Luxury's New Home

Over the next few weeks, Milan, Paris, and New York will knock down their slick runways and conclude their respective 2011 fashion weeks. While there will be much talk about the length of hemlines, the use of tulle over silk organza, and whether 'black' is the new 'black', there will be modest coverage of the real story in fashion—how quickly and dramatically fashion's audience has changed. When I say audience, I don't mean the mostly American and European fashionistas in attendance at the shows; I refer to the most important consumers to luxury goods manufacturers—the rising Chinese middle and upper classes. Each and every designer and fashion house will be secretly hoping that their collections and brands connect with the increasingly important Chinese consumer.

And with good reason. In 2010, Chinese consumers accounted for roughly 10% of the luxury goods market. By 2020, according to CLSA Asia Pacific Markets, China will account for 44% of global luxury goods sales.

Today, some of the major luxury brands derive a significant share of revenue from the Asia Pacific region, with China representing the greatest share: Burberry 33%, Prada 43%, LVMH 34%, Gucci 48%, and Mulberry 12%. These figures obscure the fact that in major retail outlets in Paris, London, and New York, a significant number of consumers in the stores are Chinese nationals on holiday. Moreover, their in-store spending is, on average, higher per transaction than that of Western shoppers. This has all led to recent announcements by Prada, Burberry, and others to increase planned openings of stores in China.

Indeed, despite the local heritage of luxury brands and their connections to the national identities of the countries where they were founded, the world of luxury fashion has decidedly and emphatically relocated to China. There was once a saying amongst buyers at major department stores that expressed the need to focus on the end consumer; they would ask, "But will it sell in Peoria?" That question can be revised now. Luxury goods companies today need to ask, "Will it sell in Wuhan?"

The importance of the Chinese market to the luxury goods sector has not been lost on the Chinese. In fact, Chinese investment in the sector is on a sharp rise. While some Chinese investors have acquired stakes in local brands, the real focus has been on acquiring stakes in Western brands. A few examples include YGM Trading Ltd.'s recent acquisition of the Asian rights to the UK's

Aquascutum; Trinity Ltd.'s purchase of Italian menswear company Cerrutti; Fosun International Ltd.'s acquisition of a 9.5% stake in Greek jewelry retailer Folli Folie; and Chinese investor Peter Woo's 8% stake in partner Salvatore Ferragamo.

A number of major fashion houses have indicated their intent to sell part or all of their stakes in various well-known brands—House of Galliano, Roberto Cavalli, Pierre Cardin. The sellers of these brands have made no secret of the fact that they are indeed courting Chinese investors. Having recently completed work for a number of clients in the sector, I can say that there are a number of good brands available at a fair price. However, there are some significant issues that Chinese investors need to consider when investing in Western brands. The following are some key issues:

- Beware the halo effect: Successful luxury goods brands cultivate a story and an emotion around the heritage and lifestyle these brands can offer. This positive emotional attachment is perfect in generating sales at the consumer level, but investors must maintain a level of rationality when purchasing such brands. The halo effect can often obscure the fact that despite a great name and history, the brand has historically not performed financially, has limited growth opportunities for the future, or has had limited success entering the Asian market. Investors need to separate the business and the opportunity from the blinding effects of the brands' halo. This requires investors to place greater focus on the company's financial and commercial due diligence, preferably by a firm that is capable of evaluating businesses in emerging markets.
- Understand the seller's motivation: The headline stories of why firms or individuals might be selling a luxury brand are rarely the full story. Many of the brands up for sale cite the fact that the founders seek to exit the business or that the companies are seeking funds for major expansion. These may be valid reasons, but they often obscure true motivations such as a brand in decline or a company that is failing to deliver on financial objectives. To ferret out the motivations of the sellers, some level of reputational investigation is recommended. A key component of this would be a discreet investigation to understand what advisors, former employees, or key competitors might know about the true intentions for a sale.
- Realize that multiple store openings are not enough: It is difficult to find a luxury brand that has not already made headway into China. Many firms tout this as proof of their ability to connect with Chinese consumers, and place great

value on the growth story for their brands in China. However, having stores in China is different to having a growth story in China. Key questions such as how quickly have stores turned profitable, which Chinese cities are the stores located, is there a market for such a brand in Tier 2 cities, what are Chinese consumers' perception of the brand and can that perception be changed or maintained.

- Justify the valuation: Luxury goods brands typically trade at higher price multiples. Also, current valuations of luxury brands are higher than they have been historically. Any purchase of a luxury brand is likely to be at a premium price and competition for such brands will continue to be keen. Nonetheless, the growth trajectories of the underlying businesses must support these valuations. Chinese buyers flush with cash should ensure that the brands justify the valuations in order to reap good financial returns.

Chinese investors are in a unique position to derive significant returns from what is now a truly Chinese luxury sector. But financial success is not ensured. A greater focus on the issues and circumstances underlying the brand's performance as highlighted above should help investors determine which of the luxury brands will survive the discerning demands of Chinese consumers.