

# Bulgari

BULG.MI

## Rome or away?

- We believe Bulgari is strategically less well placed than its peers.
- Positive developments are already in the price, in our view.
- We are initiating with an Underperform rating.

**Strategically less well placed than peers:** We believe Bulgari is strategically less well positioned relative to its peers as it is exposed to the watch & jewellery segment, which has suffered the greatest margin decline of all luxury segments, and appears to have less pricing power than some of its peers. We estimate inventory holding to be 595 days' sales at December 2002—we expect this to have a negative impact on margins given the strengthening of the euro.

**Management addressing issues, but . . .** On the positive side, management has shown both a willingness and an ability to address the issues faced by the group. However, we believe the upside is already in the price and risks to forecasts remain on the downside. Specifically, we remain concerned that selling expenses may need to revert towards historical averages. In our view, the group has yet to show that it can expand without absorbing cash.

**Catalysts:** In our view, the share price is highly geared and has a close correlation to foreign-currency movement—effectively making the stock a play on euro weakening. Outperformance against our pessimistic forecasts would lead to revision of our valuation—but other factors still militate against our overall view.

**Valuation and view:** We initiate on the stock with an Underperform rating and a target price of €3.8 based on DCF fair value on a seven-year CAP, partially adjusted for tax benefits. This target price represents a 14.6% discount to the closing price on 8 May 2003.

Bulgari is an Italian luxury goods company whose products include jewellery, watches, fragrances, leather accessories and silks. Bulgari has established a luxury hotel joint venture with Marriott hotels.

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**FOR IMPORTANT DISCLOSURE INFORMATION relating to the Firm's investment banking relationships, if any, with companies mentioned in this report and regarding the Firm's rating system, valuation methods, analyst certification and potential conflicts of interest, please refer to the Disclosure Section at the end of the report.**

Rating	UNDERPERFORM* [V]
Price (08 May 03)	4.45 (eu)
Target price (12 months)	3.80 (eu)
Market cap. (eu m)	1,317.93
Enterprise value (eu m)	1,420.54
Region/country	European/Italy
Sector	Luxury Goods
Analyst's Coverage Universe	Luxury Goods
Weighting (vs. broad market)	MARKET WEIGHT
Date	12 May 2003

\* Stock ratings are relative to the coverage universe in each analyst's or each team's respective sector.  
[V] = Stock considered volatile (see Disclosure Section).



The price relative chart measures performance against the eur\_djeu index. On 08/05/03 the eur\_djeu index closed at 200.92. On 08/05/03 the spot exchange rate was eu0.87 /US\$1.

Performance over	1mth	3mths	12mths
Absolute (%)	7.8	11.9	-48.8
Relative (%)	5.9	4.6	-23.2

Year	12/01A	12/02A	12/03E	12/04E
Revenues (eu m)	766.1	773.3	771.0	816.9
EBITDA (eu m)	126.69	139.79	120.22	132.49
Net income (eu m)	68.2	76.0	61.9	70.9
CSFB adj. EPS (eu)	0.28	0.29	0.24	0.27
ROIC (%)	10.6	10.7	9.0	9.6
P/E (x)	16.0	15.2	18.8	16.7
P/E rel (%)	118.5	120.8	204.3	220.2
EV/EBITDA (x)	12.6	10.2	11.8	10.7

Dividend 2002 (eu)	21.90	Book value/share (12/02, eu)	1.8
Dividend yield (%)	492.4	Free float (%)	43.5
IC (12/03E, eu m)	712.08	Number of shares (m)	296.30
Net debt (12/03E, eu m)	102.6	EV/IC (12/03E, x)	2.0
Net debt/equity (12/03E, %)	17.4	Current WACC (12/03E, %)	8.4

Source: FTI, Company data, Datastream, CSFB (EUROPE) LTD. Estimates.

## Investment summary

Focus on high-end jewellery and watches	Bulgari, based in Italy, is the smallest of the five luxury companies currently under our coverage. Its primary focus of operations is high-end jewellery and watches, mostly under the Bulgari brand.
Strategically less well placed than peers	<p>In the accompanying sector note (<i>Handbags at five paces</i>), we identify seven key drivers of competitive advantage in the luxury goods sector. We believe Bulgari is less well positioned than its peers because:</p> <ul style="list-style-type: none"> <li>• it is exposed to the watch and jewellery segment, which has suffered the greatest decline in margins of all luxury segments;</li> <li>• it appears to have less pricing power than some of its peers—watches remains a highly competitive segment; and</li> <li>• working capital levels are still high—we estimate inventory holding to be 595 days' sales at December 2002, which we expect to have a negative impact on margins given strengthening of the euro.</li> </ul>
Catalysts include . . .	<p>We believe positive catalysts for the stock include: the delivery of production efficiencies and continuation of the cost-saving programme, leading to achievement of stability in margins, further improvement in capital turns, and the delivery of sustained organic growth in revenues.</p> <p>Bulgari uses foreign-currency hedging to mitigate short-term earnings risks; however, we believe risks still remain to watch distribution through volatility caused by pipeline effects in the retail chain, and also risks of grey market trading.</p> <p>Bulgari has begun to establish some positive momentum from the turnaround in profitability in Q4 2002, but maintenance of this momentum requires continued cost cutting and efficiencies.</p>
Management seeking to address issues	On the positive side, management has shown both willingness and ability to address issues faced by the group. It has addressed issues of costs in 2002 and has delivered on the promised reduction in working capital and debt.
Upside already in price . . . downside risks remain	However, we believe the upside is already in the price and risks to forecasts remain on the downside. Specifically, we remain concerned that selling expenses may need to revert towards historical averages and, in our view, the group has yet to show that it can expand without absorbing cash.
Effectively a play on euro weakening	<p>In our view, the share price is highly geared and has close correlation to foreign currency—effectively making the stock a play on euro weakening. Outperformance against our pessimistic forecasts would lead to revision of our valuation—but other factors still militate against our overall view.</p> <p>We initiate on the stock with an Underperform rating and a 12-month target price of €3.8 equating to our DCF fair value on a seven-year CAP, assuming 30% tax, and then adjusting for 90% of the potential upside to valuation assuming the group's current effective tax rate of 16%. This target price represents a 14.6% discount to the closing price on 8 May 2003.</p>

Strategic  
assessment: Bulgari is less  
well placed than its peers

**Figure 1: Summary drivers of value**

		Bulgari	Gucci	Hermes	LVMH	Richemont
<b>Structural</b>	Geographical mix	3	3	3	2	3
	Business mix	2	3	5	4	2
<b>Operational</b>	Pricing power	2	3	5	4	1
	Working capital	1	4	4	3	2
	Vertical integration	2	4	4	3	1
<b>People</b>	Management	3	2	5	4	1
	Design / quality	3	3	3	3	3
<b>Total</b>		<b>16.0</b>	<b>22.0</b>	<b>29.0</b>	<b>23.0</b>	<b>13.0</b>
<b>Low score</b>		<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<b>High score</b>		<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>

Source: CSFB estimates

**Figure 2: Comparative valuation table**

Local currency in millions, unless otherwise stated

	Bulgari	Gucci	Hermès	LVMH	Richemont	Richemont (luxury)
RIC	BULG.MI	GCCI.AS	HRMS.PA	LVMH.PA	RIFZ.VX	n/a
Share price	€ 4.4	€ 84.8	€ 125.2	€ 38.6	SFr. 20.3	n/a
Rating	UNDERPERF.	NEUTRAL	NEUTRAL	OUTPERF.	UNDERPERF.	n/a
Target price	€ 3.8	€ 90.0	€ 125.0	€ 45.0	SFr. 17.0	n/a
Potential	-14.6	6.1	-0.2	16.7	-16.3	n/a
Up/Downside (%)						
Market capitalisation	1,318	8,703	4,607	18,895	11,289	5,061
Enterprise value	1,421	7,610	4,238	23,664	12,689	6,461
P/E (x)						
2002A	15.2	26.3	20.9	23.0	11.5	16.3
2003E	18.8	25.9	21.0	17.2	12.9	21.2
2004E	16.7	21.5	19.9	14.8	10.9	13.3
EV/EBITDA (x)						
2002A	10.2	17.8	11.6	10.7	17.5	8.9
2003E	11.8	15.8	11.5	8.9	21.0	10.7
2004E	10.7	13.1	10.9	8.0	17.5	8.9

Source: Reuters, Company data, CSFB estimates

## Summary of key brands

Source: Company data

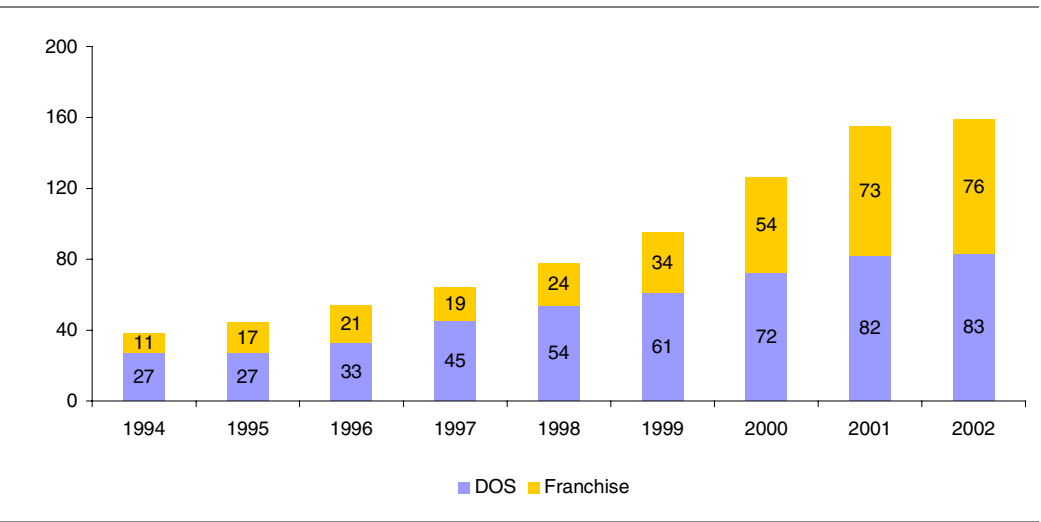
Country	Percentage
RO Europe	25%
Japan	21%
Amer.	15%
RO Asia	17%
Italy	14%
Other	8%

Wines & Spirits	Fashion & Leather 	Perfumes & Cosmetics 	Watches & Jewellery 	Others
	Bulgari	Bulgari	Bulgari Gerald Genta Daniel Roth	Bulgari (home design)

Decrease in capital efficiency

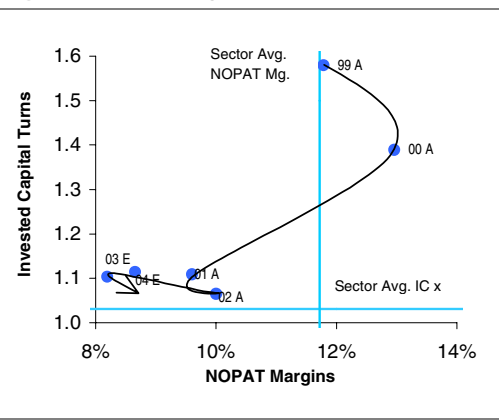
share price gearing to trade weighted currency index

Figure 7: Shops



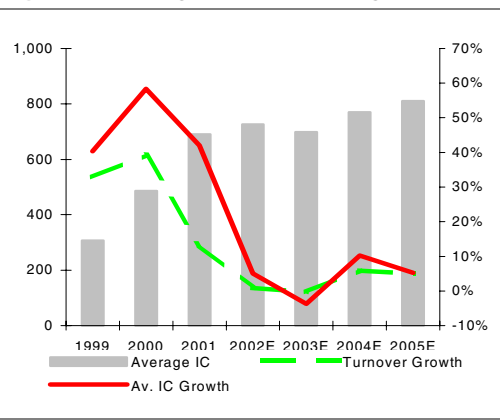
Source: Company data, CSFB research

Figure 8: Efficiency matrix



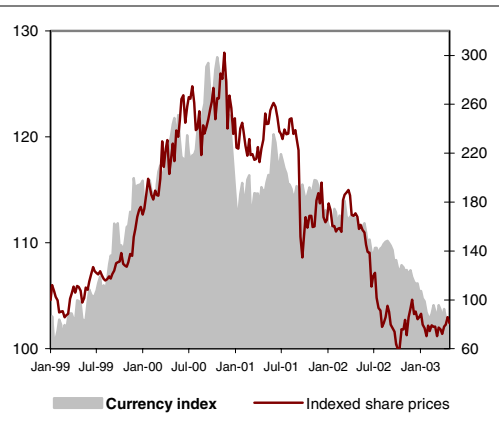
Source: Company data, CSFB estimates

Figure 9: Average IC & turnover growth



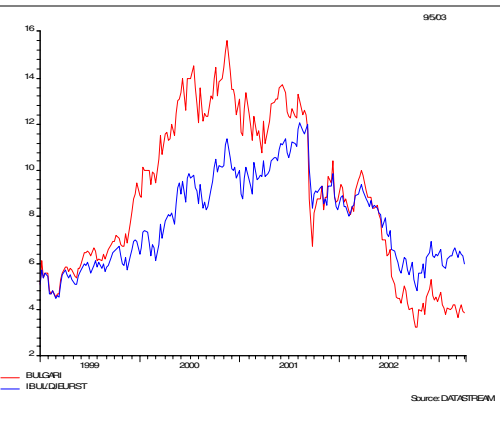
Source: Company data, CSFB estimates

Figure 10: Currency index & share price



Source: Datastream, CSFB research

Figure 11: Price & price relative



Source: Datastream

## Strategic assessment

A summary SWOT analysis is given in Figure 12.

Expansion of retail networks has been a significant driver of growth for luxury goods companies—through both the supply of evident unsatisfied demand for luxury branded products and the capture of retail margins via vertical integration.

Although Bulgari's origins date back to 1884, its position as a leading luxury goods company, in our view, is largely the result of an aggressive growth policy during the 1990s, which saw the number of Bulgari stores increase from 44 in 1995 (the year of listing on the Milan stock exchange) to 126 in 2001 and turnover increase by over 280% over the same period (development of the Bulgari store network is given in Figure 7).

Over this same period, the perfumes and cosmetics business has grown from around 12.5% of revenues to the current level of approximately 17.2% of group revenues.

Like Hermes, the growth achieved by Bulgari was largely 'organic'—that is, without the effects of any significant corporate acquisitions—goodwill and intangibles account for only around 6.3% of total assets in 2002. However, because of the high inventory holdings needed in the jewellery and the watch industries, the expansion necessitated substantial incremental invested capital, and resulted in net operating cash outflows of €72m over the period 1998 to 2001 (even before capex of a further €202m). With favourable foreign-exchange rates supporting margins (and the build-up of inventory), this strategy for growth was largely successful, in our view.

We believe Bulgari's recent difficulties stem from the launch of a new jewellery range in September 2001, which had necessitated a build up of inventory and high product marketing costs. The inventory situation was then aggravated by a slowdown in watch purchases by retailers and indeed the acceptance by Bulgari in some cases of stock returns post 11 September.

**Figure 12: Bulgari: SWOT analysis**

<b>Existing Strengths</b> Distinctive jewellery brand in unbranded market. Management has shown willingness and ability to react to changing circumstances. Low tax rate.	<b>Existing Weaknesses</b> Can the company sustain growth without drain on cash? High (albeit reducing) inventory holdings. Less pricing power than many of its peers. Exposed to volatility of demand from watch retailer Hotel joint venture: opportunity or distraction?
<b>Opportunities</b> Additional store expansion in largely unbranded jewellery market. Further improvement in watch distribution. Integration of manufacturing—Crova acquisition. Integration of Roth and Genta technical expertise to add legitimacy to Bulgari watches. Opera fund investments.	<b>Threats</b> Tactical changes to marketing spend potentially damaging? Further weakening of US dollar and yen. Continuing reluctance to travel—geopolitical issue SARS.

Source: CSFB research

As inventory holdings increased, weakness of the US dollar and yen increased pressure on margins and demand was hit by macroeconomic weakness and by the effects of continuing geopolitical uncertainty on international travel.

In short, in our view, the aggressive and successful expansionary strategy of the 1990s became a handicap for the group.

In 2002, to the credit of management, it sought to reduce inventory holdings and we estimate generated cash from operations (pre capex) in the region of €180m, compared with cumulative outflows in the previous four years of approximately €72m.

The group did manage to increase margins in 2002, although a significant factor in this was the reduction in marketing expenditure from an average of around 13.0% of annual revenues in the years 1998–2001 to 9.9%. We estimate that this resulted in a cost 'saving' of around €24.0m in 2002.

We consider that the major strategic challenge facing Bulgari is how to sustain growth in revenues and margins without a further drain on operating cash flows and without compromising brand support in the form of marketing expenditure.

## Financial analysis and projections

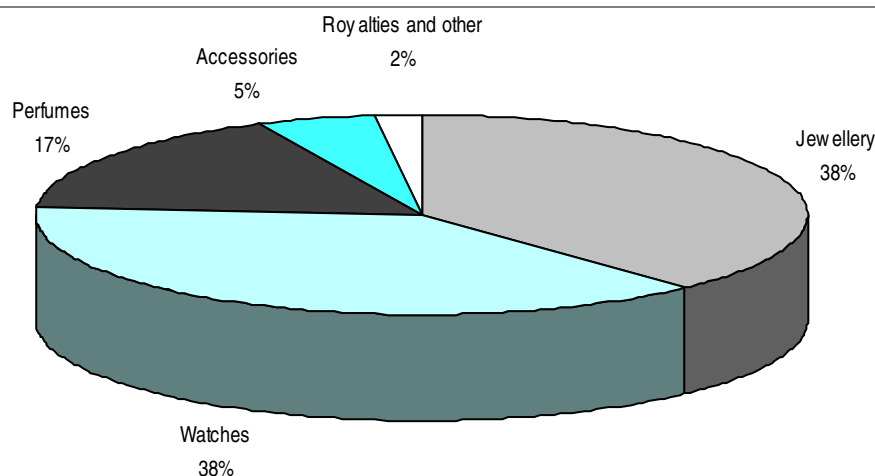
### Background

The core of Bulgari's business is in distinctive high-end jewellery and watches. The jewellery business is positioned at an average price point that management estimates to be around US\$3,500, on a par with that of Cartier, but significantly above the US\$300 average estimated for Tiffany.

With the exception of niche brands, Daniel Roth and Gerald Genta, Bulgari watches are assembled by the group using movements purchased from external suppliers (notably Swatch). As such, the positioning of the watches is largely in non-technical segments.

In 1989, jewellery accounted for around two thirds of group sales and watches the remainder. Since then, the product categories have been extended and the range of products expanded into perfumes and cosmetics (launched in 1993) and accessories (1996), followed by eyewear (via a production and distribution agreement with Luxottica) and leather goods. The split of revenues in 2002 by sector is given in Figure 13.

**Figure 13: Bulgari: Activity by sector 2002**



Source: Company data

Figure 3 illustrates our estimate of the geographical and business mix of Bulgari group turnover in 2002. Figure 4 provides further illustration of the development of the offering (in terms of broad categories of activity) during the period.

Most of the group's activities are conducted under the Bulgari brand name (details of brands by business segment are given in Figure 6).

### EVA<sup>®</sup> analysis

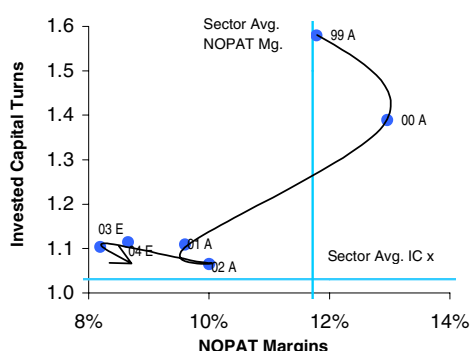
Figure 14 plots invested capital turns against NOPAT margins over the period 1999–2004E. The chart therefore illustrates Bulgari's capital efficiency, and shows how this has changed over time. (By way of additional explanation, the further away a point on the chart is from the origin, the higher the ROIC.)



Bulgari's capital efficiency decreased substantially in 2001 as capital increasingly became tied up in inventory and margins decreased. In 2002, cost-control measures resulted in the stabilisation of NOPAT margins, although average IC turns continued to increase slightly. We expect the improvements in working capital achieved during 2002 to benefit average IC turns statistics in 2003, although it remains to be seen whether the actions taken by the group will be sufficient to sustain any lasting improvement in capital efficiency.

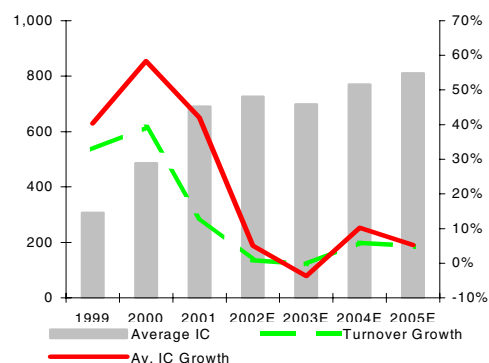
In Figure 15, we illustrate the impact of a reduction in inventory in 2002, which resulted in slowing growth in average IC during 2002 and brought about a reduction in average IC for 2003. We assume that Bulgari continues to steadily invest capital thereafter (consistent with the view expressed by management that inventory turns are now at an appropriate level) to sustain future growth in turnover, albeit at a lower level.

**Figure 14: Efficiency matrix**



Source: Company data, CSFB estimates.

**Figure 15: Average IC & turnover growth**



Source: Company data, CSFB estimates.

Figure 16 summarises the returns on invested capital achieved by Bulgari in the period 1999 to 2002. (Pending publication of the 2002 full financial statements, 2002 figures remain estimates.)

**Figure 16: Bulgari: Returns on invested capital**

eu in millions, unless otherwise stated

	1999	2000	2001	2002E	2003E	2004E	2005E	Incremental		% Increase	
								1995-2002	1999-2002	1995-2002	1999-2002
Invested capital	357	616	766	686	712	754	793	529	328	339	92
NOPAT @ 30% tax	57	88	74	77	63	71	77	61	20	368	35
ROIC (%)	18.6	18.0	10.6	10.7	9.0	9.6	10.0	11.5	6.1		

Source: Company data, CSFB estimates

In our view, too much attention is paid to the absolute level of ROIC in any one year relative to WACC, rather than the directional movement of the ROIC-WACC spread. Invested capital is essentially an historical figure, and is therefore of lesser relevance. What matters more to value creation is how *incremental* capital is invested in business to derive *incremental* returns to shareholders.

Using a standard cash tax rate of 30% throughout the period (to enable better comparison across periods and groups), incremental returns on incremental capital

have fluctuated widely from year to year since the group's listing in 1995. In our view, this fluctuation is mainly as the result of the timing during the year of the significant investments made by the group in the pursuit of its growth strategy.

Looking at aggregate incremental capital since 1995, and incremental returns thereon the trend in returns has, however, clearly turned down. Return on incremental invested capital over the period 1995–2002 amounted to 11.7%, significantly ahead of WACC, (which we estimate to be around 8.4%). Looking at the period 1999–2002, the return on incremental invested capital falls to around 6.3%, which (even allowing for an effective tax rate of around 16%, implying a ROIC of 7.5%) is below the cost of capital.

Note that Bulgari's accounting tax rate is less than the standard rate of 30%, with a low of 10.9% in 1999, although it is currently around 16%. We understand from discussions with the company that the lower rate results from favourable structures agreed with Swiss tax authorities and management has indicated that it believes the current rate to be sustainable in the long run.

We believe NOPAT margins for the group will come under increased pressure (for further discussion, see the following section). Accordingly, in the current environment, while the group may be able continue to grow revenues and profitability, we question whether near-term growth can be achieved at rates above the cost of capital necessary for expansion.

Our conclusions from this analysis are:

- Until the combination of adverse factors affecting trading in 2001, Bulgari had pursued an aggressive policy of expansion that generated significant EVA<sup>®</sup> for the benefit of shareholders.
- Since 2001, value has been destroyed as NOPAT margins have reduced. In 2002, the group sought to increase margins through radical cost-cutting measures, and to reduce capital invested in the business by better managing working capital—in particular, inventory.
- Key to future value creation will be improving margins, while at the same time improving capital disciplines.

## Projections

Our projections for the group are given in Figure 21–Figure 23.

The key earnings data from Figure 21 are summarised in Figure 17.

**Figure 17: Bulgari: Summary earnings data**

*eu in millions, unless otherwise stated*

	2000	2001	2002	2003E	2004E	2005E
Turnover	676.0	766.1	773.3	771.0	816.9	857.3
EBITA	125.2	105.1	110.5	90.3	101.0	110.1
Margin (%)	18.5	13.7	14.3	11.7	12.4	12.8
EPS fully diluted clean (€)	0.38	0.28	0.29	0.24	0.27	0.29

*Source: Company data, CSFB estimates*

Revenue assumptions are given in Figure 18.

The headline growth in revenue results from the combination of assumptions regarding the underlying organic growth in turnover and the effects of changes in foreign-exchange rates.

**Figure 18: Bulgari: Revenue growth assumptions**

%

	Headline				Organic			
	2002	2003E	2004E	2005E	2002	2003E	2004E	2005E
Jewellery	2.1	- 0.3	6.0	5.0	6.5	4.5	6.0	5.0
Watches	- 1.0	- 0.1	6.0	5.0	3.4	4.7	6.0	5.0
Perfumes	4.9	- 0.6	6.0	5.0	9.1	4.3	6.0	5.0
Accessories	3.7	- 0.2	6.0	5.0	7.8	5.1	6.0	5.0
Royalties and other	- 19.8	- 0.3	3.0	2.0	- 15.8	5.0	3.0	2.0
Total	0.9	- 0.3	5.9	4.9	5.3	4.6	6.0	4.9

*Source: Company data, CSFB estimates*

For the purpose of our projections, we have assumed that exchange rates remain constant at levels as of 1 April: US\$1.062/€1 and ¥128.1/€1.

On the basis of such consistency, we expect the average US dollar exchange rate for 2003, relative to the euro, to weaken by 12.6%, on top of a 5.5% adverse variance in 2002. For the Japanese yen, we estimate the adverse currency variance in 2003 to be 7.0% on top of an 8.6% adverse variance in 2002.

After allowing for the effects on invested capital of the inventory reduction instigated in 2002, the assumed growth in invested capital is greater than assumed growth in turnover (Figure 15). We therefore assume that the company pays for its growth through the steady investment in new shops and development of manufacturing capabilities.

We assume that Bulgari suffers erosion in the EBITA margin of 260bps, from 13.9% in 2002 to 11.3% in 2003, before improving margins gradually to 12% in 2004E, 12.5% in 2005E and 13.0% in 2006E.

Despite the group's hedging policies, we believe margins will be under pressure in the short term from movements in exchange rates. Admittedly, this view is more pessimistic than the latest management guidance that production efficiencies will compensate for

the effects of currency movement and operating profit should grow in line with volumes (which we take to mean flat margins).

The effect of foreign-exchange movements on Bulgari is likely to be significant in the current year (we estimate an adverse currency effect on revenues in 2003 of around 4.9% of revenues). Bulgari has already indicated that it will be adopting a “conservative” approach to pricing with only limited increases. Furthermore, we believe with new product launches in 2003, such as the Allegra jewellery range and new fragrances, including Omnia (launch scheduled for September), marketing costs are likely to trend back towards the 1998–2001 average of 13%. Accordingly, despite the indications from the company to the contrary, we have adopted a more cautious stance on margins.

## Valuation and catalysts for change

### Valuation

Our valuation of Bulgari is based on detailed projections for the group, which take into account only the development of the existing business and not possible future acquisitions.

Further detailed assessment of the valuation of Bulgari relative to its peers in the Luxury Goods sector is given in our accompanying sector note *Handbags at five paces*.

Figure 19 shows a comparable company analysis for Bulgari against the sector.

**Figure 19: Comparative valuation table**

*Local currency in millions, unless otherwise stated*

	Bulgari	Gucci	Hermès	LVMH	Richemont	Richemont (luxury)
RIC	BULG.MI	GCCI.AS	HRMS.PA	LVMH.PA	RIFZ.VX	n/a
Share Price	€ 4.4	€ 84.8	€ 125.2	€ 38.6	SFr. 20.3	n/a
Recommendation	UNDERPERF.	NEUTRAL	NEUTRAL	OUTPERF.	UNDERPERF.	n/a
Target Price	€ 3.8	€ 90.0	€ 125.0	€ 45.0	SFr. 17.0	n/a
Potential Up/Downside (%)	-14.6%	6.1%	-0.2%	16.7%	-16.3%	n/a
Market Capitalisation	1,318	8,703	4,607	18,895	11,289	5,061
Enterprise Value	1,421	7,610	4,238	23,664	12,689	6,461
P/E (x)						
2002A	15.2	26.3	20.9	23.0	11.5	16.3
2003E	18.8	25.9	21.0	17.2	12.9	21.2
2004E	16.7	21.5	19.9	14.8	10.9	13.3
EV/EBITDA (x)						
2002A	10.2	17.8	11.6	10.7	17.5	8.9
2003E	11.8	15.8	11.5	8.9	21.0	10.7
2004E	10.7	13.1	10.9	8.0	17.5	8.9

*Source: Company data, CSFB estimates*

In our view, the most widely used bases for valuation in the luxury goods sector, P/E and EV/EBITDA, have become less relevant for the purpose of absolute valuation in an environment of macroeconomic and geopolitical uncertainty, volatility of foreign-exchange markets, and declining margins in the sector as a whole. They remain a useful benchmark for relative valuation at any point in time; however, given the structural shift in the industry, we see little relevance in attempting to justify target prices based on historical trading ranges.

Our preferred method of valuation is EVA<sup>®</sup>, effectively a surrogate for DCF. Figure 20 sets out our Bulgari value projections.

**Figure 20: Bulgari: EVA®/DCF valuation**

eu in millions, unless otherwise stated

	2003E	2004E	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E
	1	2	3	4	5	6	7	8	9	10
<b>Net Sales</b>	<b>771</b>	<b>817</b>	<b>857</b>	<b>909</b>	<b>963</b>	<b>1,021</b>	<b>1,082</b>	<b>1,147</b>	<b>1,216</b>	<b>1,289</b>
<i>Growth (%)</i>	-0.29	5.95	4.95	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Operating costs	643	678	708	750	795	843	893	947	1,004	1,064
<i>Op cost (%)</i>	83.36	82.99	82.55	82.55	82.55	82.55	82.55	82.55	82.55	82.55
Depreciation	38	38	39	42	44	47	50	53	56	59
<i>Depn (%)</i>	4.93	4.64	4.61	4.61	4.61	4.61	4.61	4.61	4.61	4.61
EBITA	90	101	110	117	124	131	139	147	156	166
<i>EBITA margin (%)</i>	11.71	12.36	12.85	12.85	12.85	12.85	12.85	12.85	12.85	12.85
Taxes on EBITA	(20)	(22)	(24)	(26)	(27)	(29)	(31)	(32)	(34)	(36)
<i>Cash tax rate (%)</i>	30.00	30.00	30.00	30.00	30.00	30.00	30.00	30.00	30.00	30.00
<b>NOPAT</b>	<b>63</b>	<b>71</b>	<b>77</b>	<b>82</b>	<b>87</b>	<b>92</b>	<b>97</b>	<b>103</b>	<b>109</b>	<b>116</b>
Depreciation	38	38	39	42	44	47	50	53	56	59
Gross Cash Flow	101	109	117	124	131	139	147	156	165	175
Change in working capital	(18)	(33)	(29)	(18)	(19)	(20)	(22)	(23)	(24)	(26)
<i>Change in wc (%)</i>	2.3	4.0	3.3	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Capex	(47)	(49)	(51)	(45)	(48)	(51)	(54)	(57)	(61)	(64)
<i>Capex (%)</i>	6.06	5.97	5.90	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Minority Interest	(3)	(3)	(3)	(3)	(3)	(4)	(4)	(4)	(4)	(5)
Gross investments	(67)	(85)	(82)	(67)	(71)	(75)	(80)	(84)	(89)	(95)
<b>Free Cash Flow</b>	<b>34</b>	<b>24</b>	<b>34</b>	<b>57</b>	<b>60</b>	<b>64</b>	<b>68</b>	<b>72</b>	<b>76</b>	<b>81</b>
Discount rate (%)	1.00	0.92	0.85	0.79	0.72	0.67	0.62	0.57	0.52	0.48
Discounted FCF	34	22	29	45	44	43	42	41	40	39
Cumulative FCF	34	56	85	130	173	216	258	299	338	377
Residual value (t+1)	842	918	973	1,031	1,093	1,159	1,228	1,302	1,380	1,421
PV of residual	842	847	828	810	792	774	757	740	724	688
PV of cumulative FCF	34	56	85	130	173	216	258	299	338	377
Net (Debt) Cash	(103)	(103)	(103)	(103)	(103)	(103)	(103)	(103)	(103)	(103)
PV of Equity	773	800	811	837	862	888	912	936	960	963
Outstanding shares (units)	296.3	296.3	296.3	296.3	296.3	296.3	296.3	296.3	296.3	296.3
<b>Value per share (eu)</b>	<b>2.6</b>	<b>2.7</b>	<b>2.7</b>	<b>2.8</b>	<b>2.9</b>	<b>3.0</b>	<b>3.1</b>	<b>3.2</b>	<b>3.2</b>	<b>3.2</b>

Source: Company data, CSFB estimates

The model assumes inter alia:

- a WACC for Bulgari of 8.4%; and
- an explicit forecast period to 2005—thereafter we assume revenues grow at 6% per annum and EBITA margins are held constant.

The value per share in any one year is equal to the present value of cash flows up to and including that year, with a terminal value ascribed to the business based on the following year's NOPAT discounted at WACC with *nil growth thereafter*.

Accordingly, by way of illustration, if, as highlighted in Figure 20, we were to assume that Bulgari enjoys a competitive advantage sustainable for a seven-year period (approximating one business cycle), and thereafter returns only the WACC on incremental investment, the implied value of the group would be €3.1.

Alternatively, at the current price of €4.45, based on these projections, the market-implied competitive advantage period is in excess of ten years.

We believe the high valuation of Bulgari (using this approach) potentially stems from differences between our assessment of cash generation and those priced in by investors. In our projections for year-end 2003, we have taken a more cautious view than the company appears to be indicating (no *formal* guidance has been given by Bulgari) in comments during presentations to analysts. (The latest management guidance is that production efficiencies will compensate for the effects of currency movement and operating profit should grow in line with volumes—which we take to mean flat margins.) To the extent that Bulgari is able to outperform our expectations in 2003, this would potentially rebase our EVA<sup>®</sup>/DCF valuation.

A further factor affecting valuation is that, for consistency, we have assumed a cash tax rate in the above calculations of 30%. Management has indicated in presentations that the current effective rate of 16% is sustainable for the foreseeable future. If we were to use a 16% effective cash tax rate, the value per share on a seven-year cap would increase to €3.9, within 12.4% of the current market valuation.

We believe a fair value for the stock is €3.1. This is fundamentally based on the EVA<sup>®</sup>/DCF calculation and a competitive advantage period of seven years.

## Catalysts for change

Following on from the above financial analysis and also the assessment of competitive advantage in luxury goods contained in our accompanying sector note, in our view, the key catalysts for a re-rating of sector as a whole would be:

- a reversal of the weakness of the US dollar and the yen against the euro; and
- a recovery in luxury spending patterns as a whole—indicated by improvement in benchmark statistics combined into CSFB's Panier Garni index (for further details on this, please see Appendix 2 of our accompanying sector report).

Stock-specific catalysts include:

- the delivery of production efficiencies and continuation of the cost-saving programme, leading to the achievement of stability in margins;
- further improvement in capital turns; and
- the delivery of sustained organic growth in revenues.

For Italian regulatory purposes, Bulgari is required to report earnings on a quarterly basis. Analysis of the 2002 quarterly returns showed significant volatility in quarterly operating margins, which were just 10.3% in Q1, 9.3% in Q2, and 13.1% in Q3, compared with 20% in Q4. The company indicated in 2002 that quarterly operating performance is not necessarily a reliable guide to the outlook for the full year. The prior-year comparisons, especially in the first half of 2003, are relatively weak, in our view, and accordingly, we would advise caution in interpreting in particular the first-half results.

**Figure 21: Bulgari: Profit and loss account***eu millions, unless otherwise stated*

	2000	2001	2002	2003E	2004E	2005E
<b>Net sales</b>	<b>676.0</b>	<b>766.1</b>	<b>773.3</b>	<b>771.0</b>	<b>816.9</b>	<b>857.3</b>
Cost of sales	(234.0)	(270.0)	(294.8)	(293.0)	(306.3)	(321.5)
<b>Gross margin</b>	<b>442.0</b>	<b>496.1</b>	<b>478.5</b>	<b>478.0</b>	<b>510.5</b>	<b>535.8</b>
Gross margin (%)	65.4	64.8	61.9	62.0	62.5	62.5
Total operating costs	(319.3)	(394.0)	(370.9)	(390.7)	(412.5)	(428.6)
Operating income	122.8	102.1	107.6	87.3	98.0	107.2
Net financial income / (expenses)	1.4	(3.1)	(8.7)	(5.0)	(5.0)	(5.0)
Exceptional items	(12.1)	(10.5)	(7.5)	(5.0)	(5.0)	(5.0)
<b>Income before taxes</b>	<b>112.0</b>	<b>88.5</b>	<b>91.4</b>	<b>77.3</b>	<b>88.0</b>	<b>97.2</b>
Income taxes	(13.5)	(16.6)	(14.1)	(12.4)	(14.1)	(15.5)
<i>Effective tax rate (%)</i>	<i>12.1</i>	<i>18.7</i>	<i>15.4</i>	<i>16.0</i>	<i>16.0</i>	<i>16.0</i>
Consolidated net income	98.5	72.0	77.3	64.9	73.9	81.6
Minority interests	(3.0)	(3.8)	(1.3)	(3.0)	(3.0)	(3.0)
<b>Net income</b>	<b>95.5</b>	<b>68.2</b>	<b>76.0</b>	<b>61.9</b>	<b>70.9</b>	<b>78.6</b>
<i>Goodwill</i>	<i>2.4</i>	<i>3.0</i>	<i>3.0</i>	<i>3.0</i>	<i>3.0</i>	<i>3.0</i>
<i>Exceptionals</i>	<i>12.1</i>	<i>10.5</i>	<i>7.5</i>	<i>5.0</i>	<i>5.0</i>	<i>5.0</i>
<i>Net income bef GW and exceptionals</i>	<i>110.0</i>	<i>81.6</i>	<i>86.5</i>	<i>69.9</i>	<i>78.9</i>	<i>86.6</i>
Earnings per share basic (eu)	0.33	0.23	0.26	0.21	0.24	0.26
EPS, fully diluted (eu)	0.33	0.23	0.26	0.21	0.24	0.26
CSFB EPS basic clean (eu)	0.38	0.28	0.29	0.24	0.27	0.29
CSFB EPS fully diluted clean (eu)	0.38	0.28	0.29	0.24	0.27	0.29
Number of shares:						
Average shares outstanding (m)	292.047	294.302	295.966	296.150	296.446	296.743
Fully diluted shares (for EPS)	292.674	294.302	295.966	296.150	296.446	296.743
Dividend (split adjusted)	0.086	0.062	0.074	0.081	0.090	0.098
Dividends paid	25.2	18.3	21.9	24.1	26.6	29.2
Dividend cover (x)	3.8	3.7	3.5	2.6	2.7	2.7
<b>EBITDA</b>	<b>136.8</b>	<b>126.7</b>	<b>139.8</b>	<b>120.2</b>	<b>132.5</b>	<b>143.0</b>

*Source: Company data, CSFB estimates*



**Figure 22: Bulgari: Balance sheet**  
*eu in millions, unless otherwise stated*

	2000	2001	2002	2003E	2004E	2005E
Cash and equivalents	33.8	47.9	48.9	65.4	73.1	89.8
Short-term investments	0.4	0.0	0.0	0.0	0.0	0.0
Trade receivables	117.4	123.9	143.0	137.3	145.1	152.7
Other receivables	85.9	94.0	83.4	83.4	83.4	83.4
Inventories	447.0	547.5	477.5	503.5	535.8	564.1
Accrued income and prepaid expenses	3.8	5.5	5.6	5.5	5.8	6.1
<b>Current assets</b>	<b>688.3</b>	<b>818.9</b>	<b>758.3</b>	<b>795.2</b>	<b>843.3</b>	<b>896.1</b>
Net PP&E	87.8	96.2	87.6	96.1	105.0	114.5
Intangibles	21.2	24.0	21.3	21.6	21.9	22.1
Goodwill (purch and consol)	42.8	40.3	37.4	34.4	31.4	28.5
Financial assets	24.5	23.7	26.6	26.6	26.6	26.6
<b>Fixed assets</b>	<b>176.2</b>	<b>184.3</b>	<b>172.9</b>	<b>178.7</b>	<b>185.0</b>	<b>191.7</b>
<b>Total assets</b>	<b>864.5</b>	<b>1,003.2</b>	<b>931.2</b>	<b>973.8</b>	<b>1,028.2</b>	<b>1,087.8</b>
Accounts payable	147.7	118.9	119.2	121.8	127.7	133.6
Accrued expenses and other current liabilities	35.6	33.6	33.7	33.7	35.4	37.0
Income taxes	20.1	32.6	32.6	32.6	32.6	32.6
Short-term debt	135.3	224.8	68.0	68.0	68.0	68.0
<b>Current liabilities</b>	<b>338.7</b>	<b>409.9</b>	<b>253.5</b>	<b>256.1</b>	<b>263.7</b>	<b>271.2</b>
Deferred income taxes	8.8	10.3	20.4	20.4	20.4	20.4
Long-term debt	100.0	100.0	100.0	100.0	100.0	100.0
Reserve for employee severance	6.0	7.7	8.9	8.9	8.9	8.9
Provisions and other liabilities	6.0	0.2	0.2	0.2	0.2	0.2
<b>Long-term liabilities</b>	<b>120.9</b>	<b>118.1</b>	<b>129.5</b>	<b>129.5</b>	<b>129.5</b>	<b>129.5</b>
Minority interests	9.6	10.6	9.6	9.6	9.6	9.6
Common stock	20.5	20.7	20.7	20.7	20.7	20.7
Share premium	97.0	112.8	112.8	112.8	112.8	112.8
Retained earnings + other reserves	268.7	310.1	367.8	407.9	454.7	506.7
Other reserves and translation	9.2	20.9	37.3	37.3	37.3	37.3
<b>Shareholders' equity</b>	<b>395.4</b>	<b>464.5</b>	<b>538.6</b>	<b>578.6</b>	<b>625.4</b>	<b>677.5</b>
<b>Total liabilities and equity</b>	<b>864.5</b>	<b>1,003.2</b>	<b>931.2</b>	<b>973.8</b>	<b>1,028.2</b>	<b>1,087.8</b>

Source: Company data, CSFB estimates

**Figure 23: Bulgari: Cash flows***eu millions, unless otherwise stated*

	2000	2001	2002E	2003E	2004E	2005E
<b>Net income</b>	<b>95.5</b>	<b>68.2</b>	<b>76.0</b>	<b>61.9</b>	<b>70.9</b>	<b>78.6</b>
Depreciation and amortisation	29.1	38.9	41.0	40.9	42.5	43.8
Minority interest			1.3	3.0	3.0	3.0
Change in employee severance provisions	1.3	1.6	1.2	0.0	0.0	0.0
Net book value of fixed assets sold	0.5	0.4	0.0	0.0	0.0	0.0
Change in deferred taxes/other	-1.9	0.8	10.2	0.0	0.0	0.0
<b>Operating cash flow</b>	<b>124.4</b>	<b>109.9</b>	<b>129.7</b>	<b>105.9</b>	<b>116.4</b>	<b>125.5</b>
Inventories	-165.0	-100.5	70.1	-26.1	-32.3	-28.3
Accounts receivable	-47.7	-9.0	-19.1	5.7	-7.8	-7.6
Accounts payable	28.5	-18.0	0.3	2.6	5.9	5.9
Other current assets and liabilities	5.6	-4.4	0.0	0.1	1.3	1.3
Net change in current assets and liabilities	-178.5	-131.9	51.3	-17.7	-32.8	-28.7
<b>Net cash from operations</b>	<b>-54.1</b>	<b>-22.0</b>	<b>181.0</b>	<b>88.1</b>	<b>83.6</b>	<b>96.8</b>
Capital expenditure (tangible and intangible)	-97.0	-48.8	-33.0	-46.7	-48.8	-50.6
Acquisition of other investments			-2.9	0.0	0.0	0.0
Other fixed asset movement (inc goodwill)	-0.8	-9.7	6.3	0.0	0.0	0.0
Disposals/other change in non-current assets			0.0	0.0	0.0	0.0
Acquisition/disposals of consolidated companies			0.0	0.0	0.0	0.0
<b>Net cash used in investing</b>	<b>-97.8</b>	<b>-58.5</b>	<b>-29.6</b>	<b>-46.7</b>	<b>-48.8</b>	<b>-50.6</b>
Proceeds from stock issuance/(buy back)	4.2	16.0	0.0	0.0	0.0	0.0
Change in treasury shares			10.6	0.0	0.0	0.0
Dividends paid by parent company	-16.6	-25.2	-18.3	-21.9	-24.1	-26.6
Dividends paid to minorities	2.0	1.0	-2.3	-3.0	-3.0	-3.0
Proceeds from debt/other long term receivables	108.7	16.6	-156.8			
<b>Net cash from financing</b>	<b>98.4</b>	<b>8.5</b>	<b>-166.8</b>	<b>-24.9</b>	<b>-27.1</b>	<b>-29.6</b>
Change in scope of consolidation				0.0	0.0	0.0
Effect of exchange rate changes on cash	14.2	10.0	16.4	0.0	0.0	0.0
Net change in cash	-39.3	-61.9	1.0	16.5	7.7	16.6
Cash at beginning of period	-40.4	-79.8	-141.7	-140.8	-124.2	-116.5
Cash at end of period	-79.8	-141.7	-140.8	-124.2	-116.5	-99.8

*Source: Company data, CSFB estimates*

**Companies Mentioned** *(Price as of 08 May 03)*

Bulgari (BULG.MI, eu4.45, UNDERPERFORM, TP eu3.8)

Gucci (GCCI.AS, eu84.8, NEUTRAL, TP eu90)

Hermès International (HRMS.PA, eu125.20, NEUTRAL, TP eu125)

LVMH (LVMH.PA, eu38.56, OUTPERFORM, TP eu45)

Richemont (RIFZ.VX, SFr20.3, UNDERPERFORM, TP SFr17)



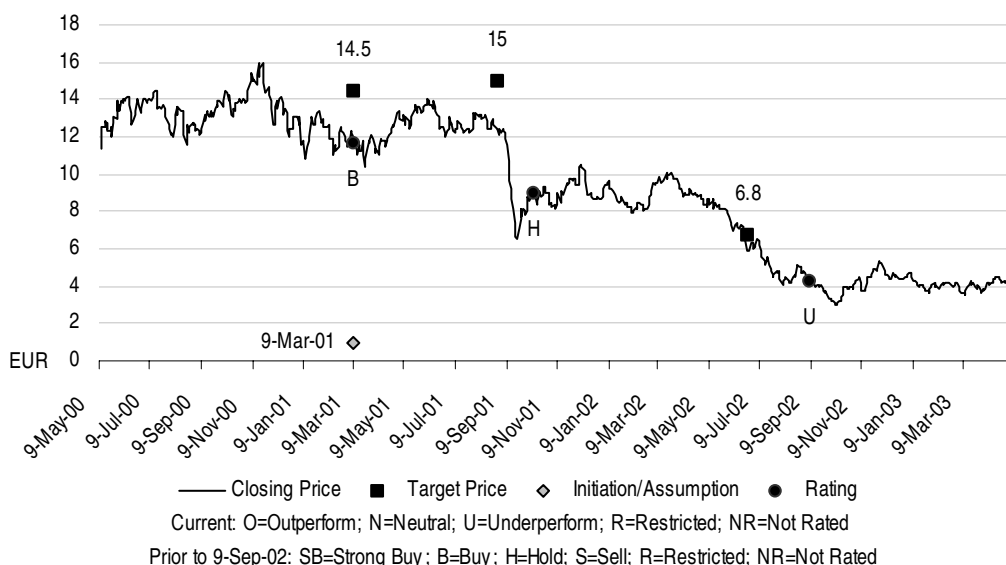


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The charts below reflect the views of the analyst who previously covered these stocks. Coverage was dropped in September 2002.

### 3-Year Price, Target Price and Rating Change History Chart for BULG.MI



BULG.MI Date	Closing Price (EUR)	Target Price (EUR)	Rating	Initiation/ Assumption
09-Mar-01	11.7	14.5	BUY	X
28-Aug-01	12.397	15		
10-Oct-01	9.007		HOLD	
24-Jun-02	5.87	6.8		
06-Sep-02	4.316		UNDERPERFORM	

The analyst(s) responsible for preparing this research report received compensation that is based upon various factors including CSFB's total revenues, a portion of which are generated by CSFB's investment banking activities.

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**Neutral:** The stock's total return is expected to be in line with the industry average\* (range of  $\pm 10\%$ ) over the next 12 months.

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*\*The industry average refers to the average total return of the analyst's industry coverage universe (except with respect to Asia/Pacific, Latin America and Emerging Markets, where stock ratings are relative to the relevant country index).*

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**Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

**Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

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**Global Ratings Distribution\***

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<b>Neutral</b>	43%	(37% banking clients)
<b>Underperform</b>	20%	(32% banking clients)
<b>Restricted</b>	2%	

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**Price Target:** (12 months) for (BULG.MI)

**Method:** DCF

**Risks:** Growth below our forecast; Further strengthening of €

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