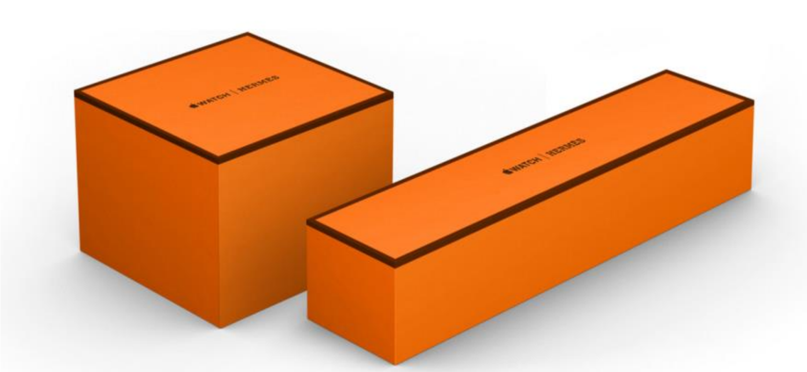
Investment Insight

THE CIPRIANI PRINCIPLE: "ICONIC" BRANDS AND THEIR VALUE

> If I could figure out how to make spaghetti with tomato sauce
> and sell it for $30 like Harry Cipriani, I would.
>
> *Daniel Boulud*

Harry Cipriani at the Sherry Netherland is a New York institution. I recall an article in the New York Times quoting regulars on how their diet food tasted better at Cipriani (Arrigo would stop the microwaved plates of Lean Cuisine at the kitchen door and add butter, cream and salt until it met his standards) and Daniel Boulud, the chef, about Cipriani's ability to sell the simplest plate of spaghetti for the highest price in New York City.

I read the article several decades ago and I have not been able to find a citation. Its message however has stuck with me ever since. Daniel was *the* French restaurant in New York at the time, the successor of Lutèce and La Côte Basque, and its chef had to go to great effort to put together the choicest of French cuisine to match the price of a plate of spaghetti at Cipriani. We all know what that message was: The value of a brand is what people are prepared to pay, not the quality, innovation or cost of the product or service that it represents.



I thought about this when looking at the latest "iconic" Apple Watch Hermès. According to Forbes, Apple is the single most valuable brand in the world, with a value of $154.1 billion, almost double that of Google, the next most valuable. Steve Jobs was undoubtedly a visionary who created both the most valuable company and the most valuable brand in the world by offering us products that we did not even know ourselves we wanted. From the Macintosh computers which match the era of our Cipriani story, to the iPad and the iPhone, Apple has created consumer electronics as it is today. Apple's strength has been to push the functionality, innovation and design of its product to drive adoption, market share and premium pricing.

Our quibble is that despite its success it remains a hardware company. The penetration of the iPhone at least in the United States and in Europe seems to have plateaued and the innovation on the latest models appears increasingly incremental so far. Recurring services

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account for only a small part of revenues and the closed iTunes and Apple "ecosystem" Steve Jobs has always sought to create is being disintermediated by different applications and content providers. We are convinced of the demand for online devices and services but we believe in more open architectures and network effects not closed systems, which is why we prefer companies like Google or Amazon.

Forbes

The World's Most Valuable Brands

	Rank	Brand	Brand Value	1-Yr Value Change	Brand Revenue	Company Advertising	Industry
	#1	Apple	$154.1 B	6%	$233.7 B	$1.8 B	Technology
	#2	Google	$82.5 B	26%	$68.5 B	$3.2 B	Technology
	#3	Microsoft	$75.2 B	9%	$87.6 B	$1.9 B	Technology
	#4	Coca-Cola	$58.5 B	4%	$21.9 B	$4 B	Beverages
	#5	Facebook	$52.6 B	44%	$17.4 B	$281 M	Technology
	#6	Toyota	$42.1 B	11%	$165.1 B	$3.6 B	Automotive
	#7	IBM	$41.4 B	-17%	$81.7 B	$1.3 B	Technology
	#8	Disney	$39.5 B	14%	$28 B	$2.6 B	Leisure
	#9	McDonald's	$39.1 B	-1%	$82.7 B	$719 M	Restaurants
	#10	GE	$36.7 B	-2%	$92.3 B	-	Diversified

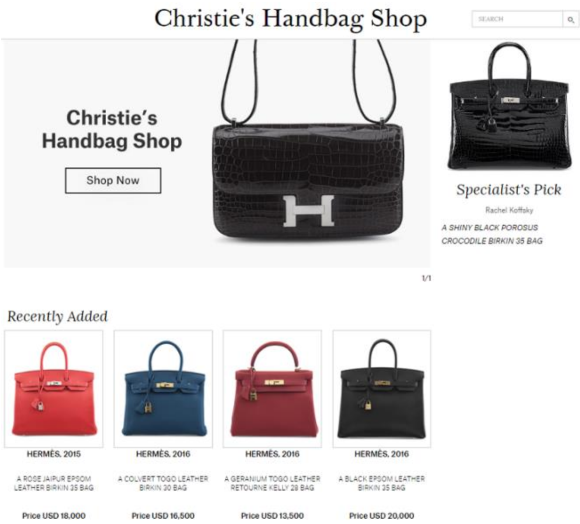
The Apple Watch has been a particular conundrum for us. It is unquestionably a well-designed product that packs a lot of functionality into a small object which is both fun and interesting to wear. But is Apple really ahead of the curve again by giving us a product that we did not know we wanted? Apple believes the key differentiator lies in its functionality. Wearables that aid health and fitness by providing information, monitoring and tracking of exercise are all becoming increasingly ubiquitous and many of our friends are wearing Apple Watches or Fitbit-like wearables alongside their Swiss watches.

Yet unlike the iPhone or the iPad, it appears that the functionality is not sufficiently enticing. Whilst Apple Watch sales are not officially released by Apple, we believe that they are hovering close to five million a quarter. These sales pale in comparison to that of the iPhone or the iPad, leading us to believe that in its current version the Apple Watch is more of an accessory rather than a utility.

Apple seems to think along similar lines as well. The launch of the Apple Watch coincided with the hire of Angela Ahrendts, the former Chief Executive of Burberry, as head of retail, and also collaborations with other major brands. The Apple Watch appears to be the first of Apple's products that seeks to capitalise on their brand cache and not just on its functionality and design.

This brings us to the Apple Watch Hermès and to the Cipriani principle. On Apple's US website, the watch retails from $1,149 for the most basic to $1,499 for the "Etoupe Swift Leather Double Buckle Cuff". With a standard Series 2 Apple Watch selling for $369 and no difference in functionality between the watches, that means people are prepared to pay $780 or more for a leather watchband and a digital watch face.

Hermès is the ultimate global luxury company. Its business is built on its iconic (no quotation marks necessary) handbags. They are instantly recognisable, unlike most others they do not carry logos, they sell for small fortunes, they are subject to waiting lists of varying lengths and verifiability, and like the most famous watch brands Rolex and Patek Philippe they have a deep and liquid aftermarket with auction house Christie's running a dedicated online auction site seemingly solely dedicated to Hermès handbags.



Hermès has had singular success with other traditional items, including ties, scarves and accessories, as well as with more contemporary items such as apparel and perfumes. The latter are ubiquitous and accessibly priced offering a first chance at an association with the brand that for some must culminate in the possession of a cherished handbag. The shares of Hermès are equally as prized by investors and its valuation is at a significant premium to any other luxury goods manufacturer. This premium valuation can only be justified by its continuous improvement in sales and margins, which has seemed impervious to the ups and downs of consumer spending or Chinese measures against "extravagance".

So whilst Apple has to produce a revolutionary, highly innovative and complex product that combines the latest in technological innovation and its uncompromising design prowess into an object of unprecedented size and functionality, Hermès can get a French worker to stitch a watchband in the same way it would have been done for the first wristwatch ever produced at the turn of the last century and sell it for twice as much. The most marked example of the power of the Hermès watch is not the band, hand-made to exacting standards as it is, but the branded watchface, which after all is just a digital design that could be copied even more readily than the wristband itself or a Hermès handbag.

A plate of spaghetti, a watchband or a digital watchface: as long-term investors, our objective is to invest in quality businesses we can buy at the right prices to participate in their value generation over time. Our primary concern is the estimated time to their disruption. What does the difference in pricing between an Apple watch and a leather watchband tell us about the relative value of these two brands? Of course Apple generates tremendous sales and earnings from its products. We do not have sales numbers for the Apple Watch but there is no reason to believe it is not profitable given the millions of watches sold. As a company Apple has high margins but Hermès' are just as high. Apple's share price has increased tenfold over the past ten years whereas Hermès has increased "only" fourfold. Yet, Apple's price to earnings multiple today is less than half of that of Hermès.

This difference in valuation is not unjustified. It has to do with the Cipriani principle. The basic quality has to be maintained but once it is established its competitive advantage can be more enduring than the most innovative and complex of competitors. The longer the estimated time to disruption, the clearer that competitive advantage, the more sustained we think the value generation can be. With Apple we are concerned about the quality of its business whereas with Hermès it is the valuation. It is clear which company we are drawn to and we are fortunate that markets give us opportunities to buy it, and others like it, from time to time.

N.B., we have not discussed the quality of Cipriani's spaghetti with tomato sauce. It is perhaps best sampled in person and we look forward to hearing your views.

Christopher Rossbach
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