Portfolio Watch

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ESTÉE LAUDER – A CAUTIONARY TALE

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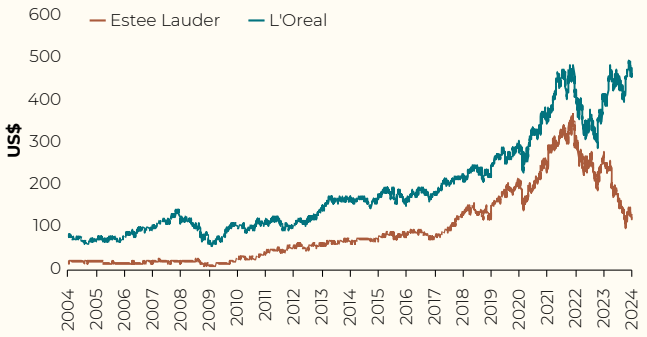
Historically, beauty industry giants L'Oréal and Estée Lauder have exhibited similar growth patterns, resulting in a strong correlation in their share price performance. However, in 2023, a remarkable and unprecedented disparity emerged between the fortunes of the two companies. Estée Lauder saw a significant 41% decline in its share price, while L'Oreal's surged by 40%. This intriguing development took place in a backdrop where the overall beauty industry expanded by a projected 9%, prompting us to question the validity of the age-old saying, "a rising tide lifts all boats".

WHAT IT TAKES TO LEAD THE MARKET

L'Oréal was added to the Private Clients Global Equity Portfolio in December 2019. At the time, we highlighted the value of the group's diverse product portfolio and extensive distribution and manufacturing footprint. This diversity and scale placed the group in a very good position to benefit from faster-growing verticals within the beauty industry, such as fine fragrances and active cosmetics, as well as faster-growing regions, such as the Middle East and Latin America.

Graph 1: L'Oréal and Estée Lauder share price since 2004



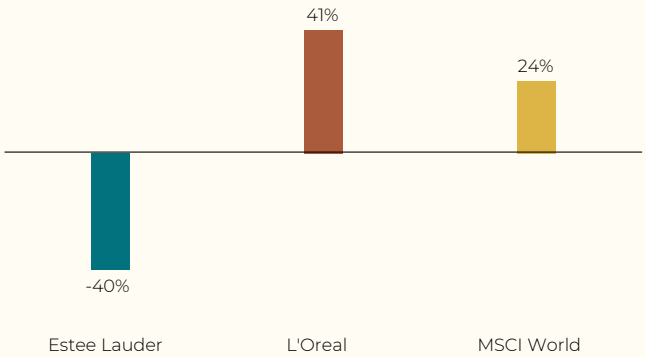
Source: Private Clients by Old Mutual Wealth

The strength of L'Oréal's business model shone through during the COVID-19 pandemic when it was able to outperform the market and gain market share. This was due to a robust and mature e-commerce strategy as well as local manufacturing and distribution capabilities. Estée Lauder, on the other hand, struggled during the pandemic as it lacked meaningful exposure and access to the mass market and its distribution footprint was over-exposed to travel retail.

A SERIES OF UNFORTUNATE EVENTS

During 2021, in anticipation of borders re-opening and commercial travel resuming, Estée Lauder eagerly restocked the Chinese market and travel retail store network. However, ad hoc lockdowns were subsequently implemented in China, economic growth fell and travel retail remained depressed. Furthermore, the group's largest market, the US, also reported destocking and faced a slowdown in demand that rocked the global luxury goods sector. As a result, Estée Lauder found itself overstocked in two of its largest markets (a disastrous predicament for a luxury brand) and resorted to discounting, which eroded margins quite significantly.

Graph 2: L'Oréal and Estée Lauder Total Return (2023)



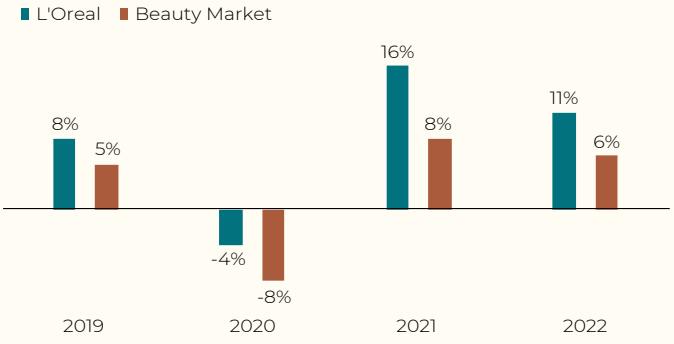
Source: Private Clients by Old Mutual Wealth

To further complicate the situation, Estée Lauder completed a US$2.25bn acquisition of Tom Ford in April 2023, which was partially funded with debt. This acquisition was made at a time when interest rates were at their highest in a decade, and management was already struggling to reinvigorate growth in skincare and make-up. For the quarter July to September 2023, Estée Lauder's earnings per share declined by 94%. With the strain on cash flow driven by a collapse in earnings and the increased leverage driven by the acquisition, the group faces the risk of being downgraded by credit ratings agencies. This alarmed investors, prompting a sharp sell-off in 2023.

Management have unveiled a profit recovery plan, which is expected to bear fruit in 2025 and 2026. For this year though, with travel retail volumes remaining below 2019 levels, sales and earnings are expected to remain under pressure, and the group will need to diversify its distribution channels to support growth. This of course requires considerable investment.

While we do not hold Estée Lauder in our portfolios, we were encouraged by the group's recent second quarter result. While revenue (-8%) and earnings per share (-20%) continued to decline, management announced an extensive restructuring plan, targeting a 3% - 5% reduction in headcount. Retrenching staff is often the most difficult decision to make, however, it is often the most effective action when the goal is reducing the cost base to be more in line with a lower sales volume. Lower staff costs should support gross and operating profit growth in the comparable 2025/6 financial period, which will positively impact management's credibility and investor sentiment and provide the group with a stronger foundation from which to rebuild.

Graph 3: Annual Sales Growth



Source: Private Clients by Old Mutual Wealth

THE POWER OF CAREFUL STOCK SELECTION

Amid Estée Lauder's woes, L'Oreal was able to grow sales and market share significantly, with L'Oréal Luxe Division becoming the global luxury beauty market leader by sales volumes. We are confident that it remains well placed to continue gaining market share – both in the mass and luxury beauty markets. A conservative balance sheet and prudent capital allocation further supports the group's premium valuation rating. We therefore maintain our view that L'Oreal is the best-in-class beauty company and highlight the importance of careful stock selection, even in seemingly "defensive" industries.

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