
SAVIGNY PARTNERS NEWSLETTER

Dear Friends

2006 has been a year of development and consolidation for Savigny Partners.

On the client front, we continued to develop our relationship with a number of clients, helping some in discussions relating to acquisition opportunities and initiating a divestiture process for others, including the sale of hip US footwear brand Sigerson Morrison to Marc Fisher Footwear which took place in the summer.

We also consolidated our platform by moving to new office space in Mayfair, by launching our dedicated website www.savignypartners.com, and, last but not least, through the arrival of Sidika Owen and William Plane to the team (please refer to our website for background details).

We thought we would not send a New Year's card this year, but rather offer our views on a few topics which are currently much debated within the luxury goods and specialty retail sectors, namely what is happening to Japan, whether China is really "it" and the advent of private equity investors in the industry.

We also crafted our own luxury goods index, encompassing various European and American stocks which offer a good benchmark for the industry as a whole. As this is the first time this index is presented, we show its evolution relative to the FTSE All World Index since January 2000 – the graph shown on page 5 is very telling!

Finally, our newsletter would be incomplete without a brief review of the deals which took place in the sector in 2006 (and those which were rumoured to happen but did not take place!).

Please feel free to direct any question or comment to me (good and bad). We hope you will find it interesting.

Pierre

Japan - A Maturing Market

Maturing customer base both in age and psychology

While Japan has been a vital market for the luxury goods sector in the past decade (25% of global revenues in 2006), the country has recently shown signs of a fundamental shift in consumption patterns.

Japan's second wave baby boomer generation, which was the bedrock of luxury goods consumption in the 1990's – aged between 20-29 years old, still living with their parents thus benefiting from a high level of disposable income – is now in its 30's, buying a home and starting a family. As a result, this generation's purchasing priorities have shifted away from discretionary fashion items to more essential purchases such as homewares.

As well as getting older, the typical Japanese luxury goods consumer has become wiser, more confident and individualistic. Whilst in the past, luxury fashion and accessory brands were coveted as a symbol of social status and, as such, needed to be instantly recognisable either through prominent logos or trademark styles, Japanese luxury goods consumers are now looking for products to suit their lifestyle and express their individuality.

These two developments have strong implications for luxury goods brands, who have responded by diversifying their offering from being purely fashion and accessories to include other lifestyle products, such as homewares, spas and beauty products, and by tailoring their product offer to an increasingly demanding market.

As well as getting older, the typical Japanese luxury goods consumer has become more individualistic

Development of home-grown fashion brands

As their tastes have matured, so has the Japanese luxury goods consumers' interpretation of luxury brands and how to wear them. Japanese luxury consumers have effectively pioneered a new and unique style, referred to as luxury streetwear. Not only has this style attracted the attention of a number of Western designers, who regularly visit Japan for inspiration, it has led to the flourishing of a number of home grown brands, such as Evisu, Samantha Thavasa and Bathing Ape. These labels, underpinned in part by a weak Yen, have proven to be strong contenders against overseas luxury labels in Japan and have also achieved scale and notoriety overseas.

The rise of local brands could be a threat for medium to small luxury brands but the major players do not appear to be worried. Even though they have entered a stagnant phase in Japan, they still believe in the Japanese consumer's propensity to spend.

Japanese luxury consumers have pioneered luxury streetwear

Increased domestic presence of overseas luxury brands

After the Asian crisis in 1998 and the subsequent devaluation of the Yen, overseas luxury brands sought to reduce their exposure to the declining number of Japanese tourists by capturing their customers at home. A number of brands restructured their portfolio of licenses in Japan and started substantially increasing their own retail network either in partnership with licensees or alone. By 2003, the store penetration of the larger luxury goods companies (store per capita) was the same in Japan as in Italy, despite Italy being heavily reliant on tourist revenue at its luxury shops.

The intensified competition between brands has prompted them to develop a better understanding of the local market and offer products that are better tailored to local needs. Not only did stores multiply, stores also got bigger with monumental flagships opening in the fashionable districts of Tokyo, offering a wide range of products, some of them unique to the Tokyo market. Today, the major luxury players including Louis Vuitton, Gucci, Hermes, Chanel and Ralph Lauren continue to invest in Japan.

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China's Luxury Market

China, the next Japan?

China has barely paused for breath this year in its rise to global power. For the third year in a row, its economy is on track to grow by more than 10%. China has spawned a new cast of millionaires and an emerging middle-class centred in large cities on the coast. This new wealthy elite is hungry for luxury brands. According to Merrill Lynch, in 2004 China already accounted for approximately 11% of global luxury goods sales. By 2014, it is expected to catch up with Japan and America and represent 23% of the market.

By 2014, China is expected to represent 23% of the market

China nevertheless remains a two-tier economy with its wealth and economic development being concentrated in the Yangtze River Delta, the Pearl River Delta in Guangdong and the Beijing-Tianjin corridor. Population estimates for these areas range from 250-300 million, of which around 7 million are estimated to be middle class; this compares to Japan's total population of 130 million. The pace of development, as well as population growth (both organic and from migration) in these key areas are likely to be a more accurate barometer of luxury goods consumption than the development of China as a whole.

Luxury retail presence still limited

The bulk of luxury goods purchases by China are accounted for by Chinese tourists. The mainland market is believed to account for only 2 to 3% of industry revenues. Even though luxury outlets are opening up in key metropolitan areas such as Beijing, Shanghai and Guangzhou, Hong Kong remains the favoured shopping destination for mainlanders as, not only is there more choice, luxury goods are cheaper in Hong Kong than in mainland China, where heavy import duties and value-added taxes can add up to 35% or more to the price of luxury goods.

Hong Kong remains the favoured shopping destination for mainlanders

The retail presence of European luxury brands in mainland China is still relatively limited; for example, Gucci has only 10 stores in mainland China compared to 54 stores in Japan alone and 61 elsewhere in the Asia-Pacific. Currently there are no branded luxury department stores in mainland China. Luxury brands therefore have to rely on own retail expansion for sales growth, either through boutiques in hotels and shopping malls or stand-alone stores, rather than on developing a wholesale network.

Profitability remains an issue

It is estimated that only one out of ten consumer brands currently present in mainland China is profitable, as the market is not yet large enough to accommodate but the strongest brands. Leading players such as Cartier, which has been present in mainland China for 15 years and is one of the leading luxury jewellery brands there, are supposed to be barely breaking even as they continue to invest in building the brand's image through heavy advertising (Cartier apparently spends about \$9million on advertising) and a growing retail presence.

Only one out of ten consumer brands in mainland China are profitable

Manufacturing today, branding tomorrow

China has proven its credentials in terms luxury goods manufacturing. The country is shaking off its reputation as the counterfeit centre of the world and an increasing number of luxury brands are re-locating their production from Europe to China. Signs of home-grown design talent are also emerging – China's fashion week is an established fixture, having celebrated its tenth anniversary in 2006, and a small number of up-and-coming fashion designers are already catering to China's affluent.

It is estimated that there are more than 100,000 students attending fashion courses

China's government is keen to foster young talent. It is estimated that there are more than 100,000 students attending fashion courses. During the last year, we have met a number of Chinese companies whose focus is on developing local talent and domestic brands. Could the pace of China's evolution from a pure manufacturing concern to a developer of brands catch us by surprise?

Private Equity and Luxury Goods

Private equity is driving M&A growth

The private equity sector is by all accounts the single largest buyer and seller of businesses in the market as a whole today. Some observers credit private equity firms with a good half of the entire M&A market, with almost no limit on deal size due to the ever increasing amounts of capital available to the leading funds. The buyout boom has been fuelled by a number of factors: private equity groups have been able to raise huge capital for acquisitions, thanks to increased demand from pension funds for exposure to alternative assets, while attractive bank lending terms have helped equity groups spend aggressively.

Interest for the luxury goods sector

This has led some commentators to herald the advent of private equity investors to the luxury goods sector. Indeed, these last few years the fashion and luxury goods sector has seen some activity from private equity funds. In the last twelve months Change Capital Partners acquired Jil Sander, Sun Capital Partners took on Stila Cosmetics, and Sciens Capital Management and Plainfield Asset Management together bought Aspree. 2005 saw the \$5 billion acquisition of Neiman Marcus by Texas Pacific Group, and Tommy Hilfiger being taken private by Apax Partners in a \$1.6 billion buyout. Earlier deals included the purchase of a stake in Escada by HMD Partners (2003), the acquisition of Calvin Klein jointly by Apax Partners and PVH and the buy-out of Ferretti by Permira (both in 2002), and the acquisition of Bally by Texas Pacific Group in 1999. However the two deals that really fire people's imagination are the acquisition in 2004 of Jimmy Choo by HM Capital Partners from Phoenix Equity Partners, another private equity firm, and the grandfather of all private equity deals in the sector: the (now ancient) acquisition of Gucci by Investcorp.

Part of the reason for more active interest from private equity firms lies in their perception that the luxury goods sector has become more "rational": acquisition multiples have come down from the crazy days of 1999-2000, and the management pool available to be put to work at target companies is deeper, as illustrated by the recruitment of former executives from the detergent industry to senior positions at luxury goods companies. Private equity funds are also attracted by the growth potential in new markets, such as China, Russia, and the Middle East, and by the widespread emergence of affordable luxury. Finally, recent success stories such as Jimmy Choo have demonstrated that private equity ownership can yield high returns.

Pinch of salt

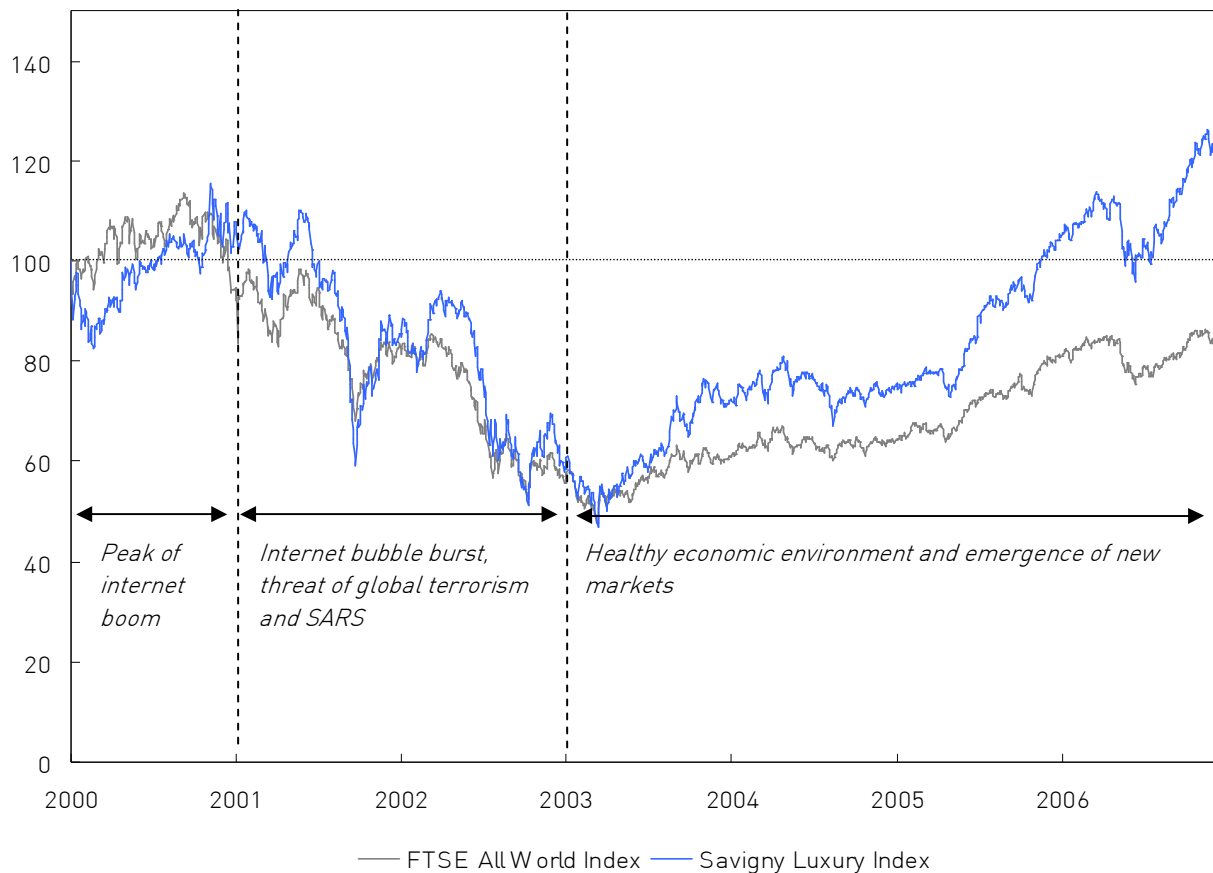
Despite recent activity, purported interest from major private equity participants and the strong growth in the luxury goods sector, we do not believe that private equity funds have been as active as they have been in other sectors.

We think that the term "luxury goods", as it relates to recent private equity activity is sometimes a bit of a misnomer, and covers a variety of different situations, ranging from turnarounds (Aspree, Bally, Stila) to almost pure retail (Neiman Marcus). We are of the opinion that luxury goods companies remain uneasy targets for the typical private equity fund: while a healthy luxury goods business will have very enjoyable margins, acquisition multiples tend to be higher than in most sectors, the development of own retail for luxury goods companies is very cash-consuming, and true successes are rarely built within the typical investment holding requirement of 3 to 5 years. Add to that the fact that a significant part of a luxury goods company's success takes its roots in the design and creativity sphere, and you find a series of elements that do not necessarily lend themselves well to rational private equity investment. Let us see what happens in 2007!

The luxury goods sector is perceived to have become more "rational"

However, we believe hurdles will remain

Savigny Luxury Index vs. FTSE ALL World



Note: The Savigny Luxury Sector index focuses on European and American luxury goods manufacturers and retailers

After a record decade in the 1990's, supported by the longest stock market bull run in history, a benign macro-economic environment and favourable currency movements, the market began to weaken at the end of 2000 as investor sentiment faltered.

September 11, 2001 was a tipping point for the sector, with the terrorist attacks having a substantial impact on international travel, a key driver of luxury goods sales, and on consumer sentiment in general.

The increased threat of global terrorism, the run-up to the war on Iraq and the threat of a global SARS pandemic dealt further blows to the industry in 2002 and early 2003.

The luxury market rebounded in 2003 and continued to grow in 2004 (although at a slower pace) supported by an improving economy and a recovery in Japanese overseas travellers.

The upward trend continued at a faster pace in 2005 and 2006, driven principally by a benign economic environment, the emergence of new markets such as China, the Middle East, Russia, the US "sunbelt states", and a substantial increase in the number of high net worth individuals. According to Forbes magazine, there are now 793 dollar billionaires in the world, compared to 476 three years ago.

The SLI has outperformed the FTSE All World by about 12% in the last 6 months of 2006. The outlook suggests that the strong growth momentum will continue as the global economy is heading in the right direction, provided there are no threats of a global pandemic or geopolitical catastrophes to throw it off balance.

M&A Activity in the Sector

Companies that have changed ownership in 2006

- Itochu Corporation acquired a 40% stake in Paul Smith Ltd in January for \$78 million
- Oakley Inc, the listed US retailer, acquired Oliver Peoples Inc in February for \$51 million
- Antichi Pellettieri Spa, a subsidiary of listed Mariella Burani Fashion Group Spa, acquired a 51% stake in Coccinelle Spa in February for €30 million
- Change Capital Partners, the UK private equity firm, acquired Jil Sander AG in February
- Link Theory Holdings, the listed Japanese apparel retailer, acquired Helmut Lang in March
- Yucaipa Companies LLC acquired Garrard in March. Asprey & Garrard was resurrected as Asprey International with the backing of Sciens Capital LLC, the US buyout firm and Plainfield Asset Management, the US hedge fund
- Tercade SA, a holding company controlled by Olivier Goldberg, acquired French retailer Old England SA in March
- The management of TM Lewin, backed by the Bank of Scotland, acquired the company in May for £50 million
- Hellenic Distributions SA acquired jewellery chain Links of London in July for £45 million
- Marc Fisher Footwear, the US footwear company, acquired a majority stake in Sigerson Morrison in July
- Baugur Group, the Icelandic investment firm, acquired House of Fraser in August for £603 million
- Matlin Patterson Global Advisers LLC, the US private equity firm, acquired Cerruti 1881 SAS in August
- King Power Group of Hong Kong acquired Agatha SA, the French costume jewellery chain in August
- Aber Diamond Corporation, the listed Canadian diamond company, acquired the remaining 47% that it did not already own in Harry Winston in September for \$157 million
- Reig Capital Group, the Andorra based investment company, acquired Loris Azzaro Couture in October
- Liz Claiborne Inc, the listed US apparel retailer, acquired Kate Spade LLC in November for \$124 million.

Deals that did not happen

- Hermes: the Hermes share price shot up by about 50% between September 2006 and January 2007, fuelled by intense speculation. While much has been said about the purported desire for liquidity by nth-generation family members, representatives of different family branches have been appointed to senior positions at the company, and the "commandite" structure shows no sign of faltering
- Tiffany, Bulgari: both companies were rumoured to be potentially available and witnessed a 33% rally in their stock price in the second part of 2006, comfortably outperforming the Savigny Luxury Index, which increased by about 22% over the same period. We think valuation stands in the way of a deal, although both would be a good strategic fit for some of the largest industry participants
- Ghurka: this small, high-end US leather goods brand was reported to be in discussions in late 2006, but no transaction was consummated

Sector valuation

Index Components	Market Cap EUR m	YoY Price Growth [%]	P/E (x) Estimate (current)	P/E (x) Estimate (forward)	EV / LTM			EBIT Margin [%]	Sales Growth [%]
					Sales (x)	EBIT (x)	EBITDA (x)		
LVMH	38,632	2.8	20.3	18.2	2.9	14.8	12.5	18.1	11.5
Richemont	23,178	28.1	18.6	17.2	4.6	24.3	21.0	17.6	17.4
PPR	14,341	17.0	21.2	16.9	1.0	15.9	10.6	6.1	1.3
Coach	12,728	37.1	26.6	22.0	5.5	14.9	13.7	36.2	23.5
Luxottica	10,778	11.6	24.2	20.7	2.5	16.0	14.0	13.8	34.3
Swatch Group	10,538	41.6	21.5	19.4	2.6	13.6	11.1	17.4	3.4
Hermes	9,816	30.3	36.9	33.4	5.0	18.6	16.4	26.9	7.2
Ralph Lauren	6,553	51.4	22.6	20.0	1.6	10.7	8.8	14.3	13.3
Burberry	4,235	48.8	24.9	20.1	3.0	14.5	12.5	22.1	3.8
Tiffany & Co	4,178	1.0	21.8	19.1	2.2	13.8	10.7	16.0	8.6
Bulgari	3,299	20.1	24.7	21.7	3.2	18.8	15.4	15.6	10.6
Valentino Group	2,371	41.5	25.0	21.4	1.2	10.8	8.4	11.3	11.4
Tod's Group	1,989	11.1	30.0	24.4	3.4	17.3	14.1	17.9	19.6
Safilo	1,272	-3.5	29.3	20.0	1.8	15.6	12.0	11.5	9.0
Savigny Luxury Index		21.3	22.8	20.0	3.2	16.6	13.8	18.3	13.1

Source: Bloomberg. Note: [1] Exchange rate used: £1 to €1.48, 1 Swiss Franc to €0.62 and 1\$ to €0.76, [2] Current and Forward P/E are based on IBES yearly estimates [3] Share prices as at 18 January, 2007