Is the luxury industry really a financier's dream ?

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SUMMARY OR ABSTRACT

Although modest in terms of sales , compared to most other sectors, luxury does get a high share of investors' , financial analysts' and media attention . Why would this sector receive a share of attention much bigger than its actual weight ? Is it because of its glamourous image, or the incredible prices attached to its products , now displayed in all the media for mass desire ? Are the financiers dreaming too ?

An analysis of published financial accounts shows that Luxury Groups' performance does not appear exceptional. Companies from the internet economy exhibit much greater profitability. Of course not all luxury groups are equal : some, such Hermès, show outstanding financial performance but many others do not. Though, luxury groups appear to make financial market dream when considering their valuation multiple.

What then fuels the dream ? First , the expectations based on these best of class companies . They make believe that their success can be emulated as long as one follows the discipline of a real luxury strategy .Another explanatory factor is that Luxury groups brand portfolios exhibit themselves a wide variance of results. Most brands are at pain, while some show remarkable results. It is these exceptions which carry the dream of the sector. Most investors do believe that, with flair and the right turn-around , each small or ailing luxury brand will have its chance. Just as Dior or Louis Vuitton were small and unexciting , once they were bought by LVMH they have now reached the sky and become the stars of the luxury world.

Is the luxury industry really a financier’s dream ?

Although modest in terms of sales , compared to most other sectors,luxury does get a high share of investors’ , financial analysts’ and media attention . Why would this sector receive a share of attention much bigger than its actual weight ? Is it because of the prestige attached to its major brands ,or the fact that financiers are themselves key clients of luxury and are amazed by the prices they pay ? The most often heard explanation is that luxury would be a financiers’ dream and exhibit a very high profitability : this is why it is a beloved object of attention from investment groups , financial analysts and the medias .

But is luxury really a financiers‘ dream ? Beyond the shiny image of its groups and brands what is the reality of their financial performance ? The purpose of this paper is to analyze luxury companies’ key financial performance indicators and to compare them with those of groups from other sectors , thus assessing the validity of the luxury sector attractiveness among the financial community .Is luxury a pure dream ?

The paradox of the luxury industry

There is a luxury industry paradox. Luxury captures the attention from the financial community, from business analysts, Investment Banks. The world economic press regularly presents a focus on this sector and its main actors, be they multi-brands Groups such as LVMH, Richemont, PPR, Pernod-Ricard, or independent companies such as Bulgari, Prada, Armani, Burberry, Ralph Lauren,….

This is odd when it is reminded that the luxury sector is indeed quite small. According to Bain & Co, a leading consulting company specialized on this sector, the 2009 global luxury revenues amount to 153 Billion Euros. This estimate is based on the sum of the revenues of 200 companies and brands which can be called luxury. This last figure should be compared to the net sales of Wal-Mart (291 Billion Euros) or that of the FMCG heavyweight champion : Procter and Gamble (59 Billion Euros).

Why then all this fuss about an industry, fragmented into a myriad of small brands, the whole representing just half the sales of the largest world mass retailer? Is it because these brands are so prestigious and have gained worldwide recognition and fascination? Is it because the financial community itself is the core target of these luxury brands and thus cannot remain neutral vis à vis names which exert such strong seductive power on them?

It is classic to hear that the reason lies elsewhere: luxury would in fact be a financiers' dream. Luxury brands would be extremely profitable, and as such, they merit special attention. In a recent interview, B Arnault , LVMH 's CEO made it still more straight : " Luxury is the only sector that can provide luxurious margins " (Capital, May 2010)

The problem is that the luxury sector as a whole is quite opaque. Public companies try to hide as much as possible brand informations behind aggregated branch data . The many family companies do not publish any data . The allusion to an extreme profitability is close to a rumor, that is to say an alleged information widely circulating among financial analysts, but still needing to be verified (Kapferer , 1990). The sustained belief in the high profitability of the sector may be fueled by the very high prices luxury goods command and the impressive multiples used by retailers between wholesale and consumer prices. Not to speak of the gap between the retail price -often criticized as exaggerated- and the hypothesized cost of goods. This pushes people to believe that intangible elements, such as prestige, can boost prices to the sky at little cost thus leading to unusual profits.

Another source of the widely circulating belief of luxury as one of the most profitable sectors could come from history. It may have been the case yesterday, far less nowadays, but the story still receives widespread belief today.

It is time to look at this question today: is luxury really a financial dream?

The data do exist, coming from Groups such as LVMH, the luxury sector world leader, or other public groups such as Richemont, Pernod-Ricard or L'Oréal which must publish each quarter their financial results. However, in this sector, there still is a vast number of family owned, non public companies and brands which are totally secretive about their performance (Chanel, Prada, ….). As a rule, the luxury sector does not like to talk much about the corporate side of its activity, especially financial results. The objective is to maintain the mystique. Would the reader appreciate as much the food at A.Ducasse or J.Robuchon restaurants if he/she knew the gross margin and operating profits of their business? Can one be admirative of their financial performance and still have a neutral look at their price list? What is the taste of their EBITDA?

In addition, even public Luxury Groups cultivate mystery. LVMH rarely presents financial results by brand but by branch. As a consequence, one has to rely on insiders' information to guess the profits of each brand.

This article explores in depth the profitability of the luxury sector. Its sources are the annual reports and all types of published information. Its aim is to put luxury into a comparative perspective and to foster more research on this topic. We have selected data from the 2008 fiscal year, almost a normal one, for 2009 has been an exceptional one , due to the economic recession which badly hit most of luxury companies .

The dream of the capital markets

It is now evident that, in our modern economies, companies do consider shareholders as their most important stakeholders. This does not mean other stakeholders are not taken into account (managers, employees, consumers, bankers, society as a whole) but, to ensure the funding of the company, shareholders must be seduced.

To satisfy them, management has to create value: shareholders do not look so much for dividends but want to see their share value growing. They expect management to design strategies as to increase their company's value.

Companies can be seen as cash flow generating machines. Shareholders ask themselves regularly how long will those machines be producing cash flows and what will be the level of these cash flows in the future. Of course there is an inherent risk there: the future is mute. In fact we do not know the future, we can just predict it, guesstimate it. Certainly, past accounting figures do help making up forecasts, but the past is not a valid predictor of the future in modern dynamic and turbulent markets. Also, companies' turn-around strategies precisely aim at transforming a looser into a winner.

If shareholders do not know the future, they have to imagine it, to invent it. The financial market is the place where all the hopes concur. Finance is not so much about numbers; it is about emotions and dreams. Interestingly, the word dream is also at the heart of the comprehension of how luxury works among clients: luxury brands do propose products, services and symbols which embed the dream of a luxury life : the ordinary of extraordinary people and the extraordinary of ordinary people (Kapferer and Bastien, 2009) . This possibility to access to a dreamed life through possession of luxury items or by experiencing a unique luxury moment is at the heart of the growth of the luxury business; luxury prices are the measure of the intensity of people's desire to reach this dream. Luxury companies CEO's know they have to build their brands in order to make their clients dream, hence generate high future cashflow. This in turn that will create big hopes from the capital market; shareholders will dream about the future and share values will surge.

We already come to a first conclusion: in Luxury, consumers' dream is the source of shareholders' dream. The more a brand evokes status, glamour, seduction, exceptional quality, prestigious clients, the more it can make the consumer market dream and command high prices and mark ups. If, in addition, the company has built trust amongst the financial community through a steady and consistent delivery of exciting quarterly results, then capital markets are going to dream about this brand. For shareholders the future is more than bright: it becomes gold.

Assessing the growth performance of luxury companies

But, after the bet comes reality. Are luxury companies delivering outstanding performance? There are many performance indicators: sales growth, gross margin, operating profit, volatility and financial risk, cash flows amongst others. Let us analyse them all, one after the other.

Our Luxury industry sample includes only publicly traded companies for which we have publicly disclosed financial information. Amongst what are considered luxury companies (Xerfi, 2007), we have selected a sample of the 12 companies with the largest revenues. This corresponds to roughly 60% of what is considered to be the world market sales of luxury articles, 170 to 180 billion Euros in 2008.

TABLE 1. Luxury groups Sales (Fiscal Year 2008)

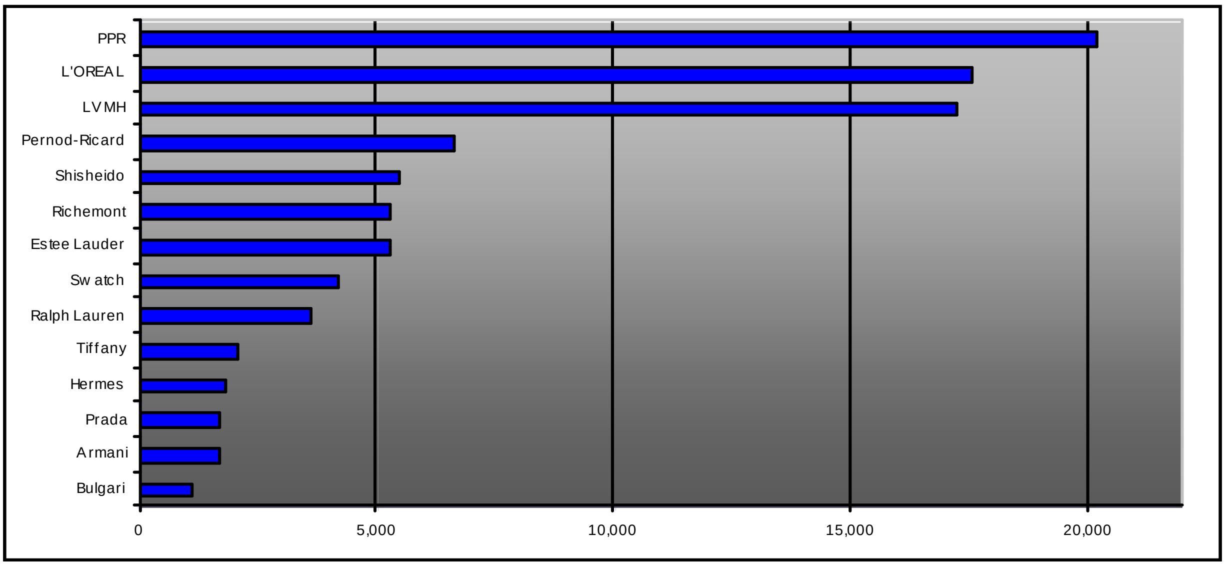
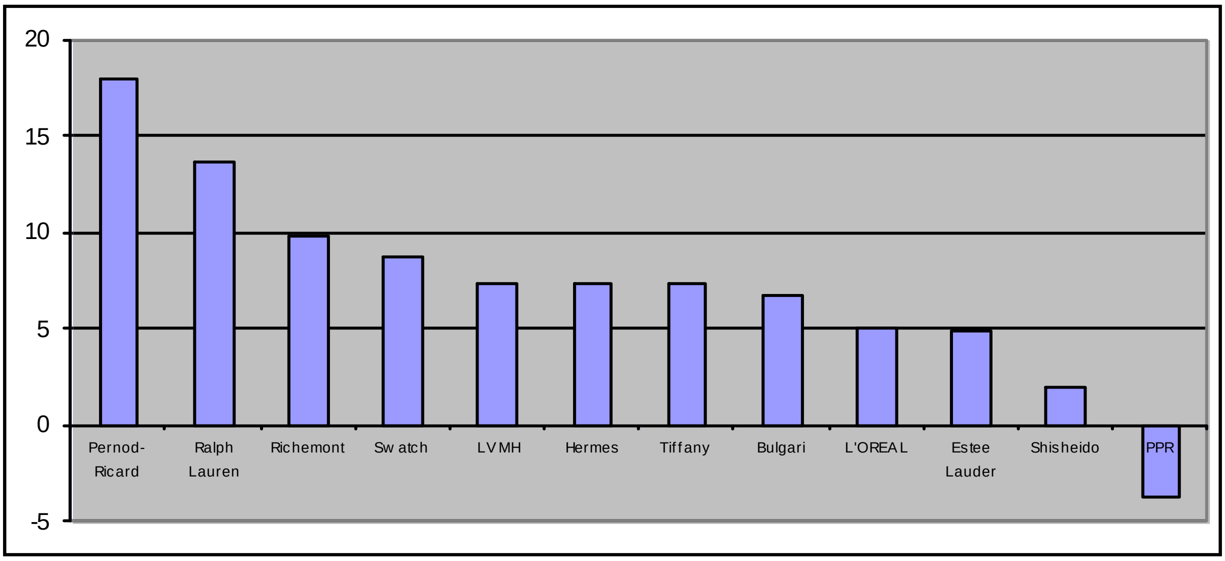


Table 1 shows the revenue distribution in the sample. Three heavyweights stand out, PPR SA (formerly known as Pinault-Printemps-Redoute), l'Oréal and LVMH (Louis-Vuitton-Moet-

Henessy). It may not be a coincidence that the three of them are French. Each of these companies regroups numerous brands, some of them being independently traded, but we generally have little specific financial information for each brand. Other companies are 3 to 15 times smaller typical of an industry still largely fragmented.

A first key performance indicator is the sales growth rate. Table 2 provides us with luxury companies' average growth over the past 5 years (2004-2008). The luxury sector grew by an average 7.5 % per year. Nothing exceptional: other sectors' average growth varied from 4% to 12% (Reuters financial data). It is similar to the non-cyclical consumer goods and services sector and is slightly lower than the FMCG sector heavyweight, Procter and Gamble, 8.5%. Pernod-Ricard, the wine and spirit producer and distributor, certainly stands out with a 17% growth rate but this is mainly due to the acquisition of Allied Domecq (2005) and its acquisition of other premium brands. In any case the Luxury industry is definitely not competing with the technology leaders such as Google (50%) or Apple (30%). In terms of growth the luxury industry doe not appear as a financial market dream.

TABLE 2. Luxury groups average growth over the last five years



Is Luxury a low risk industry?

Financial markets usually measure the market risk of a stock as its sensitivity to market swings. The degree of correlation between stock and market returns, known as the beta coefficient (Brealey, Myers and Allen, 2008), is a good indicator of the market risk.

A beta of one would indicate that the stock follows exactly the market. If the beta is lower than one it means that the stock dampens the market swings. In other words, it has a lower volatility that the market and is considered has having a low risk. On the contrary, a higher than-one beta stock amplifies the maket swings and is thus considered as a high-risk stock.

Analyses by Xerfi and Roland Berger (2006) showed that the luxury sector is characterized by a relatively low market risk; certainly global luxury sales do go up or down with the GDP evolution, but alledgedly not so much. We all have in mind Hermès being able to post a 15 % increase in sales in 2009, right in the middle of the crisis. The picture is more mixed when looking at luxury firms' betas. Many of them have a below one beta like Richemont, 0.7, L'Oréal, 0.8, or Hermès, 0.9, indicating a low market risk. But their betas are still higher than low-risk companies such Coca-Cola, 0.6, and Wal-Mart, 0.5. Also, some firms exhibit quite high betas like Ralph Lauren, 1.8, and Tiffany, 1.7. A likely explanation for Ralph Lauren is that it acts more as a fashion brand than a luxury one. Luxury brands sell great classics and iconic products which are perceived by clients as long term investments, a sure value in periods of economic turmoil. There is no such iconic product at Ralph Lauren. The same holds true for Tiffany.

One could argue than the globalization of luxury business should lead to lower risk; by selling in all continents luxury companies and houses do balance the risks (Chadrah and Husband, 2006). When the USA stopped buying luxury items in 2009, Asia was still in love with luxury. Though isn't'it the same for most industries? Also, don't we see all markets becoming more and more correlated? In any case, the luxury sector does not really stands out in terms of low market riskiness.

Looking at financial performance

Let us now turn to financial performance indicators. The Income Statement provides the *Gross Margin*, the firm's ability to mark-up its products and the *Operating Profit* or EBIT (Earnings Before Interest and Taxes), the most commonly used profitability figure. The *Cash Flow from Operations*, the amount of cash generated by the business, is drawn from the Cash Flow Statement. Finally, the Balance Sheet provides the *Debt to Equity* ratio, measuring the firm's level of indebtness, which is a good indicator of financial risk.

Taking LVMH as an example, and the 2008 fiscal year (that is to say before the economy went into full recession), the world leading luxury group posted revenues of 17,193 million Euros, a Gross Profit of 11,181 million and an EBIT of 3,485 million Euros.

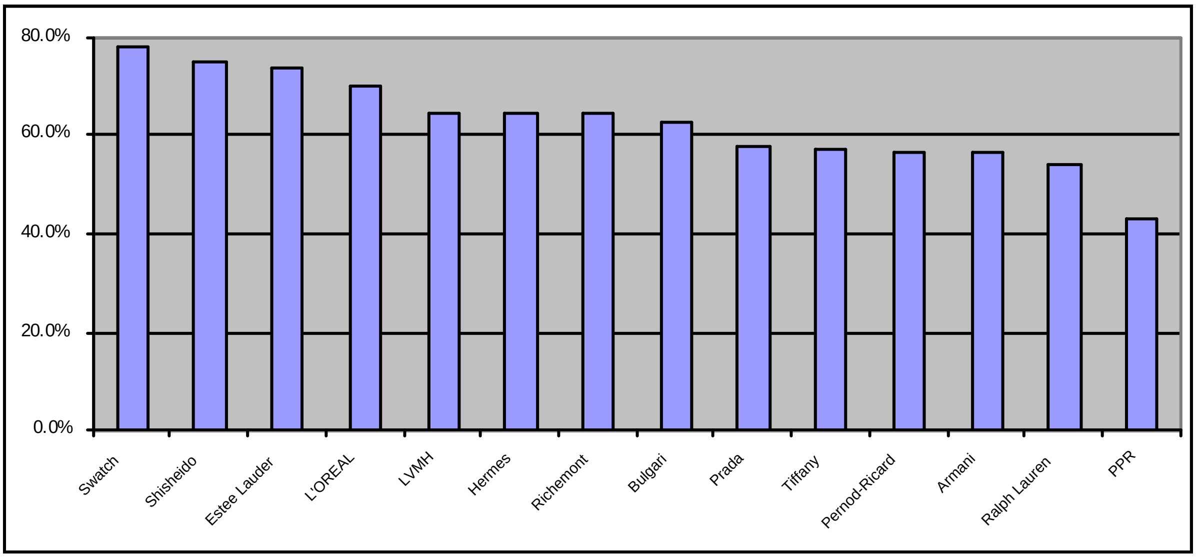
TABLE 3. LVMH Income Statement, Fiscal Year 2008

Revenues	17,193	
Cost of sales	- 6,012	
Gross Profit	11,181	(Gross Margin = 65 %)
Operating expenses	- 7,696	
EBIT (Operating Profit)	3,485	(Return On Sales = 20.3 %)
Net exceptionnal items	- 41	
Net interest	- 240	
Taxes	- 893	
Net Income	2,311	(Ratio = 13.4 %)

Percentage ratios such Gross Margin, ROS and Net Icome % are useful indicators to compare profitabilities within a sector and between sectors.

It can be seen from Table 4 that the luxury sector exhibits a very high Gross Margin as a percentage of sales, a 62 % average in 2008. This is an impressive figure, acting as a sweet dream to financial analysts' ears. This should not be a surprise: everyone knows that luxury good prices incorporate relatively little production costs. The price of luxury is by essence a discriminatory price: it aims at fulfilling the sociological function of luxury.

TABLE 4. Luxury Gross Margin (FY 2008)



There is luxury because many people cannot afford it. Luxury core function is to act as a social stratifyer . Luxury pricing is also called Veblen pricing , for demand grows as price goes up. It exploits the logic of externalities. In conspicuous consumption (Veblen, 1899), a key consumer segment (often called the « snobs ») derives value from uniqueness, and exclusivity (Groth and McDaniel, 1993). The snob's value for a product decreases as the number of people who buy the product increases (Amaldoss and Jain, 2005 (a); Amaldoss and Jain, 2005 (b)). As a result, snobs are ready to pay more to contemplate less people being able to buy the same item.

Conformists just act the other way round: they desire to look like everybody. Their value for a product increases as the number of people who buy the product increases. This segmentation has important financial consequences: snobs exhibit less price elasticity or even positive price elasticity. As a result, unlike usual firms, the luxury firm should focus on maximizing its prices and margins instead of looking after market share domination.

This segmentation also explains why Asia is luxury brands' present gold mine. Chadah and Husband (2006) have pointed out that Asia was in love with luxury. There is a cult of the luxury brand, leading to extreme behaviors such as Shibuya school girls in Japan prostituting themselves to be able to buy a 700 Euros Louis Vuitton bag. These authors claim that « a staggering 94 % percent of Tokyo women in their 20's own a Louis Vuitton piece » (2006, page 1).

How can one explain such luxury fever? One hypothesis would be that, in a continent where personal reputation is an obsession as well as face saving, no one wants to be perceived as visibly inferior to others: it would be the case if he/she seems unable to afford the well known signs of « being a respected person », that is, luxury brands with their logos.

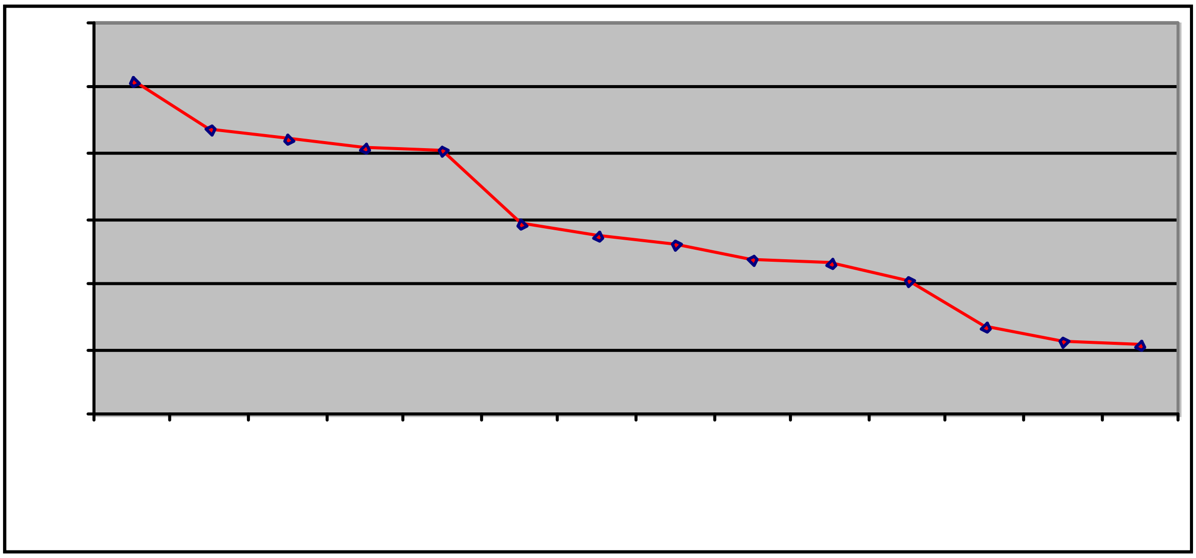
Asian conformists, the majority of people, hate non conformity above all, to a point where they are ready to pay a disproportionate price (vs their own revenues) to stay in-group. As a result, Asian snobs must themselves buy the highest priced items of the most prestigious brands to get rid of the conformists, who will abandon the social pursuit after a certain level of price is reached.

The social dynamics of luxury explain why accessible luxury is a short term view if one wants to stay in the luxury business. High prices, sustained by the prestige of the brand, make the products more desirable for the brand prestige endows the buyer with aura.
This is why, as prices go up, so does the ratio price/cost of goods. The luxury sector 62 % average gross margin reflects that situation.

Building prestige for luxury brands is lengthy and costly: prestige is fragile and can be quickly lost. For instance Kort & al. (2006) demonstrated how a price discount policy dilutes brand prestige. Jaguar was sold to the Indian Tata by Ford Corporation because it could not charge high prices anymore; its prestige had been diluted by the repeated introduction of new accessible models.
Luxury sells access to a dream of exclusivity, identification with exceptional people and their rich life style but it also sells the possession of products with high intensity of labor, art, spirit, quality and sensuality. This dream building needs important communication and operating expenses such as the costs of staging exceptional fagship stores in the best streets of the world capital cities.

Table 5 looks at remaining earnings once all costs to bring the product to the consumer - R&D, Selling, General and Administrative expenses- are subtracted from the Gross Margin. It actually presents the ratio known as Return on Sales (ROS = EBIT / Sales). The luxury industry exhibits an average 13 % ratio. The clear leader is Hermès with a remarkable 25 % ROS, while many other brands do seem to overspend or to spend with less efficiency: their Return on Sales could be as little as 5 %.

TABLE 5. Return on Sales in the Luxury Industry (FY 2008)



The case of Hermès has been already analyzed in depth .This company is following a pure luxury strategy with all the constituents of the luxury business model : full control of the value chain, own stores, no licenses, no delocalization of production, worship of the product, products partly hand-made, importance of creation, capitalization on heritage and history, etc… . It is no surprise that this company was the only one to see its sales increase in 2009, right during the recession: its revenues grew by 8.5% (4.1% at constant exchange rates). Pernod Ricard fares very well also: this is the result of a steady and consistent trading up or premiumization policy. This is witnessed by the fact that this major Spirits and Wine Group (N° 2 in the world) did purchase along the years major world icons such as Chivas, Martell, Mumm, Perrier Jouët, Royal Salute, The Glenlivet, Ballantines, Jameson, Beefeater and most recently Absolut Vodka.

One clearly sees a gap between gross margin average ratio (62 %) and average ROS (13 %): the rumor of luxury as a financiers' dream seems based more on Gross Margin than EBIT, the profitability once the costs of consumer dream building are deducted.

Table 6 adds an element of comparison. It presents profitability figures for the luxury group sample over five years (from 2004 till 2008 included) as well as those of the "Most Powerful Brands" as defined by the MillwardBrown brand ranking (MillwardBrown, 2008 and 2009). The top 5 brands included at that time: Google, Microsoft, Coca-Cola, IBM and McDonald's. We also add in the table Procter and Gamble, the reference company in the Consumer Good sector and Wal-Mart stores, the largest retailer in the world (13th in MillwardBrown ranking).

TABLE 6. 5-year average profitability: Luxury vs other industries

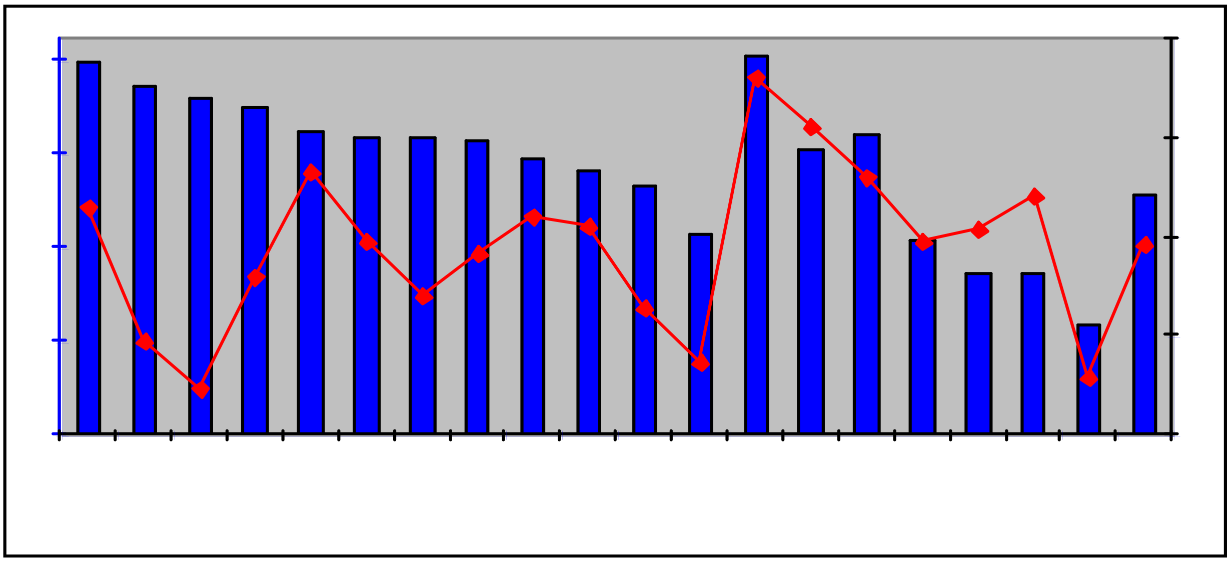


Table 6 confirms that the luxury sector does stand out in terms of gross margin (see above Bar chart using the left scale). Only Microsoft exhibits a far reaching 81% gross margin. This is because it won the battle of the norms (Windows), thus building a position of quasi monopoly among PC softwares. Microsoft can charge monopoly prices without much fear of letting a challenger enter the market by cutting prices. Google and Coca Cola also present high gross margin figures. At this time Google is also a quasi monopoly in the internet search market. Coca Cola, outside the USA, is fully dominating its sector through an extended distribution network, Pepsi Cola lagging far behing and sometimes being even absent of some countries. Though, neither of them can compete with the best luxury performers.

L'Oréal Group exhibits an impressive 70 % gross margin. L'Oréal sells a variety of brands: luxury brands (Lancôme, Elizabeth Arden), premium brands (Biotherm, Kiehl's,...), mass prestige brands (Maybelline, L'Oréal Paris) and even local heroes (strong local brands). In L'Oréal case, a key factor of success is its segmentation by channel of distribution (selective stores, pharmacies, hairdressors, supermarkets,...). Brands are specialized by channel of distribution. This hides a large cost cutting transversality at the production level: sameness of ingredients, molecules, chemical formulas as well as of packagings creates large economies of scale, not to speak of the common R&D centers and the mass media discounts obtained from Group purchases. Finally hair, skin care and make up are emotional categories; women's self confidence is boosted by the premium price they pay as exemplified by L'Oréal long lasting slogan: 'because I am worth it'.

All other companies in our sample, although they are leaders in their field and top brands do not fare as well. One remarks that the reference of the industry, Procter and Gamble, reaches only 51.4% which roughly corresponds to the industry average, 49.5%. Even IBM the leader of its sector fetches about 42% with most other companies showing gross margin ratios below 30%.

Evidence thus seems to point that the luxury industry is able to leverage its aura into above average mark-ups competing neck to neck with the most profitable businesses. With respect to gross margin we may conclude that the luxury industry is a dream machine.

Now, if one looks at the ROS indicator, as represented by the red line in Table 6 (using the right hand scale), the story appears quite different. One cannot conclude that the luxury industry has any advantage. The average ROS for the luxury industry over the last 5 years, 14.2%, is about the same than the average ROS for the Consumer Goods industry, 13.5%. The results are the same if we compute the weighted ROS where the ROS are weighted by the firms' revenues; firms' size does not affect the findings. When comparing the luxury average to the ROS from the non luxury sub-sample, almost all firms beat this average.
Just for the record, Hermes' much hyped profitability is equivalent to Coca-Cola's; Richemont owner of Cartier has the same profitability than IBM.
Our ealier finding showing the rumor of luxury as a financiers' dream seems to be based more on gross margin than EBIT is confirmed: sheer profitability, measured by ROS, is not so exciting. Per se the luxury industry is not exceptional.

What level of financial risk?

Looking at the 2008 balance sheet of LVMH one can compute the company's financial leverage (Total Debt / Equity): 5,860 / 12,804 million euros that is to say 46 %. 46% of LVMH financing came from bank loans or bond issues. Contrary to funds provided by shareholders, borrowed money has to be reimbursed and it bears an interest rate. The higher the debt, the higher the interest rate expenses and therefore the higher the possibility that the company is not able, when bad times come, to generate enough cash flows to pay for its interest charge: the company is bankrupt. Financial markets acknowledge this financial risk.

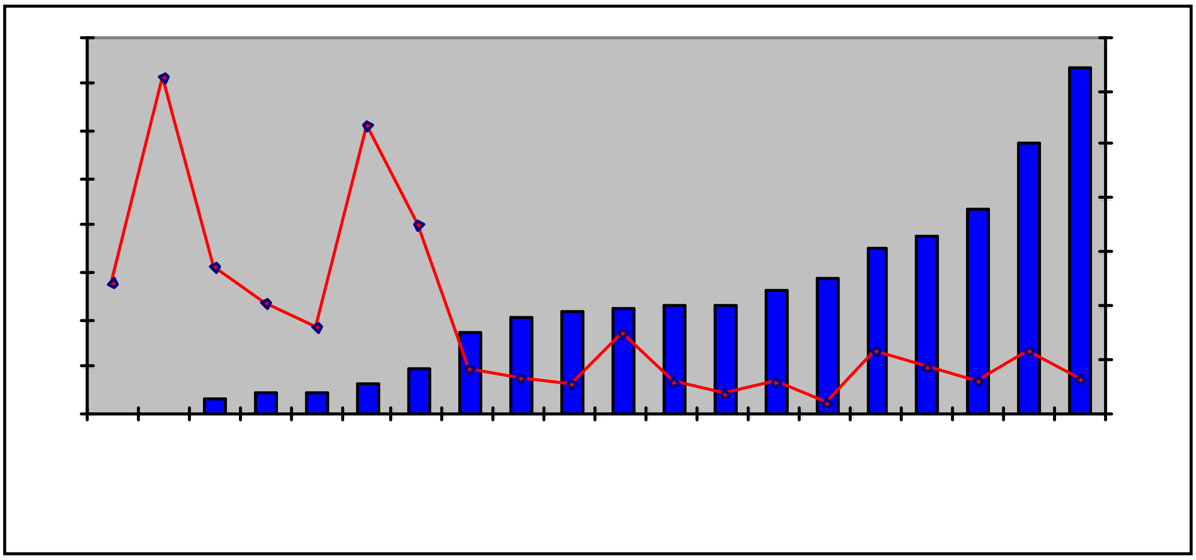
According to their interest coverage, that is the amount of interest to be paid compared to their cash flows, companies are given a financial rating, from AAA, investment grade, to BB, junk debt. The interest rate charged will largely depend on that rating. This is crucial in turbulent times, as we have seen over the last 2 years. In 2008, the interest rate difference between AAA and BB companies was close to 9%. Financial risk will therefore have a definite impact on the firm's profitability and its capacity to excite the markets. We have recently seen, with Greece, violent markets reaction to too high level of debt: it almost crashed the Euro zone. The situation is quite similar with companies.

On average, our sample luxury companies show moderate leverage, many of them below 20%, see Table 7, the financial leverage appearing as a bar chart (with the left scale).This should be compared to the 35% average leverage in the Consumer Goods industry. Luxury companies have a low financial risk. Only Pernod Ricard with a financial leverage of 96% stands out. This is the result of its aggressive external growth policy: to migrate upscale, it had to finance through borrowing the acquisition of world blockbusters.

If one plots on the same graph the cash rate, which is the cash as a percentage of sales, as it appears in Table 7 as a red line (with the right scale), our above conclusion is reinforced. Actually, half of the luxury groups have a low financial leverage and a high cash rate; Hermès, Swatch Group, Armani, Ralph Lauren and Richemont: they hold onto plenty of cash, a virtue which will be most appreciated in the following year when, because of the recession, cash will be scarce. Estee Lauder which has a high leverage, 86%, has at the same time a high cash rate indicating idle cash reserves which could be easily mobized if needed be. Except for

Pernod-Ricard all of our luxury firms have a fairly low financial risk. Two possible explanations: luxury firms need little funding because of slow growth or do they generate so much cash that they are able to cover their financing need? This is what we will investigate in the next paragraph.

TABLE 7. Luxury companies ranked by increasing financial risk (FY 2008)

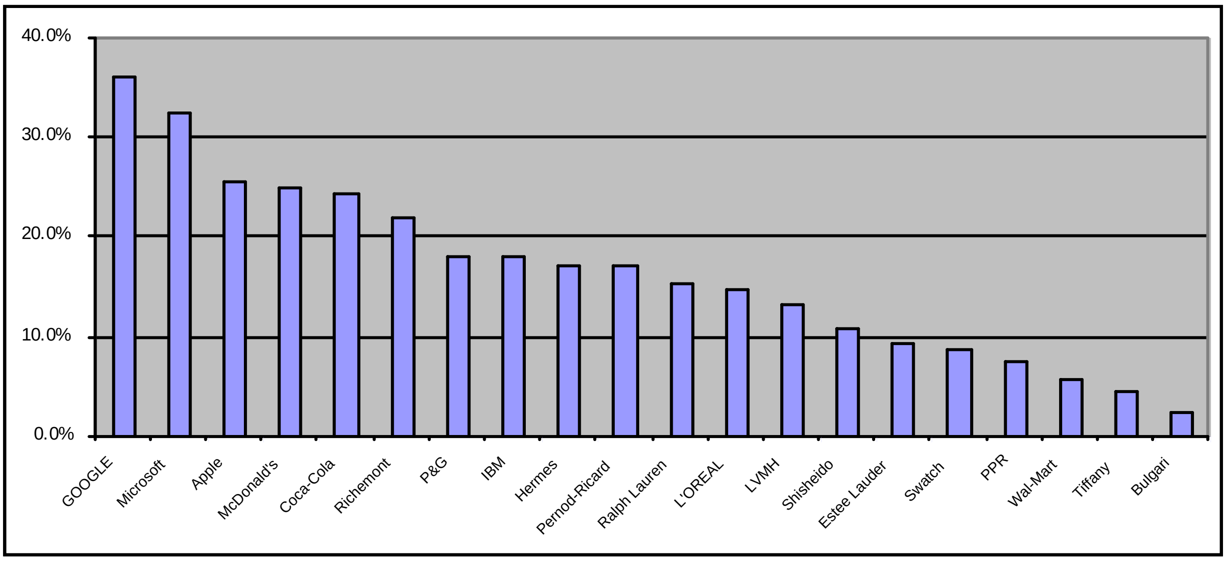


Are luxury companies cash machines?

The ability to generate strong Cash Flows from Operations (CFO) is provided by the Cash Flow Statement. Cash flow from operation is equal to Cash Earnings minus the increase in Net Working Capital, that is the cash tied up to operate the business. What is at stake here is the firm’s capacity to convert earnings into cash. As we are all well aware of, earnings do not necessarily mean cash. A profitable company overshooting the demand for its products will constitute large inventories; because the company is profitable, the Income Staement will show positive earnings but the company could be cash short since it has to pay for the production costs of products sitting on the shelf.

Table 8 compares the cash flow rates (CFO/Sales) from luxury groups with those of our Top Brands sample. It clearly shows that the luxury industry doesn't seem to be extracting the last nickel from their operations. It is by-passed by all non luxury companies. Even the very profitable Hermes has an average CFO rate. The average luxury CFO rate (weighted by sales or not), 14%, is even smaller than the industry reference P&G, 18%. In any case, luxury groups do not fare so well in comparison with Google, an almost 40 % CFO rate, or even Coca-Cola, 26%.

TABLE 8. Cash flow rate from operations : luxury and non luxury groups (FY 2008)



How come luxury companies do such a great job at generating gross margin and fail to generate substantial cash flow?

It may be inherent to the luxury industry and not necessarily due to a lack of efficiency. One should remember that to act as a luxury company, one should go beyond standards and expectations in terms of quality, creativity, luxuriousness, communication etc…. Classical cost-efficient marketing promotional techniques used by mass brands will definitely reduce the level of creativity and exuberance which creates the gap between luxury brands and its many imitators trying to copy luxury brands communication codes. The etymology of luxury is the Latin ‘luxus’ which refers to freedom, the absence of constraints, the capacity to reach extremes and to indulge in excesses. Would luxury companies still belong to luxury if they were driven by cost-containment controllers?

Are Haute Couture defilés too expensive? Is the price paid by Cartier to have the incredible right to exhibit its own history and jewelry at the heart of The Forbidden City in Beijing too high? How should we measure the return on investment knowing that China will be the N° 1 luxury market in twenty years from now and already accounts for 50 % of the world luxury market growth? Those are difficult questions to answer but one never aims too high to communicate the implicit hierarchy between prestige brands; some brands have heritage, others just have a story telling ability. Luxury is the business of status: it has to be acquired and proven by the ambition and extravagance in everything the luxury brand does.

Does the financial market dream?

From the above analyses, the luxury industry:

- has an average growth,

- seems to help weathering market swings (below-one betas),

- has high gross margins,

- shows a below par profitability (ROS),

- exhibits fairly low levels of financial risk (leverage),

- generate comparatively weak cash flows.

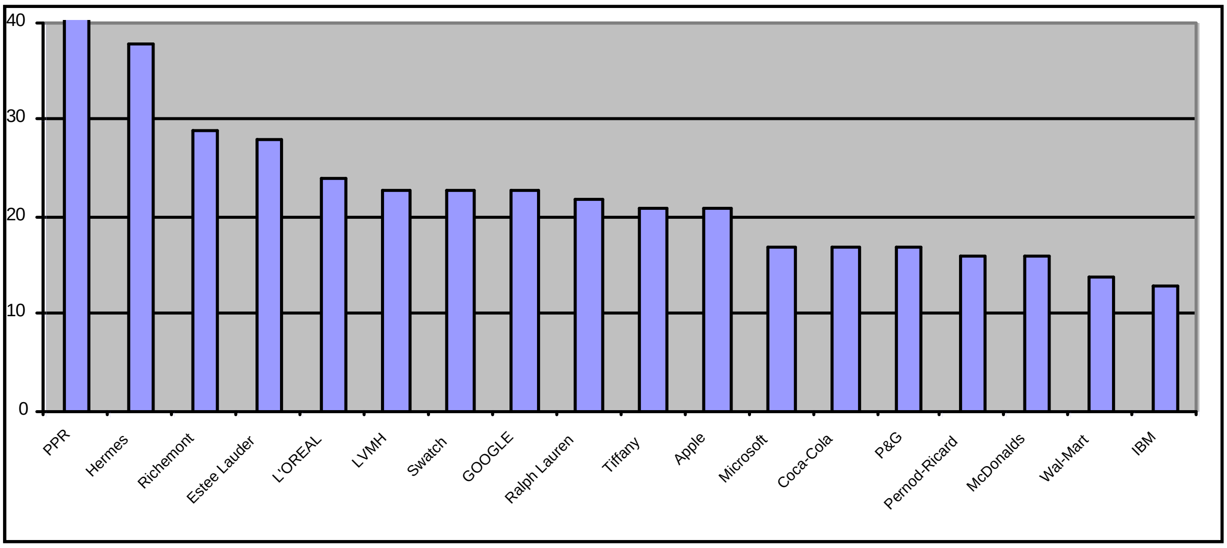
Is there then a unique luxury financial specificity? If yes, it should be found in the valuation multiples, the prices investors are ready to pay to benefit in the future from a Euro of Earnings (Price Earnings Ratio, PER) or a Euro of Cash flow (Price to Cash Flow, P/CF).

Valuation Multiples

When analyzing valuation ratios we decided not to use 2008 share prices. At that time, we were in the heart of the maëlstrom and most luxury share prices were badly punished. It seems that, surprised by the intensity of the crisis, financial markets did not believe in the luxury sector anymore; more basic consumer goods appeared to be a safer bet. Just for the record, let’s note that the share prices of LVMH, Swatch and Tiffany almost doubled between December 2008 and December 2009, when Procter and Gamble, Coca-Cola and Wall Mart did not see any change. Obviously valuation ratios were distorted. To be coherent, we used companies’ Fiscal year 2009 Financial Statements and share prices at the time of the closing of the fiscal year, usually December 31, 2009.

Table 8 compares luxury and non luxury top brand companies in terms of Price Earning Ratio (PER), the most commonly used valuation multiple. The PER used are ‘Trailing Twelve Months’ (TTM) ratios as reported by Reuters Finance Stock Overview and double checked with data reported by Yahoo! Finance on the basis of data provided by Thompson.

TABLE 9. PER of luxury and non luxury companies (TTM 2009)



Results are striking. Except for one, Pernod Ricard, all luxury companies exhibit a PER above 20, when most non luxury brands have a PER below 17 (the PER for Shisheido and Bulgari were not available). The graph speaks for itself: luxury brands benefit from valuation multiples clearly above other brands, even though the latter are profitable and top names in their trade. One could argue that results may be biaised: could it be that luxury brands' low profitability boosts their PER since low luxury earnings would mechanically biased PER upward? Two examples seem to indicate it is not the case. First Wal-Mart which we have seen has quite a low profitability commands just a PER of 14. On the other end Hermès, which enjoyed a very high profitability, has a PER of 38.

Interesting also is the PER of Procter and Gamble, 17. This is not a luxury and the absence of dream factor is reflected in its PER. Also, Pernod Ricard does not seem to benefit from any dream factor; maybe the group is not considered yet as a truly luxury group.

Two last remarks; first, Apple enjoys the same PER as luxury firms but one has to take into account the stunning success of its latest products, IPhone and IPad. PPR has a huge PER but in this case one believes it’s due to its low, almost negative, profitability; the ratio is of little significance.

Even though the figures are really impressive, one would even argue that luxury PER are in fact downward biased; this is due to the reporting of most luxury groups.

Luxury groups publish aggregate figures only: LVMH does not produce public information on each of its 50 brands. It is however well known that some of them are not profitable at all. B. Arnault, LVMH CEO, decided to divest personnally from Christian Lacroix after enduring 10 unprofitable years. It means that, within the 50 brands of LVMH, or of any other luxury group, some brands must be extremely profitable as to offset the losses of all those in the red. Probably financial markets have difficulties to dissecate the results and fully integrate the dream on the most profitable brands.

The above argument would rightly push luxury groups to divest their lesser brands as to focus on the succesful ones. Obviously Hermés one-brand strategy supports this approach, its PER of 38 speaks for itself. We would argue quite the contrary.

In nowaday’s turbulent world with ever shorter product cycle, it is very difficult for a luxury brand manager to feel secure about the future. As argued above the appeal of a brand is essentially emotional and therefore volatile. This is the essence of the trade: what is utmostly desired today could be totally ignored tomorrow. How long will Louis Vuitton bags generate one hour waiting queues on the sidewalk in the center of Roma? Of course the prestige of a luxury brand helps extending the engine life but brand cemeteries are everyday more full.

Facing such a situation, encountered also in many other industries (Technology, Pharmaceutical and of course Consumer Goods) experts have argued that firms should manage simultaneously exploitation and exploration, (Saias and Tabatoni, 2003). Firms should achieve excellence in day to day operation as to maximize earnings and cash flows but, at the same time, prepare for the future by exploring new ventures, in the case of the luxury industry building up new brands (or reviving old brands). Clearly, companies will not want to advertise too much their costly exploring activities to avoid financial markets frustration and run the risk to have to abandon initiatives before they bear fruit. The industry is rich in fairy tales of such brand turn-over. After all, the fortune of Mr Arnault, the sixth richest man in the world according to Forbes, February 2010, is basically due to the fact that he once acquired the control of a quite small company manufacturing luggage and leather goods, called Louis Vuitton. Later he also bought Dior, an ailing company at that time. Many multi brand luxury groups seem to have chosen that path with much success: LVMH, Pernod Ricard, PPR and Richemont amongst others.

One unintended consequence will then be a concentration trend of the industry. It has been argued at length that little synergies could be expected from multi brand groups except for media buying, retail channel pooling and negotiating power with mass retailers. In fact the competitive advantage of large multi brand groups comes from their ability to finance exploration. Transforming a boutique brand into a global blockbuster necessitates huge investment and competences that only large groups will have. Also, their access cost to financing will be much lower. This has been recently advocated by Bain & Co consultant which predicts the luxury industry to “be set for a new wave of mergers, acquisitions and IPO’s as the industry recovers from its worst year ever”, Businessweek, 2010.

Finally having in the pipe a portfolio of future brands provides some additional strategic flexibility. Such flexibility confers to its holder a growth option which has been shown to add much value to the firm (O. Tabatoni, 2010). Once those embeded options better recognized by stock markets, one could expect an extra boost to their multiples.

Profitable Growth

To isolate the profitability factor, one has used another measure of firms’ dream power, namely the Price to Sales ratio, P/S. This ratio indicates how much financial markets are ready to pay for one Euro of sales. A high ratio attests to the excitement generated by the firm with investors. At first sight, one sees that most luxury groups have a P/S ratio between 2 and 3. This is an encouraging result when one compares to the S&P 500 with a P/S ratio slightly less than 2. A few exceptions though: Hermès has a 5.2 Price to Sales ratio, but we are now used to Hermès’ extraordinary performance. On the other end of the spectrum lie PPR, Shisheido and Ralph Lauren. Those companies do not seem to enjoy much dream power. Either financial market do not consider them as real luxury company, Shisheido and Ralph Lauren, or not yet there, in the case of PPR.

However, luxury companies pale in comparison to other MillwardBrown Top Brand companies: 4 out of 6 enjoy the highest P/S ratio. This simple analysis seems to contradict our previous findings. Some additional considerations may be necessary to better grasp luxury specificity.

Luxury groups, as any company, will make the market dream if they exceed shareholders expectations. Which are they?

To invest in the shares of a young enterprise, shareholders would expect more than a mere 3% ; such a return could be obtained by investing in Government Bonds. This is the centrepiece of a ‘finance mind’: investors’ expected return, called Cost of Capital, should be in line with the risk taken. But, if a firm wants to have investors dreaming, it should devise strategies which generate returns above the Cost of Capital, strategies which deliver positive Economic Profitability; today, all CFO’s are telling us that they have to “beat” their Cost of Capital. At the same time, to preserve their market share and profitability and to attract new investors firms have to grow. Those two imperatives have been coined in the commonly used expression, *Profitable Growth*.

This is summarized by the diagram below. It stresses the fact that profitability and growth should be simultaneously present for value to be created. The gray area representing the amount of value created will be very small if the firm does not deliver on one axis.

Profitable Growth

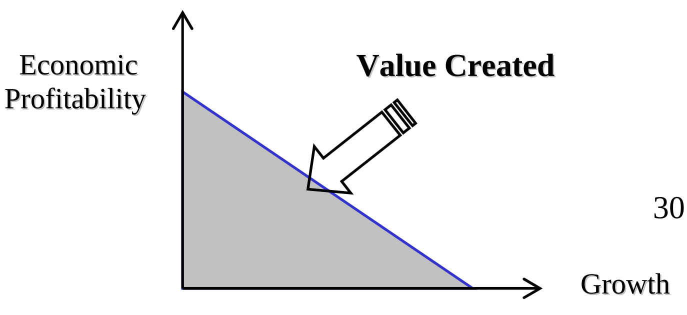


FIGURE 1 : Profitable growth

Only those firms which generate Profitable Growth should enjoy a high Price to Sales ratio. Then, if luxury firms did not generate Profitable Growth and still have a high P/S ratio it would mean that luxury firms are exciting financial markets beyond their financial performance, the true sign of a capacity to make the markets dream.

We did not possess any reliable information for the firms' cost of capital. Given the low level of leverage of most of our luxury firms (except Pernod-Ricard) and a priori similar business risk we have decided to neutralize the cost of capital; we will then use the EBIT as measure of profitability.

To achieve more reliable results and to avoid the December 2008 valuation trough which might be distorting the data, one has used 5-year averages for Growth and EBIT over the 2005-2009 period.

TABLE 10. Price to Sales ratio and of Profitable Growth

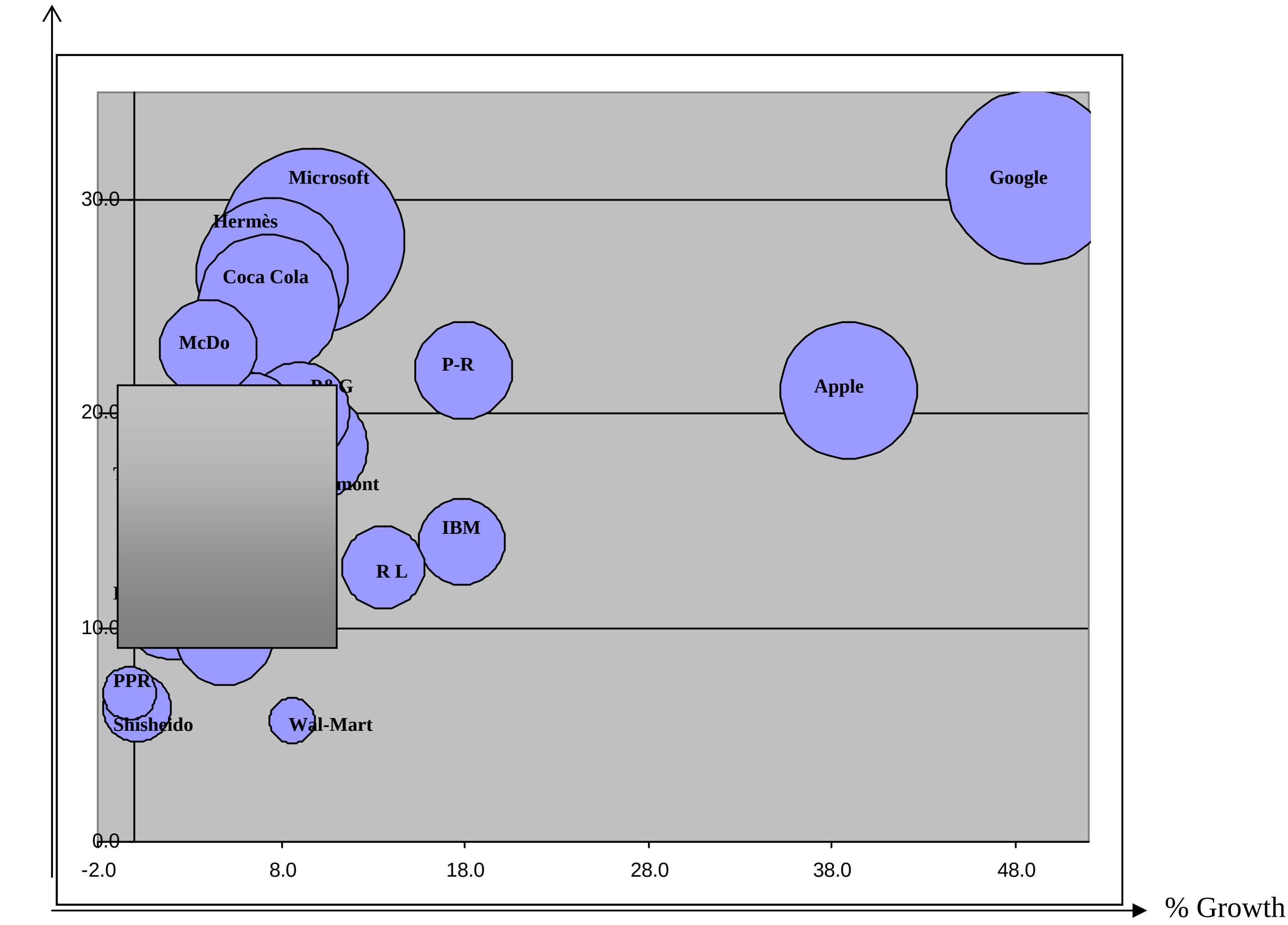


Table 10 relates our sample companies' Price to Sales ratios with their 5-year profitability and growth ratios. Price to Sales are represented by the blue circles; the larger the circle, the higher the Price to Sales ratio.

In the shaded square one finds the bulk of the luxury firms. Their growth is moderate, less than 10% and their profitability between 10% and 20%. Though, they all have a Price to Sales ratio superior to 2 a ratio clearly higher than the 1.5 average for the industry. No other firm is able to reach that level of P/S ratio without having a far superior profitability, Microsoft and Coca Cola, or growth, Apple and Google. Also, very successful non luxury firms do not fetch better P/S ratios although they exhibit higher growth, IBM, or higher profitability, MacDonalds.

Even if we look at the bottom left part of the Graph, where we have the three firms with low profitability and low growth, PPR, Shisheido and Wal-Mart, both luxury firms have a higher P/S ratio than Wal-Mart although they exhibit much less growth. Given PPR and Shisheido low M/S, one may question wether financial markets are considering those firms as belonging to the luxury sector. Also one may question whether PPR is pure luxury play. FNAC and Conforama, two of its best known brands, are definitely not in the luxury segment and Puma, a worldwide sports brand, is not either. Shisheido is a luxury brand in Europe, but not so much in Asia which still represented 78% of its sales in 2009.

The same argument could be extended to two other firms. With substantial growth, more than 10%, Ralph Lauren is not able to reach a P/S ratio of 2. Ralph Lauren does not seem to benefit from any luxury premium. Also, Pernod Ricard has a P/S ratio of 2.2 but to achieve it, P-R had to deliver 18% growth and an average 22% profitability. Financial markets seem to still consider Pernod Ricard as a Spirit and Wine supplier and not yet a full luxury brand.

Conclusion

Our findings about the luxury industry can be easily summarized: although one has not found a defining specificity in terms of operational performance except for high gross margin, however a dream factor seems to operate with financial markets ; PER and P/S ratios testify to it. Luxury groups enjoy clearly superior valuation multiples which could not be justified on the basis of shareholders expectations in terms growth and profitability.

A factor very known from casino gamblers seems to be influencing the financial community : the fact that some of the luxury companies do attain exceptional results acts as fuel for the dream . In addition , it is well known that , within LVMH ,world N°1 luxury group with more than 50 brands , one of them alone -Louis Vuitton - contributes disproportionately to the profitability of the Group , offsetting the still poor results of many other brands of their portfolio . The same holds true for Richemont whose financial results rely mostly on the Cartier brand itself . But there is still a widespread belief in the potential of all others . Just as L Vuitton was a small company when B. Arnault (LVMH founder) fully bought it in 1989 and has now become the star of the whole sector , everyone believes that each luxury brand will have its chance if properly managed . One should simply emulate their luxury strategy . Another factor today sustains this dream: luxury companies are just sitting at the edge of a huge growth potential, named China and India , Brazil , Russia. The size of their middle class will make these countries dominant markets for luxury companies : aspirations to compete for status have just been released there. They will be the main markets of tomorrow: when exactly is not sure, but they will be so, for sure. That is no dream.

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