Business Analysis and Valuation on the Burberry Group

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Abstract. This paper aims to give the shareholders reasonable recommendations on buying, holding or selling Burberry’s shares. It takes account of the business strategy, and ratios from financial statements, presented in Part 2 and 3. We consider the competitive forces of Burberry using Porter’s five-force framework. Then, we analyse Burberry’s financial conditions comparing with LVHM and come to the conclusion that although the ROE is declining, Burberry has a better ratio of ROE than most of its competitors. Finally, we forecast the key index in Part 4 and then use different models on valuation of the firm in part 5. A conclusion can be made that Burberry’s share price will increase in the future, thus we recommend that Burberry’s shareholders can hold and buy more stocks to gain the yields from dividend and rise in stock price.

Burberry’s Industry & Company Strategy Analysis

Industry Analysis

In the past five years, although the increase of consumers drives the emerging market to robust, the luxury market met a challenge of economies headwinds. The luxury price increases from 10% to 15% to control the devaluation of sterling, while some objective macro factors slightly worsen the performance of luxury business. Meanwhile, geopolitical concerns also impact GDP and the return of equity.

Company Analysis

Threat of New Entrants. The threat of new entrants to Burberry is relatively small. Burberry has established a potential entry barrier: a huge number of money has been designed to provide a sensitive supply chain, which can save time and cost to the maximum extend and satisfy the high quality requirements of production.

Rivalry among Existing Firms. With the popularity of the internet business and the rising cost of shop, Burberry focuses on the electricity supplier and digital and plays a cost advantage. However, with other luxury brands have joined the digital army, Burberry’s pioneer advantage disappeared. On the whole, the luxury market competition is still fierce.

Threat of Substitute Products. The threat of substitute products can have different results with different groups. For people who cannot afford luxury goods, the threat of substitute products is high, because the emergency of new brands with lower price, super imitation ability and fakes of luxury goods have caused great pressure on the existing luxury brands. Obviously, there are no substitute products for the loyal consumers of Burberry.

Bargaining Power of Buyers. Burberry’s bargaining power of buyers is low. The consumption of Burberry for high-income group is higher than that for other groups. This group is highly sensitive to fashion and has a certain ability to consume.

Bargaining Power of Suppliers. Burberry’s bargaining power of suppliers is low. This is mainly because Burberry take the way to obtain stable raw materials from the group internal factories and small order from external raw material suppliers in order to give full play to the competitive advantage and control the cost from the most primitive raw material link.

In conclusion, luxury market has high barriers to entry. In addition, there is small bargaining power of buyers and suppliers.
Ratio Analysis

Overall ROE Performance of Burberry

The table 1 shows the ROE of Burberry from 2012 to 2017. It is obvious that there exists a decline trend, which is partly due to the sluggish economies and the downturn of the luxury goods market from 2012.

| Year | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|------|------|------|------|------|------|------|
| ROE(%) | 29.74 | 24.62 | 27.51 | 23.50 | 19.41 | 16.95 |

The table 2 shows the movement of ROE among four luxury companies. As it illustrates, Burberry does not get an abnormally high or low ROE. And its ROE is relatively higher most of the time than LVMH and Dior, which is due to its competitive strategy of digital sales that helps to increase its profit. Thus, Burberry is relatively competitive in luxury industry.

| Year | 2013 | 2014 | 2015 | 2016 | 2017 |
|------|------|------|------|------|------|
| LVMH(%) | 15.32 | 14.24 | 26.54 | 15.51 | 15.64 |
| Prada(%) | 28.54 | 30.21 | 25.07 | 15.85 | 10.88 |
| Burberry(%) | 24.62 | 27.51 | 23.50 | 19.41 | 16.95 |
| Dior(%) | 14.76 | 13.58 | 11.90 | 21.38 | 14.70 |

ROE Decomposition Analysis

To further investigate which factor leads to the decline of ROE and why Burberry has a higher ROE, in figure 1 we use Du Pont analysis and compare Burberry with its historical performance and LVMH.

| Comp. | 1-Tax/EBT | EBIT/Rev. | Rev./TA | 1-Int./EBIT | 1+Debt/Equity |
|-------|-----------|-----------|---------|-------------|---------------|
| Burberry | 1-0.27 | 0.14 | 1.15 | 1-0 | 1+0.42 |
| LVMH | 1-0.33 | 0.18 | 0.63 | 1-0.06 | 1+1.14 |

From the table 3, we notice that the profitability and gearing both account for the decline of ROE compared to LVMH. To further investigate profitability, we find in the table 4, the GPM of Burberry is higher than that of LVMH, but Burberry’s NPM is lower, which is well explained by the previous strategy analysis that Burberry is spending large amount of money in building and reinforcing its brand positioning.
Table 4. Profitability ratio of Burberry and LVMH.

| Profitability          | Burberry | LVMH |
|------------------------|----------|------|
| Gross Profit Margin(GPM) | 0.699    | 0.653|
| Net Profit Margin(NPM)  | 0.104    | 0.116|

**Reason for Burberry’s higher ROE.** From the table 5, we can find that Burberry has a higher ATO than LVMH. Since LVMH is a large group, it expands more than Burberry, thus leading to higher assets, especially the higher intangible assets due to brands. We can conclude that the decline of ROE is mainly due to its profitability and financial leverage either from its historical performance or the comparison with its rival. However, Burberry’s higher ATO will help to maintain the high level of ROE in the luxury industry.

Table 5. Asset turnover of Burberry and LVMH.

| ATO          | Burberry | LVMH |
|--------------|----------|------|
|              | 1.15     | 0.63 |

**Forecast**

**Assumptions**

Based on the previous 6-year ROE analysis of Burberry and mean reversion theory, we predict that the ROE will decline in the next three years.

Table 6. Estimation of ROE.

| Year | 2018 | 2019 | 2020 |
|------|------|------|------|
| ROE(%) | 16   | 15.5 | 15   |

To be prudent, we assume the PM will slowly decline as follows. Of course, the PM will have a recovery if the brand positioning is completed.

Table 7. Estimation of profit margin.

| Year | 2018 | 2019 | 2020 |
|------|------|------|------|
| PM(%) | 9.4  | 8.9  | 8.6  |

The gearing tends to be stable, since the capital structure of a company will not change on a regular basis. Therefore, we assume the gearing to remain 0.42 in the following three years.

We assume the dividends paid out from 2018 to 2020 increase with a constant change as that in 2017 for simplicity.

Table 8. Estimation of dividend.

| Year | 2018 | 2019 | 2020 |
|------|------|------|------|
| Dividend | -170.6 | -176.7 | -182.8 |

**Valuation**

Based on the above forecast, we use Dividend Discounted Model(DDM) and Residual Earnings Model(RE) to valuate Burberry’s worth.

According to formulas of two models, there are two crucial factors, growth(g) and cost of equity(r_e). We use data in 2018 as benchmark.

Table 9. Calculation of g.

| ROE(2018) | Retention rate(b) | Growth(g)=ROE*b |
|-----------|-------------------|-----------------|
| 16.95%    | 42.82%            | 7.26%           |

According to equation 1, 2, we can computed RE, Div. and AEG as table 11,12 and 13.

\[ RE_t = (ROE_t - r_e) \times B_{t-1} \]  

\[ r_e = r_f + \beta (r_m - r_f) + r_{aev} \]
Table 10. Forecast of dividend.

| Dividend_{(2019)} | Dividend_{(2020)} | Dividend_{(Terminal)} |
|-------------------|-------------------|-----------------------|
| 176.7             | 182.8             | 196.1=182.8*(1+7.26%) |

Table 11. Forecast of RE

| RE_{(2019)} | RE_{(2020)} | RE_{(Terminal)} |
|-------------|-------------|-----------------|
| 120.3       | 117.7       | 126.2=117.7*(1+7.26%) |

According to equation 3 and 4, we conclude the value of equity in 2019 is £10267.1m, £8323.7m, respectively.

\[
V_0^E = \sum_{t=1}^{T=3} \frac{d_t}{(1 + r_c)^t} + \frac{1}{(1 + r_c)^T} \frac{d_{T+1}}{r_c - g}
\]  

(4)

\[
V_0^E = \sum_{t=1}^{T=3} \frac{RE_t}{(1 + r_c)^t} + \frac{1}{(1 + r_c)^T} \frac{RE_{T+1}}{r_c - g}
\]  

(5)

Summary

| Beginning book value | Value from forecast period (2018-2020) | Value beyond forecast horizon (terminal value) | Total Value |
|----------------------|----------------------------------------|-----------------------------------------------|-------------|
| DDM                  | N. A.                                  | 447.9                                         | 9819.2      | 10267.1 |
| RE                   | 1697.8                                 | 305.2                                         | 6320.7      | 8323.7 |

Based on 1842P per share and ordinary shares (445,173,065) from Burberry Financial Report, the market value of Burberry is £8200m in May 2019 which is lower than valuation of equity.

In conclusion, Burberry has advantages in luxury market because of its leadership in digital sales, products innovation and maintaining stability in the long-run growth of revenue. Burberry takes conservative policies to hedge against risk in luxury industry. On account of ratio analysis, Burberry behaves well in ROE. Thus, we recommend that shareholders can continue to hold or buy more shares of Burberry.

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