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LAP OF LUXURY

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"The best things in life are free. The second-best things are very expensive"
COCO CHANEL

After a period of extraordinary growth, the luxury sector is showing signs of slowing. An inevitable normalisation or evidence of something more fundamental? Lindsay Scott considers the long-term outlook for the industry and some of its most illustrious exponents.

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A key element in the post-Covid global economic recovery has been the vigour of private consumption, with an impatient public let off the leash following restrictive lockdowns. Even in the face of rising inflation, higher interest rates, and geopolitical ructions, the indefatigable consumer has proved more resilient than many expected, and their appetite for luxury has been voracious.

But having feasted on the post-Covid buying boom, the luxury sector is now

facing gathering macro headwinds. As the CFO of LVMH, Jean-Jacques Guiony highlighted at the Walter Scott conference back in May, luxury has gone through an extraordinary period of growth that was never going to last. Judging by the recent results and share price reaction in some companies, has the expensive Berluti shoe now dropped, with investors going through the process of discounting a sub-par long-term earnings trajectory?

The 'macro' has certainly become more uncertain and has not helped sentiment. The US posted consensus-busting third-quarter annualised GDP growth of 4.9% driven by the familiar story of buoyant consumption, but Main Street is dipping into its savings, judging by the significant decline in the savings rate. Retail sales, while still ticking along, have charted a tilt away from discretionary spending. Elsewhere, the picture is more muted. Broad consumption trends have dimmed in Europe with economies teetering on the edge of recession, while the nascent recovery in Japan is paradoxically challenged by the inflation it has long sought, with real wage growth not matching rising prices. Markets continue to be dismayed by the pace of recovery in China and the travails of the property sector, although recent data has pointed to a degree of stabilisation.

"Countering these near-term macro currents is the classic long-term demand argument"

On the surface, this would suggest a challenging environment. Countering these near-term macro currents is the classic long-term demand argument. The history of the modern world is that economies expand over time, notwithstanding periodic cycles. The upper middle class and the 'HNW' and 'UHNW' cohorts are growing, especially in Asia including China, and the 'travelling customer' has been a driver of growth. According to Bain & Co[1], the luxury goods market is likely to grow to between €530bn and €570bn by 2030 – more than double its size compared to 2020.

While these in themselves might seem positive drivers, they only count if a business has the brand, financial strength and management to leverage on these trends, and it's not easy.

There are few other products that symbolise the human character more than luxury goods. More than just a display of wealth, there is a universal, emotionally driven desire to own an item that conveys a certain image and style. Wanting 'the best' is innate. But to create these goods requires an organisation imbued with a sense of culture, flair, craftsmanship, and tradition; attributes reflected in the allure of its products beyond mere functionality, and which help elevate the brand. It is a business hard to replicate. Yet at the same time the history of luxury is one of innovation, where successful companies can develop new products that capture the imagination and set trends, and are able to respond deftly to market, demographic, and technological shifts.

"LVMH's recent revenue statement highlighted the return to a more normal growth trajectory"

LVMH continues to display these attributes. The company's recent revenue statement highlighted the return to a more normal growth trajectory, although in the near term, the economic backdrop is not without its hurdles. Organic revenue growth was 9% in its third quarter, which is a marked reduction from two consecutive quarters of 17% growth. A reduction from such elevated levels was to be expected however, and 9% is consistent with historical trends. Geographically, the market that experienced the biggest downturn was Europe, due to this 'normalisation' of demand from both locals and tourists. The US was sluggish, reflecting some consumer macro caution, and management had been flagging that the American aspirational consumer was 'at risk'. This refers to the category of customer that might not yet be able to afford the company's pricier offerings but is in the market for smaller items, and indeed this was evident in the decline in online, more-bijou leather goods, and in some of the company's non-coastal stores. Inventory and pricing issues impacted the Wines and Spirits division, although the numbers also reflected some tough comparisons with a buoyant period last year. In the key Fashion & Leather division, which accounts for some 50% of group sales, growth in the third quarter slowed to 9%, which led to a 16% gain for the nine-month period.

Japan has been tracking well, helped by increased tourist arrivals, with sales up 30% year on year in the quarter, while the Rest of Asia saw 11% growth. Despite the angst over the country's economic recovery, management has been highly satisfied with the performance of China and Chinese nationals' offshore spending. Together, sales to this group are up 40% on a two-year basis. Talking at our aforementioned research conference, Mr Guiony noted that the addressable luxury population in China is estimated to be somewhere between 20 and 40 million, and consequently long-term growth prospects remain very strong.

"The Group is confident in the continuation of its growth"

Company guidance is typically more qualitative than quantitative, but "in an uncertain economic and

geopolitical environment, the Group is confident in the continuation of its growth and will maintain a strategy focused on continuously enhancing the desirability of its brands, drawing on the authenticity and quality of its products, excellence in distribution and agile organisation".

This focus on product quality is paramount. Even canvas bags, where the margins are massive, have to be of the highest quality. In CEO Bernard Arnault's view, LVMH is selling you culture, not a bag. The ability to adapt is also a feature of the company. Brands have to manoeuvre around cyclicality and taste shifts, a task at which LVMH is very adept. There has been a tilt towards more subtle designs, less bling, which the company has captured. Market demographics have shifted, with Generation Z and Millennials becoming an increasingly important demand source. Through its creativity, and with the benefit of its marketing clout, LVMH has always managed to cater to a new audience yet maintain its appeal to the existing one. The brand has a huge draw. Pharrell Williams' first LV men's show on the Pont Neuf in Paris garnered 1.1 billion views when first streamed. This has now grown to 3 billion.

LVMH's growth is clearly returning to a more normalised level. The luxury market typically grows at 6% per annum over time. Given that LVMH retains the ability to grow faster than that, and with its strong pricing, the long-term return outlook, we believe, remains highly attractive.

Hermès also remains an exemplar of quality and brand strength. Buying a hard-to-get Birkin or Kelly bag is like gaining admission to an exclusive club. The company sits at the top end of the luxury market, catering to a very wealthy client base, and controlling supply carefully. So far it has defied the sector gloom, with sales beating expectations in the third quarter. For the nine months to the end of September, group stores delivered 22% growth and wholesale 23%, with all regions reporting growth north of 20%.

"If you build it, they will come"

The automotive equivalent of Hermès is **Ferrari**. To paraphrase the famous film quote, "If you build it, they will come – and pay more for the optional extras". Just-released third-quarter results saw adjusted earnings before interest and tax rise 42%, while revenues grew 24% year on year, with the company enjoying the benefits of higher volume, enriched product and country mix, higher 'personalisations' and pricing gains. The order book remains at high levels across all geographies and models and the company's entire output for 2025 is covered, which resonates with the company founder's comments that "we will always sell one less Ferrari than the market wants". The production of the four-door Purosangue (Ferrari shuns the term SUV) and the 812 Competizione A is ramping up. Significantly, hybrid models accounted for 51% of sales. No shudders from 'Ferraristi' about the growth in hybrids, then. For the full year, revenues and profits were guided higher, with the company expecting around 28% earnings per share growth. The iconic status of the Prancing Horse, the company's racing heritage, technological innovation and its exclusivity, have propelled Ferrari firmly into the luxury bracket.

"The world's great luxury companies have key common attributes"

From our perspective, the world's great luxury companies have key common attributes. They are businesses with strong brands, highly defensible market leadership, robust balance sheets, excellent profitability and cash generation, and are able to adapt well to changing market conditions. While investors ponder the ebbs and flows of cycles, the history of consumer behaviour suggests that luxury spending trends are likely to remain intact over the long run, and in our view, these companies are in pole position to benefit.

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[1]https://www.bain.com/about/media-center/press-releases/2023/global-luxury-goods-market-accelerated-after-record-2022-and-is-set-for-further-growth--despite-slowing-momentum-on-economic-warning-signs/

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