HUGO BOSS AG (BOSSn.DE – €108.31)

July 22, 2015

HUGO BOSS AG (BOSSn.DE) is a premium-luxury wholesaler and retailer of men's and women's luxury modern apparel, eveningwear, sportswear, shoes, and leather accessories. The Company also markets licensed fragrances, eyewear, watches, children's fashion, and home textiles. The Company's portfolio consists of four brands: (1) BOSS, (2) BOSS Orange, (3) BOSS Green, and (4) HUGO. The Company is headquartered in Metzingen, Germany and its fiscal year ends on 12/31.

Thesis Summary

We are concerned about potentially weak traffic trends in the Americas region given a promotional retail environment and potentially lower tourism. In addition, we are concerned about a slowdown in Europe and China comparable sales growth as a result of lower-than-expected foot-traffic. Our concerns are heightened given a multi-period build of inventory. In our view, the inventory build cannot be rationalized by retail store expansion. Accordingly, we believe gross margin may be pressured in the near term as the Company attempts to rationalize inventory levels. Further, we are concerned about the achievability of FY 15 margin guidance and consensus estimates given elevated inventory levels and a slowdown in retail comparable sales. Finally, we are concerned about earnings sustainability given deterioration in cash flow generation over the last three periods.

Catalysts and Timing

- Weaker-than-expected Q2 15 margins due to inventory and weak comparable sales
- Weaker-than-expected Q2 15 comparable sales
- The Company is unable to achieve FY 15 consensus expectations and FY 15 guidance

Company Data

Country/Exchange	Germany/Frankfurt
Reporting Currency	Euro
Accounting Standard	IFRS
Shares Outstanding (mil)	70.4
Float (mil)	63.4
Avg. Volume	210,337
52 Week Range	€94.54 - €120.40
Dividend Yield	3.4%
Market Cap (bil)	€7.6
Net Debt (mil)	€98.4
TTM Rev (mil)/Rev Growth	€2,626.5/7.2%
TTM EBITA (mil)	€591.0
TTM Gross Margin %/Change	66.1%/30 bps
TTM Op. Margin %/Change	16.9%/(160 bps)

Historical EPS

	Actual	Expected	Surprise
Q1 15	€1.10	€1.22	(9.8%)
Q4 14	€1.09	€1.43	(23.8%)
Q3 14	€1.67	€1.79	(6.7%)

Estimate Drift

	Est.	1M Ago	6M Ago	1Yr Ago
Q2 15 Rev	€623	€634	--	--
FY 15 Rev	€2,827	€2,824	€2,820	€2,835
FY 16 Rev	€3,028	€3,025	€3,045	€3,069
Q2 15 EPS	€1.00	€0.91	--	--
FY 15 EPS	€5.40	€5.42	€5.94	€6.11
FY 16 EPS	€6.00	€6.00	€6.64	€6.86

Peers Mentioned In This Piece

- LVMH Moet Hennessy Louis Vuitton SE (LVMH.PA)
- Burberry Group (BRBY.L)
- Christian Dior (DIOR.PA)
- Hermes International (HRMS.PA)
- PVH Corp (PVH)
- Prada S.p.A (1913.HK)
- Salvatore Ferragamo S.p.A (SFER.MI)

Please refer to the end of this report for an updated version of *The Short List*.

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Background and Bull Story

Company Background

Company background: HUGO BOSS AG (BOSSn.DE) is a premium-luxury wholesaler and retailer of men's and women's luxury modern apparel, eveningwear, sportswear, shoes, and leather accessories. The Company also markets licensed fragrances, eyewear, watches, children's fashion, and home textiles. The Company's portfolio consists of four brands: (1) BOSS, (2) BOSS Orange, (3) BOSS Green, and (4) HUGO. The Company is headquartered in Metzingen, Germany and its fiscal year ends on 12/31.

Segments and geographic exposure: In FY 14, the Company generated 60.9% (63.2%) of revenue (operating income) in its Europe segment, 22.8% (17.8%) in its Americas segment, 14.0% (13.2%) in its Asia-Pacific (APAC) segment, and 2.2% (5.8%) from licensing. In FY 14, the Company generated 17.4% of revenue in Germany, 18.1% in the US, 8.4% in China.

FY 14 Results by Segment	% of Revenue	% of Operating Income	FY 14 Revenue by Geography	% of Revenue
Europe segment	60.9%	63.2%	Germany	17.4%
Americas segment	22.8%	17.8%	Other Europe	43.5%
APAC segment	14.0%	13.2%	US	18.1%
Licenses segment	2.2%	5.8%	Other Americas	4.8%
--	--	--	China	8.4%
--	--	--	Other Asian	5.7%
--	--	--	Licenses	2.2%
Total Revenue	100.0%	100.0%	Total	100.0%

Channels, brands, and stores: In FY 14, the Company generated 57.2% of revenue in the retail channel, 40.5% in wholesale, and 2.3% through licensing. The retail channel consists of freestanding stores, shop-in-shops (operated by the Company on the retail space of its partners), factory outlets, and e-commerce. The wholesale channel consists of department stores, specialist retailers, franchise stores, and online.

In FY 14, the Company generated 72.3% of revenue from the BOSS brand, 10.1% from BOSS Orange, 9.5% from HUGO, and 8.2% from BOSS Green. BOSS is the Company's flagship men's and women's brand. The men's collection consists of modern businesswear, eveningwear, and sportswear products. The women's collection consists of businesswear, leisurewear, evening apparel, shoes, watches, eyewear, fragrances, and accessories. BOSS Orange is the Company's urban casualwear collection. BOSS Green is the Company's active sportswear line. HUGO is the Company's contemporary line for men and women.

FY 14 Channel Analysis	% of Revenue	FY 14 Brand Analysis	% of Revenue
Retail	57.2%	BOSS	72.3%
Wholesale	40.5%	BOSS Orange	10.1%
Licenses	2.3%	HUGO	9.5%
--	--	BOSS Green	8.2%
Total	100.0%	Total	100.0%

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In FY 14, 57.2% of total retail stores were located in Europe, 23.2% in APAC, and 19.6% in the Americas. In addition, 51.0% of retail stores were shops-in-shops, 37.3% freestanding stores, and 11.7% outlets.

FY 14 Stores by Geography	Store Count	% of Total Stores	FY 14 Stores by Type	Store Count	% of Total Stores
EMEA	595	57.2%	Shop-in-shops	531	51.0%
APAC	242	23.2%	Freestanding stores	388	37.3%
Americas	204	19.6%	Outlets	122	11.7%
Total	1,041	100.0%	Total	1,041	100.0%

Sourcing: In FY 14, the Company sourced 47.0% of its procurement volume from Eastern Europe, 33.0% from Asia, 11.0% from Western Europe, 5.0% from North Africa, and 4.0% from the Americas. In FY 14, the Company sourced 20.0% of its procurement volume internally. The Company operates production facilities in Izmir, Turkey; Cleveland, US; Metzingen, Germany; Radom, Poland; and Morrovalle, Italy. The Company sourced the remaining 80.0% volume from independent contract suppliers.

FY 14 Sourcing Analysis	% of Sourcing Volume
Eastern Europe	47.0%
Asia	33.0%
Western Europe	11.0%
North Africa	5.0%
Americas	4.0%
Total	100.0%

Bull Story: Retail Growth and Margins, Womenswear, And Online Growth

Retail growth and margin expansion: Between FY 10 and FY 14, the Company increased its retail store count by 93.9% from 537 to 1,041 stores.[1] As a result of the significant retail expansion, retail revenue increased 112.9% to €1,471.3 million. Over the same period, gross margin increased 700 bps from 59.1% to 66.1%. In its FY 14 Annual Report, the Company represented retail gross margin is higher than wholesale channel gross margin. Further, the Company guided for revenue growth in the high-single digits until FY 20 and adjusted EBITDA margin to increase to 25.0% over the same period.

On its Q4 14 Conference Call on 03/12/15, the Company guided for 50 new store openings in FY 15, excluding takeovers of wholesaler's stores. In addition, in Q1 15, the Company took over 17 freestanding stores in South Korea from a wholesale partner. Further, effective 04/01/15, the Company took over 21 freestanding stores in China from a franchise operator.

[1] Organic store openings accounted for 57.1% of gross openings during that period, while takeovers of the Company's wholesalers and franchise partners accounted for the remaining 42.9%.

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Retail Analysis (€ in millions)	FY 14	FY 13	FY 12	FY 11	FY 10
Retail revenue	€1,471.3	€1,314.1	€1,149.7	€924.2	€691.1
Change	*12.0%*	*14.3%*	*24.4%*	*33.7%*	*35.4%*
Retail store count	1,041	1,010	840	622	537
Change	*3.1%*	*20.2%*	*35.0%*	*15.8%*	*22.6%*
Gross margin	66.1%	64.9%	61.6%	60.8%	59.1%
Change in bps	*110*	*340*	*70*	*170*	*560*
Retail comparable sales	3.0%	2.0%	5.0%	8.0%	9.0%

Given significant retail revenue and retail store count growth in recent periods, analysts expect retail revenue growth to increase to 16.1% (13.6%) in FY 15 (FY 16). In addition, analysts expected continued gross margin expansion of 10 bps (80 bps) in FY 15 (FY 16).

Estimate Analysis (€ in millions)	FY 17E	FY 16E	FY 15E	FY 14	FY 13
Retail revenue	€2,200.9	€1,941.8	€1,708.7	€1,471.3	€1,314.1
Change	*13.3%*	*13.6%*	*16.1%*	*12.0%*	*14.3%*
Gross margin	67.9%	67.0%	66.2%	66.1%	64.9%
Change in bps	*90*	*80*	*10*	*110*	*340*

Growth opportunity in womenswear category: In Q1 15 (FY 14), womenswear product sales increased 4.0% (10.0%) year-over-year on a constant currency basis, 200 (500) bps higher than menswear sales. In its FY 14 Annual report, the Company represented it had identified opportunities to expand its womenswear line. Accordingly, the Company guided for womenswear to increase from 11.0% of total revenue in FY 14 to at least 15.0% by FY 20. Given strong performance of womenswear products in recent periods, some analysts expect the category to contribute to sales growth.

Strong online sales growth over the last four years: In Q1 15 (FY 14) online revenue increased 17.0% (10.2%) year-over-year, 800 (450) bps higher than total revenue growth. From FY 11 to FY 14, online revenue increased from 3.6% of retail revenue to 4.6%. Given significant growth in online revenue performance, some analysts expect the Company to be able to generate 10.0% of retail revenue online by FY 18.

Online Revenue Analysis (€ in millions)	Q1 15	FY 14	FY 13	FY 12	FY 11
Online revenue	€21.0	€67.8	€61.5	€48.9	€32.9
Change	*17.0%*	*10.2%*	*25.8%*	*48.6%*	*67.0%*
Retail revenue	€370.1	€1,471.3	€1,314.1	€1,149.7	€924.2
Change	*14.7%*	*12.0%*	*14.3%*	*24.4%*	*33.7%*

Dividend yield and valuation: As of the date of publication, HUGO BOSS trades at 18.7 (22.5) times next twelve-month (last twelve-month) earnings, 5.0% (0.7%) below comparable luxury peers. In addition, HUGO BOSS currently pays a dividend yield of 3.4%, 170 bps above its peers.

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Valuation Analysis	Dividend Yield	LTM P/E	NTM P/E
LVMH Moet Hennessy Louis Vuitton SE (LVMH.PA)	1.9%	14.9	21.5
Burberry Group (BRBY.L)	2.2%	20.7	19.5
Christian Dior (DIOR.PA)	1.7%	14.2	18.5
Hermes International (HRMS.PA)	0.9%	41.3	32.4
Hugo Boss AG (BOSSn.DE)	3.4%	22.5	18.7
Kering SA (PRTP.PA)	2.4%	37.3	16.3
Michael Kors Holdings Ltd (KORS)	0.0%	9.3	9.2
Prada S.p.A (1913.HK)	2.5%	23.5	23.5
PVH Corp (PVH)	0.1%	18.4	15.8
Ralph Lauren Corporation (RL)	1.5%	16.5	18.1
Compagnie Financiere Richemont (CFR.VX)	2.0%	29.0	19.1
Salvatore Ferragamo S.p.A (SFER.MI)	1.5%	28.9	25.9
Swatch Group SA (UHR.VX)	1.8%	18.0	17.5
Peer average	1.7%	22.7	19.7
HUGO BOSS AG above (below) peer average	*170 bps*	*(0.7%)*	*(5.0%)*

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Voyant's Earnings Risk Assessment

We are concerned about potentially weak traffic trends in the Americas region given a promotional retail environment and potentially lower tourism. In addition, we are concerned about a slowdown in Europe and China comparable sales growth as a result of lower-than-expected foot-traffic. Our concerns are heightened given a multi-period build of inventory. In our view, the inventory build cannot be rationalized by retail store expansion. Accordingly, we believe gross margin may be pressured in the near term as the Company attempts to rationalize inventory levels. Further, we are concerned about the achievability of FY 15 margin guidance and consensus estimates given elevated inventory levels and a slowdown in retail comparable sales. Finally, we are concerned about earnings sustainability given deterioration in cash flow generation over the last three periods.

Weak Americas Traffic, Potential Promotional Environment and Slowing Tourism

Slowdown in Americas segment revenue growth suggests challenging business environment, in our view: In Q1 15, constant currency Americas revenue increased 2.0%. Constant currency Americas revenue growth slowed in seven out of the last nine periods. On its Q1 15 Conference Call on 05/06/15, the Company represented the US market continued to be affected by a "promotional" retail environment. Based upon our understandings of representations made to us by the Company, the US business may have experienced weaker-than-expected traffic. In addition, we believe a strong US dollar may have negatively impacted demand from European tourism.[2]

> In the Americas, revenues increased 2% on a currency adjusted basis. The US market alone was up 4%, also still affected by a promotional market environment at retail. While Canada grows solidly, revenues in Central and South America declined at a double-digit rate. (CFO Mr. Mark Alexander Langer, Q1 15 Conference Call, 05/06/15)

Constant Currency Revenue Growth Analysis	Q1 15	Q4 14	Q3 14	Q2 14	Q1 14
Americas segment revenue	2.0%	1.0%	11.0%	7.0%	(2.0%)
Year-over-year change (in bps)	*400*	*(800)*	*1,100*	*(200)*	*(800)*

We believe the following commentary from certain premium-luxury brands suggests a challenging Americas operating environment:

- **Michael Kors highlights weak traffic trends in North America:** In Q4 15, Michael Kors constant currency comparable store sales declined 1.7% year-over-year. On its Q4 15 Conference Call on 05/27/15, Michael Kors attributed the weakness, in part to, to continued "weak traffic trends in North America." In addition, Michael Kors highlighted a reduction in North American tourist traffic.[3]

  > While we were pleased with the continued momentum in our overall business, comparable store sales declined 1.7% on a constant currency basis. We attribute this primarily to a continuation of weak traffic trends in North America, including a reduction in tourist traffic. (Michael Kors Chairman and CEO Mr. John D. Idol, Q4 15 Conference Call, 05/27/15)

- **Prada's American markets impacted by foreign currency:** On its Q1 15 Conference Call on 06/12/15, Prada represented American markets experienced a soft start to the year due to bad weather and unfavorable currency movements (which resulted in lower demand from tourists).

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[2] On 07/08/15, we spoke with HUGO BOSS Head of Investor Relations Mr. Dennis Weber regarding (1) the market environment in China, Europe, and the US, (2) inventory levels, (3) the Company's new inventory management systems, and (4) margins. We appreciate Mr. Weber's attentiveness to our inquiries.

[3] While we acknowledge that Michael Kors sells predominately women's accessories, we believe the general tourist traffic trends will have similar (if not the exact same) impact on Hugo Boss's menswear brand in North America.

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The American markets saw a softer start in the year, penalized by the bad weather in February, but also by unfavorable FX, resulting in less tourists. (Prada CFO Mr. Donatello Galli, Q1 15 Conference Call, 06/12/15)

- **PVH also experienced a decline in international tourist traffic:** On its Q1 15 Conference Call on 06/02/15, PVH represented it experienced declines in traffic and spending at certain US tourist destinations.

  In North America in the second quarter, our Calvin Klein retail comps are running flat and on plan. We're seeing strong sales in our permanent population stores while stores located in tourist destination locations like Miami, Orlando, New York and Las Vegas are feeling the pressure from weaker international tourist traffic and spending. (PVH Chairman and CEO Mr. Emanuel Chirico, Q1 15 Conference Call, 06/02/15)

China And Europe Slowdown, Retail Store Traffic Declines

China revenue slowdown heightens our concerns: On its Q4 14 Conference Call on 03/12/15, the Company represented the Chinese luxury market declined for the first time in 2014. In addition, the Company disclosed its Hong Kong traffic trends decelerated significantly as a result of political tensions and a noticeable slowdown in tourism. In Q1 15, China constant currency revenue declined 3.0% year-over-year. On its Q1 15 Conference Call, the Company represented it experienced declining store traffic in China as a result of (1) weakening economic trends, (2) oversupply of retail space, and (3) deterioration in social acceptance of premium-luxury products.

Constant Currency Revenue Growth Analysis	Q1 15	Q4 14	Q3 14	Q2 14	Q1 14
APAC segment revenue	1.0%	5.0%	13.0%	2.0%	7.0%
Year-over-year change in bps	*(600)*	*0*	*900*	*(500)*	*600*

In China, however, declining store traffic continues to be a drag on our performance. We attribute this to the further weakening of overall economic trends, an ongoing oversupply of retail space, as well as the deterioration in social acceptance of premium and luxury products, all factors which are unlikely to disappear any time soon. (Chairman and CEO Mr. Claus-Dietrich Lahrs, Q1 15 Conference Call, 05/06/15)

We believe the following commentary suggests peers have also experienced a slowdown in China:

- **Burberry comments on slowdown in Hong Kong foot traffic:** On its Q4 15 Conference Call on 05/20/15, Burberry represented Asia Pacific growth was impacted by a further deterioration in Hong Kong. Burberry represented a decline in foot-traffic resulted in a deceleration of comparable sales in Q4 15.

  Asia Pacific delivered low single-digit growth, impacted by a further deterioration in Hong Kong through the half. Footfall in Hong Kong was down again, more significantly than in the third quarter. So we continued to focus on the things we could control, increasing conversion year on year, partly offsetting the decline in footfall. Comp sales for the half were down mid single digit, including Q4, which was down high single digit. (Burberry CFO Ms. Carol Fairweather, Burberry Group Plc Trading Update Call, 04/15/15)

- **Prada highlights weakness in Chinese luxury market:** On its Q4 14 Conference Call on 03/30/15, Prada represented the macroeconomic environment was more challenging than expected and luxury consumption was impacted by a general economic slowdown. Further, Prada represented Chinese customer spending patterns have been influenced by anti-extravagance measures and a corruption crackdown by the Chinese government.

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> Macroeconomic environment was more challenging than expected and this is clear for everybody in support. The luxury consumptions have been affected by a general economic slowdown and the spending patterns of Chinese customers have been influenced by anti-extravagance, I always say, the anti-corruption campaign. (Prada Chairperson and Executive Director Mr. Carlo Mazzi, Q4 14 Conference Call, 03/30/15) [4]

- **Kering experiences weakness in mainland China and Hong Kong:** In Q1 15, Kering's Gucci (Bottega Veneta) brand Asia Pacific revenue declined 10.0% (9.0%) year-over-year. On its Q1 15 Conference Call on 04/21/15, Kering represented the luxury market "remained tough" in China. In addition, Kering highlighted ongoing weakness in Hong Kong.

> The context remained tough for the luxury sector in mainland China and was further complicated by widening price gaps. Ongoing weakness in Hong Kong and Macau, which together account for 12% of the division retail sales, weighed on revenue. (Kering CFO Mr. Jean-Marc Duplaix, Q1 15 Conference Call, 04/21/15)

Slowdown in European growth heightens our concerns: In Q1 15, EMEA segment constant currency revenue increased 3.0% year-over-year, the slowest growth in eight periods. Further, EMEA segment constant currency revenue growth slowed in five out of the last eight periods. On its Q1 15 Conference Call, the Company represented traffic levels declined year-over-year at its full-priced European stores. In addition, the Company highlighted a difficult European apparel market environment.

> While traffic levels in our full-price retail business declined year over year, in particular in Europe and China, conversion rates and, above all, basket sizes, developed positively. (CFO Mr. Mark Langer, Q1 15 Conference Call, 05/06/15)

Constant Currency Revenue Growth Analysis	Q1 15	Q4 14	Q3 14	Q2 14	Q1 14
Europe segment revenue	3.0%	4.0%	8.0%	10.0%	8.0%
Year-over-year change in bps	*(500)*	*(900)*	*0*	*(400)*	*1,300*

Multi-Period Inventory Build, Potential Gross Margin Pressure

Inventory builds in Q3 14: In Q3 14, inventory increased 18.9% year-over-year to €485.7 million, while revenue increased 8.9% to €716.5 million. Accordingly, inventory-to-revenue increased 9.2% to 0.678, the third consecutive increase. On its Q3 14 Conference Call on 11/01/14, the Company attributed the increase to retail expansion. The Company also attributed inventory levels to lower-than-expected fall/winter sales performance in September and October. Further, the Company represented there was no immediate write-down risk with the excess fall/winter merchandise and announced it would tighten inventory management over the "next few months."

> Inventories increased 19%, or 15% excluding currency movements. Retail expansion including takeovers was the main driver behind the increase. The age structure of inventories, however, remained at healthy levels. Nonetheless, we are working on different measures to tighten inventory management again over the next few months. The inventory situation is now due to the facts that we expected when we took the production order for these inventories back in February and March this year. We had a more positive outlook on the retail like-for-like development for fall/winter than we were able to achieve in September/October. (CFO Mr. Mark Langer, Q3 14 Conference Call, 11/04/14)

[4] In November 2012, Chinese President Mr. Xi Jinping introduced anti-graft measures to reduce political corruption. The anti-graft measures empowered China's anti-corruption office to actively investigate Communist Party, government, military, and state-owned company officials for evidence of corruption. For a detailed background on the anti-graft measures, please see our 04/22/15 Compagnie Financiere Richemont *Comprehensive Analysis*.

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Inventory continues to build in Q4 14: In Q4 14, inventory increased 15.1% year-over-year to €507.4 million, while revenue increased 5.3% to €683.6 million. Accordingly, inventory-to-revenue increased 9.3% to 0.742. In addition, finished goods increased 220 bps to 88.3% of total inventory, the highest level in at least six years. On its Q4 14 Conference Call, the Company represented it would continue to improve inventory turnover in its retail channel in FY 15.

> Inventories increased 15% or 8% excluding currency movements. This represents visibly slower growth compared to the end of the third quarter. Nonetheless, we will be working towards improving inventory turnover in our own retail in particular in order to generate a better performance in 2015. (CFO Mr. Mark Langer, Q4 14 Conference Call, 03/12/15)

Inventory surges in Q1 15: In Q1 15, inventory increased 25.3% year-over-year to €539.3 million, while revenue increased 9.0% to €667.5 million. Accordingly, inventory-to-revenue increased 15.0% to 0.808. On its Q1 15 Conference Call, the Company attributed the increase to retail expansion and slower-than-expected retail sell-through. Based upon our understanding of representations made to us by the Company, inventory levels are most elevated in the Americas segment as a result of weaker-than-expected retail sell through. **Given (1) evidence of weak traffic trends in the Americas and (2) slowing growth in China and Europe, we are concerned the Company is carrying excess inventory.**

> Inventories increased by 25% to €539 million. Excluding currency effects, the increase still amounted to 12% driven by retail expansion as well as a slower than expected own retail sell-through in the last six months. (CFO Mr. Mark Alexander Langer, Q1 15 Conference Call, 05/06/15)

Inventory Analysis (€ in millions)	Q1 15	Q4 14	Q3 14	Q2 14	Q1 14
Inventory	€539.3	€507.4	€485.7	€487.8	€430.4
Revenue	€667.5	€683.6	€716.5	€558.9	€612.6
Inventory-to-revenue	0.808	0.742	0.678	0.873	0.703
Year-over-year change	*15.0%*	*9.3%*	*9.2%*	*6.3%*	*6.7%*

We have the following observations about inventory:

1. **Retail growth does not rationalize inventory build, in our view:** In its quarterly Conference Call presentations, the Company discloses working capital changes on a constant currency basis. In Q1 15, constant currency inventory increased 12.0% year-over-year, while retail stores increased 4.2%. Over the past three periods, constant currency inventory increased 630 bps higher (on average) than retail store growth. Accordingly, we believe that retail store growth cannot entirely rationalize the inventory build. **In our view, the inventory build may be related to (1) weak retail traffic trends in the Americas, (2) slowdown in premium-luxury good consumption in China, and/or (3) slowing European revenue growth.**

Inventory Analysis	Q1 15	Q4 14	Q3 14	Q2 14	Q1 14
Constant currency inventory change (A)	12.0%	8.0%	15.0%	13.0%	16.0%
Retail store count (B)	4.2%	3.3%	8.6%	14.5%	17.5%
Difference (A – B) in bps	*780*	*470*	*640*	*(150)*	*(150)*
Constant currency retail revenue growth	6.0%	6.0%	11.0%	17.0%	19.0%

2. **Implementation of inventory management systems may have contributed to inventory levels, in our view:** The Company is currently launching two retail inventory management systems. The retail merchandise planning (RMP) system will provide a fully integrated view of stock flows in the Company's retail stores. The RMP

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system is expected to be complete in 2015. The retail assortment planning (RAP) system is designed to optimize retail store merchandise assortments. The RAP system is expected to be rolled out in FY 16 for the 2016 fall collection. These system implementations are expected to result in higher sales, improved full-price sales, and lower inventory and higher inventory turnover. **In our view and experience, ERP system implementations can manifest in elevated inventory levels as a result of execution risk.**

3. **Decline in payables relative to inventory suggests potential rationalization efforts, in our view:** Based upon our understanding of representations made to us by the Company, we believe the Company may scale back sourcing and purchasing in H2 15 to help rationalize inventory levels. In Q1 15, accounts payable increased 8.8% year-over-year to €217.8 million, while inventory increased 25.3% to €539.3 million. Accordingly, accounts payable-to-inventory declined 13.1% to 0.404, the sixth consecutive decline.

   Hence, we believe the Company may be attempting to rationalize inventory levels. **Given the multi-period increase in inventory despite slowdown in purchases, we are concerned the Company may have to increase discounts and/or promotions in order to rationalize inventory.**

Accounts Payable Analysis (€ in millions)	Q1 15	Q4 14	Q3 14	Q2 14	Q1 14
Accounts payable	€217.8	€255.0	€202.2	€240.5	€200.1
Inventory	€539.3	€507.4	€485.7	€487.8	€430.4
Accounts payable-to-inventory	0.404	0.503	0.416	0.493	0.465
Year-over-year change	*(13.1%)*	*(5.8%)*	*(16.8%)*	*(13.2%)*	*(6.9%)*

4. **Elevated inventory levels may pressure gross margin, in our view:** In Q1 15, gross margin increased 10 bps year-over-year to 65.5%, the second lowest improvement in at least eight periods. On its Q1 15 Conference Call, the Company represented positive channel mix shift (from wholesale to retail) was partially offset by inventory write-downs. The Company represented the inventory write-down had a mid-million euro impact on gross profit.

   > Gross margin benefited from a positive overall distribution channel mix. However, this was partly offset by a negative inventory valuation effect reflecting some write-downs following the recent buildup of inventories…it's a smaller, mid-single million euro impact that we had from inventory valuation. (CFO Mr. Mark Alexander Langer, Q1 15 Conference Call, 05/06/15)

Gross Margin Analysis	Q1 15	Q4 14	Q3 14	Q2 14	Q1 14
Gross margin	65.5%	68.2%	64.1%	66.7%	65.4%
Year-over-year change in bps	*10*	*(80)*	*60*	*150*	*360*

   Based upon our understanding of representations made to us by the Company, we believe the Company will rationalize excess inventory through its outlet channel (11.7% of total company stores). On its Q1 15 Conference Call, the Company represented outlet stores have lower gross margin than its full-price stores. Accordingly, we believe any mix shift towards outlet stores may negatively impact margins.

   Our concerns are heightened given that analysts currently expect the Company to generate 10 bps of gross margin expansion in FY 15. Further, we believe the Company's excess inventory relates to fall/winter clothing. Hence, we believe gross margin may be pressured in Q3 15 and Q4 15 as the Company attempts to eliminate the seasonal merchandise.

Lack Of Margin Expansion In Recent Periods Heightens Our Concerns

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EBITDA margin pressure: In Q1 15, adjusted EBITDA margin declined 170 bps year-over-year to 19.7%, the largest decline in eight periods. In addition, sales and distribution expense increased 13.7% year-over-year (to €264.3 million) on an absolute basis and 160 bps (to 39.6%) relative to revenue. On its Q1 15 Conference Call, the Company attributed the decline in adjusted EBITDA margin to (1) retail cost increases, (2) negative currency impacts on selling and distribution and general and administrative expenses, (3) a step-up of marketing expenditures, and (4) investments in logistics and IT.

The Company attributed the "significant step-up" in marketing expenditures, in part, to foreign currency and online investments. Further, the Company guided for at least the same level of marketing investments (as a percentage of sales) given the "highly competitive environment." **Given evidence of slowing growth in major markets and elevated inventory levels, we are concerned about the sustainability of EBITDA margins.**

> There was the overall retail cost increase, due to underlying cost increases and the cost of takeovers was above the gross margin contribution. For both selling and distribution and G&A costs, FX effects have played a major role. We do expect also a significant negative impact from the weakening of the euro, in particular with our operations in the US and in Switzerland. In addition, Q1 has seen a significant step-up in our marketing expenditure, so we continued to invest in a difficult market environment, in particular in the online field.
>
> G&A, with 12% growth, but there is a significant part of that also due to FX effect. In addition, we are executing right now taking more services on the online business in-house also triggers sizeable investments in our IT systems. All three factors taken together, FX effects plus the investment in logistics and IT, led to a G&A development that is probably the -- with the strongest growth in the first quarter. (CFO Mr. Mark Langer, Q1 15 Conference Call, 05/06/15)

Margin Analysis (€ in millions)	Q1 15	Q4 14	Q3 14	Q2 14	Q1 14
Selling & distribution expense	€264.3	€289.0	€245.5	€227.9	€232.5
Year-over-year change	*13.7%*	*9.3%*	*12.1%*	*7.7%*	*18.3%*
Selling & distribution expense as % of revenue	39.6%	42.3%	34.3%	40.8%	38.0%
Year-over-year change (in bps)	*160*	*150*	*100*	*100*	*480*
Adjusted EBITDA	€131.5	€167.4	€181.9	€110.2	€131.3
Year-over-year change	*0.2%*	*6.5%*	*5.1%*	*8.3%*	*(1.0%)*
Adjusted EBITDA margin	19.7%	24.5%	25.4%	19.7%	21.4%
Year-over-year change (in bps)	*(170)*	*30*	*(90)*	*60*	*(90)*

Comp store sales slowdown may pressure margins, in our view: In Q1 15, constant currency retail comparable sales increased 3.0% year-over-year, representing a slowdown of 300 bps. In addition, we believe the Company needs to achieve mid-single digit constant currency revenue to leverage retail fixed costs to improve retail margins and achieve its long-term 25.0% EBITDA margin guidance. The Company only achieved mid-single digit (+4.0%) constant currency comparable retail sales in five out of the last ten periods.

Given (1) a slowdown in constant currency retail comparable sales in recent periods, (2) evidence of traffic slowdown in the Americas and China, and (3) elevated inventory levels, we believe EBITDA margin expansion may be limited in the near term. Further, given lack of consistent mid-single digit constant currency retail comparable sales over the last ten periods, we are concerned about the achievability of the Company's long-term EBITDA margin guidance.

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Constant Currency Retail Comparable Sales Analysis	Q1 15	Q4 14	Q3 14	Q2 14	Q1 14
Retail comparable sales	3.0%	0.0%	4.0%	4.0%	6.0%
Year-over-year change (in bps)	*(300)*	*(300)*	*0*	*200*	*400*

FY 15 guidance and consensus expectations may be difficult to achieve, in our view: As of the date of publication, analysts expect gross margin (adjusted EBITDA margin) to increase (decline) 10 bps (70 bps) in FY 15. Further, analysts expect gross margin and adjusted EBITDA margin to improve in both FY 16 and FY 17.

Margin Analysis	FY 17E	FY 16E	FY 15E	FY 14	FY 13
Gross margin	67.9%	67.1%	66.2%	66.1%	64.9%
Year-over-year change (in bps)	*80*	*90*	*10*	*110*	*340*
Adjusted EBITDA margin	23.3%	22.8%	22.3%	23.0%	23.2%
Year-over-year change (in bps)	*50*	*50*	*(70)*	*(20)*	*70*

On its Q1 15 Conference Call, the Company reaffirmed its prior guidance for FY 15 mid-single digit constant currency revenue growth and 6.0% adjusted EBITDA growth (at midpoint). On its Q1 15 Conference Call, the Company represented it expects to achieve its FY 15 adjusted EBITDA guidance as a result of gross margin improvement and tight operating cost management. **Given (1) flat adjusted EBITDA in Q1 15, (2) evidence of challenging premium/luxury demand in China, US, and Germany, and (3) elevated inventory levels, we are concerned about the achievability of FY 15 guidance and consensus expectations.**

FY 15 Guidance Analysis	FY 15 Guidance
Constant currency revenue growth	Mid-single digits
Adjusted EBITDA growth	6.0%

> This outlook is based on the assumption of low single-digit comp store sales growth, reflecting the currently challenging market environment and the revenue contribution from new space. We expect the latter to accelerate, compared to first quarter levels, predominantly as a result of the two takeovers in Asia. Adjusted EBITDA is expected to grow by 5% to 7% in reported terms. The improvement will be supported by gross margin increases, thanks to channel mix and tight operating overhead cost management. (Chairman and CEO Mr. Claus-Dietrich Lahrs, Q1 15 Conference Call, 05/06/15)

FY 15 Capex Ramp May Pressure Margins, In Our View

On its Q4 14 Conference Call, the Company guided for FY 15 capex to increase 55.9% to €210.0 million (at midpoint). In addition, the Company guided for 50 store openings (excluding takeovers). The Company represented that retail would account for 60.0% of its FY 15 capex budget. As of the date of publication, analysts only expect revenue to increase by 9.9% (7.2%) in FY 15 (FY 16). Accordingly, **we believe operating margin may be pressured if the Company does not achieve significant sales growth.**

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Capital Expenditure Analysis (€ in millions)	FY 15 (guidance)	FY 14	FY 13	FY 12	FY 11
Capital expenditures	€210.0	€134.7	€185.3	€165.8	€108.5
Year-over-year change	*55.9%*	*(27.3%)*	*11.8%*	*52.8%*	*95.1%*

Cash Flow Deterioration Heightens Our Concerns

In Q1 15, twelve-month cash from operations (CFO) declined 12.4% year-over-year to €376.6 million, while net income declined 1.3% to €328.5 million. Accordingly, twelve-month CFO-to-net income declined 11.2% year-over-year to 1.147, the sixth consecutive decline. Further, twelve-month free cash flow (FCF) declined 10.0% year-over-year to €230.1 million, the first decline in at least seven periods. Given (1) a multi-period decline in cash flow generation, (2) elevated inventory levels, and (3) evidence of weak (in our view) end markets, we are concerned about the sustainability of earnings.

Cash Flow Analysis (€ 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)	€376.6	€395.4	€403.3	€436.0	€430.0
Net income	€328.5	€334.5	€344.9	€342.6	€333.0
CFO-to-net income	1.147	1.182	1.170	1.273	1.292
Year-over-year change	*(11.2%)*	*(5.3%)*	*(16.6%)*	*(8.4%)*	*(5.5%)*
Free cash flow (FCF)	€230.1	€268.4	€276.5	€282.8	€255.6

Risks to Our Thesis and Conclusion

Risks to our thesis: The following developments could present challenges to our thesis:

- Constant currency retail comparable sales improve, leading to EBITDA margin leverage.
- Traffic trends in the Americas region reverses, resulting in improved retail comparable sales.
- The Company is able to rationalize potentially excess inventory through its outlet channel without material margin implications.
- Weakening premium-luxury goods consumption trend in China reverses.
- Tight cost management allows the Company to achieve its FY 15 adjusted EBITDA guidance.

Conclusion: We are concerned about potentially weak traffic trends in the Americas region given a promotional retail environment and potentially lower tourism. In addition, we are concerned about a slowdown in Europe and China comparable sales growth as a result of lower-than-expected foot-traffic. Our concerns are heightened given a multi-period build of inventory. In our view, the inventory build cannot be rationalized by retail store expansion. Accordingly, we believe gross margin may be pressured in the near term as the Company attempts to rationalize inventory levels. Further, we are concerned about the achievability of FY 15 margin guidance and consensus estimates given elevated inventory levels and a slowdown in retail comparable sales. Finally, we are concerned about earnings sustainability given deterioration in cash flow generation over the last three periods.

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