GROUPE H E C

L'OREAL
CASE STUDY

Please send any questions on this case study to the author via the mail box on the web site www.vernimmen.net

Pascal Quiry **August 2002**

DISCLAIMER

Like in an historical novel, where imaginary situations are inserted into an actual context, and invented characters interact with historical figures, this case study introduces a plausible discussion among members of the L'Oreal Board of directors on the future of the 20% stake it holds in the pharmaceutical group Sanofi which will be reduced down to 10% following the sucessfull takeover of Aventis by Sanofi. The conversations below never took place and were invented by the author of this case study, purely for teaching purposes. They should under no circumstances be interpreted as a reflection of reality in anyway whatsoever.

A few excerpts from discussions of L'Oreal's Strategic and Financial Committee on January 23, 2004

The L'Oréal strategic and financial committee is a committee made up of L'Oréal board members, whose role is to look into the implications of major strategic and financial decisions of the group, before this are discussed at plenary board sessions.

The group Chairman, the vice chairman responsible for finance and administration and 4 directors sit on the committee.

Chairman:

Ladies and Gentlemen, as you are aware, Sanofi-Synthélabo, in which we have a 20% stake, has informed us of its wish to launch an unsolicited offer on Aventis, one of its major competitors. This doesn't come as much of a surprise, given that the pharmaceutical sector worldwide is still very fragmented, and the growing cost of R&D quite naturally encourages concentration.

Let assume that this offer will eventually be successful. Such a link-up would lead to a dilution of our 20% stake in Sanofi to around 10%. We would no longer be able to account for it under the equity method, i.e. instead of recording 20% of Sanofi-Synthélabo's earnings on our income statement, we would book 10% of the dividend to be paid out by the new group Sanofi-Aventis.

I'd like to get your preliminary opinion regarding our future strategy: shall we keep this 10% stake, shall we increase it back to 20%, shall we selling it on the market or dividend it out to our shareholders?…..

Director n°1:

But if I understand correctly, since the dividend pay out ratio of this new group would be less than 100%, we would be recording lower earnings on this investment on our income statement after the link-up than before?

Vice Chairman:

Yes, that's right

Director n°2:

And so we'd see a drop in our earnings per share?

Vice Chairman:

Yes, that's right

Director n°3:

But I just don't get it. I thought that this deal would create value for our shareholders, as Sanofi will pay a control premium which value is below the value of synergies created by this merger and nevertheless our EPS is apparently going to drop???

Director n°2:

But then the L'Oréal share price is going to fall too!!!!

Director n°4:

But today, given the size of our stake in Sanofi, which is around 25% of our market capitalisation, and the different fields we operate in – cosmetics for L'Oréal and pharmaceuticals for Sanofi, any analyst worth his salt would look at L'Oréal not as a single product group but as a cosmetics group that has a diversified high-earnings interest in the pharmaceuticals sector. In other words, the value of L'Oréal should not be determined on the basis of net profits x PER, but as follows: net profits excluding earnings on our 20% stake in Sanofi x PER + 20% of the market cap of Sanofi. After the link-up, the reasoning would remain the same, except that instead of a 20% stake in Sanofi we would have a 10% stake in Sanofi-Aventis which, if I've understood you correctly, would be worth more than our current 20% stake in Sanofi because the control premium paid is below the value of synergies.

Vice Chairman:

Yes, you're right on the last point.

Director n°2:

This is all very theoretical and analysts, as you can read in the papers every day, are full of talk and at the end of the day, they'll shoot for the easy option. EPS is the only thing that matters and EPS is going to drop, so I'm against this link-up.

Director n°3:

But in that case, why not buy up shares in the new group after the link-up, and increase our stake from 10 % to 20%. We could then consolidate this holding instead of only booking a fraction of its earnings which are paid in the form of dividends.

Director n°1:

But how would we finance an investment like that?

Director n°3:

By borrowing of course. We have a large capacity for borrowing.

Director n°4:

Well I just don't get it. We've been told that L'Oréal's future lies in cosmetics with a lot of new promising markets to conquer : Russia, China, India, and eventually Africa over the long run. And now you would want us to buy huge quantities of Sanofi-Aventis shares at high price instead of investing in our core business?

Director n°2:

Yes, but if we did, the impact on our EPS would be positive and this would be a good deal!

Director n°1:

Even if our current financial leverage is quite low with only € 1 bn of net debt, I do not see how we could raise more than € 6 bn of new bank debt, as it would raise our leverage ratio to 1. But we would need at least € 11 to 14 bn to buy a further 10 % of the new group after the link-up.

……………………

Director n°1:

This in fact leads us in to a basic issue that we need to deal with – what should we do tomorrow with this 10% stake in Sanofi-Aventis? There are no synergies with our core business and we have no control over the group. Shouldn't we just make things easy for ourselves and sell this stake, and use the cash generated by a sale to pay of our bank debts and long-term borrowings, and put the balance in a savings account.

Director n°2:

Well hang on a minute now, dear fellow.   Why on earth would you want us to replace an item on the assets side of our balance sheet that gives us a 25% return every year, with cash that will only earn 2%?   I can think of no better way of destroying value!

Director n°4:

I'm wondering if you haven't got the wrong end of the stick. Our stake in Sanofi, I grant you, recorded on our books for €1,680m, and in 2003, earned us €415m in pre-tax profits, which is where we get the rate of 25%. But if we were to sell it, we'd get around €8bn, i.e. its market price and I do not see how we could create or destroy value by just selling an asset at its fair value!

Director n°3:

I agree with you on that last point, but I think that we should look beyond the immediate future. In a year from now, our 10% stake in Sanofi-Aventis will earn us €500m given the group's increasing profits. The money we get from a sale on the market will still only be earning €160m with interest rates at current rates (2%). So I think that we should hold on to our stake in Sanofi-Aventis.

Director n°1:

What worries me about this deal is that the financial markets may look unfavourably on the fact that we have net cash assets of €8bn. Analysts may start wondering what we're going to do with this cash, and whether we may just waste it, overpaying for acquisitions because we're awash with money. And I fear that the value of this cash may be discounted, even though the L'Oréal management team has an excellent reputation and is, justifiably so, considered to be one of the best in the world, across all sectors.

Director n°3:

Don't worry about it. Firstly, it is common knowledge that Tchibo might have some difficulties to finance the acquisition of the Allianz's stake in Nivéa and that it might be forced to sell its controlling interest in Nivéa, which opens up a very interesting investment opportunity for us. We would seek a rate of return on this investment equal at least to the return on capital employed that we are making today, which is 14%.

Director n°4:

I don't understand where you get the 14%, since our cost of capital is only 7%.

Director n°1:

Well look here dear chap, we are most certainly not planning on making an acquisition which would dilute our very good return on capital employed. You need to re-read your Vernimmen! We need at least 14%

Director n°2:

Yes, our purveyors of funds would be very pleased indeed if every year we earned 14% on our operating assets of € 9,677m.

Director n°4:

Are you sure? I thought that the expected rate of return applied to the market value of the operating asset and not the book value.

Director n°1:

Well you seem to have some difficulties in understanding basic modern corporate finance! Fair value or market value has nothing to do with ROCE. L'Oréal used its capital employed to build up its operating assets for an amount equal to €9,677m. L'Oréal simply needs to get a 14% return on this capital to make both shareholders and lenders happy.

But let's go back to the core question. I am of the opinion that we should sell this 10% stake on the market and use the proceeds to buy back part some L'Oréal's shares as our share price is 20% below its all-time high. The impact on the EPS would surely be positive as our PE ratio (26) is larger than the one of Sanofi-Aventis (17). And I am sure that this will push up our share price.

Director n°2:

I do not understand why you want to get rid of this stake in this group L'Oréal created 30 years ago. It has been our best ever investment! Its stock price has increased by 20% a year over the last 30 years. Why on earth Sanofi-Aventis should not be able to do the same in the future? Look, its 2003 net income is up 21 %. My God, we are not financial guys but industrialists! The day Nivéa will be put for sale, we will sell this stake to finance such an acquisition. But in the meantime, can we find a better investment? I do not think so.

QUESTIONS

1. Provide a brief financial analysis of L'Oréal. State your views.

2. Provide an analysis of the market value of L'Oréal. State your views.

3. Do you think, like Director N°1, that the contemplated link-up between Sanofi and Aventis would not be in L'Oréal's best interests, as it would lead to a reduction in the earnings that L'Oréal could book? Why?

4. Do you think, like Director N°4, that the contemplated link-up between Sanofi and Aventis would be in L'Oréal's best interests, as it would lead to an increase in the value of L'Oréal's assets? Why?

5. Do you think, like Director N°3, that the 2 preceding points of view could be reconciled if L'Oréal bought enough shares in the new group after the link-up between Sanofi and Aventis, to raise its stake to 20%? Why?

6. Do you think, like Director N°1, that the maximum level of debt L'Oréal could incur is limited to 100 % of its equity ? If not, what would you suggest ?

7. Would the sale by L'Oréal of its 10% stake in Sanofi-Aventis create value for the shareholders of L'Oréal? Why?

8. Would it be a good idea financially speaking to keep the cash made on the sale of the 10% stake in Sanofi-Aventis on the asset side of L'Oréal's balance sheet? Why?

9. What else could it be used for other than for financing an investment?

10. Should L'Oréal seek a rate of return that is equal to its cost of capital or equal to its return on capital employed on an investment which has the same level of risk as its current activity? Why?

11. Would a L'Oréal shareholder who had bought shares when the group was established seek the rate of return as determined by the CAPM (around 7%) on the book value of L'Oréal shareholders' equity or on market capitalisation ? Why ?

12. Do you think like Director N°1 that a buy-back of L'Oréal shares financed through the disposal of its stake in Sanofi-Aventis would have a positive impact on L'Oréal's EPS? Why?

13. What would be your recommendation to L'Oréal regarding its 10% stake in Sanofi-Aventis:

- Keep the stake,
- Sell it and keep the cash on the balance sheet,

- Dividend it out to L’Oréal’s shareholders,
- Sell it and buy back L’Oréal’s shares with the proceeds,
- Or any other idea you might think of.

Why?

Appendix

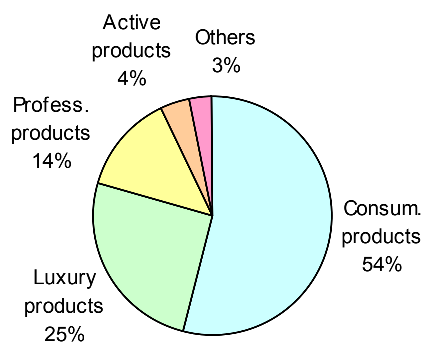
L'OREAL

1. Overview :

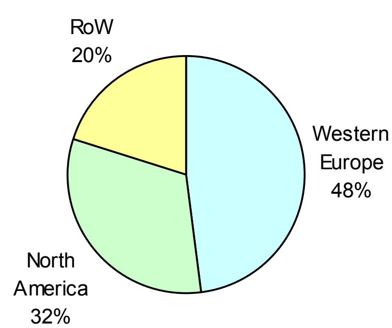
L'Oréal is the world's largest cosmetics company with a global market share of approximately 14%. The company is present in over 150 countries with 283 subsidiaries, 46 plants and over 48 000 employees. In 2001, L'Oréal totalled revenues of €14 billion and a net result of €13 billion. Its current market capitalization ranges around €50 billion.

Its majority shareholder is Gesparal with 53.7% of the shares, with the balance being free float. In turn, Gesparal is controlled by Madame Bettencourt (51%) with Nestlé holding the balance of the shares in Gesparal.

Breakdown of Revenues by activities
2001



Breakdown of Revenues by regions
2001



L'Oréal's global positioning
on its markets

	Global position
Haircare	N°1
Colour cosmetics	N°1
Skincare	N°3
Fragrances	N°3
Bath and shower	Not significant

2. Financial Performance :

Consolidated P&L (fiscal year end 31/12)

Euros million	1999	2000	2001e	2002e	2003e
Net sales	**10 751**	**12 671**	**13 943**	**15 134**	**16 454**
Growth	*12,1%*	*17,9%*	*10,0%*	*8,5%*	*8,7%*
Purchases	-2 039	-2 307	-2 535	-2 745	-2 974
Gross profit	**8 712**	**10 364**	**11 407**	**12 389**	**13 479**
% of Net sales	*81,0%*	*81,8%*	*81,8%*	*81,9%*	*81,9%*
Personnel costs	-1 883	-2 218	-2 474	-2 669	-2 841
External charges	-5 103	-5 989	-6 518	-7 087	-7 725
Taxes	-131	-146	-160	-178	-193
Changes to provisions	-37	-85	-91	-99	-107
EBITDA	**1 558**	**1 926**	**2 164**	**2 356**	**2 613**
% of Net sales	*14,5%*	*15,2%*	*15,5%*	*15,6%*	*15,9%*
Depreciation	-293	-386	-426	-449	-477
EBIT	**1 265**	**1 540**	**1 738**	**1 907**	**2 135**
% of Net sales	*11,8%*	*12,2%*	*12,5%*	*12,6%*	*13,0%*
Net financial expense	-141	-219	-193	-166	-144
Corporate tax	-429	-489	-567	-638	-731
Equity affiliates	137	200	241	326	389
Net profit bef cap gains, mino	**832**	**1 032**	**1 219**	**1 428**	**1 650**
% of Net sales	*7,7%*	*8,1%*	*8,7%*	*9,4%*	*10,0%*
Disposal of fixed assets	-2	-10	143	-6	-7
Restructuring costs	-31	-24	-29	-31	-33
Amort. of goodwill	-6	-24	-29	-29	-29
Minority interests	-6	-5	-5	-5	-5
Net book profit after minorities	**787**	**969**	**1 299**	**1 357**	**1 576**
% of Net sales	*7,3%*	*7,6%*	*9,3%*	*9,0%*	*9,6%*

Consolidated Balance sheet (fiscal year end 31/12)

Euros million	1999	2000	2001e	2002e	2003e
Total fixed assets	5 918	7 605	8 058	8 281	8 522
Tangible assets	*1 409*	*1 612*	*1 669*	*1 643*	*1 635*
Intangible assets	*3 404*	*4 641*	*4 878*	*5 049*	*5 220*
Financial assets	*1 105*	*1 352*	*1 511*	*1 589*	*1 667*
WCR	1 242	1 560	1 678	1 822	1 966
Stocks	*1 045*	*1 306*	*1 540*	*1 673*	*1 805*
Others debtors	*2 836*	*3 136*	*3 644*	*3 957*	*4 270*
Trade creditors	*1 562*	*1 729*	*2 058*	*2 235*	*2 412*
Other creditors	*1 077*	*1 153*	*1 448*	*1 573*	*1 697*
Capital employed	**7 160**	**9 165**	**9 736**	**10 103**	**10 488**
Shareholder's equity	5 798	6 590	7 550	8 340	9 230
Minority interests	10	10	14	17	20
Provisions	519	728	899	976	1 054
Net debt	833	1 837	1 273	770	184
Capital employed	**7 160**	**9 165**	**9 736**	**10 103**	**10 488**

Consolidated Cash-flow statement (fiscal year end 31/12)

Euros million	1999	2000	2001e	2002e	2003e
EBIT	**1 265**	**1 540**	**1 738**	**1 907**	**2 135**
Depreciation	293	386	426	449	477
Amortization of goodwill	6	24	29	29	29
Net financial expense	-141	-219	-193	-166	-144
Tax	-429	-489	-567	-638	-731
Change in Working Capital	10	-318	-118	-144	-144
Operating cash flow	994	1 242	1 433	1 581	1 767
Maintenance CAPEX	-244	-320	-351	-381	-412
Expansion CAPEX	-298	-160	-198	-213	-229
Acquisitions	-163	-1195	-18	0	0
Disposals	54	76	114	0	0
Free cash flow	0	0	0	0	0
Dividends	-211	-267	-305	-348	-397
Share issues	0	0	0	0	0
Other items	-200	-54	7	8	0
Change in net debt	-411	-321	-298	-340	-397
% of Net sales	*-3,8%*	*-2,5%*	*-2,1%*	*-2,2%*	*-2,4%*

Ratios

Euros	1999	2000	2001e	2002e	2003e
WCR / Sales (in days)	42,2	44,9	43,9	43,9	43,6
EBITA after tax / Turnover	7,5%	7,7%	7,9%	8,0%	8,2%
Turnover / Capital employed	1,5 x	1,4 x	1,4 x	1,5 x	1,6 x
ROCE after tax	11,2%	10,6%	11,3%	12,0%	12,9%
ROA (excl. Minorities)	7,2%	7,1%	8,8%	8,8%	9,7%
ROE (excl. Minorities)	13,6%	14,7%	17,2%	16,3%	17,1%
Net debt / EBITDA	0,5 x	1,0 x	0,6 x	0,3 x	0,1 x
Gearing	14,3%	27,8%	16,8%	9,2%	2,0%
Net financial expense / EBITA	11,1%	14,2%	11,1%	8,7%	6,7%
Adjusted nb shares (million) (1)	676	676	676	676	676
EPS (2) : L'Oréal stated	1,23	1,53	1,80	2,11	2,44
EPS growth (2)		*+24,1%*	*+18,1%*	*+17,1%*	*+15,5%*
EPS	1,16	1,43	1,92	2,01	2,33
EPS growth		*+23,1%*	*+34,1%*	*+4,5%*	*+16,1%*
DPS	0,34	0,37	0,45	0,51	0,59
Payout ratio	28%	24%	25%	24%	24%
Dividend yield	0,5%	0,5%	0,6%	0,7%	0,8%

(1) : Share split on 03/07/00 : share price was divided by 10

(2) : EPS is calculated by dividing the Net profit bef cap gains, mino by the adj. number of shares

Source : Consensus brokers notes

3 Overall Performance :

Historical share price performance (1)

Euros	**1999**	**2000**	**2001**	**2002** (2)	**2003** (2)
Maximum	79.65	93.50	91.30		
Minimum	54.70	60.70	66.85		
Average	61.82	78.94	78.52		
31/12	79.65	91.30	80.90		
Adjusted nb shares (3)	676	676	676		
Mkt Cap. (million) as of 31/12	53 843	61 719	54 688	54 688	54 688
Net Debt (million)	833	1 837	1 273		
Minority interests (million)	10	10	14		
Enterprise Value (million) as of 31/12	54 686	63 566	55 975	55 975	55 975
Sales (million)	10 751	12 671	13 943	15 134	16 454
EV / Sales	5.1 x	5.0 x	4.0 x	3.7 x	3.4 x
EBITDA (million)	1 558	1 926	2 164	2 356	2 613
EV / EBITDA	35.1 x	33.0 x	25.9 x	23.8 x	21.4 x
EBIT (million)	1 265	1 540	1 738	1 907	2 135
EV / EBIT	43.2 x	41.3 x	32.2 x	29.4 x	26.2 x
Net book profit after mino. (million)	787	969	1 299	1 357	1 576
PER	68.4 x	63.7 x	42.1 x	40.3 x	34.7 x
Shareholder's equity (million)	5 798	6 590	7 550	8 340	9 230
PBR	9.3 x	9.4 x	7.2 x	6.6 x	5.9 x

(1) : All share prices are adjusted to take into account the share split of 03/07/00

(2) : Calculations based on L'Oréal share price as of 31/12/01

(3) : Share split on 03/07/00 : share price was divided by 10

Source : Datastream & Annual report

Share Price Evolution :