CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

November 26, 2015

Ferrari – Great Brand, But Will It Be a Great Stock?

Ferrari N.V. (NYSE:RACE) is a luxury sports car manufacturer based in Maranello, Italy. Founded in 1929, Ferrari is now recognized as one of the world's best brands.

We are always searching for new high-quality investment opportunities, so we paid close attention when Ferrari completed its initial public offering (IPO) on the New York Stock Exchange in late October.

Ferrari has many of the characteristics of a high quality business. Its competitive position is enhanced by its racing pedigree:

> In Formula One racing, the Ferrari name is synonymous with technologically advanced powertrains, a nearly insurmountable winning record, and a rich heritage that goes back to before the inaugural F1 World Championship for Drivers in 1950. Ferrari is the only F1 racing team that actually receives payment from the league just to participate. Ferrari has won 16 constructors' titles since the prize was initiated in 1958…. The Formula One racing team's notoriety and technological innovation spur demand for the sale of on-road Ferrari cars.[1]

The company's customers tend to be ultra-high net worth individuals, a category that is growing on a global basis and tends to be relatively insulated from short-term economic downturns. In addition, Ferrari's customers are loyal. According to the IPO prospectus, in 2014, approximately 60% of the company's new cars were sold to existing Ferrari owners, and 34% of its customers own more than one Ferrari car.

To maintain its reputation of exclusivity and scarcity, Ferrari wisely pursues a low volume production strategy. In 2014, the company shipped only 7,255 cars.[2] While producing fewer cars than it could sell in any given year limits short-term growth and profitability, it also prevents brand dilution and commoditization of the product. Customers are often on wait lists to buy its cars, and no discounts are available. Overall, Ferrari's competitive advantages are demonstrated by its net profit margins of around 10%, much higher than average automakers.

We could go into further depth regarding the company's products or competitive advantages, but it is sufficient to say that we do view the company as a high-quality business that we would like to own at the right price.

That brings us to valuation. Successful investing demands more than finding high-quality businesses. Many companies have great future prospects, but they are "priced-in" - already accounted for in the current stock price. To get an edge and deliver superior returns, we believe in making our purchases at times when companies are trading at undervalued levels.

Without going into too much detail, Ferrari appears to be overvalued at current prices (US$46 per share and a market capitalization of US$8.63 billion). In other words, the current stock price already fully reflects an optimistic view of the company's future growth.

In 2014, the company produced 7,255 Ferraris to meet worldwide demand. 2015 guidance is for 7,700 units.[3] Longer-term, the company believes it can reasonably increase volume 4% per year through 2019 to 9,000 units.[4] That is positive, but it is immediately clear that this is not a fast revenue growth business. We are not criticizing the company's low volume production strategy aimed at producing exclusivity and scarcity for the luxury buyer. We are simply observing the potential limitations on this company's future growth. Looking at historical results, we see the same story. The IPO prospectus discloses that Ferrari achieved a compound annual growth rate in net revenues of 7% from 2005 to 2014. This is a good achievement, especially when considered in the context of the global financial crisis of 2008-2009. It is just not impressive enough growth to compel us to pay a very high "growth company" valuation for Ferrari shares.

Looking at the analyst consensus earnings estimates provided by Bloomberg, Ferarri is expected to earn US$1.65 in 2015 and US$1.80 in 2016.[5] At US$46 per share, buyers are paying approximately 28 times 2015 estimates, a premium multiple. Without discussing other valuation metrics in more detail, we will say that we would be much more interested in buying the stock in the low 30s. We can accept that a company with Ferrari's track record and brand power deserves a premium valuation; however, we require that the valuation be low enough that the potential reward far outweighs the risks before we invest.

The next major event in Ferrari's history will likely occur in early 2016. Only 9% of Ferrari's shares were distributed to investors as part of the IPO. Currently, parent company Fiat Chrysler Automobiles N.V. (Fiat) retains an 80% interest and the son of Enzo Ferrari owns 10%. Early in the new year, Fiat plans to transfer its remaining interest in Ferrari to Fiat shareholders. It is likely that many of these shareholders will want to sell their Ferrari shares. This spin-off event may lead to a buying opportunity for investors like us who are interested in owning Ferrari at a lower valuation.

David W. Papau *BA, CIM, FCSI*
Portfolio Manager
T: 604 641-4358
david.papau@cibc.ca

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager
T: 604 608-5223
michael.armstrong@cibc.ca

Andrey Schmidt *BA, LLB*
Investment Advisor
T: 604-608-5224
andrey.schmidt@cibc.ca

CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

---

1 http://news.morningstar.com/articlenet/article.aspx?id=723142
2 Ferrari Prospectus dated October 20, 2015 (p. 4)

[3] http://corporate.ferrari.com/en/ferrari-posted-record-q3-2015-performance
[4] http://news.morningstar.com/articlenet/article.aspx?id=723142
[5] Ferrari reports in Euros, but Bloomberg provides a $US conversion.

David Papau, Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. They and their clients may own securities mentioned in this column. Their views do not necessarily reflect those of CIBC World Markets Inc.