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INVESTOR CAMPUS

GLOBAL IDEAS

11 July 2013

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Pandora - "charmed" by the turnaround potential

Investment thesis

After a few years of phenomenal growth, Danish-headquartered jewellery maker Pandora's fortunes deteriorated dramatically from mid-2011, which culminated in two years of flat revenue (FY11-12) and a 40% EPS decline in FY12. Far from being the mere victim of market conditions, Pandora's management team plainly admits to the business having lost its way to an extent, with key issues being the following:

- ⇒ Soaring commodity prices led the group to put through untimely price increases at a time of economic hardship in some Western countries.
- ⇒ The group overestimated the extent to which consumers would have an appetite for higher price-points as the company introduced more expensive product lines.
- ⇒ The quality of in-store execution faltered in a number of areas, with specific issues being quality of assortment and visual merchandising.

In response, Pandora set out to reset its business in 2012 by doing the following:

1) Introducing a greater proportion of entry-level, "bread and butter" products at lower price points (the average price point dropped 4% in FY12) into the product mix. In addition, new products are being launched, with a focus on growing its rings category.
2) The group launched a voluntary 'refresh' programme and took back slow-moving, discontinued items to the value of DKK609mn (DKK1.00=R1.72) in FY12 from its retailers and replaced these items with best-sellers to improve stock turns at a retail level.

Figure 1: Pandora forecasts

Pandora A/S				
June y/e	**FY12**	**FY13F**	**FY14F**	**FY15F**
Diluted HEPS (DKK)	9.2	12.9	18.6	21.2
% growth		*40%*	*44%*	*14%*
DPS (DKK)	5.5	6.0	8.1	8.5
P/E	23.8x	17.x	11.8x	10.3x
DY	2.5%	2.7%	3.7%	3.9%
Share price (DKK)	**218.60**			
12-mnth fwd P/E	13.8x			

Source: Anchor Capital

3) The group is now delivering seven collections (drops) to retailers per year compared to two previously; this reduces the risk of pushing too much inventory into the channels.

The above measures appear to be showing some early signs of success. Following two years of flat sales, Pandora's sales rose by 40% in 1Q13, driven largely by strong volume gains across all regions—some of this was due to Easter/Valentines Day timing issues, but the trend was firmly positive nonetheless. In addition, the group's policy of hedging forward its commodity exposure (principally silver and gold) should result in strong gross margin gains over the next twelve months as sharply falling commodity prices flow through to reduced cost of sales for the group.

In line with *Bloomberg* consensus estimates, we expect the group to deliver ~40% EPS growth in FY13. Importantly, these numbers still imply margins well-below the company's peak and we expect further strong gains into FY14. The stock trades at a **forward 14x P/E multiple** and we rate it a BUY with strong earnings momentum likely to sustain the current rating for some time.

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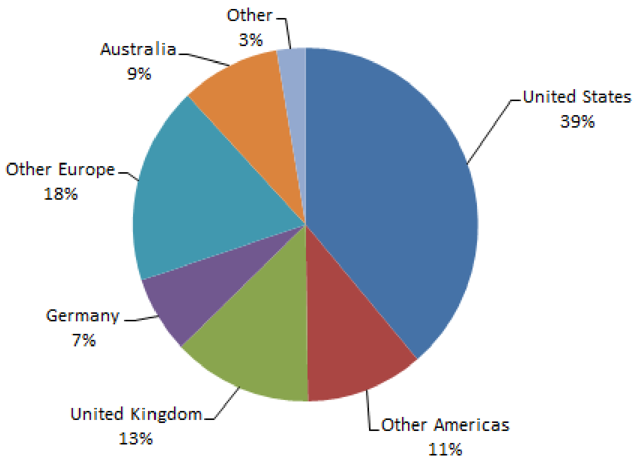
Who are Pandora?

Pandora is a manufacturer and marketer of affordable jewellery (average price point of DKK130, or GBP15) and charms under the Pandora brand, with products including bracelets, charms and rings (amongst others).

The company was founded in 1982 and is headquartered in Copenhagen, Denmark but the group's products are all manufactured from five dedicated facilities in Gemopolis, an industrial zone outside Bangkok, Thailand. The group's products are sold all over the world, with the largest market being the US - accounting for 40% of sales:

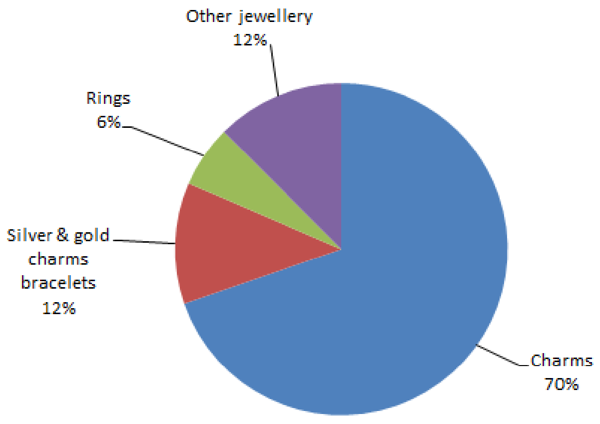
Figure 2: Pandora geographical sales mix



Source: Pandora FY12 annual report

Pandora derives 70% of its sales from its charms (customers typically purchase a bracelet, to which they add charms—normally associated with a special occasion), which highlights some product concentration risk but we note that management aims to grow the ring category significantly in the next few years in order to round out the product offering:

Figure 3: Pandora sales by product type (FY12)



Source: Company data, Anchor Capital calculations

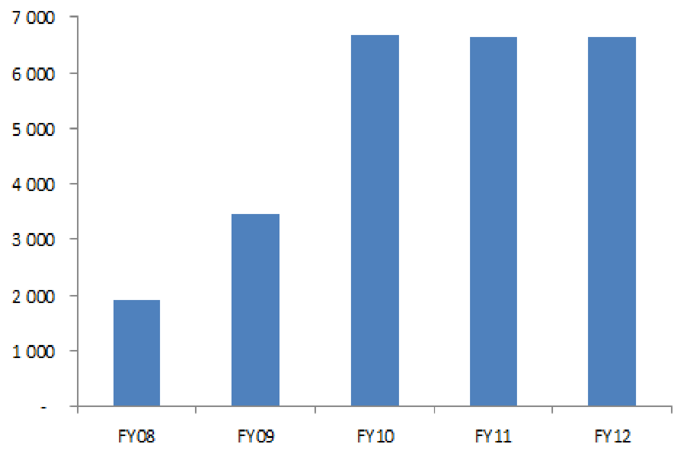
Have they been charging too much?

We are always attracted to companies that have strong brands in the minds of consumers, and we believe Pandora possesses quite a strong brand equity—hence our interest in the company.

However, It must be remembered that, unlike many 'hard' luxury brands (such as Richemont's Cartier), Pandora cannot claim the same level of deep authentic heritage that comes with a long tradition of precision European craftsmanship. Indeed, the group's products are manufactured in factories in Thailand, and while most potential customers may not be aware of this, it would be a stretch to say the brand has authentic deep heritage.

As a result, we believe the pricing equation can only be stretched so far, and by the company's own admission, overall price points probably became too stretched in recent years. The net result has been sales stagnation in FY11/12 as the group introduced price cuts and more appropriately priced merchandise into its mix:

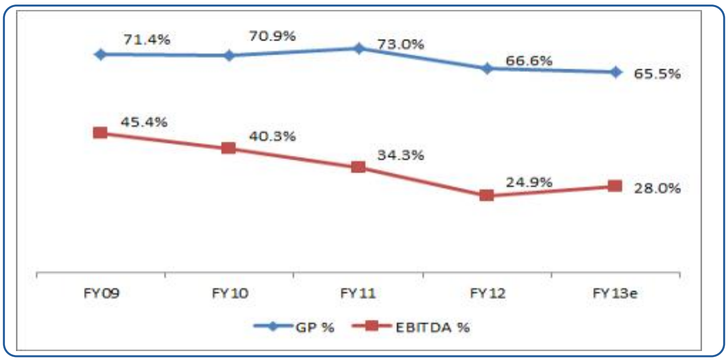
Figure 4: Pandora revenue (DKKmn)



Source: Pandora FY12 annual report

During FY12, the group's gross and operating profit margins came under significant pressure as Pandora took price decreases and absorbed the lagged impact of significantly higher commodity prices in its cost of sales:

Figure 5: Pandora gross and EBITDA margins (%)



Source: Pandora FY12 annual report; Anchor Capital calculations

Commodity prices should be a major margin tailwind from 2H13/FY14

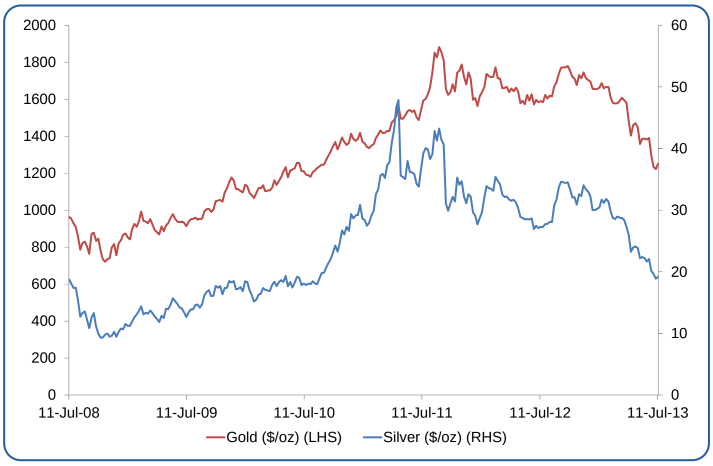
From a raw material perspective, the major input commodities used in the manufacture of the group's products are gold and silver, which account for a substantial portion of cost of goods sold. While a dramatic rise in these prices in recent years has served to crimp Pandora's margins, the reverse will apply now given the sharp reductions in these commodities.

The group's policy with respect to hedging the cost of commodities is to cover forward 100%, 80%, 60% and 40% of expected gold and silver consumption for the following four quarters. As a result, there is generally a time lag of 6-12 months for the spot price of respective commodities to impact on the group's gross margins.

The group provided guidance that FY12 gross margins would have been 67% based on average gold and silver prices ($1,672 and $31.36, respectively) if one ignores the effects of hedging—the actual GP margin was 66.6%. Furthermore, guidance was provided that for each 10% deviation in quarterly gold and silver prices, the gross margin would deviate by 200-300 bpts.

For FY13, we expect to see marginally lower gross margins as the lagged effect of higher commodity prices should still be in the base, but we expect GP margins to rise significantly in FY14 as the group will now be hedging out its commodity requirements at much lower gold and silver prices—current spot prices of gold and silver are 25% and 40% below their respective FY12 average levels:

Figure 6: Gold and silver prices and averages (table)



$/oz	Silver	% ch	Gold	% ch
FY10	24.1		1 227	
FY11	35.3	46%	1 574	28%
FY12	31.2	-12%	1 672	6%
Spot	19.2	-39%	1 250	-25%

Source: iRess

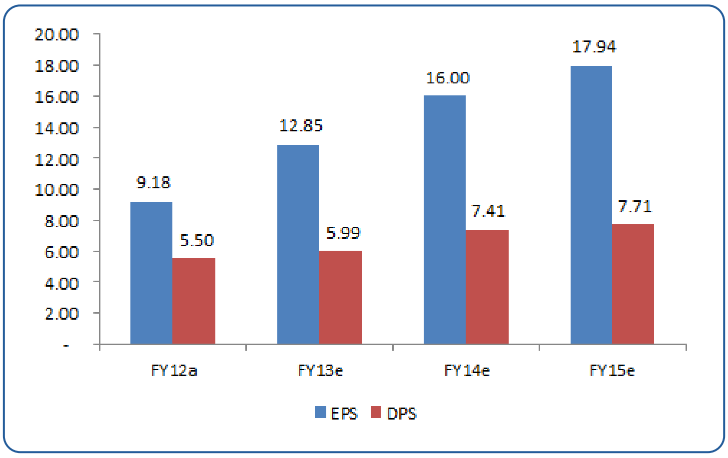
Based on spot commodity prices and the group's hedging policy, we expect that Pandora's gross margins could expand by as much as 750 bpts from its FY12 levels, which would take GP margins beyond their previous peaks. This clearly assumes all other factors remain constant and the group does not cut prices. While the market is expecting a significant increase in earnings (as judged by *Bloomberg* consensus estimates) in the next few years, we believe it is not completely factoring in the full potential margin benefit of current commodity price levels.

Figure 7: Margin and earnings sensitivity to changes in commodity prices

	FY13e	*Change in gold/silver prices fully annualised:*					
	Base	-10%	-15%	-20%	-25%	-30%	-35%
Revenue (DKKmn)	7 982	7 982	7 982	7 982	7 982	7 982	7 982
GP	5 228	5 428	5 528	5 628	5 727	5 827	5 927
margin %	65.5%	68.0%	69.3%	70.5%	71.8%	73.0%	74.3%
Opex (DKKmn)	-3 169	-3 169	-3 169	-3 169	-3 169	-3 169	-3 169
PBIT (DKKmn)	**2 060**	**2 259**	**2 359**	**2 459**	**2 559**	**2 658**	**2 758**
Tax @ 19% tax rate	-391	-429	-448	-467	-486	-505	-524
PAT(DKKmn)	**1 668**	**1 830**	**1 911**	**1 992**	**2 073**	**2 153**	**2 234**
# of shares in issue (mn)	129.4						
EPS	**12.9**	**14.1**	**14.8**	**15.4**	**16.0**	**16.6**	**17.3**
% change		*10%*	*15%*	*19%*	*24%*	*29%*	*34%*

Source: Anchor Capital calculations

Figure 8: Bloomberg consensus EPS/DPS estimates, DKK



Source: Bloomberg IBES consensus estimates

For FY13, we expect earnings growth of 40% - broadly in line with consensus expectations. However, most of this growth will likely be driven by strong growth in sales volumes and fixed overhead recovery rather than significant GP margin expansion.

In 1Q13, the group delivered 40% sales growth with EBIT growth of 70%, but we note that 1Q figures were boosted by the timing of Valentines Day deliveries (favourable impact of DKK150mn, or 11%) as well as Easter falling into 1Q in 2013 as opposed to 2Q in 2012. Nevertheless, we think the company could well deliver 20% sales growth for the full year—the company's "more than DKK7.2bn" sales guidance appears conservative given the 1Q performance.

Importantly, as mentioned previously the strong performance in 1Q was not at all helped by gross margin expansion. So, while we expect a moderation in sales growth in the quarters ahead, GP margins should begin to widen which should sustain strong EPS growth.

Pandora boasts impressive metrics, even at trough earnings

Despite the 40% reduction in Pandora's earnings in FY12, this remains a business with impressive profitability and return metrics:

- 66% GP margin
- 22% operating margin
- 26% return on capital employed; 20% RoE

What makes the return metrics above even more impressive is the fact that the vast majority of the group's balance sheet comprises intangibles, so the returns on real assets (stock, debtors) are much higher and the overall RoE should rise over time from current levels. In the table below, we benchmark Pandora against some other global luxury goods businesses. It is clear that the group is a minnow in size compared with other luxury goods majors (see revenue), which indicates the potential for growth.

Figure 9: Pandora vs other luxury goods companies

	Tiffany & Co.	Richemont	Swatch	Pandora	Prada	LVMH
Revenue ($mn)	3 794	12 962	6 275	1 134	4 214	35 888
Gross margin	57.0%	64.2%	n/a	66.6%	72.0%	65%
EBIT margin	18.4%	23.9%	25.4%	22.2%	27.0%	20%
RoE	17%	21%	18%	21%	31%	14%
RoCE	**24%**	**39%**	**29%**	**26%**	**47%**	**20%**
Intangibles % of equity	**n/a**	**9%**	**7%**	**74%**	**38%**	**75%**
Inventory as % of sales	59%	43%	57%	20%	10%	29%
Forward P/E multiple	**20.3**	**18.0**	**15.6**	**15.1**	**22.1**	**16.6**

Source: Company annual reports, Anchor Capital calculation, Bloomberg

The group's balance sheet is strong (net debt at 31 March: DKK192mn; 3% gearing), and on-going strong cash generation is funding dividends and share buy-backs; the group has initiated a DKK700mn share buyback programme which is to be completed by end December 2013 and should result in shares in issue declining 2-2.5%, providing a boost to EPS. Given the moderate capex requirements of the business (DKK300mn in FY13), we expect that the group could extend this buyback programme beyond FY13.

Figure 10: Pandora cash flows

DKKmn	**FY12**	**FY13E**	**FY14E**
Cash generated by operations	1 831	2 236	3 118
Less: interest	-43	-	-
Less: tax	-428	-391	-557
less: capex & acquisitions	-231	-490	-300
Free cash flow	1 129	1 354	2 261
less: dividends	-715	-777	-1 033
Equals: surplus cash	**414**	**578**	**1 228**

Source: Pandora AFS, Anchor Capital estimates

Distribution is one of the key risks

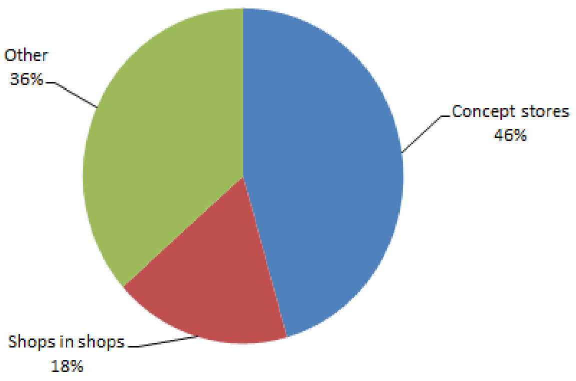
Unlike many of the group's luxury goods peers, Pandora does not own and have full control over its distribution network, with the company's products sold through a network of authorised resellers. The risk associated with this is reduced visibility of end-consumer demand (although mitigated by the group's decision to increase its number of drops per year), as well as control over the customer experience. The group is aiming to increase the proportion of sales from concept stores, and plans to open another 150 concept stores in FY13.

Figure 11: Pandora points of sale

# of points of sale	FY09	FY10	FY11	FY12
Concept stores	196	421	604	809
Shop-in-shop	512	958	1 036	1 114
Gold	1 345	1 523	1 612	2 034
Branded	**2 053**	**2 902**	**3 252**	**3 957**
Silver	2 061	2 458	2 515	2 854
White & travel retail + 3rd party	5 712	5 258	4 965	3 563
Total	**9 826**	**10 618**	**10 732**	**10 374**

Source: Pandora FY12 annual report

Figure 12: Revenue split by store type (FY12)



Source: Pandora FY12 annual report, Anchor Capital calculations

Valuation and conclusion

Placing Pandora amongst a typical peer group is tricky because the company is neither a hard luxury goods group nor a pure retailer. Nevertheless, the stock looks cheaper than the average of a blend of peer companies (*Bloomberg* peer group) when measured by consensus forward P/E multiples:

Figure 13: Pandora A/S valuation vs peers

Name	Price Currency	Price	P/E (Trailing 12m)	12m fwd P/E
SWATCH GROUP AG/THE-BR	CHF	542.50	18.3	15.6
FINANCIERE RICHEMONT-DEP REC	ZAr	9125.00	n/a	18.0
TIFFANY & CO	USD	75.53	22.8	20.3
PRADA S.P.A.	HKD	71.15	29.3	22.1
LVMH MOET HENNESSY LOUIS VUI	EUR	131.40	19.2	16.6
PANDORA A/S	DKK	218.50	21.8	15.1
SIGNET JEWELERS LTD	USD	70.01	15.5	13.7
TIFFANY & CO	USD	74.92	22.6	20.1
FIELMANN AG	EUR	82.20	27.3	24.6
HAL TRUST	EUR	97.00	16.3	13.5
WH SMITH PLC	GBp	760.50	10.9	10.1
JUMBO SA	EUR	7.89	13.2	12.7
FOLLI FOLLIE SA	EUR	16.10	11.4	7.6
CHOW TAI FOOK JEWELLERY GROU	HKD	8.11	14.7	12.0
LUXOTTICA GROUP SPA	EUR	40.45	21.0	25.8
SANRIO CO LTD	JPY	4900.00	34.5	28.0
CABELA'S INC	USD	66.59	22.1	18.2
GNC HOLDINGS INC-CL A	USD	46.52	19.2	15.0
SA SA INTERNATIONAL HLDGS	HKD	7.40	25.3	19.8
JARIR MARKETING CO	SAR	198.00	20.3	17.2
			Average	17.3

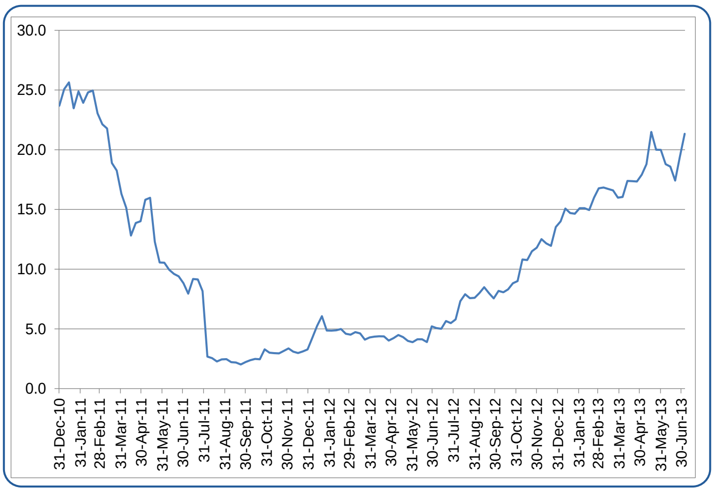
Source: Bloomberg, Anchor Capital calculations

Our earnings forecasts are more bullish than that of the market, but are reliant on key commodity prices not rising from current levels. At a 12-month forward 14x P/E multiple (Bloomberg consensus = 15x), we think the stock looks cheap when considering the return profile of the business and likely earnings trajectory over the next few years.

Figure 14: Pandora share price (DKK218)

Source: Bloomberg

Figure 15: Pandora trailing P/E multiple



Source: Bloomberg

Figure 16: Typical examples of Pandora jewellery

Source: Pandora

Sean Ashton

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