Investment views

Where to focus in luxury and apparel

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What's in a brand?

Brands have the recurring power to fulfil the need to '**express ourselves**'. In a pivotal year, 2018 is the first time more than half of apparel and footwear sales will originate outside of Europe and North America. As consumer markets globalise, our equity analysts take a closer look at luxury and apparel and those companies which can meet the growing needs of the global consumer.

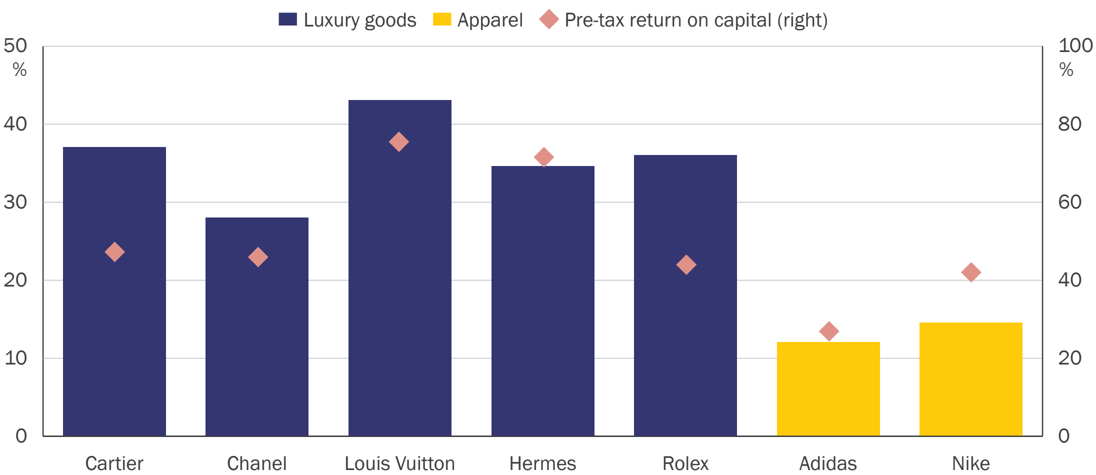
What we see from our research is that established and sizeable luxury and apparel businesses like **LVMH**, **Richemont** or **Nike** enjoy clear advantages. In summary, leading names in these sectors with ownership of dominant brands and a global platform for growth are able to drive **superior earnings growth** and **cash generation** vis-a-vis smaller competitors. These businesses will also be better positioned against future market disruption.

The winners take it all

The future sees dominant brands reaping greater rewards for their parent companies as the gap between leaders and laggards widens. Size allows leaders to tap into global demand for their products whilst smaller, second tier brands increasingly fall behind. This is the case for both the luxury goods and apparel sectors. In luxury goods, **age also matters** and we have identified a select number of brands with a distinct heritage and strong brand equity which affords them pricing power, namely **Louis Vuitton**, **Hermes**, **Cartier** (controlled by Richemont), **Rolex** and **Chanel** (both not listed). In the apparel sector, we think **Nike** still rules supreme with **Adidas** the only potential challenger.

Operating margins

The pricing power of dominant brands results in attractive operating margins.



Source data from this chart is taken from company financial statements as well as Rothschild & Co Bank AG equity research estimates

"The rise of big data can be leveraged by large brands"

Keeping customers satisfied

Traditional brand owners face a myriad of challenges given the rise of online retail, increased price transparency in the digital age and **rising consumer expectations** in terms of time, convenience and innovation. In order to meet these challenges and succeed, we think leading companies need to deliver:

- seamless, integrated off- and on-line distribution to customers; and
- a unique and differentiated shopping experience.

By getting the above right, companies can increase customer loyalty, maximize sales at full price and strengthen their brand equity.

As part of this trend, luxury and apparel businesses will continue to **integrate their business models**, rejecting sales to wholesalers in exchange for **greater direct sales** to consumers either via physical stores or their own online platforms.

It is important to remember that wholesalers often negatively impact brand equity and the ability to sell at full price to the end customer.

Integrated business models require physical and technological infrastructure which smaller players will struggle to finance. Large brands will also be able to **leverage big data**, to gain granular customer insights which helps them develop new products and increase sales penetration.

A positive growth outlook

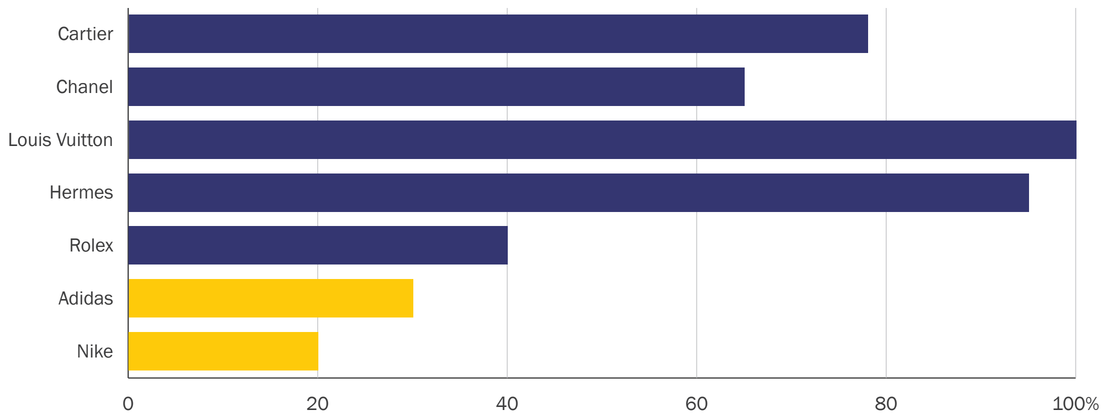
Consumer spending looks set to continue to outpace GDP growth, driven by **greater disposable income**, particularly in emerging markets. We therefore expect growth in the mid-single digits for providers of luxury goods and apparel.

Luxury goods will benefit from an increasing number of **high income consumers** as well as stronger pricing power for its most dominant brands.

The apparel sector is also well positioned to capture the benefits from the shift towards **healthier lifestyles** and increased participation in sports. In addition, we think the threat from a shift in consumer spending from material goods to experiences is exaggerated as up-and-coming and **aspirational consumers** initially focus their spending on material goods to showcase their growing status.

Share of direct sales

Leading brands are growing their share of direct (both physical and online) sales.



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“The digital age is acting as a great equalizer”

Seeking superior growth

The internet age is acting as a **great equalizer** with product information and prices just a click away whilst social media has reduced barriers to entry for new competitors. In this environment, leading players can focus and invest in **innovation and serving customers** with quality products. As a result, we think it is increasingly important that we invest in larger luxury and apparel players as they will be able to deliver **superior growth** over the medium- to long-term vis-a-vis smaller competitors. In particular we look for two characteristics:

- **Global reach**: A company’s global presence drives volumes given stronger pricing power. This should produce mid-to high single revenue growth;
- **Leveraging powerful brand equity**: Economies of scale help to generate even higher earnings growth whilst maintaining attractive returns on capital.

Conclusion

We have increased our conviction in luxury and apparel businesses held in our equity universe. **LVMH**, **Richemont** and **Nike** are all stocks that should continue to compound in the double digits whilst investors in smaller, sub-scale and less differentiated businesses put themselves at the risk of permanent capital loss.

For more information

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Important information