Visions are changing

- Providing a more holistic view of the eyewear industry. We broaden our eyewear coverage by initiating on Essilor (Outperform, TP €127), GrandVision (Underperform, TP €19) and Safilo (Neutral, TP €6). This broadens our coverage to include all of the key eyewear players, enabling us to provide a more detailed industry view. This comes at a time of considerable change with the launch of the mega-merger between the two largest players in the industry: Essilor and Luxottica.

- Three areas of differentiation. i) We initiate on Essilor and provide a detailed pro forma EssilorLuxottica model and explicit synergy forecasts. ii) We dissect the online vs. omni-channel dynamics, turning more bearish on the impact of online on the eyewear industry, especially for retailers. iii) Using the Optical Business Barometer, a survey carried out by Jobson Optical Research covering c300 ECPs in the US, we can provide a more transparent view of the largest eyewear market. We find sentiment in the US is improving, supporting our company forecasts.

- Essilor (O/P, TP €127) and Luxottica (O/P, TP of €58 increased from €50). Essilor and Luxottica have traded sideways over the past month after losing some of the share price gains made on the day of the merger announcement. We see this as an attractive entry point into both names as, combined, we expect EssilorLuxottica to grow faster than the market, with greater margin accretion than the two companies would generate separately. Supported by strong cash generation, we forecast a 15% TSR from FY17-19e. (full note here)

- GrandVision (U/P, TP €19). Following our analysis of online and what it means for pure play retailers and industry profitability, we are more bearish on GrandVision. We believe medium-term earnings are at risk GrandVision will need to invest more significantly in omni-channel and reduce store expansion, in our opinion. (full note here)

- Safilo (N, TP €6). Safilo could be an attractive turnaround story as it implements its ‘2020 Vision’ strategic plan, addressing inefficiencies in its operations and promoting its own brands. However risks around licenses (especially Dior) leave us cautious at this stage. (full note here)
Table of contents

Key charts 3

Investment thesis 4
Outperform-rated stocks .................................................................4
Neutral-rated stocks ....................................................................5
Underperform-rated stocks ..........................................................5
Valuation and operating metrics.....................................................6

Sector review 8
Underlying market trends remain constructive .........................9
EssilorLuxottica would be best placed to capture profits ............14

Key theme #1: EssilorLuxottica highlights the need for new growth 15
A wave of eyewear consolidation ...............................................15
Consolidation will continue in the eyewear industry .................18
Essilor/Luxo acquisition history has been strong ..................19

Key theme #2: Online vs Omni channel 23
Omni-channel better placed in developed markets ..................23
Store rationalization will have to happen regardless ...............26
Profit implications are negative for online .........................29
Stock implications from our online analysis .......................31
Proprietary e-commerce survey .............................................33

Key theme #3: The US 37
Luxottica Group (LUX.MI) ...........................................................45
GrandVision N.V (GVNV.AS) .......................................................46
Essilor International SA (ESSI.PA) .............................................47
Safilo Group Spa (SFLG.MI) .........................................................48
Key charts

Figure 2: We believe the eyewear market’s strong underlying growth drivers remain intact

Estimated eyewear market segment size at retail value (£b, lhs), forecasted 3 yr CAGR, cc growth (%, rhs)

Source: Euromonitor. Historical constant 2016 prices, forecast constant 2016 prices

Figure 3: Analysis suggests lens finishing in labs has the largest profit pool along the value chain

y-axis: CFROI – discount rate, x-axis: proportion of total gross investment base; (134.33 Yen/€), FY15

Source: Company data, Credit Suisse HOLT®, Credit Suisse research

Figure 4: The eyewear industry remains very fragmented with consolidation likely to continue

% of total optical retail sold through the internet channel

Source: Essilor FY15 results presentation

Figure 5: We grow more constructive around online, estimating it to become 10% of sales by 2025e

Source: Euromonitor, *Eyewear data Essilor 2014 Investor day, Credit Suisse research

Figure 6: We expect online to increase pricing competition and negatively impact industry profits

Variation in frame and lens prices across countries, local currency

Source: Company data, Credit Suisse research

Figure 7: We introduce the OBB which suggests sentiment in the US optical market is improving

Across the entire US, how do think the overall optical business trend will be for the next 6 months

Source: Jobson Optical Business Barometer (OBB)
Investment thesis

Outperform-rated stocks

**Essilor: Initiate with an Outperform rating** ([Full note](#)). Recent share price weakness opens up an attractive entry point into Essilor and the EssilorLuxottica story, in our view. Valuation on 12-month forward EV/EBIT is trading back below EssilorLuxottica’s ex synergy average of 17.3x at 15.6x EV/EBIT on our FY18 pro forma numbers. We believe the companies will outperform in the long term as the merger should address many of their individual legacy problems and could end the capital-intensive diversification story at Essilor.

We believe the market is underestimating the synergy potential. We estimate only c€150m (NPV) of synergies are currently priced in, based on a comparison of the market caps of both companies pre and post announcement and a WACC of 7%. Management has guided towards an EBIT impact from synergies over the mid-term of €400-600m. We forecast peak synergies of €540m by FY21 split evenly as per guidance between revenue-driven synergies and cost-driven synergies. This leaves us forecasting a pro forma TSR over the next three years of 15%, higher than our underlying estimates for Luxottica and Essilor individually.

**We set our target price at €127.** Our target price for Essilor is backed out of our pro forma EssilorLuxottica merger model, as we believe the merger will go ahead. The pro forma model is built up from our underlying Essilor model (as detailed in the financial tables in the separate initiation note published today: [Seeing EssilorLuxottica clearly](#)), underlying Luxottica model and estimates of synergies on the revenue and cost lines. We then use a DCF with WACC of 6% and our Credit Suisse HOLT® Linker to reach our target price of €127. On our target price and FY18 pro forma EBIT we believe the company will trade on an EV/EBIT multiple of just under 18x. This is ahead of the historical EV weighted average but justified in our opinion given the higher barriers to entry and greater competitive advantage we believe the combined entity will have.

**Blue Sky valuation of €137, grey sky valuation of €90.** Our Blue Sky scenario assumes EssilorLuxottica can implement synergies faster, grow further ahead of the market and generate greater margin improvements than assumed in our base case. This leads to a 10% increase in operating profit for FY18. Taking the historical EV weighted average EV/EBIT multiple of Essilor and Luxottica of 17x, leads to a Blue Sky valuation for Essilor of €137. Our Grey Sky scenario assumes the merger does not go through and FY18 operating profits are reduced by 15% as the eyewear market sees a marked slowdown in growth and Essilor’s relationship with the independents suffers from the launch of the merger. Using an average historical multiple of 16x leads to a Grey Sky valuation for Essilor of €90.

**Key risks to our investment thesis for Essilor.** We highlight the following key risks to our investment thesis: i) the merger does not go through either because it is rejected by Essilor shareholders at the annual shareholders’ meeting on 11 May (two-thirds must vote in favour for it to be approved) or anti-competition authorities rule against it; ii) the eyewear industry sees a material slowdown in underlying growth; iii) EssilorLuxottica loses wholesale market share as independents move away from the larger conglomerate; or iv) the merger goes through but is executed poorly.

**Luxottica: Reiterate Outperform** ([Full note](#)). We do not believe the proposed merger with Essilor derails the equity story for Luxottica. We expect the self-help initiatives to be run to completion and with the help of Essilor some of the legacy issues to be solved. For example, Luxottica can leverage Essilor’s relationship with the US independents, can benefit from insourcing of lens costs and develop LensCrafters omni-channel faster with Essilor’s online expertise.
Increase our target price to €58 (from €50). Given the terms of the deal specify an explicit exchange ratio of Luxottica shares for Essilor shares, with one Luxottica share equal to 0.461 Essilor shares, we back out our Luxottica target price from our pro forma Essilor target price. This leaves us forecasting a €58 target price for Luxottica. Similarly our Blue Sky scenario is backed out of Essilor’s Blue Sky valuation of €137, giving €63.

Grey Sky scenario assumes the merger does not happen. Luxottica’s Grey Sky valuation is based on the underlying Luxottica operating profit for FY18 declining by 15%. We assume the merger does not go through, LensCrafters does not reaccelerate growth and North America wholesale organic growth does not re-accelerate after it laps the impact of the MAP policy. Applying Luxottica’s 10-year average EV/EBIT multiple of c15x leads us to a Grey Sky valuation of €41.

Neutral-rated stocks

Initiate on Safilo with a Neutral rating. Although we think Safilo looks relatively attractive on valuation (EV/Sales), we do not see this as a good time to buy the name. Admittedly, we see the potential for a turnaround story as the company implements its ‘2020 Strategic plan’. This includes such initiatives as SAP implementation, insourcing of volumes and cost savings of €25-30m from FY17-19, which could support margin accretion and topline outperformance. However, we are not fully assured that Safilo’s earnings are no longer at risk from further licences leaving or that the investment plan will not be derailed by the loss of licences or be executed poorly. The company’s revenues are still overexposed to licenses, at 75%, and its own brands are struggling to gain momentum. Moreover, based on the recent commentary from LVMH and its JV with Marcolin for its eyewear brands, we think Dior is likely to leave at the end of its contract in December 2020. We estimate that the Dior license and LVMH licenses account for almost a quarter of Safilo’s annual sales.

Valuation looks stretched on EV/EBIT but undervalued on EV/Sales. Following FY16 results we look at EV/Sales given the volatility of the earning story. On this metric the company is trading on a 0.4x multiple on our FY18e, below history of 0.7x and the eyewear sector of 3x. If we look at the normalized EV/EBIT multiple over the next 5 years on our adjusted EBIT forecasts the stock trades on 20x, ahead of its historical average of 10x.

Target price set at €6. Our target price is based on an average of a DCF and our Credit Suisse HOLT Linker™ valuation. We remain conservative with our DCF metrics, with a 1.5% long-term growth rate, 3.5% operating margin and 8% WACC. Our Blue Sky scenario assumes the company is able to execute the ‘2020 Vision’ plan fully and meet its targets, accelerates the turnaround of the own brand portfolio and executive cleanly on the EyeWay transformation. This gives scope for a 10% increase in earnings, in our view. Applying a multiple of 13x, 1std deviation from the historical average EV/EBIT multiple gives us a Blue Sky valuation of €10. Conversely if the company suffers further deterioration of own brands and EyeWay does not go as planned, introducing new disruption, we see the potential for a 25% decrease in operating profit. Applying a trough EV/EBIT multiple of 7x leads to a Grey Sky valuation of €3.

Key risks to our investment thesis for Safilo. On the downside: i) Dior terminates its contract earlier than expected, ii) the own brands do not regain momentum; iii) the ‘2020 Strategic plan’ is executed poorly. To the upside: i) Dior does not leave; ii) own brands reaccelerate growth; iii) the company is able to buy in another strong brand with the help of HAL Holding (majority shareholder).

Underperform-rated stocks

Initiate on GrandVision with an Underperform rating. The stock price is up just over 20% since its trough in December 2016. This is against the Amsterdam Index up 14% over the same period. Given there have been limited consensus earnings upgrades,
this has led to a recovery in EV/EBIT multiples from a trough of <14x. Although it still trades broadly in line with its historical levels of 16.5x (albeit over a short history) at c16x, when we compare it with a basket of European retailers and Specialty retailers, it sits at a 31% premium on 12-month forward EV/EBIT compared to a historical premium of 26%. We believe the company is underestimating the impact of online and underinvesting in the channel. To remain competitive, we think GrandVision will have to significantly increase investments and – as we expect online to be a lower-margin channel – is likely to face margin pressure in the future. Moreover, we believe most of the initiatives the company has deployed since FY11 to grow margins are now largely played out. We therefore expect EBITDA margins to plateau after FY19 at just over 16%.

**Target price set at €19.** Our target price is a simple average of a DCF and our HOLT Linker. Our DCF uses a WACC of 8% and terminal growth rate and margin of 3% and 10%, respectively. We calculate our Blue Sky scenario assuming the company can resist profit pressure from omni-channel initiatives and the move to online eyewear sales happens at a slower rate. This gives around 15% potential upside to our profit numbers. We apply an EV/EBIT multiple of at least one standard deviation above the historical average, giving a Blue Sky valuation of €30. We base our Grey Sky scenario on further channel shift to online and over expansion of retail outlets. Additionally we assume no positive impact from deregulation in France. This leads to our forecast operating profit being 25% lower than our current estimates. We then apply an EV/EBIT multiple of at least one standard deviation below the historical average, deriving a Grey Sky valuation of €16.

**Key risks to our investment thesis for GrandVision.** i) online channel does not take off; ii) the US faces significant de-regulation; iii) management moves into lens finishing which improves margins; and iv) consumers become more promotion–driven, supporting topline outperformance.

**Valuation and operating metrics**

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**Figure 8: Eyewear sector valuation table**

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Elizabeth</td>
<td>O</td>
<td>110.5</td>
<td>127.2</td>
<td>15%</td>
<td>24.26</td>
<td>25.58</td>
<td>19.0</td>
<td>15.0</td>
<td>3.3x</td>
<td>3.3x</td>
<td>14.1x</td>
<td>19.5x</td>
<td>3.1x</td>
<td>3.1x</td>
<td>0.1%</td>
</tr>
<tr>
<td>GrandVision</td>
<td>U</td>
<td>23.1</td>
<td>19.3</td>
<td>(17%)</td>
<td>8.94</td>
<td>6.514</td>
<td>22.5</td>
<td>21.6x</td>
<td>1.9x</td>
<td>1.8x</td>
<td>11.5x</td>
<td>10.8x</td>
<td>15.5x</td>
<td>15.5x</td>
<td>3.9x</td>
</tr>
<tr>
<td>Luxottica</td>
<td>O</td>
<td>58.9</td>
<td>58.9</td>
<td>16%</td>
<td>24.26</td>
<td>24.894</td>
<td>26.2x</td>
<td>23.1x</td>
<td>2.5x</td>
<td>2.4x</td>
<td>12.3x</td>
<td>11.1x</td>
<td>16.8x</td>
<td>16.0x</td>
<td>2.0x</td>
</tr>
<tr>
<td>Safilo</td>
<td>N</td>
<td>7.6</td>
<td>7.6</td>
<td>(9%)</td>
<td>412.50</td>
<td>502</td>
<td>32.1x</td>
<td>30.6x</td>
<td>3.8x</td>
<td>3.7x</td>
<td>15.2x</td>
<td>17.2x</td>
<td>21.2x</td>
<td>20.1x</td>
<td>-</td>
</tr>
<tr>
<td>Fielmann</td>
<td>NC</td>
<td>72.1</td>
<td>NA</td>
<td>NA</td>
<td>6,014</td>
<td>5,711</td>
<td>32.1x</td>
<td>30.6x</td>
<td>3.8x</td>
<td>3.7x</td>
<td>15.2x</td>
<td>17.2x</td>
<td>21.2x</td>
<td>20.1x</td>
<td>2.7%</td>
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<td>Fielmann</td>
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<td>5,424</td>
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<td>17,329</td>
<td>17,326</td>
<td>32.1x</td>
<td>29.6x</td>
<td>4.2x</td>
<td>4.1x</td>
<td>14.4x</td>
<td>13.7x</td>
<td>8.3x</td>
<td>NA</td>
<td>1.6%</td>
</tr>
<tr>
<td>Global average</td>
<td></td>
<td></td>
<td></td>
<td>76,666</td>
<td>25.6x</td>
<td>23.2x</td>
<td>3.2x</td>
<td>3.8x</td>
<td>15.7x</td>
<td>12.7x</td>
<td>15.8x</td>
<td>16.3x</td>
<td>1.7%</td>
<td>1.8%</td>
<td>NA</td>
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Source: Company data, Credit Suisse estimates, Thomson Reuters; Priced as of close on 14 March
Figure 9: European retailing and specialty retailing peers

<table>
<thead>
<tr>
<th></th>
<th>EV/EBIT CY17e</th>
<th>EV/EBIT CY18e</th>
<th>P/E CY17e</th>
<th>P/E CY18e</th>
</tr>
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<td>Hennes &amp; Mauritz</td>
<td>14.4</td>
<td>12.6</td>
<td>18.9</td>
<td>16.7</td>
</tr>
<tr>
<td>Inditex</td>
<td>20.3</td>
<td>18.1</td>
<td>26.0</td>
<td>25.2</td>
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<td>Marks &amp; Spencer</td>
<td>10.5</td>
<td>10.1</td>
<td>11.4</td>
<td>11.1</td>
</tr>
<tr>
<td>Next</td>
<td>8.9</td>
<td>9.7</td>
<td>9.8</td>
<td>10.6</td>
</tr>
<tr>
<td>OVS</td>
<td>9.3</td>
<td>7.8</td>
<td>13.2</td>
<td>11.6</td>
</tr>
<tr>
<td>XXL</td>
<td>17.4</td>
<td>14.0</td>
<td>21.4</td>
<td>17.0</td>
</tr>
<tr>
<td>Matas*</td>
<td>10.6</td>
<td>11.4</td>
<td>10.3</td>
<td>10.8</td>
</tr>
<tr>
<td>KappAhl*</td>
<td>8.2</td>
<td>7.5</td>
<td>11.5</td>
<td>10.3</td>
</tr>
<tr>
<td>SportsDirect Int.*</td>
<td>14.2</td>
<td>12.9</td>
<td>18.7</td>
<td>17.0</td>
</tr>
<tr>
<td>Dufry</td>
<td>26.3</td>
<td>22.3</td>
<td>16.4</td>
<td>14.5</td>
</tr>
<tr>
<td>Kingfisher</td>
<td>10.1</td>
<td>8.7</td>
<td>12.0</td>
<td>10.5</td>
</tr>
<tr>
<td>Dixons Carphone</td>
<td>6.8</td>
<td>6.2</td>
<td>9.4</td>
<td>8.8</td>
</tr>
<tr>
<td>Pets at Home Group*</td>
<td>10.1</td>
<td>9.8</td>
<td>12.4</td>
<td>11.9</td>
</tr>
<tr>
<td>European retail simple avg.</td>
<td>12.9</td>
<td>11.6</td>
<td>14.9</td>
<td>13.5</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse estimates, Thomson Reuters, * consensus numbers, Priced as of close on 14 March
Sector review

We add Essilor, Safilo and GrandVision to our eyewear coverage. Given the announcement on 16 January 2017 that Essilor and Luxottica have agreed to merge, targeting completion in 2H17 (assuming all necessary approvals are received), we initiate on Essilor as a standalone company with a fully working pro forma model of the new EssilorLuxottica entity.

- For now Essilor International is a €24bn market cap company, generating c€7.1bn in revenues in FY16. While Luxottica is the leading manufacturer and distributor of high-end branded frames, Essilor is the leading manufacturer and distributor of lenses. The company also has some exposure to sunglasses and online platforms providing direct-to-consumer access.
- GrandVision is a €6bn market cap company and generated c€3.3bn in revenues in FY16. It sits at the high end of the value chain as a pure play optical retailer.
- Safilo’s business model is most similar to Luxottica’s, but with lower retail exposure and on a smaller scale. The company manufactures branded frames under own brand labels and license agreements. It generated c€1.3bn in revenues in FY16 and has a market cap of c€400m.

Figure 10: An overview of the eyewear value chain and key players. We discuss where the profit lies later in this section

Eyewear value chain

Chemical companies and glass manufacturers
Luxottica
Safilo
Essilor through Bolon brand
Fielmann
Rodenstock

Other generic/branded manufacturers

Raw material supplier

Frame manufacturer

Lens manufacturer

Lens lab

Retail store / online

Luxottica
Hoya
Essilor
Independent Labs
Essilor
Luxottica

Fielmann
Younger
Carl Zeiss
Carl Zeiss
GrandVision – no finishing
Fielmann

Other integrated manufacturers with labs
Optical chains with integrated labs
Online with integrated labs

Other integrated manufacturers with labs
Mass retailers
Non-integrated chains

Source: Company data, Credit Suisse research

We estimate a global sell-out market share based on a €96bn industry. There are many ways to calculate market share for these companies, given: i) the broad definition of the eyewear industry, which can include sunglasses, prescription (Rx) glasses, contacts and surgery; and ii) the companies’ mixes of retail vs. wholesale. For Essilor the company states it has a c40% market share of the lens industry based on volumes, with Euromonitor estimating a c30% market share based on retail value. For Luxottica and Safilo we have market share data from Euromonitor for the frames, sunglass and luxury eyewear markets (see Figure 12). Essilor estimates the global sell-out value for contact lenses, spectacle lenses, readers, sunglasses and frames is c€96bn in FY15 (source FY16 results presentation). Using this we find GrandVision has a market share of c3%, based on FY15 revenues. Additionally, assuming a 2x markup between wholesale and sell-out revenue, Luxottica would have a c13% market share, Essilor c14% and Safilo c3% of the global retail sell-out.
The new EssilorLuxottica entity would therefore be the market share leader by far. This is not new to the market and could be a sticking point for some investors who believe the planned merger may face significant scrutiny from anti-competition authorities. In the merger presentation, released with the announcement, the companies gave market share data by region. We extend this analysis with market share by product category (see Figure 13 and Figure 14).

Underlying market trends remain constructive
Eyewear market expected to grow at 3% CAGR to 2019. In Figure 15 we detail the current size and expected future size of the overall frames, lens and sunglass market, breaking out expectations around the luxury subsector – sunglasses and spectacle frames. Currently the frame market sits at €32bn based on retail value and the lens market at over €42bn. These markets are both expected to grow at an average CAGR of 2% over the next three years, according to Euromonitor. The Luxury segment (which includes luxury frames for prescription glasses and luxury sunglasses) is set to grow faster than the industry as a whole, favouring Luxottica’s and partly Safilo’s product exposure. Luxury sunglasses are forecast to grow at 8% over the next three years and luxury spectacle frames at 5%. Both of these markets currently sit at €68bn based on retail value.
Sunglasses continue to grow ahead of the prescription market. The broader sunwear market is expected to grow by 6-7% per annum to 2018, according to Essilor. We note this is double Euromonitor's expectation, at 3%. The luxury sunglass segment is set to grow by c8% (source: Euromonitor). The market can be split into three segments: luxury fashion, performance and entry/mid-tier. The luxury segment is the largest by value. Euromonitor calculates that it was worth c€8bn in 2015. However, on volumes the luxury segment is the smallest at c28m units (source: Euromonitor) while entry/mid-tier accounts for >500m units and performance for 25-30m units.

A more cyclical, discretionary purchase... Although the sunglasses market is expected to grow at almost double the rate of the prescription market, it is more exposed to cyclical trends such as the weather. We have seen this more recently for both Essilor and Luxottica, with weak sun sales in 2Q16 because of unfavourable summer weather conditions in North America.

Figure 16: Luxury sunglass segment to grow at c8% over the next three years, ahead of the market
Volume, value, ASP split of growth for luxury sunglasses, %

... which plays into affordable luxuries. However, we believe this category is becoming increasingly important to investors looking for exposure to the Luxury space given sunglasses fall under 'affordable luxuries'. Although we look at the eyewear category in terms of GDP and disposable income, when we think of it in the context of the Luxury space we focus on wealth accumulation. The Credit Suisse Research Institute recently reduced its medium-term forecasts for global wealth accumulation from 7% to 5%. We
believe this will drive lower growth of higher-priced luxury goods. As such, we believe affordable luxuries will outgrow high-end luxuries in the medium term.

**We reiterate our positive stance on the eyewear industry.** In our initiation of Luxottica last June (Attractive entry point for the long-sighted, 15 June 2016) we walked through the underlying growth drivers of the eyewear industry, particularly prescription (Rx) and luxury sunglasses. We reiterate this positive view as:

1. **Vision correction remains an underpenetrated market.** Of the global population (7.2bn), 63% need vision correction according to Essilor. However, only 1.9bn (i.e. 42% of those requiring correction) are in fact corrected. Given eyeglasses account for 86% of the vision correction in the world (source: Essilor Investor Day 2014) there is a clear preference for this correction solution across developed and emerging consumers. Additionally, with only c30% of the world's population owning a pair of sunglasses and 10% of Rx wearers owning prescription sunglasses (see Figure 17), this product category is also significantly underpenetrated.

2. **Demographics are still supportive.** As development of long sightedness (or presbyopia) is an age-related process, ageing populations provide a significant contribution to the growing number of people that require vision correction. Essilor expects the number of people with presbyopia to increase at a CAGR of 2.5% between 2015 and 2030 (source: FY15 results presentation).

3. **Move to online and increased ‘screen time’ is also supportive.** Although this has not been clinically proven to cause direct eye damage, the strain it causes can contribute towards the occurrence of myopia or shortsightedness. Essilor forecasts the number of people suffering from myopia to increase from 1.7bn in 2015 to 2.7bn in 2020, a CAGR of 3.3% (source: FY15 results presentation). Myopia is corrected by simple single vision lenses and as lens innovation turns to more preventative solutions, vision damage from screens has opened up a new category of lens innovation with anti-blue light properties.

4. **Emerging market story remains.** Figure 18 shows the positive correlation between consumer wealth and spending on lenses, as the lens spending per capita (y-axis) increases as GDP per capita increases (x-axis). The ability to afford vision correction is more often a limiting factor for EM consumers, and of the 2.5bn people requiring...
vision correction worldwide in 2013, c95% were in emerging markets (source: Essilor). We therefore see the growing middle class and increasing disposable incomes in emerging markets as positive trends for this industry (see Figure 19). Moreover, the development of the online channel opens up distribution and education, supporting growth.

5. **Premiumisation makes developed market opportunities as attractive as emerging markets.** Developed market growth is also supported by the potential for shortening replacement cycles and driving multi purchases. Premiumisation has had a greater influence on the frames market given consumer habits. Estimates from Euromonitor suggest the luxury spectacle frames market has outgrown the overall spectacle frames industry since 2011 although was subject to a greater deceleration during the financial crisis, see Figure 22. Splitting the components of growth into volumes and ASP, we have seen lower volume growth from the luxury segment which has been compensated by a higher degree of pricing power. We find a c500bps growth differential between the ASP of luxury spectacle frames and the total spectacle frames market industry (see Figure 23).

6. **Premiumisation is a lens story, as well as a frame story.** For lenses, the process of trading up is more technical, looking to add layers with additional properties; e.g. anti-UV. Given 70% of the lens EBIT value comes from coatings and materials, (source: Essilor FY14 investor day), and these only come at an incremental cost to the
manufacturer, this clearly provides a positive mix contribution. The prescription lens market is expected to grow by 3-4% over the next three years (source: Essilor FY15 results presentation).

We see four negatives for the industry at this stage:

1. **Online may help topline but will suppress industry profits.** Although we remain positive around the underlying growth trends for Rx and sun, online does have the potential to disrupt industry growth. Overall we expect online to be positive for the topline growth in emerging markets as it opens up distribution and awareness in countries that lack infrastructure and education around eye health. We expect the additional volumes here to outweigh the pricing pressure it brings in developed markets. However, it also has the potential to shift revenues to new more online-focused players from more established players that are perhaps slow to invest in the channel. Additionally and more importantly, we believe online has the potential to depress industry profits as investing in the channel and providing basic e-commerce functionalities such as free returns all come at a considerable cost.

2. **And 2016 has seen a strong deceleration in growth.** Looking at the Euromonitor data for 2016, overall eyewear industry constant currency growth decelerated from +3% in 2015 to flat in 2016 as spectacle frames and lenses fell from +2% and +5%, respectively, to 0%. This was the first time in five years the industry reported almost no growth. The luxury segment saw stronger growth, with luxury spectacle frames maintaining growth at 4% in 2016 while sunglasses continued to grow by high-single digits (8.5% 2015 vs. 7.5% 2016). We believe this slowdown was driven largely by the US, the world’s largest eyewear market, where growth slowed across the retail industry and consumers were more focused on the election at the end of the year. Essilor estimates the US market is worth $30bn based on the sell-out value for contact lenses, spectacle lenses, readers, sunglasses and frames (source: Essilor US Field Trip), out of a total of €96bn – i.e. the US is c30% of the market.

3. **Contacts could gain market share.** We do not currently see contacts as a significant threat to prescription glasses but we continue to monitor this risk. We think consumer engagement remains limited, due to: i) the cost of contacts considering they must be reordered. Clearly there is the option of yearly lenses, but these are arguably easier to lose/break than glasses; ii) consumer comfort; and iii) the hassle around the product. Additionally we find most consumers who use contacts also have a pair of prescription glasses or prescription sunglasses. Therefore, contacts do not completely cannibalise glasses sales but do extend the replacement cycle of the glasses.

4. **Laser surgery remains a potential threat.** Again, similar to contacts, we do not see laser surgery as a significant threat at the moment but will continue to watch for any
change in consumer engagement. We feel consumers still see pricing as too high (varying from £2,500 to £3,200 depending on the type of procedure in the UK, according to lasereyesurgeryhub.co.uk) and are not comfortable with certain aspects of the procedure. Additionally, laser eye surgery is far more established for myopic correction, while presbyopic solutions have struggled to gain significant recognition.

**EssilorLuxottica would be best placed to capture profits**

**The largest profit pool sits with the lens finishing labs.** In this value chain we believe the most lucrative stage is converting the lens puck into a finished prescription lens. This is despite the fact that lens innovation faces considerable pricing pressure. This process involves adding different value-added layers such as anti-reflective coatings and anti UV light coatings that come with significant pricing power and a very limited cost to the manufacturer. In fact, Essilor states the relative margin of selling to an independent optician through a non-owned lab is 50% while through its own lab it is 100% – a 1:2 profit ratio.

**Profit in the value chain sits with Essilor and the new EssilorLuxottica entity.** Using HOLT we assess the current pools of value across the key listed eyewear companies. As separate companies, we find Essilor captures more profit than Luxottica despite Luxottica recording an absolute EBITDA 20% higher than Essilor in FY15 (looking at the areas of the bars in Figure 26). Essilor owns c500 lens labs across the globe and on volume terms finishes c25% of its total lens production volume. Before the launch of the merger, Luxottica had been investing in three centralised lens labs. In Europe this was so the company could offer its wholesale partners lens finishing capabilities for the Ray-Ban brand. Given this analysis of profit pools, we saw this as a positive move for the company to capture more profits of the value chain. As a combined entity, EssilorLuxottica will be able to further increase this exposure and potentially be able to capture the lens finishing profits for all prescription frame sales to wholesale partners.

**Figure 26: Essilor holds the largest profit pool of the eyewear sector**

y-axis: CFROI – discount rate, x-axis: proportion of total gross investment base. (134.33 Yen/€), FY15

**Figure 27: Lens players have highest margins in the eyewear industry**

EBITDA margins for the key industry player

Source: Company data, Credit Suisse HOLT®, Credit Suisse research
Key theme #1: EssilorLuxottica highlights the need for new growth

The eyewear industry remains very fragmented. Essilor quotes over 350,000 independent eye care professionals in the retail landscape and 1,500 to 2,000 other distributors and laboratories (see Figure 28). We believe this fragmentation is in part driven by the nature of the business model. Many of the lens labs and independent eye care professionals are run as family businesses and are supported by their strong consumer/client relationships and customer loyalty. But it is also driven by the regulation around opticians, ophthalmologists and optometrists – ‘The 3 Os’. Although consolidation has been a longstanding theme, we think there is still plenty of scope for this to continue.

Companies have looked to consolidate as they search for new areas of growth. Over the past couple of years we have seen a number of important strategic decisions from the key players, especially more recently with the proposed mega-merger between Luxottica and Essilor. We believe this has been largely driven by the need to find new areas of growth as growth of their traditional businesses arguably starts to roll over (see Figure 29). This is: i) despite the favorable underlying industry growth; and ii) exacerbated by online disruption. Developments online are lowering barriers to entry for new competitors and putting pressure on global brands via increased price transparency.

Figure 28: The eyewear industry remains very fragmented with consolidation likely to continue

Current view of the eyewear industry

<table>
<thead>
<tr>
<th></th>
<th>Prescription lenses</th>
<th>Sunglasses</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturer</td>
<td>ESSILOR</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distributors &amp; Laboratories</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail</td>
<td>350,000+ Eye Care Professionals</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,600 to 2,000 Local operations</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>150 to 200 Small operators</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>250 to 350 Manufacturers</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>619-450 million pairs of non-prescription sunglasses</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>250-300 million pairs of readers</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Essilor FY15 results presentation

Figure 29: Group organic growth for eyewear companies has started to roll over

Constant currency growth of eyewear companies

Source: Company data, Credit Suisse research

A wave of eyewear consolidation

Both Essilor and Luxottica were making tentative steps into each other’s business areas prior to the merger announcement. In Figure 30 and Figure 31 we summarise the key moves we have seen over the past couple of years by the four eyewear stocks under our coverage. Essilor has diversified the most, building a presence in the frame manufacturing space (although small), retail space and e-commerce. Additionally, the company has looked to build up barriers to entry and gain more pricing power by focusing on branded products via the sunglass category (see Figure 31) and investing in advertising for its branded lenses. The company has picked up a number of sunglass own brands (e.g. Costa in the US and Bolon in Asia) as well as license agreements through the Stylemark acquisition (see Figure 33).

We believe this and succession issues at Luxottica triggered the merger. Luxottica, on the other hand, has pushed further into lens labs and lens finishing. The company recently built up its lens finishing capabilities in Europe, centralising its offering so that it could provide lens lab facilities to European wholesale partners. This directly encroaches on Essilor’s business and exposes the company to what we believe is the largest profit...
pool along the value chain. We believe that these moves, plus the fact Leonardo Del Vecchio (the founder and majority shareholder of Luxottica) seemed to be struggling to find a CEO to replace him (given the degree of CEO turnover we have seen since 2014 and his return to an executive role in the company at the start of 2016) could have potentially triggered the merger announcement.

**Figure 30: Company coverage of the eyewear value chain**

Dark blue blocks represent established business lines. Lighter boxes with text represent examples of new business moves.

<table>
<thead>
<tr>
<th>Frame manufacture</th>
<th>Lens manufacture</th>
<th>Lens lab – taking the puck to finished lens</th>
<th>WIS</th>
<th>Retail</th>
<th>Online (ex wholesale)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Essilor</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Small exposure through Bolon acquisition</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Luxottica</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have always had lens labs attached to LensCrafters stores but looking to expand centralised labs and offer to wholesale partners</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>GrandVision</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tech Centers do edging and mounting but no finishing capabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Safllo</strong></td>
<td></td>
<td>Very limited – started pilot with Smith in the US</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Credit Suisse research

**We believe this was earlier than the market expected.** In September 2014, Mr Cavatorta (the interim CEO of Luxottica) said "In terms of Essilor, that was -- that potential deal was explored from both sides more than a year ago. It was least one and a half years ago. And in the end, there was a common thinking between Mr. Del Vecchio, Andrea, myself and the Board, it was shared with them, that there were no -- there were not the right conditions to go ahead with that deal." (source: Thomson Reuters transcript of call on management structure, September 2014). The market therefore knew this deal could be on the table at some point in the future. However, we would have expected it to come at the end of Luxottica’s three-year investment plan detailed in March 2016 as the company arguably would have been in a better position operationally and possibly in a better negotiating position.

**But if the merger was to happen, we think it needed to happen sooner rather than later.** Although these moves were tentative, the companies were clearly investing significantly in capabilities that they could ultimately get from one another. We have mentioned Luxottica’s interest in lens labs, but Essilor also had been expanding its B2C network, especially in the US. This had involved:

i) Purchasing three major doctor alliance groups in the US, serving a network of c7,000 optical retail locations (equivalent to Luxottica’s retail network worldwide and almost double Luxottica’s North America store footprint). These are PERC, VisionSource and Opti-Port. Note that c80% of Essilor’s business is with independents in the US.

ii) Growing its online presence organically and inorganically as a pure-play online retailer.
iii) The acquisition of Photosynthesis Group in China – this company owns multiple retail banners that it franchises out across Asia.

It was clear the company was also warming up to retail (note 99% of Essilor’s revenues are from the wholesale channel excluding online) with management commentary becoming increasingly open to the topic, in our view. Therefore the deal needed to happen sooner rather than later to avoid wasted investments or remove potential synergies/benefits from the deal.

**Figure 31: Company exposure to branded and unbranded components in the eyewear industry**

Dark blue blocks represent established business lines. Lighter boxes with text represent examples of new business moves.

<table>
<thead>
<tr>
<th>Do they sell... (either through the W/S or retail)</th>
<th>Own branded lenses</th>
<th>Unbranded lenses</th>
<th>Own brand sunglass frames</th>
<th>Own brand prescription frames</th>
<th>3rd party brands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Essilor</td>
<td>Not exactly a new initiative but more emphasis on this via dedicated marketing spend</td>
<td></td>
<td>Bought FXI, Xiamen Yanui Optical (Bolon and Molsion brands focused on China), Costa etc.</td>
<td>Expanding some of their brands into Rx e.g. Bolon</td>
<td>Stylemark acquisition came with some license agreements e.g. Reebok</td>
</tr>
<tr>
<td>Luxottica</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GrandVision</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Safilo</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Credit Suisse research

**GrandVision has also looked to push further into branded lenses.** As Essilor has looked to invest more into consumer engagement of its lens brands, GrandVision, one of the largest conglomerates of retail chains, has focused more on its own branded lenses rather than using the lens manufacturers’ brands. According to GrandVision, this is a positive for the suppliers as they no longer need to invest in the merchandising, packaging etc. However, this moves the pricing power and hence profit pool away from manufacturers towards GrandVision. If more retail chains follow suit, we can expect greater margin pressure for the manufacturers.

**Figure 32: Essilor said it does not want to play in the luxury fashion sunglasses segment**

Layout of the sunglass landscape and Essilor brands

Source: Essilor analyst conference 2014

**Figure 33: Essilor does not want to increase its revenue sensitivity to licensed brands**

Essilor split between licensed and own brands and price point exposure for sun and readers division

Source: Essilor US Field Trip, Credit Suisse research

**We would note Essilor’s move into mid-tier sun was a clear negative for Safilo** – even more so after the proposed merger with Luxottica, as Essilor will be able to leverage Luxottica’s frame knowhow. Safilo has a more balanced portfolio than Luxottica in terms of
price points, with mid/entry tier exposure as well as luxury. By buying brands such as Foster Grant and Mustang, Essilor and now EssilorLuxottica is competing directly with Safilo. This investment does not create significant internal competition between Essilor and Luxottica as Luxottica is more focused on luxury branded frames, which Essilor did not venture into.

**GrandVision entered the US with ForEyes, but quality of locations is lacking.** Further to Essilor’s moves in the US, GrandVision has entered the market through the acquisition of the ForEyes retail chain. This chain consisted of 116 stores at the time of purchase and generated €638m in revenues in FY15. Although this network is not significant, it gives GrandVision a foothold for further expansion, encroaching on Luxottica’s retail presence and Essilor via the independent ECPs. However, we would note that the locations – largely suburban retail parks – are different from Luxottica’s LensCrafters locations, which are usually in cities.

**Figure 34: GrandVision is pushing its in-house exclusive brands, which have higher margins**

<table>
<thead>
<tr>
<th>Product</th>
<th>Contribution (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lenses</td>
<td>&lt;5%</td>
</tr>
<tr>
<td>Contact lenses</td>
<td>25%</td>
</tr>
<tr>
<td>Frames</td>
<td>&gt;70%</td>
</tr>
<tr>
<td>Sunglasses</td>
<td>&lt;4%</td>
</tr>
</tbody>
</table>

(Contributions of in-house exclusive brands by volume for GrandVision)

**Figure 35: Only 9% of the cities where LensCrafters is present contain a ForEyes store**

<table>
<thead>
<tr>
<th>Total stores</th>
<th>24%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total cities</td>
<td>9%</td>
</tr>
</tbody>
</table>

(Overlap in store network between ForEyes and Luxottica)

Offering a different value proposition from LensCrafters with reduced overlap of brands. Notwithstanding the lack of high-traffic locations, we would flag that the GrandVision business model is naturally more promotion-driven. We believe price usually contributes negatively to sales year-on-year. Admittedly this may become more relevant to US consumers, who are increasingly promotion-driven. However, as the company increases its exposure to in-house exclusive brands, we expect the product overlap of ForEyes stores compared with LensCrafters and ECPs to decrease (see Figure 34). We therefore see these developments as a limited threat to LensCrafters at this stage.

**Safilo and Luxottica expand into pigment capabilities.** We have seen Safilo look to expand its lens capabilities by buying back the full amount of LENTI. The company already owned 76% of LENTI, but in September 2016 it bought back the whole amount in order to fully leverage its technology for the design and manufacture of state-of-the-art decorated lenses. Moreover, in a similar vein, in 2Q16 Luxottica purchased a small pigment company for which it will leverage the company’s technology for value-added lens layers in such products as Oakley PRISM and Ray-Ban Chromance. This acquisition gives the company control of the raw material and knowhow around colour contrasts for lenses.

**Consolidation will continue in the eyewear industry**

We expect further consolidation given the fragmented nature of the industry. Following the proposed merger of Luxottica and Essilor, we think other industry players would continue to look to consolidate. The sector remains very cash generative and we think M&A remains on the table even for players such as Safilo that have weaker balance sheets. Both Luxottica and Essilor have achieved an average cash conversion of around
100% over the past decade. Therefore even as a combined entity and given the merger is a share-for-share transaction, the balance sheet remains very healthy. In fact, we forecast EssilorLuxottica to turn net cash positive in FY20e.

GrandVision has built up its store network through acquisitions and is likely to continue. We do not believe GrandVision will change its current model and think it will continue to expand its retail footprint. The company had >6,500 stores at YE16 and we expect this to grow further at an average rate of 3% over the next five years. We expect this to be supported by low-single-digit growth from acquisitions.

HAL Holdings stakes raise questions around the possibility of a tie-up between Safilo and GrandVision. Given the stakes HAL Holdings has in Safilo and GrandVision, at 42% and 77% of share capital, respectively, we think a potential tie-up between the companies is not out of the question. A combination between these two companies would replicate Luxottica’s current structure, with frame manufacturing and a retail presence. However, we think GrandVision is unlikely to move away from its pure-play retail model and given the degree of self-help/investments Safilo currently requires following the loss of the Kering licenses, we do not think it would be an attractive tie-up for either company.

Safilo will continue to look for brands. Safilo continues to look into buying in another brand to support its own brand portfolio. The company’s greatest vulnerability is its overexposure to licencing agreements, which account for 75% of its revenues. In the past, the company’s investment plans and basic strategy implementation have been derailed by the company losing large licences. At the end of FY06 it was the Ralph Lauren licence, the end of FY12 it was the Armani licence, and the end FY16 it was the Gucci licence and now the Dior licence appears to be at risk. Finding a strong proprietary brand to help reduce the company’s sensitivity to licences is key, in our opinion.

Essilor/Luxo acquisition history has been strong

Traditionally, Essilor has been the largest acquirer among our four eyewear companies. Over the past 10 years, the company has averaged a constant currency growth of 10.5% per annum. Scope has contributed towards 53% of reported growth while underlying organic growth (or LFL as the company calls it) has contributed 38% (see Figure 38). These acquisitions have been associated largely with lens labs (based on number of transactions) and the majority have been bolt on, resulting in the company supporting, on average, 23 acquisitions per year over the past decade. This focus on M&A is exemplified by the CEO remuneration structure with 10% of the bonus dependent on targets around bolt-on acquisitions (as of FY16 remuneration plan).
And the most effective according to our HOLT M&A scorecard. Using the HOLT valuation framework, we are able to assess a company’s ability to carry out successful M&A. The scorecard ranks over 2,200 companies assigning them a percentile based on i) pricing skill, ii) operating skill, and iii) growth ability. These criteria look at i) whether CFROI® increased (cheap) or decreased (expensive) from the acquisition, ii) whether CFROI levels improved over the next 3 years following the transaction, and iii) whether the firm continued to grow in the three years after the acquisition. Under this criteria Essilor ranks in the 82nd percentile while Luxottica ranks in the 46th. (100th percentile = best).

GrandVision has focused on bolt-on acquisitions, driving c50% of cc growth FY12-15... Given the fragmented nature of the eyewear industry, GV has tended to increase its retail exposure inorganically through acquisitions of retail chains. Between 2014-2016, the company bought in almost 1,000 stores just through acquisitions, with an average scope growth of 4% from FY12 to FY15. The company states it usually takes 12-18 months to fully incorporate a new store into the GrandVision model, providing a new assortment, training and branding. This varies depending on whether the acquisition is bolt on, or a new market entry. Note, traditionally, the company will rebrand the stores under GV banners if these are already present in the country but, in some instances, it retains the acquiree banner e.g. For Eyes acquisition.
but has reported a consistent write-down of goodwill since FY10. In order to understand how accurate/good these companies are at assessing the value of their acquisitions outside of HOLT, we crudely assess how often, and to what extent, the companies have had to impair goodwill. Safilo has taken the greatest magnitude of write-downs because of its acquisition of retail chains in FY08 whose growth estimates were considerably revised down in FY09. GrandVision, on the other hand, has reported a steady level of write-downs since the first available data in FY10 although, admittedly, only at low level of <1% of assets.

**Figure 42: Growth for GrandVision accelerated in FY15 driven by acquisitions**

![Growth for GrandVision accelerated in FY15 driven by acquisitions](image)

Source: Company data, Credit Suisse estimates

Luxottica has been more strategically focused... To recap Luxottica has tended to focus on larger strategic acquisitions buying in key brands such as Vogue (1990), Persol (1995), Ray-Ban (1999) and Oakley (2007). Additionally, the company has bought in some of its largest retail chains including LensCrafters (1995) and Sunglass Hut (2001). It is less obvious how much this has driven growth given the lack of disclosure between scope and organic growth but we estimate, including currency, growth by acquisitions has added c35% to reported growth.

**Figure 43: GrandVision has paid the highest multiple on average for its acquisitions**

![GrandVision has paid the highest multiple on average for its acquisitions](image)

Source: Company data, Credit Suisse research. FX : 1.11 $/€, 1.42 CAD/€, 0.73 £/€, 3.7 BRL/€, 1.48 AUD/€

**Figure 44: The multiple Luxottica has paid for acquisitions since 2001 has increased sharply**

![The multiple Luxottica has paid for acquisitions since 2001 has increased sharply](image)

Source: Company data, Credit Suisse research. Note some of the earlier transactions were of listed companies. Total purchase price taken as of 20-F reports for the transactions

...And been effective at pricing these acquisitions. We look at the average cost (net of cash acquired)/revenue of acquisitions for Essilor (covering 2005 to mid-2016), Luxottica
(2001 to 2014) and GrandVision (2011-2015). This includes 264 acquisitions for Essilor, 9 for Luxottica and 22 for GrandVision. From this analysis, we find Luxottica appears to have paid the lowest multiple while GrandVision, the highest (see Figure 43). However, we would note the multiple paid by Luxottica has increased steadily over the past decade (see Figure 44). Admittedly, the market conditions, type of asset and interest rates will have had an influence on these multiples as well but it is interesting to note that the pricing power appears to have shifted from Luxottica to acquirees.

**Safilo’s acquisitions have led the company in a number of directions.** Given Safilo’s more volatile financial history the company has undertaken fewer acquisitions than the other eyewear peers. However, like Luxottica, it has bought its key proprietary brands and tried (with little success) to broaden its direct to consumer access through retail chains. Of note, the company bought two retail chains in Mexico and Australia and subsequently had to sell them as the company fell into financial distress. Today, the company has c100 Solstice stores remaining in the US, down from >300 stores, under a number of banners, globally. Although, arguably, the market believes these are also up for sale (in the FY15 results call management did not rule out the chain’s disposal) as they are not seen as a strategic focus and the stores have reported negative double digit constant currency growth over the past five quarters.
Key theme #2: Online vs Omni channel

Omni-channel better placed in developed markets

Online to have a growing influence in the optical retail market. The debate around online and the disintermediation of the eyewear market remains a key question. The channel has grown from c3% of total optical retail sales in 2009 to 4% in 2014, a CAGR of 16% (source: Essilor US Field Trip). And has a market value of c€4bn. Sales are still heavily skewed towards the contact lens category as we believe it accounts for c70% of eyewear products sold online. The opportunity therefore lies in both prescription eyewear and sunglasses, in our opinion. These categories remain marginal at only c6% and c24% of the online market respectively, according to our channel checks.

Sunglasses are more susceptible to online purchases. We believe, for sunglasses, online could reach a similar level of penetration as apparel and especially so for models with iconic shapes. We do expect some variation across geographies as online for this category is dependent on how familiar the consumer is with the product. For example, we would expect greater penetration in the US vs. China despite both consumer clusters having a high propensity to buy online, with the difference lying in the less mature sunglass market in China.

Myopic consumers could more easily shift to online in our opinion. We also expect a greater degree of online penetration for myopic consumers (currently 38% of vision correction needs according to Essilor). Myopic consumers only need simple lenses for vision correction, which once you have your pupillary distance and the right magnifications are easier to buy online. It therefore becomes simple for consumers to get their eyes tested in store and use online sites to search for the best prices.

Varifocal lenses give the advantage to omni channel players over pure online. However, the one category we see as truly undisruptable in the eyewear segment is progressive lenses for presbyopic consumers (47% of vision correction needs according to Essilor). These lenses require more accurate measurements and adjustments which need to be made in person for the right fit as they contain a number of points of focus. Additionally these lenses usually come at a higher cost decreasing the likelihood a consumer will buy online. Presbyopic consumers form a larger segment of those requiring vision correction and we assume its relevance should continue to increase as people live longer and ageing populations become larger in the emerging world.
Online to reach 10% of sales by 2025e in our view. Essilor currently expects the online eyewear market to grow at c18% from 2014 to 2020e reaching €9.7bn and accounting for c10% of total optical retail. But the segment penetration currently still lags behind other consumer goods (see Figure 47). We believe online is important and optical retail will convert to omni-channel but we do believe it will be a slow process. This is because, although we see solutions to headwinds for the channel in the coming years, the nature of the product category (ie, long replacement cycle, higher unit cost vs. traditional fast fashion and higher daily use) means we are not yet at the tipping point for rapid acceleration. We therefore forecast c10% growth p.a. leading to 10% penetration by 2025e.

Concerns around fakes will not necessarily limit pure online penetration. The number of comments surrounding pure play online websites that are not the mono-brand sites and concern about fakes is still extremely high. Searching on google for the pretavoir website, for example, pulls up ‘pretavoir fake’. However, given consumers’ concerns, brands such as Ray-Ban have granted certain sites ‘authorized dealers’ which should help to install some trust. As more brands look to do this and independent online sites gain consumer trust, we expect this headwind to fall away.

The process of purchasing is still cumbersome but improving. c69% of US consumers abandon their cart (source Baymard Institute) during check out, and 27% of these state the reason is because of a too long/complicated checkout process. Given the process of ordering lenses takes a considerable amount of time, ie, entering the prescription, choosing the lens and understanding what value the additional layers bring, this could be an important bottleneck for online penetration. However, more advanced sites in the US offer the options of either scanning the prescription or emailing later to try and ease the purchasing process. Moreover, most keep a store of your prescription to promote repeat purchases.

Consumer price sensitivity is increasing, reinforcing online sales. For those consumers looking to buy online, the degree of price transparency is now higher than ever. Therefore, online provides an attractive opportunity for cost saving consumers. It is also increasingly important to ensure price harmonization across channels for global brands. For example, for Ray-Ban, competition across online platforms driven by price transparency between third party retailers has led to discounting of products. Luxottica has therefore had to pull back in key regions and look to better control distribution...
where online penetration is high such as China (removing third party distributors), the US (using MAP), and Europe (using ARA). This is no doubt the correct strategy but highlights how careful brands have to be as online becomes increasingly important.

- **It takes less effort for consumers to shop around.** Moreover, as websites such as camelcamelcamel.com and google launch price comparison cards, the consumer is having to put in smaller amounts of effort to compare prices for products across multiple websites. For example, searching Ray-Ban aviator in google pulls up a price comparison card, this allows you to select a model and then pull up all the websites google has found that model on, and their prices. Prices in the UK vary from £66.36 to £125 (see Figure 50) with the average discount to the Ray-Ban.com store at c30%.

- **Online price variation will hurt frame manufacturers.** We compare the price online and offline of Ray-Ban RB5228 prescription glasses with single vision, 1.6 lenses with scratch resistance, AR and anti-UV. The analysis shows the wide variation in online frame prices in the UK but not in the US as we see the impact of MAP. In fact assuming the David Clulow price for this model of £125 is correct (ray-ban.com in the UK does not sell Rx glasses), the average discount is 16%. Surprisingly, in both the UK and US, the biggest source of variation is in the lens pricing with a max price of £134 in the UK vs. min of £25 and a max price of $115 in the US vs. min of $35. This puts the average total cost for the frame and lenses at £165 vs. offline of £278, a c40% saving. We believe the market is underestimating the impact online will have on both frames and lens pricing.

**Figure 51: Online lenses have the greatest variation in prices**

Frame and lens prices, local currency

![Frame and lens prices, local currency](image)

**Figure 52: Offline we see a different picture with both frames and lenses facing pricing variation**

Frame and lens prices, £

![Frame and lens prices, £](image)

Source: Company data, Credit Suisse research

- **Refunds have become easier.** In Figure 53 we assess the returns profile for a number of online providers. The vast majority of online providers in the US now offer full refund on purchases and up to 30 days for a return.

- **Barriers to entry are lowered by the online channel.** Using the UK market as a proxy, we understand it is relatively easy to set up an online eyewear company given the loose regulation and limited insurance coverage. For unbranded lenses and frames, manufacturers can be found easily at eyewear exhibitions. Once a minimum order of frames is placed, the company only needs to find a lens manufacturer with associated lab to process each of its orders with no need to hold lens stock on its books as well. Although in the UK eyewear retailers should hold copies of customer’s signed prescriptions, we found when buying on any of the European/UK based websites, a copy of the prescription was not requested. Moreover to set up a website that sells branded frames we believe a company needs to i) order a minimum number of products which varies by brand – more widely distributed at c50 pieces while higher end brands at c100 pieces, and ii) complete a profiling of your offering, providing details on either the website or where the retail store is located. For higher end brands,
we understand the location of the store may limit which brands are offered but for websites it is just a judgement of the quality of website. We understand selling Ray-Ban has become more difficult as the company has started to limit its ARA agreements and requires each unit to be registered in order to stop B2B selling but we believe it is still relatively easy to stock the product legally.

However, we think the higher the degree of premiumisation, the lower the level of pure online penetration. We see the trend of premiumisation as an important headwind for pure play online providers. The more expensive the frame and, more importantly, the lens, the less likely consumers are to trust online providers, in our opinion. Lenses quickly reach into triple figures if value added layers such as anti-reflected coatings are added and high quality materials used. This is one headwind which we believe is unlikely to soften in the near term as consumers become more accustomed to buying online given replacement cycles for this type of purchase are relatively long.

**Figure 53:** Analysis of online returns policies

<table>
<thead>
<tr>
<th>US ONLY</th>
<th>Refund</th>
<th>Progressive/simple</th>
</tr>
</thead>
<tbody>
<tr>
<td>coastal.com</td>
<td>30 days to return or exchange. Call Vision Care center to get prepaid postage stamp.</td>
<td>Sun/Rx Both</td>
</tr>
<tr>
<td>costadelnar.com</td>
<td>30 days to return. Free of charge return. Do not exchange items</td>
<td>Sun/Rx Rx Both</td>
</tr>
<tr>
<td>eyebuydirect.com</td>
<td>14 days to return/exchange. Free shipping for orders &gt;$99 or new customers with orders &gt;$15. Call Customer service for return authorization email.</td>
<td>Sun/Rx Rx Both</td>
</tr>
<tr>
<td>fostergrant.com</td>
<td>30 days to return for refund or exchange, after 30 days can exchange only.</td>
<td>Sun/Rx Rx Both</td>
</tr>
<tr>
<td>framesdirect.com</td>
<td>30 days to return or exchange. For non Rx or contact lenses - free exchange or full refund minus 10% restocking fee. Customer must pay shipping fee. For Rx - free exchange. If new lenses required 50% of original lens price credited towards new lenses. For refunds full price refunded minus 50% of lens price. Customer must pay shipping fee.</td>
<td>Sun/Rx Rx Both</td>
</tr>
<tr>
<td>glasses.com</td>
<td>30 days to return or exchange Call for authorization. Free shipping for return.</td>
<td>Sun/Rx Rx Both</td>
</tr>
<tr>
<td>glassesusa.com</td>
<td>14 days to return. 90 days to process refunds. 100% money back or exchange. must email or call to start return process. Will be given a free return shipping label once emailed or called. Future orders placed using 100% store credit / exchange code are not eligible for another return.</td>
<td>Sun/Rx Rx Both</td>
</tr>
<tr>
<td>oakley.com</td>
<td>90 days to return or exchange. Can return to store for full refund or exchange. Return by mail - get return authorization number and pre-paid return label.</td>
<td>Sun</td>
</tr>
<tr>
<td>rayban.com</td>
<td>45 days to return. Get return authorization number and pre-paid return label.</td>
<td>Sun/Rx</td>
</tr>
<tr>
<td>readersglasses.com</td>
<td>30 days of purchase. Need return authorization code. Free of charge return.</td>
<td>Sun/Rx readers</td>
</tr>
<tr>
<td>smartbuyglasses.com</td>
<td>100 days to return. Must contact the customer service team to get special returns note.</td>
<td>Sun/Rx Rx Both</td>
</tr>
<tr>
<td>sunglasshut.com</td>
<td>90 days to return since online purchase. Need to print off free shipping label but no need to call. Store purchase cannot be returned by mail. Can return online purchase to store within 90 days of purchase.</td>
<td>Sun</td>
</tr>
<tr>
<td>sunglassesshop.com</td>
<td>30 days to return.</td>
<td>Sun</td>
</tr>
<tr>
<td>warbyparker.com</td>
<td>30 days to return or exchange. Free return shipping for orders within 50 united states. If lenses scratch within 1 year will replace for free.</td>
<td>Sun/Rx Both</td>
</tr>
<tr>
<td>zennioptical.com</td>
<td>30 days to call for a return authorization number. If made a mistake during the order or just don't like the glasses - 50% refund excl shipping or one-time-due 100% store credit. If feel manufacturing error. return glasses for inspection within 30 days. If made incorrectly will be remade free of charge.</td>
<td>Sun/Rx Both</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse research

**Store rationalization will have to happen regardless**

Warby Parker gives us an interesting example of omni-channel vs. online. Examples such as Warby Parker show that pure online retailers perhaps are at a disadvantage without some brick and mortar retail presence. This is even despite launching the company in one of the most advanced online eyewear markets, the US (5% penetration vs. 4% globally in 2014). Moreover, it shows the potential of omni channel as an attractive opportunity. The startup, launched in 2010, initially as a pure play online retailer has chosen to invest in traditional bricks and mortar store expansion with 30 stores at the start of 2016, 46 at the start of 2017 (from the website store locator) and plans to grow this footprint further in 2017.
Omni channel provides a better consumer offer than pure play in our opinion. We believe this is because the consumer still likes to go into store to try frames on in person and still has to get their eyes tested in person. Therefore the category need for stores is greater than say for apparel. This purchase has a longer replacement cycle (2-3 years in the US), a higher unit cost than traditional fast fashion and is worn every day; therefore the need for the consumer to ensure the right fit/style is arguably higher. Moreover as product newness increases in the industry it becomes more important for consumers to feel and try the product on in person.

Omni-channel has succeeded in other industries. Sephora and Ulta Salon in the US provide a very persuasive argument that omni-channel can gain market share over pure online or pure retail players. Both sell cosmetics, a different product category to eyewear, but because the eyewear industry lacks a comparable established example of omni-channel, we turn to these retailers to understand if the consumer prefers omni-channel. Ulta Salon reports that multi-channel guests spend 2.4x more than store-only guests and 4.3x more than single channel guests. Moreover, Sephora continues to report double-digit comp growth in its stores despite having a relatively large retail presence with c400 stores in the US (around half of Luxottica’s LensCrafters). We therefore believe omni-channel should have the advantage over pure players and perhaps more so for the eyewear industry than the cosmetics industry seeing as optical retailers can also rely on eye exams to drive traffic into store.

Omni-channel players will need to rationalize their store footprint. Although we would prefer omni-channel to pure play online retailers, we admit our companies under coverage with bricks and mortar stores may still have to undergo some store rationalization in certain regions in which they are over-exposed. They will no longer need wide distribution networks to reach the consumer when they have online platforms. Moreover as traffic falls across retail stores whether it be eyewear or apparel, having a wide store base can be costly. Admittedly online purchases can be filled through a store, but as Luxottica and GrandVision centralize their DCs and lens labs, order fulfillment will not come through store doors but the centralized hubs further reducing the need for a wider footprint.
We believe Luxottica is already starting to do this with its LensCrafters network in the US. Luxottica has its largest retail exposure in the US, the largest online eyewear market. We believe the company understands the implications of online as it has stepped away from its 1,400 LensCrafters store target. It currently has c900 stores and can open up to 500 within Macy’s stores but we expect some store closers at the same time as the company rationalizes its portfolio and makes a shift to smaller stores without bolt-on lens labs. We therefore expect a reduction in the average store size (40/50% size of average store) and a handful of net openings over the next couple of years, improving the quality – e.g. revenue per sq foot of the stores. Moreover the number of Sunglass Hut stores has remained flat this year and we expect some net closures moving forward.

GrandVision continues to expand aggressively. The company has increased the number of POS at around 7% per annum since FY11. Although management does not give any guidance around the target number of stores, we do not expect this trend to change over the short to medium term. The company will see some reduction in store size, though, similar to Luxottica, as it looks to lower the average store footprint from 120 sqm to 80 sqm as it centralizes its lens cutting and edging facilities.

Online eye exams would add further disruption for retail stores. Essilor believes this could be possible in the next 2-3 years through smart refraction technologies. The company will look to have access to the full purchase cycle from exam to order online,
either through a technology acquisition or through partnerships. It has already launched an open contest for innovative refraction applications. Competitors such as Zeiss already offer an online eye assessment which can be used to advise consumers if they need an eye test.

**Opternative is starting to gain traction.** Opternative launched the first online eye exam that could provide a prescription in the US in mid-2015. This is a refractive eye exam which allows an ophthalmologist to review the results and make a clinical decision before issuing a prescription. The cost of the eye exam is $40 vs. $79 instore at LensCrafters and £25 instore at Vision Express (GrandVision) for example. 1-800 contacts in July 16 launched, in collaboration with Opternative, the InstaRx which endorses Opternative’s online exam and accepts their prescriptions for contact lens orders. This was the first public endorsement of the exam from a large player in the eyewear industry.

**Opternative will have more of an impact on the independents.** First, an eye examination still requires an authorized ophthalmologists to write the prescription and given we understand the examination does not effectively test for the top 30% of the most severe eye conditions we expect some hesitance from the professional vision care community. Additionally, as independents capture around 69% (on a volume basis) of the eye exam business in the US (a disproportionate amount vs. the retail sales they capture, source: Essilor US Field Trip) there has been a strong amount of pushback in a number of states from these groups. In some states, they have been successful in preventing Opternative from offering its services e.g. South Carolina, by claiming the technology was not accurate enough. We note Luxottica generates a low single digit % of revenue from eye exams while GrandVision generates much less, as most eye exams are given for free.

**Profit implications are negative for online**

**Margin accretion should come with accelerated growth and leverage of costs...** Data from Essilor suggest once a consumer has made a transaction online, (see Figure 61) profit contribution can be higher than the traditional lens business. However, fully understanding the cost of online comes down to;

i) how the company splits out centralized costs for this channel,

ii) how it thinks of development costs and whether these are charged or capitalized,

iii) the cost of initially capturing a purchase i.e. conversion rate and how this is accounted for

iv) how the cost of returns and logistics are accounted for, and

v) how the costs of checking and authorizing each prescription (in the US – 1 out of 4 prescriptions are invalid according to our channel checks) are accounted for.

...But target online margins remain below group margins for industry players. Essilor is currently targeting 10%-12% contribution margin by 2018 vs. group contribution margin at 18%. Therefore we can conclude that although margin accretion should come with scale, there are a number of factors which we highlight below that mean online is overall a drag on industry profit pools for the time being. Moreover, given that, in the apparel industry, online continues to be a drag despite being more established, we can assume further margin upside will take a long time to see and likely be fairly limited.

**Return costs could be an important drag on profitability, and greater than apparel.** Given the size and weight of purchases, logistic costs will be lower for eyewear vs. other categories such as apparel. The cost of returns for contact lenses and sunglasses should also not differ too much as these products can be easily re-sold. However, the important aspect of the profitability of online eyewear is around the returns of prescription glasses. The lenses within these glasses will have been edged, finished and mounted to specific
frames with a specific shape and prescription. Therefore the likelihood of reselling these glasses is clearly limited – the frames may be re-used but the lenses and the cost of producing them will be unrecoverable. As we found earlier, most online sites now offer full refunds, and so this could be a heavy drag on profitability for this channel if return rates are high and consumers select highly customized products.

Although product margins are good, high levels of Rx returns are not sustainable. We understand it is possible, on scale, to buy frames from Asian manufacturers at <$5-10. It is also possible to get single vision stock lenses for $2-5. On top of that there are some labour costs and consumption costs for the process of edging and mounting them in the frame (but this is largely automatized). If we say shipping costs are $5, the total cost of producing the frames and lenses without personalization is c$20-25. Therefore the crude margin on a pair of glasses from Warby Parker for example is c70% (single vision glasses are sold at c$95). If the glasses are returned and re-made, the margin drops to c55% (assuming the same frames are used). Moreover we calculate if the cost of free returns is $5 to the company, it would become loss making if 2.3 pairs are returned and refunded (cost of $30) for every one pair sold (assuming no salvage value from the returned products).

Progressive lens sales are the greatest drag on profitability. Our channel checks suggest that the underling profit margins for progressive lenses are lower than basic stock lenses. If basic stock myopic lenses are bought at c£5, we understand the cost of a basic progressive lens is c£55 at wholesale price. Although retailers look to significantly increase the retail price of progressive lenses to preserve the margin, >£200 vs. myopic at £60 it appears certain online providers do not do that. We find varifocal lenses at £49 on glassesdirect.co.uk for example. Additionally given we believe progressive lenses are harder to fit, with a slight error in the lens center point making them unusable, we would expect higher return rates for these lenses. Both factors lead us to believe progressive glasses will drag the most on online profitability.

Sun and contacts should not be as much of a drag on profitability as Rx. As we have mentioned previously in this report, we do not believe contact lenses and sun sales should be as great a drag on profitability as prescription. However, sun prescription will clearly suffer the same dynamics as pure prescription sales. Additionally we would flag personalized products could also have important implications for profitability. Granted these still remain a very small percentage of sales. However, we doubt personalized products made through the ‘Remix’ offering on Ray-Ban.com for example will be kept as inventory or be re-used for other orders. Despite this, ray-ban.com does offer full refunds for remix products.

Figure 60: Online can drive topline according to Essilor
Average pairs per order and number of purchases over a 3-year period

Figure 61: Margin per consumer is higher online according to Essilor
Base 1 = Essilor lens business estimated contribution margin per consumer. US market prescription eyeglasses

Source: Essilor US Field Trip
A way to reduce return costs could be to offer a more limited selection of optical lenses. Using the UK market as a proxy, we assess the number of lens options available online and instore. We find there is a considerable range of lenses on offer at the online stores, with the majority offering a number of different thickness of lenses (index 1.5 to 1.74) and additional lens layers such as anti-reflective, UV protection and anti-blue light. At David Clulow, we see a similar offering for single vision lenses with only the additional benefit of choosing between i) bespoke, ii) digital and iii) conventional surfacing for varifocal lens. We also find a similar offering at Vision Express suggesting online retailers do not significantly limit product types to help control costs.

Variation in lens prices cannot be explained purely by the supplier. As we have said previously, price transparency afforded by the internet is clearly having knock-on effects on both frames and lenses. Some retailers such as GrandVision do not see these eyewear websites as a threat because of the quality of the lenses on offer. However it appears some websites such as pretavoir.com, lensway.co.uk and smartbuyglasses.co.uk are still supplied by big players such as Essilor and offer some branded options competing directly with the quality of products sold by GrandVision.

There could also be a negative mix effect from no one-to-one contract. There is a smaller chance of trading up through additional finishing layers such as anti-reflective given the lack of a salesman and face-to-face interactions. Therefore we do expect some price mix effects from the outperformance of this channel over selling through bricks and mortar stores.

Omni-channel could benefit from store banners if they have strong branding. If stores/products have strong brand awareness such as Sunglass Hut or Warby Parker we believe their online platforms will capture more growth than pure online players. This is because the online site benefits from the natural marketing gained from owning bricks and mortar stores. Therefore, we would expect them to see higher conversion rates, reinforcing the advantage of having some retail presence. For Essilor’s highest performing pure play platform conversion is still low single digits and the cost to convert a consumer varies from $25 for the low end website (avg. cost per product of $13) to >$100 for the higher end websites according to our channel checks.

Stock implications from our online analysis

Essilor and Luxottica have a similar sized presence online... Essilor quotes 5% of Group sales were online in FY15, bringing online revenues to €340m. Luxottica quotes 4% of Group sales were online in FY15 (and have guided towards finishing the year at 5%) which puts its online revenue between €360m and €450m. Of its online exposure c60% is generated from own online and 40% from wholesale partners.

…but we see little scope for internal competition when these two companies merge. Essilor’s online revenues are generated by a number of multi-brand, unbranded and mono-brand owned sites as well as through wholesale partners. The company’s own platforms have been bought in over the past couple of years and include coastal.com and eyebuydirect.com. In North America, for example, where online revenues from its own websites reached 44% of its total online exposure (as of FY16 results), Essilor is heavily exposed to multi-brand pure play offerings. Luxottica does not have as many website banners as Essilor, with a focus primarily on sunglasshut.com, rayban.com, oakley.com and to some extent glasses.com. The company also has websites for LensCrafters and David Clulow, for example, but these are not transactional. Given the varied nature of platforms under Essilor and Luxottica, we see little scope for internal competition with the only clear worry being between glasses.com and Essilor’s multibrand websites. However, Luxottica have been gradually de-emphasizing this platform as the company uses it more as a forum to experiment around omni-channel offerings for LensCrafters.

Essilor’s wide online footprint will put the combined company at an advantage. We feel Essilor’s advantage with online sits in its investments across regions, especially
outside the US. The company has also picked up websites in Asia and areas which have limited optical retail networks and a high propensity for consumers to shop online. We believe this could put the company at an advantage as consumer engagement starts to improve. Although we appreciate leveraging distribution via online in some emerging countries will be difficult given the distribution infrastructure in place, it could be easier than expanding via bricks and mortar stores, in our opinion.

Figure 62: Essilor now has a number of online platforms in the US and further afield

Figure 63: Essilor’s two multi-brand websites provide the bulk of online revenues

Source: Essilor analyst conference

Source: Essilor US Field Trip. Multi brand – framesdirect.com and coastal.com

Sunglasshut.com plays on omni channel but lenscrafters.com gives away some advantage. As we prefer omni-channel to pure play online stores we see this as a potential advantage for EssilorLuxottica vs. the industry. This is definitely the case for the Sunglass Hut retail banner which has an increasingly integrated channel experience. However Lenscrafters.com is still lagging behind, with only the ability to check stock availability or book an eye exam and no transactional functionality. LensCrafters does have the partnership with glasses.com which allows consumers to order glasses online but get them adjusted in LensCrafters stores (a more omni-channel service). However, we do not feel this is enough and believe the company is losing its competitive advantage by not having a fully integrated omni-channel offering for LensCrafters. This could change more rapidly with the insight from Essilor and we feel would provide a strong competitive advantage over other industry players.

GrandVision is leveraging retail locations and launching full omni-channel. We believe less than 3% of Group sales originate from online. These are mostly contact lenses and sunglasses. The company currently only offers a transactional omni-channel service for prescription in Germany, providing online booking, pre selection of frames and the ability to order to home and store. Admittedly, this is a much more omni-channel experience than LensCrafters. Management is using China and Germany to develop the experience before rolling out further afield.

But remains too dismissive of disruption. However, the company has a much wider optical retail store footprint in its key region (Europe) vs. Luxottica in its key region (US) and no plans to scale back on expansion as online develops. We are therefore concerned that the company is underestimating the impact digital could have on the need for such a significant sized bricks and mortar network. Moreover, GrandVision only plans to roll out its new online platform over the next two-to-three years, we understand.

Safilo’s online presence remains limited. Safilo currently only has a transactional website for Smith out of its own brands. The company lacks websites for Polaroid and Carrera and unlike Luxottica does not own a multi-brand platform. However, online now represents a significant part of the Smith business suggesting the company can
successfully launch mono brand sites, and including pure internet wholesale partners, online accounts for 5% of Group sales, in line with Luxottica and the industry.

**Economies of scale will also help to give the advantage to EssilorLuxottica.** We believe the primary reason EssilorLuxottica will benefit the most from online or at least be less impacted by the disruption it causes, is because of the company’s size. This size will help reduce costs if integrated fully as the company captures more volumes from the online market and has a greater chance of re-selling returned products. Additionally, by now covering every point of the value chain, the company is exposed to all the profit pools and therefore has the ability to maximize profits in a channel that will potentially see profits squeezed.

**Proprietary e-commerce survey**

**Google’s ‘Test my site’ assesses speed and mobile friendliness.** In order to assess which of these online websites in the US and Europe are best positioned to capture consumer sales, we use Google’s ‘Test my site’. This scores each website based on (i) the mobile friendliness, (ii) the mobile speed, and (iii) the desktop speed. Each of the three assessments are scored out of 100 with the average given in Figure 64 and Figure 65. The criteria the three assessments are based on are detailed in Figure 66. We see little variation between websites on mobile friendliness with the key differentiation between websites coming from mobile or desktop speed.

**Overall, Luxottica-owned websites outperform Essilor on Google’s ‘Test my site’.** This analysis puts Luxottica’s online platforms on average just above Essilor’s in the US, while Essilor sits in line with competition in Europe. This is interesting to note given Luxottica’s strategy, focusing more on omni-channel rather than pure play. It would be reasonable to think, given this strategy, its websites would be of lower quality and perhaps lag behind its competition but this analysis suggests otherwise.

**Costal.com is still a drag on Essilor’s portfolio.** It is also interesting to see that costal.com scores at the bottom of this analysis despite the fact that Essilor has only just recently launched this platform. Coastal.com was acquired in 2014 and seen as a strategic acquisition that the company could not miss. However, the business it bought was heavily reliant on promotions and the turnaround of coastal.com has taken longer than expected and has not realized the margin potential management had initially guided towards. Issues re-establishing the brand and removing loss-making promotions led in part to the company not reaching management's 2014 expectations of 19% contribution margin by 2016 (contribution margin is the underlying operating margin Essilor guides towards). The company printed 18.6% contribution margin at FY16 results. The relaunch of the website with new branding, exclusive products and MyFit capabilities leave management confident in this turnaround story.
We are concerned there may be a lack of integration. We also note that the scoring for the Essilor-owned websites varied more considerably than the Luxottica-owned sites. This is because Essilor does not tend to integrate its acquisitions and therefore the websites it has acquired still run off their own individual platforms with little synergies/background integration between each other. We wonder with the Luxottica merger whether this will be the case and the ecommerce platforms will be run independently from one another. We believe EssilorLuxottica would benefit more from complete online integration across platforms.

Proprietary mobile site scorecard to understand more fully the offering. We build on the work carried out by our US retail team (see CS Fashion Mobile Commerce Analysis: Who is winning the race away from the desktop published 11 October 2016) and assess these websites and their mobile experience according to a 20-step criteria. As our team details, the use of mobile online platform is expected to see even greater growth and penetration than desktop. The 20-step criteria gives us a quantitative mobile platform performance score which we can use to effectively compare across platforms. We look at qualities such as ease of social linking, typeface and readability as well as the use of 'breadcrumbs' (a website navigation technique which allows the user to keep track of how they reached their location).

Figure 66: US based websites total score
Average overall score based on (i) mobile friendliness (ii) mobile speed and (iii) desktop speed. blue = Essilor owned, stripes = Luxottica owned, grey = Safilo, red = private

Figure 65: European based websites total score
Average overall score based on (i) mobile friendliness (ii) mobile speed and (iii) desktop speed. blue = Essilor owned, stripes = Luxottica owned, dotted = GrandVision, red = private

Figure 66: Testmysite uses a number of criteria for the 3 scores
Criteria used in scoring

<table>
<thead>
<tr>
<th>Mobile friendliness</th>
<th>Mobile speed and Desktop speed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avoid plugins</td>
<td>Avoid landing page redirects</td>
</tr>
<tr>
<td>Configure the viewport</td>
<td>Enable compression</td>
</tr>
<tr>
<td>Size content to viewport</td>
<td>Leverage browser caching</td>
</tr>
<tr>
<td>Size top targets appropriately</td>
<td>Minify CSS</td>
</tr>
<tr>
<td>Use legible font sizes</td>
<td>Minify JavaScript</td>
</tr>
<tr>
<td></td>
<td>Minify HTML</td>
</tr>
<tr>
<td></td>
<td>Optimize images</td>
</tr>
<tr>
<td></td>
<td>Prioritize visible content</td>
</tr>
<tr>
<td></td>
<td>Reduce server response time</td>
</tr>
<tr>
<td></td>
<td>Eliminate render-blocking JavaScript and CSS in above-the-fold content</td>
</tr>
</tbody>
</table>

Source: testmysite.thinkwithgoogle.com

Figure 67: Essilor and Luxottica platforms come top of our proprietary website survey
Overall score using our proprietary mobile scorecard

Source: Credit Suisse research, E:Essilor owned, L:Luxottica owned, Ot:Other, S:Safilo
Warby Parker underperforms but app provides an advantage. Using this framework, we see that, of the top 6 highest scoring websites, 3 are from Luxottica and 2 are from Essilor. Both score particularly highly on how easy it is to access sizing charts, the typeface/readability of the site and the access at home. However, using this survey, Warby Parker underperforms as it lacks product reviews, sizing detail on the mobile site and, with no scrolling site ID, it is difficult to navigate. However, Warby Parker is one of the only websites to offer an app. On the app store, this scores 4.5 stars from 238 ratings with the only negative comments focusing on the prescription upload. This compares to glasses.com app which scores 1.5 stars out of c200 ratings.
## Figure 68: Proprietary mobile e-commerce survey

<table>
<thead>
<tr>
<th>Type of eyewear</th>
<th>Rs lenses</th>
<th>Ability to buy中心城市's top 5 brands within 24hrs</th>
<th>Mobile formalized browser website</th>
<th>Easiest way of navigating the homepage</th>
<th>Most amount of noise</th>
<th>Easiest to social linking</th>
<th>Mobile access to SKU charts of site</th>
<th>Product function</th>
<th>Clickability</th>
<th>Customer support</th>
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<tr>
<td><strong>Sunglasses</strong></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sun &amp; readers</td>
<td>Unbranded</td>
<td>Y</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Good</td>
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<tr>
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<td>N</td>
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<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Good</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Spectacles</strong></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Sun &amp; readers</td>
<td>Unbranded</td>
<td>Y</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Good</td>
<td>Good</td>
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</tr>
<tr>
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<td>N</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Good</td>
<td>Good</td>
<td>Best</td>
<td>Good</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse research
Key theme #3: The US

The US remains the largest optical market and relatively underdeveloped. According to Essilor, the US represents a c$40bn Vision Care industry based on sell-out sales. The largest proportion of this industry at c32% is the lens market, followed by the frame market at c24% (see Figure 69). However, the market still remains relatively underdeveloped with room for growth through i) increased consumer coverage, and ii) increased penetration of value added lenses (see Figure 70).

Recent company commentary suggests a softening of the market. Through 2016, we have seen a deceleration in reported underlying growth for all the key players in the US market. There have been a number of short-term company specific issues (e.g. the impact of MAP on Luxottica W/S North America numbers) and the presidential election towards the end of the year may have had some influence on consumer engagement. Our research has shown that customers postpone purchases more markedly in an election year on a number of items, including eyewear given the uncertainty and focus on a new president. We believe this was compounded by poor weather at the start of the year which impacted the start of the sun season. Therefore there is a lack of transparency as to whether this is a longer term structural downturn or just a small cyclical pause in growth this year.

Figure 69: The US is the largest eyewear market by value…
Sell-out sales. Including; readers, surgery, sunglasses, contact lenses, exams, frames and lenses, ($b)

Figure 70: …but remains relatively underdeveloped
Penetration of total lens industry, %

Source: Company data, Credit Suisse research
**EssilorLuxottica will dominate the US market.** Based on company data, we understand the combined EssilorLuxottica will have a c30% market share in North America. Together the combined company has even greater penetration of every part of the value chain compared to the standalone entities. This is because it is i) where Luxottica is the most developed in pure sun and Rx retail, ii) where Luxottica also takes part in the vision insurance market with the second largest provider EyeMed, iii) where Essilor has developed its pure online retailing most extensively and iv) where Essilor also has a significant influence on the independent eye care professionals through the buying groups Vision Source, PERC and Opti-Port. These account for c7,000 locations which we believe account for c30% of the independent market. (March 16 Review of Optometric Business suggested c10,000 locations were signed up to an alliance membership which represented nearly 40% of independent practices).

Our channel checks suggest this slowdown was not out of the ordinary for an election year. We have conducted a number of interviews with consultants that have previously worked extensively in the eyewear industry in the US and still have some visibility on market trends. These interviews suggest the trends from this year were not dis-similar to previous trends during a general election year. Moreover given the arguably greater consumer focus on this year’s election it was perhaps not a surprise that shopping and eyewear fell out of focus. This is supported by our OBB data, introduced below, which shows an improvement in independent ECP’s six-month forward expectations in Q4 (see Figure 74). Additionally Luxottica reported 4Q16 wholesale north America organic growth of +5.5% against our expectations of -10% as the company saw strong growth from ECPs towards the end of the year, when consumers focus returned to the category. This more than offset continued MAP weakness.

We introduce the Optical Business Barometer of c300 independent ECPs in the US. Collected by Jobson Optical Research, the OBB is an on-going perception study measuring trends in the optical retail business. The data are reported on a quarterly basis, usually around a week before companies in the sector start to report. It covers c300 respondents who consider themselves active at an optical retail location in a group no larger than 3 stores and therefore can be considered as independent ECPs.

**Figure 73: Sequential improvement in sentiment with YoY changes improving**

**Question 1: How do you rate the overall optical business trend for the immediately past month?**

**Figure 74: Forward looking expectations have moved up over 4Q, post the election**

**Question 2: How do you think the overall optical business trend will be for the next 6 months?**

The survey shines light on both forward looking and historical changes. The survey covers 9 questions asking respondents to assess the business for the immediate past month as well as the prospects for the next 6 months, therefore giving us some colour on backward and forward looking expectations. The questions are split between the overall optical business, eyeglasses, contact lenses and eye exams. Moreover the data can be
split between broad areas across the US and by annual retail sales categories. The list of questions are:

1. At the location at which you are principally active, how do you rate the overall optical business trend for the immediately past month (eye care products and services)? (from 1 to 5, 5 = very positive, 1 = very negative)

2. At the location at which you are principally active, how do think the overall optical business trend will be for the next 6 months? (eye care products and services)?

3. At the location at which you are principally active, how do you rate eyeglass sales for the immediately past month?

4. At the location at which you are principally active, how do think the eyeglass sales trend will be for the next 6 months?

Figure 75: #3: How do you rate the eyeglass sales for the immediately past month?

From 1-5, 5 = very positive, 1 = very negative

Figure 76: #4: How do think the eyeglass sales trend will be for the next 6 months?

From 1-5, 5 = very positive, 1 = very negative

5. At the location at which you are principally active, how do you rate the number of people having eye examinations for the immediately past month?

6. At the location at which you are principally active, how do think the number of people having eye examinations trend will be for the next 6 months?

Figure 77: #5: how do you rate the number of people having eye examinations for the immediately past month?

From 1-5, 5 = very positive, 1 = very negative

Figure 78: #6: how do think the number of people having eye examinations trend will be for the next 6 months?

From 1-5, 5 = very positive, 1 = very negative

7. At the location at which you are principally active, how do rate contact lens sales for the immediate past month?
8. At the location at which you are principally active, how do think the contact lens sales trend will be for the next 6 months?

Figure 79: # 7: how do rate contact lens sales for the immediate past month?
From 1-5, 5 = very positive, 1 = very negative

Figure 80: # 8: how do think the contact lens sales trend will be for the next 6 months?
From 1-5, 5 = very positive, 1 = very negative

9. Across the entire US, how do think the overall optical business trend will be for the next 6 months (retail and eye care services)? See Figure 83.

Historically, these data have correlated with eyewear corporate US growth. To understand how effective the data are in providing read through to our companies, we back test the backward-looking indices y-o-y change compared with the relevant reported numbers for each company. For Luxottica, the LensCrafters LFL is c70% correlated to the overall index change while for Essilor there is slightly less of a correlation with the organic growth of its Lens and Optical instruments business in North America. For Safilo the correlation is much lower given the company specific issues that have been relevant since 2009, in our opinion. We do not look at the GrandVision numbers given the small exposure to the US. This suggests some predictive power from these numbers which are published roughly a week before the eyewear companies report, helping to provide some valuable insights.

Figure 81: c70% correlation between overall index change and LensCrafters LFL
YoY % change in index vs. Lenscrafters LFL

Figure 82: c55% correlation between overall index change and Essilor N. America Lens growth
YoY % change in index vs. Essilor Lens and Optical North America

Forward looking questions suggest sentiment in the sector is improving. Sentiment among the ECPs for the US Optical environment (question 9) had been decelerating since 4Q14. However, the most recent data set suggests the ECPs have turned more positive, with year-on-year change in sentiment returning to positive growth (see Figure 83).
Figure 83: Sentiment towards the US eyewear market’s future development has turned more positive

Across the entire US, how do you think the overall optical business trend will be for the next 6 months?

Figure 84: Contact lenses see no deterioration YoY

Across the entire US, how do you think the category trend will be for the next 6 months, YoY change

Positive correlation between future US optical expectations and key growth drivers... We find there is a positive correlation between the US Optical forward looking index (question 9) and i) 1 quarter-forward LensCrafters LFL, ii) 1 quarter-forward North America wholesale growth, and iii) Essilor North America lens and optical instruments organic growth. This suggests there is some predictive power associated with ECPs’ expectations over the next 6 months and numbers reported by our analysts in the following quarter.

…and between the future US optical expectations and consensus EPS. We also see an interesting correlation between the US Optical forward looking index (question 9) and consensus EPS estimates for both Essilor and Luxottica. If we shift the index forward one quarter (as the question is about the perception of the market over the next 6 months) it is interesting to note the implied reacceleration if this relationship holds.

Figure 85: Essilor consensus EPS has tracked fairly closely to the sentiment towards the optical business trends over the next six months...

Essilor 12th-month fwd consensus EPS estimates vs. sentiment of the US optical market over the next 6 months, shifted one quarter forward

Figure 86: …and the same can be said for Luxottica

Luxottica 12th-month fwd consensus EPS estimates vs. sentiment of the US optical market over the next 6 months, shifted one quarter forward

We incorporate the directional trend of the data into our forecasts. This survey and its implications for the North America growth for our companies is important because of the sensitivity of Luxottica and Essilor’s top line to this region. We estimate LensCrafters and North America optical wholesale account for c25% of Luxottica group sales, i.e. excluding sun sales, while the optical lens and instrument category in North America...
accounts for c39% of sales for Essilor. The 4Q16 data have been more positive than 3Q16 therefore we estimate a reacceleration in North America growth in 1Q17 for both Luxottica and Essilor.

We find during times of low sentiment Essilor has outperformed Luxottica. We look at the seven periods in which sentiment for the next 6 months deteriorated sequentially. If we look at the LFL numbers, Essilor has outperformed Luxottica in the majority of these occasions. In fact, only when the company relies on building out retail distribution, do we see an outperformance of Luxottica vs. Essilor. This fits with market commentary around retail chains losing market share during 2008 and 2009. Therefore as a combined entity the new EssilorLuxottica will become more resilient to the underlying trends in the US, benefiting when ECPs outperform or when chains outperform.

Two warnings signs which suggest that ECPs are starting to feel the pinch. First, Luxottica has seen an increase in interest from the independents in its STARS program in the US. And, second, Essilor has seen high interest from ECPs in their FrameDream program. Both of these initiatives hand control over from the ECP to the corporate and have historically seen resistance from ECPs. This has largely been because independents have wanted to keep control of their business as they are usually run by entrepreneurs or family businesses. Moreover Luxottica and to some extent Essilor, also represent competition with LensCrafters and online platforms. The recent change suggests perhaps the ECPs have struggled this year and are looking for programs to support growth which they may have not usually considered.
Luxottica’s upgrade of LensCrafters stores could drive further reacceleration. Luxottica has shown how it is able to turn around its LensCrafters stores. In 2014 it introduced a two-step plan which involved product segmentation and store refurbishment. The benefits in LensCrafters LFL following the product segmentation and re-assortment was material enough for management to delay the refurbishment as LFL increased to c5%. We note this may have also been partly supported by introducing LensCrafters to VSP and other insurance provider panels. It was only in 2016 the company decided to launch its new store format, removing the lens labs, introducing the Clarify eye exam and making the stores more compact and modern. Given their history of improving LFL through self-help measures, we expect some reacceleration at the start of 2017. We believe this will be helped later in the year by the contribution from the new General manager, Giorgio Candido who joins from the Salmoiraghi retail chain.

LensCrafters is over concentrated in the south which has seen more robust sentiment. The data from Jobson can also be split by region. We calculate the greatest number of LensCrafters stores (c315) are found in the south with the lowest number in the northeast (see Figure 91). Looking at the year–on–year change in overall sentiment towards the next 6 months, the south and mid-west record positive changes in forward looking sentiment year on year, which is favourable for Luxottica given its larger concentration of stores in the south. However, in its second largest region, the west, there was a considerable slowdown in sentiment after several quarters of positive momentum.

Luxottica has shown before how it is able to turn around its LensCrafters stores. In 2014 it introduced a two-step plan which involved product segmentation and store refurbishment. The benefits in LensCrafters LFL following the product segmentation and re-assortment was material enough for management to delay the refurbishment as LFL increased to c5%. We note this may have also been partly supported by introducing LensCrafters to VSP and other insurance provider panels. It was only in 2016 the company decided to launch its new store format, removing the lens labs, introducing the Clarify eye exam and making the stores more compact and modern. Given their history of improving LFL through self-help measures, we expect some reacceleration at the start of 2017. We believe this will be helped later in the year by the contribution from the new General manager, Giorgio Candido who joins from the Salmoiraghi retail chain.

### Figure 91: LensCrafters are over exposed to the south of the US...

Distribution of LensCrafters stores across the US, %

Source: Company data, Credit Suisse research

### Figure 92: …which has seen a good improvement in sentiment vs. 3Q15

Y-o-Y change in sentiment for overall sentiment, %

Source: Jobson Optical Business Barometer, Credit Suisse research
Power still lies with the managed care providers in the US... In our initiation of Luxottica we discussed the US managed care market and importance of vision insurers (see ‘Attractive entry point for the long-sighted’ June 2016). The two largest insurers, VSP and EyeMed (owned by Luxottica), dominate the market and through large scale programs with employers have access to a very large pool of consumers. These insurance providers can use member marketing and better discounts to push their consumer clusters into stores – controlling the flow of traffic in the US optical retail landscape.

…and they are looking to dictate more of the market. Moreover, in response to increasing competition, vision care insurers have started to also dictate the lens labs used when finishing and processing orders associated with their insurance plan. Initially this required ECPs and approved chains to go to an insurer approved lab but this has developed to specifically dictating insurance orders to insurer owned labs, putting pressure on private lens labs and other manufacturers. From our channel checks, we believe this is done by VSP but not yet done by EyeMed. EyeMed does push retailers to choose one of its third-party approved labs by offering cheaper prices via these labs but this is not compulsory. Interestingly Essilor is currently one of the partners that make up this third-party EyeMed approved network.

EssilorLuxottica has a significant advantage in this market if it levered the insurance platform. As well as being more resilient to the US as a combined entity, we also believe the new entity can have a greater influence in the insurance market. According to our channel checks, VSP has become more aggressive with pricing recently as it tries to take market share and differentiate itself. Historically, insurers had relatively different member panels (retail chains/ECPs signed up to the program) but these have converged in recent years, putting the onus on pricing to win employer contracts. Competing on pricing would put pressure on margins but we believe the benefit of being able to push consumers into LensCrafters/other own retail stores, or even the independents under Essilor’s buying Groups, far outweighs the drag on profitability if EyeMed was run at break even, for example. Moreover, we would see it as a positive if following a successful integration of the EssilorLuxottica company, the company looked to expand insurance coverage by buying up another established insurance company such as Superior Vision Insurance.
Luxottica Group (LUX.MI)

Increase target price given merger synergies

- Reiterate Outperform and increase target price to €58 from €50. Luxottica’s share price is back towards pre-Essilor merger announcement levels and appears to be pricing in little to no synergies for the deal. We believe this creates an attractive entry point into a value-generating merger. Luxottica now trades in line with the luxury sector vs. a 10-year historical premium of 21%. EssilorLuxottica ex synergies trades just below its 5-year 12-month forward consensus EV/EBIT of 17.3x, and on 15.6x FY18E.

- **Investment story intact.** We do not believe the merger timing was a sign the equity story at Luxottica had derailed, and we continue to think the investment plan will run to completion. We believe this merger was driven by i) the synergies of becoming purely vertically integrated, creating a fully independent company with no sacrifice of profits along the value chain; ii) the end to the capital-intensive and lower-return divestment into each other’s businesses; and iii) the need to solve the succession issues at Luxottica.

- **We believe EssilorLuxottica can outperform.** With the merger, we believe some of the legacy problems at each company are removed. This includes under penetration of emerging markets, Luxottica’s weakness with the independents, particularly in the US, and the online strategy. See our detailed EssilorLuxottica model in Seeing EssilorLuxottica clearly, also published today.

- **Risks to our investment case:** i) the merger does not happen, ii) the eyewear industry experiences a significant slowdown, especially in the US, and iii) the company initiative is executed poorly.

- **New target price of €58.** We back out Luxottica’s target price from Essilor’s given the stated exchange rate of 0.461. This target price is derived from a 50:50 weighting of a pro forma DCF for EssilorLuxottica and a Credit Suisse HOLT® Linker including synergies of €540m, in line with company guidance of €400-600m.
Digital threat too big for now

- **We initiate on GrandVision with an Underperform rating and €19 TP.** GrandVision (GV) is a mass-market player in optical retail. Since its IPO in January 2015, it has expanded its store network, which has contributed >60% of topline growth. Additionally, through supply chain reorganisation and efficiency programmes, the company has expanded margins by 170bps since FY11 leading to a peak adj. EBITDA margin of 16.2% in FY16.

- **The threat of digital on a pure-play retailer seems too great.** We see online as a growing disruptor in this industry. GV operates websites for all of its 29 banners, but these vary in quality with only two websites offering the option of buying Rx glasses. We believe the company is underestimating the threat of digital and the need to invest in this channel and remains focused on building out bricks-and-mortar stores. We expect online to limit topline growth and result in downside to margins in the mid-to-long term.

- **Margin expansion initiatives seem to have largely played out.** GV has implemented a number of strategic initiatives such as i) supply chain reorganisation and ii) launch of a global ERP system. This has helped to expand margins, but with most initiatives largely complete, we struggle to see further potential for margin accretion.

- **We are just below consensus on EBITDA.** We forecast LFL growth of c3% and organic growth ex acquisitions of c4% over the next five years (company guidance of 5% medium term). This leads to peak EBITDA margins of 16.4% by FY19E. This leaves us 2%/2%/4% below consensus on FY17/18/19 EBITDA. With a 25-50% payout ratio, we estimate a TSR of 9% FY16-19E.

- **Valuation does not look supportive; threat of further sell-off by HAL.** The shares have rallied >25% since the lows of December 2016, trading on a EV/EBIT of 16x on our FY18e and at a 35% premium to European retailing/specialty retailing sector on consensus 12-month forward EV/EBIT. We note the overhang from a further sell off by HAL, the majority shareholder. Risks include a slower-than-expected transition by consumers to online and deregulation in France boosting LFL by more than we expect.
Seeing EssilorLuxottica clearly

- **We initiate on Essilor with an Outperform rating and a TP of €127.** Essilor and Luxottica’s share prices have trended back towards pre-announcement levels and no longer price in management’s guided merger synergies of €400-600m. We think this has been driven by: a) profit taking; b) execution risk; and c) concerns over approvals from competition authorities. We understand the first point given the stock has outperformed the CAC 40 by c25% over the past five years, but we detail in this report why we believe the anti-trust and execution concerns are overstated.

- **The roadmap to EssilorLuxottica.** We believe the market is overestimating the execution risk, and in this report we outline the seven key initiatives we think management should implement to harness the full synergies of the merger. These include i) lens insourcing, which we estimate could lead to €150m of cost synergies, and ii) centralisation of lens and frame inventory with lens labs to build the company’s competitive advantage. On anti-trust, we believe the company has some optionality in the US (the market where we believe there could be an issue) through a possible portfolio review.

- **Average EPS growth of 12% out to 2021e.** We forecast €540m of EBIT synergies, driven equally by revenue and costs. This supports our >6% growth forecast for EssilorLuxottica over the next five years, along with our forecast for 330bps of contribution margin expansion by 2021. We forecast EssilorLuxottica to turn net cash in FY20e with a 40% payout ratio. We forecast a 15% TSR over the next three years.

- **Risks:** We see two key risks, i) the deal does not go through because of competition issues or it is rejected by Essilor shareholders at the AGM on 11 May; or ii) the execution of the merger is poor.

- **Valuation is supportive, opening up an attractive entry point into the name.** EssilorLuxottica ex synergies trades on an average historical 12-month forward consensus EV/EBIT of 17.3x. Currently the combined entity is trading at a c10% discount to this on our FY18 estimates, at 15.6x. Our target price of €127 is based on a simple average of our Credit Suisse HOLT® Linker and a pro forma DCF for EssilorLuxottica.

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### Financial and valuation metrics

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<th>12/17E</th>
<th>12/18E</th>
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<tbody>
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<td>Revenue (€ m)</td>
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<td>7,770.1</td>
<td>8,312.0</td>
<td>8,881.0</td>
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<td>EBITDA (€ m)</td>
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<td>1,964.0</td>
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<td>Prev. EPS (€)</td>
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<td>EV/EBITDA (x)</td>
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<td>14.1</td>
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</tr>
</tbody>
</table>

| Dividend (12/17E, €) | 1.50 | Net debt/equity (12/17E, %) | 18.2 |
| Dividend yield (12/17E, %) | 1.4 | Net debt (12/17E, € m) | 1,381.4 |
| BV/share (12/17E, €) | 26.9 | IC (12/17E, € m) | 8,962.9 |
| Free float (%) | 90.5 | EV/IC (12/17E, (x) | 2.9 |

Source: Company data, Thomson Reuters, Credit Suisse estimates

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### Share price performance

The price relative chart measures performance against the CAC 40 INDEX which closed at 4974.3 on 14/03/17. On 14/03/17 the spot exchange rate was €1/E 1.94/US$1.
Safilo Group Spa (SFLG.MI)

Lack of brand visibility leaves us cautious

- Potential for a strong self-help story but earnings still at risk from licence overhang; initiate with Neutral and target price of €6. We like the name because of the 2020 Strategic Plan laid out by current CEO Luisa Delgado. We believe this has scope to become a strong turnaround story as the company removes some of the more basic operational limitations with SAP implementation, improved manufacturing capabilities and insourcing of volumes (70% of global volumes outsourced). Safilo is reducing lead times, rationalising stock keeping units (SKUs) and plans to cut costs by c€25/30m.

- We remain cautious given licence exposure. The turnaround story looks to be at risk from Safilo’s legacy problem around licences. The first major investment plan in 2011 was derailed by the loss of the Gucci licence and the CEO to Kering. It is likely that the Dior licence and the accompanying LVMH licences will also leave. We estimate Dior is c.€200m of revenues (just under 25% of annual sales) and we include part of its loss in our FY21e sales.

- Lack of strength in Safilo’s own brands. Safilo has been targeting a reversal of its licence to proprietary brand weighting. It currently sits at 75% licences, and targets 60% by 2020. However, outperformance of own brands is yet to materialise. We forecast -11% constant currency (cc) growth in FY17 as the Gucci licence ends and the company guides towards -15%/-20% growth of its ‘going forward brand portfolio’ in 1Q17. We forecast 5%/6% cc growth thereafter and c160bps of EBITDA margin expansion over FY16-FY20, giving total shareholder return of low single digits over the next 3 years.

- Risks include i) Dior terminating its contract earlier than expected/or not at all, ii) own brands do not regain momentum, iii) further issues with execution of 2020 Strategic Plan or iv) the company buys in another strong brand.

- Valuation in line with history. Safilo trades on a normalised EV/EBIT of 20x over the next 5 years, ahead of its 10-year average at c10x, but looks undervalued on EV/Sales of 0.4x vs. history of 0.7x. Our TP of €6 is based on an average of our Credit Suisse HOLT® Linker™ valuation and DCF using a weighted average cost of capital of 8% and terminal growth of c2%.

The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1472.5 on 14/03/17
On 14/03/17 the spot exchange rate was €1/Eu 1.17, Eu.94/US$1

Financial and valuation metrics

<table>
<thead>
<tr>
<th>Year</th>
<th>12/16A</th>
<th>12/17E</th>
<th>12/18E</th>
<th>12/19E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue (€ m)</td>
<td>1,252.9</td>
<td>1,130.1</td>
<td>1,202.2</td>
<td>1,264.6</td>
</tr>
<tr>
<td>EBITDA (€ m)</td>
<td>86.7</td>
<td>28.6</td>
<td>60.8</td>
<td>86.9</td>
</tr>
<tr>
<td>Adjusted net income (€ m)</td>
<td>13.68</td>
<td>-16.00</td>
<td>1.10</td>
<td>14.97</td>
</tr>
<tr>
<td>CS EPS (adj.) (€)</td>
<td>0.22</td>
<td>-0.26</td>
<td>0.02</td>
<td>0.24</td>
</tr>
<tr>
<td>Prev. EPS (€)</td>
<td>5.0</td>
<td>-1.2</td>
<td>0.7</td>
<td>2.2</td>
</tr>
<tr>
<td>ROIC (%)</td>
<td>30.2</td>
<td>-25.8</td>
<td>376.6</td>
<td>27.6</td>
</tr>
<tr>
<td>P/E (adj.) (x)</td>
<td>119.4</td>
<td>-211.7</td>
<td>3664.2</td>
<td>300.7</td>
</tr>
<tr>
<td>P/E rel. (%)</td>
<td>5.3</td>
<td>15.4</td>
<td>6.8</td>
<td>4.5</td>
</tr>
<tr>
<td>EV/EBITDA (x)</td>
<td>0.00</td>
<td>Net debt/equity (12/17E, %)</td>
<td>3.1</td>
<td></td>
</tr>
<tr>
<td>Dividend yield (12/17E, %)</td>
<td>0.0</td>
<td>Net debt (12/17E, € m)</td>
<td>27.3</td>
<td></td>
</tr>
<tr>
<td>BV/share (12/17E, €)</td>
<td>13.9</td>
<td>IC (12/17E, € m)</td>
<td>903.9</td>
<td></td>
</tr>
<tr>
<td>Free float (%)</td>
<td>48.6</td>
<td>EV/IC (12/17E, x)</td>
<td>0.5</td>
<td></td>
</tr>
</tbody>
</table>

Share price performance

The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1472.5 on 14/03/17
On 14/03/17 the spot exchange rate was €1/Eu 1.17, Eu.94/US$1

<table>
<thead>
<tr>
<th>Performance</th>
<th>1M</th>
<th>3M</th>
<th>12M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute (%)</td>
<td>0.1</td>
<td>-17.5</td>
<td>-17.4</td>
</tr>
<tr>
<td>Relative (%)</td>
<td>-2.0</td>
<td>-22.1</td>
<td>-28.4</td>
</tr>
</tbody>
</table>

Source: Company data, Thomson Reuters, Credit Suisse estimates
Companies Mentioned (Price as of 14-Mar-2017)

Dixons Carphone Plc (DC.L, 304.1p)
Essilor International SA (ESS.PA, €110.8, OUTPERFORM, TP €127.0)
Fielmann (FIEG.DE, €71.66)
GrandVision N.V (GVNV.AS, €22.98, UNDERPERFORM, TP €19.0)
HOYA (7741.T, ¥5,424)
Hennes & Mauritz (HMB.ST, Skr246.5)
Inditex (ITX.MC, €31.39)
KappAhl (KAHL.ST, Skr46.4)
Kingfisher (KGF.L, 341.1p)
LVMI (LVMH.PA, €198.35)
Luxottica Group (LUX.MI, €50.1, OUTPERFORM, TP €58.0)
Marks & Spencer (MKS.L, 330.5p)
Matas (MATAS.CO, Dkr99.0)
Next (NXT.L, 3929.0p)
OVS Spa (OVS.MI, €5.48)
Pets at Home Grp (PETSP.L, 188.3p)
Safilo Group Spa (SFLG.MI, €6.58, NEUTRAL, TP €6.0)
Sports Direct (SPD.L, 297.1p)
ULTA Salon, Cosmetics & Fragrance, Inc. (ULTA.OQ, $285.38)
XXL ASA (XXLA.OL, Nkr93.0)

Disclosure Appendix

Analyst Certification

Catherine Tillson and Guillaume Gauvillé, CFA, each certify, with respect to the companies or securities that the individual analyzes, that (1) the views expressed in this report accurately reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

3-Year Price and Rating History for Luxottica Group (LUX.MI)

<table>
<thead>
<tr>
<th>Date</th>
<th>Closing Price (€)</th>
<th>Target Price (€)</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-Jun-16</td>
<td>44.82</td>
<td>52.00</td>
<td>O *</td>
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<tr>
<td>07-Oct-16</td>
<td>40.85</td>
<td>50.00</td>
<td></td>
</tr>
</tbody>
</table>

* Asterisk signifies initiation or assumption of coverage.

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**Neutral (N)**: The stock’s total return is expected to be in line with the relevant benchmark* over the next 12 months.

**Underperform (U)**: The stock’s total return is expected to underperform the relevant benchmark* over the next 12 months.

*Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock’s total return relative to the analyst’s coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. As of 2nd October 2012, U.S. and Canadian as well as European ratings are based on a stock’s total return relative to the analyst’s coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock’s total return relative to the average total return of the relevant country or regional benchmark: prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock’s absolute total return potential to its current share price and (2) the relative attractiveness of a stock’s total return potential within an analyst’s coverage universe. For Australian and New Zealand stocks, the expected total return (ETR) calculation includes 12-month rolling dividend yield. An Outperform rating is assigned where an ETR is greater than or equal to 7.5%; Underperform where an ETR less than or equal to 5%. A Neutral may be assigned where the ETR is between -5% and 15%. The overlapping rating range allows analysts to assign a rating that puts ETR in the context of associated risks. Prior to 18 May 2015, ETR ranges for Outperform and Underperform ratings did not overlap with Neutral thresholds between 15% and 7.5%, which was in operation from 7 July 2011.

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**Target Price and Rating**

**Valuation Methodology and Risks: (12 months) for Essilor International SA (ESSI.PA)**

**Method:** Our target price of €127 is based on a simple average of our HOLT Linker and a DCF (WACC of 6%, long-term growth of 3%) based on our pro forma EssilorLuxottica model. We rate the shares Outperform as we believe the stock looks attractive on most metrics and has a stronger competitive positioning than its peers as the eyewear industry faces increasing disruption from online.

**Risk:** Key risks to our Outperform rating and €127 target price include: The merger with Luxottica falls through. Further deceleration and weakness in the US optical market. Increased competition from other lens manufacturers. Bad weather affecting the sun season. Resistance from independent opticians in the US to take on Essilor-branded products. Acquisitions of overpriced or poor-quality assets.

**Target Price and Rating**

**Valuation Methodology and Risks: (12 months) for GrandVision N.V (GVN.VAS)**

**Method:** Our Underperform rating and €19 target price is based on a simple average of our HOLT Linker and our DCF valuation. We believe the stock looks less attractive than peers and expect further earnings downgrades.

**Risk:** Key risks to our Underperform rating and €19 target price are: i) the company manages to effectively launch omni channel which allows them to capture more market share and drive top line. ii) online disruption is less than expected. iii) The company manages to expand aggressively in the US and take market share. iv) The company’s exclusive brands gain market traction and drive volumes into store.

**Target Price and Rating**

**Valuation Methodology and Risks: (12 months) for Luxottica Group (LUX.MI)**

**Method:** Our target price of €58 and Outperform rating is based on applying the guaranteed exchange ratio of 0.461 Essilor shares for each Luxottica share. The Essilor share price is a simple average of our DCF and a HOLT Linker model (using a 15-year competitive advantage period window) and the EssilorLuxottica proforma. With the stock having de rated significantly post deal and valuation coming back in line with its the 5yr consensus 12mth fwd EV/EBIT of EssilorLuxottica ex synergies, we think current levels represent an attractive entry point and rate the stock Outperform.
Risk: Key risks to our target price of €58 and Outperform rating include: (i) the merger deal falls through (ii) broad macro weakness (iii) a significant decline in US domestic purchases (iv) loss of key licenses such as Prada (v) key proprietary brand Ray-Ban loses brand equity.

Target Price and Rating
Valuation Methodology and Risks: (12 months) for Safilo Group Spa (SFLG.MI)

Method: Our target price of €6 is based on a simple average of our Credit Suisse HOLT(R) Linker (TM) and our DCF valuation. We believe the stock should look more attractive despite the risk associated with the name as the company looks to implement its 2020 Strategic Plan. Given the stock is trading close to our target price, we rate the shares Neutral.

Risk: Key risks to our Neutral rating and €6 target price are i) one of the key licences such as Dior terminates their agreement early or does not renew their agreement. ii) Broader slowdown in the eyewear sector especially in the US. iii) The proprietary brands fail to gain market share and consumer traction. iv) the business sees significant disruption as it implements its IT transformation.

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