23rd November 2016

Luxury & Consumer Goods

Essilor

Price EUR95.63

American Vertigo: US market slowdown in the ST but attractive MT call

Fair Value EUR123 vs. EUR128 (+29%) **BUY**

Bloomberg	EF FP
Reuters	ESSI.PA
12-month High / Low (EUR)	123.6 / 95.6
Market Cap (EUR)	20,857
Ev (BG Estimates) (EUR)	22,538
Avg. 6m daily volume (000)	487.1
3y EPS CAGR	9.0%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-8.8%	-14.7%	-16.5%	-16.9%
Consumer Gds	-4.4%	-5.9%	-2.6%	-7.1%
DJ Stoxx 600	-1.0%	0.2%	0.9%	-6.8%

YEnd Dec. (€m)	2015	2016e	2017e	2018e
Sales	6,716	7,092	7,536	8,024
% change		*5.6%*	*6.3%*	*6.5%*
EBITDA	1,263	1,313	1,409	1,516
EBIT	1,183	1,243	1,339	1,451
% change		*5.1%*	*7.8%*	*8.4%*
Net income	757.1	826.1	901.1	987.9
% change		*9.1%*	*9.1%*	*9.6%*

	2015	2016e	2017e	2018e
Operating margin	17.6	17.5	17.8	18.1
Net margin	11.3	11.6	12.0	12.3
ROE	13.3	12.9	12.6	12.5
ROCE	20.0	19.7	20.3	20.8
Gearing	34.7	24.8	16.3	9.2

(€)	2015	2016e	2017e	2018e
EPS	3.57	3.86	4.21	4.62
% change	-	*8.3%*	*9.1%*	*9.6%*
P/E	26.8x	24.8x	22.7x	20.7x
FCF yield (%)	4.2%	4.4%	4.8%	5.0%
Dividends (€)	1.15	1.30	1.40	1.55
Div yield (%)	1.2%	1.4%	1.5%	1.6%
EV/Sales	3.4x	3.2x	2.9x	2.7x
EV/EBITDA	18.2x	17.2x	15.7x	14.3x
EV/EBIT	19.4x	18.1x	16.5x	14.9x

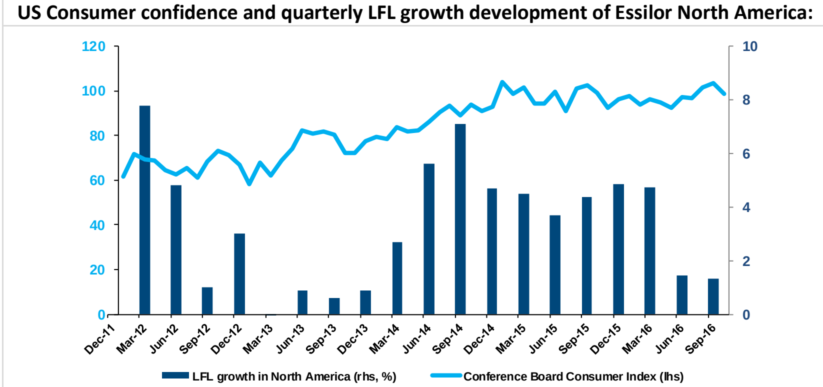
In our view, the significant share price correction (-6%) stems more from the negative sentiment implied by this new profit warning one month after the Q3 publication, rather than the downward revision in estimates (only -2.5% on average over 2016-18). Given this unexplained slowdown in the US optical market (~44% of L&OI sales) we have adopted a cautious stance on this region in Q4 2016 and 2017. Hence, our new FV of EUR123 vs. EUR128 but Buy recommendation reiterated.

ANALYSIS

- **Unexplained slowdown in the US optical market.** Historically, the US optical market is influenced by macro indicators such as GDP growth, consumer confidence and the unemployment rate. As shown in the chart below, this correlation was also true when comparing US consumer confidence and the LFL growth performance of Essilor. Surprisingly, since Q2 2016 optical players (incl. EI and LUX) have been witnessing a sharp slowdown in the optical market whilst the macro environment has remained well-oriented. Hence a vague communication from Essilor since the top management and US teams struggle to explain why this market decelerates.

- **Reasons: what we know and don't know: 1/ is declining traffic in optical stores due to online retailers** like in apparel? **In our view, no:** the online channel (~4% of total market) continued to achieve 10-13% growth ytd but neither the latest market data, nor Essilor's own websites have posted higher growth rates driven by consumers shifting from offline to online; **2/ Is the US market impacted by trading down? No:** the slowdown was caused by softer volume growth in all price points (=less demand), but value growth remained in positive territory, meaning no deflationary trends; **3/ Have consumers demonstrated a wait-and-see behaviour? Yes:** our answer is supported by the deceleration in the number of eye exams (rolling 12m: 0-1% at end-September vs. +1.2% at end-June, +2.1% at end-March and +3% at end-December 2015), proving that consumers do not intend to renew or replace their lenses in the ST. Yet, like LUX and EI, **we can hardly explain the reasons of this "wait-and-see" attitude but the US elections?** A possible pick up in November and December might confirm this scenario.

US Consumer confidence and quarterly LFL growth development of Essilor North America:



Source: Company Data, Conference Board, BG ests

- **North America: what to expect for Q4 and onwards?** In its recent history, Essilor has already coped with these US consumers' "wait-and-see" attitudes that last approx. four quarters: over **2008-09** (Q4 2008 => Q3 2009) because of the crisis and in **2013** (Q1 13 => Q4 13) due to the Sequester/Shutdown impacts, as well as the painful launch of the Varilux S series progressive lens, as only 10% of the US Rx labs were equipped with the required technology to produced it.

- In light of the revised outlook announced yesterday, **we now anticipate 0.5% growth in Q4 2016 vs. 1.8% initially**, after +1.3% in Q3 and +2.5% in 9M. Essilor controls to some extent three key levers to regain some momentum but obviously a >3-4% would be difficult to achieve if the US market does not rebound:
  - **Step up in marketing expenses** to encourage consumers to replace their lenses and revitalise traffic, this strategy being successful in Europe against a fragile macro environment,
  - **Further integration of the dynamic alliance group channel** (Vision Source, PERC/IVA and Opti-Port) that will positively impact LFL growth next year
  - **The revamped website for Coastal** and its new commercial proposition should help regain some traction, but not before Q1 17 in our view.

For 2017 & 2018: we have voluntarily adopted a conservative assumption for North America with +2.5%e vs. +4%e initially. We remind that Q1 is set to face a challenging comparison base (Q1 17: +4.7%) and the anniversary effect of the "Transitions headwind" will only occur in Q2. Consequently, the FY LFL growth performance should be back-end loaded (H2 2017 >H1 2017). **For 2018:** we have retained +3.5% for North America vs. +4% previously.

VALUATION

- This new announcement of a weak US optical market in October (one of the lowest months in the year) casts some doubts on Essilor's growth profile in the ST. Despite this headwind, the group has demonstrated its capacity to gain market share in North America (adjusted for one-offs: ~+2.5%e in Q2 and ~+3%e in a flat market) thanks to its execution and strategy.
- Following this correction, the stock returned to more attractive levels to play the group's sound fundamentals over the MT but admittedly, we do not believe the share price would rerate in the ST unless there are early signs of acceleration in the US optical market.
- We have cut our EPS forecasts by 2.5% on average over 2016-18 in light of more conservative forecasts on the US market and the revised CM guidance. It is worth noting that the stronger USD (~48% of total sales) is a tailwind for 2017, not yet factored into our estimates. Consequently, we are revising down our FV to EUR123 vs. EUR128 initially but are confirming our Buy recommendation as the US market harbours significant growth opportunities over the MT-LT (*see our feedback from the US Field Trip*).

NEXT CATALYSTS

- Essilor will report its FY 2016 results on 17th February 2017.

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