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LUXURY PRODUCTS AND RETAIL

BECAUSE YOU'RE WORTH IT — UNDERSTANDING THE INVESTMENT FUNDAMENTALS OF LUXURY RETAIL

By Alan Lok, CFA, Eunice Chu, ACCA and Guruprasad Jambunathan

Dopamine. It's the pleasure-inducing brain chemical that is released when we treat ourselves to something new. And the surge of elation we get when we go to the cash desk and discover there's an additional 30% discount? Well, that's the dopamine kicking in big time.

Of course, all retailers are fully aware of this reward-motivated behavior, but none more so than the luxury goods branch of the industry.

CHASING A DREAM

Compared with other industries, the luxury retail business model certainly has some distinct characteristics.

For a start, its demand curve is not downward sloping. In other words, demand does not always increase with a decline in price — in fact, one of the industry's key tricks is to raise the average cost of an item — the rationale being that higher prices keep the middle class (the target customer group) chasing the dream of luxury.

HAVE YOU SEEN HIS ROLEX?

Contrary to typical offerings from other industries, a luxury brand's image is not pushed solely at potential consumers. Massive communications to nontarget groups are also crucial. Product admiration from others creates a sense of social and economic superiority among actual consumers — the glint of a Rolex under a starched cuff impresses strangers and makes the owner feel wonderful. Indeed, anything that enhances this sense of uniqueness can boost sales.

BRAND PROTECTION

Maintaining full control over the value chain, as well as distribution channels, is a necessity rather than a choice. There are countless real-life examples of quality names that have been tarnished at the hands of franchisees or appropriated by nontarget groups. Burberry still has an image problem in the United Kingdom because it became the brand of choice for lower socioeconomic elements of the population. Moreover, a command of the manufacturing chain results in consistent craftsmanship and a supreme eye for detail, while a close-knit distribution channel guarantees that the one-to-one customer service is top notch.

In many situations, the functionality of the product is secondary. After all, Jimmy Choo sandals and slip-on Crocs serve precisely the same purpose, but the latter would look strangely out of place at the Oscars. Service delivery is far more important. Essentially, the entire business proposition means adhering tightly to the noted set of strict principles to preserve the uniqueness of the luxury item and trigger enormous brand "stickiness."

From an analyst's perspective, this can be a tricky business model to grasp. Many of us are, perhaps, rather sober in nature and not easily swayed by the ephemeral glitter of high-end consumerism. A safe bet, therefore, is to examine the companies in this sector as we always do — logically and with an incisive mind.

PRICED TO PERFECTION?

A good place to begin your journey is by understanding the company's profile and identifying where in the luxury retail chain it operates. What unique value proposition does the company offer to customers?

Ascertain the discretionary and nondiscretionary demand for the company's products and services. At the same time, establish which of the company's product categories is most sensitive to price changes. These products could be affected by long-term demographic, macroeconomic, and geographic factors, so get to know what these are. For example, what is the average age and level of wealth of consumers in the company's key markets? Is this expected to change? Importantly, does the firm undertake segmentation of its customer base? If so, what dimensions does it use? These could include specific product lines, brands, or strategies that target different groups.

With regard to price, what is the company's strategy for different products, and which of these offerings are most immune to price changes? Do past trends support this?

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SALES COUNTER

In terms of sales, does the company provide a detailed breakdown of its performance in terms of volume and price? Similarly, check whether it generates growth by same-store sales, net additions, inorganic growth, and foreign exchange impacts — and explore how this trend will evolve.

The various elements that drive a firm's cost profile and how it manages these elements also are linked to sales. What are the company's gross, operating, and net margins? This information will prompt you to learn more about the business's profitability and cash position versus its competitor's position.

RECOGNIZING THE NAME

Given the importance of a company's branding strategy, it is crucial to investigate how a luxury retailer markets its products and services and to establish how much it spends on these pursuits. What are the primary modes of advertising and promotion activity: television, magazines, or billboards? Who heads up the company's creative team and what are their credentials? Do these people truly understand the nuances of luxury branding?

GLOBAL REACH

From a technology perspective, review the firm's social media presence and pay attention to its preferred channel. This can tell you a lot about its target audience — Instagram is aimed at under 30s, whereas Facebook has a broader demographic. Looking ahead, consider whether the company grasps how e-commerce affects its sales. Does it have a strategy to increase revenue from home shopping?

Although the internet makes the world feel smaller, people living in different regions still have different tastes. So, establish the geographic importance of the company's outlets and the pricing structures across these different geographies. Which products are the most popular in each location? You may find that a company with a higher exposure to the industrial world has stagnating sales, but a firm with a strong presence in China, for example, is experiencing a surge in activity.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS

The luxury retail sector, with its soft focus on making life more pleasurable, does not automatically spring to mind as an industry that needs to focus too closely on environmental, social, and governance factors. Underneath the cashmere coat, however, the industry faces the same challenges as any other part of the economy. Consider a company's energy, electricity, and water use and its waste generation. Has it invested in ways to improve performance on these fronts?

What is the company's policy on sourcing raw material from conflict zones? Does it ensure that the extraction and sourcing of this material is done in a lawful, fair, and sustainable manner? From a labor perspective, can it provide evidence that it treats its employees and suppliers fairly? Finally, it is vital to know whether the company directly or indirectly employs child workers.

As always, these guidelines are designed to provide you with a short but solid foundation to kick-start any future analysis. So, rest your feet on that expensive Italian leather sofa, relax, and start your in-depth journey through the sector.

About the Authors

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Infographic showing the step-by-step process of analyzing the luxury retail industry

01 DEMAND

- Degree of non-discretionary demand
- Channels of revenue
- Sources of revenue
- Tourist traffic

02 PRODUCT AND MARKET SEGMENTATION

- Luxury product positioning
- Affordable luxury vs. Premium luxury products
- Price sensitivity of products/services

03 STRUCTURAL INFLUENCES

- Target market segmentation
- Current competition
- Barriers to entry
- Competitive differentiation
- Communication of key value proposition
- Brand reputation
- Impact of social media

04 GAUGING PERFORMANCE

- Pricing Strategy
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- Wholesale vs. Retail

05 MEASURING GROWTH EXPECTATIONS

- High-net-worth individuals population
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06 ESG FACTORS

- Operating Conditions
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- Waste generation
- Sourcing of sustainable materials
- Fair treatment of employees
- Fair treatment of suppliers

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Common to the Sector

1. What is the degree of elasticity of demand for the company's products and services?

a. What is the extent of change in demand observed in response to a unit change in price?
b. Does price decrease and increase have same elasticity? Does the elasticity vary across price levels?
c. Which product categories are more sensitive to price changes than others? What are the dynamics driving these differences?
d. What are the details of the company's price investment strategy? How does it compare with industry practices?

2. What are the details of the demand profile of the company's products and services?

a. What is the consumption profile of the products managed by the company?
b. What are the key factors driving their consumption?
c. How does the company forecast demand for its products?
d. Is there a seasonality observed in demand for the products managed by the company? What are some examples of such products and the strategy used to manage seasonality?

3. What are the long-term demographic, macro-economic and geographic factors affecting demand?

a. What is the average age of the population in the company's key markets?
b. How is it expected to evolve?
c. What is the share of discretionary consumption as a percentage of GDP in key markets? Is there space for structural growth of consumption?
d. What is the level of urbanisation in key markets?
e. What are the other factors that could affect demand? How does the company see these evolving in the coming years? How does the company intend to leverage these trends?

4. How does the company undertake segmentation of its customer base? What dimensions (age, income, geography, etc.) are used for this purpose?

a. Under which segments does the company classify its customer base?
b. What are the differences observed in the consumption and spending behaviour of customers across these segments?
c. How does the company track the consumption and spending behaviour of customers in these segments?
d. What are the details of specific product lines, brands and marketing strategies to target customers in different segments?

5. How easy is it for new players to enter and compete? What are the entry barriers?

6. How has been the company's performance in terms of volume growth?

a. What is the break-down of the company's sales performance by volume and price?
b. What are the details of other aspects of sales growth such as same-store sales, new store sales, inorganic growth and the effect of foreign exchange?
c. What are the key qualitative factors driving these numbers?

7. What is the cost structure of the company's products and services? How does it compare with that of peers?

a. What are the key elements that drive the company's cost profile?
b. How does the company manage each aspect of cost?
c. What are the gross, operating and net margins on an aggregate basis and across key product lines?
d. How have the company's margins evolved over the past few years? How does the company expect margins to shape up in future?

8. What is the company's strategy for space expansion and store opening? What are the associated expenses?

a. How does the company optimise utilisation of retail space through the addition and closure of stores? What is the approach between optimising utilisation in existing stores vs opening new stores?
b. How many stores have been added and how many have been closed in the last few years?
c. What are the details of the company's strategy underlying store opening and closures?
d. How do sales from new stores compare with sales from existing stores?
e. If new stores typically contribute more, how long do they continue to provide higher sales? If they contribute less, how long does it take for them to catch up with older stores?

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9. What are the most and least effective channels of revenue generation for the company?

a. Which are most and least stable sources of sales for the company?

b. What are the most common direct and indirect sources of income?

c. How has the revenue mix from different channels and sources evolved over the past few years? How is this expected to shape up in the next few years?

d. How much of sales is driven through the online channel? How is the channel's contribution expected to evolve?

10. What is the impact of tourism on demand for the company's products and services?

a. What proportion of the company's revenue is generated from international travellers compared with revenue from domestic buyers in its key markets?

b. How different are the ticket sizes (spending per purchase) of domestic and international customers for various product categories?

c. Which are the major stores and products that depend primarily on tourist traffic?

d. How much revenue is generated from these stores and products?

e. How much revenue can be attributed fully to tourist spending?

f. What is the company's strategy to manage dependence of growth on tourist spending?

11. What part of the luxury retail chain does the company operate in?

a. Does the company's products fall under the affordable luxury category aimed at mid- to high-end customers or the premium luxury category targeted at ultra-high net-worth individuals?

12. How is the company's customer base, specifically the High Net-worth Individual (HNI) segment, evolving in its key markets? How is the company responding to these changes?

a. Which regions does the company consider as its primary markets?

b. What proportion of the customers are repeat or regular customers?

c. How does the company retain and cross-sell to regular customers?

d. What is the company's strategy to target customers from new regions?

e. What are the details of rewards or incentives offered to attract new / first-time customers?

13. How would the company explain the key unique value proposition it offers to customers?

a. In the company's view, how are its brands perceived in the market?

b. What are the results of a brand valuation exercise done by the company?

c. How differentiated are the company offerings, in its view, in relation to those of its competitors?

14. What are the details of the company's branding strategy? What are the associated costs?

a. How much is the Advertising and Promotion (A&P) cost as a proportion of revenue and total costs?

b. What are the main modes of the company's A&P activities (TV, print, outdoor, internet etc.)?

c. How seasonal are the company's promotional activities?

d. What strategies does the company employ to promote awareness and value of its brands?

e. Does the company disclose details of its creative team? What are their credentials and track record?

15. How does the company keep track of changing customer preferences?

a. How do the life cycles of the company's products compare with those of competing products?

b. What is the typical average lifespan of a product the company introduces in the market?

c. In the company's view, does the market perceive it as a follower or as a creator of new trends?

d. How quick is the company to adapt to the changing preferences of customers?

e. In the company's view, to what extent can its products be replaced or re-created?

f. What is the impact of digitisation on the company's business?

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16. What is the influence of social media on reach and sales of the company's products?

a. Which social media channels (Facebook, Twitter etc.) does the company has a presence in?

b. Which of these channels does the company find to be the most useful?

c. What are the details of the company's strategy in managing social media outreach?

d. Which aspects of the social media channels (user activity, engagement etc.) are tracked by the company?

e. How correlated are sales to momentum of the company's brands in social media channels?

f. How does the company track social media activity around its brands in China, in the absence of Google and other major global channels?

g. In the company's view, how important will be the role of social media in future?

17. What are the details of the company's pricing strategy for different products?

a. Which products does the company expects to undergo large price increases in future?

b. What is the likely effect of these price increases? How does the company intend to manage this?

c. Which products are less vulnerable to price changes, in the company's view? Is this supported by past trends?

18. What is the mix of the company's business between wholesale and retail channels?

a. What is the mix of revenues from retail and wholesale businesses?

b. How has the trend been over the past few years and how is it expected to be in the future?

c. Which channels earn the most margins for the company?

d. What are the challenges to expand the channels in which margins are most lucrative?

19. What is the extent of the impact of geographic location of selling outlets on price realisation?

a. Where are a majority of the company's stores located?

b. How different are the selling prices across different geographies?

c. Does the company actively practice differential pricing or tries to minimise the price differences across locations and geographies?

d. What are the regions where the margins are superior to others?

20. What are the details of the company's strategy to manage inventory?

a. What are the inventory days by channel, mode and geography?

b. What are the details of waiting period for customers, if any, for the company's products?

c. What strategies does the company employ to push inventory to dealers?

d. What are the issues faced in sourcing raw materials?

e. How much of critical raw material requirements depend on external vendors?

f. How many days does it typically take for raw material conversion?

g. How geographically spread is the manufacturing process?

h. What are the modes of transporting raw materials and finished goods?

i. What other challenges does the company face with respect to managing inventory?

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Environmental, Social and Governance

21. What are the details of the company's ESG principles, practice and track record?

a. What is the energy, electricity, water use and waste generation intensity of the company's operations? What are the steps being taken to improve performance on these fronts?

b. What proportion of the company's stores and other buildings are certified under programmes such as LEED?

c. What is the company's policy on sourcing raw material from conflict zones? What measures does the company practise to ensure the extraction and sourcing of these are done in a lawful, fair and sustainable manner?

d. Does the company track the packaging intensity (e.g. amount of packaging used per tonne of goods sold) of its products? What are the details of any programmes to encourage suppliers to reduce packaging, use biodegradable or recycled material?

e. What are policies and practices implemented by the company to ensure fair treatment of employees, contractors and workers employed by suppliers?

f. How does the company ensure its operations do not directly or indirectly employ child labour?

g. What measures does the company practise to ensure customer privacy and the safety of customer data collected and stored by it? Have there been any breaches of customer privacy or data?

h. To what extent do various stakeholders in the company's supply chain practise ESG principles? How does the company's actions influence the practices of its suppliers? How does the company plan to improve adherence by its suppliers?