Hugo Boss

Price EUR54.12

Proactive reset plan in still tough apparel markets

Fair Value EUR87 (+61%) **NEUTRAL**

Bloomberg	BOSS GR
Reuters	BOSG_p.DE
12-month High / Low (EUR)	120.0 / 51.3
Market Cap (EURm)	3,810
Ev (BG Estimates) (EURm)	3,893
Avg. 6m daily volume (000)	367.6
3y EPS CAGR	-3.1%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-18.2%	-30.5%	-46.8%	-29.3%
Pers & H/H Gds	4.9%	-1.8%	3.7%	-2.5%
DJ Stoxx 600	5.8%	-8.2%	-7.2%	-8.8%

YEnd Dec. (EURm)	2014	2015e	2016e	2017e
Sales	2,572	2,809	2,852	3,007
% change		*9.2%*	*1.5%*	*5.5%*
EBITDA (reported)	571	590	518	564
EBIT	448.7	447.7	375.5	416.9
% change		*-0.2%*	*-16.1%*	*11.0%*
Net income	333.3	319.3	277.2	313.5
% change		*-4.2%*	*-13.2%*	*13.1%*

	2014	2015e	2016e	2017e
Operating margin	17.4	15.9	13.2	13.9
Net margin	13.0	11.4	9.7	10.4
ROE	39.5	34.0	26.7	25.9
ROCE	33.2	29.1	23.7	24.6
Gearing	5.1	8.8	2.9	-4.8

(EUR)	2014	2015e	2016e	2017e
EPS	5.04	4.67	4.07	4.59
% change	*-*	*-7.3%*	*-12.9%*	*12.6%*
P/E	10.7x	11.6x	13.3x	11.8x
FCF yield (%)	7.4%	7.7%	8.5%	8.8%
Dividends (EUR)	3.62	3.62	3.25	3.70
Div yield (%)	6.7%	6.7%	6.0%	6.8%
EV/Sales	1.5x	1.4x	1.3x	1.2x
EV/EBITDA	6.7x	6.6x	7.4x	6.7x
EV/EBIT	8.6x	8.7x	10.2x	9.0x

At the Analysts Conference yesterday, management spent some time on the major initiatives it has implemented in the US (category migration) and China (price adjustments) to address the tough apparel market environment. 2016 will be marked by a strict focus on margin protection (set to pay off mostly in 2017) and on FCF protection, which is a key priority this year. The group therefore remains committed to the 60-80% pay-out ratio corridor, which should partly ease off worries about the impact of a dividend cut, especially since Hugo Boss is first and foremost a growth story.

ANALYSIS

- **US: Hugo Boss to step up category migration at wholesalers:** note that this strategy of replacing the BOSS brand by the HUGO and BOSS Green brands (lower entry prices) is not new and was successfully completed across Europe in 2015. Hugo Boss was planning to implement this category migration in the US this year but the group was obliged to accelerate the pace given tough market conditions (US sales down 5% FX-n). At the same time, the group has continued to upgrade its distribution network as retail now accounts for 59% of US sales vs. 49% in 2012. Last but not least, rebates have helped to clear inventories which should return to healthier levels by the end of H1 2016.
- **China: prices cut by 20% to strengthen the value proposition.** In a Chinese men's luxury apparel market down 12% last year, revenues at the German group fell 9% FX-n. This adverse environment forced Hugo Boss to take several initiatives in the country: **(i) price reduction of 20%** to reduce the price gap (*see chart overleaf*) between France and H-K (35% premium after adjustment) and Mainland China (50% premium) and to open up to aspirational customers, **this price cut will affect the GM by 100bp in 2016**, **(ii) approx. 20 store closures** out of a total store network of 131, we believe these closures will mainly affect the former franchise stores which are smaller (~100 sqm on average) and less profitable, and **(iii) ongoing renegotiation of rental contracts,** which already had positive results.
- **Tight focus on margin protection…** Surprisingly, the group expects **GM** to remain flat vs. 2015, which is more optimistic than our forecast. The negative impact from the price adjustments in China (-100bp) should be offset by the positive channel mix and an efficient rebate management (i.e. discontinuation of lower margin price-off business in the US). However **opex** costs will continue to rise given flat SSSG, retail expansion and IT/logistic cost increases. The group is launching initiatives to mitigate this inflation such as reducing the overhead cost structure, renegotiating rental contracts and reviewing the entire store network to eventually close the DOS that are highly dilutive to the group's profitability. Note that these measures will mainly bear fruit in 2017, **justifying guidance for adj. EBITDA to decrease at a low double-digit rate this year**.
- **… and on FCF generation.** Management clearly stated that it was targeting an increase in FCF for 2016, driven by strict inventory management and lower capex investments (below EUR200m vs. EUR220m spent in 2015) as the group will open fewer stores than the MT target of 20-25 openings per year. This FCF protection, in addition to the commitment to the 60-80% payout ratio corridor, probably reassured investors who feared a significant dividend cut. On our estimates, Hugo Boss would have to decrease the dividend by 10% to return to a P/O ratio of 80%, implying a marginal impact on the dividend yield (6% vs. 6.6%).
- **Recessionary market environment reflected in current trading.** All the above-mentioned measures are part of the "reset plan" which is all the more urgent in that retail comp store sales have further deteriorated with a mid single-digit decrease over the first two months after -1% in Q4 and +2% in 2015 because of the US market, while trends have slightly improved in Asia-Pacific (albeit still negative) and remain in positive territory for Europe.
- **Minor adjustments to our FY16-17 assumptions that are aligned with guidance.** We expect 2% FX-n growth for 2016, in line with the target for a "low single-digit increase". This performance includes a flat SSSG for the entire year. As for profitability, we anticipate a 12% drop in adj. EBITDA, representing a margin decline of 290bp to 18.3%

(To be continued next page)

VALUATION

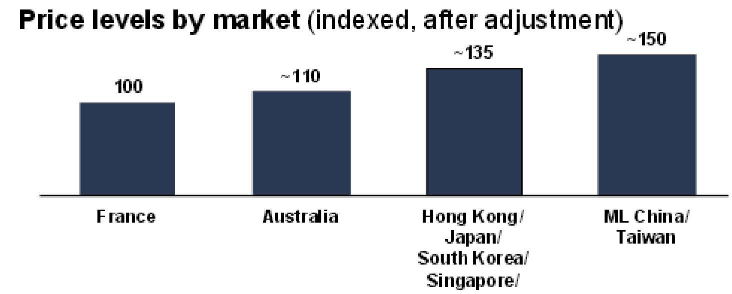
- The market should have been reassured by the group's proactive initiatives aimed at protecting margins (over the MT) and FCF generation (as early as 2016), illustrated by the strong commitment to the 60-80% corridor dividend policy. However, the positive impacts from this "reset plan" will be gradual, especially at the margin level (in 2017).
- Given that sluggish trends in the apparel market are lingering, as highlighted by weak current trading, we also believe it is too soon to adopt a positive stance despite the low valuation at 10.2x 2016e EV/EBIT (21% discount vs. 2007-16 historical average).

NEXT CATALYSTS

- Hugo Boss is due to release its Q1 2016 Results on 3rd May.

Table 1: New price gap between France and Hugo Boss' main markets in Asia-Pacific:

*(**France** is 20% more expensive than Germany whilst the **US** is slightly above France)*



Source: Company Data

Table 2: Sales outlook by region and channel

Source: Company Data

Table 3: FY 2016 outlook:

Outlook 2016	
Sales growth (currency adjusted)	Low single-digit percentage increase
Gross margin	Stable performance
EBITDA before special items	Low double-digit percentage decrease
Capex	< EUR 200 million
Free cash flow	Increase

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