

# [Lvmh in the recession the substance of style](https://assignbuster.com/lvmh-in-the-recession-the-substance-of-style/)

http://www. economist. com/node/14447276 LVMH in the recession The substance of style The world’s biggest luxury-goods group is benefiting from a flight to quality, but the recession is also prompting questions about the company’s breadth and balance Sep 17th 2009 | Paris | from the print edition \* \* Bloomberg “ THERE are four main elements to our business model—product, distribution, communicationand price,” explains an executive at LVMH, the world's largest luxury-goods group. “ Our job is to do such a fantastic job on the first three that people forget all about the fourth. For decades LVMH's formula has worked like a spell: seduced by beautiful status-symbols, perfect shops and clever advertising, millions of people have swooned forgetfully towards the firm's cash registers. At Louis Vuitton, LVMH's star company, the model's pricing power has yielded consistent profit margins of around 40-45%, the highest of any luxury-goods brand. These days customers are finding it far harder to forget about price. The seriously rich, of course, are still spending freely.

But much of the industry's rapid growth in the past decade came from middle-class people, often buying on credit or on the back of rising house prices. According to Luca Solca of Bernstein Research, 60% of the luxury market is now based on demand from “ aspirational” customers rather than from the wealthy elite. The recession has quickly reversed the trend to trade up, and people are delaying expensive purchases. Bain & Company, a consulting firm, expects the industry's sales to fall by a tenth in 2009, to €153 billion ($225 billion).

Some executives even expect a lasting shift in customers' preferences, towards discretion and value. Bernard Arnault, chairman and chief executive of LVMH, believes that the whole industry needs to rebrand itself. “ The word luxury suggests triviality and showing off, and the time for all that has gone,” he says. Brands which sold “ blingy” easy-to-sell products, milking old names, he says, will fare particularly badly in the newenvironment. LVMH, by contrast, has never taken such an approach, he says, instead emphasising quality, innovation and creativity.

To underline these values, the group is going back to basics in its daily operations. “ Before the crisis, we were putting a lot of energy into beautiful stores, but now we care a bit less about expanding our network and even more about design and price,” says an executive. A few years ago, for instance, at the height of the boom, one LVMH brand was putting diamonds all over its watches, so that it was almost difficult to tell the time. “ Now we are getting back to what really matters, which is nice movements and design,” he says.

For some luxury firms, the recession's effects have already been brutal. Private-equity firms and other outside investors which rushed into the industry at its peak have suffered most. “ At the top of the market this industry was perceived as easy by outsiders,” says Mr Arnault. “ You borrowed 80% of a target's asking price and hired a good designer, but the strategy has not been successful in several cases. ” Lenders to Valentino, an Italian fashion house, are reportedly trying to renegotiate its debt. Permira, a private-equity group, bought the firm in 2007 in a deal valuing it at €5. billion. Permira has since written down its equity investment of about €900m by more than half. Prada Holding, through which Miuccia Prada and her husband control Prada Group, another Italian house, recently restructured its loans in order to defer payment to banks. Prada Group has denied that there are talks to bring in a minority shareholder. Two particularly weak firms, Christian Lacroix, a Paris-based ready-to-wear and haute couture label which used to be part of LVMH, and Escada, a German maker of luxury womenswear, filed for bankruptcy earlier this year.

Amid this turmoil, LVMH is performing relatively well (see chart 1). It has benefited from an established pattern in the luxury industry: when people have less, they spend what they do have on the best quality. Shoppers are going for fewer, classic items—one Burberry raincoat, rather than three designer dresses, or a single Kelly bag by Hermes, a French luxury-goods group, instead of four bags from various lesser designers. For this reason, says Yves Carcelle, chief executive of Louis Vuitton and president of fashion and leather goods for LVMH, “ Vuitton always gains market share in crises. As reliable and sturdy as one of its own handbags, therefore, Vuitton is carrying LVMH fairly comfortably through the recession. In the first half of 2009 the group's revenues were about the same as a year before, though profits were 12% lower. Two divisions—wine and spirits, and watches and jewellery—were the worst affected: their revenues each fell by 17% and their profits by 41% and 73% respectively (see chart 2). Rapid de-stocking by retailers exacerbated the effect of falling demand.

But the falls were offset by Vuitton, where revenue rose by a double-digit percentage, registering gains in every market. “ It is incredible that in a downturn the consumer still buys so many Louis Vuitton bags, but she or he does,” says Melanie Flouquet, luxury-goods analyst at JPMorgan in Paris. Vuitton's performance, and the overall robustness of LVMH, a global conglomerate with more than 50 brands and revenues of €17. 2 billion in 2008, should allow it to take advantage of its competitors' weakness in the recession. In the next few years we expect several failures in the industry and good opportunities to acquire assets at attractive prices,” says Mr Arnault. Shareholders in the firm are particularly preoccupied by what he might buy and sell in the next few years. What explains Vuitton's resilience? Beneath the gloss of advertising campaigns, catwalk shows and each season's fleeting trends, Vuitton brings a machine-like discipline to the selling of fancy leather goods and fashion. It is the only leather-goods firm, for instance, which never puts its products on sale at a discount.

It destroys stock instead, keeping a close eye on the proportion it ends up scrapping (which it calls the “ destruction margin”). In 2005, when Maurizio Borletti, owner of several prominent department stores in Italy and France, was preparing for the opening of a refurbished La Rinascente department store in Milan, he recalls, the Vuitton people built a scale model of the building in their offices to understand customer flows and get the best positioning. “ In this they're the most professional in the industry,” he says.

Unlike most other luxury marques, Vuitton never gives licences to outside firms, to avoid brand degradation. Its factories use techniques from other industries, notably carmaking, to push costs down ruthlessly and to allow teams of workers to be switched from one product to another as demand dictates. It has adopted methods of quality control, too: one quality supervisor came from Valeo, a French auto-parts supplier. The result is long-lasting utility, beyond show, which is valuable in difficult times. Owning shops gives Vuitton control over levels of stock, presentation and pricing.

It was not therefore affected by the panicked price-slashing of up to 80% by American luxury department stores in the run-up to Christmas last year—a “ catastrophe” for others in the industry, according to Mr Arnault. Although other LVMH divisions have been hit by outside retailers de-stocking during the crisis, Vuitton has managed its own inventory, with no competition for space from other brands. With a global network, says Mr Carcelle, the firm can move poorly selling stock to shops where it has performed better. The luxury of diversity

Vuitton's ability to offset the steep falls in other divisions shows the value of the diversified conglomerate model in luxury goods. Richemont, the industry's second-largest company, has a less varied portfolio and greater exposure to watches and jewellery, demand for which has been especially weak. According to a recent trading statement, its sales fell by 16% in the five months to the end of August. A group structure also yields savings when negotiating deals for advertising space, property and credit-card fees. It helps to have a specialist beauty retailer, Sephora, and a chain of airport shops, DFS, to sell perfumes and cosmetics.

When Vuitton develops watches, say, it can call on the talents of TAG Heuer. But LVMH's breadth also comes in for criticism. Although there is undoubtedly value in some diversification, some people ask whether 50-odd brands under one roof are too many. Vuitton, for instance, would doubtless like to see disposals of weaker brands as a result of the crisis, and a greater concentration of resources on the group's key businesses. The group's executives devote the bulk of their attention to the most important of these: Louis Vuitton, Moet Hennessy in drinks, TAG Heuer in watches, Christian Dior in perfumes and cosmetics, Sephora and DFS.

The group has many smaller businesses, and these get much less attention in such a big group. LVMH does not disclose financial figures for individual brands, but at its presentation of first-half results the group'sfinancedirector replied to an analyst asking about fashion and leather-goods that a “ handful” had lostmoney“ somewhere”. There is speculation that Celine, a ready-to-wear clothing and accessories label, Kenzo, a fashion brand which analysts have long suggested LVMH dispose of, or Loewe, a Spanish leather-goods brand which has so far failed o win much of a following outside Spain and Japan, are among the less profitable. Nevertheless, the group can use the might of Vuitton to support its smaller, upcoming brands. A department store, for instance, may be asked to take Loewe or Celine in order to get Vuitton. That often frustrates people at Vuitton, however, who would prefer to use the power of the brand for its own benefit, says a person who knows the company well. “ They've never heard of another of LVMH's brands saying, ‘ Either give this to Vuitton or I won't come',” he says.

Apart from the synergy in watch design, Vuitton does not find that it benefits much from the rest of the group. The reason why LVMH has many small brands which aren't quite making it, says another person familiar with the company, is that Mr Arnault is an optimist who believes that every property can at some point be turned around. That can pay off: some years ago Mr Arnault halted the imminent sale of a make-up line. Thanks to the distribution muscle of Sephora, it has since turned into a bestseller in America.

Investors, however, are nevertheless wary of what they see as Mr Arnault's tendency to collect brands. The crisis has also underlined the fact that Vuitton dominates the group's results. Were it not for Vuitton, estimates one analyst, LVMH's sales would have fallen by 3% in the first half of 2009 and profits would have plunged by 40%. In normal times Vuitton contributes about half of the group's profits, and most of the rest comes from Moet Hennessy. In the first half of this year, however, Vuitton contributed an estimated 70% of profit.

That leads some people to question whether LVMH is overly dependent on the leather-goods firm. “ You can argue that there's nothing as good as Vuitton in LVMH's portfolio,” says Pierre Mallevays of Savigny Partners, who was formerly director of acquisitions at LVMH, “ but that simply states the fact that LV's business model is the gold standard of luxury brands; no other brand in the world compares to it. ” The biggest risk to LVMH is Vuitton, argues Ms Flouquet, since it accounts for such a big proportion of profits; the company depends on it, she says.

The risk to Vuitton, in turn, is that it could fall out of fashion or lose its exclusivity in the eyes of consumers. So far there is no sign of fatigue with the brand. LVMH's senior managers have devised ways to refresh it. In the late 1990s, for example, Mr Arnault saw that there was a risk that as a maker of leather goods alone, Vuitton could be perceived as boring. In 1997 he hired Marc Jacobs, then a relatively unknown designer, to design a fashion line. The aim was to generate seasonal buzz and press coverage.

Vuitton's senior executives at the time were against the idea, fearing that adding fashion could undermine a timeless image, but Mr Arnault's move proved successful. To avoid overexposure of its signature “ Monogram” print, Vuitton has taken care to develop a wide range of products and other patterns. “ We increase the number of product lines and we are careful to have several different colours and shapes,” says Mr Arnault. Thus Vuitton sells reasonably priced handbags—the smallest Speedy Bag costs €430 in Paris—but also wildly expensive custom-made luggage, reinforcing its exclusive image.

Another effective tactic is to make limited-edition handbags which are hard to get hold of. Five or so years ago Vuitton depended to a large degree on one market, Japan. Most Japanese women owned at least one Vuitton product—and hence provided a large proportion of Vuitton's profits, which worried analysts at the time. Yet the Japanese market for luxury goods was souring. Spending on such items in Japan has fallen sharply since the end of 2005, according to a recent report by McKinsey, a consulting firm. Young women are more individualistic than their mothers, and are seeking out lesser-known brands. You used to see thousands of Vuitton bags coming at you in the Ginza shopping district but far fewer now,” says Radha Chadha, author of a book, “ The Cult of the Luxury Brand: Inside Asia's Love Affair with Luxury”. That reliance on one country is no longer so marked (see chart 3). Fortunately, Vuitton has since rapidly established a strong position in what it hopes will become another Japan: China. “ The Chinese consumer is in a love affair with the Vuitton brand,” says Ms Flouquet. According to LVMH, in the first half of 2009 sales to Chinese people (at home and travelling) made up 18% of Vuitton's revenue.

Despite widespread concerns about counterfeiting in the country, the Chinese are now Vuitton's biggest customer base after the Japanese. The key to the firm's success, says Mr Arnault, has been approaching the market exactly as if it were a developed market. “ We treat the Chinese customer as being very sophisticated. ” Many competitors, by contrast, have at times lowered their standards for shops in China, he says, using inferior furniture or positioning their stores poorly. Going into new markets and developing new product lines will enable Vuitton o continue producing double-digit growth for years to come, says Mr Carcelle. On every trip to mainland China—he makes five or six a year—he tries to discover a new city and meet its mayor. Mr Carcelle is also tackling other new frontiers: in October he will open a shop in Sukhbaatar Square in Ulan Bator. “ Already if you go to an upmarket disco in Ulan Bator you will see a significant number of our bags,” he says. Vuitton's expansion into China, Mongolia and new product lines such as watches and shoes, suggest that the leather-goods firm will continue to be LVMH's main source of growth.

However, it also means that the group may become more rather than less reliant on Vuitton. In theory, the answer could lie in strengthening some of LVMH's smaller names, such as Fendi, a fashion and leather-goods brand. But buying a big, established, global brand with potential for growth could be both a quicker and a surer route. Or maybe that oneImagineChina A new collection? Analysts and bankers are convinced that Mr Arnault wants to buy the Hermes Group, a producer of leather goods and fashion which matches Vuitton for quality and design.

Because Hermes is run so conservatively, says an investment banker who knows LVMH well, it is only a quarter of the size that it could be. “ Mr Arnault would grow it while preserving its values,” he says. Earlier this year, there were rumours that LVMH would sell Moet Hennessy to Diageo, the world's biggest spirits group, which already owns 34% of the business. Such a sale could raise money to buy Hermes. Mr Arnault, however, refuses to be drawn into commenting. For the moment, such an acquisition is impossible, since thefamilywhich controls Hermes does not want to sell, and the firm is strongly defended against takeover.

Nevertheless, says the banker, the family which controls it has several branches, all with different views. “ It's a pressure cooker and some day it will blow up,” he says. Chanel, another closely held global luxury brand, could also make a desirable target for LVMH. Some people recommend a merger with Richemont, which, Mr Solca argues, would address LVMH's relative weakness in watches and jewellery. Any such deals, or selling Moet Hennessy, would radically change the balance of the group. “ I would be surprised if LVMH sold Moet Hennessy. The business has high margins, high ashflow and it is well managed,” says Ms Flouquet. “ They would probably only sell it if they had a large deal ahead. ” Shareholders are nervous that LVMH will pay too high a price for a large acquisition. For this reason the group's valuation may not fully reflect its performance during the crisis. Such concerns are not likely to deter Mr Arnault, who has demonstrated his confidence in LVMH's prospects in luxury by raising his stake in the group over time: he owns 47%. If LVMH does go shopping, it will probably behave like one of its best customers: with price in mind, but willing to spend on enduring prestige.