non-allocated costs). Following the IPO in February 2015, HAL owns 77% of the capital and free float stands at 21%.

| **Income Statement (EURm)** | **2014** | **2015** | **2016** | **2017e** | **2018e** | **2019e** |
|---|---|---|---|---|---|---|
| Revenue | 2,817 | 3,205 | 3,316 | 3,484 | 3,649 | 3,819 |
| *Change (%)* | *7.5%* | *13.8%* | *3.5%* | *5.0%* | *4.8%* | *4.7%* |
| *Change LFL (%)* | *-%* | *-%* | *-%* | *-%* | *-%* | *-%* |
| Gross Profit | 2,073 | 2,328 | 2,415 | 2,542 | 2,668 | 2,791 |
| EBITDA | 449 | 512 | 537 | 573 | 614 | 654 |
| EBIT | 289 | 353 | 358 | 396 | 429 | 461 |
| *Change (%)* | *6.8%* | *22.4%* | *1.4%* | *10.6%* | *8.2%* | *7.5%* |
| Financial results | (34.4) | (19.1) | (10.0) | (7.0) | (3.6) | (0.79) |
| Pre-Tax profits | 254 | 334 | 348 | 389 | 425 | 460 |
| Tax | (79.7) | (103) | (96.0) | (113) | (123) | (133) |
| Minority interests | (13.4) | (18.3) | (21.0) | (22.1) | (23.1) | (24.2) |
| Net profit | 161 | 213 | 231 | 254 | 279 | 303 |
| *Change (%)* | *13.9%* | *32.0%* | *8.7%* | *10.0%* | *9.6%* | *8.5%* |
| **Cash Flow Statement (EURm)** | | | | | | |
| Operating cash flows | 346 | 403 | 425 | 455 | 486 | 515 |
| Change in working capital | (8.3) | 36.9 | 4.3 | (0.20) | (0.20) | (0.20) |
| Capex, net | 132 | 132 | 140 | 174 | 164 | 172 |
| Financial investments, net | 233 | 138 | 12.7 | 117 | 54.7 | 57.3 |
| Dividends | 9.9 | 46.2 | 46.3 | 78.3 | 90.3 | 113 |
| Other | 67.1 | 70.1 | 33.2 | 0.0 | 0.0 | 0.0 |
| Net debt | 919 | 939 | 750 | 665 | 488 | 315 |
| Free Cash flow | 222 | 235 | 281 | 281 | 322 | 343 |
| **Balance Sheet (EURm)** | | | | | | |
| Cash & liquid assets | 134 | 198 | 181 | 267 | 444 | 617 |
| Other current assets | 506 | 538 | 596 | 625 | 655 | 685 |
| Tangible fixed assets | 408 | 431 | 444 | 446 | 430 | 414 |
| Intangible assets | 448 | 454 | 446 | 446 | 446 | 446 |
| Other assets | 1,052 | 1,178 | 1,168 | 1,168 | 1,168 | 1,168 |
| Total assets | 2,548 | 2,799 | 2,835 | 2,952 | 3,142 | 3,329 |
| LT & ST debt | 1,053 | 1,137 | 931 | 931 | 931 | 931 |
| Other liabilities | 826 | 830 | 897 | 926 | 956 | 986 |
| Shareholders' funds | 668 | 832 | 1,007 | 1,094 | 1,255 | 1,412 |
| Total liabilities | 2,548 | 2,799 | 2,835 | 2,952 | 3,142 | 3,329 |
| Capital employed | 1,736 | 1,908 | 1,898 | 1,899 | 1,883 | 1,867 |
| **Financial Ratios** | | | | | | |
| Gross Margin (% of sales) | 73.60 | 72.65 | 72.83 | 72.96 | 73.10 | 73.06 |
| EBITDA margin (% of sales) | 15.96 | 15.96 | 16.20 | 16.46 | 16.83 | 17.11 |
| EBIT margin (% of sales) | 10.25 | 11.02 | 10.80 | 11.37 | 11.75 | 12.07 |
| Tax rate | 31.34 | 30.84 | 27.57 | 29.00 | 29.00 | 29.00 |
| Net Margin | 5.72 | 6.64 | 6.97 | 7.30 | 7.64 | 7.92 |
| ROE (after tax) | 25.88 | 27.33 | 24.42 | 24.58 | 23.33 | 22.37 |
| ROCE (after tax) | 17.57 | 18.71 | 19.48 | 21.05 | 22.96 | 24.88 |
| Gearing | 138 | 113 | 74.54 | 60.74 | 38.88 | 22.29 |
| Pay out ratio | 0.0 | 16.61 | 33.87 | 35.49 | 40.51 | 40.47 |
| Number of shares, diluted | 254,444 | 252,428 | 252,624 | 252,624 | 252,624 | 252,624 |
| **Per share data (EUR)** | | | | | | |
| EPS | 0.63 | 0.84 | 0.92 | 1.01 | 1.10 | 1.20 |
| Restated EPS | 0.70 | 0.86 | 0.96 | 1.02 | 1.12 | 1.21 |
| *% change* | *-71.2%* | *22.9%* | *12.0%* | *6.2%* | *9.5%* | *8.4%* |
| BVPS | 2.63 | 3.30 | 3.98 | 4.33 | 4.97 | 5.59 |
| Operating cash flows | 1.36 | 1.60 | 1.68 | 1.80 | 1.92 | 2.04 |
| FCF | 0.87 | 0.93 | 1.11 | 1.11 | 1.27 | 1.36 |
| Net dividend | 0.0 | 0.14 | 0.31 | 0.36 | 0.45 | 0.48 |

*Source: Company Data; Bryan, Garnier & Co ests.*

**INDEPENDENT RESEARCH UPDATE**

2nd June 2017

Luxury & Consumer Goods

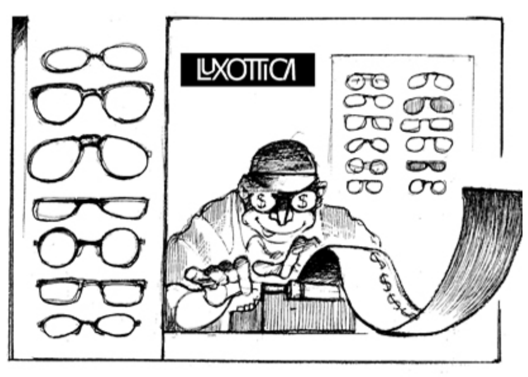
# Luxottica

## On the runway… set for a take-off before 2018?

**Fair Value EUR64 vs. EUR52** (price EUR53.90) **BUY vs. NEUTRAL**

| | |
|---|---|
| Bloomberg | LUX IM |
| Reuters | LUX.MI |
| 12-month High / Low (EUR) | 55.1 / 40.6 |
| Market capitalisation (EURm) | 26,112 |
| Enterprise Value (BG estimates EURm) | 27,048 |
| Avg. 6m daily volume ('000 shares) | 683.6 |
| Free Float | 32.9% |
| 3y EPS CAGR | 10.4% |
| Gearing (12/16) | 20% |
| Dividend yield (12/17e) | 2.05% |

| YE December | 12/16 | 12/17e | 12/18e | 12/19e |
|---|---|---|---|---|
| Revenue (€m) | 9,086 | 9,677 | 10,161 | 10,766 |
| EBIT (€m) | 1,345 | 1,543 | 1,661 | 1,809 |
| Basic EPS (€) | 1.77 | 2.00 | 2.17 | 2.38 |
| Diluted EPS (€) | 1.77 | 2.01 | 2.17 | 2.39 |
| EV/Sales | 3.00x | 2.79x | 2.62x | 2.43x |
| EV/EBITDA | 14.7x | 13.0x | 12.0x | 10.9x |
| EV/EBIT | 20.3x | 17.4x | 15.9x | 14.4x |
| P/E | 30.4x | 26.8x | 24.8x | 22.6x |
| ROCE | 11.0 | 12.4 | 13.3 | 14.4 |

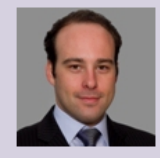



**Since the announcement of the tie-up, management's attention has focused on continuing its projects so that it is ready to take off once the partnership with EI is finalised. Despite everything, we believe that the first promising signs should appear rapidly, helped by a more buoyant optical market than in 2016. Our new FV for the future EI-LUX group (EUR138) prompts us to adjust our FV on Luxottica to EUR64 vs. EUR53, and upgrade our recommendation from Neutral to Buy, based on: (i) the gradual improvement in fundamentals, (ii) the success of the merger, while benefiting from more affordable multiples and (iii) an eventual increase in the minorities buy-out bid**

- **The group's rebound is firstly set to stem from the US (~56% of sales).** Numerous initiatives aimed at strengthening the group, such as MAP at RayBan, the reorganisation of Oakley and the new retail concept at LensCrafters, are still weighing on its US performances. However, the first beneficial effects should be visible as of Q2, helped by easier comparison with the year-earlier period and a healthier US market. The earlier LUX restores robust momentum in the US, the more chances the future EI-LUX combined entity (US ~54% of sales) will have of rapidly unlocking its synergies targets.

- **Does LUX's licence business present a risk?** This risk seems small to us for a number of reasons: **1/** the weight of these licences is relatively low (around 10-15% of total sales => ~6-7% of EI-LUX sales), **2/** licensors are mostly groups with a single brand or with only one strong brand (Prada, Dolce & Gabbana, Chanel, etc.), and have no interest in bringing their business back in-house, or lack the critical mass to do so, and **3/** the advantages of vertical integration: with 8,000 stores and a network of more than 150,000 wholesale doors, LUX is a key player in optical distribution.

- **LUX: an affordable share to play the EI-LUX operation as well.** Even though some of the discount stems from the exchange parity, the LUX share is trading 15% lower than EI in terms of 2017e EV/EBIT. Whereas EI is due to launch a bid to buy out Luxottica's minority interests, we do not rule out the possibility of having to raise its offer (cash sweetener?) if it struggles to reach the squeeze-out threshold (95%).

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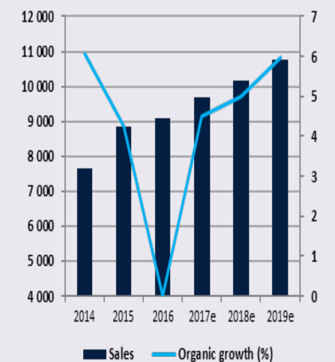
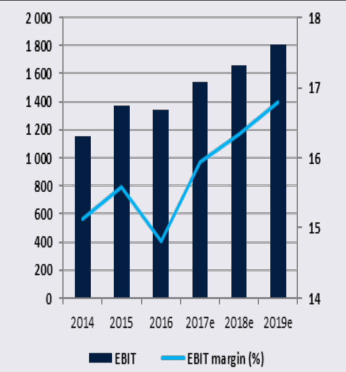
Please see the section headed "Important information" on the back page of this report.




**Company description**

With 2016 sales of EUR9.1bn, Luxottica is the global leader in luxury eyewear. The Italian group is organised into two businesses: (i) Retail (61% of sales) with the distribution of optical products via more than 7,700 stores across the globe (LensCrafters, Sunglass Hut…) and (ii) Wholesale (39% of sales) which concerns the design, production and marketing of prescription frames and sunglasses thanks to a portfolio of house brands (Ray-Ban, Oakley…) and licences (Prada, Giorgio Armani, Ralph Lauren, Chanel…) that is unrivalled in the sector. Mr Leonardo Del Vecchio, the group's founder and current Chairman, remains the majority shareholder with approx. 62% of the share capital. Worth noting is that Giorgio Armani holds a ~5% stake. Free float stands at around 33%.

| **Income Statement (EURm)** | **2014** | **2015** | **2016** | **2017e** | **2018e** | **2019e** |
|---|---|---|---|---|---|---|
| Revenue | 7,652 | 8,837 | 9,086 | 9,677 | 10,161 | 10,766 |
| *Change (%)* | *4.6%* | *15.5%* | *2.8%* | *6.5%* | *5.0%* | *6.0%* |
| Gross Profit | 5,078 | 6,001 | 5,932 | 6,386 | 6,737 | 7,161 |
| EBITDA | 1,542 | 1,853 | 1,858 | 2,081 | 2,226 | 2,407 |
| EBIT | 1,158 | 1,376 | 1,345 | 1,543 | 1,661 | 1,809 |
| *Change (%)* | *9.7%* | *18.9%* | *-2.3%* | *14.7%* | *7.6%* | *8.9%* |
| Financial results | (97.5) | (98.5) | (26.6) | (59.5) | (54.5) | (44.5) |
| Pre-Tax profits | 1,060 | 1,278 | 1,319 | 1,483 | 1,606 | 1,764 |
| Tax | (414) | (471) | (466) | (519) | (562) | (617) |
| Minority interests | (3.4) | (2.8) | (1.8) | (1.9) | (2.0) | (2.1) |
| Net profit | 643 | 804 | 851 | 962 | 1,042 | 1,145 |
| *Change (%)* | *18.0%* | *25.1%* | *5.8%* | *13.1%* | *8.3%* | *9.8%* |
| **Cash Flow Statement (EURm)** | | | | | | |
| Operating cash flows | 1,128 | 1,290 | 1,392 | 1,562 | 1,664 | 1,790 |
| Change in working capital | (11.8) | 86.1 | 34.8 | 57.4 | 46.9 | 58.7 |
| Capex, net | 419 | 464 | 658 | 677 | 559 | 538 |
| Financial investments, net | 41.1 | 21.0 | 128 | 145 | 152 | 161 |
| Dividends | 312 | 692 | 430 | 441 | 529 | 573 |
| Other | (81.0) | 20.2 | 313 | 0.0 | 0.0 | 0.0 |
| Net debt | 1,013 | 1,006 | 1,177 | 936 | 560 | 101 |
| Free Cash flow | 720 | 740 | 699 | 827 | 1,058 | 1,193 |
| **Balance Sheet (EURm)** | | | | | | |
| Cash & liquid assets | 1,454 | 865 | 867 | 1,108 | 1,484 | 1,943 |
| Other current assets | 1,714 | 1,964 | 2,161 | 2,280 | 2,377 | 2,498 |
| Tangible fixed assets | 1,318 | 1,436 | 1,673 | 1,812 | 1,805 | 1,745 |
| Intangible assets | 1,385 | 1,442 | 1,477 | 1,477 | 1,477 | 1,477 |
| Other assets | 3,724 | 3,942 | 4,122 | 4,122 | 4,122 | 4,122 |
| Total assets | 9,594 | 9,649 | 10,300 | 10,799 | 11,266 | 11,786 |
| LT & ST debt | 2,467 | 1,870 | 2,044 | 2,044 | 2,044 | 2,044 |
| Other liabilities | 2,199 | 2,361 | 2,472 | 2,533 | 2,583 | 2,646 |
| Shareholders' funds | 4,929 | 5,418 | 5,784 | 6,222 | 6,639 | 7,096 |
| Total liabilities | 9,594 | 9,649 | 10,300 | 10,799 | 11,266 | 11,786 |
| Capital employed | 6,792 | 7,239 | 7,903 | 8,099 | 8,140 | 8,138 |
| **Financial Ratios** | | | | | | |
| Gross Margin (% of sales) | 66.35 | 67.91 | 65.29 | 65.99 | 66.30 | 66.51 |
| EBITDA margin (% of sales) | 20.15 | 20.97 | 20.45 | 21.51 | 21.91 | 22.36 |
| EBIT margin (% of sales) | 15.13 | 15.58 | 14.81 | 15.94 | 16.34 | 16.80 |
| Tax rate | 39.06 | 36.86 | 35.37 | 35.00 | 35.00 | 35.00 |
| Net Margin | 8.40 | 9.10 | 9.36 | 9.94 | 10.26 | 10.63 |
| ROE (after tax) | 13.06 | 14.86 | 14.72 | 15.48 | 15.71 | 16.14 |
| ROCE (after tax) | 10.39 | 12.01 | 11.00 | 12.38 | 13.26 | 14.45 |
| Gearing | 20.55 | 18.56 | 20.35 | 15.04 | 8.43 | 1.43 |
| Pay out ratio | 49.85 | 49.98 | 50.00 | 55.00 | 55.00 | 55.00 |
| Number of shares, diluted | 479,247 | 482,073 | 480,026 | 480,026 | 480,026 | 480,026 |
| **Per share data (EUR)** | | | | | | |
| EPS | 1.34 | 1.67 | 1.77 | 2.00 | 2.17 | 2.38 |
| Restated EPS | 1.44 | 1.68 | 1.77 | 2.01 | 2.17 | 2.39 |
| *% change* | *10.5%* | *16.1%* | *5.8%* | *13.1%* | *8.3%* | *9.8%* |
| BVPS | 10.28 | 11.24 | 12.05 | 12.96 | 13.83 | 14.78 |
| Operating cash flows | 2.35 | 2.68 | 2.90 | 3.25 | 3.47 | 3.73 |
| FCF | 1.50 | 1.54 | 1.46 | 1.72 | 2.20 | 2.49 |
| Net dividend | 0.72 | 0.89 | 0.92 | 1.10 | 1.20 | 1.31 |

*Source: Company Data; Bryan, Garnier & Co ests.*

# INDEPENDENT RESEARCH UPDATE

2nd June 2017

Luxury & Consumer Goods

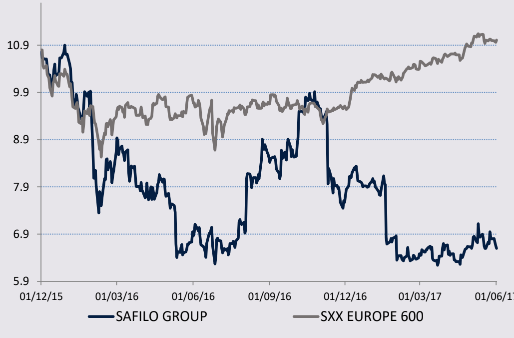
# Safilo

## Safilo still exposed to headwinds

**Fair Value EUR6,5** (price EUR6.73) **NEUTRAL**

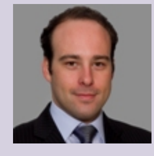
| | |
|---|---|
| Bloomberg | SFL IM |
| Reuters | SFLG.MI |
| 12-month High / Low (EUR) | 9.9 / 6.2 |
| Market capitalisation (EURm) | 422 |
| Enterprise Value (BG estimates EURm) | 464 |
| Avg. 6m daily volume ('000 shares) | 233.6 |
| Free Float | 42.2% |
| 3y EPS CAGR | 24.0% |
| Gearing (12/16) | 6% |
| Dividend yield (12/17e) | NM |

| YE December | 12/16 | 12/17e | 12/18e | 12/19e |
|---|---|---|---|---|
| Revenue (EURm) | 1,253 | 1,137 | 1,191 | 1,248 |
| EBIT (EURm) | -116.27 | 0.54 | 27.38 | 43.69 |
| Basic EPS (EUR) | -2.32 | -0.21 | 0.27 | 0.47 |
| Diluted EPS (EUR) | 0.25 | 0.19 | 0.42 | 0.47 |
| EV/Sales | 0.38x | 0.41x | 0.38x | 0.36x |
| EV/EBITDA | 5.8x | 13.4x | 6.5x | 5.1x |
| EV/EBIT | NS | 864.3x | 16.4x | 10.2x |
| P/E | 27.3x | 35.1x | 15.9x | 14.4x |
| ROCE | -29.9 | 0.5 | 1.7 | 2.8 |



**Safilo was unfortunately the privileged partner of Kering and LVMH (five licences at SFL = 27% of total sales), which were the only two groups with the capacity (and interest) to bring their eyewear businesses back in-house. In this context and faced with the EI-LUX pair-up, it is even more vital for SFL to reduce its exposure to licences (~77%e of sales) and to succeed its transformation (Plan 2020).**

- **Saved by house brands...** Safilo still aims to generate 40% of sales from its portfolio of own-brands by 2020 (vs. around 23% in 2016e). The success of the five house brands as of 2017 (especially Smith, Carrera and Polaroid) will be key to: **(i)** showing that the group is capable of moving towards this 2020 target (BG estimate of 30-35%), **(ii)** reducing its exposure to non-renewals and **(iii)** ensuring better visibility on margins (no royalties or marketing contribution to share with licensors).
- **... and by a radical transformation.** Since 2014, SFL has implemented significant projects to strengthen its sales and logistical structure (supply chain, IT etc.). Today, the negative effects are unfortunately more visible than signs of an improvement (Q1: organic decline of 14.5% excluding Gucci and retail associated with the automation of the Padua distribution centre), but these initiatives are vital to bolster the group's medium and long-term execution and operating performances.
- **Can Safilo stay independent?** This question is worth asking given the merger of EI-LUX and the ramp-up of Kering Eyewear (sales of around EUR340m before integration of Cartier) and the LVMH-Marcolin joint venture (sales of around EUR400-500m). HAL, the key shareholder at GVNV (77%) and SFL (42%) could be tempted to merge the two groups in order to create a vertically integrated mini-Luxottica but the two groups are following opposing strategies and aim to remain independent. In our view, SFL could remain so on condition that it succeeds its 2020 strategic plan.
- **The share price has stabilised but visibility is still too poor.** The prerequisites to a rebound in the share price are: **(i)** a surge in organic growth in Q2 (end to upheaval caused by the Padua site), **(ii)** an acceleration in the portfolio of own-brands and **(iii)** the signing of new licences.

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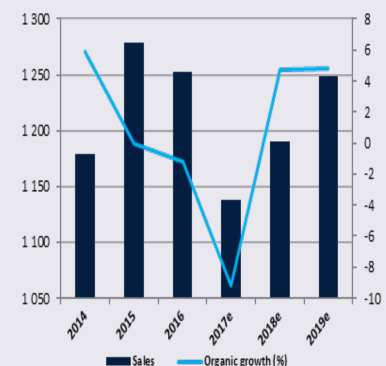
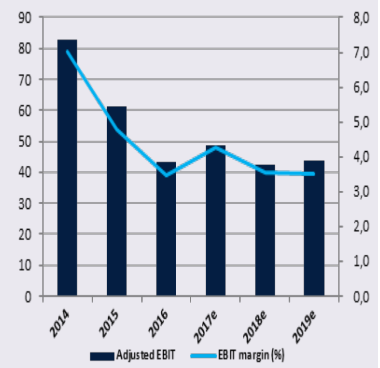



**Company description**

With 2016 sales of EUR1.2bn, Safilo is the second-largest player in luxury & premium eyewear. The Italian group has a wholesale-oriented business model (94% of sales) which concerns the design, production and marketing of prescription glasses and sunglasses thanks to a wide portfolio of licences (Dior, Gucci, Bottega Veneta, Hugo Boss...) and three major house brands (Carrera, Polaroid and Safilo).

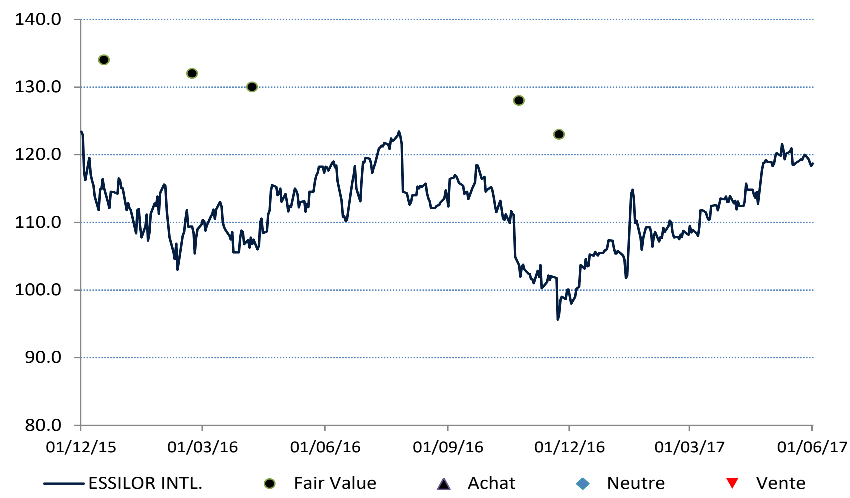
Since April 2012 the main shareholder with a 42% stake is HAL, a holding-company which also owns GrandVision. The Tabacchi family's holding company (Only 3T) now only has a 9% stake. Hence free float amounts approx. 42%

| **Income Statement (EURm)** | **2014** | **2015** | **2016** | **2017e** | **2018e** | **2019e** |
|---|---|---|---|---|---|---|
| Revenue | 1,179 | 1,279 | 1,253 | 1,137 | 1,191 | 1,248 |
| *Change (%)* | *5.1%* | *8.5%* | *-2.0%* | *-9.2%* | *4.7%* | *4.9%* |
| Gross Profit | 719 | 757 | 716 | 605 | 655 | 702 |
| EBITDA | 111 | 82.4 | 80.9 | 34.7 | 69.1 | 87.4 |
| EBIT | 75.3 | 0.83 | (116) | 0.54 | 27.4 | 43.7 |
| *Change (%)* | *0.7%* | *-98.9%* | *-14 074%* | *-%* | *4 997%* | *59.6%* |
| Financial results | (8.6) | (27.0) | (10.0) | (2.0) | 0.0 | 2.5 |
| Pre-Tax profits | 64.9 | (25.2) | (126) | (1.5) | 27.4 | 46.2 |
| Tax | (25.4) | (26.9) | (19.5) | (12.0) | (10.3) | (16.9) |
| Minority interests | (0.42) | (0.33) | (0.00) | (0.00) | (0.00) | (0.00) |
| Net profit | 39.0 | (52.3) | (146) | (13.5) | 17.1 | 29.3 |
| *Change (%)* | *151%* | *-234%* | *-178%* | *90.8%* | *-%* | *71.4%* |
| **Cash Flow Statement (EURm)** | | | | | | |
| Operating cash flows | 74.9 | 29.5 | 51.5 | 46.1 | 58.8 | 73.0 |
| Change in working capital | 41.3 | (11.7) | (42.0) | (24.2) | 11.1 | 12.1 |
| Capex, net | 38.9 | 47.8 | 52.3 | 48.9 | 47.6 | 47.4 |
| Financial investments, net | 0.0 | 2.9 | 2.5 | 5.7 | 6.0 | 1.2 |
| Dividends | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 6.3 |
| Other | (24.6) | (82.8) | (2.8) | 10.0 | (20.0) | 0.0 |
| Net debt | 163 | 89.9 | 48.4 | 42.7 | 28.6 | 22.6 |
| Free Cash flow | (5.4) | (6.5) | 41.2 | 21.4 | 0.03 | 13.5 |
| **Balance Sheet (EURm)** | | | | | | |
| Cash & liquid assets | 88.6 | 86.6 | 109 | 115 | 129 | 135 |
| Other current assets | 565 | 554 | 573 | 526 | 548 | 571 |
| Tangible fixed assets | 203 | 197 | 198 | 212 | 218 | 222 |
| Intangible assets | 638 | 646 | 512 | 512 | 512 | 512 |
| Other assets | 103 | 107 | 135 | 135 | 135 | 135 |
| Total assets | 1,598 | 1,591 | 1,527 | 1,500 | 1,542 | 1,575 |
| LT & ST debt | 252 | 177 | 157 | 157 | 157 | 157 |
| Other liabilities | 372 | 416 | 497 | 474 | 484 | 496 |
| Shareholders' funds | 974 | 999 | 873 | 869 | 900 | 922 |
| Total liabilities | 1,598 | 1,591 | 1,527 | 1,500 | 1,542 | 1,575 |
| Capital employed | 1,144 | 1,121 | 448 | 962 | 979 | 995 |
| **Financial Ratios** | | | | | | |
| Gross Margin (% of sales) | 60.96 | 59.19 | 57.12 | 53.20 | 55.00 | 56.20 |
| EBITDA margin (% of sales) | 9.39 | 6.44 | 6.46 | 3.05 | 5.80 | 7.00 |
| EBIT margin (% of sales) | 6.39 | 0.07 | (9.28) | 0.05 | 2.30 | 3.50 |
| Tax rate | 39.17 | (107) | (15.43) | (820) | 37.50 | 36.50 |
| Net Margin | 3.31 | (4.09) | (11.63) | (1.18) | 1.44 | 2.35 |
| ROE (after tax) | 4.58 | 0.69 | 1.76 | 1.38 | 2.94 | 3.18 |
| ROCE (after tax) | 4.00 | 0.15 | (29.94) | 0.51 | 1.75 | 2.79 |
| Gearing | 16.76 | 9.00 | 5.54 | 4.91 | 3.18 | 2.45 |
| Pay out ratio | 15.99 | 0.0 | 0.0 | 0.0 | 36.56 | 21.33 |
| Number of shares, diluted | 62,736 | 62,782 | 62,782 | 62,782 | 62,782 | 62,782 |
| **Per share data (EUR)** | | | | | | |
| EPS | 0.62 | (0.83) | (2.32) | (0.21) | 0.27 | 0.47 |
| Restated EPS | 0.71 | 0.11 | 0.25 | 0.19 | 0.42 | 0.47 |
| *% change* | *13.5%* | *-84.5%* | *122%* | *-22.1%* | *121%* | *10.7%* |
| BVPS | 15.53 | 15.91 | 13.90 | 13.84 | 14.34 | 14.69 |
| Operating cash flows | 1.19 | 0.47 | 0.82 | 0.73 | 0.94 | 1.16 |
| FCF | (0.09) | (0.10) | 0.66 | 0.34 | 0.00 | 0.22 |
| Net dividend | 0.10 | 0.0 | 0.0 | 0.0 | 0.10 | 0.10 |

*Source: Company Data; Bryan, Garnier & Co ests.*

# Price Chart and Rating History

## Essilor



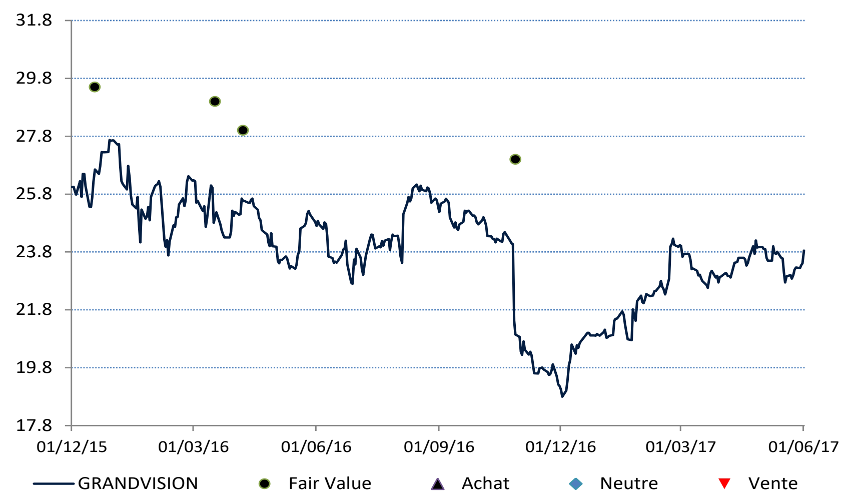

**Ratings**

| Date | Ratings | Price |
|---|---|---|
| 27/10/08 | BUY | EUR33.545 |

**Target Price**

| Date | Target price |
|---|---|
| 23/11/16 | EUR123 |
| 22/11/16 | Under review |
| 24/10/16 | EUR128 |
| 07/04/16 | EUR130 |
| 22/02/16 | EUR132 |
| 18/12/15 | EUR134 |
| 31/07/15 | EUR126 |
| 22/04/15 | EUR124 |
| 16/04/15 | EUR120 |
| 20/02/15 | EUR110 |
| 16/02/15 | EUR108 |
| 13/01/15 | EUR104 |
| 18/06/14 | EUR96 |

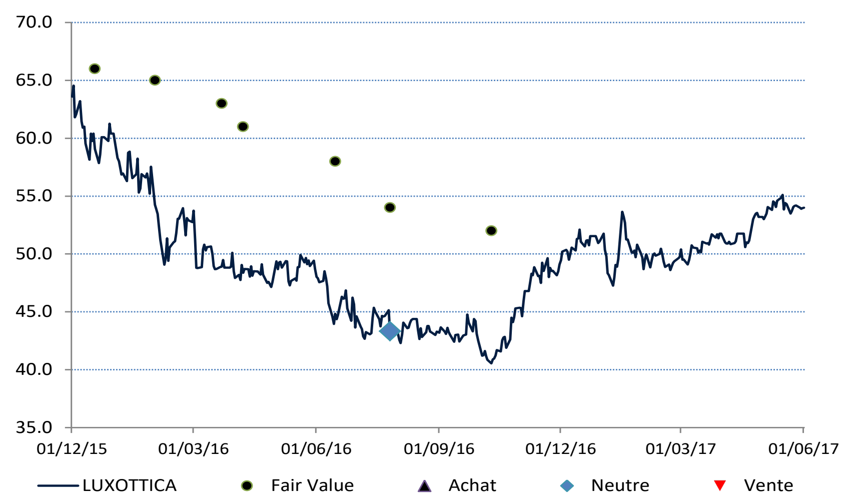
# Grandvision




| Ratings | | |
|---|---|---|
| **Date** | **Ratings** | **Price** |
| 15/09/15 | BUY | EUR22.73 |

| Target Price | |
|---|---|
| **Date** | **Target price** |
| 28/10/16 | EUR27 |
| 07/04/16 | EUR28 |
| 17/03/16 | EUR29 |
| 18/12/15 | EUR29.5 |
| 15/09/15 | EUR27.5 |

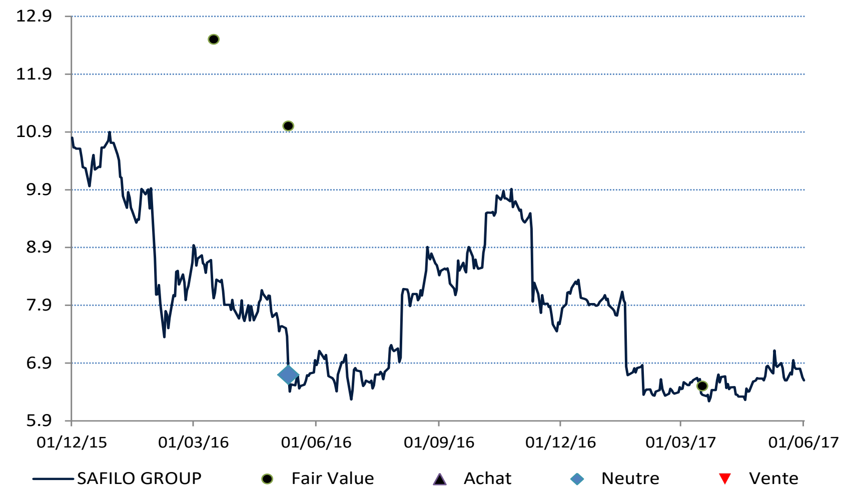
# Luxottica




| Ratings | | |
|---|---|---|
| Date | Ratings | Price |
| 26/07/16 | NEUTRAL | EUR44.64 |

| Target Price | |
|---|---|
| Date | Target price |
| 10/10/16 | EUR52 |
| 26/07/16 | EUR54 |
| 26/07/16 | EUR54 |
| 15/06/16 | EUR58 |
| 07/04/16 | EUR61 |
| 22/03/16 | EUR63 |
| 01/02/16 | EUR65 |
| 18/12/15 | EUR66 |
| 28/07/15 | EUR64 |
| 05/05/15 | EUR63 |
| 10/04/15 | EUR61 |
| 04/03/15 | EUR57 |
| 03/03/15 | Under review |
| 20/01/15 | EUR53 |
| 09/01/15 | EUR50 |
| 18/06/14 | EUR46 |

# Safilo




| Ratings | | |
|---|---|---|
| **Date** | **Ratings** | **Price** |
| 11/05/16 | NEUTRAL | EUR7.37 |
| 24/06/15 | BUY | EUR13.35 |
| 03/09/14 | NEUTRAL | EUR16.03 |

| Target Price | |
|---|---|
| **Date** | **Target price** |
| 17/03/17 | EUR6.5 |
| 16/03/17 | Under review |
| 11/05/16 | EUR11 |
| 16/03/16 | EUR12.5 |
| 05/08/15 | EUR14 |
| 10/04/15 | EUR15 |
| 17/03/15 | EUR14.5 |
| 07/11/14 | EUR13.5 |
| 03/09/14 | EUR15 |

Please see the section headed "Important information" on the back page of this report.

# Bryan Garnier stock rating system

For the purposes of this Report, the Bryan Garnier stock rating system is defined as follows:

**Stock rating**

BUY Positive opinion for a stock where we expect a favourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential upside based on valuation), but also takes into account a number of elements that could include a SWOT analysis, momentum, technical aspects or the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

NEUTRAL Opinion recommending not to trade in a stock short-term, neither as a BUYER or a SELLER, due to a specific set of factors. This view is intended to be temporary. It may reflect different situations, but in particular those where a fair value shows no significant potential or where an upcoming binary event constitutes a high-risk that is difficult to quantify. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

SELL Negative opinion for a stock where we expect an unfavourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential downside based on valuation), but also takes into account a number of elements that could include a SWOT analysis, momentum, technical aspects or the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

**Distribution of stock ratings**

BUY ratings 47.5% NEUTRAL ratings 36.4% SELL ratings 16%

# Research Disclosure Legend

| | | | |
|---|---|---|---|
| 1 | Bryan Garnier shareholding in Issuer | Bryan Garnier & Co Limited or another company in its group (together, the "Bryan Garnier Group") has a shareholding that, individually or combined, exceeds 5% of the paid up and issued share capital of a company that is the subject of this Report (the "Issuer"). | No |
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