Navigating Challenges and Seizing Opportunities: An Update on the Fashion Industry

Current State of the Industry

In 2023, the fashion industry faced persistent and deepening challenges. At a regional level, the US and Europe witnessed slow growth, while China's strong performance at the start of the year faded in the second half. Weaker demand affected both the luxury and non-luxury segments, and the prevailing sentiment among fashion industry leaders was one of uncertainty. This deep-rooted uncertainty was fuelled by potential recessions, geopolitical instability, inflationary pressures, and general economic anxiety.

Following a post-pandemic rally, the luxury sector also faced challenges this year, and luxury powerhouses posted contrasting results. While some, like LVMH, Hermes, and Brunello Cuccinelli, recorded boosts in sales, others, such as Salvatore Ferragamo, Burberry, and Kering's Gucci, Yves Saint Laurent, and Bottega Veneta, reported sales declines in the last quarter. These warning results led major luxury stocks to trade 15% cheaper than their five-year average, based on multiples of expected earnings. Inflation ate into middle-class shoppers' purchasing power and confidence as pandemic savings were used up. This particularly impacted trendier labels that rely on aspirational buyers. Brands with wealthier clients, such as Hermès and Louis Vuitton, proved more insulated from the slowdown. According to UBS, the overall luxury sector sales growth will slow to an average of 5% in 2024 after delivering an average of 10% organic growth each year since 2016.

Kering

The Paris-based luxury powerhouse Kering [PA: KER] owns a series of established portfolio brands, such as Gucci, Yves Saint Laurent, and Bottega Veneta, among others. Kering continues to be among the leaders in the European personal luxury goods market, valued at €95bn in 2023, with a 20% market share.

Under the leadership of Marco Bizzarri since 2015, Gucci, which accounts for 50% of Kering's total revenue, thrived, with revenues growing from €3.9bn in 2015 to €10.5bn in 2022. However, Gucci's recent post-pandemic sales growth has trailed behind competitors such as LVMH's Louis Vuitton and Dior due to the brand's marketing and product strategy shifts focusing more on trend-driven products, influencer partnerships, and younger customers. While successfully broadening the brand's appeal, this strategy has alienated wealthier, long-term customers who favor luxury status more than chasing trends. Gucci's poor performance has prompted a management shuffle and restructuring process in which Marco Bizzarri and Alessandro Michele resigned. In their place, the company appointed Jean-François Palus as CEO and Sabato De Sarno as creative director.

Difficulties due to slowing Asia-pacific demand for Gucci products

Kering has recently been facing market difficulties, reflected by the stock price falling approximately 37.7% YTD – from €574 to €358, where it was trading on March 26th. Kering's financial performance has also deteriorated, with EBITDA falling 16% from 2022 to 2024E. In terms of growth prospects, the near future seems static for the group due to expected sales leveling out at the €20bn mark. Most concerning, however, is that the EPS estimate revisions have decreased by 30% for FY24 and FY25. The conglomerate witnessed its worst one-day market capitalization percentage decrease on March 19th, when the stock price fell by 13%. This particular fall is due to management lowering total sales estimates for Q1 of 2024 by 10%. Driving the fall in management estimates is Gucci's decline in sales of 20% y/y. In addition to accounting for half of the company's total revenue, Gucci also

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accounts for two-thirds of the conglomerate's operating profitability. Driving the decline in Gucci sales is a decrease in demand across Asia, particularly in China. China's demand for luxury products has remained beaten since COVID-19, and the mixed Chinese yuan backdrop may have created an additional barrier to demand recovery. The Asia-Pacific region accounted for 35% of Kering's total revenue in 2023, signifying the conglomerate's export dependence.

Exploring new market segments - Kering's acquisition of Creed

In a bold move to bolster its presence in the fragrances sector and diversify geographic sources of revenue, Kering completed the acquisition of the luxury cologne maker Creed in June 2023 in an all-cash transaction. Creed, previously owned by BlackRock, was purchased for €3.5bn at an assumed 23x EBITDA multiple in a slight premium to competitor valuations around 20x EBITDA.

Kering's acquisition of Creed, a brand with a 263-year legacy and impressive EBITDA margins of over 50%, represents a prestigious addition and a source of robust profitability for Kering. This move is strategic, tapping into the beauty sector's potential as a critical entry point to luxury consumption. It aligns with Kering's aim to bolster its beauty division with Creed's strong global presence and esteemed product range. Despite inflationary pressures and concerns about a potential recession, sales of high-end fragrances have remained robust, presenting ample expansion opportunities. The luxury perfume market is anticipated to grow at a 10-year CAGR of 6.2% from 2023 onwards, reaching a market size of €23.26bn by 2033. Europe accounts for 35% of the luxury perfume market, which presents an opportunity for Kering to diversify its exposure to volatile Asia-Pacific markets.

Looking ahead, Kering has outlined ambitious plans for Creed's expansion. The company aims to capitalize on expanding into emerging markets and leveraging opportunities in travel retail, including airports and duty-free outlets. Additionally, plans are underway to diversify Creed's product range to include offerings for women, body care, and home fragrances. However, it's worth noting that Kering's beauty division currently excludes Gucci and YSL brands due to existing licensing agreements. Nevertheless, the company's previous ventures, such as exploring the acquisition of Tom Ford's beauty business, underscore its commitment to expanding its beauty portfolio and cementing its position as a dominant force in the luxury market.

Expanding the luxury portfolio – Kering's acquisition of a 30% stake in Valentino

This transaction closed in December 2023, marks a return to deal-making in the luxury fashion market for Kering. Kering's agreement to acquire a 30% stake in Valentino for €1.7bn, with an option for full ownership by 2028, underscores its strategic vision for expansion in the luxury fashion market. Furthermore, the partnership between Kering and Mayhoola, the Qatari investment fund that owns Valentino, hints at potential reciprocal investments, with Mayhoola also owning the French fashion label Balmain. Kering's decision to invest in Valentino reflects its confidence in managing and nurturing fashion brands, drawing parallels with its success in revitalizing Saint Laurent. Despite facing challenges at Gucci, Kering remains optimistic about the luxury industry's post-pandemic resilience, particularly among affluent consumers.

LVMH

LVMH [PA: LVMH], the Paris-based conglomerate focused on luxury goods across diverse sectors like fashion, wines, cosmetics, and jewelry and with a broad portfolio also including media and real estate, reported a record-breaking year in 2023, with revenues reaching €86.2bn, marking a 9% increase over the previous year. This development was fueled by organic revenue growth of 13% across its diverse business groups, with particularly strong performances in Europe, Japan, and the rest of Asia, all achieving double-digit organic growth.

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The stock price is up 15% YTD - from €722 to €830, where it traded on March 26th. The conglomerate's profitability remains strong, with EBITDA continuously growing at a 5-year CAGR of 19.3%, and the market is pricing in lasting growth for the group with the P/E (NTM) multiple at 25, in comparison to 16 for Kering, which is its closest competitor.

Acquisition of a 36% stake in Tod's

On February 10th, the footwear brand Tod's [MI: TOD] entered a partnership with L Catterton, a private equity firm backed by LVMH. This alliance is set to transition Tod's from a public entity to a private one, indicating its removal from the Milan Stock Exchange. Under the terms of the agreement, L Catterton will acquire a 36% share in Tod's at €43 per share, which is an 18% premium to market price on February 10th, for a total of €512m, implying an enterprise valuation of Tod's of €1.4bn. It is important to mention that LVMH already has 10% ownership of the firm. Tod's performance improved last year, with the group announcing in January that sales increased 11.9% in 2023 to €1.13bn, with all brands gaining in the double digits. The acquisition is a strategic effort to blend Tod's storied tradition with the vast luxury network of LVMH, ensuring the brand's growth under the continued leadership of the Della Valle family. In 2022, the Della Valle family, who owns a majority stake in Tod's, aimed to delist to rejuvenate the brand and overcome challenges related to public listing requirements, like mandatory earnings publications, which they felt hindered long-term strategic goals. This move was part of a broader strategy to enhance operational flexibility, streamline management costs, speed up decision-making, and reduce costs associated with public listing. However, their initial privatization attempt fell short due to not meeting the necessary ownership threshold.

Participation in Birkenstock's IPO

On October 11th, Birkenstock Holding [NYSE: BIRK], the German sandals producer, debuted on the NYSE with an IPO offering of $46 per share, offering 32.26m ordinary shares – implying a valuation of $8.6bn. L Catterton, backed by LVMH and the family-holding fund of Bernard Arnault, had acquired a majority stake in Birkenstock two years before the IPO. The IPO saw Birkenstock and L Catterton releasing approximately 32m shares. L Catterton, post-IPO, retains about 83% ownership of Birkenstock, continuing to exercise substantial control over its operations. In an interesting move, billionaire Bernard Arnault's family holding company – Financière Agache, signaled its intention to acquire up to $325m in shares in the IPO. This move is complemented by expressions of interest from significant investors like the Norwegian sovereign fund and T. Rowe Price Group Inc.'s Durable Capital Partners LP, collectively aiming for a $300m investment.

The strategic acquisition by L Catterton and the Arnault family investment company over two years ago at a valuation of approximately €4bn has propelled Birkenstock into an era of significant investment in production capabilities in Germany. Birkenstock's strategic shift towards global luxury markets is a direct result of the partnership forged two years prior with L Catterton. Birkenstock's adherence to its core values, combined with strategic brand positioning, has driven substantial financial growth, with revenues reaching $1.17bn in the nine months leading up to June 30th, reflecting a 21% increase from the previous year.

Talks of acquiring Paris Match Magazine

In a move that underscores its ambition to expand its media portfolio further, LVMH is in advanced talks to acquire the French publication Paris Match from the Lagardère group. This development, announced alongside Lagardère's annual earnings release, follows LVMH's strategic interest in bolstering its media holdings, including prestigious titles such as Le Parisien and Les Echos. The acquisition of Paris Match signifies LVMH's continued investment in cultural and journalistic enterprises. This negotiation with Lagardère, which recently became part of

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media conglomerate Vivendi, controlled by the Bolloré family, marks a critical juncture in LVMH's efforts to diversify and strengthen its presence in the media landscape.

Acquisition of Château Minuty

LVMH's strategic acquisitions and expansions further illustrate its growth and diversification strategy. This includes acquiring the Minuty estate to bolster its Wines & Spirits business. This move, officially unveiled during Wine Paris on February 15th, 2023, has ignited a buzz of speculation and discussion, marking a significant expansion in LVMH's wine portfolio. Château Minuty boasts 160ha of vineyards on the prestigious Saint-Tropez peninsula. The acquisition, estimated between €350m and €450m, underscores LVMH's commitment to premium rosé, with the Farnet family, owners since 1936, continuing their involvement.

Prada's Performance and Investments

Prada S.p.A [HKD: PRDSY] engages in the distribution and manufacture of luxury goods, and apart from the Prada brand, it also owns Miu Miu, Church's, Cas Shoe, and Pasticceria Marchesi. On March 7th, Prada reported net revenues of €4.7bn, which drove its stock price up by 11.2%. Those earnings were mainly driven by a 58% rise in Miu Miu's sales compared to 2022 and the group's performance in Japan, where sales were up by 44% on a year-on-year basis, driven mainly by local consumers. However, according to analysts, the short-term trend may be highly volatile, and the sharp rise in Miu Miu's sales might not be sustainable in the long run. In the meantime, there is a strong belief that the group's commitment to elevating the brand status and its ability to margin expansion through sales density will allow Prada to keep optimistic forecasts.

While many companies have focused on the technological advancements of e-commerce, Prada has adopted a different approach. According to chairman Patrizio Bertelli, e-commerce will not suppress physical retail spaces. The increase in post-pandemic in-person shopping reflects this. According to Monique Pollard, Citi's head of European internet equity research, e-commerce growth is slowing, and it mainly attracts broader engagement, while in-person retail spaces draw high-spending customers. This trend has led Prada's management to pursue a $1bn investment in new retail spaces. The idea is to give customers a unique experience by converging all its business activities. The new retail stores will serve food provided by Pasticceria Marchesi and give art exhibitions operated by the contemporary art foundation Fondazione Prada.

Prada is not the only company investing in physical stores. The real estate firm JJL estimates that fashion houses have added 60000m^2 of retail space between 2022 and the end of 2023, proving that physical stores are still a viable option in a digitalized world.

Shein and its IPO Plans

Founded in 2008 by Chris Xu in China, Shein was inspired by the Chinese retail e-commerce giant Alibaba partially adopting its business model. Although Shein manufactures most of its products in China, it targets customers from the West, especially the younger Generation Z, with its wide variety of styles and affordable prices. In 2022, Shein moved its headquarters to Singapore to pursue a more international approach and for financial and regulatory reasons, but it kept its manufacturing in China. Shein has set an ambitious target of reaching $58.5bn in revenues by 2025, which would be as much as H&M and Zara combined. Shein's management plans to achieve these figures by increasing customer loyalty and creating a third-party marketplace to compete with Amazon and Asos. However, these targets are challenging to accomplish as Generation Z is characterized by a low retention rate. Furthermore, Shein is facing high competition from Pinduoduo's backed Temu. To achieve its final goal of becoming a global

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retailer and competing with industry leaders, Shein is seeking a $64bn valuation in its IPO and is trying to raise between $1.5bn and $3bn.

Shein had planned to list in the US but is currently facing some challenges, mainly due to its ties to China. The current political tensions between the US and China are putting Shein at a disadvantage as US lawmakers have recently pressured many China-based companies. Furthermore, US regulators are targeting a legal loophole that is currently allowing Shein and Temu to avoid paying import duties. Although the company moved its headquarters to Singapore, its supply chain heavily relies on Chinese manufacturers, who are allegedly using cotton from the Chinese region of Xinjiang. These connections to China highly undermine Shein's credibility in the eyes of US lawmakers who heavily scrutinize the company.

This hostility has made a possible listing on the New York Stock Exchange challenging and led the company to consider a listing in London. The London Stock Exchange is currently facing stagnation in the IPO market, with IPO activity falling from the recorded 45 listings in 2022 to 23 in 2023, a 49% decrease. The LSE lacks selling points, which could incentivize companies to list on its market, and Brexit has damaged London's international reputation. To revitalize IPO activity, the British government is adopting many reforms that make the listing process more accessible, such as removing the IPO eligibility requirement of a 3-year financial and revenue-earning track record with a clean working capital statement. The statement by a UK government official, "We aren't pushing them, but of course, we would welcome an IPO", shows how the stagnation of the LSE works in favor of Shein. The retailer is not considering a listing in Hong Kong due to the market's poor performance and the high influence of the Chinese government.

Farfetch Acquisition

On January 31st, Coupang, Inc., [NYSE: CPNG], headquartered in the US, announced the completion of its acquisition of the assets of Farfetch Holdings plc. This pivotal acquisition sees Farfetch gaining access to $500m in capital, ensuring its continued provision of exceptional services. The merger integrates Coupang's operational network across South Korea, Taiwan, Singapore, China, and India with Farfetch's luxury retail prowess, setting the stage for significant and globalized sustainable growth.

Coupang's acquisition of Farfetch, a platform once celebrated for its success in luxury e-commerce, emphasizes the evolving challenges and opportunities within the industry. Farfetch's uncertain financial standing leading up to the acquisition highlights the inherent tension between the traditional high-margin luxury model and the inherently low-margin nature of e-commerce. This tension, coupled with a resurgence in consumer preference for physical retail experiences post-pandemic, has posed significant operational challenges, culminating in Farfetch's search for a "white knight" to avert insolvency.

Outlook for the Industry

The last year was a challenging period for the fashion retail industry. With ongoing geopolitical tensions and unfavorable macroeconomic conditions, consumers faced high uncertainty. Such dynamics pushed consumers to spend less and incentivized quality and reliable products, which helped recognized brands but, at the same time, put small and independent businesses into difficulty. Looking forward, we can expect 2024 to be a year of new opportunities. Consumers are regaining confidence with inflation slowing down and predicted rate cuts in the second half of the year. Furthermore, high unemployment is leading to an increase in real wages, further boosting the propensity to spend on consumers.

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According to research presented by Bain & Company, retailers are aiming to diversify their revenues with beyond-trading activities that see retailers expanding their operations into the digital world. Firms can create marketplaces that link third-party sellers to customers (B2C) or businesses (B2B), generating a commission on each transaction. Another way a company can increase its revenues is by providing additional services and products that rely on existing assets, like monetizing customer data or utilizing logistics infrastructure services and underexploited advertising channels. It is estimated that beyond-trading revenues will contribute by 2030 to over 50% of the industry profits. M&A will play a crucial role in this transition. Retailers will utilize lower valuations and decade-low P/E ratios to acquire companies that generate cost synergies and achieve economies of scope and scale. Retailers can gain a competitive advantage over their competitors by engaging in frequent M&A deals and taking advantage of the economic slowdown. This allows us to conclude that 2024 will be a year in which we can expect a revival of the consumer retail M&A market.

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