2020 OUTLOOK

Luxury Retail: For Now, The Old Guard Still Reigns Supreme

Within the consumer retail investment space, luxury retail continues to be both a highly dynamic and fruitful sub-industry for retail and institutional investors alike. In 2020, luxury retail will continue to evolve substantially as leading brands continue to joust for consumer awareness and purchasing dollars. Understanding the drivers of luxury retail business models, and existing and emerging trends poised to disrupt the space in 2020 will be an integral part of an investor's success as the new year approaches.

Limestone's Consumers team has outlined, analyzed, and provided guidance on the following topics:

- The delineation of luxury retail within the C&R universe;
- The explanation of the 'Veblen' effect and case studies examining its importance for a company's survival;
- The most important trends in luxury retail in 2020;
- The existing luxury retail brand hierarchy and the emergence of players attempting to break-in;
- The major publicly-traded conglomerates dominating luxury retail and key mid-sized portfolio companies;
- Valuation and historical performance of the space;
- The team's outlook on the space's future and view on the most important aspects of a potential investment;
- 2 case studies poised to shift the space permanently.

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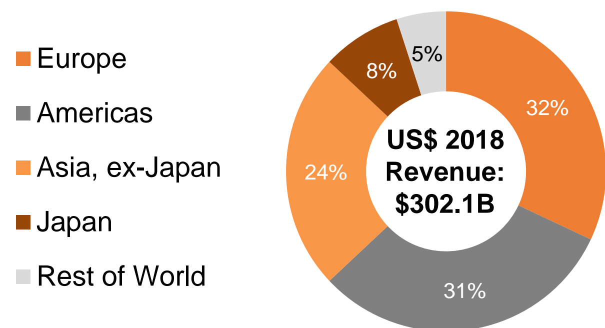
History of Luxury Retail: Significant Evolution to Present Day

Prior to today's economy, luxury items were exclusive to members of high-society. During these times, luxury was a way in which the wealthy defined and communicated their political, social, and economic standing, as well their self-worth. The heightened emphasis on luxury items was primarily driven through the supply and demand dynamics at that time. These items were produced in small quantities on an order-by-order basis, catering only to elite clientele.

This serves as a stark contrast to luxury retail today, which has transformed to a global multibillion dollar industry. Now, 60% of the luxury goods market is controlled by 35 leading brands, many of which have excess of $1 billion (USD) in revenue per year. Further, the industry has been substantially affected by the corporate quests of achieving top-line growth and maximizing margins. This has led to the creation of sweatshops and counterfeit goods, diluting the prestige of luxury.

In spite of these negative effects, the growth within the space has created investment opportunities amongst a wide array of businesses. These players continually compete on the basis of price, market expansion, and production differentiation.

Figure 1. 2018 Share of Global Personal Luxury Goods Market by Region

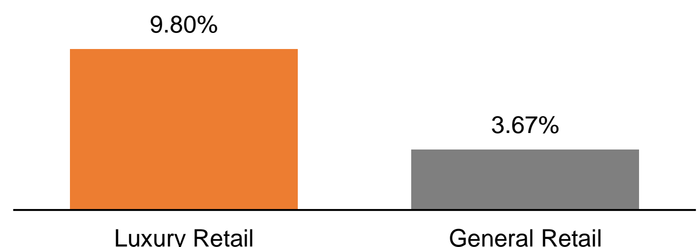


The Distinction: Luxury Retail and Regular Consumer Retail

The primary difference between luxury retail and regular consumer retail is pricing. As implied by the name, luxury items are typically more expensive. The value propositions that incentivise consumers to pay a premium for these goods are various. Some believe deeply in the correlation between the price of a good and its quality, which suggests that luxury retail offerings are higher-grade in nature. Another dimension is the social value inherent in these goods. Names such as Chanel, Christian Dior, or Burberry are well-recognized for their prestige, allowing the wearer to communicate their superior wealth or status to others.

Since luxury retailers do not necessarily compete purely on the basis of price, they must resort to other forms of differentiation to attract consumer demand. This is often sourced from the quality or unique features of the item, but can also arise from the type of experience consumers receive throughout the buying process. This industry characteristic creates opportunity for businesses to adopt strategic initiatives that facilitate margin expansion or robust revenue growth. Intuitively, successful luxury retailers are able to enjoy higher pricing power due to their respective brand equity. This translates into higher reported margins relative to general retail, as depicted in Figure 2.

Figure 2. Luxury Retail vs. General Retail Average Net Profit Margin



Sources: New York Times, Bain and Company, NYU Stern, Deloitte

The Vast Range of Luxury Goods: A 'Hierarchy' of Luxury Brands

Luxury goods range from everyday luxuries, such as Starbucks coffee and Apple products, to premium luxury brands such as Cartier and Hermes, to bespoke luxury brands such as Leviev, Patek Philippe and Graff.

The determination as to where a luxury brand falls on the pyramid is determined by the brand's average price points and their level of accessibility, measured by number of POS.

The idea that the luxury industry is attempting to adapt to consumer demands of accessibility is a paradox in itself. Exclusivity and lack of accessibility is what defines notable bespoke luxury brands. Premium brands such as Gucci and Louis Vuitton have been losing prestige due to the increase in knockoffs that have allowed the brand to become too well known and accessible.

Figure 3 below demonstrates the vast range of brands that comprise the luxury retail brand spectrum. While brands appearing lower in the pyramid are often part of a parent company that is publicly-traded, luxury brands appearing higher tend to be privately-owned.

Figure 3. The Luxury Brand 'Hierarchy'

Price Points

GRAFF

PATEK PHILIPPE GENEVE
HW
Breguet Depuis 1775
BOTTEGA VENETA

Chopard
HERMÈS PARIS
BVLGARI
ROLEX
Cartier
TIFFANY & CO.
OMEGA

LOUIS VUITTON
DAVID YURMAN
PRADA
TOD'S
TISSOT

COACH NEW YORK
MONT BLANC
GEOX
TIFFANY & CO.*

Number of Points of Sale

Source: Business Insider

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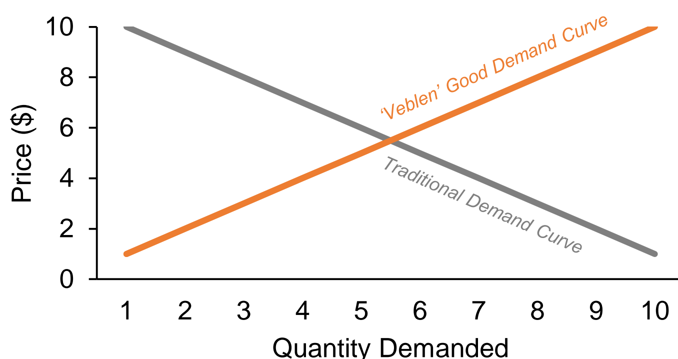
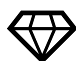
The 'Veblen' Effect Explained: Brand Equity is Everything in Luxury Retail

The business models of a vast number of luxury retailers rely on an important phenomenon called the 'Veblen' effect. While the law of demand learned in Economics 101 stipulates that the higher the price a retailer charges on any given good, the lower the quantity demanded, the 'Veblen' effect entails the complete opposite – the higher the price of a 'Veblen' good, the higher the quantity demanded will be for that good.

Figure 4. Normal vs. 'Veblen' Demand Curve



The 'Veblen' effect is primarily driven by fundamentals that stray away from the traditional influences of a normal demand curve. Consumers seek out 'Veblen' goods for two primary reasons related to the acquisition of social status and desire for recognition:



Conspicuous Consumption: acquisition of luxury goods to demonstrate **superior economic power** (e.g. Birkin bag)

Conspicuous Leisure: undertaking leisure for the primary purpose of **displaying social status** (e.g. an exotic vacation)

The 'Veblen' effect enables luxury retailers to charge premium prices and in turn reap higher margins and returns in comparison to their non-luxury counterparts. In most cases, the existence of the effect for a company results from the building and marketing of a collection of symbols and associations over time, which consequently results in favourable brand equity.

'Veblen' Effect Case Study: The Decimation of the Michael Kors Brand

The decline of the Michael Kors (MK) brand over the past half-decade serves as a cautionary tale for current luxury brands of the severe implications that result from the deterioration of the 'Veblen' effect. At the beginning of this decade, Michael Kors was viewed as a premier luxury brand by the retail industry – the company's share price rose 4x from its 2011 IPO to the beginning of 2014.

As MK surged in popularity, the company became able to charge top-of-the-line premium prices for its product line. From 2009 to 2014, the company's EBITDA margin rose from 10.4% to a staggering 32.9%, attributable to the brand's increasing 'Veblen' effect and in turn the purchasing behaviour the brand's customers.

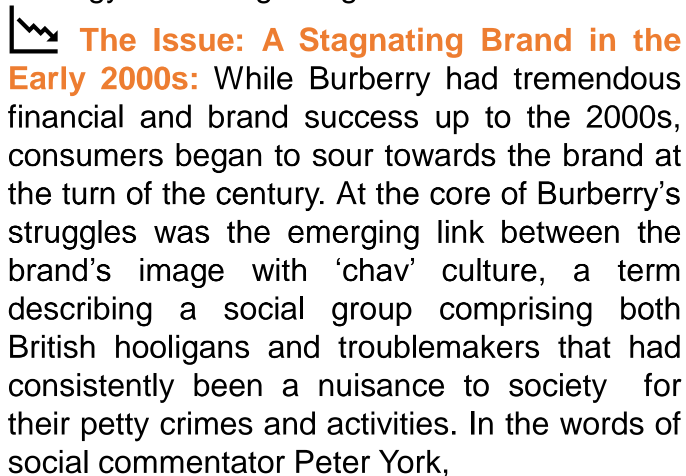
As the decade hit the half-way mark, it became increasingly clear that the brand had suddenly lost its appeal to its core demographic. In 2019, it has become apparent which factors have ultimately led to the demise of the MK brand:

Occurrence	Implication on Business Success & 'Veblen' Effect
1) Overzealous Store and Product Expansion	▪ Oversupply of products led to the overexposure of the MK brand – no longer highly-coveted, it led to the near extinction of the 'Veblen' effect
2) Presence in Outlet Malls and Discount Retailers	▪ Presence in outlet malls and non-luxury retailers such as TJ Maxx discouraged consumers from continuing to pay premiums for products
3) Wholesale Channel Actions	▪ Department stores have engaged in substantial discounting of MK products, further diluting brand equity (MK does not have control over this)

Sources: CFI, Fortune, Business Insider, Capital IQ

‘Veblen’ Effect Case Study: **Burberry’s Renaissance**

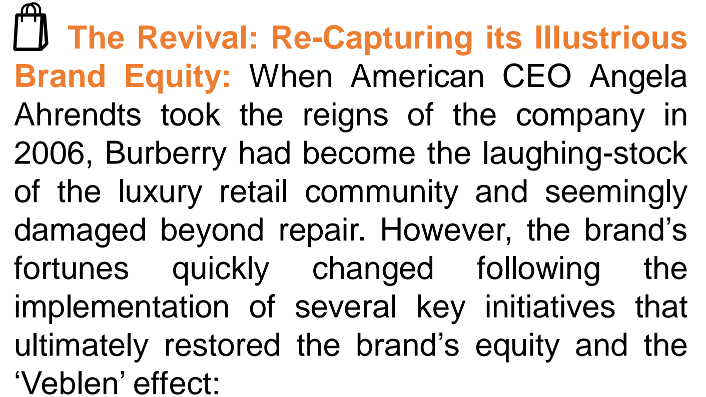
From its first store in Basingstoke in 1856 to present, the Burberry brand has evolved into a globally-recognized powerhouse. The Burberry check pattern and other associated symbols continue to enable the brand to maintain strong consumer demand while commanding increasingly higher prices, demonstrating the existence of the ‘Veblen’ effect for the Burberry brand. However, such brand equity was not acquired without several obstacles. One of the most well-known turnarounds the brand has undertaken historically was chief executive Angela Ahrendts’ successful turnaround strategy at the beginning of the 2000s.



The Issue: A Stagnating Brand in the Early 2000s: While Burberry had tremendous financial and brand success up to the 2000s, consumers began to sour towards the brand at the turn of the century. At the core of Burberry’s struggles was the emerging link between the brand’s image with ‘chav’ culture, a term describing a social group comprising both British hooligans and troublemakers that had consistently been a nuisance to society for their petty crimes and activities. In the words of social commentator Peter York,

> *“Quite a lot of people thought that Burberry would be worn by the person who mugged them.”*

Such a link was able to further breed from the abundance of counterfeit Burberry products available that made the brand affordable to this social group, which unquestionably desired the social status and power that the brand was previously associated with. Further fueling the brand’s decline was the oversupply of the check pattern to the masses – the esteemed Burberry check pattern was accessible through the purchase of essentially any Burberry product, diminishing its previous exclusivity. Burberry’s brand equity issue reached a climax when it began being outright banned in a multitude of social venues.



The Revival: Re-Capturing its Illustrious Brand Equity: When American CEO Angela Ahrendts took the reigns of the company in 2006, Burberry had become the laughing-stock of the luxury retail community and seemingly damaged beyond repair. However, the brand’s fortunes quickly changed following the implementation of several key initiatives that ultimately restored the brand’s equity and the ‘Veblen’ effect:

Management Action	Implication of Action on Burberry
1) Removal of Lower-Priced Products	▪ Lower-priced products, such as baseball caps with the check, were discontinued, reducing brand access to certain groups
2) Reducing Availability of Check Pattern	▪ In 2001, the infamous check was on 1/5th of all products – three years later, it was on less than 5% of the product portfolio
3) Brand/ Product Offering Consistency	▪ Every design, from 2009 and onwards, had to be approved by one individual, Chief Creative Officer Chris Bailey
4) Digital Innovation	▪ Became an industry pioneer, building out social media aggressively and streaming fashion shows in 2010
5) Targeting Millennials	▪ Competitors ignored millennials – such would become integral given that Chinese luxury good consumers are on avg. younger

The key to the turnaround’s success is no secret – by reviving a key asset, the check pattern, that indubitably was the primary driver of the ‘Veblen’ effect, Burberry was able to return to its position as a global powerhouse.

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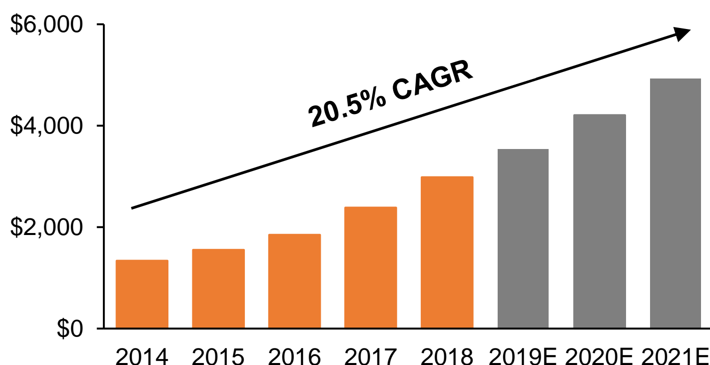
Trends in Luxury Retail 2020: The Emergence of Technology

Throughout recent years, technology has become deeply integrated into the business models of many companies operating within the Consumers sector. This is not surprising. Given the intense competition within the space, it comes with no shock that market players have leveraged innovation to differentiate themselves from their rivals. Businesses have each taken advantage of technology in a combination of three distinct ways: e-commerce selling, electronic marketing, and the digitalization of brick-and-mortar stores.

E-Commerce

With the high intensity of competition being a commonality amongst all retail industry verticals, consumers have been offered an abundance of goods and services, all differentiated on the basis of price, quality, and features. As a result, consumer expectations have staggered, and companies must provide the highest level of convenience, quality, or affordability to increase their respective market positions. One avenue of differentiation is selling goods online. The compelling value proposition behind this mode of transaction is three-pronged: timeliness, convenience, and knowledge through the ability to easily compare similar product offerings. Resultingly, e-commerce sales has seen robust growth throughout the years, as shown in figure 5.

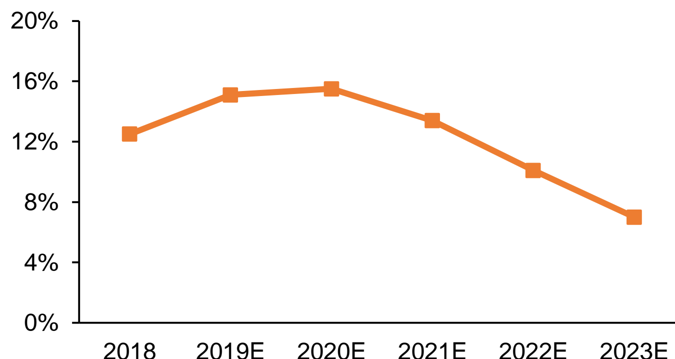
Figure 5. Global Retail E-Commerce Sales



Digitalization of Physical Stores

Despite the impressive historical increase e-commerce has seen, consumer verticals such as luxury retail are adamant on focusing heavily on their physical locations. The reason being is that these industries are high-touch in nature, meaning that the products offered require a significant degree of personalization to facilitate the selling process. This characteristic is prevalent in the fashion industry, in which a steep decline in e-commerce sales growth is expected. This is shown in Figure 6**.**

Figure 6. E-Commerce Revenue Growth in the Fashion Industry



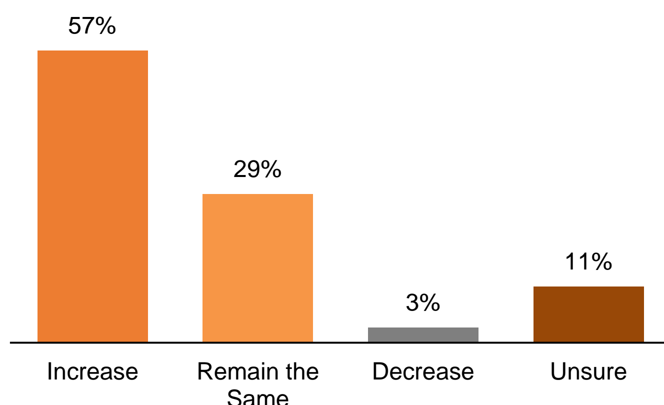
It is important to note, however, that luxury retailers are still leveraging technology through digitalizing their physical locations. Examples of how these investments manifest themselves include holograms, automated checkout stations, and virtual reality (VR). These innovations are intended to augment the experience of customers on the basis of customization, glamour, and convenience. For high-touch industries that differentiate themselves through quality and brand equity, technology has played an important role in spurring and retaining customer demand. U.S. brands lose approximately $41 billion each year due to poor customer service, displaying the essentiality of optimizing in-store experiences.

Sources: Statista, Retail Customer Experience

Online Marketing

Consumers have been to keen to adapt and integrate technology into their everyday lives. Millennials specifically are often referred to as the "connected generation" in the sense that they shop online, constantly use smartphones and mobile devices, and their purchases are influenced by what they read on social media. To quantify, 66% of millennials use social networking to stay informed compared to only 40% of the baby boomer generation. This unprecedented use of technology has not gone unnoticed by retailers. In an effort to raise awareness and drive demand for their respective products, businesses have leveraged online platforms for marketing purposes. The adoption of this technique is not expected to stagnate. As shown in Figure 7, the majority of North American business-to-consumer (B2C) marketers were expected to increase their content marketing budgets from 2018 to 2019.

Figure 7. Expected Changes to Content Marketing Budgets from 2018 to 2019



With such a significant amount of investment in the space, it becomes important to understand more granularly how this capital is deployed effectively. The most substantial driver behind online marketing success revolves around the growing need for personalization by consumers. Essentially, businesses need to create advertisements that cater to each customer's unique interests and needs. 74% of online consumers get frustrated by websites that contain advertisements that have nothing to do with their interests. Fortunately, digital marketing has made this request a possibility. Businesses now have access to detailed consumer data derived from social media platforms and internet service providers, which they leverage to create individualized marketing tactics and ultimately attract consumers.

An interesting point to note is that while many businesses have significantly capitalized on online marketing, a select amount of high-end retailers have purposely strayed away from this tactic. This is especially prominent amongst bespoke brands such as Graff and Leviev that exclusively target ultra-wealthy individuals. The intuition behind this strategy is to reinforce the notion that these names are so prestigious, exclusive, and desirable that their offerings need not be advertised to the general population. Instead, demand is driven primarily through referrals and word-of-mouth marketing, reinforcing perceptions of prestige, exclusivity and desirability.

Portfolio Implications

Technology has effectively polarized consumption across the retail spectrum. Consumers can now easily compare products' features and price tags. As a result, discount retailers who are able to charge the lowest are expected to see an increase in sales. On the other end, luxury retailers who differentiate themselves though brand equity, unique offerings, or highly personalized marketing tactics are also expected to thrive. Within the luxury retail space specifically, we will continue to seek out names that display these superior attributes and trade at attractive valuations.

Sources: BDC, Statista, Content Marketing Institute, Hubspot

Trends in Luxury Retail 2020: China's Continued Influence

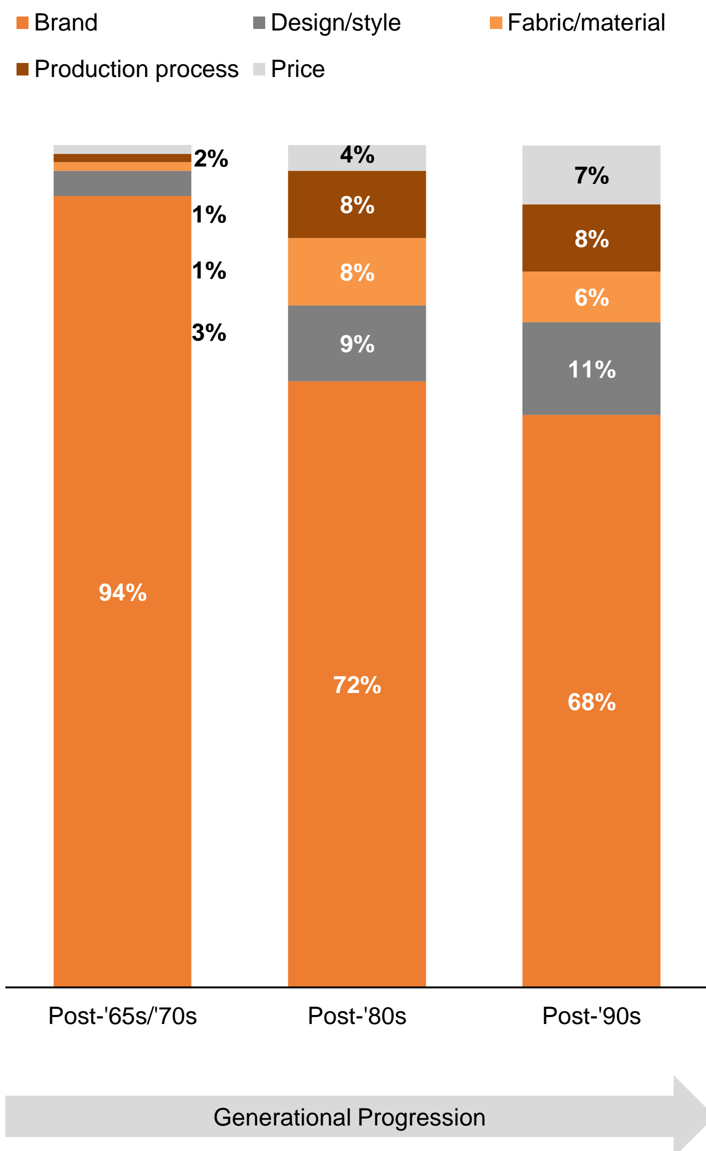
China's economy has been rapidly growing over the past 30 years, having experienced an average annual GDP growth rate of 9.32% since 1988. This is mainly due to high amounts of large-scale capital investments and accelerated productivity growth. With per capita income levels increasing at a similar pace, China's population has inherently benefitted from higher levels of wealth. In particular, upper-middle to affluent classes are anticipated to respectively grow at a 28% and 17% CAGR from 2018 to 2025. The growth within these demographics has, and will continue to enable Chinese consumers to increase their consumption of luxury goods. In fact, it is anticipated that Chinese consumers will contribute to 40% of global spending on luxury goods by 2025.

The significant increase in consumption of luxury goods began with Generation Y. This demographic grew up during China's enormous growth, which continued amongst succeeding generations. Another key motivation for Chinese consumers to purchase luxury items revolves around the notion of individuality. Luxurious brands are scarce amongst the general population – buying and wearing these items act as a way to differentiate oneself from others. This demand has incentivized foreign luxury brands to enter China, and subsequently benefit from a financial standpoint.

This pertinacious desire was observed when Canada Goose (NYSE: GOOS) attempted to capitalize upon this opportunity by opening a store in Beijing. In spite of tensions rising between Canada and China due to the detainment of Meng Wanzhou, the CFO of Huawei, and a nationwide push for boycotts against the parka manufacturer, Chinese shoppers continued to line up outside in sub-zero weather to be the first to purchase a coat.

As consumption patterns have evolved, consumers have developed more sophisticated perceptions of products in the market. In today's economy, consumers' affinity for luxury products extends beyond quality and brand, but also considers the sourcing of materials greatly. This shift has redefined the way companies market their offerings. For instance, many high-quality products are now being evaluated based on the social impact of their value chain, as opposed to merely features.

Figure 8. Primary Reason For Purchase



Sources: McKinsey, The World Bank

Trends in Luxury Retail 2020: Repeat, Reuse, Recycle, Rent

Today, luxury good consumer patterns entail a delicate balance that retailers must aim to serve; a balance between demand for newness and sustainable consumption. The modern-age demands have led to the introduction of new business models in the luxury industry such as consignment, subscription-based models and the presence of legacy-start-up partnership businesses.

A 2015 European study concluded that (1) 33% of women consider clothes "old" after three wears and (2) one in seven consider it "fashion faux-pas" to be tagged in an outfit more than once on social media. The rise of social media, where users post content daily are influencing purchasing decisions and patterns. The mentality has shifted from consumers investing in fewer, higher quality staple pieces to one that craves variety and newness.

In tangent, consumers are pressuring the industry to attend to ESG demands. In the luxury retail space, major players have been increasingly scrutinized for common practices such as burning unsold goods and the means by which elements such as diamonds and gold are sourced.

This crossroad of consumer demands has developed an opportunity for the sharing economy. The second-hand type business models tend to both ends of the scale by providing consumers access while promoting sustainability practices in the space.

1 Consignment

Consignment is an arrangement in which a business or person, (consignor), gives merchandise to an agent (consignee) to sell via the consignee's platform. After the sale of an item, the consignee receives a fee for their agency services. The RealReal is a leading luxury consignment business whose mission is to help extend the life cycle of luxury goods.

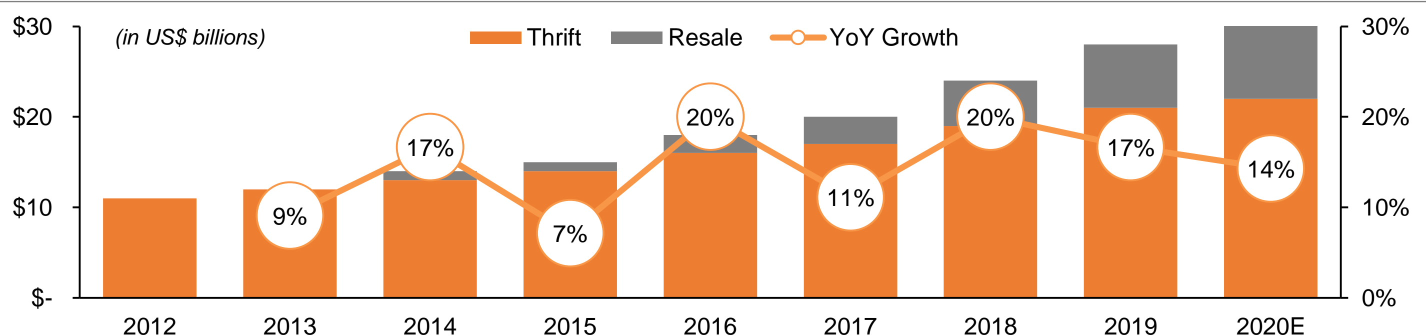
2 Subscription Based

The success stories of Netflix, Apple Music and others have inspired players in the retail space. Start-ups, such as China's Ycloset, allow subscribers access to a variety of clothing for a monthly fee.

3 Partnerships

Legacy brands are simultaneously trying to enter the space by partnering with start-ups who have made a name for themselves.

Figure 9. Sharing Economy on the Rise



Although thrift makes up the majority of the sharing economy market right now, the resale market is expected to outpace the thrift market within the next decade.

Sources: Deloitte, Goldman Sachs, McKinsey, thredUP

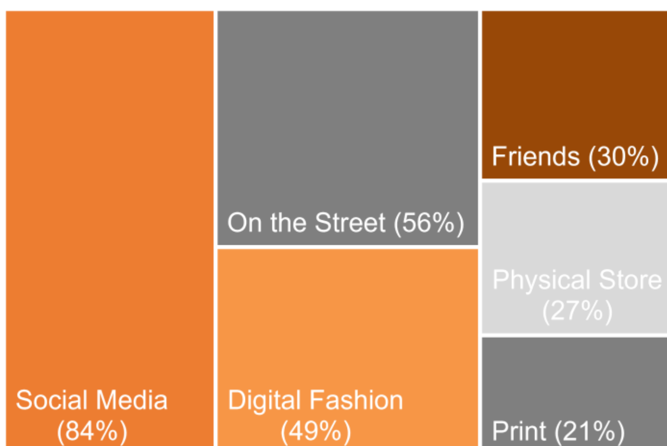
Trends in Luxury Retail 2020: The New Kids on the Block

According to the Luxury Institute, legacy luxury brands are re-examining the value of the heritage and history that is associated with their brand name. As generations and consumer priorities shift, brand heritage and history now rank only sixth in a list of top consumer priorities. This trait has been superseded by quality, customer service, design, craftsmanship and exclusivity. In the last three years, legacy brands' performance across all product segments has seen moderate growth (+3-4%). This stagnation has been a signal for the need to innovate, a challenge for legacy brands. This has left a gap in the market for younger luxury retail companies.

The New Kids: Streetwear

Streetwear fashion is a subculture that has been around since the 1970s. Through the rising trend of athleisure around the world, streetwear brands have taken off to become "modern luxury". Streetwear firms specifically target a modern, younger demographic, and are known to reinvent the status quo and are highly integrated with online platforms such as social media and digital fashion. For example, 84% of customers desire to purchase streetwear that is inspired by social media, and 49% are influenced by digital fashion.

Figure 10. Source of Purchase Inspiration[1]



Legacy Redemption Strategy

To maintain position within the industry, legacy brands must capitalize on the changing industry landscape without alienating traditional, older demographic customers. A prominent strategy many legacy brands are undertaking is brand contamination, specifically with streetwear firms. By partnering with these businesses, legacy brands are able to contaminate their own brand name with the streetwear brand and be associated with the newness and modernism that comes with streetwear. The most well-known cases include Louis Vuitton x Supreme, Manolo Blahnik x Vetements and Jimmy Choo x Off-White.

Louis Vuitton x Supreme

In 2017, Louis Vuitton and Supreme announced their collaboration, arriving in pop-up shops across the world. The collaboration featured streetwear and luggage items in Supreme's classic bright red primary colour, with both brands' logos coated on all products.

Figure 11. Louis Vuitton x Supreme

The partnership was unlike prior Supreme collaborations in that the products would not be available through brick-and-mortar or online. Aligned with Louis Vuitton's attempt to regain exclusivity, the limited, one-off collaboration was sold exclusively through pop-up shops and Louis Vuitton stores.

Source: PwC

1. Figures do not sum to 100% as respondents were able to select more than one option as their inspiration of purchase.

Trends in Luxury Retail 2020: Conglomerates Dominate

The financial success experienced by luxury retail conglomerates has led to a sustained positive outlook, per market sentiment.

As shown in Figure 13, these companies have experienced a significant increase in market capitalization relative to their small-scale peers.

Figure 13. Market Capitalization Evolution, Bigger vs. Smaller Names

Kering - (ENXTPA:KER)
Hermès - (ENXTPA:RMS)
Tod's - (BIT:TOD)
Salvatore Ferragamo - (BIT:SFER)
LVMH Moët Hennessy - (ENXTPA:MC)
350%
300%
250%
200%
150%
100%
50%
Dec 2014
Feb 2016
Apr 2017
Jun 2018
Aug 2019

Further Divergence Between the "Haves" and "Have Nots"

Gaining significant scale over industry players provides companies with further control over their brand image and prices. These are two important factors in the consumer decision-making process, especially when it comes to evaluating alternatives. Moreover, this advantage enables companies like LVMH, Gucci, and Hermès to gain access to much more comprehensive customer data. A large amount of sales across a diversified portfolio of companies allows conglomerates to benefit from larger and therefore more insightful sets of data. In turn, they can leverage this information to inform future initiatives that are tailored to dynamic customer preferences and trends.

This information shows the apparent competitive advantages granted to the largest players in the space. Given these material benefits, it is expected that business will continue to consolidate as a means to maintain, or increase, their dominance.

Source: Capital IQ

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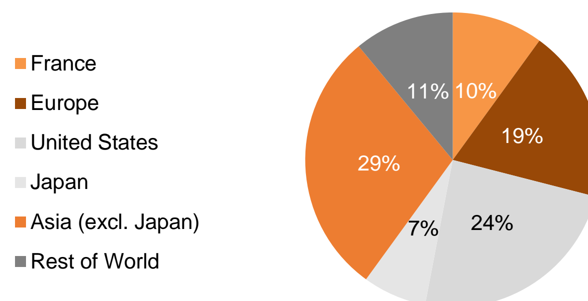
Conglomerate Spotlight: **LVMH (EPA: MC)**

Company Overview

As the world's leading luxury products conglomerate with 4,590 stores worldwide, LVMH owns globally recognized brands such as Louis Vuitton, Hennessy and Fendi. Their overarching strategy focuses on inorganic growth to build and grow a portfolio of luxury retailers. The size of the name allows it to enjoy unparalleled economies of scale.

Figure 14. 2018 Revenue by Geography



Financial Overview

In millions of Euros	2017	2018	2019
Revenue	**€ 42,636**	**€ 46,826**	**€ 50,158**
% Growth	*13.4%*	*9.8%*	*7.1%*
Gross Profit	27,853	31,201	33,216
% Margin	*65.3%*	*66.6%*	*66.2%*
EBITDA	**9,864**	**11,702**	**12,197**
% Margin	*23.1%*	*25.0%*	*24.3%*
Free Cash Flow	**4,479**	**5,155**	**5,523**
Conversion (%)	*10.5%*	*11.0%*	*11.0%*

Previous Transactions

Date	Target	Size
Nov 2019	TIFFANY & Co.	$16.2B
April 2017	Christian Dior	$13.1B
Oct 2016	BVLGARI	$716M
Mar 2011	RIMOWA	$6.0B

Conglomerate Spotlight: **Kering S.A. (EPA: KER)**

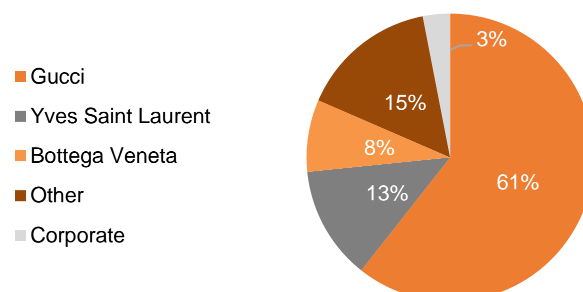
Company Overview

Kering S.A. is the world's fourth largest luxury company with 1,439 stores distributed across the globe. Owning luxury houses such as Gucci, Yves Saint Laurent, Balenciaga, Pomellato, and Bottega Veneta, Kering applies a similar inorganic growth strategy to that of LVMH's. Kering aims to leverage each of their subsidiaries' brand equity and recognition to generate customer awareness, demand, and ultimately, sales. In doing so, it maximizes the synergies created from their various business acquisitions. Recently, Kering has communicated a focus towards maximizing sustainability throughout its operations, as well as capitalizing on unique opportunities afforded by its brand portfolio to further strengthen their position in a dynamic consumer landscape.

Financial Overview

In millions of Euros	2017	2018	2019
Revenue	**€ 10,816**	**€ 13,665**	**€ 14,872**
% Growth	-	*26.3%*	*8.8%*
Gross Profit	7,916	10,198	11,074
% Margin	*73.2%*	*74.6%*	*74.5%*
EBITDA	**3,221**	**4,447**	**4,918**
% Margin	*29.8%*	*32.5%*	*33.1%*
Free Cash Flow	**2,174**	**3,837**	**4,071**
Conversion (%)	*20.1%*	*28.1%*	*27.4%*

Figure 15. 2018 Revenue by Brand



Source: Capital IQ

Notable Mid-Sized Portfolios: Capri and Tapestry

From Michael Kors to Capri Holdings:

Capri Holdings Limited is another conglomerate with brands that cover the full spectrum of fashion luxury. Similar to LVMH, the company's strategy is very decentralized. It aims to support each brand, but also ensures that they maintain their exclusivity and independence. They own names such as Versace, Jimmy Choo, and Michael Kors.

The company emerged after Michael Kors purchased Versace for $2.12B in 2018. This acquisition was the spark that turned Michael Kors into a small-scale conglomerate, similar to the likes of LVMH and Kering.

Tapestry: The Struggle of Mergers

Coach was once an independent luxury retailer that decided to shift from a single unit house model and grow its business via acquisitions.

The company changed its name from Coach to Tapestry, Inc. in late 2017 after its second acquisition. In 2015, Coach bought shoemaker Stuart Weitzman for $574M. Two years later, it purchased Kate Spade for $2.4B with the hope of realizing synergies by turning around the underperforming business. However, this deal has yet to reach this level of accretion.

In combination, market and trade turbulence, in addition to premium acquisition prices, have led to investor disappointment. Since the acquisition of Kate Spade, Tapestry's share price has declined by approximately 35%.

This realization was critical for a lot of investors as it illustrated that luxury brand reputations do not sustain themselves, and management must continuously focus on re-developing luxury houses in order to remain important in the eyes of consumers.

A Notable Luxury Retail Giant: Hermès (EPA: RMS)

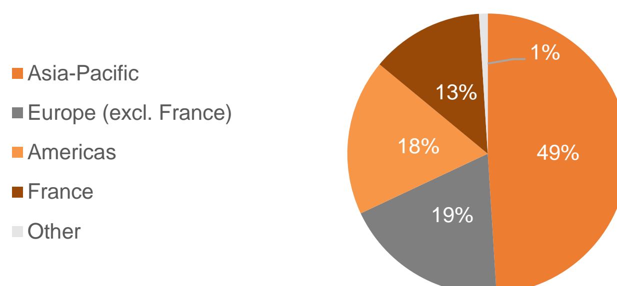
Company Overview

Established in 1837, Hermès is a French luxury goods manufacturer. With 300 stores worldwide, it has become a global icon known for its leather products and scarves. The company maintains a personalized, family-led image. Unlike many of its other peers, Hermès does not pursue inorganic growth or celebrity endorsements, and actively stays away from mass production. The brand is well positioned to meet new-aged consumer's demands of personalization and sustainability. For instance, the brand is known for its use of natural materials (versus man-made) and claims that each product is manufactured by hand by only one craftsman. The legacy brand has partnered with modern players. For example, the company has partnered with Apple in the creation of the Apple Watch Hermès.

Financial Overview

In millions of Euros	2016	2017	2018
Revenue	**€ 5,202**	**€ 5,549**	**€ 5,966**
% Growth	*13.4%*	*6.7%*	*7.5%*
Gross Profit	3,520	3,890	4,175
% Margin	*67.7%*	*70.1%*	*70.0%*
EBITDA	**1,910**	**2,166**	**2,308**
% Margin	*36.7%*	*39.0%*	*38.7%*
Free Cash Flow	**1,233**	**1,242**	**1,547**
Conversion (%)	*23.7%*	*22.4%*	*25.9%*

Figure 16. 2018 Revenue by Geography



Sources: Company Website, Capital IQ

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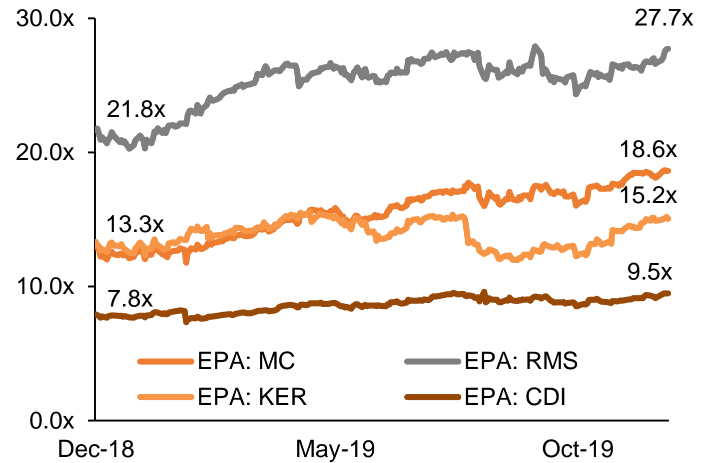
Luxury Retail Valuation: Premium for Ownership Required

It is clear that luxury goods have gained much traction in the everyday lives of consumers over the last 10 years. Given this growth, investors have been keeping a keen eye on luxury stocks that present a potentially appealing return for their portfolios.

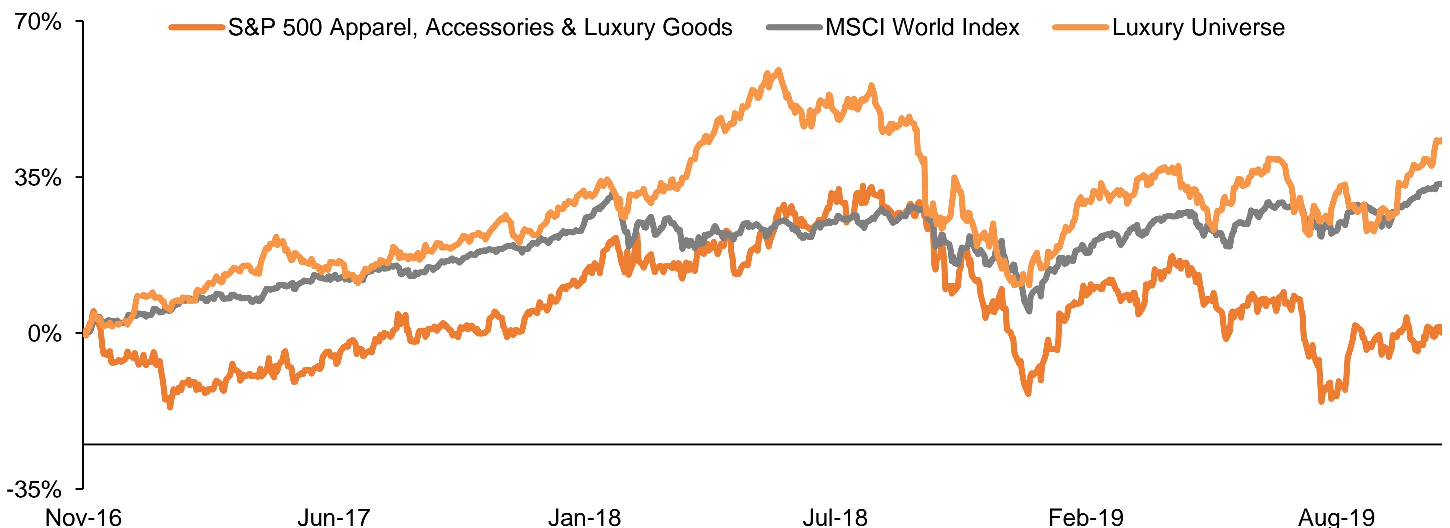
Since 2015, LVMH (MC), Kering (KER), Hermes (RMS), and Christian Dior (CDI) have been growing sales at an average of 9.0% p.a., with every company additionally never experiencing a drop in sales growth (with the exception of Kering, whose sales dropped once in 2017). This tremendous performance has made for a much more competitive landscape, and both companies and investors have been spending substantial capital to garner upside. In early 2019, public markets saw luxury stock valuations significantly rise due to the high level of demand. This happened especially in the "safer" stocks, as investors were fearful of taking on positions in smaller players given the looming economic slowdown. Over the same 5 year period LVMH, Hermes, and Kering saw their EBITDA multiples expand 5.6x, 6.0x, and 1.7x, respectively, which has had an adverse effect on the risk/return profile of these businesses. Due to this, investors have recently shied away from the industry, as shown in Figure 17.

Figure 17. LTM EV/EBITDA Multiples



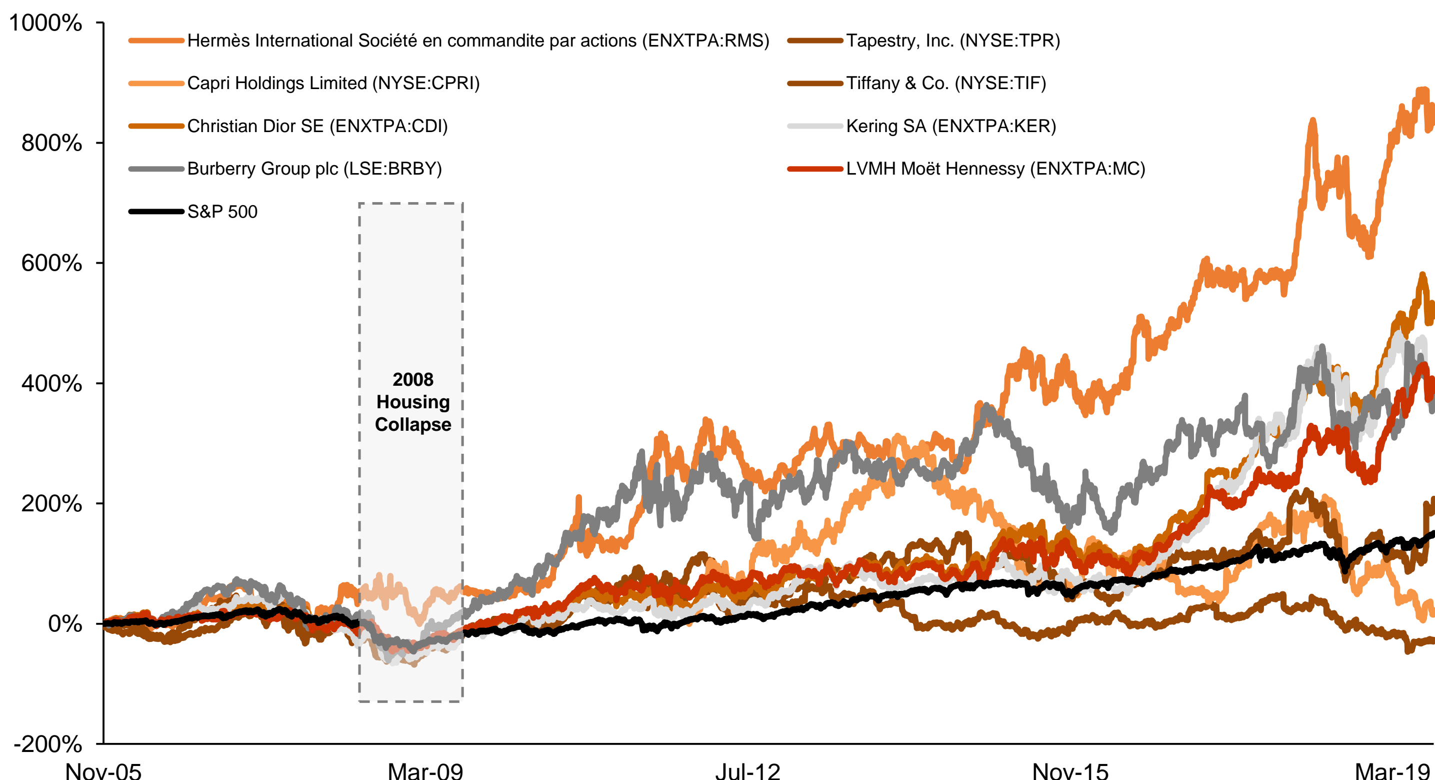
While these high-profile conglomerates are undoubtedly trading at a premium, the initiation of long-term positions may still be warranted given the lack of headwinds each of these businesses face. Buyer behaviour and the brand equity of each of these portfolios have created competitive advantages that have become seemingly insurmountable by peers.

Figure 18. Luxury's Performance Diverges as Scope Narrows Towards Top



Source: Capital IQ

Share Price Performance: Luxury Brands Continue to Climb



Contrary to Popular Belief: Resiliency During Economic Hardship

The graph above depicts an interesting characteristic amongst high-end retailers. Luxury items are generally considered discretionary in nature, meaning that they are not necessary for survival or self-sustenance. Therefore, theory would stipulate that during times of economic depression, consumers are less likely to purchase these goods due to a lack of disposable income. This results in poor financial performance for these businesses, leading to a compression in share price. While this theory holds true for many industries, luxury retail appears as an exception. The stocks shown above outperformed the S&P 500 index by ~22% on worst day of its performance during the 2008 crisis. Interestingly, the worst performing stock during this period was Tapestry, Inc., a business that is predominantly sells middle-priced products relative to the peers outlined in the above figure. These insights bring to light the conclusion that high-priced luxury products are surprisingly resilient to economic downturns, while mid-priced products display a high degree of sensitivity. This can be explained through analyzing the customers that these brands serve. Regardless of the economic environment, only wealthy consumers are able to afford the offerings of company's such as Hermès or Burberry. Due their high income, these customers are significantly less affected during recessions relative to the rest of the population. Resultantly, the names that serve them do not experience a sharp decline in revenue. Essentially, these brands benefit from the Veblen effect due to their prestige and exclusivity. This explains why mid-priced products fail to demonstrate this same resiliency as they provide less social value to members of high society.

Source: Capital IQ

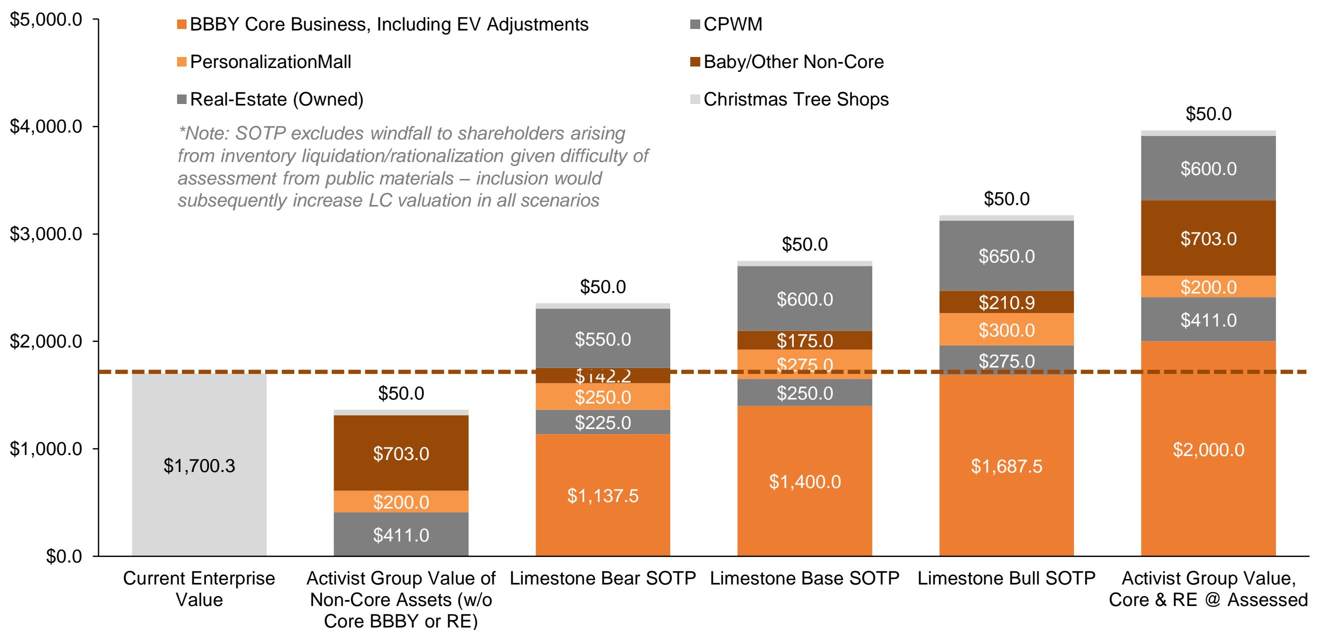
1	Luxury Retail Background
2	The ‘Veblen’ Effect
3	2020 Trends in Luxury Retail
4	Company Spotlights
5	Limestone’s Outlook
6	M&A Case Studies

Limestone's Outlook on the Luxury Retail Space

Through consistent coverage of the consumer retail space from a value investor's lens over the past half-year, Limestone's C&R team has developed several insights that both retail and institutional investors should be aware of as they continue to screen for and diligence prospective investment ideas in the C&R space. The following summarizes select insights while providing further commentary:

1) Potential Substantial Upside from Traditional Brick & Mortar Names

- Several brick & mortar companies are currently trading at significant discounts to book value and underlying asset value (owned real estate, depreciated plant and equipment, etc)
- Two prominent names that Limestone is currently watching that exhibit such characteristics include Macy's, Inc. (NYSE: M) and Bed Bath & Beyond (NASDAQ: BBBY)
- Both share prices are trading near 3-year lows, implying that the market is assigning little to no value to the businesses as going concerns given assessed real estate
- C&R team pitched BBBY on 10/02/19 as a 'Long' – a key component of the investment thesis was that the BBBY's SOTP value was substantially greater than its market value



Limestone SOTP Key Assumptions	
Core Bed Bath & Beyond Stores	Proportionate EBITDA * 3.5-4.5x (Currently Trades @ 3.4x, LTM)
Cost Plus World Market	Former Executive + PE $250M Purchase Offer
Personalization-Mall	Bids $250-300M for Entity
buybuy BABY/ Other Non-Core	~8x Core/Baby Stores, Conservative Estimate
Christmas Tree Shops	Activist Group Assessment; <$700K EV per Store (81)
Real Estate (Owned)	Amortized Value on BS, Unadjusted for Market

In spite of utilizing extremely conservative estimates, LC's SOTP valuation implies upside even in a worst-case scenario (firesale-like prices), showing the disconnect between publicly-listed shares and the underlying assets of the business

- With the brick & mortar 'apocalypse' that has transpired over the past decade, the book value > market value dynamic has transpired for several other players in addition to BBBY

Sources: Capital IQ, Company Filings, Legion Partners, Macellum Capital Management, Ancora, EDGAR

Limestone's Outlook on Luxury Retail Space (Cont'd)

2) The Anticipated Struggle of Mid-Tier Luxury Brands in a Recessionary Period

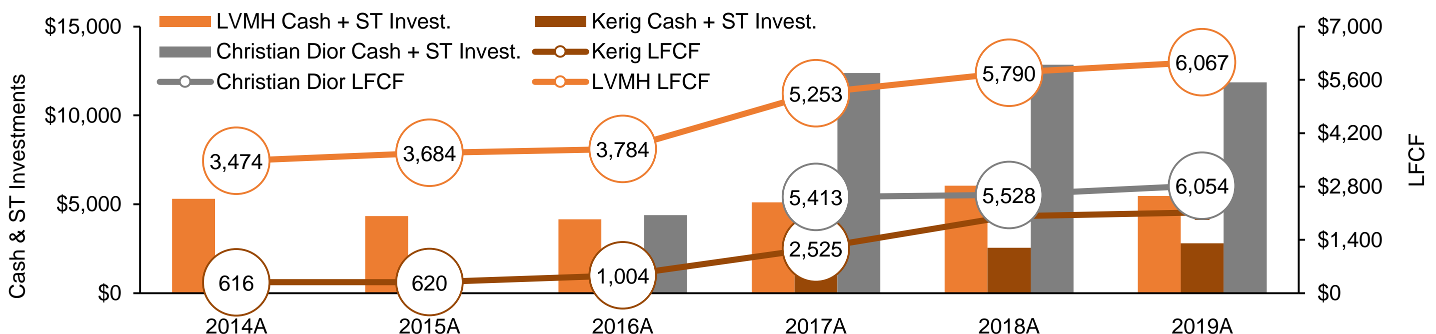
- While timing unclear, the end of the current economic expansionary cycle is inevitable (2020-22)
- Upon the analysis of several factors, Limestone's C&R team expects high-end conglomerates to maintain a relatively similar level of financial performance through a recessionary period; on the other hand, the team expects mid-tier luxury names such as Capri Holdings Limited (NYSE: CPRI) and Tapestry, Inc. (NYSE: TPR) to face more difficulty than high-end peers
- Such can be attributed to the greater discernment that consumers have demonstrated with respect to choice of brands, which will undoubtedly be magnified during a recessionary period as consumers become more cash-strapped and likely cut spending of low-mid-tier luxury brands, as opposed to reducing spending on the higher-end of the spectrum
- However, the C&R team believes that the struggle will not be as acute, as brands have undertaken key initiatives over the past decade such as inventory control, diminished reliance on wholesalers, reducing discounts, and investing further in strengthening brand equity
- Historically, the Great Recession from 2007-09 removed 9% of market value from broader luxury goods market; nevertheless, these brands recovered extraordinarily quickly and flourished

Investors may be positioned to reap gains by buying high-end names following the onset of sell-offs related to the market's misconception that these names would struggle immensely in recessionary periods, similarly to other consumer discretionary sub-industries

3) Conglomerates' Increasing Desire to Buyout Luxury Retail Brands

- Limestone's C&R team believes that conglomerates have become increasingly hungry to acquire both heritage and up-and-coming brands, in order to maintain the ~double-digit top-line growth (%) that these conglomerates have achieved over the past 2-3 years
- Conglomerates' brands are limited in the number of goods and accessories they can release into the market in a given year, due to the necessity to upkeep scarcity to maintain 'Veblen' effect
- Accordingly, inorganic growth will become an increasingly important avenue for conglomerates as internal projects and investment opportunities that yield > cost of capital become limited

Figure 18. Conglomerates' Increasing Cash Balances Require Deployment



- Evidence of increasing conglomerate appetite include recently announced LVMH/Tiffany deal

Sources: Capital IQ, Vogue Business

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1 Luxury Retail Background

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Case Study: LVMH Acquisition of Tiffany & Co.

The Acquirer: LVMH

LVMH is the world's largest luxury conglomerate, whose holdings include Louis Vuitton, Christian Dior, Bvlgari and soon, Tiffany & Co. The luxury giant has actively been trying to pursue growth in the industry as its jewelry portfolio is the smallest and least diversified of across of it its business groups. Currently, LVMH's business segments include fashion and leather, selective retailing, perfumes and cosmetics, wines and spirits, and watches and jewelry.

The Target: Tiffany & Co.

Founded in 1837 and based in New York, Tiffany & Co. has established itself as a leading jewelry brand. It is known for two segments: its high end diamond collection and its lower-luxury sterling silver collection. In the past few years, Tiffany & Co. has experienced declining sales, most recently due to the lack of Chinese tourist revenues. Over 40% of its revenue is generated in the America's and only 11% is generated in Europe leading plenty room for geographic expansion.

Deal Overview

After months of speculation, in late October, LVMH made an offer to acquire Tiffany & Co. for $120 per share. In response, Tiffany & Co. rejected the initial offer and asked the French conglomerate to raise their offer to $135 per share. After weeks of deliberation, on November 25th, 2019, LVMH reached a deal to acquire Tiffany & Co. for $135 per share. This deal totaled $16.2 billion, representing a 30% premium and up $15 from LVMH's original offer. The deal represents a 4.1x EV/Revenue multiple and 18.5x EV/EBITDA.

Currently, LVMH watches and jewelry segment totals $4.72 billion of sale, post-acquisition, sales of those items would reach $9.16 billion.

Figure 19. LVMH Revenue Breakdown ($B)

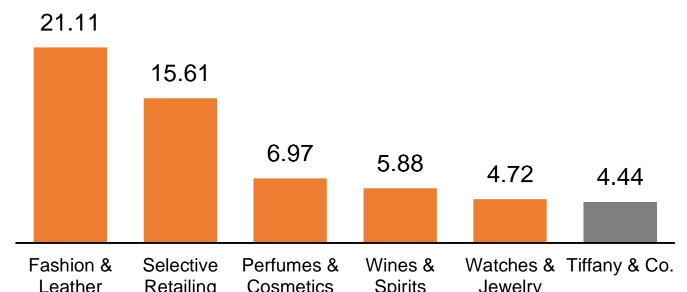
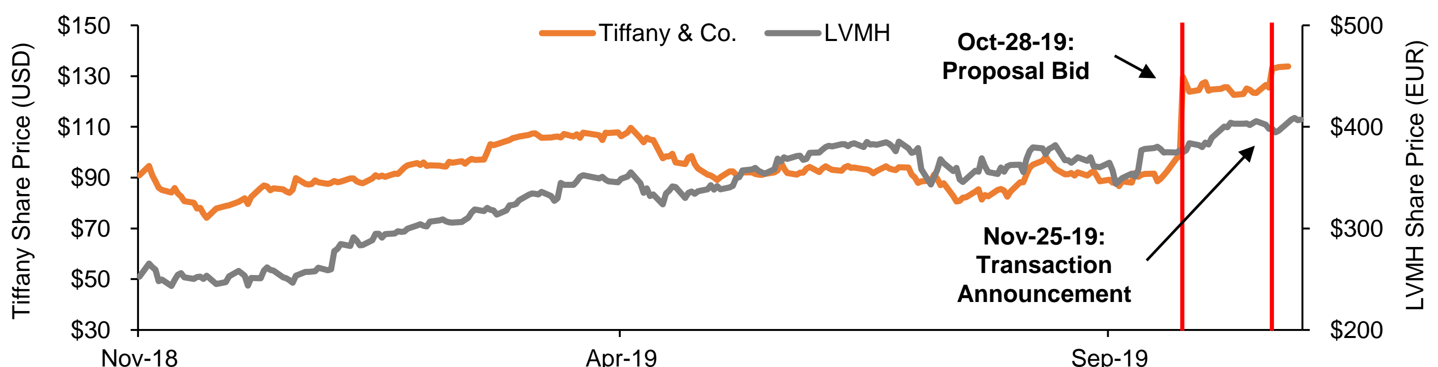


Figure 20. Investor Sentiment to LVMH Acquisition of Tiffany & Co.



Tiffany & Co.'s stock price jumped ~30% on day of the news acquisition and LVMH's stock price saw a modest reaction.

Sources: Capital IQ, Quartzy

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Case Study: Chanel and Merger Talks

Summary

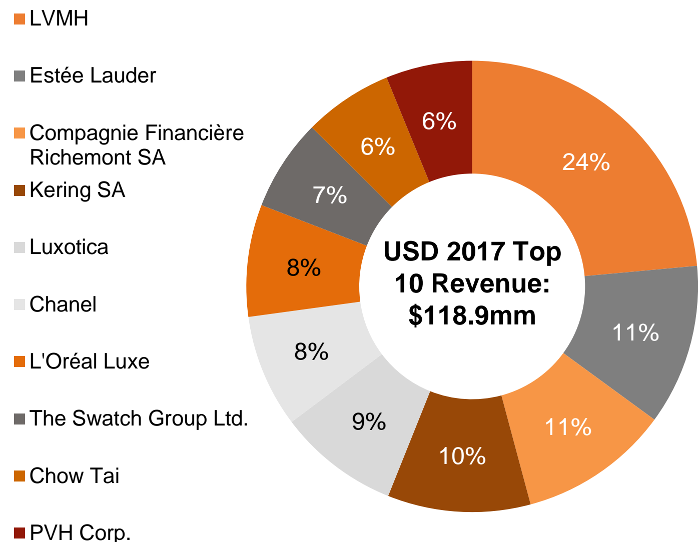
Chanel S.A. is privately-held French company that focuses on high-fashion and ready-made clothes, luxury products, as well as accessories. The name has become well-known globally for its prestige, pedigree, and focus on innovative designs that simultaneously support functionality and flatter a women's figure.

With the mature and extremely competitive landscape inherent in the luxury retail industry, it comes to no surprise that larger brands have opted towards consolidation to reduce competition, expand to new markets, and realize cost savings through economies of scale. A speculation currently arising from the space is the potential for an acquisition of Chanel by LVMH, a large luxury goods conglomerate. The talks began with the death of Karl Lagerfeld in February 2019, who was the creative director of Chanel. Coupling this news with the fact that Chanel's owners have both reached retirement age brings into question Chanel's future as a privately-held entity. Given its prominence, Chanel is no doubt a very desirable acquisition target. However, these talks are only speculation. The feasibility of such a feat, as well as other strategic alternatives requires further exploration to determine whether these rumours will come to fruition.

Strategic Alternatives for Chanel

1. Acquisition: Chanel holds significant market share within the luxury goods space. So while an acquisition does certainly reduce competition pressure, the challenge in fulfilling this endeavour lies in the company's price tag. Analysts previously estimated Chanel to be worth €50 billion. However, management has expressed that this figure is nearer to €100 billion. Considering that this represents ~55% of LVMH's equity value, this decision poses significant risk to the conglomerate should the deal not reach the expected level of accretion.

Figure 21. Total Revenue of Top 10 Luxury Retailers by % Contribution



2. Initial Public Offering (IPO): Chanel has the scale to become its own entity should it require capital for future initiatives.

3. Remain Private: The brand will simply focus on maintaining its position within the space. Also, LVMH plans on developing a "mini-channel" with Christian Dior Couture, so the deal may not be needed.

Acquisition Potential End Results

If the deal were to occur, LVMH would significantly increase its market share and thus, generate cost-savings through economies of scale. Furthermore, the brand would have access to Chanel's pedigree, patented designs, and human capital, all of which can be combined with LVMH's current resources to increase the accretion of the deal.

Sources: Business of Fashion, Deloitte

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