Dreams Come True: Luxottica and Essilor to Merge

Luxottica Group S.p.A. (BIT: LUX) — market cap as of 10/02/2016: €24.15bn
Essilor International SA (EPA: EI) — market cap as of 10/02/2016: €23.72bn

Introduction

On January 16, 2017, Italy-based eyewear leader Luxottica SpA and French lensmaker Essilor International SA announced one of the largest cross-border mergers ever in Europe. The combined company, which should have an estimated market value of about €47bn (pre-synergies), will be a global leader in the €90bn fast-growing eyewear industry.

About Luxottica Group SpA

Luxottica is the world's largest eyewear company. Founded in 1961 by Leonardo Del Vecchio, who to this date is CEO and Executive Chairman, it is headquartered in Milan, Italy and over the years has expanded its presence to more than 150 countries across 5 continents. The company is currently listed in Milan and New York.

As a vertically integrated business, the company designs, manufactures, distributes and retails its products. Its portfolio includes both proprietary brands, among which Ray-Ban, Persol and Oakley, as well as licensed brands, including Giorgio Armani, Bulgari and Valentino.

Luxottica's strategy so far has consisted of a continued expansion in the eyewear and eye care sector either organically or through acquisitions, 10 of which took place over the past 6 years. This approach has proven to deliver consistently positive results: FY2015 net sales of €9bn show a 5-year CAGR of 11% and FY2015 net income of €804m is more than double net income recorded in 2010. Moreover, over the same time span the company has seen a remarkable reduction in leverage, measured as Net Debt to EBITDA, which has dropped from 1.8x to 0.5x. The company will report annual results for 2016 on March 1, although 2016 adjusted 9-month net sales of €6.94bn are in line with the prior year figure (€6.95bn).

Mr. Del Vecchio, through his holding company Delfin, is the major shareholder with a 61.9% stake. Other big owners are Giorgio Armani (4.7%) and Deutsche Bank Trust Company Americas (5.49%).

About Essilor International SA

Essilor is a French company founded in 1849 and listed in the Euronext Paris. The group's historical activity has been producing corrective (ophthalmic) lenses of which it is, as of today, the world's largest manufacturer. More recently, it is has also expanded its operations in the sun and reading glasses businesses as well as in the production of ophthalmic instruments and equipment.

With as many as 250 acquisitions completed in 10 years, the company has been growing quickly, and profitability has been consistently improving. Revenues and net income have both tripled since 2004, reaching respectively €7bn and €757m in 2015. Essilor will post 2016 full-year results on February 17, and has reported 2016 9-month net sales of €5.31bn, up 5.5% from the prior year figure (€5.03bn).

Essilor had been included in Forbes' ranking of the World's 100 most innovative companies. It currently holds 7900 patents and operates 5 R&D centers, in which it has invested more than €200m just in 2015. In that same year, the company has launched more than 250 new products.

Industry Overview

The eyewear industry is heavily dominated by the two players in question: about 70% of all glasses sold are from Luxottica, and Essilor commands a similar presence in the lenses industry. There are currently many different smaller players in the industry, such as niche, luxury companies like Gucci (owned by the France-based holding company Kering), or innovative start-ups like the US-based Warby Parker. Other than these, other main players in the industry include Italy-based Safilo Group S.p.A., US-based multinational Johnson & Johnson, and a host of smaller players such as Germany-based manufacturer of optical systems Carl Zeiss AG.

According to data compiled by Essilor, approximately 4.5bn people are in need of vision correction and over half of them still require correction, especially among developing countries (Asia, Africa, and Latin America). Furthermore, Euromonitor reports that the industry is set to enjoy a sustainable growth rate of 2.5% until the end of the decade. Although the largest players reach high levels of vertical integration, there are many up-and-comers working to disrupt the supply chains of Luxottica and Essilor, either through selling goods directly to customers, or by means of bypassing traditional distribution networks through a range of e-commerce solutions. Moreover, the industry exhibits a remarkable consolidation trend, best exemplified by the long history of acquisitions perpetrated by Luxottica's iconic founder Leonardo Del Vecchio, as well as by Essilor's recent acquisition of UK-based Vision Direct Group Ltd., amongst others.

Despite the prospects of growth, the industry faces an important structural challenge. Not all types of glasses are regarded by consumers as essential goods (e.g. sunglasses). This can have a relevant impact on revenues, especially in periods of economic downturn. In addition, developing markets have gradually acquired a very important role in relation to the future prospects of the industry. A number of additional risk factors come with expansion in developing countries, translating primarily in higher revenue volatility and exchange rate risk.

Deal structure

The combination appears as a genuine merger of equals, with both companies' EV being in the range of €26-27bn.

According to the terms of the deal, Delfin will contribute its entire stake in Luxottica (approx. 62%) to Essilor in return for newly issued Essilor shares, at an exchange ratio of 0.461 Essilor shares for each Luxottica share. Subsequently, in accordance with Italian take-over provisions, Essilor will launch a mandatory public exchange offer to acquire all the remaining issued and outstanding shares of Luxottica, at the same exchange rate. The final objective is eventually to proceed with Luxottica's de-listing.

At transaction closing, which is expected in H2 2017, Essilor will become a holding company with the new name of "EssilorLuxottica" and will take on all the operating activities previously performed by Essilor.

EssilorLuxottica will be listed on the Euronext Paris and will be part of the CAC 40 index, with Delfin being the largest shareholder. Mr. Del Vecchio's holding company is expected to own between 31% and 38% of EssilorLuxottica's shares, although its voting rights will be capped, like that of any other shareholder, to 31%.

Leonardo Del Vecchio will serve as Chairman and CEO of EssilorLuxottica. Hubert Sagnières, Essilor's CEO and Chairman, will become Vice-Chairman and deputy CEO of EssilorLuxottica, having equal powers to Mr. Del Vecchio. Both managers will also retain their previous positions in Luxottica and Essilor International. The board composition of EssilorLuxottica also reflects the balance of powers between the combining entities: Essilor and Delfin will each appoint 8 out of 16 board members.

Deal rationale

The deal is backed by a strong rationale. First, the two companies have highly complementary business models: Luxottica focuses on the production of sunglasses and frames, whereas Essilor concentrates on lenses manufacturing. Secondly, in recent years both companies have entered lines of business where they faced competition from each other. As a result, and naturally, the merger alleviates the burden of such competition. Moreover, analysts at US-based investment bank Jefferies forecast stable future growth rates for the visual health and eyewear business, ranging between 2% to 4%. The two companies are also claiming that 2.5bn people worldwide suffer from uncorrected vision problems. Thus, the deal will put the combined entity in a favorable position to address such growing demand, with sales in 150 countries and a total of 140'000 employees worldwide.

As regards synergies, the companies expect benefits from cost cutting, cross selling and distribution enhancement in the range of €400m to €600m per year, of which €200-300m per annum coming from market growth acceleration (revenue), and €200-300m per annum from supply chain optimization as well as G&A and purchasing cost reduction (cost). The market appears to be optimistic in this regard, with the equity value of the soon-to-be combined companies rising overall by €4.8bn (as of Jan 16), potentially implying even higher expected synergies. EssilorLuxottica is expected to generate more than €15bn in revenues with an EBITDA of approximately €3.1bn, excluding synergies.

In addition, Luxottica will benefit from the deal also from a governance standpoint. In fact, Del Vecchio is finally putting an end to Luxottica's succession puzzle (controversially, he has never wanted to let any of his six children take control of the company), which had generated issues in retaining top management, with 3 CEOs leaving the company in the past three years.

The biggest question mark still pending on the deal is whether regulators will allow the merger in light of anti-trust legislation. Despite the complementary operations, detaining significant market power over the both manufacturing of frames and that of lenses could understandably lead regulators to identify a monopolistic threat.

Finally, the combined company is likely to face increasing competition from innovative products combining high technology and eyewear, like the Google Glass or the Spectacles developed by Snap. In that regard, the merger strengthens the two companies' position to invest either internally or externally in research and development, continuing the trend of Luxottica's failed partnership with Google, or Essilor's R&D effort in the production and design of connected glasses.

Market reaction

The market reaction on the day of the announcement (January 16, 2017) was positive, with an 11.9% increase in Essilor's share price and an 8.2% rise in Luxottica's. As of February 10, 2017, both share prices have declined from the peak that was reached upon the announcement, but are still higher then pre-deal levels, signaling investors' confidence in the merger.

Financial Advisors

Citigroup and Rothschild are advising Essilor, while Mediobanca is the financial advisor for Delfin.

Tags: Luxottica, Essilor, Del Vecchio, eyewear, succession puzzle, merger of equals, visual health, glasses, sunglasses, EssilorLuxottica, Safilo, Johnson & Johnson, Citigroup, Rothschild, Mediobanca, Delfin, Euronext, connected glasses