Making money on big spenders

By Barbara Wall
Friday, June 22, 2007

As the rich get richer and demand for the finer things in life beats forecasts in new markets like China and Russia, more investors are clambering aboard the luxury gravy train.

Uche Okonkwo, director of Luxe E.t.c., a consulting firm in Paris, said that 2007 looked likely to be an even better year for most luxury brands than 2006, when companies reported growth in revenue and profit of 20 percent.

"Indicators for 2007 so far suggest that many brands are achieving revenue returns at up to 50 percent higher than forecasts, which were considered to be quite optimistic," she said.

The emergence of an affluent and aspiring middle class in South Korea, Taiwan and China is driving sales in Asia, the fastest growing market for high-end goods. A report by Merrill Lynch predicted that the Chinese share of the global luxury-goods market would hit 25 percent in 2014, up from 12 percent now. Asia's love affair with top brand names is no secret, with Japan alone accounting for 40 percent of luxury-goods sales worldwide.
Okonkwo said she also saw positive trends in economies like the United States, which "is under-penetrated by top brands compared to markets in Europe." On the downside, she said, a strong yen could eventually prove problematic for companies selling to Asia. But she pointed out that several brands had raised the prices of luxury goods by as much as 10 percent without a noticeable effect on sales.

"Leather goods, accessories and jewelry remain the star income generators for most brands in both emerging and mature markets," she said. "Cosmetics are also seeing a revival, particularly in mature markets like Europe and the United States, where there is a strong focus on products made with natural and sustainable ingredients."

The brands that have done the most to capitalize on those trends, she said, include Fendi, Louis Vuitton, Stella McCartney and Daniele de Winter, a line of organic beauty products based in Monaco.

Okonkwo suggested that Internet marketing would redefine the way luxury brands do business and would act as a challenge, especially as consumers become more savvy. Companies like L'Oréal, Daniele de Winter, Coty Fragrance Group and Piaget "are investing heavily in e-business so that they can build intimate relationships with consumers worldwide without overexposing the brand," she said. LVMH and Gucci have their own e-logistics systems to manage multicountry distribution, although they have not yet adapted e-retail for the global market, which Okonkwo said would be ideal. Other companies have embraced interactive flash animation to give their products an edge online. JimmyChoo.com lets shoppers view its high-priced, high-heeled shoes on avatars with the same height and dimensions as the shopper.

These trends have not been lost on the investment community. Private equity interest is increasing - Permira has taken a stake in Hugo Boss, for example - and a flurry of initial public offerings is expected later this year from companies looking to raise money to develop a global customer base. Within 18 months, investors could be able to purchase shares in Moschino, Prada and Damiani, the Italian jeweler.

The fund management industry has also been quick to tap into the luxury goods theme. Early entrants include ING Groep's Prestige & Luxe fund, introduced in January 1998. Since then the fund's average annual return has been in the region of 30 percent. Credit Suisse Global Prestige fund has gained 28 percent since its inception in June 2006. Its largest holdings include Tod's Group, Swatch Group, LVMH, Porsche and Richemont.

A new contender is CHIC, brought out June 4 by Dominion, a Swiss investment management company. The fund will invest in about 60 companies, including luxury names like LVMH and Burberry, but also middle-market companies like Quiksilver and Safilo, an Italian manufacturer of sunglasses.

Alex Bell, chief executive of Dominion, has high hopes for the fund, whose goal is to attract $1 billion in its first 18 months. "CHIC appeals equally to men and women, which is unusual for an investment product," Bell said. "Many of our investors are already customers of CHIC's portfolio companies - or want to be. Try that with a hedge fund."

Bell acknowledged that the appeal of the luxury goods sector might also have something to do with its recent stock market performance. "Luxury goods companies tend to go down as a sector slightly less than the market, and move up faster when markets are on a roll," he said. When compared with the FTSE from June 2003 to June 2007, the back-tested performance of CHIC is substantially higher, at 70.63 percent compared with 44.22 percent for the FTSE.

Susan Tarry, a luxury goods analyst at Standard Life Investments in Edinburgh, agreed that the long-term fundamentals for luxury stocks were strong, but she cautioned that bargains were becoming elusive. "Bid speculation has pushed up the valuations of companies like Hermès to levels that are increasingly hard to justify," she said. She also expressed worries about the weak yen, which could depress demand from the important Japanese market.

Ralf Stromeyer, a consumer goods analyst with Allianz Global Investors in Frankfurt, said he shared some of Tarry's concerns. "Some companies are in a better position than others to exploit the growth characteristics of the emerging economies," he said. Companies he thought would stand the test include L'Oréal, LVMH, Richemont and Geox, an Italian footwear designer whose earnings are growing at 30 percent a year.

Jeroen Brand, an equity analyst at ING Investment Management in Belgium, suggested that investors might also want to consider niche players like EganaGoldpfeil, a German maker of high-end watches and jewelry. EganaGoldpfeil stands to benefit from strong demand for designer watches in Asia, especially Hong Kong. Brand also favored Dufry South America, which sells prestigious brands from a chain of shops located at airports and other tourist destinations in the region, on the theory that Dufry would benefit from an increase in tourism.