Fundamental Analysis Department

Consumer Industry Report on U.S. Luxury Goods

NUS INVESTMENT SOCIETY

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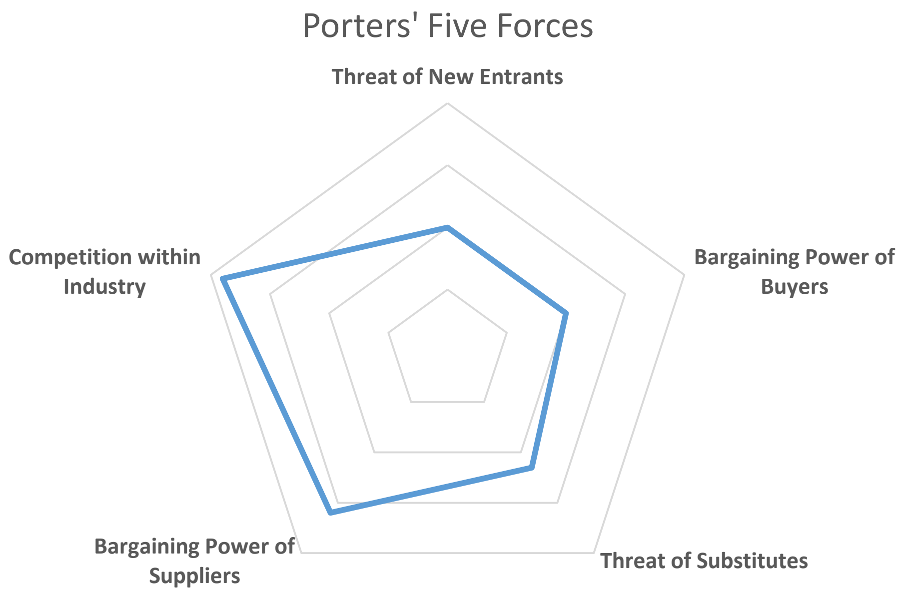
Introduction

The term "luxury goods" is often classified as goods that are not a necessity but are highly-desired within a culture or society. In other words, the sales of luxury goods are often driven by substantial brand power and the ability to evoke certain perceptions of reaching the upper echelons of society. The demand for these products is fuelled by desires rather than needs. Luxury brands are able to represent the upper class of society through their price as these products do not come cheap. An example is the brand Hermès. The prices of Hermès bags can range from over S$10,000 and up to S$400,000. In addition, waiting lists for these bags can stretch for years (Deborah L. Jacobs, 2013). The power of its branding is the central idea of the whole luxury goods business and pricing model.

Porter's Five Forces

To illustrate the overview of the industry, Porters' Five Forces is used in our analysis.



Threats of New Entrants: Low

The engine that drives the sale of luxury goods is its brand. People go for brands that have reputable statuses. The presence of strong brands creates brand loyalty of its consumers. As such, barriers to entry in this industry are generally high due to the difficulty in penetrating into the highly saturated luxury goods market. A newly entered brand that wants to compete with established brands such as Hermès or Coach would find themselves in a disadvantaged position as they are not able to compete with them in terms of demand. In addition, new brands would likely suffer from poor profit margins. Furthermore, given the large economies of scale that incumbent firms have, they are able to drive out newly entrants who lack the competency. Established luxury brands are able to minimize risk through diversification of their brand portfolio. Moreover, established brands that are listed in the stock exchange market (example Coach being listed in the New York Stock Exchange) tend to have more financing options.

Bargaining Power of Buyers: Low

Luxury goods tend to have a rather inelastic demand. Prices of luxury goods tend to be high even during an economic downturn. Despite having a bleak European backdrop of the past few years, the luxury goods industry has continued to thrive. (The Economist, 2014) In the luxury goods industry, a decrease in price will lead to a perception of a fall in quality of the product and a corresponding fall in demand. This is in stark contrast to normal goods, in which a decrease in price will lead to an increase in demand. (Bagwell, Bernheim, 1996) Rather, an increase in the price of the luxury goods will attract more customers who equate quality with price. Therefore, it is this unique quality of luxury goods that enable them to thrive even under unfavourable economic conditions. However, with that being said, it actually depends on the brand itself. High-end luxury goods such as Hermès and Louis Vuitton tend to have no discounts or promotions for their products while lower end luxury products such as Michael Kors and Coach have regular promotions and discounts for their products. So it ultimately depends on the brand. Lowering the price significantly may actually signal a drop in quality or old designs which may deter people from purchasing it.

Threats of Substitutes: Low

There are three main factors for the threats of substitutes: the price of substitutes, quality of substitutes and switching costs to consumers. It can be argued that there are virtually no substitutes for luxury goods as each brand is unique and cannot be replaced with another brand. Hence, even though non-luxury products offer the same functionality as most luxury products, due to the significant differences in brand perceptions, non-luxury products offer at a most a weak form of substitute to the luxury brands. Another point of concern for the luxury goods market is the increase in worldwide shipping of counterfeit goods from China. "Grade A" counterfeit products from China are arguably almost identical to the real product and often only experts are able to tell the difference between a genuine and fake luxury product. As such, consumers who are not able to afford the genuine product tend to go for these counterfeit goods that are similar in quality but much cheaper in price. However, we have assessed the impact of the proliferation of counterfeit products on the luxury goods market to be low. This is due to counterfeit products not evoking the same kind of elite status symbol that genuine luxury goods provide. Rather, users of counterfeit luxury products are always susceptible to the possible embarrassment if the product used was identified to a fake one. In fact, most consumers would choose to go for a lower end luxury product as compared to a counterfeit high-end luxury product.

Bargaining power of suppliers: Moderate

Many brands have acquired suppliers to protect their competitive advantage against other brands as well as to insulate themselves against future rising supply costs. As such, relationship with the suppliers is very important. Switching to a new supplier will also cause an increased risk of switching to a lower quality supplier. The number of suppliers available is also low for these luxury brands as many of their products require highly skilled craftsman. However, given that most luxury companies are huge conglomerates, they still tend to hold significant bargaining power over their suppliers.

Competitive rivalry within the industry: Moderate

Many of the brands do take competitive brands into consideration when setting prices. Different brands set different prices based on the quality and prestige each is perceived to be. This is due to the brand loyalty that each brand has. However, post financial crisis, the luxury goods market has carved out a new segment—the affordable luxuries such as Coach and Michael Kors. Unlike top tier brands like Hermès, these brands are considered to be at the lower spectrum of the luxury brand industry, competing more on price rather than exclusivity. As such, with the rise in middle income population who desire to own their own luxury brand products, the increase in sales for these lower end brands increases enough to provide competition for the higher end brands. (Lisa Wang, 2013)

Key Performance Determinants

Disposable Income

Disposable income is the amount of money that households have available for spending and saving after income taxes have been accounted for. It is often monitored as one of the many key economic indicators used to gauge the overall state of the economy. The reason why disposable income is a key performance indicator especially for the luxury goods industry is because the greater the disposable income of consumers, the more they are able to spend on luxury goods.

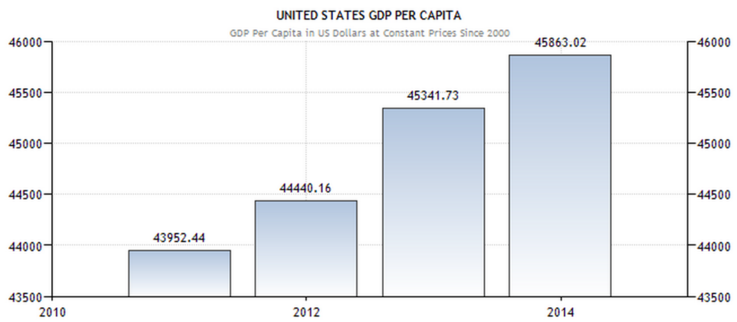
Unemployment Rate

Unemployment rate refers to the percentage of total labour force that is unemployed but actively seeking employment and willing to work. This is another key performance indicator for the luxury goods industry. With a lower unemployment rate of a country, it shows that majority of the people are having jobs. This also means they will be drawing salaries and hence being able to spend on the products or goods they desire. A lower unemployment rate also shows that the economy is doing well, the consumers' confidence is likely to be high and hence people are more willing to spend.

Gross Domestic Product (GDP) per capita

Lastly, GDP per capita is a measure of the total output of a country that takes the gross domestic product (GDP) and divides it by the number of people in the country. The per capita GDP is especially useful when comparing one country to another because it shows the relative performance of the countries. A rise in per capita GDP signals growth in the economy and tends to translate as an increase in productivity.

Figure A: US GDP Per Capita



Source: Tradingeconomics.com, US Bureau of Economic Analysis

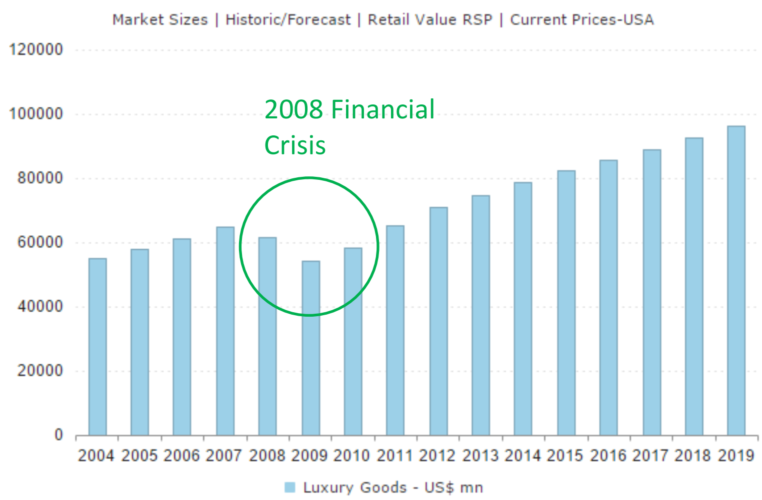
It can be seen that in Figure A, there has been a rise in GDP per capita for the US.

These 3 performance indicators are often used to relate to the luxury goods industry. A greater in-depth analysis will be done on how these 3 indicators affect the sales and demand in the luxury industry below.

Industry Drivers

The US luxury goods market was hit badly by the financial crisis in 2008 due to weak demand for luxury products. However, since 2009, the luxury goods sector has rebounded and is one of the strongest performing sectors to date.

Figure B: USA Luxury Goods Market



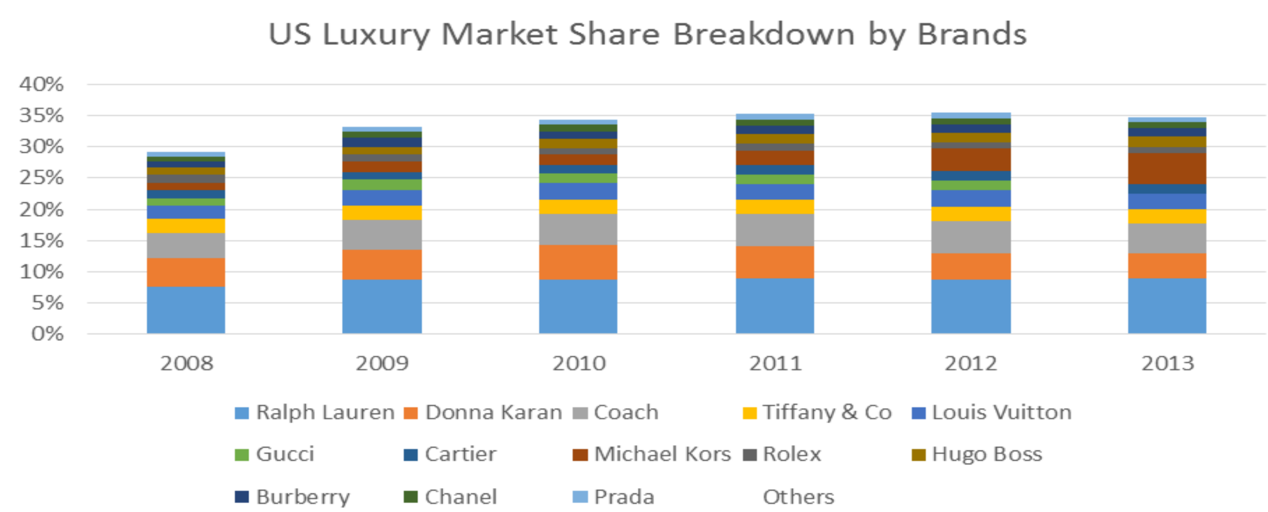
Source: Euromonitor

Overview

Ever since luxury goods sector bottomed out at the end of 2008, it has been growing at a remarkable CAGR of 7.86%.

Traditionally, income level has been the main growth driver for luxury products. Luxury goods provide a form of differentiation for the wealthy and the premium pricing reinforce the notion of exclusivity. However, when the economy collapsed in 2008, sales of luxury goods plunged as the number of wealthy individuals fell significantly, greatly reducing the demand for expensive luxury goods. However, the global growth trajectory since 2009 has seen the luxury goods sector grow at rapid rates. The three main drivers that contributed to this growth spurt are examined below.

Figure C: US Luxury Market Share by Brands



Source: Euromonitor

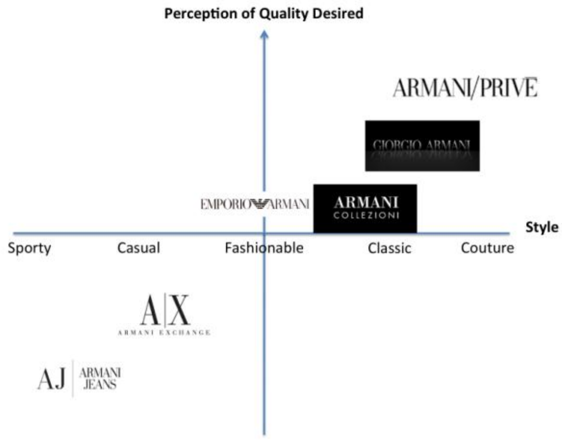
Key driving forces behind Luxury Goods sector growth

Market Segmentation

One of the key strategies to increase sales and reach out to more customers is to extend the portfolio of associated-brands.

The Armani Family as shown in the diagram on the right has a range of associated sub-brands that caters for a wide spectrum on consumers styles ranging from the "sporty" to the "couture".

Figure D: Armani's range of associated sub-brands

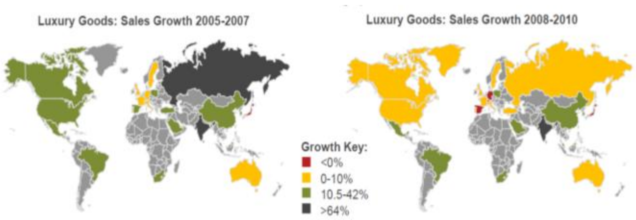


Source: Janaramorenna.blogspot.com

By performing segmentation, the brand is allowed to reach out to a wider variety of consumers without diluting the brand prestige or image. This strategy is especially important, as it allows the company to specifically target segments of available consumers. During an economic downturn, for example, brands with associated sub-brands can scale down on the businesses targeting the middle-income spenders, and subsequently ramping it up again when the economy recovers. Some other examples of brands that adopt market segmentation include Marc by Marc Jacobs and Purple Label collection by Ralph Lauren.

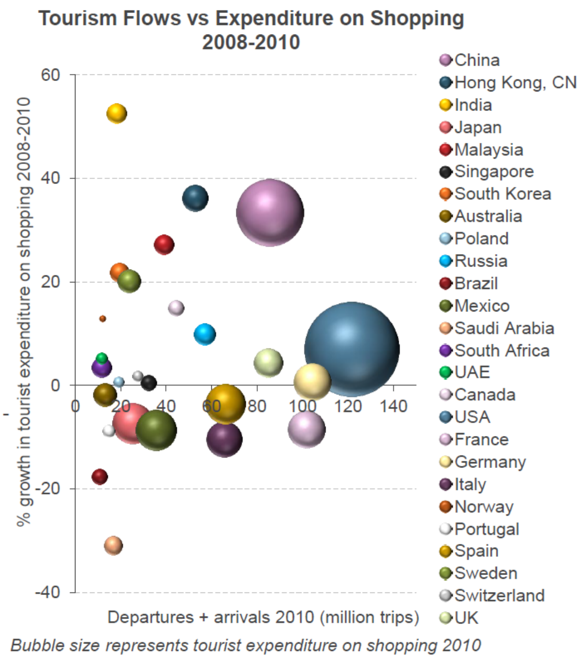
An alternative form of market segmentation is through opening more outlets stores as the same branded products are often significantly cheaper. According to Euromonitor, the number of full-price stores in Ralph Lauren's US market was reduced noticeably during 2012 while the number of outlets increased. Of the 350 standalone stores that Ralph Lauren operates directly, nine are flagships, 170 are full-price stores, and as many as 171 are outlets that are selling heavily discounted overstock and past-season products. Using this strategy, Ralph Lauren has continue to expand its market share from 9% to 10% the 4-year period.

Figure E: World Luxury Goods Sales Growth 2005 - 07 vs. 2008 -10 Period



Source: Euromonitor

Figure F: Tourism Flows vs. Expenditure on Shopping 2008 -2010



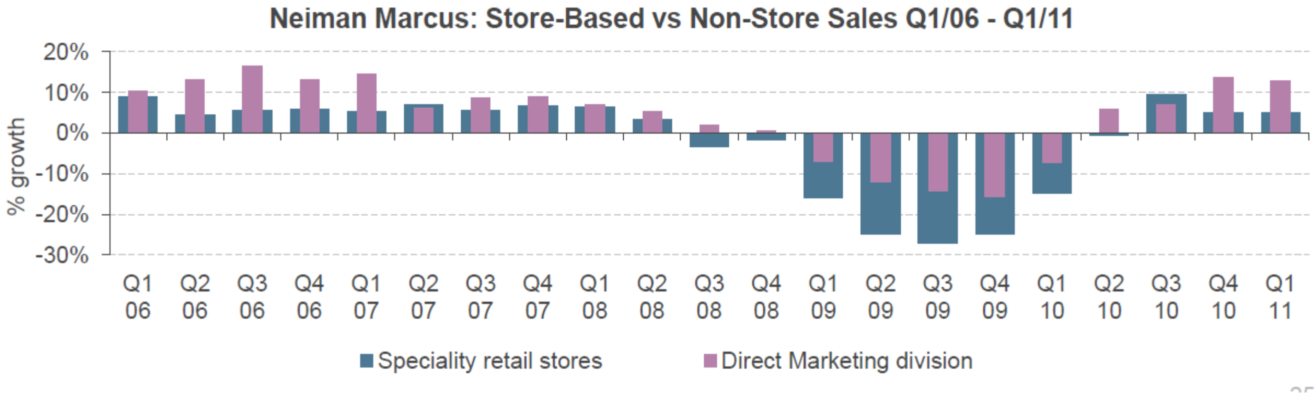
New Demands, New Customers

One clear message could be taken away from Figure E is that while most of the developed countries were experiencing sales decline, sales growth for luxury goods remained strong in BRIC countries. Coupled with stronger economic recoveries, the demand for luxury goods is considerably stronger in these countries even after the episode of financial crisis in 2008. Figure F has also shown that this stronger demand could have spilled over to other markets such as of the US. The Chinese tourists, especially, have been making more trips and the percentage growth in their expenditures on shopping have been as high as around 32%. We are expecting a significant percentage of their expenditures to be luxury goods since the Chinese tourists are famous for shopping luxury products overseas.

Another new group of customers that could have given US luxury market a boost is the new group of metro sexual men who are more concerned with their appearance than the women. This group of "pretty boy" as described by British journalist Mark Simpson, devote a lot time, energy and cash to look good. Due to the rise of male vanity, certain luxury categories that have been traditionally oriented towards women have already turned to gain share amongst men. Luxury bags for example; between 2006 and 2013, volume sales of men's luxury bags rose by over 56%. In the field of super-premium fragrances, retail volume of men's fragrances rose by 24% between 2008 and 2013. And despite the crippling effects of the recession, neither volume nor value dipped during that time frame. In contrast, volume sales of women's fragrances rose 17% in the same time period. Sales of men's luxury jewellery also outperformed that of women's in the same period in both volume and value terms.

Embracing E-commerce

Figure G: Neiman Marcus: Store based vs. Non Store sales 2006 to 2011



Source: Euromonitor

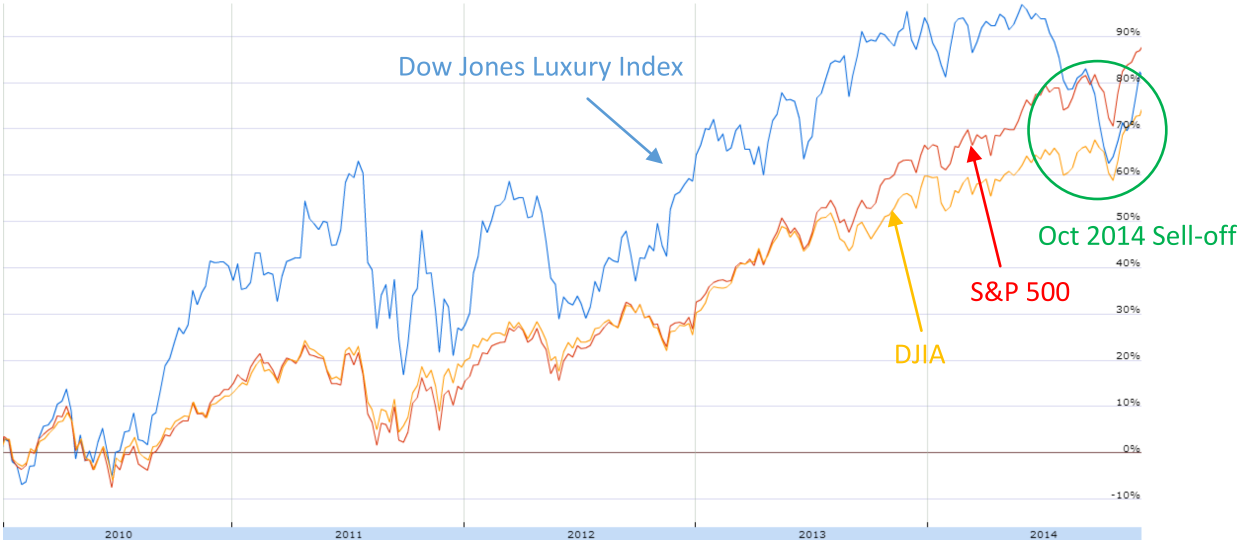
During the economic crisis, the non-store sales of Neiman Marcus, an American luxury specialty department store, have proved more resilient than its store-based operations as indicated by the slower to go into negative growth and quicker to recover trend. By 2010, the non–store sales had made up as much as 16% of the total sales. The obvious benefit of e-commerce is that it brings convenience to certain groups of potential customers such as the white-collars who can afford but are often tied-up with works. Another benefit is that E-commerce also helped to expose the luxury brands to more potential customers rather than opening more traditional stores which required significant capital outlay. These may have explained why online luxury retailing grew by 14% in 2013.

Gucci is one of the brands that have done well in e-commerce. It raised the importance of its online activity by branding its re-launched website in 2010 as its "digital flagship". In this sense, it suggested that its online stores will be in synced with the brand's image and purchasing online would not be any different from purchasing at its retail stores. In fact, many of the brands including Gucci have launched exclusive items that are only available online, bringing new exclusivity for its online shoppers. This gave the online shopper the same "exclusive feel" as when they visited the physical store. By 2014, it was already a leading brand on Facebook with 15 million "likes", has a good 1.33 million followers on Twitter.

Current Industry Outlook

Recent Dip in Luxury Sector, But Fundamentals Remain Strong

Figure H: Dow Jones Luxury Index vs. S&P500 vs. Dow Jones Industrial Average



Source: Google Finance

The luxury goods sector has historically performed better than the average stock, beating the S&P500 and Dow Jones Industrial Average consistently over the last five years. The strong luxury sector can be attributed to the rising average consumer incomes across the US and solid employment data. However, the recent sell-off in October 2014 saw luxury stocks plunge below the S&P500 for the first time in the last 4 to 5 years. We believe these worries are unwarranted given that the fundamentals of the luxury goods sector remain strong. On the contrary, the recent sell-off have provided opportunities for investors to pick up luxury good stocks at bargain prices, which we shall elaborate in our stock pick section below.

What Happened to Luxury Stocks during the Recent Sell-Off

The recent sell-off in October 2014 was triggered by global growth concerns as Federal Reserve Officials hinted at delays in interest rates hikes. A delay in interest rate hikes represent that the Federal Reserve does not believe that the global growth recovery can be sustained without the low interest rates environment. Consequently, investors view this negatively and reacted via a flight to safety to safer investments and asset classes. Luxury products increase in demand under good economic conditions and high levels of consumer income. In addition, luxury stocks typically fare worse than the average stock in an economic downturn, since consumer sentiment tend to be low and the demand for luxury products is low. As such, October 2014 saw investors selling away their portfolios in luxury goods to take on safer investments, such as more defensive stocks (e.g. consumer staples) and safer asset classes such as high grade corporate bonds or government bonds.

However, the sell-off remains unwarranted as overall US consumer data remained strong across the year. In addition, there was no major upheaval in the financial markets or structural change in the economy to present a persistent economic downturn in the next financial year. Rather, the negative investor sentiments were built on unfounded worries due to the previous scare of the financial crisis in 2008. We see this as a good opportunity to take up positions in luxury goods stocks now as we predict that luxury stocks will go back to its previous levels prior to October 2014.

Fundamentals of Luxury Goods Remain Strong

Strong US fundamental data have supported our thesis that the luxury goods sector remains positive. This is evident from the three elements of US consumer data to be discussed below, namely the high levels of disposable income, high consumer spending and low unemployment rates in the US.

Strong US Disposable Income Data to Support Luxury Sector

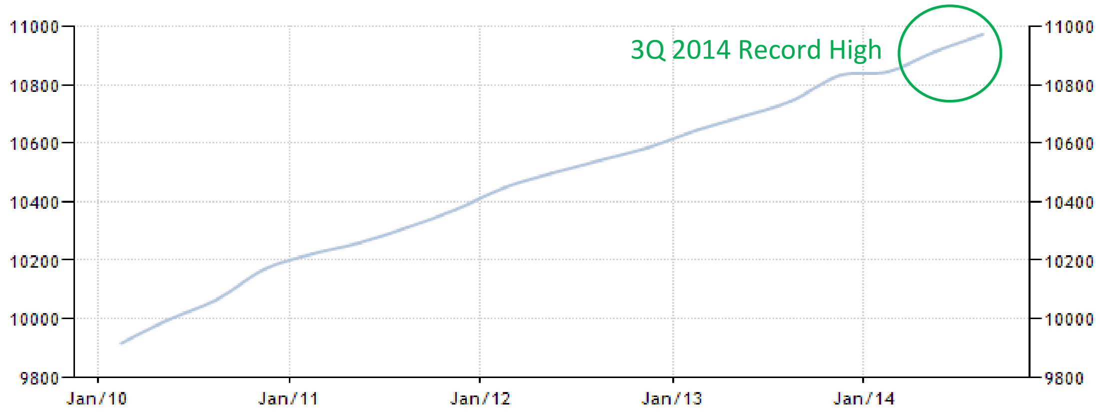
Figure I: US Disposable Personal Income

Source: Tradingeconomics.com, US Bureau of Economic Analysis

The luxury goods sector is driven by HENRYs, which represent High Earners Not Rich Yet. This term refers to households earning between US$250,000 to US$500,000. This sizeable group reflects the potential consumer base in the luxury goods segment that is currently able to afford mid-tier luxury but are unable to afford hyper-luxury goods such as Hermès. The strong rise in US disposable personal income over 2014, with a record high of 13,118.40 Billion USD attained in August 2014 presents huge growth potential for the luxury goods sector. With a surge in the number of HENRYs in 2014, greater luxury spending is expected in the next year notwithstanding unforeseen economic conditions. Given the positive growth trajectory of the US economy, these HENRYs will move on to become tomorrow's consumers of today's luxury brands.

Higher Levels of Consumer Spending

Figure J: US Consumer Spending

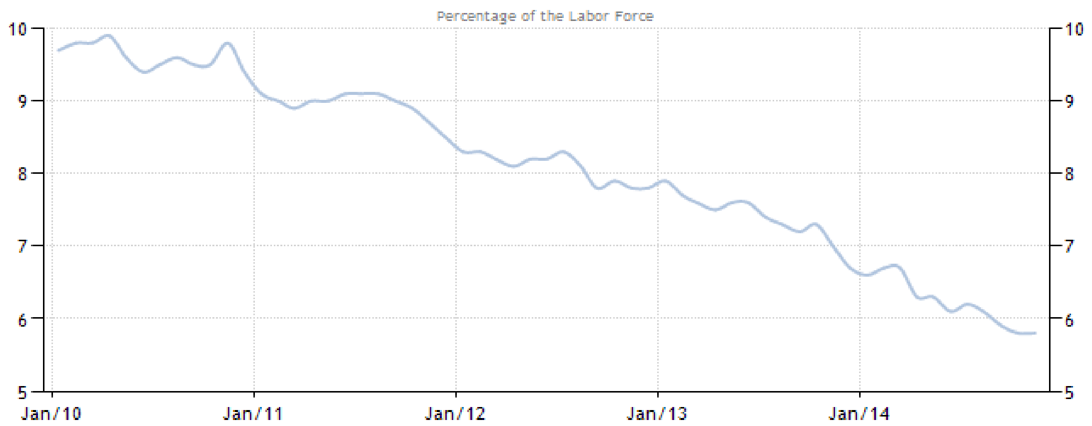


Source: Tradingeconomics.com, US Bureau of Economic Analysis

Consumer spending plays a huge role in supporting our luxury segment growth thesis. US has seen higher levels of consumer spending in 2014, reaching a record high of 10,972.1 USD Billion in the third quarter of 2014. The high levels of consumer spending suggest positive consumer sentiment. This is particularly important to the luxury goods sector as luxury good companies typically fare better under good economic conditions. High consumer spending also indicates that consumers perceive sound financial conditions to continue in the near-medium term. This indicates that luxury goods companies should continue to enjoy the high annual growth rates in their profits as seen in the past 5 years.

Low Unemployment Rates

Figure K: US Unemployment Rates



Source: Tradingeconomics.com, US Bureau of Economic Analysis

Unemployment rates have reached an all-time low of 5.8% in the last 5 years. Low unemployment rates suggest soundness of the economy and economic stability. While low unemployment rates are not a direct key driver for luxury goods, it supports our luxury growth thesis by maintaining strong consumer sentiment and a positive financial outlook of the US. We posit that the low unemployment rates will allow disposable income to increase as well. As such, the low unemployment rates present a positive outlook for the luxury sector as a whole, and luxury spending should continue to remain high. As such, we expect net profits of luxury brands to continue to grow under such favourable economic conditions. The recent sell-off presents greater opportunities for investors given that investors are now able to own the underlying businesses of these luxury stocks at more attractive valuations.

Stock Profiles

Michael Kors Holdings Ltd (NYSE: KORS)

Current Price: USD$76.70

Company Description

Michel Kors Holdings Limited is a global luxury lifestyle brand. The company operates in retail, wholesale, and licensing with a strategically controlled global distribution network focused on company-operated retail stores, leading department stores, speciality stores and select licensing partners.

Table 1: Key Financials and Ratios of Michael Kors Holdings Limited

Key Financials	
Market Cap (mil)	15793.4
Shares Outstanding (mil)	203.93
Free Float	198.59
52-Wk High	101.04
52-Wk Low	68.25
ROE	46.37%

	2012	2013	2014
P/E	58.73	28.86	28.77
P/B	19.68	10.92	10.49
ROE	43.38%	52.89%	46.37%
D/E	4.97%	-	-
EBITDA	285.2	684.3	1087.8
EPS (USD)	2.02	3.27	3.85
DPS	-	-	-

Source: Bloomberg

Strong Domestic and International Growth

Michael Kors is the epitome of an international fast-growing luxury brand. Top US retailers such as Macy and Piper Jaffray have named Michael Kors as one of the most popular brands in the luxury consumer market, and this claim is definitely backed by the company's outperformance in their financial results. In the latest quarterly earnings announcement, Michael Kors Holdings reported a 42.7% year-on-year increase in second quarter revenue to $1.1 billion in 2014. Strong growth performance can be attributed to a 29.8% increase in sales within North American, which accounts for a lion's share or 72.9% of global revenue. International operations also saw a corresponding increase in the top-line despite gloomy macroeconomic outlook. Michael Kors has been seeking to increase the contributions of international sales to total revenue, and this move has started to pay off. Revenue grew tremendously in both the European and Japanese market – revenue from Europe surged by 108.6% to 237.9 million, and revenue from Japan increased by 106.3% to $16.5 million. The company aims to further expand their presence in China, Korea, Southeast Asia and Australia from the existing 116 retailoutlets to approximately 200 in the long-term.

In the Pink of (Financial) Health

The company is also in the pink of health with strong revenue growth, coupled with healthy cash flows and zero debt. The company is generating substantial cash flows from its operating activities, and most of it is channelled towards capital expenditure to fuel future growth through international expansion. With stable cash flows and a lack of debt in its balance sheet, the company will be able to borrow easily in the future to finance any growth investments. Michael Kors should not be facing any financing problems when exploiting global growth opportunities in the near future, suggesting that the company's capacity for growth is indeed intact.

Cheap for Growth Prospect

With a spotless track record for outperformance and a promising growth prospect in the near future, KORS is only trading at a price of 20.2x earnings – slightly above the average PE for S&P at 19.5. Historical PE ratio for the past two years has been around 28x earnings, and the current valuation is near the all-time low. Forward PE might be more relevant in evaluating a fast-growing company like KORS. With a forward PE of 16.6, KORS is cheaper than industry average forward PE of 18.2. The management also recently announced $1 billion dollar share repurchase scheme over the next two years, suggesting that management might agree to the view that the company's equity is indeed undervalued given its growth prospects.

Conclusion

Considering the company's track record of revenue outperformance, and the strong growth potential for the years ahead, we believe that KORS will continue to outgrow its peers in the near future as it seeks out more opportunities for expansion. At its current valuation, we believe that KORS is an excellent pick for growth investors seeking exposure to the recovering US economy.

Coach, Inc (NYSE: COH)

Current Price: USD$34.46

Company Description

Coach, Inc. designs, produces, and markets primarily leather goods. The Company's products include handbags, business cases, men's and women's accessories, luggage and travel accessories, leather outwear, and gloves. Coach, together with a licensing partner, offers watches, footwear, fragrance, and eyewear.

Table 2: Key Financials and Ratios of Coach, Inc

Key Financials	
Market Cap (mil)	9496.8
Shares Outstanding (mil)	275.59
Free Float	273.01
52-Wk High	56.88
52-Wk Low	32.72
ROE	21.72%

	2012	2013	2014
P/E	16.96	15.33	11.06
P/B	8.37	6.68	3.91
ROE	36.20%	31.17%	21.72%
D/E	1.17%	0.04%	4.80%
EBITDA	1644.9	1687.5	1309.4
EPS (USD)	3.6	3.66	2.81
DPS (USD)	0.98	1.24	1.35

Source: Bloomberg

Stiff Competition in North American Market

Sales declined by 5.3% from $5,075 million in 2013 to $4,806 million in 2014, primarily due to strong competition in the North American home market from fast expanding luxury brands such as Michael Kors (KORS) and Kate Spade (KATE). Coach's revenue from the North America accounts for approximately 65% of total revenue, and in the last quarter, the figure fell by an astounding 26.1% year-on-year to $221.5 million. Fast growing luxury brands have seemingly outflanked Coach in terms of sales and marketing as the company reduced promotional events in the region as part of its effort to control cost. It is definitely a worrying sign, in view of an expanding consumer discretionary sector in US, that Coach is experiencing a decline in its domestic top-line figure. Moreover, its market share has also shrank from 5.10% in 2012 to 4.90 % in 2013. We believe that Coach will continue to underperform as sales in North America languish under increasingly stiff competition for other Europeans and American brands.

Low Valuation

At the current market price of $34.46, COH is trading near its 52-week low. Despite declining revenue and a bleak growth prospect, the current PE ratio of 12.1 – significantly below average industry PE of 20.5 – might present an attractive entry point for value investors. The cheap valuation, however, can be justified by the consistent underperformance through the past three years. In view of the persistent current struggles that the company is facing in expanding its sales, we believe that the fundamentals of the company will remain relatively weak in near future.

Potential Acquisition Target

The underperformance and low valuations of COH presents an opportunity for competitors to acquire the company. It has been rumoured that in the past year, Kering, a French luxury goods holding company that owns Puma, Gucci and etc, had intentions of acquiring Coach. Few weeks ago, LVMH, the holding company of the consumer luxury brand Louis Vuitton, expressed its interest in COH. The news of this acquisition sent the share price of COH up 3.5% in a day, and potential developments could further drive up the share price.

Conclusion

As Coach struggles to repair its brand and turn-around the business, we recommend a “wait and see” approach for the time being. Although the multiples of the company are low, we believe that they are low for a fundamental and persistent reason – which Coach is unable to compete with younger and faster growing luxury brands. A potential acquisition could potentially bring up the value of the stock, but such a strategy would be a risky play.

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