- The European-dominated luxury goods industry is extremely well-positioned in the current macroeconomic environment.
- Luxury goods play an important symbolic and aesthetic role in emerging markets with rapid, but uneven, income growth.
- Emerging markets consumption is expected to grow by 6.3% per year over the next 20 years.
- As emerging markets' contribution to global GDP increases, so too will the relative importance of the luxury goods sector.
- The luxury goods sector is open to entrepreneurial entry, as value is predicated on the creativity of the artist-designer.

Champagne Wishes and Caviar Dreams

BY JASON M. THOMAS

As the Chinese economy slowed in 2012, evidence began to emerge that the global luxury goods sector had become "too dependent" on developing Asia for its growth. Given that the luxury goods industry is overwhelmingly concentrated in Europe, where domestic demand has contracted by 0.5% per year in the aggregate since 2008,[1] dependence on fast-growing emerging and developing markets seems like a nice problem to have. The slowdown in global growth in 2012 did help to dispel illusions of the luxury goods industry's invulnerability and homogeneity, but did not alter the well-established pattern of Europe-to-emerging market goods flows.

Luxury goods manufacturers enjoy two key advantages relative to other sectors in the current macroeconomic environment. First, the products likely to fare best in a world of "currency wars" are those for which few substitutes exist. Brand and quality consciousness anchor luxury demand in a way that's not likely to be perturbed by temporary shifts in relative prices. Second, luxury brands are likely to benefit disproportionately from emerging and developing economies' growing share of global output. Income growth leads to brand awareness, changes in consumer tastes, and a shift in expenditures towards higher quality goods. McKinsey estimates that annual emerging markets consumption will reach $30 trillion by 2025.[2] One would anticipate that the growth in the sales of luxury goods would exceed the expected 150% cumulative growth in total consumption in these economies over this period (6.3% per year). It is both ironic and underappreciated that the decline in Europe's relative importance to the global economy could actually be the main driver of growth in one of Europe's key industries.

An Overview of the Luxury Goods Industry

There is no official definition of what constitutes a "luxury good." In Italy, a "luxury good" is whatever product is sold by a member of the luxury syndicate Altagamma. The same rules apply in France where the luxury syndicate is Comité Colbert. The closest one comes to an official, internationally consistent definition

[1] EuroStat.
[2] McKinsey, "Winning the $30 trillion decathlon: Going for Gold in Emerging Markets," August 2012.

is the "Apparel, Accessories and Luxury Goods" industry classification in the Global Industry Classification Standard (GICS). This classification is reserved for the manufacturers of apparel, designer handbags, wallets, luggage, jewelry and watches. In aggregate, the top 1,000 firms in the industry generated $293 billion in global sales in 2011.

As shown in Table 1, the Apparel, Accessories and Luxury Goods industry is dominated by European manufacturers. Among the top 25 firms by sales, Europe accounts for 68% of sales, 77% of gross profits, and 78% of both Ebitda and net profits. European firms also account for 75% of the sector's market capitalization. Despite its dominance, the industry in Europe trades at a 9% discount, with an average enterprise value of 13.5x trailing twelve month's Ebitda compared to a 14.8x average for their non-European counterparts. [3]

Table 1: Top 25 Firms by Apparel, Accessories and Luxury Goods Sales, 2012

Company	TTM Revenue (USD)	Gross Margin	Ebitda/Sales	Net Margin	Home Economy
LVMH	37,053.20	64.7%	24.7%	12.2%	Europe
Christian Dior	35,029.66	65.6%	25.0%	5.0%	Europe
Adidas	19,622.92	47.7%	9.5%	3.5%	Europe
Richemont	12,533.23	64.5%	27.4%	19.7%	Europe
VF	10,879.86	46.5%	15.9%	10.0%	U.S.
Luxottica	9,342.93	64.7%	18.8%	7.6%	Europe
Swatch	8,515.19	79.0%	28.7%	20.5%	Europe
Ralph Lauren	6,924.40	59.3%	19.3%	10.4%	U.S.
PVH	5,939.64	53.0%	13.1%	7.2%	U.S.
Rajesh	5,135.46	2.3%	2.2%	1.6%	India
Coach	4,929.30	72.8%	34.3%	21.3%	U.S.
Hanes	4,525.72	31.4%	11.9%	3.6%	U.S.
Prada	4,101.02	71.9%	31.2%	17.9%	Europe
Lao Feng Xiang Co	4,099.50	3.9%	4.1%	2.4%	China
Hermes	3,964.12	68.7%	35.1%	20.4%	Europe
Jones Group	3,798.10	36.1%	6.3%	-1.5%	U.S.
Seiko	3,341.57	31.4%	8.1%	1.2%	Japan
Hugo Boss	3,092.96	61.9%	22.1%	13.1%	Europe
Burberry	3,079.56	70.9%	24.8%	12.1%	Europe
Onward	3,044.75	47.7%	7.6%	1.5%	Japan
Fossil	2,857.51	56.2%	19.7%	12.0%	U.S.
Gitanjali Gem	2,769.93	12.3%	6.7%	3.8%	India
Carter's	2,381.73	39.4%	13.2%	6.8%	U.S.
TSI	2,265.24	49.8%	13.1%	-12.0%	Japan
Shree Ganesh	2,071.86	6.7%	5.8%	4.4%	India

The Apparel, Accessories and Luxury Goods industry classification is obviously imperfect in that it is simultaneously too broad (it includes low-margin apparel manufacturers like Hanes) and too narrow (it excludes the manufacturers of footwear, automobiles, and yachts). Bain & Co. produces an annual survey of luxury goods spending that aims for greater precision. According to the most recent survey, personal luxury goods sales reached €212 billion ($275 billion) in 2012 or as much as €750 billion ($975 billion) when luxury cars, wine and spirits, hotels, in-home and out-of-home food, home furnishings, and yachts are included.[4]

[3] All reported data derived from S&P Capital IQ.
[4] Bain & Co., "2012 Luxury Goods Worldwide Market Study," October 2012.

The more focused the definition of "luxury goods" the larger the European share of the industry's global market capitalization, with a range generally between 80% and 85%.[5]

The Near-Term Outlook

Among those companies reporting full results for calendar year 2012, sales were up 12.2%, roughly the same growth rate registered the past two years. According to earnings forecasts compiled by Bloomberg, sales among firms in the broader "Textiles, Apparel, and Luxury Goods" industry are expected to increase by about 8% per year, in the aggregate, over the next two years. Using Bain & Co.'s more narrow definition, global luxury goods sales grew by 10% in euro terms in 2012, the third consecutive year of double-digit growth. Bain estimates that sales growth will moderate to between 4% and 6% per year in constant-currency terms over the next three years, or roughly four times the expected growth rate of euro zone GDP over the period.

Table 2: Global Sales Growth, Apparel, Accessories and Luxury Goods

Year	Growth Rate (in USD)
2012	12.2%
2011	12.2%
2010	12.0%
2009	0.0%
2008	1.6%

Much of the growth in recent years has been generated by emerging Asia, especially China. In euro terms, luxury goods sales in China grew at an annual average rate of 26% between 2008 and 2012.[6] As pointed out by numerous equity analysts, the 20% growth in 2012 was misleading because it was due mainly to a weakening euro.[7] In RMB terms, luxury sales growth in China slowed to 8% in 2012. Some of the decline has been attributed to an anti-corruption campaign, which reduced expensive gifts. However, some of the slowdown in China-based sales was likely due to luxury goods spending by Chinese citizens outside of China, which accounted for more than two-thirds of all Chinese purchases of luxury goods in 2012. According to Bain, sales of luxury goods in Europe increased by 5% in 2012, but this growth was largely illusory because tourist spending accounted for between 20% and 60% of total luxury good purchases in Italy, France, Germany, and the U.K. When counting foreign purchases, Chinese nationals are now the largest consumers of luxury goods in the world, with 2012 purchases in excess of €50 billion, or 25% more than the €40 billion purchased by Americans.

The Symbolic and Aesthetic Significance of Luxury Brands to Emerging Market Consumers

While a slowdown from 25% annual growth rates in China seems inevitable, the decline is not going to be apportioned equally across luxury goods manufacturers. More importantly, there are strong reasons to suspect that the sales growth rates achieved in China will be replicated elsewhere. Luxury goods can serve as important symbols of self-achievement for new entrants to the middle class. As the global middle class adds 3 billion people over the next 20 years, it is reasonable to expect many of these entrants to use European luxury goods to document their newfound affluence. Bain estimates that growth in luxury goods sales in Brazil, India, South Africa and Southeast Asia will average between 15% and 30% per year for the next five years.

[5] C.f, Credit Suisse, "Global Luxury Goods," January 2013, where European firms account for 81% of total market capitalization or HSBC, "Luxury goods," July 2012, where European firms account for more than 84% of total industry market capitalization.
[6] PWC, "Market Vision: Luxury," 2012 and Bain & Co. (2012).
[7] "Luxury goods show signs of losing lustre," *Financial Times*, August 10, 2012.

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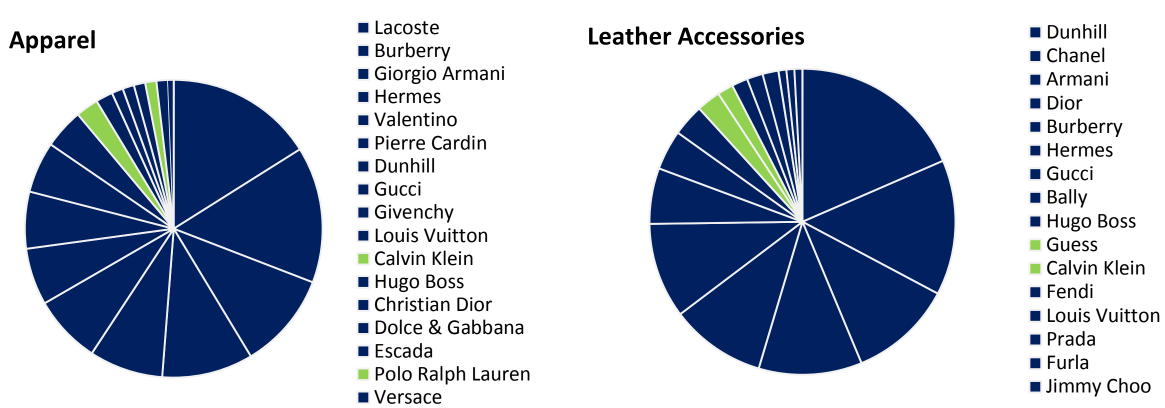
It is no secret that marketing to emerging market consumers tends to focus on "brand prominence" where the logo of the luxury brand is conspicuously displayed on the item so the purchaser can clearly signal his or her economic status to new acquaintances.[8] As a Chinese man explained to marketing researchers in a recent focus group, "What I like about luxury is that it is expensive."[9] While such candor may seem especially crass, the luxury goods space depends on the existence of a disconnect between a product's market price and its functional value. If the market price of a good were determined entirely by its functional utility, there would be no such thing as luxury goods.[10]

This is not to say that differences in quality do not matter, but rather that perceptions of value are contextual. Luxury goods serve as an important signaling device in economies where incomes are growing rapidly but unevenly, which perfectly describes emerging markets. Empirical research documents that the higher a country's income level and more unequal the allocation of that income, the higher that country's relative imports of luxury goods.[11] Income inequality in virtually all emerging economies exceeds the developed country average, with inequality increasing from already high levels in China, India, South Africa, Argentina, and Russia between 1993 and 2008.[12] With emerging markets forecast to contribute over 60 cents of every marginal dollar of global output over the next five years, these trends are likely to accommodate sustained increases in luxury goods sales.[13]

As economies become richer, luxury goods manufacturers tend to use logos in more discreet ways and introduce a multiplicity of symbols.[14] The most recent Bain report suggests this dynamic is already taking hold in China. The best luxury goods firms must simultaneously market to (1) consumers who prefer conspicuously branded products to signal their elevated economic status to the masses; as well as (2) consumers who prefer inconspicuously branded products to signal their refined taste to their peers.[15] Inconspicuously branded luxury goods often boast the fattest margins precisely because the absence of a salient logo implies that the purchase price is based on "quality" rather than symbolism. The most expensive handbags are those with the smallest logos; the more expensive the Mercedes Benz model sold in the U.S., the smaller its "silver star" emblem.[16]

Figure 1: Brands "Worth Paying More For" (U.S. Brands in Green; European in Blue)[17]



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[8] Han, Y.J, et al. (2010). "Signaling status with luxury goods: the role of brand prominence," *Journal of Marketing*.
[9] Kapferer, J.P. (2012). "Abundant rarity: The key to luxury growth," *Business Horizons.*
[10] Kapferer, J.P. (2010). "Luxury after the crisis: Pro logo or no logo?" *European Business Review*.
[11] Bohman, H. and Nilsson, D. (2006). "Income Inequality as a Determinant of Trade Flows," CESIS Working Paper No. 73.
[12] OECD, "Special Focus: Inequality in Emerging Economies," *Divided We Stand: Why Inequality Keeps Rising*, 2011.
[13] IMF, *World Economic Outlook*, October 2012.
[14] Kapferer (2012).
[15] Nunes, et al. (2010). "Conspicuous consumption in a recession: Toning it down or turning it up?" *Journal of Consumer Psychology*.
[16] Han, Y.J, et al. (2010).
[17] Credit Suisse Emerging Consumer Survey 2013.

European luxury brands have mastered the art of subtle communication in ways that American rivals have not. Figure 1 depicts the share of Chinese survey respondents who identified certain brands as "worth paying more for." In the case of apparel, European brands accounted for 96.3% of survey responses; for leather accessories, the European share was 99.1%. Interestingly, there is not a single European luxury template; the brand prominence, communication, and inventory strategies of each group differ more among themselves than they do with U.S. or Japanese rivals. The only commonality is the occasional reference to the continent's culture and history.

The pricing power these brands possess may be an underappreciated asset in the current monetary environment. Central banks' increased reliance on ultra-accommodative monetary strategies to reduce the foreign exchange value of their domestic currencies has introduced new vulnerabilities for multinational businesses. Currency moves like the 20% depreciation of the Japanese Yen relative to the Korean Won will likely force manufacturers of goods that can be easily substituted in the supply chain to choose between a decline margins or sales.[18] Luxury goods manufacturers generally do not have to face such decisions. In the midst of the Great Recession (May 2009), both Gucci and Louis Vuitton responded to the collapse in handbag sales by increasing prices and introducing new product lines.[19] The strategy succeeded in both cases, with lost sales replaced by higher margins and, eventually, greater sales volume as well.

The Paradox of Exclusivity Opens the Door to Entrepreneurs

Increased sales of luxury goods create a paradox where goods apparently valued for their rarity are widely owned. The best example of this phenomenon is Louis Vuitton handbag sales in Japan, where 85% of Japanese women own a Louis Vuitton product but yet continue to embrace the brand's image of exclusivity.[20] In the place of the objective rarity pursued by brands like Ferrari and Phillipe Patek, where a finite number of products are produced and sold, most luxury goods manufacturers instead pursue "qualitative rarity," where artistry, unique brand experience, or historical pedigree foster impressions of value.[21] This "qualitative rarity" often depends on theatrics that distance the product from the world of commerce and instead present the good as a form of art.

Rather than being limited to brands already in existence, the luxury goods industry, through its focus on "qualitative rarity," is especially welcoming to new entry. One could easily conceive of a new brand based on the work of an eccentric fashion designer, engrossed in his art and unwilling to settle for anything less than perfection. Once designed, the entrepreneur's fashion could be reproduced infinitely without detracting from the creative genius that produced the prototype. The consumer who purchases the item in this case counts himself as part of a well-informed class of elites able to delineate between commerce and art. According to Reuters, the hospitable conditions for market entry have led many European entrepreneurs to eschew existing corporations and instead launch niche luxury goods brands with "no history but plenty of imagination."[22]

Conclusion

Those concerned that the European-dominated luxury goods industry had become too dependent on China seem to have it backwards: the rapid and unequal income growth in China generated huge demand for the symbolic and aesthetic value of European luxury goods. While a slowdown from the 25% compound annual

[18] Decline measured from September 2012 to March 2013. Data from Bloomberg.
[19] Nunes et al. (2010).
[20] "The Empire of Desire," *The Economist*, June 2, 2012.
[21] Kapferer (2012).
[22] "Small labels lure big bucks in fashion's latest trend," *Reuters*, March 13, 2013.

growth rates is inevitable, the dynamics that gave rise to such robust growth in China are likely to be present in other emerging economies. If emerging market consumption grows at the anticipated 6.3% annual rate for the next twenty years, income elastic luxury goods sales should more than triple over that period. With the industry open to entrepreneurial entry, investors need not focus on established brands or public equity to gain access to the growth opportunity.

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