

FIN 505 – FINANCIAL MANAGEMENT

FINAL INDIVIDUAL ASSIGNMENT

Expected time for completion: 5 hours

The final document has to be saved as a Word or PDF file **labelled with your ID (eg: 201821221.doc)**. Excel spreadsheets should be **inserted in the text**. Send the both the PDF and EXCEL files to dcoutton@inseec.com **one month** after the end of the last FIN 505 course, the latest. The final document will be automatically checked upon receipt with anti-plagiarism software.

PRADA'S HONG KONG IPO

In March 2011, a team at Crédit Agricole's CLSA unit was reviewing data for Prada's initial public offering (*IPO*). Preparations were well underway for the June floatation of the luxury goods and fashion powerhouse in Hong Kong. Securing the Prada mandate had been a major coup: a successful IPO would bring hefty commissions and reputation and a leg-up on the coming wave of luxury IPOs. Yet, as Prada failed in four listing attempts in the past decade, everyone was praying for a case of "fifth time lucky!"

PRADA GROUP

Prada, the iconic Italian luxury group, designed, produced, marketed and distributed products in three core categories: leather goods (i.e., bags, luggage and accessories - a 50% of sales, its largest, fastest-growing and highest-margin segment); footwear (25%) and ready-to-wear (24%). Eyewear and fragrances were licensed out. In 2010, it had some 8,000 employees and €251m in earnings on revenues of €2bn.

Prada (79% of sales), its eponymous core fashion brand, mixed Italian tradition and modernism. Miu Miu (17%) was a more edgy label aimed at younger, fashion-conscious clientele. Church's (2.5%) offered handcrafted footwear of classical British elegance and Car Shoe (1%), luxury driving moccasins with rubber studded soles.

Prada had integrated the entire value chain to retain greater control over product development, relationships with suppliers of raw materials, in-house manufacturing of key products at 11 production sites and strict quality standards. This ensured higher margins through efficient production, short lead times and brand integrity.

For wholesale distribution (29% of sales), Prada supplied multi-brand and department stores as well as franchise stores. For retail distribution (71%), it owned 30 directly operated stores (DOS) in prime locations in 70 countries and 18 outlets for past collections. Ecommerce was Prada's fastest growing distribution channel.

Prada's communication emphasized quality and exclusivity through a combination of media coverage, fashion shows, DOS design, architecturally striking flagship stores and modern art and culture events.

Prada was present in all key markets: Europe ((43% of sales, half in Italy); Asia ex-Japan (31%, over half in China); North America (14.5%); and Japan (10.8%). It hoped to strengthen in traditional markets and expand in developing markets. Notably, China had emerged as Western luxury's new El Dorado and access to its rising affluent middle class through local store or by targeting Chinese tourists abroad was vital.

Other strategic priorities including developing Miu Miu's emerging status as a super brand and a greater focus on leather goods. Shifting from wholesale channels to the DOS network to maintain tighter control over brand exposure, sourcing and pricing was also essential: Prada trailed its main rivals in DOS network size and with development and administrative costs being fixed, retail expansion drove higher margins.

A BRIEF FINANCIAL HISTORY

In 1913, Mario Prada opened a store in Milan selling leather goods and luxury items, which became popular with the European elites. His daughter Luisa succeeded him and in 1978, her own daughter Maria (Miuccia), a leftwing activist and mime student, took over the then struggling family business.

Miuccia and her future husband, leather goods entrepreneur Patrizio Bertelli, would shape Prada's identity, industrial structure and strategy, marrying style with business, she as head of design and he as CEO.

In 1979, Miuccia designed her first international hit: a rugged yet stylish black nylon backpack that showcased her signature utilitarian look. Wholesale accounts were opened with department stores and boutiques around the world and Prada opened its own stores in Milan, Madrid, New York, London, Paris and Tokyo. Prada took an important turn in 1989 when it unveiled its first and hugely popular, women's wear collection and held its first fashion show in Milan. The style embraced a worker aesthetic, its appeal being anti-status. The year 1993 saw the establishment of Miu Miu, the launch of its first women's collection and that of Prada's first men's collection.

In the late 1990s, in a bid to build a luxury empire to rival LVMH and Gucci, Prada went on a shopping spree. Among other labels, it acquired Helmut Lang and Jil Sander in 1999, Church's and a stake in Fendi in 2000 and Car Shoe and Genny in 2001. However, the acquisitions' debt burden nearly broke the company's back.

To de-lever, Prada planned IPOs in Milan in 2001 and again in 2002, valuing the company about €8bn, but had to cancel them amid post-9/11 market gloom. Instead, it sold its stake in Fendi and its Byblos brand and spent several years cleaning up its balance sheet, restructuring its debts, selling off small unprofitable brands (e.g., Jil Sander and Helmut Lang in 2006) and improving profitability for its core brands, Prada and Miu Miu.

Prada's awful timing continued as IPO plans valuing the firm at €5bn twice in 2007-08 which were canceled due to the global crisis and so Prada had remained private (Exhibit 2). Patrizio, Miucci and her siblings Alberto and Marina owned a holding company, Amsterdam-based Prada Holding By, which owned 94.9% of the operating company, Prada SpA. Italian bank Intesa Sanpaolo held the remaining 51% for €100m in 2006 in a loan settlement. From the ill-fated acquisitions, the holding and the operating companies had over €1bn in debt.

THE IPO DECISION

Aware that floating Prada's shares on a stock exchange would be a transformational event for the company, Prada's leadership considered carefully whether, where and when to list.

One IPO objective was to raise funds for the firm with a primary offering of new Prada SpA shares (*new shares*). Some 75% of proceeds, expected to be around €230m, would go to improving and expanding the DOS network, 15% to paying some of Prada SpA's debt and 10% to the working capital requirements and general corporate purposes.

Another aim was for the owners to monetize their equity stakes in a secondary offering in which they, not the company, would sell existing Prada SpA shares (*sale shares*), hopefully for upwards of €1.5bn. Intesa Sanpaolo would exit almost entirely, while Prada BV would use part of the proceeds to repay its debts.

Hong Kong's stock exchange had established itself as a major listing venue, topping the charts for IPO proceeds in 2009 and 2010 and had started attracting international issuers. Its main draw was the 10% to 15% price premium companies could expect compared with other markets, which analysts attributed to local investors "getting" what China could mean for a business. Prada ticked most boxes for a foreign listing there: a strong financial track record, a clear and growing footprint in China and a growth story backed by a credible business plan.

With luxury multiples at a three-year high and in line with ten-year averages, the timing seemed favorable. One concern was that markets expected a Hong Kong IPO's proceeds to go to business development in Asia, while Prada's IPO would be mostly a secondary offering. Another issue was that the upcoming Milan IPOs of upscale Italian sportswear brand Moncler and shoemaker Ferragamo could dent investor appetites for Prada's shares.

Beyond an immediate access to funds, an IPO would also facilitate future financing for both the firm and its owners. By listing, Prada could tap new pools of debt and equity and use shares as payment in acquisitions. Besides, by establishing a price and a liquid market for the stock, listing would make it easier for owners to engage in further share sales, allowed after a one-year lock-up period, or to use stock as collateral for loans.

Hong Kong's stock market was appealing from that viewpoint as well, as the liquidity it offered made raising follow-in funds easier. Meanwhile, Prada would be able to tap a diversified global institutional investor base. US and European investors could participate in Hong Kong IPOs, as well as Asian investors, less active investing abroad.

As the first Western luxury listing in Hong Kong, Prada would also send a strong signal about its Asian ambitions and enhance brand awareness in Asia. In addition, the IPO would enable Prada to offer stock-based packages to personnel and to set up a governance structure to outlast the family's direct involvement in management. "Going public" involved considerable expense: Although a low rate for Hong Kong and one usually reserved to mega-IPOs, 1.9% of IPO proceeds would go to bank fees. Another 2.5% would go to lawyers' and auditors' fees and charges for listing, compliance, advertising, etc. The IPO would also demand significant management time.

IPO underpricing was another cost: IPO shares typically "popped" (i.e., experienced a large price rise on the first trading day). In Hong Kong, the price rose by 15% on average. Thus, on average, IPO were below what investors appeared willing to pay. This could leave a lot of money left on the table.

On-going costs of "being public" were large too. They included reporting regular financial statements and proxy materials, managing public relations, analyst and investor briefings, press releases, etc. Having the media would be critical, as one aim of a Hong Kong IPO was to reach out to Asian consumers. Hong Kong investors also had specific "education needs." In Prada's case, they would incur capital gains tax and withholding tax on dividend in Italy. This would be new to them, as Hong Kong had no capital gains tax, no sales tax or VAT and minimal income tax.

Another issue for the family was that it would become accountable to new shareholders and enjoy less freedom of action. Although the risk of a takeover was moot given the 80% equity stake the family would retain, there would still be the pressure to deliver short-term results and meet analyst forecasts.

THE IPO PROCESS

Taking Prada public would involve many steps over an intense period of six to eight months. To help with the process, Prada selected investment banks (*underwriter*) in a *beauty contest*. Goldman Sachs and CSLA, Crédit Agricole's Hong Kong—based Asian brokerage unit, would lead the syndicate with UniCredit and Intesa Sanpaolo's Banca IMI unit, two Italian banks on Prada's board, while Chinese and Japanese banks ICBC and Mizuho would play a less prominent role.

After a soft kickoff meeting in Milan in late 2011, the lead banks set to work, marshaling an army of bankers, lawyers, accountants and various other experts, organized in different workshops over three phases.

During the first phase, Prada's corporate structure 'was simplified, audited financial accounts were prepared for the last three years and thorough business, financial, legal and regulatory due diligence were conducted.

The second phase, already under would set the offering's parameters. A key workshop was to develop the equity story depicting Prada's identity, assets, strategy and prospects. The centerpiece of all communication for the IPO, it would help coordinate public and investor relations and analyst and investor presentations. The prospectus describing the term of the IPO was the most important among the numerous legal, regulatory and contractual items required. In Hong Kong, it would be reviewed not by a regulatory body, as in most countries, but by the stock exchange itself.

Other important workshop focused on valuation, which required building a business plan and projections and tracking peers to set an initial price range for the IPO and on structuring the issue (calibrating the primary vs. secondary tranche the institutional vs. retail tranches, etc.).

The third phase, to start in a few weeks, would consist of marketing the offer and executing the transaction.

A pre-deal research report on Prada had been mailed to over 1,500 investors (except in the U.S., Canada and Japan due to local regulations), starting a blackout period for the banks' research output on Prada (*quiet period*).

Next the underwriters' research analysts would meet and grill Prada's leadership (*analyst presentation*) and start presenting the IPO to institutional investors globally (*premarketing*). Based on their feedback, the initial price range would be adjusted (a high-end price about 30% above the bottom-end price was typical).

Investors would then be sent the preliminary prospectus and, with two weeks to go, management would travel on a grueling international roadshow, presenting the IPO to hundreds of institutional investors in meetings large and small and even in one-on-ones with the most important institutions.

The banks' reputation rode on the fraction of one-on-ones they organized that would eventually lead to share orders. Concurrently, the banks would run the book building, collecting institutional investors' confidential indication of interest in a volume of shares at different prices in the range and compiling them into the book of demand.

The book would close on a Friday to allow Prada's management and its bankers to meet in Hong Kong, sign underwriting agreements, price the issue and allocate the shares over the weekend.¹ The underwriters would sign a firm commitment agreement, whereby they guaranteed the sale of all shares at the set price (i.e., committed themselves to buying any unsold shares).

The pricing of the IPO and the allocation of shares to institutional investors were discretionary, not rule based and the banks' skill in reading the book would be critical to balancing different goals. All else being equal, a higher price was desirable. At the same time, a lower price might encourage buying and a steady price increase in the aftermarket (i.e., *post-IPO*). Hence, the banks usually aimed to price the IPO within the top quartile of the range, but not as high as possible, which ensured that demand for the shares exceeded supply (*oversubscription*).

The final prospectus would then be printed, and allocation would begin. Based on the book, the banks would decide each investor's share allocation. Large, reputable, long-only, long-term investors would be favored, as would institutions that had participated in premarketing and marketing and given more bullish feedback.

Trading in Hong Kong's stock exchange would start a week later. Among other services, the underwriters would take actions in the market to stabilize the price (*price support*). A greenshoe option (overallotment option) would allow them to increase the total offering by up to 15%, the extra shares coming from Prada Holding BV.

VALUATION

But all this would come much later, assuming the IPO went ahead. For now, the team had to propose an initial price range based on standard valuation methodologies: multiples and discounted cash flow analysis.

Trading Multiples

First, a set of publicly traded industry peers (*comparables or comps*) was needed (Exhibit 3). With no listed luxury goods firms fully comparable to Prada, the team formed three comparison groups based on Prada's key attributes: pure-play global business, super-brand positioning and growth markets exposure.

Luxury peers were split into Cor Luxury Tier 1 (Bulgari, Burberry, Hermes and LVMH) and Core Luxury Tier 2 (Richemont, Tiffany and Tod's) by prestige and positioning. Third came an Asian Consumer Panel of consumer goods companies (Belle International, L'Occitane and Trinity). The team left out such companies as Coach, PPR (Gucci's owner, now named Kering) and Polo Ralph Lauren and, in the end, decided to drop Bulgari and Hermes due to unusual trading activity: LVMH had acquired Bulgari at a substantial premium and had also increased its equity stake in Hermes, feeding takeover rumors.

Consumer goods and retail IPOs analysts focused on two ratios: price/earnings (P/E) and enterprise value-to EBITDA (EV/EBITDA). Trailing ratios used the latest annual earnings and EBITDA and forward ratios one- and two-year forecasts (Exhibit 4). One-year forward ratios were the most common. The

¹ Retail investors were reserved 10% of the issue (*retail tranche*) to be sold over a shorter period. A Hong-Kong specific claw back rule mandated the tranche to increase if their demand exceeded the offering

team thought EV/EBITDA more suitable for Prada Asian and U.S. brokers used mainly P/E for Hong Kong listed consumer stocks and getting them to adjust their approach was a tall order.

As growth impacted the ratios, analysts also used P/E-to-growth (PEG) and EV/EBITDA-to-growth ratios (i.e., one-year forward P/E or EV/EBITDA divided by the annualized two-year growth rate of earnings or EBITDA).² Given Prada's superior growth and Hong Kong's rich valuations, the bankers hoped to price Prada well above its peers (i.e., a 20% premium would be added to the multiples-implied share values).

Discounted Cash Flow (DCF) Analysis

The team opted to value Prada as of the end of FY10 (i.e., 01/31/2011). It had built projections on a pro forma statements for a six-year forecast period covering FY 2011 to FY 2016 (Exhibit 4).³ To start with, the team had selected data from the financial statements that Prada had prepared for the previous three years (FY 2008 – FY 2010). Prada had also provided a business plan, to be used as a basis for the forecast period's first three years (FY 2011 – FY 2013).

For the period's last three years (FY 2014 – FY 2016), the team had built its own forecasts. First, sales were expected to grow from their FY 2013 level by 10.5%, 7.4% and 7.3% in FY 2014, FY 2015 and FY 2016, respectively. Next, EBITDA was derived from sales, assuming cost of goods sold (COGS) and operating expenses stayed the same ratio to sales as in FY 2013 (i.e., keeping the EBITDA margin at its FY 2013 level over FY 2014-16). Capital expenditures (CAPEX) projections built on new stores, store maintenance and industrial and corporate CAPEX forecasts.⁴ Depreciation was set at 4% of sales. Inventory days and accounts receivable and payable days were deemed stable so net working capital would grow with sales. Last, a 27% worldwide tax rate was judged suitable.

A terminal value reflecting Prada's worth beyond FY 2016 would be estimated both as the value of a perpetuity growth rate of 2.5% and based on an EV/EBITDA exit multiple computed from comparables.

A weighted average cost of capital (WACC) was needed. Prada being private, stock return statistics were not available. The team had thus compiled financial data on Prada's peers and on bond markets (Exhibits 3 and 5). It would use a 5% market risk premium and assume a conservative target of zero leverage for Prada.

Other Considerations

While P/E ratios gave equity values directly, EV/EBITDA ratios and DCF analysis generated enterprise values. Getting from an enterprise value to an equity value required accounting for debt and cash. Prada had over €1bn in debt at the holding and operating company level. Specifically, Prada SpA had long- and short-term debt of €299.5m and €191.7m, respectively and €116.3m in cash and cash equivalents (mostly government bonds). Prada Holding BV had no cash and €600m in debt collateralized by 70% of Prada SpA's total of 2.5 billion shares.

² For instance PEG was calculated as the P/E ratio for FY 2011 divided by the compound annual growth rate (CAGR) of earnings between FY 2012, where $(1 + \text{CAGR})$ was computed as the square root of the ratio of the FY 2012 earnings forecast to FY 2010 earnings. EV/EBITDA-to-growth was assessed similarly from the CAGR of EBITDA.

³ Forecasts were in euros, but the IPO price would be in Hong Kong dollars (€1 = HK\$10.732).

⁴ They assumed CAPEX of €1.8m per new store (the FY 2011-13 average), €25m per year for store maintenance CAPEX, €30.7m for industrial CAPEX (the FY 2011-13 average) and €23.7m for corporate CAPEX (the FY 2010 level).

Finally, multiples and DCF gave pre-money values (i.e., equity values excluding the funds the firm was to raise in the IPO). Yet IPO investors would buy in the post-IPO Prada, which would include the extra funds. The post-money equity value including those funds equaled the pre-money value plus the forecast of IPO proceeds for the company. The hope was to also raise some €230m from the primary offering and €1.5bn from the secondary offering. The exact amount would of course depend on the issue's final size and pricing.

CONCLUSION

At this stage, the valuation would be based both on multiples and on DCF analysis, although multiples would take increasing precedence over time as the transaction drew closer. The team knew the initial price range would evolve with feedback at the market conditions but setting the price range carefully was essential as it would anchor all discussions of value. Lowballing could mean a lot of money left on the table and overshooting created the risk of a dismal performance at the IPO and in the aftermarket. The current volatility in financial markets and the ongoing Greek crisis only made matters worse. Difficult to find a price consensus...

BUSINESS CASE ISSUES

All issues can be solved only using the data provided.

Question 1: What are the pro and cons for Prada to be listed in Hong Kong? You might analyze the issue from the family and minority shareholders perspective, from the company point of view (finance, strategy...) and from the lead banks perspective.

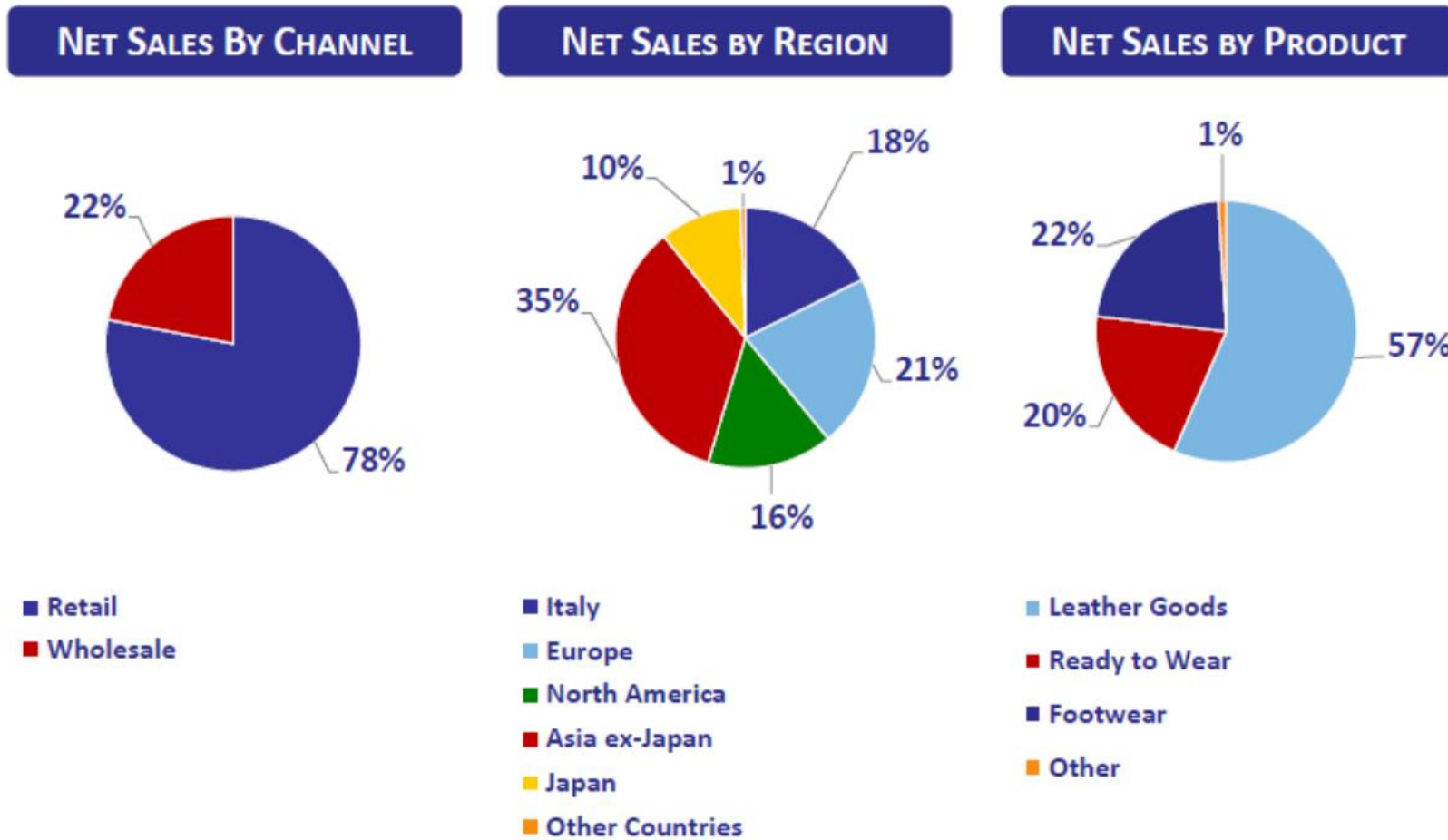
Question 2: What are the risks (a) of getting listed and (b) of being listed?

Question 3: Comparable valuation approach, what would be the IPO price range (a) using the Forward P/E ratio and (b) Forward EV/EBITDA ratio assuming the company sample is made of all companies (Exhibit 3). Note that the bankers assume a 20% premium to be added to the multiples-implied share values; that the estimated 2011 EBITDA and Net income are respectively 652 and 333 M€ for 2,500 million shares. Warning: Net Debt has to be computed when using the EV/EBITDA ratio.

Question 4: DCF valuation approach, what would be the IPO objective range using a DCF method.

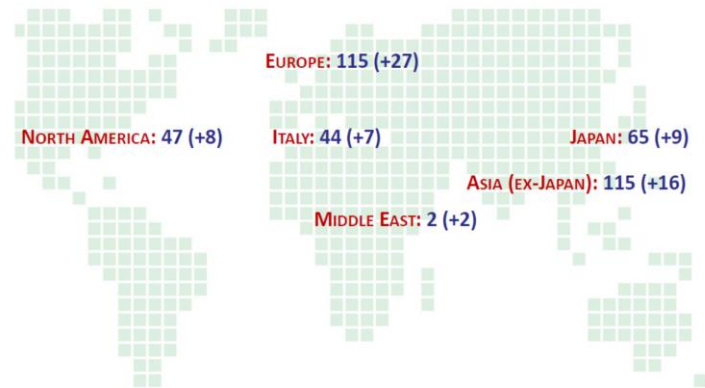
- (a) Free Cash-Flow to the Firm (FCFF) can be computed from Exhibit 3.**
- (b) Compute and explain why the WACC equals 8.55%.**
- (c) Calculate the Terminal Value assuming it is the average of the 2 methods described in the Case study. Note that the perpetual growth rate (g) is 2.5% and that the WACC is equal to 8.55%.**
- (d) Finally, after discounting the FCFF and Terminal value and after consideration of the Net Debt (which includes the Holding Debt), compute the Pre-money share price (with 2,500 million shares) and Post-money share price (with 2,500 million shares and the newly shares issued).**

EXHIBIT 1 – PRADA'S BRAND, PRODUCTS CATEGORIES, DISTRIBUTION CHANNELS, SEGMENTS & 2011 SALES



Retail Overview

388 DOS at Jan 2012 with 75 openings and 6 closing



Net Sales by Brand (€ mn) – Full year

	2010	Mix %	2011	Mix %	2011 vs 2010
Prada	1,586.8	79%	1,999.3	79%	+26%
Miu Miu	353.0	17%	441.1	17%	+25%
Church's	53.0	3%	59.2	2%	+12%
Car Shoe	17.9	1%	17.0	1%	-5%
Others	6.2	-	6.7	-	+7%
Total	2,017.1	100%	2,523.3	100%	+25%

EXHIBIT 2 – PRADA'S COMPLEX OWNERSHIP STRUCTURE

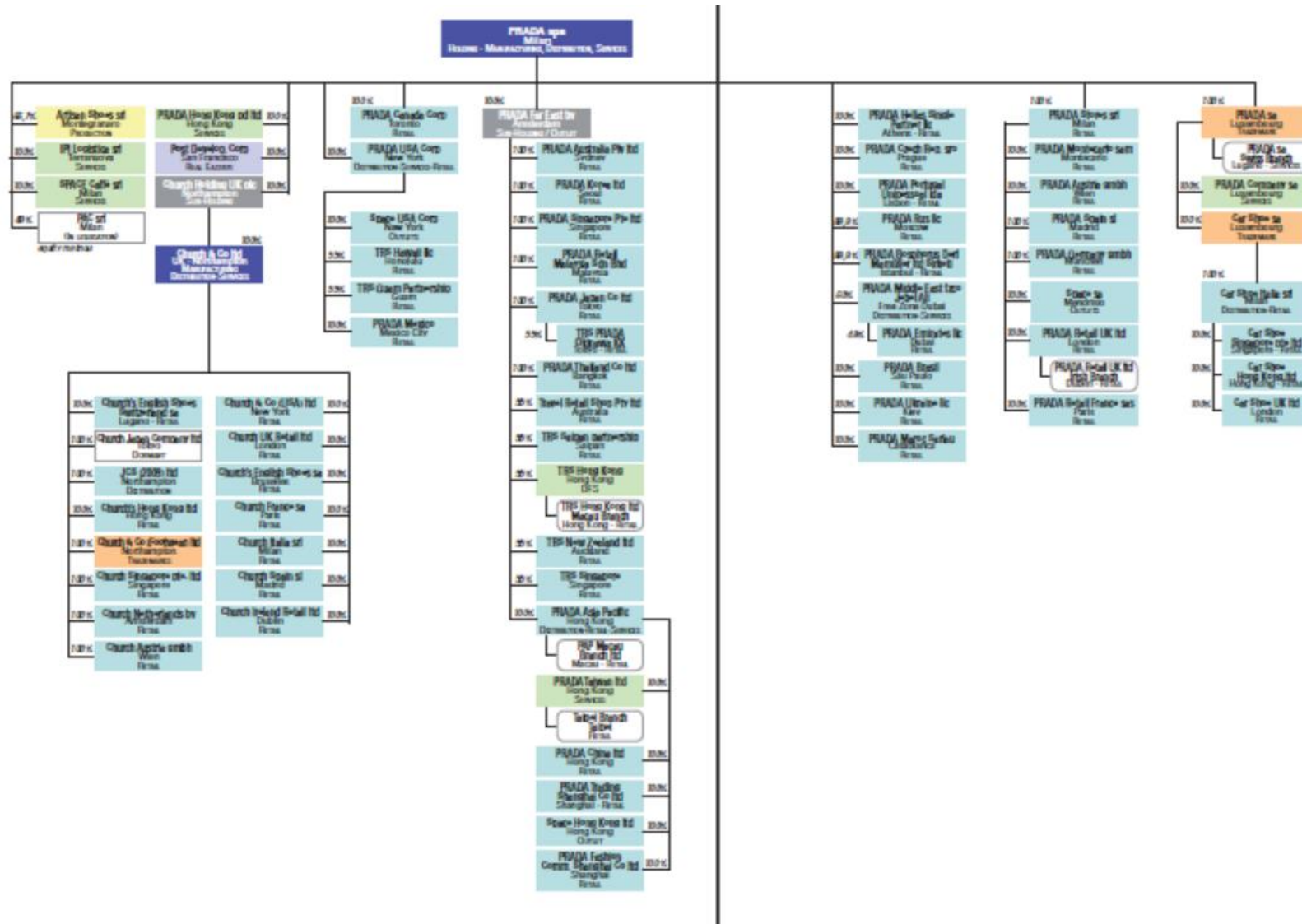


EXHIBIT 3 – FINANCIAL DATA FOR COMPARABLE COMPANIES

Company	Stock Exchange	Currency	Stock price 03/10/2011 (€)	Shares Outstanding (millions)	Market Capitalization (€m)	Debt (€m)	Cash (€m)	EBITDA FY 2010a	EBITDA FY2011e	EBITDA FY2012e	Net Income FY 2010a	Net Income FY2011e	Net Income FY2012e	Beta	Tax Rate
Belle International	Hong Kong (HKEx)	HKD	1,32	8 404,3	11 094	6	556	478	597	720	375	470	557	1,11	18%
Bulgari	Milan (BIT)	EUR	7,60	302,0	2 295	494	283	160	193	229	51	95	123	0,68	16%
Burberry	London (LSE)	GBP	13,85	431,3	5 974	287	398	378	468	546	217	278	332	1,24	30%
Hermès	Paris (Euronext)	EUR	154,94	105,2	16 300	64	989	733	828	936	426	495	554	0,25	33%
L'Occitane	Hong Kong (HKEx)	HKD	1,83	1 453,6	2 660	85	280	164	197	238	97	120	145	0,98	25%
LVMH	Paris (Euronext)	EUR	113,11	490,6	55 492	5 266	2 802	5 295	5 965	6 635	2 286	2 936	3 363	0,97	33%
Richemont	Zurich (SWX)	CHF	41,35	575,8	23 809	701	1 213	1 572	1 947	2 150	1 019	1 330	1 517	1,12	15%
Tiffany	New York (NYSE)	USD	44,56	126,3	5 628	372	487	512	572	636	255	296	339	1,91	34%
Tod's	Milan (BIT)	EUR	78,07	30,6	2 389	75	196	194	220	246	108	123	139	0,47	32%
Trinity	Hong Kong (HKEx)	HKD	0,70	1 713,7	1 200	65	47	44	62	79	30	43	58	0,76	34%
Coach	New York (NYSE)	USD	40,39	301,6	12 182	18	684	935	1 064	1 176	538	646	719	1,34	33%
Swatch	Zurich (SWX)	CHF	84,41	148,7	12 552	83	2 517	1 214	1 341	1 499	786	942	1 060	1,12	25%
PPR	Paris (Euronext)	EUR	108,92	126,3	13 757	4 464	3 125	1 957	2 188	2 390	897	1 078	1 275	0,82	28%
Polo Ralph Lauren	New York (NYSE)	USD	90,40	97,8	8 841	201	461	661	774	862	359	420	461	1,29	40%
Pandora	Copenhagen (CSE)	DKK	41,65	129,6	5 398	66	208	361	470	568	231	344	435	0,40	18%

Note: All amounts in millions of euros except stock prices

EXHIBIT 4 – FINANCIAL FORECASTS

Prada forecasts (€millions)		Actual		Business Plan			Forecasts		
	FY 2008	FY 2009	FY 2010	FY 2011e	FY 2012e	FY 2013e	FY 2014e	FY 2015e	FY 2016e
Net sales	1 648	1 561	2 047	2 392	2 804	3 173	3 506	3 765	4 040
% growth		-5,3%	31,1%	16,9%	17,2%	13,2%	10,5%	7,4%	7,3%
EBITDA	282	290	534	652	814	964			
% Net sales	17,1%	18,6%	26,1%	27,3%	29,0%	30,4%	30,4%	30,4%	30,4%
Depreciation & Amortization	92	103	118	135	159	177			
% Net sales	5,6%	6,6%	5,8%	5,6%	5,7%	5,6%	4,0%	4,0%	4,0%
EBIT	190	187	416	517	655	787			
% Net sales	11,5%	12,0%	20,3%	21,6%	23,4%	24,8%			
Net income	101	103	251	333	432	527			
% Net sales	6,1%	6,6%	12,3%	13,9%	15,4%	16,6%			
CAPEX	159	118	174	247	281	211	133	133	133
Working Capital Requirement (WCR)	271	259	321	375	440	498			
% Net sales	16,4%	16,6%	15,7%	15,7%	15,7%	15,7%	15,7%	15,7%	15,7%

EXHIBIT 5 – EUROPEAN BOND MARKET DATA

Government bonds	YTM	Corporate bond (ratio)	YTM
6-month maturity	0,80%	AAA-rated bonds	3,98%
1-year maturity	1,21%	AA-rated bonds	4,12%
2-year maturity	1,69%	A-rated bonds	4,35%
5-year maturity	2,71%	BBB-rated bonds	5,09%
10-year maturity	3,55%	High-yield bonds	6,67%

Note: YTM refers to the bond's yield to maturity