LUXURY INDUSTRY: 2015 TRIMESTER 1 & OUTLOOK

(A) ECONOMIC FRAME

Since TBTL's 2014 trimester 3 newsletter the overall economic situation has not changed and does not promise fundamentally different circumstances in the midterm.

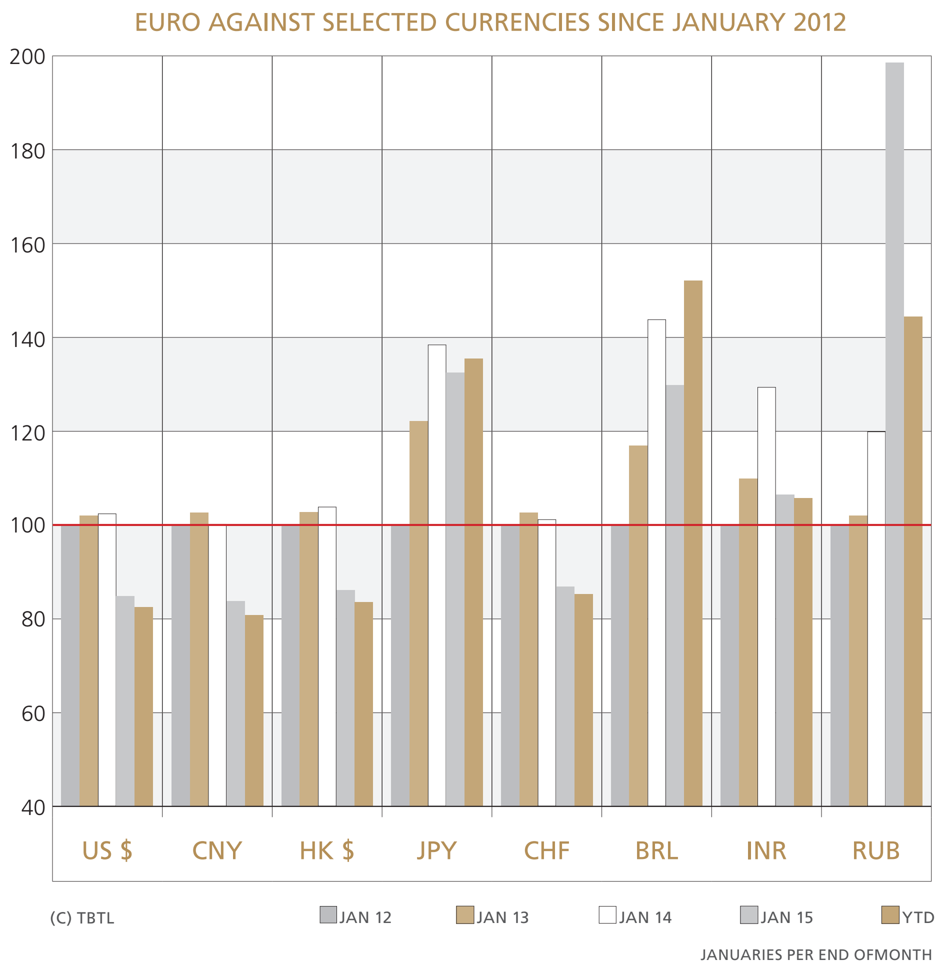
According to the IMF, the world economy is expected to grow at a rate of 3.5% compared to 3.4% of last year. The World Bank recently predicted a global economy growth of 2.8% - down 0.2 basic points from its January forecast. 2015 Q1 did not show any major confirming or contradicting trends.

GPD GROWTH RATE IN %

	YoY			QoQ	YoY
	2012	2013	2014	Q1 2015	LE 2015
USA	2.3	2.2	2.4	-0.7	2.0
Japan	1.8	1.6	-0.1	0.6	0.8
China	7.8	7.8	7.4	1.3	6.8
Hong Kong	1.7	2.9	2.3	0.4	2.8
Brazil	1.8	2.7	0.1	-0.2	-1.0
India	5.1	6.9	7.2	4.1	7.5
Russia	3.4	1.3	0.6	0.0	-3.8
Germany	0.6	0.2	1.6	0.3	1.7
France	0.3	0.3	0.4	0.6	1.2
UK	0.7	1.7	2.6	0.3	2.7
Italy	-2.8	-1.7	-0.4	0.3	0.5
Spain	-2.1	-1.2	1.4	0.9	2.5
Switzerland	1.1	1.9	2.0	-0.2	0.8
WORLD	3.2	3.4	3.4	—	3.5

A long winter slowed down the US economy. Switzerland, as a tourist destination and not only a luxury goods exporting nation, has started to feel the impact of the national bank's decision to unhook the Swiss franc from the Euro. And China saw its slowest first quarter start for the last six years over uncertainties about the government's next steps to stimulate its economy while ensuring the challenges such as the property market are staying in focus. Hong Kong is struggling with mainland tourists being accused to fuel parallel business while the Macao gambling business is affected by continuous anti-corruption measurements from the Chinese government. However, economies in India and Japan have experienced surprisingly good beginnings for 2015. Also, reforms in Spain do encourage beliefs that reforms in the Eurozone will finally pay off. Obviously, the Greek debt problem may have some repercussions on all predictions and further developments.

Currencies: Since Autumn 2014 the US $, the Chinese RMB, the HK $ and since January 2015 the CHF have gained strength against the Euro. This has turned the Eurozone into a more attractive tourist and shopping destination while reducing export prices for luxury goods. As a country of origin that amounts, according to TBTL estimates, to approximately 7-9% of global luxury production and offered services, Switzerland, however, is challenged by opposite factors. Despite a strong position against the Euro, the CHF was able to keep an almost stable exchange rate against the US$ and the Chinese renminbi.



On the political side the same global topics run the news and affect world economy as at the end of last year: As the Ukraine conflict continues, overall economic dynamism in the CIS region remains at very low levels. Recently, controversies over maritime borderlines between neighbouring Asian countries have added to complexity in geopolitical developments – such as old and new conflicts in the Middle East.

(B) Markets, Product Categories & Brands

As luxury is a consumer's "good mood" item, TBTL believes that markets and brands cannot expect any major positive global economic impulses in the months to come given the current general frame. Furthermore, a look at Q1 figures of major market players does not reveal any signs of a surprisingly strong industry's development. In October 2014, Bain & Company estimated an industry's growth of 7% for that year. For 2015 and the next 12 months TBTL foresees an increase of 5-7%.

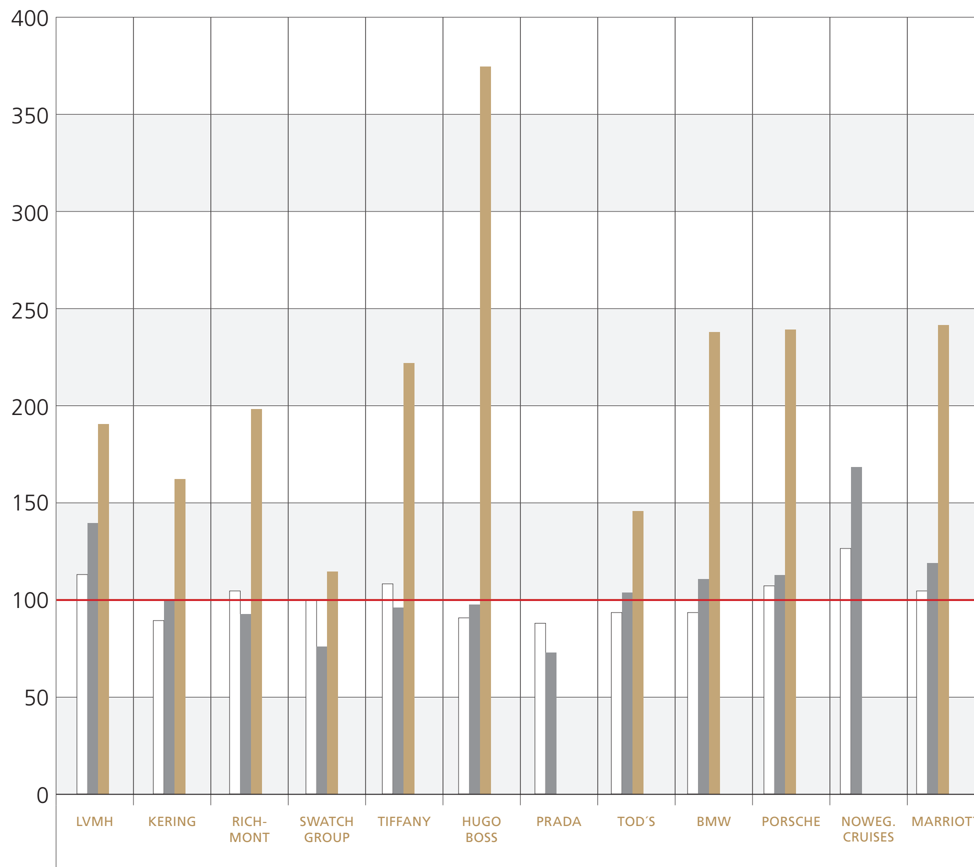
Due to its weight in size, the high-end car industry will again influence the overall performance of the luxury industry this year. For Q1 many brands reported strong growth: Porsche +29%, Mercedes-Benz +18%, BMW (BMW, Mini, Rolls-Royce) +8%, Audi 6%. Sales in Europe are gaining momentum, and the US remains at high sales levels. However, China may slow down as numbers indicate for year over year May figures. At present, however, company statements do not warn of a decrease of the current dynamism till the year's end. A look into particular markets reveals interesting insights: Although the overall Russian market dropped by 37% in the first four months of this year with a reduction of 50% of automobile imports, sales of luxury car makers like Lamborghini (+266%), Rolls-Royce (+90%), and Bentley (+63%) rose strongly against the trend (source IHS automotive).

In comparison, the Swiss watch industry as a main driver of the product category currently feels the impact of several disturbing factors: a strong Swiss franc, actions taken by the Chinese government to curb corruption, and product oversupply. According to the numbers of the Swiss Watch Federation, for year to date including May the industry has contracted by 1.1% in value (pieces +2.7%). Whereas the segment of timepieces with an export value of 0-200 CHF increased by 6.7% all other segments stagnated or lost momentum: 201-500 CHF (-3.1%), 501-3.000 CHF (-5.5%), the segment +3.000 CHF (-0.1%). While some markets have shown strength (UK +26%; Italy +12%; Singapore +7%; the US +3%), others slowed down considerably (Russia -29%; HK -20%; UAE -11%; Japan -9%). Overall, stocks are still high on brands' and retailers' levels and continuous discounting and parallel distribution keep the industry under pressure.

In the business of luxury hotels and resorts Marriott International announced a Q1 increase of 7% revenue per available room (RevPAR organic 5%). In 2015 the company intends to add 7% of net rooms. For the same period competitor InterContinental reports an organic RevPAR of 6% and a net increase of 5% in rooms.

As far as the big luxury groups are concerned, LVMH reports a group's Q1 revenue plus of 16% (+3% on a like-to-like basis). Wines and spirits were up 12% (yet at comparable structures and constant currency exchange rates -1% due to a depressed Chinese market). Fashion and leather contributed with a revenue growth of 13% (+1%). Perfumes and cosmetics increased by 16% (+6%) and watches and jewellery amounted for +19% (+7%). Kering indicated a Q1 revenue growth of 11% (organic 1%) while absorbing a turnover decrease of its fashion brand Gucci of 8%.

Investors' future market expectations can be mirrored in the development of share prices – see the following example of selected stock exchange listed companies:



(C) Snapshots Topics & Trends

The luxury industry is currently facing various challenges. Although it can easily be assumed that luxury for many reasons continues to be translated into further consumption, its nature and therefore ways of branding, customer targeting, defining marketing-mixes and so on will change strongly. Some current important trends:

1. Changing consumer information and buying behaviour

The times are gone when it used to be sufficient to publish product pack shots, to add a high item's price tag and to locate the brand's logo onto the right end bottom corner of an advertising page. Today customers around the world have become, to a high degree, more competent and independent for causes such as:

- Internet and new communication tools as well as platforms have dramatically increased information and thus knowledge about products, prices, merchandise availabilities etc. and resulted in smarter and more opportunistic consumers.

- Consumers not only in "old" but also in emerging markets are becoming increasingly well-informed and sceptical about simple, too-commercial marketing approaches. Brand transparency, honesty, sophistication, creativity, compliance to ethical and environmental standards etc. are getting more essential to consumers' purchasing criteria.
- Younger consumers ("millennials") are not as willing to spend their high incomes and inherited wealth on classical luxury goods as former generations were. They consume differently – or sometimes not all. These new habits are prompting, for instance, the high-end car industry to invest in car sharing services and traffic guided control systems to motivate metropolitan inhabitants to remain faithful to the product category in the hopes that at later stages of their consuming life cycle they will nevertheless acquire premium or luxury automobiles.

2. Digitalisation revolutionises the luxury industry

On June 8th Reuters reported that Richemont has invited LVMH, Kering and others to invest in the newly combined Yoox/Net-à-Porter online fashion retailer. Vertical integration some years ago meant "simply" to bypass distribution and classical wholesale market players in, for instance, setting up mono-brand boutiques to control the flow of products, the definition of prices and discounts, the brands' presentation at the POS – and to absorb mid-stream margins, of course.

A less euphoric consumer demand, the appearance of micro-consumer segments, oversupply, aggressive grey markets, and especially the growth of online shops and the emergence of self-promoted, yet actually opportunistic online "luxury" brands have made the original quest for control very difficult. Only if classical brands master the flow of their products to the homes of their customers will they maximise chances to remain or to become strong global players – and that also requires the control of the Hydra called the Internet. The stakes are fundamental: If luxury brands are no longer able to create business cases of exclusivity in which products and services offer world record features and consumers find in the offerings a positive satisfaction for their social aspirations, in which product availability remains scarce despite the need to reach ambitious sales targets, or in which communications are not diluted by multiple online sales offers, only then will the industry continue to have stars that lift the image of authentic luxury.

Hence, it makes strategic sense that brands not only set up their own digital sales channels but also acquire multi-brand luxury online platforms and brand them with the same intensity as the products they offer. If the industry fails there is a risk that the myth of luxury will disappear in the endless cacophony of the Internet. And even posh mono-brand boutiques will not stop customers taking advantage of enjoying the luxury experience there while looking for the best deal on the Internet. Though Reuters may be bad news for classical distributors and wholesalers, for the industry as such they are good news.

The other factor of the digital revolution is its increasing impact on product development. It creates new opportunities and challenges. One product category about to be hit is the traditional watch industry. Though the (negative) impact will not be as big as the introduction of the quartz watch in the '70s, the smart watch and entries of new competitors will nevertheless eat away market shares of traditional market players. The highest risk of substitution is not only driven by a cooler brand attraction of modern technology icons among mainly young consumers but additionally by the incremental functional USPs of smart watches versus classical ones. Besides various new utilities delivered by thousands of apps, smart watches offer appealing traditional designs yet in more variety, e.g. different dial designs on demand in one single watch. Other luxury categories feeling the digital impact on their offering, too: mobile communication connectivity in cars, private jets and yachts; remote communication of high-end home appliances; and others are just a few to mention.

3. Funding and ROI

In either saturated and/or stagnating environments competition is often about gaining market shares. Hence, luxury groups and brands need to polish their positionings, sharpen their USPs and improve professionalism on all levels of their value chains. In doing so they currently and increasingly face a classical dilemma: While revenues and therefore margins are under pressure, cost control seems to be the answer. However, companies in the world of high-end products and services need strong brands – publish or perish. In anti-cyclic measures, investments into brand awareness and image make sense if liquidity permits - and they should comprise more than just investments into short-term-oriented sales promotions.

For those who are short of cash, TBTL often surprisingly witnesses that market analysis is not carried out carefully or does not result into appropriate decision-making and action. Simple ABC-analysis confirms frequently the 80-20-Pareto principle that a few yield the bulk of revenues and margins. However, companies are afraid of drawing consequences in focussing on fewer, yet more profitable consumer segments, markets and distribution partners – while potentially increasing the exclusive image of their brands at the same time.

Given tight budgets, the other potential to increase profitability and liquidity is to enhance the quality of branding. Within the same financial frame many brands could get more return on investment if their positionings were more unique, creative, and closer to segmented customer needs. Instead, in many product categories it can be observed that a great number of brands content themselves in using interchangeable, boring images and scripts that only deliver clichés with no excitement. It seems that the art of epic storytelling gets increasingly lost, resulting in luxury goods and services being turned into mere commodities. If too many brands create product oversupplies the answer is to dare more in branding to make the crucial difference.

As liquidity is a factor many brands, especially small ones, increasingly look for co-owners and exit options. However, the M&A universe is currently, and will be for some time, a buyers' market. Potential purchasers are difficult to identify as insecurities surround the luxury industry. Revenues, especially of smaller brands, often do not outweigh future cost of restructuring and business development (for example into manufacturing capabilities, retailing or advertising). The current financial KPIs in balance sheets in the context of the industry's semi-optimistic outlook often tell a different story than potential brand goodwills assumed by sellers. On the other side: Acquisition prices will likely come down further in the next 12 months, rendering investments more attractive.

An interesting and innovative way of equity buildups is crowd funding. In the environment of high-end products and services only few cases have taken place (real estate, fashion, beauty products). Minimum investment sums vary from 10 to 10,000 Euros. Hence, it is too early to draw sustainable conclusions to assess successes for owners in collecting money or for investors in terms of rates of returns. Yet, TBTL assumes that crowd investing – generally already considered risky – bears even higher dangers in luxury businesses. Potential investors are likely to base decision-making more on emotional factors than on financial rationales. Second, luxury start-ups need a very high amount of funding for brand building while at the same time access to global classical distribution has been limited due to concentration processes and vertical integration of strong market players. Whether crowd funding really helps companies to collect critical masses to advance remains to be seen. Hence, the potential success of small companies venturing into crowd funding will largely depend on business cases that offer truly unique selling proposals and guaranteed access to sales channels – often likely to be the online world for lack of alternatives.

TBTL strongly believes that many categories of high-end products and services are facing challenges that will result in new industry structures and processes. Some categories have already gone through a phase of consolidation, and others will follow. Presumably, the emergence of more oligopolies will be a logical consequence of current business dynamics and thus will threaten the existence of many mid-size and smaller brands. Hence, for those brands it will be crucial to find their niches in creating wonderful offerings, in telling exciting stories, in being closest to consumers. For the credibility of luxury their continuous existence is of utmost importance. Only if luxury does not stop creating product and service world records and in granting customers a self-esteem that mirrors cultivation, sophistication, success, attractiveness, education or any other affirming attribute will it remain the elite and credible expression of consumption.

Dr Frank Müller

About The Bridge To Luxury

The Bridge To Luxury (TBTL) is one of the few worldwide operating consulting firms specialising in supporting companies that offer high-end consumer goods and services. TBTL's vision is to successfully connect luxury, prestige, premium and prosumer brands with customers, distribution partners, media, personnel or investors.

Through its own and network structures, TBTL is a full service provider for high-end brands in assisting them on strategic and operational levels such as company and market analyses, definitions of brand strategy, optimisation of marketing mixes, restructuring and organisation, executive research, funding, strategic partnerships and maximising profitability. To find out more please consult TBTL's homepage:

www.thebridgetoluxury.com

TBTL was founded in 2009 by Frank Müller. Previously, he was a managing director of A. Lange & Söhne and Glashütte Original's CEO. As member of the extended group management board of The Swatch Group Frank Müller overlooked the corporation's South-East Asia business. He studied business administration at the University of Mannheim and at the ESCP Europe and received his doctorate from the University of St. Gallen.

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