# Risk Rating: Moderately Low

## Pandora A/S (PNDORA.DK – DKK670.00/$99.82) June 5, 2015

Pandora (PNDORA.DK) designs, manufactures and markets hand-finished and modern jewellery made from genuine metals at affordable prices. The Company primarily sells charms and charm bracelets in addition to rings and other jewellery in more than 90 countries on six continents. The Company's store network primarily includes franchise owned and operated stores in addition to stores owned and operated by the Company. The Company sources its own raw materials and manufactures all products in Thailand. Founded in 1982, the Company is headquartered in Copenhagen, Denmark. Its fiscal year ends 12/31.

## Thesis Summary

We believe FY 15 revenue guidance is less back-end weighted and may be more achievable given persistent increases in new store opening guidance. In our view, revenue growth may continue to benefit from branded store network expansion, particularly concept stores. Further, we believe revenue sustainability risk is reduced due to consistently positive like-for-like sales in all four geographies, concept revenue-per-store growth, owned and operated store growth, rising Rings revenue, and certain store structure changes. Consistently improving accounts receivable levels and lower past due receivable levels strengthens our view on revenue sustainability. We believe gross margin risk is lower given healthy inventory levels, inventory write-down moderation, and potential for lower sales returns. We are concerned about recent turnover of the Chairman, CEO, and CFO. Those concerns are heightened given the potential fashion risk of the Company's core product (i.e. Charms). **We believe earnings risk is moderately low.**

### Company Data

| | |
|---|---|
| Country/Exchange | DK/OMX |
| Reporting Currency | DKK |
| Accounting Standard | IFRS |
| Shares Outstanding (mil) | 128.1 |
| Float (mil) | 124.2 |
| Avg. Volume (mil) | 515,382 |
| 52 Week Range | DKK363.30 – DKK737.00 |
| Dividend Yield | 1.3% |
| Market Cap (bil) | DKK80.9/$12.1 |
| Net Cash (mil) | DKK621.0 |
| TTM Rev (mil)/Rev Growth | DKK12,897.0/34.3% |
| TTM EBITDA (mil) | DKK4,662.0 |
| TTM Gross Margin %/Change | 71.0%/(350 bps) |
| TTM Op. Margin %/Change | 34.3%/340 bps |

### Historical EPS

| (in DKK) | Actual | Expected | Surprise |
|---|---|---|---|
| Q1 15 | 3.19 | 7.69 | (58.5%) |
| Q4 14 | 8.11 | 7.83 | 3.6% |
| Q3 14 | 5.82 | 5.98 | (2.6%) |

### Estimate Drift

| (in DKK) | Est. | 1M Ago | 6M Ago | 1Yr Ago |
|---|---|---|---|---|
| Q2 15 Rev | 3.4B | 3.3B | -- | -- |
| FY 15 Rev | 15.6B | 15.1B | 13.9B | 12.3B |
| FY 16 Rev | 18.0B | 18.0B | 15.6B | 13.7B |
| Q2 15 EPS | 7.27 | 7.53 | -- | -- |
| FY 15 EPS | 32.65 | 35.47 | 33.08 | 28.90 |
| FY 16 EPS | 44.40 | 44.40 | 39.80 | 33.24 |

### Peers Mentioned In This Piece

- Signet Jewelers Ltd. (SIG)
- Tiffany & Co. (TIF)

## Background and Bull Story

### Company Background

**Company description:** Pandora (PNDORA.DK) designs, manufactures, and markets hand-finished and modern jewellery made from genuine metals at affordable prices. The Company primarily sells charms and charm bracelets in addition to rings and other jewellery in more than 90 countries on six continents. The store network primarily includes franchise stores as well as owned and operated stores. The Company sources its own raw materials and manufactures all products in Thailand. Founded in 1982, the Company is headquartered in Copenhagen, Denmark. Its fiscal year ends 12/31.

**Product groups and geographical exposure:** In FY 14, Charms revenue accounted for 66.4% of consolidated revenue, silver and gold charm bracelets accounted for 11.9%, rings accounted for 10.0%, and Other jewellery accounted for 11.6%. Charms sales include sterling silver, 14k gold, and two-tone options. The Company sells silver and gold charm bracelets in sterling silver, 14k solid gold, leather, or textile options. Rings products are sterling silver, gold, or two-tones. Other jewellery includes earrings, necklaces, and pendants. In FY 14, Americas accounted for 41.5% of consolidated revenue, Europe accounted for 44.4%, Asia-Pacific accounted for 14.1%.

| FY 14 Results by Product Category | % of Revenue | FY 14 Results by Region | % of Revenue |
|---|---|---|---|
| Charms | 66.4% | Americas | 41.5% |
| Silver and gold charm bracelets | 11.9% | Europe | 44.4% |
| Rings | 10.0% | Asia-Pacific | 14.1% |
| Other jewellery | 11.6% | -- | -- |
| Total | 100.0% | Total | 100.0% |

**Point of sale revenue:** In FY 14, concept stores accounted for 56.4% of consolidated revenue, shop-in-shops accounted for 16.8%, gold stores accounted for 12.3%, silver stores accounted for 6.6%, white and travel retail stores accounted for 4.5%, and third party stores accounted for 3.3%.

Branded stores consist of concept stores, shop-in-shops, and gold stores. Non-branded stores consist of sliver stores and white and travel retail stores. Concept stores carry a complete assortment of PANDORA products and include a minimum sales space of 40.0 square meters. Shop-in-shop stores are at least eight square meters dedicated to PANDORA products within a store or department store. Gold stores are at least four square meters in a store with PANDORA fittings and displays. Silver stores (minimum two square meter space) and white stores (window space at a minimum) include some fittings and displays and basic PANDORA displays, respectively.

| FY 14 Revenue by Sales Channel | % of Revenue |
|---|---|
| Concept stores | 56.4% |
| Shop-in-shops | 16.8% |
| Gold | 12.3% |
| Total branded | 85.6% |
| Silver | 6.6% |
| White and travel retail | 4.5% |
| Total unbranded | 11.1% |
| Total direct | 96.7% |
| Third party | 3.3% |
| Total revenue | 100.0% |

**Store network mix:** In FY 14, concept stores accounted for 14.2% of network stores, shop-in-shops accounted 15.7%, gold accounted 24.2%, silver accounted 27.7%, and white and travel retail accounted 18.1%. In FY 14, total branded stores (unbranded stores) accounted for 54.2% (45.8%) of store network revenue. In FY 14, the Company operated 251 (70) concept stores (shop-in-shops).

| Store Network Analysis (% of total stores) | FY 14 | FY 13 | FY 12 |
|---|---|---|---|
| Concept stores | 14.2% | 10.7% | 9.3% |
| Shop-in-shops | 15.7% | 13.3% | 12.9% |
| Gold | 24.2% | 22.7% | 23.5% |
| Total branded stores | 54.2% | 46.7% | 45.7% |
| Silver | 27.7% | 31.0% | 33.0% |
| White and travel retail | 18.1% | 22.3% | 21.3% |
| Total store network | 100.0% | 100.0% | 100.0% |

**Seasonality:** Revenue is historically higher in the second half of the year due to the seasonal nature of the jewellery business. In addition, the Company introduced a new launch structure in the H2 12 with seven product launches per year arranged around traditional fashion and gift-giving seasons versus two launches per year previously. Product launches include Valentine’s Day (January launch), Spring (March), Mother’s Day (April), High Summer (May), Pre-Autumn (July/August), Autumn (August/September), and Christmas (October/November).

**Manufacturing concentration:** The Company manufactures all products in its factories outside of Bangkok, Thailand. In its FY 14 Annual Report, the Company indicated Pandora Production Thailand employs more than 7,900 people and produced approximately 91.0 million pieces of jewellery in FY 14. The Company represented its seven crafting facilities are dependent on the degree to which raw materials can be imported into Thailand and products can be exported from Thailand. Accordingly, disruptions caused by political unrest or natural disasters could impact operations.

**Competitors:** Pandora's closest competitors include Thomas Sabo, Trollbeads, Endless Jewelry, Chamilia, Swarovski, and Links of London. In addition, Pandora competes with larger jewellery providers such as Signet Jewelers, Tiffany & Co., and Compagnie Financiere Richemont.[1]

**Valuation:** As of the date of publication, the Company's shares traded at 20.8x next twelve month earnings, 3.5% above the peer group average. The Company's price-to-sales ratio of 6.4x traded 142.6% above the 2.6x peer group average. Finally, the Company's shares traded at 14.5x EV/EBITDA, 28.7% above the 11.3x peer group average.

| Relative Valuation Analysis | FWD P/E | Price-to-Sales | EV/EBITDA |
|---|---|---|---|
| Pandora A/S (PNDORA-DK) | 20.8 | 6.4 | 14.5 |
| Bijou Brigitte (BIJ-DE) | 23.8 | 1.3 | 4.3 |
| H&M (HM.B-SE) | 25.1 | 3.5 | 16.7 |
| Inditex (ITX-ES) | 33.2 | 5.3 | 18.8 |
| Gap, Inc. (GAP) | 13.6 | 1.0 | 6.8 |
| Michael Kors (KORS) | 11.2 | 2.2 | 9.0 |
| Coach, Inc. (COH) | 18.6 | 2.3 | 6.1 |
| Luxottica Group (LUX-IT) | 32.6 | 3.6 | 14.6 |
| Richemont (CFR-CH) | 19.6 | 3.7 | 12.8 |
| Swatch Group (UHR-CH) | 15.0 | 2.3 | 10.8 |
| Tiffany & Co. (TIF) | 22.2 | 2.9 | 10.7 |
| Folli Follie (FFGRP-GR) | 10.0 | 1.5 | 8.2 |
| Next plc (NXT-GB) | 17.3 | 2.9 | 12.5 |
| Signet (SIG) | 19.4 | 1.7 | 15.1 |
| *Peer average* | *20.1* | *2.6* | *11.3* |
| ***% above (below) peer group average*** | *3.5%* | *142.6%* | *28.7%* |

[1] Thomas Sabo (Private), Tollbeads (Private), Endless Jewelry (Private), Chamilia (Private), Links of London (Private), Signet Jewelers Ltd. (SIG), Tiffany & Co. (TIF), Campagnie Financiere Richemont (CFR.VX).

## Voyant's Earnings Risk Assessment

We believe the Company's FY 15 revenue guidance is less back-end weighted than typical and may be easier to achieve given persistent new store opening guidance increases. In our view, revenue growth may continue to benefit from the Company's focus on branded store network expansion, particularly concept stores. Further, we believe revenue sustainability risk is reduced due to consistently positive like-for-like sales in all four geographies, concept revenue-per-store growth, owned and operated store growth, rising Rings revenue, and store structure changes. We believe gross margin may be sustainable based on historically depressed inventories, inventory write-down moderation, lower inventory-per-store compared to peers, and potential for lower sales returns. We believe consistent accounts receivable declines suggest revenue may be sustainable especially given past due receivable reductions. In our view, strong cash flow generation reduces earnings sustainability concerns. We are moderately concerned about recent turnover of the Company's Chairman, CEO, and CFO. Further, we note only one member of the Audit Committee served as a CFO of a publicly traded company and no members have public audit experience.

## Q1 15 Results: Revenue Above Expectations, Tax Ruling Impacts Earnings

On 05/12/15, the Company reported Q1 15 revenue (earnings) of DKK3,547.0 million (DKK3.19), 4.6% above (58.5% below) the consensus estimate of DKK3,389.5 million (DKK7.69). EBITDA margin increased 70 basis points year-over-year to 36.8%, 60 basis points below the consensus estimate of 37.4%. In its Q1 15 Interim Report on 05/12/15, the Company attributed better-than-expected revenue to strong like-for-like sales growth and continued concept store network expansion. Income tax expense increased 228.0% year-over-year to DKK574.0 million, 98.1% above the consensus estimate of DKK289.7 million. On its Q1 15 Conference Call, the Company attributed higher-than-expected income tax expense to the settlement of a transfer pricing audit for the FY 09 to FY 14 period with the Danish Tax Authorities.

> According to the settlement, which relates to the year 2009 to 2014, we'll pay DKK 995 million, covering tax payments and interest for the six years. As we have already made accruals for DKK 610 million related to this specific case, only DKK 364 million will impact our income tax expenses, as well as a financial loss of DKK 21 million related to interests. Consequently, our tax rate for the quarter is 60%, and excluding the additional tax, the tax rate would have been 22%. (CFO Mr. Peter Vekslund, Q1 15 Conference Call, 05/12/15)

| Q1 15 Results Analysis (DKK in millions except per share data) | Reported Results | Consensus Estimate | *Surprise* | *Y/Y Change* |
|---|---|---|---|---|
| Europe | DKK1,417.0 | DKK1,321.2 | *7.3%* | *33.2%* |
| Americas | DKK1,573.0 | DKK1,605.2 | *(2.0%)* | *34.4%* |
| Asia Pacific | DKK557.0 | DKK507.0 | *9.9%* | *55.6%* |
| Revenue | DKK3,547.0 | DKK3,389.5 | *4.6%* | *36.8%* |
| Gross margin | 71.1% | 72.1% | *(100 bps)* | *200 bps* |
| EBITDA margin | 36.8% | 37.4% | *(60) bps* | *70 bps* |
| Earnings | DKK3.19 | DKK7.69 | *(58.5%)* | *(42.9%)* |

## FY 15 Revenue And Concept Store Opening Guidance Increased

In its Q1 15 Interim Report, the Company increased its FY 15 revenue guidance 7.1% from more than DKK14,000.0 million to DKK15,000.0 million. The Company primarily attributed increased FY 15 revenue guidance to expected foreign-currency benefits of approximately 10.0% compared to initial expectations of 4.0% at midpoint. The Company reiterated its FY 15 EBITDA margin guidance of 37.0% and increased its capital expenditures guidance from DKK800.0 million to DKK900.0 million due to currency changes. Finally, the Company increased effective tax rate guidance from 20.0% to 30.0% following its settlement with the Danish Tax Authorities.

| FY 15 Guidance Analysis (DKK in millions) | Guidance (at midpoint) | Consensus Estimate | *Surprise* | *Y/Y Change* |
|---|---|---|---|---|
| Revenue | DKK15,000.0 | DKK15,270.4 | *(1.8%)* | *25.6%* |
| EBITDA margin | 37.0% | 37.3% | *(30 bps)* | *100 bps* |
| Capital expenditures | DKK900.0 | DKK622.6 | *44.6%* | *97.8%* |
| Effective tax rate | 30.0% | 22.7% | *730 bps* | *1,000 bps* |
| New concept store openings | 325 | -- | -- | *4.8%* |

**FY 15 revenue less back-end weighted than typical:** As of the date of this publication, consensus expects FY 15 revenue to increase 31.5% to DKK15,706.0 million, 4.7% above the midpoint of current guidance. Therefore, the consensus expects H2 15 revenue to account for 55.6% of FY 15 revenue, <u>210 bps below the trailing three-year average</u>. <u>**In our view, the Company's guidance is less back-end weighted than typical and may be more achievable based on accelerated new store opening guidance.**</u>

| Revenue Analysis | FY 15 (Consensus) | FY 14 | FY 13 | FY 12 | 3YR Average |
|---|---|---|---|---|---|
| H1 | 44.4% | 43.0% | 43.7% | 40.3% | 42.3% |
| H2 | 55.6% | 57.0% | 56.3% | 59.7% | 57.7% |
| Fiscal Year | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

## Branded/Concept Store Growth Could Drive Incremental Revenue Growth, In Our View

**Background on franchisee and owned and operated stores:** Based upon our understanding of representation made to us by the Company, it prefers franchisee owned and operate stores. Further, the Company indicated franchisees are responsible for costs to remodel stores to new concepts. The Company opens owned and operated concept stores as a result of franchisee problem areas (Northeast United States recently, for example), regions with brand weakness (Germany recently, for example), new markets, high value locations, and acquisitions from franchisees. On its Q4 14 Conference Call, the Company represented owned and operated stores are very profitable and generate significant cash flow.

**Branded store revenue increases:** In Q1 15, branded store revenue increased 39.8% year-over-year to DKK3,058.0 million off a significantly elevated base period (increased 38.3% in Q1 14). In its Q1 15 Interim Report, the Company attributed the branded revenue increase to higher share of branded points of sale, including owned and operated stores, as well as relative higher revenue in existing branded stores.

| Branded Store Revenue Analysis (DKK in millions) | Q1 15 | Q4 14 | Q3 14 | Q2 14 | Q1 14 |
|---|---|---|---|---|---|
| Concept stores | DKK1,949.0 | DKK2,452.0 | DKK1,589.0 | DKK1,378.0 | DKK1,322.0 |
| *Year-over-year change* | *47.4%* | *61.2%* | *43.0%* | *47.1%* | *49.9%* |
| Shop-in-shops | DKK715.0 | DKK592.0 | DKK482.0 | DKK454.0 | DKK480.0 |
| *Year-over-year change* | *49.0%* | *25.2%* | *23.6%* | *12.9%* | *25.3%* |
| Gold stores | DKK394.0 | DKK363.0 | DKK364.0 | DKK358.0 | DKK386.0 |
| *Year-over-year change* | *2.1%* | *2.8%* | *2.5%* | *23.9%* | *21.8%* |
| Total branded stores | DKK3,058.0 | DKK3,407.0 | DKK2,435.0 | DKK2,190.0 | DKK2,188.0 |
| *Year-over-year change* | *39.8%* | *45.2%* | *31.2%* | *34.5%* | *38.3%* |

***We have the following observations:***

1. **Like-for-like sales increase in all four geographies:** In Q1 15, the Company reported positive like-for-like sales-out for all four major geographies for the ninth consecutive quarter.[2] In addition, the Company reported positive double-digit like-for-like sales-out on a two-year stack basis for all four geographical regions. In our view, consistently positive concept store like-for-like sales-out may reflect underlying concept store strength.

| Like-For-Like Sales Analysis | Q1 15 | Q4 14 | Q3 14 | Q2 14 | Q1 14 |
|---|---|---|---|---|---|
| US | 8.9% | 4.7% | 3.7% | 1.7% | 8.5% |
| UK | 20.6% | 20.6% | 20.6% | 26.2% | 27.9% |
| Australia | 24.6% | 20.0% | 22.9% | 33.0% | 33.6% |
| Germany | 3.8% | 2.3% | 8.5% | 10.0% | 11.5% |

2. **Concept store growth and rising revenue-per-store:** On its Q4 13 Conference Call on 02/18/14, the Company guided for the opening of 175 new concept stores in FY 14. The Company increased FY 14 new concept store opening guidance in each of the next three quarters and ultimately opened 310 new concept stores, 77.1% above initial guidance. On its Q1 15 Conference Call, the Company increased FY 15 new concept store opening guidance from 300 to more than 325. Further, revenue-per-concept store increased 15.8% year-over-year from an elevated base period (increased 20.5% in Q1 14). **We believe persistent new concept store opening guidance increases and accelerated revenue-per-concept store growth reflect strong demand and could drive incremental group revenue growth.**

[2] The Company defines like-for-like sales-out as revenue from concept stores which have been operating for more than 12 months. The Company reports like-for-like sales-out for the United States, United Kingdom, Germany, and Australia. The Company does not report like-for-like sales-out on a consolidated basis.

| Branded Store Analysis (DKK in millions) | Q1 15 | Q4 14 | Q3 14 | Q2 14 | Q1 14 |
|---|---|---|---|---|---|
| Concept store revenue | DKK1,949.0 | DKK2,452.0 | DKK1,589.0 | DKK1,378.0 | DKK1,322.0 |
| Total branded store revenue | DKK3,058.0 | DKK3,407.0 | DKK2,435.0 | DKK2,190.0 | DKK2,188.0 |
| Concept stores | 1,447 | 1,410 | 1,307 | 1,214 | 1,137 |
| Total branded stores | 5,376 | 5,365 | 5,163 | 4,980 | 4,848 |
| Concept revenue-per-store | DKK1.3 | DKK1.7 | DKK1.2 | DKK1.1 | DKK1.2 |
| *Year-over-year change* | *15.8%* | *25.8%* | *10.6%* | *15.0%* | *20.5%* |
| Branded revenue-per-store | DKK2.0 | DKK2.3 | DKK1.7 | DKK1.6 | DKK1.7 |
| *Year-over-year change* | *17.9%* | *20.9%* | *9.9%* | *13.3%* | *19.4%* |

3. **Strong owned-and-operated store revenue growth:** Based upon our understanding of representations made to us by the Company, the Company expects to open 100 owned and operated concept stores out of the 325 total new concept stores in FY 15. Accordingly, the Company expects owned and operated concept stores to account for 30.8% of new openings in FY 15, roughly equal to 33.9% in FY 14 and above the five-year average of 14.5%. **We believe higher sales and profitability of owned and operated stores may continue to benefit operating results in FY 15 based on the Company's plan to increase owned and operated new concept stores relative to its total store network**.

| Owned and Operated Store Analysis (DKK in millions) | Q1 15 | Q4 14 | Q3 14 | Q2 14 | Q1 14 |
|---|---|---|---|---|---|
| Owned and operated stores | 381 | 321 | 282 | 234 | 218 |
| *Year-over-year change* | *74.8%* | *55.8%* | *56.7%* | *33.7%* | -- |
| Owned and operated revenue | DKK708.0 | DKK871.4 | DKK426.8 | DKK381.6 | DKK337.0 |
| *Year-over-year change* | *115%* | *85%* | *75%* | *97.6%* | -- |
| O&O revenue-per-store | DKK1.9 | DKK2.7 | DKK1.5 | DKK1.6 | DKK1.5 |
| *Year-over-year change* | *20.2%* | *16.6%* | *20.8%* | *47.8%* | -- |

4. **Revenue-per-store lags peers:** In FY 14, Pandora's total revenue increased 32.6% to $11,942.0 million, while total stores declined 3.6% to 9,906. Using the average daily DKK/USD exchange rate, revenue-per-store increased 21.9% in FY 14 to $0.2 million.[3] **While Pandora revenue-per-store is below peers, we believe accelerated revenue-per-store growth may reflect increased focus on branded store expansion and store structure changes.[4,5]**

[3] We converted the Company's revenue from DKK to USD using the average of daily DKK/USD exchange rates for each respective annual period for comparison purposes.
[4] Certain small format stores (i.e. store-in-store) negatively impact Pandora revenue-per-store. Pandora revenue-per-concept is more comparable to Signet stores as the store formats are closer in size.
[5] We excluded Signet FY given incomparability issues due the Zales acquisition.

| Revenue-Per-Store Analysis ($ in millions) | $FY_t$ | $FY_{t-1}$ | $FY_{t-2}$ | $FY_{t-3}$ | $FY_{t-4}$ |
|---|---|---|---|---|---|
| Pandora (PNDORA-DK) | $0.2 | $0.2 | $0.1 | $0.1 | $0.1 |
| *Change* | *37.6%* | *17.6%* | *(5.1%)* | *26.2%* | -- |
| Signet Jewelers Ltd. (SIG) | -- | $2.1 | $2.0 | $2.0 | $1.9 |
| *Change* | -- | *5.1%* | *0.8%* | *9.3%* | -- |
| Tiffany & Co. (TIF) | $14.4 | $13.9 | $13.8 | $14.7 | $13.2 |
| *Change* | *3.3%* | *1.1%* | *(6.5%)* | *11.4%* | -- |

## Product Diversification Could Benefit Revenue Sustainability, In Our View

**Rings revenue diversifies product offering:** In Q1 15, Rings revenue increased 84.1% year-over-year to DKK405.0 million from a significantly elevated base period (increased 86.4% in Q1 14). Accordingly, Rings revenue-to-total revenue increased 34.5% year-over-year to 0.114, the highest seasonal level in at least five years. On its Q1 15 Conference Call, the Company attributed Rings revenue growth to improved product offering as well as increased marketing activities focused on Rings.

> Particular Australia and the U.K. have seen the strong contribution from Rings but actually most markets are increasing this year of revenue generated from Rings… I can tell you that in Australia, Rings were good, a little bit more than 20% of our revenues, the same in the U.K. And in the U.S., it's close to 10%. So it's really around the world and in all the regions, we are seeing some very, very nice development in the Rings. (CEO and President Mr. Anders Colding Friis, Q1 15 Conference Call, 05/12/15)

| Product Revenue Analysis (DKK in millions) | Q1 15 | Q4 14 | Q3 14 | Q2 14 | Q1 14 |
|---|---|---|---|---|---|
| Charms | DKK2,381.0 | DKK2,656.0 | DKK1,788.0 | DKK1,705.0 | DKK1,784.0 |
| *Year-over-year change* | *33.5%* | *35.1%* | *22.0%* | *21.4%* | *22.4%* |
| Silver/gold charm bracelets | DKK422.0 | DKK465.0 | DKK388.0 | DKK262.0 | DKK312.0 |
| *Year-over-year change* | *35.3%* | *18.0%* | *27.6%* | *29.1%* | *21.9%* |
| Rings | DKK405.0 | DKK355.0 | DKK344.0 | DKK273.0 | DKK220.0 |
| *Year-over-year change* | *84.1%* | *112.6%* | *97.7%* | *200.0%* | *86.4%* |
| Other jewellery | DKK339.0 | DKK485.0 | DKK325.0 | DKK304.0 | DKK276.0 |
| *Year-over-year change* | *22.8%* | *64.4%* | *4.5%* | *30.5%* | *61.4%* |
| Total revenue | DKK 3,548.5 | DKK 3,962.7 | DKK2,846.5 | DKK2,546.5 | DKK2,593.3 |
| *Year-over-year change* | *36.8%* | *40.4%* | *26.2%* | *31.8%* | *29.5%* |

***We have the following observations:***

1. **Higher Rings revenue concentration increases average selling price:** In Q1 15, average sales price increased 29.0% year-over-year to DKK169.00, the highest level in four years. In its Q1 15 Interim Report, the Company attributed increased average sales price to currency fluctuations and higher share of revenue from Rings and owned and operated stores. On its Q1 15 Conference Call, the Company also highlighted customer preference for more expensive products. **We believe the Company's focus on driving higher Rings revenue could continue to increase Rings product mix and benefit average sales price.**

> Okay. So on the, just on the volume which we, it increases 5.6% that is the sales in volume in Q1, and as we stated previously, this is half currency and then half split between somewhat more expensive products, like the Disney and the Rings, where customers, they buy instead of two simple silver charms of $20 they buy maybe two – one slightly more expensive of $40 or $50. Or instead of two charms they buy one Ring. So that's what's impacting the ASP. And then of course the increase in our O&O share. (CFO Mr. Peter Vekslund, Q1 15 Conference Call, 05/12/15)

| Average Sales Price Analysis | Q1 15 | Q4 14 | Q3 14 | Q2 14 | Q1 14 |
|---|---|---|---|---|---|
| Rings revenue-to-total revenue | 0.114 | 0.090 | 0.121 | 0.107 | 0.085 |
| *Year-over-year change* | *34.5%* | *51.4%* | *56.7%* | *127.6%* | *44.0%* |
| Average sales price | DKK169.00 | DKK145.00 | DKK145.00 | DKK138.00 | DKK131.00 |
| *Year-over-year change* | *29.0%* | *15.1%* | *9.0%* | *3.0%* | *2.3%* |

2. **Store structure changes increases focus on Rings:** Based upon our understanding of representations made to us by the Company, the Company changed the structure of its stores where sales areas were previously organized by collections and are now organized by categories. Further, the Company allocated Rings to the highest trafficked area of the store. **In our view, increased focus on Rings in the highest valued real estate of stores may continue to benefit Rings revenue growth.**

## Depressed Inventory Levels May Benefit Gross Margin Sustainability, In Our View

**Background on inventory:** The Company offers hand-finished jewellery products primarily made of silver and gold, which account for the largest cost of sales component. In its FY 14 Annual Report, the Company represented it uses financial instruments to hedge silver and gold raw materials exposure. Specifically, the Company hedges approximately 100.0%, 80.0%, 60.0%, and 40.0% of the risk for the following one to three months, four to six months, seven to nine months, and ten to twelve months, respectively. The Company indicated these 12-month rolling hedges combined with the time lag from inventory turnover largely hedges raw materials exposure. On its Q1 15 Conference Call, the Company represented a 10.0% deviation in quarterly average gold and silver prices would have impacted gross margin by 1.0%.

**Background on inventory categories:** In its FY 14 Annual Report, the Company represented it divides inventories into four categories: introduction, released-for-sale, phasing-out, and discounted. Further, the Company indicated its internal supply chain group monitors the sales ratios and assign inventory to various categories (i.e. phasing-out or discontinued). The part of discontinued inventory that is not expected to be sold is written down to re-melt value. Inventories in the phasing-out category can be sold on normal terms or transferred to the discontinued category.

**Inventory persistently lags revenue growth:** In Q1 15, inventory increased 22.3% year-over-year to DKK1,925.0 million, while revenue increased 36.8% to DKK3,547.0 million. Accordingly, inventory-to-revenue declined 10.6% to 0.543, the lowest seasonal level in five years. On its Q1 15 Conference Call, the Company guided inventories to increase from historically depressed levels.

> Inventory was DKK 1.925 billion at the end of Q1 2015, corresponding to 14.9% of the proceeding 12-month revenue, compared to 14.1% in Q4 last year and 16.4% in Q1 2014. As highlighted in Q4,

inventories were at a too-low level following Christmas and we're now seeing an expected increase. Inventory levels are still relatively low, and you should expect to see an increase in inventories a bit further in the coming quarters. (CFO Mr. Peter Vekslund, Q1 15 Conference Call, 05/12/15)

| Inventory Analysis (DKK in millions) | Q1 15 | Q4 14 | Q3 14 | Q2 14 | Q1 14 |
|---|---|---|---|---|---|
| Inventory | DKK1,925.0 | DKK1,684.0 | DKK2,126.0 | DKK1,684.0 | DKK1,574.0 |
| Revenue | DKK3,547.0 | DKK3,961.0 | DKK2,845.0 | DKK2,544.0 | DKK2,592.0 |
| Inventory-to-revenue | 0.543 | 0.425 | 0.747 | 0.662 | 0.607 |
| *Year-over-year change* | *(10.6%)* | *(19.5%)* | *5.1%* | *(12.6%)* | *(12.9%)* |

***We have the following observations:***

1. **Finished goods inventory at historic lows:** In FY 14, finished goods inventory increased 11.2% to DKK1,054.0 million, while total inventories increased 13.0% to DKK1,684.0 million. Accordingly, finished goods inventory-to-total inventory declined 1.6% to 0.626, the lowest level in five years. **In our view, relative finished goods inventory declines may reflect demand strength and lowers the risk of inventory write-downs and/or obsolescence.**

| Finished Goods Inventory Analysis (DKK in millions) | FY 14 | FY 13 | FY 12 | FY 11 | FY 10 |
|---|---|---|---|---|---|
| Finished goods inventory | DKK1,054.0 | DKK948.0 | DKK870.0 | DKK1,340.0 | DKK875.0 |
| Total inventory | DKK1,684.0 | DKK1,490.0 | DKK1,318.0 | DKK1,609.0 | DKK1,272.0 |
| Finished goods-to-total inventory | 0.626 | 0.636 | 0.660 | 0.833 | 0.688 |
| *Change* | *(1.6%)* | *(3.6%)* | *(20.7%)* | *21.1%* | *14.1%* |

2. **Accounts payable increase suggests inventory build:** In Q1 15, accounts payable increased 55.6% year-over-year to DKK954.0 million, while inventory increased 22.3% to DKK1,925.0 million. Accordingly, payables-to-inventory increased 27.3% year-over-year to 0.496, the highest level in five years. The increase in accounts payable relative to inventory appears consistent with the Company’s expectations of higher inventory levels. **Accordingly, we believe these trends may reflect strong end-market demand and decreases the risk of gross margin compression.**

| Accounts Payable Analysis (DKK in millions) | Q1 15 | Q4 14 | Q3 14 | Q2 14 | Q1 14 |
|---|---|---|---|---|---|
| Accounts payable | DKK954.0 | DKK804.0 | DKK758.0 | DKK633.0 | DKK613.0 |
| Inventory | DKK1,925.0 | DKK1,684.0 | DKK2,126.0 | DKK1,684.0 | DKK1,574.0 |
| Accounts payable-to-inventory | 0.496 | 0.477 | 0.357 | 0.376 | 0.389 |
| *Year-over-year change* | *27.3%* | *32.0%* | *18.8%* | *198.9%* | *212.5%* |

3. **Inventory write-downs moderate:** In FY 13 (FY 12), inventory write-downs increased 103.8% (39.8%) to DKK265.0 million (DKK130.0 million), while inventory increased 13.1% (declined 18.1%) to DKK 1,490.0 million (DKK1,318.0 million). Accordingly, inventory write-downs-to-total inventory increased 80.3% (70.6%) to 0.178 (0.099). The Company shifted its product launch strategy in H2 12 from two launches per year to seven launches per year. In our view, elevated FY 13 and FY 12 inventory write-downs reflected the higher frequency of product launches per year and the associated inventory rationalization relative to prior years.

   In FY 14, inventory write-downs declined 14.3% to DKK227.0 million, while inventory increased 13.0% to DKK1,684.0 million. As a result, write-downs-to-total inventory declined 24.2% to 0.135. We believe the relative decrease in inventory write-downs reflects lapping base-period increases and improved supply chain management due to sales-out monitoring of product launch designs.

| Inventory Write-Down Analysis (DKK in millions) | FY 14 | FY 13 | FY 12 | FY 11 | FY 10 |
|---|---|---|---|---|---|
| Inventory write-downs | DKK227.0 | DKK265.0 | DKK130.0 | DKK93.0 | DKK48.0 |
| Total inventory | DKK1,684.0 | DKK1,490.0 | DKK1,318.0 | DKK1,609.0 | DKK1,272.0 |
| Write-downs-to-total inventory | 0.135 | 0.178 | 0.099 | 0.058 | 0.038 |
| *Change* | *(24.2%)* | *80.3%* | *70.6%* | *53.2%* | -- |

4. **Sales return provision increased:** In FY 14, the provision for sales returns increased 46.3% to DKK670.0 million, while sales increased 32.5% to DKK11,942.0 million. Accordingly, the sales return provision-to-revenue increased 10.4% to 0.056, the second highest level in the last five years. Based on our understanding of representations made to us by the Company, the increase in sales returns primarily related to return policies for Hannoush stores acquired in the Americas during Q3 14.

   **We believe sales returns provisions may moderate going forward based on the fact that (1) the Hannoush acquisitions annualize in Q2 15 and (2) the Company represented sales returns declined in Q1 15, either of which could benefit gross margin.**

| Sales Return Analysis (DKK in millions) | FY 14 | FY 13 | FY 12 | FY 11 | FY 10 |
|---|---|---|---|---|---|
| Sales return provision | DKK670.0 | DKK458.0 | DKK416.0 | DKK225.0 | DKK75.0 |
| Revenue | DKK11,942.0 | DKK9,010.0 | DKK6,652.0 | DKK6,658.0 | DKK6,666.0 |
| Sales return-to-revenue | 0.056 | 0.051 | 0.063 | 0.034 | 0.011 |
| *Change* | *10.4%* | *(18.7%)* | *85.1%* | *200.4%* | -- |

5. **Analysts forecast EBITDA margin expansion:** As of the date of publication, analysts expect Q2 15 EBITDA margin expansion of 90 bps year-over-year to 36.0%. In addition, FY 15 EBITDA margin is expected to expand 130 bps to 37.3%, the highest annual level since 2010. **Despite expected expansion to multi-year highs, we believe EBITDA margin forecasts risk may be lower given (1) strong like-for-like sales-out performance, (2) historically depressed finished goods and total inventory levels, (3) inventory write-down moderation, and (4) potential for lower sales returns.**

| EBITDA Margin | Q4 15E | Q3 15E | Q2 15E | Q1 15 | FY 15E | FY 14 |
|---|---|---|---|---|---|---|
| EBITDA margin | 37.6% | 38.0% | 36.0% | 36.8% | 37.3% | 36.0% |
| *Year-over-year change* | *120 bps* | *220 bps* | *90 bps* | *60 bps* | *130 bps* | *400 bps* |

## Accounts Receivable Moderation Suggests Increased Revenue Sustainability, In Our View

**Consistent receivables moderation:** In Q1 15, accounts receivable increased 22.9% year-over-year to DKK1,093.0 million, while revenue increased 36.8% to DKK3,547.0 million. As a result, receivables-to-revenue declined 10.2% to 0.308, the lowest seasonal level in five years. On its Q1 15 Conference Call, the Company attributed lower receivables to strong cash collection.

> Trade receivables was DKK 1.093 billion at the end of Q1 2015, corresponding to 8.5% of the preceding 12-month revenue compared with the 9.3% in Q4 and Q1 2014. The decrease is primarily due to strong cash collection. (CFO Mr. Peter Vekslund, Q1 15 Conference Call, 05/12/15)

| Receivables Analysis (DKK in millions) | Q1 15 | Q4 14 | Q3 14 | Q2 14 | Q1 14 |
|---|---|---|---|---|---|
| Accounts receivable | DKK1,093.0 | DKK1,110.0 | DKK1,327.0 | DKK792.0 | DKK889.0 |
| Revenue | DKK3,547.0 | DKK3,961.0 | DKK2,845.0 | DKK2,544.0 | DKK2,592.0 |
| Receivables-to-revenue | 0.308 | 0.280 | 0.466 | 0.311 | 0.343 |
| *Year-over-year change* | *(10.2%)* | *(11.6%)* | *3.4%* | *(12.5%)* | *(5.2%)* |

**Past due receivables decline:** In FY 14, total past due receivables declined 1.7% to DKK238.0 million, while accounts receivable increased 24.0% to DKK1,110.0 million. As a result, past due receivables-to-total receivables declined 20.7% to 0.214, the lowest level in five years. Further, total past due receivables-to-revenue declined 25.8% to 0.020.

The Company did not address past due receivables on its Q4 14 Conference Call or in its FY 14 Annual Report. However, based on our understanding of representations made to us by the Company, collections improvement resulted from the Company's strong brand and bargaining power. **In our view, persistently strong cash collections may lower revenue sustainability risk.**

| Past Due Receivables Analysis (DKK in millions) | FY 14 | FY 13 | FY 12 | FY 11 | FY 10 |
|---|---|---|---|---|---|
| Total past due | DKK238.0 | DKK242.0 | DKK369.0 | DKK336.0 | DKK316.0 |
| Total trade receivables | DKK1,110.0 | DKK895.0 | DKK940.0 | DKK900.0 | DKK834.0 |
| Revenue | DKK3,547.0 | DKK3,961.0 | DKK2,845.0 | DKK2,544.0 | DKK2,592.0 |
| Total past due-to-receivables | 0.214 | 0.270 | 0.393 | 0.373 | 0.379 |
| *Change* | *(20.7%)* | *(31.1%)* | *5.1%* | *(1.5%)* | -- |
| Total past due-to-revenue | 0.020 | 0.027 | 0.055 | 0.050 | 0.047 |
| *Change* | *(25.8%)* | *(51.6%)* | *9.9%* | *6.5%* | -- |

## Strong Cash Flow Generation Reduces Earnings Sustainability Concerns

In Q1 15, twelve-month cash flow from operations (CFO) increased 51.4% year-over-year to DKK4,379.0 million, while net income increased 11.7% to DKK2,777.0 million. Accordingly, cash flow from operations-to-net income increased 35.6% year-over-year to 1.577, the highest level in five years. Further, cash generated by working capital increased from negative DKK117.0 million to DKK1,287.0 million. **In our view, the improvement in cash flow-to-net income and increase in cash generated by working capital suggest earnings may be more sustainable.**

| Cash Flow Analysis (DKK in millions) | 12M Ended Q1 15 | 12M Ended Q4 14 | 12M Ended Q3 14 | 12M Ended Q2 14 | 12M Ended Q1 14 |
|---|---|---|---|---|---|
| Cash from operations (CFO) | DKK4,379.0 | DKK4,322.0 | DKK3,618.0 | DKK3,349.0 | DKK2,892.0 |
| Revenue | DKK12,897.0 | DKK11,942.0 | DKK10,803.0 | DKK10,213.0 | DKK9,600.0 |
| Net income | DKK2,777.0 | DKK3,098.0 | DKK2,830.0 | DKK2,717.0 | DKK2,486.0 |
| CFO-to-revenue | 0.340 | 0.362 | 0.335 | 0.328 | 0.301 |
| *Year-over-year change* | *12.7%* | *34.3%* | *18.5%* | *37.4%* | *17.9%* |
| CFO-to-net income | 1.577 | 1.395 | 1.278 | 1.233 | 1.163 |
| *Year-over-year change* | *35.6%* | *27.6%* | *2.9%* | *9.1%* | *(17.9%)* |

## Internal Controls and Corporate Governance

**New CFO, CEO, and Chairman appointments:** In its company announcement on 08/12/14, the Company indicated SVP, Head of Finance Mr. Peter Vekslund would replace Mr. Henrik Holmark as CFO of Pandora on 01/01/15. The Company also disclosed Mr. Holmark would be stepping down from his role as CFO of Pandora to join Dr. Marens Airwair Group Ltd as CFO.

In its announcement on 08/28/14, the Company disclosed Mr. Anders Colding Friis, then-CEO of Scandinavian Tobacco Group A/S, would succeed Mr. Allan Leighton as CEO in March 2015. Mr. Leighton previously joined the Company's Board of Directors in 2010 and served as Chairman until assuming the role of CEO on 07/01/13. The Company also indicated the Board of Directors would recommend Mr. Leighton as new Co-Deputy Chairman of the Board at the next annual general meeting.

In its Press Release on 08/28/14, the Company also disclosed the Board of Directors recommended Mr. Peder Tuborgh, CEO of Arla Foods amba, as new Chairman of the Board of Directors. In its Press Release on 10/09/14, the Company disclosed Mr. Tuborgh was elected Chairman of the Board of Directors.

**Audit opinion and Audit Committee overview:** The Company received an unqualified audit opinion in each of the past three years. The Company's external auditors represented the Parent Company financial statements provided a true and fair view of the Company's financial position. The external auditors did not express an opinion on the effectiveness of internal controls. Accordingly, we have no material concerns related to internal controls.

The Audit Committee consists of three board members. The Audit Committee Chairman Mr. Anders Boyer-Søgaard currently has served as Chief Financial Officer of GN Store Nord A/S (GN.CO) for the last seven years. Audit Committee member Ms. Andrea Alvey previously served as Corporate Financial Officer of The Body Shop International (Private) for two and half years. We note that none of the Audit Committee members are Certified Public Accountants or have experience in public accounting. However, we have no material concerns about the qualifications, experience, or independence of the Audit Committee members.

## Where We Would Do Additional Fundamental Work

- We would attempt to determine the Company's long-term opportunity for branded stores, particularly concept stores, in the United States and Asia.

- We would attempt to determine the Company's long-term ability to further diversify its product offering, particularly Rings and to a lesser extent necklaces, pendants and earrings, to offset any potential slowdown in charms.

- We would attempt to determine if larger global competitors such as Signet could launch competing charm collections.

## Questions for the Company

- How many concept stores does the Company target to operate long-term? What region does the Company see the largest opportunity for concept store growth?
- Does the Company expect to continue to open owned and operated stores at the FY 15 rate of 30.0% of total new store openings in the near-term?
- Why did the CFO, CEO, and Chairman stepdown? What led the Company to choose each successor?
- Does the Company plan to drive revenue in other product categories similar to Rings?
- What concentration of annual revenue does the Company target for Rings and other jewellery in the next one to three years?
- What is the largest opportunity to expand EBITDA margin?

## Conclusion

We believe FY 15 revenue guidance is less back-end weighted and may be more achievable given persistent increases in new store opening guidance. In our view, revenue growth may continue to benefit from branded store network expansion, particularly concept stores. Further, we believe revenue sustainability risk is reduced due to consistently positive like-for-like sales in all four geographies, concept revenue-per-store growth, owned and operated store growth, rising Rings revenue, and certain store structure changes. Consistently improving accounts receivable levels and lower past due receivable levels strengthens our view on revenue sustainability. We believe gross margin risk is lower given healthy inventory levels, inventory write-down moderation, and potential for lower sales returns. We are concerned about recent turnover of the Chairman, CEO, and CFO. Those concerns are heightened given the potential fashion risk of the Company's core product (i.e. Charms). **We believe earnings risk is moderately low.**

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