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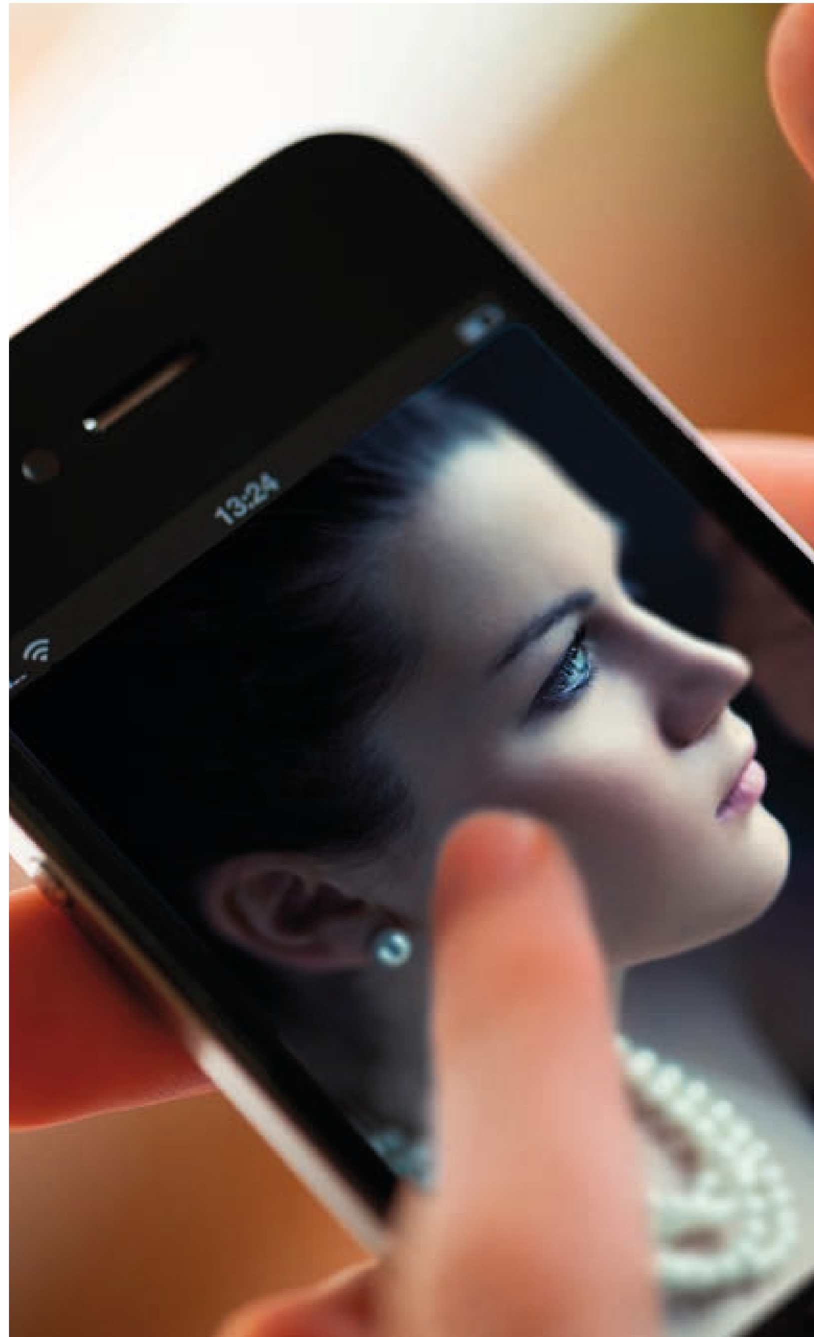
Global Powers of Luxury Goods 2014

In the hands of the consumer



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Deloitte Touche Tohmatsu Limited (DTTL) is pleased to present the 1st annual *Global Powers of Luxury Goods*. This report identifies the 75 largest luxury goods companies around the world based on publicly available data for the fiscal year 2012 (encompassing companies' fiscal years ended through June 2013).

What is luxury?

While we all recognize luxury, definitions are hard to agree on. Some define luxury by a list of attributes, others by price, and still others by exclusivity of distribution. The issue has become more complex as corporations took ownership of many luxury brands, and as lower price points and broader distribution put ownership of many luxury items into the hands of the masses.

This report frames its discussion around Euromonitor's definition of luxury goods products, which includes aspirational or premium brands as well as traditional ultra-luxury. (Please refer to the "Study methodology" section for more details). It focuses on four broad categories of luxury goods: designer apparel (ready-to-wear), handbags and accessories, fine jewelry and watches, and cosmetics and fragrances. It excludes the luxury categories of automobiles, travel and leisure services, boating and yachts, fine art and collectables, and fine wines and spirits.

The report also provides an outlook for the global economy, an analysis of market capitalization in the industry, an overview of M&A activity in the luxury goods sector, a discussion of major trends affecting luxury goods companies, and a look at the retail and e-commerce operations of the largest 75 luxury goods companies.

Global economic outlook

As the global economy recovers, the global luxury industry is growing accordingly. Not unexpectedly, growth is disproportionately focused on the Asia Pacific region. Although economic growth has lately slowed in much of Asia, this is to some extent offset by the rise in income inequality. Thus, income available to upper income households is growing faster than overall income. The near term future of the luxury market will depend, in part, on how the global economy evolves. In the pages that follow, we offer our view on the economic outlook for the major markets and the potential impact on purveyors of luxury products. Ours is a baseline view. Yet it should be noted that unexpected political decisions, by leaders or voters, could relegate our predictions to the rubbish bin. Still, we hope that what follows offers a useful road map.

China

China is the world's fifth largest luxury market according to Euromonitor and, sadly for luxury producers, the Chinese economy has slowed considerably. The critical manufacturing sector has been stung by slow overseas growth, a rising value of the yuan, and rapidly rising wages, all of which have hurt export growth. Instead, the economy has relied heavily on domestic demand, especially investment in fixed assets. This has been fueled by massive borrowing by local governments, corporations, and individuals investing in the frothy property market. Unfortunately, the growth of debt, mostly off the balance sheets of banks (in the so-called shadow banking system) has created a sizable risk to the Chinese economy. This threatens to either derail economic growth or cause further problems in an economy already suffering from serious imbalances. Although the massive investment in fixed assets has maintained employment, it has often generated negative returns. It has not contributed to the ability of the economy to grow. The government will likely have to bail out troubled financial institutions, force them to reduce lending, and thereby cause a drop in economic growth. The best way to avoid a serious crisis would be to implement significant reforms of the financial system as soon as possible. As such, the government recently announced a range of reforms intended to create a more normal economy.

The reform program proposed by the Chinese government is radical yet cautious at the same time. On the one hand it proposes increased competition for state-owned enterprises (SOEs). On the other hand, it fails to propose privatization of SOEs. On the one hand it proposes to protect private property rights, but on the other hand it fails to give up state ownership of land. On the one hand it does much to decentralize economic power by empowering the private sector. Yet on the other hand, it pulls more power into the hands of the central government, often at the expense of local and regional governments. As such, it is a mixed bag of reforms.

Despite a bit of ambiguity, it is clear what the government generally hopes to achieve. The reforms, if implemented successfully, should lead to faster economic growth, less financial risk to the economy, and a shift in growth away from investment in fixed assets. In addition, the reforms tackle a variety of social issues. The reforms will lead to greater fairness by promoting more income equality as well as a more powerful and less corrupt judiciary. Finally, the reforms are somewhat conservative in that they should help to stabilize the economy and society by engendering greater predictability. There should be more transparency of financial markets and SOE finances, more professional management of SOEs, less reliance on the decisions of fickle local officials, and more reliance on market forces to determine allocation of resources.

As for the luxury market, it depends on a robust consumer market and continued growth of the upper income cohort. On the one hand, the reform agenda proposed by the government should shift growth away from investment and toward consumer spending. On the other hand, efforts to reduce income inequality could lead to disproportionate growth of lower to middle income cohorts—although it will probably take a few years before this is manifested. In addition, the government's recent crackdown on corruption has resulted in a sharp drop in official gift giving. Going forward, this could have a negative impact on the luxury market.

Japan

Japan is the world's second largest luxury market after the United States, according to Euromonitor. Yet, during the past five years, luxury sales have grown more slowly in Japan than in any other Asian market. The problem was stagnant growth for much of that time. However, things started to change last year following the implementation of a new economic policy known as Abenomics. Having grown rapidly in the first half of 2013, Japan's economy slowed in the second half. Still, economic performance in 2013 was the best in years. This was largely a result of the monetary policy component of Abenomics (the other components are fiscal stimulus and deregulation). The monetary policy has involved sizable asset purchases by the central bank designed to suppress bond yields, create inflation, suppress the value of the yen, and boost consumer and business willingness to spend. So far it has been a modest success. Inflation is finally returning to Japan, albeit modestly. Bond yields remain low, thereby creating an environment of low capital costs which encourage investment. The yen has significantly depreciated, thereby helping export competitiveness and helping to revive Japan's manufacturing sector. A sizable increase in wealth, due to higher equity prices, has boosted consumer spending.

Despite the positive news from Abenomics, there are reasons for concern. First, Japan experienced a large increase in the national sales tax in April. This was already in the pipeline prior to Prime Minister Abe's accession to office. It is designed to improve the sustainability of Japan's pension system in the future. Yet the increase is expected to hurt consumer spending for the remainder of 2014. Moreover, earlier strength of consumer spending was partially due to consumers purchasing big ticket items before the tax increase takes place. Although the government intends to implement a sizable fiscal stimulus to offset the impact of the tax increase, it is possible that the economy will slow down considerably in the second half of 2014.

Second, sustained growth of consumer spending will require increases in wages. Yet while prices have risen, wages have not. This means declining real purchasing power for many consumers. The government has encouraged businesses to boost wages, and a leading business lobby has recommended that its members take action. Whether wages will rise in 2014 remains uncertain. If wages continue to stagnate, economic growth will suffer.

Third, one of the positive effects of Abenomics has been a sizable boost in asset prices due to the flood of liquidity from the new monetary policy. A rise in asset prices is especially helpful to upper income households and could contribute to a rise in luxury spending.

Finally, the longer term benefit of Abenomics will require radical deregulation of the economy. The details of what the government intends remain unknown, and the government has delayed implementation of some aspects of deregulation. Absent significant reform, Abenomics will not have a lasting impact on productivity growth and economic growth.

Eurozone

According to Euromonitor, the Eurozone includes four of the top 10 luxury markets in the world. These are Italy, France, Germany, and Spain. They are, respectively, the 3rd, 4th, 7th, and 9th largest luxury markets in the world. The UK, which is not part of the Eurozone, is the 6th largest luxury market. The Eurozone is now recovering from a prolonged recession, itself the result of the sovereign debt crisis. Prior to the crisis, the creation of a common currency had led to interest rate harmonization and relatively low borrowing costs across Europe. With the crisis came a loss of confidence in the durability of the euro and the ability of some countries to service their debts. Consequently, borrowing costs for Southern European countries increased dramatically leading to a severe drop in credit market activity. In addition, most European countries adopted tight fiscal policies in order to convince financial markets of their commitment to fiscal consolidation. The result was a recession which is only now ending.

The recovery came about for three main reasons. First, the ECB promised to "do whatever it takes" to save the euro. That meant that the ECB would not allow sovereign debtors to default. As a result, bond yields declined, leading to lower borrowing costs. Moreover, this caused an improvement in the ability of governments to service their debts. That, in turn, led to the second reason, which is a loosening of fiscal policy. Today, government finances in Europe are in much better shape than a few years ago. This means that countries can take a more relaxed attitude toward fiscal discipline—at least in the short run. Finally, the decline in the value of the euro, combined with wage restraint and productivity gains, caused exports to grow once again.

In 2014, the Eurozone is expected to experience modest growth. Inflation, which is very low, will remain so, thereby providing the ECB with plenty of wiggle room should it choose to engage in a more aggressive monetary policy. The ECB is studying the possibility of employing unusual policy tools to boost credit market activity. This could include something akin to quantitative easing (already in use in the US, UK, and Japan) or using fees to compel banks to lend. At the national level, several countries are increasingly committed to labor market reforms designed to reduce the cost of hiring and, therefore, reduce unemployment.

Yet perhaps the biggest obstacle to better economic performance in Europe is the absence of financial market integration. European banks are primarily supervised by their national governments. When they get in trouble, the national governments have been forced to assume bank liabilities. Banks holding Greek sovereign debt have been forced to take haircuts and banks in Cyprus have been forced to confiscate deposits. There is no Europe-wide deposit insurance and no Europe-wide system for resolving troubled banks. Negotiations have taken place aimed at creating a banking union, but the outlines agreed upon so far fall far short of true financial market integration. The countries have agreed to a modest fund for bank resolution, a requirement that national governments get involved if the fund is exhausted, and a requirement for unanimity among Eurozone members to approve using bailout funds to support banks. In other words, there will not be a strong central authority with the resources to support and resolve troubled banks. As such, this reform fails to do what is needed to harmonize credit market activity. Absent a more integrated approach, it is hard to see how credit market activity will heal quickly. It is also hard to see how the Eurozone can succeed in the long-term. It is increasingly evident that a successful currency union requires a different architecture than now exists. It requires integration of the financial system in which all banks are supervised and supported by a central authority with considerable resources and independent decision-making. This is not going to be the case under the plan now being discussed.

There remain considerable risks to the Eurozone. These include potential problems of sovereign debtors such as Greece; possible election of anti-European governments in key countries; failure of countries to enact major economic reforms that would boost productivity; and failure of Germany to boost domestic demand, thereby helping its European compatriots. Indeed much of the failure to reform the architecture of the Eurozone stems from disagreements between Germany and the other countries. Germany is worried that any joint liability involving financial institutions would effectively be a German liability. As such, it is reluctant to endorse a more integrated approach to financial reform.

The outlook across Europe varies by country. Here are some highlights:

United Kingdom

The UK is now being talked of as the fastest growing economy in Europe. Many analysts have been surprised by the pace of the recovery. Last August, the Bank of England expected the unemployment rate to stay above 7.0% until the second half of 2016. Since then unemployment has dropped sharply; it seems almost certain to fall below 7.0% in the coming months, two-and-a-half years ahead of the Bank forecast just eight months ago.

In its latest report the Bank forecasts that UK growth will accelerate to 3.4% this year, a very strong rate of growth for the UK. It would be the fastest rate in seven years and above the average rates seen in the decade before the financial crisis. Not only would it make the UK the fastest growing major economy in the industrialised world, it would mean that the UK outpaces a number of developing world economies, including Brazil and Russia.

A host of indicators suggest that we are at a turning point on investment. Firms do not seem to have very much spare capacity. A worn out capital stock and growing demand means that, at today's low borrowing costs, returns to corporate investment are likely to be attractive. Moreover, corporations have the wherewithal to invest. Corporate cash levels are high, albeit heavily concentrated in larger firms. More importantly, firms are finding it easier to raise funds from banks and from capital markets. Banks report that demand for credit to fund capital spending is at the highest level in six years.

The other factor behind the likely economic rebound is a continued recovery in consumer spending. After a four-year squeeze on earnings 2014 will be the year in which consumer spending power recovers. It is likely that the rate of growth of average earnings will accelerate significantly. Inflation is likely to drift lower, delivering a boost to consumer spending power.

Germany

Growth in Europe's largest economy is expected to accelerate in 2014, driven by a combination of rising consumer spending, business investment, and exports. The implementation of a minimum wage will boost consumer incomes, but will also cause a modest increase in unemployment.

Other aspects of the agreement of the governing coalition will have a negative impact on competitiveness. Germany remains highly dependent on exports of capital goods. A deceleration in investment in China could have a negative impact on Germany's economy. The revival of growth in the rest of Europe, however, will be helpful.

France

France has become the weakest link in the Eurozone. The economy is barely growing and 2014 is expected to be a weak year. Poor business confidence, engendered by a failure of the government to enact significant labor market reforms, will suppress investment. A partial reversal of the government's plans for very high tax rates has not convinced businesses to invest. France has lost competitiveness as productivity has lagged. Consequently, it is not experiencing the export revival seen in other Eurozone economies.

Spain

Spain is finally recovering from a long recession and growth in 2014 is expected to be modest. Spain's financial situation has improved, with bond yields now at relatively low levels. Fiscal austerity has been eased and the export sector is performing well following an improvement in competitiveness. On the other hand, the financial sector remains weak, with bank lending continuing to decline. The economy remains fragile.

Italy

Italy's longest post-war recession is finally ending, which is good news for the world's third largest luxury market. Moreover, the ascension of a new reform minded Prime Minister could lead to new efforts to reform the economy. The government is shifting away from fiscal austerity and towards more labor market reforms. In addition, Italy is gradually becoming more competitive, thereby boding well for export performance. The result is likely to be modest growth in 2014. On the other hand, Italy faces a number of

As 2014 begins, the US economy is recovering nicely after a prolonged period of modest growth. During the last two years, there were factors that held back growth. In 2012, the recession in Europe hurt the US recovery. In 2013, a severe tightening of fiscal policy in the US probably reduced economic growth by 1.5 percentage points. Yet in 2014, these factors will not play a role. Rather, Europe will be in recovery and US fiscal policy will have a modest positive impact on growth—especially now that the Congress has agreed to scale back the sequestration. In addition, there are a number of positive factors. These include rising overseas demand, increasing investment in energy production, pent up demand for household formation, and improvements in the functioning of credit markets. Indeed the economy has shown signs of strength. This has included continued growth of consumer spending, especially spending on automobiles. Significantly, it has also included a sizable rebound in the US housing market. Home prices have risen, sales of new and existing homes are up, and construction of residential property has risen. The strength of housing reflects low mortgage interest rates, declining unemployment, improved credit conditions, and the fact that private equity firms have invested heavily in foreclosed properties. The latter has contributed to the rise in property prices which, in turn, has enabled millions of homeowners to return to the market.

On the other hand, the US Federal Reserve has begun to taper its program of quantitative easing. This will entail reducing the pace of asset purchases. In the coming months, depending on economic conditions, the Fed will continue to cut back on asset purchases. Meanwhile, it will maintain a relatively loose monetary policy, keeping interest rates historically low for a longer period than previously planned. It will also take actions to boost credit market activity. Still, the tapering has already led to higher bond yields and mortgage interest rates. These can be expected to continue rising, putting some downward pressure on housing market activity.

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