Some fundamentals that investors need to look at when eyeing the luxury goods business

By Alan Lok, CFA, Eunice Chu and Gururupasad Jambunathan

Because you’re worth it: understanding luxury retail

Global reach
From a technology perspective, review the firm’s social media presence and pay attention to its preferred channel, as this can tell you a lot about its target audience – Instagram is aimed at under-30s, whereas Facebook has a broader demographic. Looking ahead, ask if the firm grasps how e-commerce affects its sales and does it have a strategy to increase the revenue from home shopping?

We shouldn’t forget, however, that although the Internet makes the world feel smaller, each region still has different tastes. So, establish the geographical importance of the company’s outlets and the pricing structures across different geographies. Which products are the most popular in each location? You may find that a company with a higher exposure to the developed world has stagnating sales, but a firm with a strong presence in China, for example, is experiencing a surge in activity.

Environmental, Social and Governance (ESG)

The luxury retail sector, with its soft focus on making life more pleasurable, does not automatically spring to mind as an industry that needs to focus too closely on ESG factors. However, underneath the cashmere coating, it faces the same challenges as any other part of the economy.

Here are some areas to explore. Look at a company’s energy, electricity, water use and waste generation – has it invested in ways to improve performance on these fronts? What is the company’s policy on sourcing raw material from conflict zones? Does it ensure that the extraction and sourcing of this material is done in a lawful, fair and sustainable manner? From a labour perspective, can it provide evidence that it treats its employees and suppliers fairly? Finally, it’s vital to know if the company directly or indirectly employs child workers.

As always, these guidelines are designed to provide you with a short, but solid, foundation to kick-start any future analysis. So, put your feet up on that expensive Italian leather sofa, relax and start your in-depth journey through the sector.

This column is an excerpt from the joint research of CFA Institute, Association of Chartered Certified Accountants (ACCA) and CRISIL, entitled “Sector Analysis: An Investors Framework”. The excerpt is printed here with permission from the three organisations. A full version of the research will be published on CFA Institute Asia-Pacific Research Exchange at www.ARX.cfa.

CFA SINGAPORE INSIGHTS
By Alan Lok, CFA, Eunice Chu and Gururupasad Jambunathan

Because you’re worth it: understanding luxury retail

DOPAMINE. It’s the pleasure-inducing brain chemical released when we treat ourselves to something new. And the surge of elation we get when we go to the cash desk and discover there’s an additional 30 per cent discount? Well, that’s the dopamine kicking in BIG time.

We’ve all been fully aware of this reward-motivated behaviour, but none more so than the luxury goods branch of the industry.

Chasing a dream
When compared with other industries, the luxury retail business model certainly has some unique characteristics. For a start, its demand curve is not downward-sloping. In other words, demand does not always increase with a decline in price – in fact, one of the industry’s key tricks is to raise the average cost of an item — the rationale being that higher prices keep the middle class (the target customer group) chasing the dream of luxury.

Have you seen his Rolex?
Contrary to typical offerings from other industries, a luxury brand’s image is not solely pushed at potential consumers. Massive communications to non-target groups are also crucial. Product admiration from others creates a sense of social and economic superiority among actual consumers – the glint of a Rolex under a starched cuff impresses strangers and makes the owner feel wonderful. Indeed, anything that enhances this sense of uniqueness will help to boost sales.

Brand protection
Maintaining full control over the value chain, as well as distribution channels, is a necessity rather than a choice. There are countless real-life examples of quality names that have been tarnished at the hands of franchisees or appropriated by non-target groups. Burberry still has an image problem in the UK because it became the brand of choice for lower socio-economic elements of the population. When compared with other industries, the luxury retail business model certainly has some unique characteristics. For a start, its demand curve is not downward-sloping. In other words, demand does not always increase with a decline in price – in fact, one of the industry’s key tricks is to raise the average cost of an item — the rationale being that higher prices keep the middle class (the target customer group) chasing the dream of luxury.

In many situations, the functionality of the product itself is secondary. After all, Jimmy Choo sandals and slip-on Crocs serve precisely the same purpose, but the latter would look strangely out of place at the Oscars. Service delivery is far more important. Essentially, the entire business proposition means adhering tightly to the above set of strict principles to preserve the uniqueness of the luxury item and trigger enormous brand “stickiness.”

From an analyst’s perspective, this can sometimes be a tricky business model to grasp. Many of us are, perhaps, rather sober in nature and not easily swayed by the ephemeral glitter of high-end consumerism. A safe bet, therefore, is to examine the companies in this sector as we always do – logically and with an inquisitive mind.

Priced to perfection?
A good place to begin your journey is by understanding the company’s profile and where in the luxury retail chain it operates. What unique value proposition does the company offer to customers?

Ascertain the discretionary and non-discretionary demand for its products and services. At the same time, establish which of the company’s product categories is most sensitive to price changes. These could be affected by long-term demographic, macroeconomic and geographical factors, so get to know what these are. For example, what is the average age and level of wealth in consumers in the company’s key markets? Is this expected to change? Importantly, does the firm undertake segmentation of it’s customer base? If so, what dimensions does it use? These could include specific product lines/brands/strategies that target different groups. With regard to price, what is the company’s strategy for different products, and which of these offerings are most immune to price changes? Do past trends support this?

Sales counter
In terms of sales, does the company provide a detailed breakdown of its performance in terms of volume and price? Similarly, check if it generates growth by same-store sales, net additions, inorganic growth and foreign exchange impacts and explore how this trend will evolve. Linked to sales are the various elements that drive the firm’s cost profile and how it manages these. What are the company’s gross, operating and net margins? This information will prompt you to find out more about the business’s profitability and cash position versus its competitors.

Recognising the name
Earlier, we touched on the importance of a company’s brand strategy. It is therefore crucial that you investigate how a luxury retailer markets its products and services and establish how much it spends on these pursuits. What are the primary modes of advertising and promotion (A&P) activity – is it via television, magazines or billboards? Also, who leads the company’s creative team and what their credentials are? Do these people truly understand the nuances of luxury branding?