The Luxury Industry in the Pandemic Era

Traditional retail businesses had struggled for a decade to overcome the competitive challenge of online sales and were already weakened before the impact of Covid-19 began to be felt in 2020. Within months of the pandemic's arrival, some long-established department store chains slipped into bankruptcy.

By contrast, luxury goods stood out as a thriving and growing subset of retailing that prior to the virus had benefitted from a distinctive set of conditions—the remarkable pace of China's economic development not least among them. Online competition was less of a threat in this corner of the retail market, likely because shoppers for luxury products enjoyed the full experience of being welcomed into an "exclusive" boutique and having a chance to see and touch the goods before buying. The pandemic made this model unworkable in the short run, and the industry had to quickly adapt to conducting sales online. The multi-brand conglomerates already dominating the luxury market had the resources to make this transition—something that small designer-led firms did not necessarily have.

Looking beyond the pandemic, future industry leadership may well go to firms that take an omni-channel approach—one combining striking boutiques in worldwide cities with well-conceived online strategies to bring buyers to the brand. Here, too, resource-rich conglomerates are likely to prevail.

Key Takeaways

- Covid-19 dealt a serious blow to the luxury goods industry, which had been experiencing steady growth for more than two decades, driven in part by rapid consumer market development in China.
- While the large multi-brand conglomerates that dominate the sales of personal luxury goods were not immune to the pandemic's effects, we think such companies are likely to withstand the pandemic's dislocations and emerge on the other side in even stronger competitive positions.
- We believe global incomes and wealth should resume their upward trajectory once the impacts of the pandemic recede. This includes emerging markets, where China is not the only country with an expanding middle class.
- Consumer trends—particularly among millennials—suggest the issue of sustainability may be increasingly important for the makers and sellers of luxury goods.

Luxury Has Taken a Hit from COVID-19, but the Long-Term Outlook Seems Attractive

Ask consumers what luxury means and you will hear myriad answers: a specific product, a preferred brand, a hospitality experience, a recent gourmet dinner, or even fine art or a luxury automobile. All would necessarily share the characteristics of artisan quality and correspondingly high prices.

The personal luxury goods segment reached its current size after 23 years of growth at an annualized rate of nearly 5%. We believe this growth may continue on the back of rising levels of income and wealth globally.

We are specifically interested in the €281 billion[1] personal goods segment of luxury that includes apparel, beauty, leather goods, shoes, watches and jewelry—a segment facing serious near-term challenges due to Covid-19 and its associated economic pressures. These challenges include the outright closure of retail stores and a steep decline in travel—especially air travel. Duty-free shopping has long been an important sales channel for beauty products. Purchasing luxury goods is a common holiday activity among many consumers, particularly the important Chinese consumer base, which accounted for 35% of global luxury sales in 2019.[2] Italian factory closures early in the pandemic also hurt. By forcing virtual cancellation of the spring/summer fashion season, these closures resulted in a glut of inventory that added to the industry's woes. While third quarter company results showed that Chinese consumers are repatriating their spending to the mainland, other parts of the world look increasingly likely to tip back into pandemic-induced restrictions, which could return to haunt the industry again.

Nevertheless, we at First Eagle focus on each industry's long-term trajectory, and here the news seems more promising. The personal luxury goods segment reached its current size after 23 years of growth at an annualized rate of nearly 5%.[3] We believe this growth may continue on the back of rising levels of income and wealth globally, including the expansion of the middle class (especially in emerging economies)—trends that could persist for years, although not without fits and starts along the way. China, for example, is considered only an "upper-middle-income" country in terms of per-capita gross national income despite being the world's second-largest economy. Only the top quintile of earners in China meet the World Bank's "high-income" threshold ($12,536 as of 2020), and that occurred only recently; there are more than 80 countries and territories worldwide that fall into the high-income category.[4] China has been a major contributor to the luxury industry's recent growth, and it is likely to become an even larger market for luxury goods if incomes continue to rise there.

The Power of Conglomerates

Large multi-brand conglomerates are already a major factor in the personal luxury goods space, and we believe current conditions are generally favorable for their continued advance. Conglomerates aggregating a large collection of luxury brands are among the largest, best-capitalized and most-profitable global businesses, and almost all of them are domiciled outside the United States.

Prominent among these companies is LVMH, with 75 "houses"—i.e., distinct brands—that generated €53.7 billion of sales in 2019 per company reports. Its houses include the eponymous Louis Vuitton, one of the world's most recognized and desired accessories and apparel brands. Other notable brands under its roof include Christian Dior (fashion), Dom Perignon (Champagne), Tag Heuer and Bulgari (watches and jewelry), and Sephora (cosmetics). We also cite Compagnie Financière Richemont as a strong player in this space. Its portfolio consists of 20 distinct brands—including such high-end watch and jewelry brands as Cartier, Van Cleef & Arpels, Vacheron

1,2,3. Source: Bain & Company; data as of November 18, 2020.
4. Source: World Bank, Haver; data as of December 1, 2020.

Constantin, Jaeger-LeCoultre and IWC Schaffhausen—that in aggregate generated €14.2 billion of sales in its fiscal 2019 year.[5]

Retail has become part selling, part marketing, part consumer discovery and part showroom. This entails building temples to luxury on high streets in key global cities. True omni-channel retail is complex and costly.

Today's luxury conglomerates have been formed for the single purpose of serving their target market. Their size and capital strength have generally helped them through the industry's current difficulties while simultaneously positioning them as even more formidable competitors when they emerge from the pandemic. We believe that in the long term, small designer-led brands or direct-to-consumer startups will not have the resources to compete effectively. Indeed, the ultimate path for many of these smaller brands is to sell to larger groups, such as those cited above and a handful of others that are positioned to tackle the task of building global recognition.

In the short run, the conglomerates' capital strength enables them to maintain their existing advantages. They continue to innovate, advertise, pay rent, perhaps obtain better locations, shift inventory globally if necessary and abruptly pivot to online as a way of making up some of the sales lost otherwise. After investing in backwardly integrated production, they have considerable flexibility.

However, we should not sugarcoat the effects of the pandemic. At LVMH sales fell 27% in first-half 2020 and 37% in the second quarter alone. Richemont, which is exposed to the more cyclical watch and jewelry space, saw a staggering 47% constant-currency decline in sales in its first fiscal quarter ended June 2020.[6] On the other hand, perhaps their long-term advantages are best illustrated by the transition to digital sales and the shifting sands of traditional retail. Bain estimates that online luxury goods sales appreciated from €4.3 billion to €33.3 billion from 2010 to 2019 to rest at nearly 12% of total industry sales. Online business has supplanted sales through specialty stores, where growth has been tepid, and at department stores, which have been struggling.

The Growing Importance of ESG Considerations[7]

Although many luxury goods brands carry the cachet of decades or centuries of renown, they clearly need to keep up with 21st century realities—not just the evolving capabilities of technology, but also the changing values of prospective customers. In many parts of the world, individuals who can afford luxury goods have become increasingly concerned about sustainable business practices.

According to Bain, 80% of the buyers in this market (particularly millennials) say they prefer socially responsible brands. Before buying a new necklace, they may ask where the gold and gemstones came from. Before purchasing a fine wool shawl, they may want to know about the living conditions of both the sheep and the shepherd. These issues are hardly new—protests against fur date back decades—but they are acquiring new urgency, and they are impacting investors as well as shoppers.

It was striking to see a recent advertisement in *The New York Times* for Tiffany & Co.—the large US-based jewelry retailer that was acquired in January 2021 by LVMH—headlined with the phrase: "The Leader in Diamond Traceability." To attract consumers concerned about unwittingly buying "blood diamonds"—those mined to finance insurgencies or terrorism—or produced with child labor, Tiffany has committed to supply-chain transparency for its diamond jewelry, from the country/region of origin for each stone to where it was cut, polished, graded and set.

In our view, actions such as these to proactively address ESG concerns may help bolster cash flow generation over time and reduce a company's fade risk. We think they should be considered alongside other fundamental factors when valuing companies and making investment decisions.

5,6. Source: Company reports; data as of December 1, 2020.

7. Environmental, social and governance (ESG) issues may be factors, among many, that are considered as part of our fundamental research process. However, we do not seek to invest in companies based on performance on ESG criteria.

The migration online may slow as stores reopen, but it is likely to be a new reality in the industry. The large groups have the capital strength to invest substantially in true omni-channel retail. Digital technology now touches every part of the business. Online discovery allows for broader reach to bring more customers to a brand, but online advertising is expensive, as are influencers. Websites must remain fresh. Retail has become part selling, part marketing, part consumer discovery and part showroom. This entails building temples to luxury on high streets in key global cities. Rent and fixtures are expensive, and logistics are a significant investment across both online and physical retail worlds. True omni-channel retail is complex and costly. Getting to this comprehensive stage is prohibitively expensive for smaller, independent, designer-led brands.

Regions of Potential Growth

Behind today's dark storm clouds and rough seas, there may be better weather ahead for the luxury goods industry.

Skeptics likely are correct in saying that no other country could replace the consumption of the Chinese, whose embrace of luxury goods and travel in the aftermath of the global financial crisis masked declines in other parts of the world. Nevertheless, from a long-term perspective, there are potential sources of growth beyond China. Looking further afield, India and Southeast Asia represent populous and, prior to the pandemic, growing economies moving up the income ladder as they industrialized. India's population of 1.35 billion already supports a luxury industry amounting to roughly US$10 billion in 2019, half of which is jewelry, according to Statista. Indian consumers have long viewed gold as a store of value, which they purchase largely by weight. A greater appreciation of design on the part of these consumers could provide a strong boost to the jewelry business.

In Southeast Asia, Indonesia's population of 270 million alone is almost surely destined to turn the country into the world's largest modest-fashion market in the years ahead. With per-capita income barely qualifying for the World Bank's "middle income" threshold of roughly US$4,000, Indonesia's runway is long.[8]

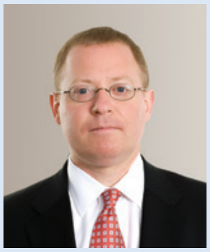
Conglomerates have the resources to position themselves for a better future and the potential to reap additional rewards, such as better customer data, greater marketing visibility and improved control of inventory.

Reduced travel may repatriate some spending back to home markets, especially in China, which has been early to emerge from the pandemic's dislocations. While such repatriation does not make up for all the pandemic's lost sales, it could result in a better geographic mix of business to support the global store networks established by the large groups.

As they work through the current economic downturn, conglomerates like LVMH and Richemont have the resources to position themselves for a better future and the potential to reap additional rewards, such as better customer data, greater marketing visibility and improved control of inventory—with the concomitant benefit of full-price discipline. Louis Vuitton, for example, which has an entirely captive retail network, rarely if ever offers discounts.

8. Source: World Bank; data as of December 1, 2020.

About the Author



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