Bags of Potential

I gave you your style, Gucci this Fendi that
Burberry bag, shoes, and the hat to match
"After My Chedda" – 50 Cent

Here at Lindsell Train we don't think of ourselves as having a great deal in common with 50 Cent, but we do share an unashamed enthusiasm for luxury brands and a liking for Burberry too! So, this is a piece exploring the reasons why we like luxury – but perhaps more importantly, it's also a piece about why luxury brands are now more relevant than ever. This is critical given our objective to invest in the right brands and the right industries to weather the global technology changes already well underway. In fact, we have said for some time that the most important thing we face as investors is the potential for new technology to disrupt industries and erode moats, and if anything we believe that this is an even more urgent concern as we go into 2019. Take the way Amazon is re-drawing distribution channels and working to make the least valuable brands redundant – indeed, Jeff Bezos has explicitly said that "Your margin is my opportunity."

Strong stuff. But we don't believe that this means that all brands are at risk, so we need to identify brands which are so desirable that no matter how people shop or receive advertising, they'll always want them. An important component of this idea is luxury. We like the way that these products tend to combine long and often storied heritages with perennially desirable brands. Hermès, Louis Vuitton and Burberry are all more than 150 years old. As 50 Cent admirably demonstrates, these brands have entered the public consciousness as a shorthand for aspiration and achievement. And authenticity unquestionably matters. A newly minted millionaire doesn't want to buy a fake item – there's no pleasure in that. It has to be the real deal. Luxury is also a way to access global wealth creation: as the middle classes grow around the world, so will their increasing demand for these aspirational goods. According to a report by Bain Consulting, on a global basis Chinese nationals accounted for roughly one in three personal luxury purchases in 2017. An encouraging stat, especially when considered alongside the fact that in 2018 the Chinese luxury spend per capita was just €60 – much lower than the figure of €176 in the USA and €205 in Japan. Lots of room for growth.

With all this in mind, we have had a number of luxury fashion names in our universe for many years, and have held a position in our UK equity portfolios in Burberry since 2008. I've spent the last six months conducting a deeper study of all the substantive quoted luxury companies we can find. In particular, I wanted to find out whether anything has changed in the luxury industry's approach to digital. For some time the industry as a whole has been frustratingly immune to the march of technology and the need to adapt. Some companies have been slow to adopt digital strategies, preferring instead to fall back on the argument that luxury products are reliant on the customer being able to touch and see them, and that digital can never offer an equivalent experience. Back in 2013, Céline's Phoebe Philo told Vogue that "the chicest thing is when you don't exist on Google." And Prada didn't even have an ecommerce site until 2016, because according to its marketing director, "the shopping experience has to remain immaculate and in-store."

We have long thought this short-sighted. Our investment thesis for Burberry is overwhelmingly underpinned by its fantastic 163 year old heritage and reputation for combining superior quality with fashionable design, but we have also been impressed with its commitment to investing in digital marketing and building out ecommerce capabilities at a time when its peers failed to see the wisdom of this. However, last year more luxury fashion companies appeared to be waking up to the potential of digital and its ability to tap into a new cohort of millennial consumers: 50% of Gucci's sales now come from consumers aged 35 and under. Saint Laurent, included like Gucci in Kering's stable of brands, has an even larger proportion at 65%. Burberry now has 40% of all its ecommerce revenues coming from mobile – admittedly still a small amount given the still modest sales from ecommerce, but remarkable given that several years ago it was doubtful whether consumers would even want to shop for luxury items online, let alone on a very small screen.

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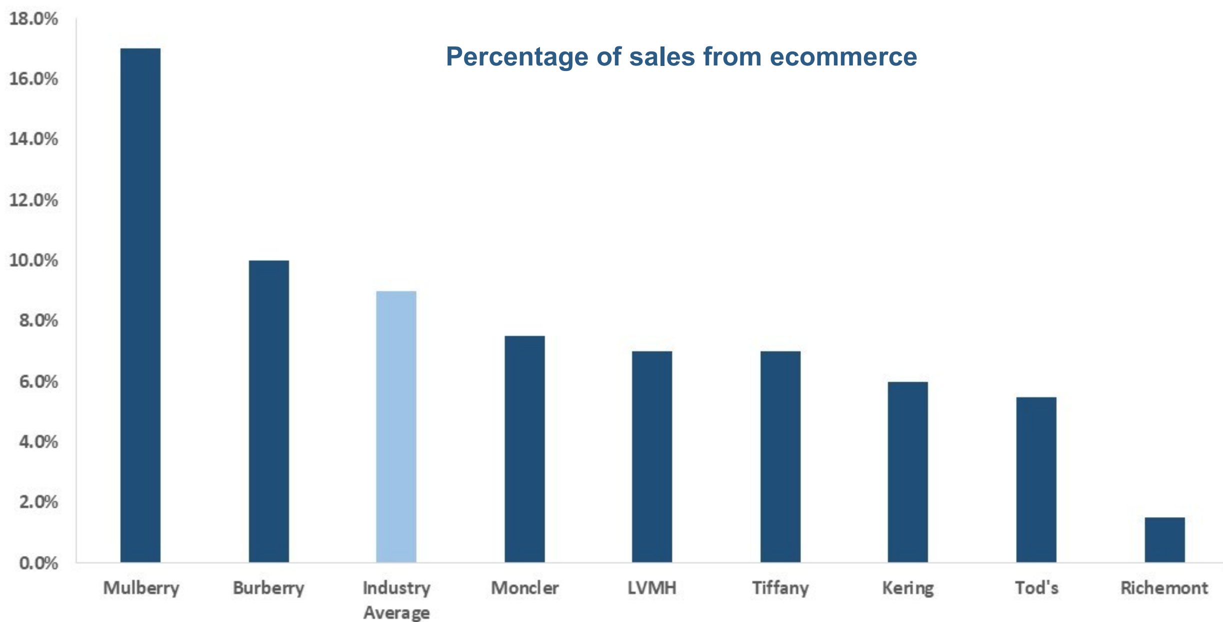

Data for 2018-2019 from available sources.

I also noted with interest the recent explosion of luxury Chinese ecommerce sites – last October French luxury house Hermès launched its own Chinese ecommerce website, following in the footsteps of Louis Vuitton and Gucci. Admittedly, Hermès' signature Birkin and Kelly handbag ranges (starting price: $11,000) are not available online – but a wide range of clothing, leather accessories and lower priced handbags are. Arguably so-called "hard luxury" watch and jewellery makers are even further behind in terms of digital – Cartier and Van Cleef & Arpels owner Richemont has just 1.5% of group sales from ecommerce. Nevertheless, I saw encouraging signs that these brands too are waking up to the potential of digital: Richemont took full control of luxury ecommerce site Yoox Net-a-Porter in 2015 and today 40% of its group marketing spend is on digital.

So a widespread embrace of digital was my first, rather cheering, finding. The second finding – and I hope it won't be too much of a contradiction – was that more than ever, experience is critical for luxury. Brands have to find creative ways to marry the digital and physical browsing and purchasing experience. We welcome the potential for higher returns on capital that luxury companies can capture as they increase their share of revenues from ecommerce and reduce their physical store footprint – this has already begun happening at Burberry, which closed a net 20 "non-strategic" physical locations last year in order to focus on more premium "high visibility, influential fashion markets". Yet I think it unlikely that luxury fashion brands will ever be completely online – the flagship store has an enduring power as a marketing tool. In the most recent results statement Burberry CEO Marco Gobbetti noted that the company still has "more than one kilometre of windows around the world", highlighting the importance of the tangible as a showcase. I'll return to Hermès' Birkin and Kelly bags as a great example of why retaining physical store locations remains so important. A mystique has sprung up around the process of acquiring these bags, as they aren't sold online and stock is kept deliberately low. The exact method of getting your hands on a bag is much debated in fashion forums, blogs and even in Vogue ("as many customers know, it can be very hard to get hold of a Hermès bag directly from the brand"), but fundamentally, according to one blogger, "You have to be offered one. And to be offered one, you should have a good relationship with your sales associate."

My third and final finding was that luxury has a remarkable halo effect. Looking across our portfolios, I believe that all consumer goods companies – whether mass market or not – can benefit from that halo effect of luxury or premium exposure in their own portfolios. We closely monitor our investee companies for evidence of this happening within their portfolios. This is timelier than ever. The Financial Times recently reported that in the US, collective revenues at consumer goods companies with annual sales of less than $5.5bn, together with private label suppliers, increased 15% between 2013 and 2018. That was more than twice as fast as the 6.5% collective revenue increase at the bigger groups. In short, smaller companies are accelerating revenues and private label penetration is increasing – and large consumer goods makers run the risk of being disintermediated and left behind.
We are asked often whether or not we think companies such as Unilever are falling behind, with many of their brands being gradually commoditised. Our answer is no: we think these portfolios are already

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populated with excellent and resilient core mass market brands. Unilever's Marmite is one such brand – the managing director of buying at Aldi, who knows a thing or two about private label, has admitted that "nobody has yet managed to launch a successful private-label yeast extract product". And I don't think that all brands should aim to become luxury, as mass market items are just as capable as luxury brands of being beloved. But we are excited to see mass market consumer companies embracing luxury as a percentage of their product mix, and are reassured that Unilever's management are taking rational action against the threat of tech change. Last year it sold out of its commoditising margarine business (at a healthy 2.3x enterprise value to sales, reflecting its continuing excellent cash generation – even these brands are not exactly dead in the water), and made 15 new acquisitions, including a number of upmarket skincare and makeup brands. I cannot mention cosmetics without a nod to our Japanese portfolio company Shiseido, which recently reported 8% of overall sales from ecommerce and an impressive 26% of that from China. With a target of 40% in China and 15% overall by 2020 there is still some way to go, but it's clear that luxury cosmetics lend themselves well to ecommerce and digital marketing and we are encouraged by Shiseido's enthusiastic adoption of both. Since the 2014 implementation of their strategy prioritising the premium global brands and ecommerce, Shiseido's share price has more than quadrupled in value.

Our beverage companies are doing the same portfolio pruning and tuning up. We continue to monitor the composition of our drinks portfolio holdings and are encouraged by their recent success in premium – Diageo's Reserve portfolio of its most premium bottles is now a solid 18% of revenues, up from just 5% in 2011. The pace of growth of these premium brands is accelerating – Reserve saw 14% year on year growth between 2017 and 2018, and 29% in Asia Pacific in the same time frame. Just to give you an idea of why this region is important, here's a stat: in China last year, two new billionaires were created every week. And that's on top of the existing three and a half million millionaires. That's a lot of spending power for luxury companies to take advantage of.

I also notice some overlap between Diageo and Hermès's strategies. While it's not yet necessary to prove your worth to your local off-licence proprietor to get your hands on a bottle of Johnnie Walker Blue, Diageo CFO Kathryn Mikells told us that this brand is never discounted and that management has actually taken the decision to constrain the supply to force up pricing. The demand is there (net sales of Johnnie Walker Reserve variants were up 8% in 2018) but we are encouraged by the fact that Diageo – like Hermès – recognises that scarcity is better for long term brand health. In addition, late last year management announced the sale of 19 small, non-premium brands. We think this is great news – again, a sign that the company is really committed to the strategy of increasing its portfolio exposure to premium.

Another of our beverage holdings, Rémy Cointreau, is also starting to look more and more like a luxury brand. The current CEO's background is actually in luxury fashion – she ran Louis Vuitton USA – rather than beverages, and the flagship product, Louis Treize cognac, is priced at an eyewatering £150 per glass. And true to the idea of luxury continuing to be an experience, Rémy has now opened three Louis Treize stores, which act as flagship locations – just like a luxury fashion store. Diageo is doing something similar with Johnnie Walker, opening the very first "experiential flagship store" in Madrid late last year. In the 21st century digital is increasingly important, but the tangible experience of a brand is still incredibly valuable. I think it's indicative of the power of trading up that the really premium beverages are now considered sufficiently luxurious to occupy their own physical flagship spaces.

To finish, some comments about what we've done as a result of this work. We have gained comfort about the whole luxury space's resilience and potential to use digital and tech change to its advantage, as well as the benefits of including luxury in mass market brand portfolios. We confirmed our confidence in the existing names in our global universe, and have added Moncler and EssilorLuxottica to the list. We continue to watch the global luxury market closely and are ready to take action if any name should present an opportunity. The recent 30% fall in the price of Mulberry meant it became a serious contender for the UK strategies, but its 70% family and other firmly held ownership presents a liquidity restraint. In the meantime we (and hopefully 50 Cent) happily continue to buy Burberry, Shiseido, Remy and Brown Forman.

Madeline Wright
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Sources: Bain Consulting via Forbes; Burberry; Business of Fashion; CPP Luxury; Diageo; Financial Times; Kering; Moncler; Morgan Stanley; Mulberry; Prada; Richemont; Shiseido; The Guardian; The Times; Tiffany; Tod's; Vogue; www.lifeofjenna.com.

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