

Profitability in the retail clothing industry marketing essay



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Evaluating the true value of a piece of equity in a company, most typically a share of common stock, is a full-time profession for legions of workers in the financial sector and a frequent activity for countless amateur investors, as well. Many methods for such evaluations exist, and an examination of a company's financial records is an all-but-required element of any such attempt. Given the commonality of the practice, it is hardly surprising that formulas for financial analysis and profitability projections have been established, or that the myriad of competing formulas take on decidedly different forms in an effort to come the closest to accurate predictions of future performance based on an analysis of current figures. Though the general recommendations made by most of these financial-based valuations can be very similar, the specifics of their mechanism and their estimations of future profitability can differ significantly, as any detailed examination of a singular formula will demonstrate.

The following pages just such a detailed examination of one specific valuation formula, the Penman decomposition method (named for its progenitor Stephen Penman), to the retail fashion industry and several of its key players in both the United Kingdom and the United States. Burberry in the UK and The Gap, Inc. in the US will be the primary foci of this analysis, though a portfolio of other companies in the industry will also be included as context within which to assess the relative profitability of both focal firms. Through an application of this particular method of financial analysis and prediction to the assembled portfolio of industry players, it is possible to develop a clear assessment of Burberry's profitability in absolute terms as well as in relation to other companies in the industry and especially a

primary US-based competitor, The Gap, Inc., while also forming a better real-world understanding of the process of valuation and profitability assessment. As the result of this analysis, directly practical recommendations as to the investment in Burberry and/or The Gap, Inc. can be made and trends in the industry as a whole can potentially be identified. This demonstrates not only the academic but also the directly practical power of the Penman decomposition method as a means of profitability assessment through financial record analysis, yielding projections for future potential based on current standings.

Prior to the presentation of the reformulated balance sheets necessary for the Penman distribution and the calculation of the relevant ratios, a brief overview and market assessment of the companies included in the portfolio will be given to provide a basic understanding of relation and position amongst the firms in the industry. Reasons for the selection of these firms as vehicles for developing an industry understanding and a means of comparison with Burberry and The Gap, Inc. will also be presented, followed by a detailed financial assessment of each of the firms included in the portfolio. This will enable the conducting of comparisons between firms, an assessment of the industry as a whole including quartile divisions and trends over time, and through the decomposition of financial documents and specifically the decomposition of return-on-equity measures as called for in the Penman decomposition method, the particular drivers of profitability in individual firms and potentially in the industry as a whole can also be identified. This will all contribute to more accurate assessments of Burberry's standing and potential profitability.

Key Players in the Retail Fashion Industry

Burberry

With over a century-and-a-half as a clothing manufacturer and retailer, Burberry remains a strong player in the retail fashion industry, and is especially well-known for its iconic trench coats and trench coat-inspired clothing lines (Burberry plc, 2012). Founded in 1856, Burberry coats and other outerwear were popularized by many of the world's most famous explorers and aviators of the latter nineteenth and twentieth centuries, and the company now operates manufacturing facilities and retail locations throughout the world. The company has a current market capitalization of approximately six billion GBP, with revenue approaching two billion over the past twelve months and a profit margin of 14.18% (Yahoo Finance, 2012). In addition to its manufacturing and direct retail operations through its 230+ stores and 200 concession boutiques in other upscale department stores, Burberry operates wholesaling and licensing divisions with several of its brand names (Hoovers, 2012). Significant growth and product innovation has occurred within the company in the past decade, reaffirming its position in the fashion industry (Burberry plc, 2012; Hoovers, 2012).

The Gap, Inc.

The Gap, Inc. was founded in 1969, and has grown from a jeans-focused manufacturer and retailer to a specialty clothing retailer operating five major brands in over ninety countries when both physical stores (numbering over 3,000) and Internet-based sales are taken into account (The Gap, Inc., 2012). A market capitalization of 16.8 billion USD (approximately 10.6 GBP)

and revenue of almost 15 billion USD (approx. 9.4 GBP) makes the company a very strong player in the US and international clothing retail business, and its five major brands (Gap, Old Navy, Banana Republic, Piperlime, and Athleta) are already or are quickly becoming household names in many regions of the world (The Gap, Inc, 2012; Hoovers, 2012a; Yahoo Finance, 2012a). Though there are some essential differences in the target market and overall operational strategy between Burberry and The Gap, Inc, the similarities of the company in their manufacturing, direct retailing, wholesaling and licensing operations make them ideal companies for comparison and could begin to point to differences in profitability between US-based and UK-based corporations operating internationally in the retail fashion industry (Hoovers, 2012; Hoovers, 2012a).

Benetton Group

Italian-based clothing manufacturer and retailer Benetton Group was founded in 1965 by Luciano Benetton and his siblings, initially simply producing colorful knitted sweaters for sale in established stores in the Veneto region but quickly expanding its product line and moving into direct retail sales (Benetton Group, 2012). Facing lagging sales and internal issues that the Benetton family felt needed drastic changes in order to correct, the company was taken private earlier this year when the Benetton siblings bought all outstanding shares in the company and regained complete control of Benetton and its several still-popular (though waning) brands (Sanderson, 2012). As such, the company has no current market capitalization amount and is not required to publish its financial records in the same manner as public companies, however the group's franchise system of retail stores as <https://assignbuster.com/profitability-in-the-retail-clothing-industry-marketing-essay/>

well as the company-owned stores still generated over two billion Euros (approximately 1.8 billion GBP) in 2011 (Benetton Group, 2012). Though current financial information is not readily available, the most recently available figures show signs of a company in trouble yet with products and a brand that are still recognizable and in demand, and the former glory of the company is entirely salvageable according to many analysts (Hoovers, 2012b). As one of Europe and indeed the world's largest clothing manufacturers and retailers, no fashion/clothing retail industry analysis or comparison would be complete without the inclusion of the Benetton Group (Hoovers, 2012b).

H&M

Recognizable in Europe, the United States, and around the world as a purveyor of affordable everyday wear, fashion, and a range of accessories, and the newer H&M Home brand has brought the company into the interior design/home décor industry, as well (H&M, 2012). Founded in Sweden in 1949, the company now operates 2,600 H&M-branded stores in over forty countries, and the company's own team of designers is responsible for all H&M collections, leading to a tight cohesion between administration and design, yet the company does not actually manufacture its products but rather orders their designs through an international network of independent suppliers (H&M, 2012; Hoovers, 2012c). This strategy has served the company well during a period of rapid growth in terms of sales and geographic spread; H&M currently has a market capitalization of 406.3 billion Swedish krona (approximately 38.7 billion GBP), and in the first half of 2012 sales generated revenue of almost sixty billion krona (just over five-

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and-a-half billion GBP) (Hoovers, 2012c; H&M, 2012; MarketWatch, 2012).

This company is in a slightly different position than many others in the industry, and appears to be on a trajectory towards its pinnacle rather than in years of potential decline as many of the other long-term players in the industry, but these differences actually make it an incredibly useful organization for use in comparisons and as H&M has a substantial industry presence its inclusion is more than warranted (Hoovers, 2012c).

Limited Brands

Though heavily focused on the United States with nearly 3, 000 specialty stores operating under its various brands, Limited Brands has a sizable and growing international presence with almost 700 stores, some of which are company-owned while others are franchise operations (Limited Brands, 2012). Company brands such as Victoria's Secret and Pink operate in narrow segments of the retail fashion industry, while Bath & Body Works expands the company's industry scope to a variety of home, health, and beauty products, moving away from decades of exclusive focus on apparel that the company had held since its founding in 1963 (Hoovers, 2012d). While design takes place primarily in-house, manufacturing is achieved through independent suppliers, generating revenue of 10. 24 billion USD (approximately 6. 47 billion GBP) (Limited Brands, 2012; Yahoo Finance, 2012b). Despite the diversity of the company's two most prominent and profitable brands, Victoria's Secret and Bath & Body Works, Limited Brands has actually been undergoing a long process bringing greater focus to its operations, divesting itself of many companies and brands over the past decade-and-a-half, including Abercrombie & Fitch, Express, and more

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(Limited Brands, 2012). The company remains a major player in apparel, however, and has revenue in this area substantial enough to warrant closer inspection in terms of industry profitability (Hoovers, 2012d).

Hermes

One of the oldest companies still operating in the retail fashion industry, Hermes of Paris, Inc. pre-dates even Burberry with its 1837 founding and has a wide variety of offerings from apparel to leather goods (including saddles and other tack), a plethora of accessories, and other consumer goods (Hermes, 2012; Hoovers, 2012e). A market capitalization of 23.3 billion Euros (approximately 18.5 billion GBP and an almost 21% profit margin on close to three billion Euros (approx. 2.38 billion GBP) makes the company a formidable player in all of its various sectors of operation, including in apparel, for which the company products and retails several specialty lines focused on specific demographics (Hermes, 2012; Yahoo Finance, 2012c). Like many other competitors in the apparel industry, Hermes is heavily diversified; unlike many competitors, it remains largely focused on upscale and luxury items, with Hermes customers often willing to pay a premium for the brand and with the recent economic upheaval not appearing to have tarnished the company's image or earnings too significantly, or at all in the long-term (Hermes, 2012; Hoovers, 2012e; Yahoo Finance, 2012c). The luxury aspect of Hermes' business focus makes it especially fitting as a comparison to Burberry.

TJX

On the other end of the clothing retail spectrum is The TJX Companies, which operates a variety of off-price retail stores in the United States, Canada, and Europe, offering seconds, overstocks, and other apparel and consumer goods at prices often significantly lower than those seen in mainstream department stores and specialty retail outlets (The TJX Companies, 2012; Hoovers, 2012f). With thousands of retail locations under the T. J. Maxx, Marshall's, T. K. Maxx, Home Goods, and other brands, The TKX Companies, Inc. is the largest discount clothing retailer in the United States and is one of the largest in the world, with a market capitalization of 34.4 billion USD (approximately 21.75 billion GBP) and twelve-month revenues of 24.25 billion USD (approx. 15.34 billion GBP) (Yahoo Finance, 2012d). Founded less than four decades ago and still relatively small and young on the international scene, this company also forms a contrast to many others in the portfolio in terms of its proven longevity and its scope of operations (The TJX Companies, 2012). Including this company in the portfolio will lead to a more comprehensive and ultimately more nuanced view of what drives profitability in the retail clothing industry.

Portfolio Overview

On the whole, the portfolio is comprised primarily of higher-end fashion retailers, approximately half of which are also manufacturers of the products they sell and most of which provide the design basis for their products. All companies included in the portfolio operate on an international basis, though the scale of spread and areas of concentration/higher sales vary considerably from company to company. Many of the companies included in the portfolio also operate in sectors other than clothing and fashion retail, <https://assignbuster.com/profitability-in-the-retail-clothing-industry-marketing-essay/>

insulating their profitability from changes in this particular market but also spreading these companies' interests and operations to a degree that could perhaps be detrimental to their growth and profitability. Examination of these issues through the analysis of these companies' financial records and specifically through an application of the Penman decomposition method.

Penman's Decomposition Method

Return-on-equity is a ratio often utilized to determine the profitability of a company to its shareholders, and is a useful measure as long as it is properly understood. According to some analysts and researchers, including Stephen Penman and Doron Nissim (2001), the traditional means of calculating return-on-equity and even of formulating balance sheets, income statements, and other financial records does not accurately reflect a firm's profitability as it combines financial and operating assets and liabilities in the firm's valuation (Wahlen et al, 2010). Separating these elements and otherwise decomposing and reconstituting the return-on-equity for each company can yield a more accurate and predictive assessment of current and future profitability, according to this view, and this must begin with a re-evaluation of financial documents. Once the various elements have been properly identified and controlled for in the financial documents, the formula for the Penman decomposition is relatively simple: return-on-equity is calculated as the sum of the return on operating assets and the financial leverage of the firm multiplied by the difference between the return on operating assets and the net borrowing costs to the firm by which its leverage was achieved (Nissim & Penman, 2001; Wahlen et al, 2010).

This equation makes explicit that there can only be a return on equity when the cost of borrowing is lower than the return on operating assets, as anything else would lead to a negative multiplier in the equation and thus yield a negative result for the return on equity. In addition, the return on equity is made up of real return on operational assets and the degree to which the company was able to profit from financial leverage, making explicit the combined elements of profit generation for stakeholders without obscuring or conflating these elements (Wahlen et al, 2010). The traditional mode of calculating return-on-equity incorporates both operational and financial aspects of a company's financial records, as well, but it does not separate these elements out or provide a clear explanation of their mechanism and interaction in creating value for a company and its shareholders. The Penman decomposition is based on the premise that these aspects of a company and their interactions are central to the profitability of the firm, and that accurately identifying these elements is necessary in carrying out true due diligence before undertaking an investment (Wahlen, 2010; Melumad & Nissim, 2009). Applying this method to the companies described above will lead to a fair and accurate assessment of their current profitability and potentially their future profitability based on current account standings, thus offering an understanding of how Burberry stacks up against the industry and against specific competitors such as The Gap, Inc. in terms of profit potential for shareholders.