FT BUSINESS OF LUXURY 2011: WHAT PRICE LUXURY?

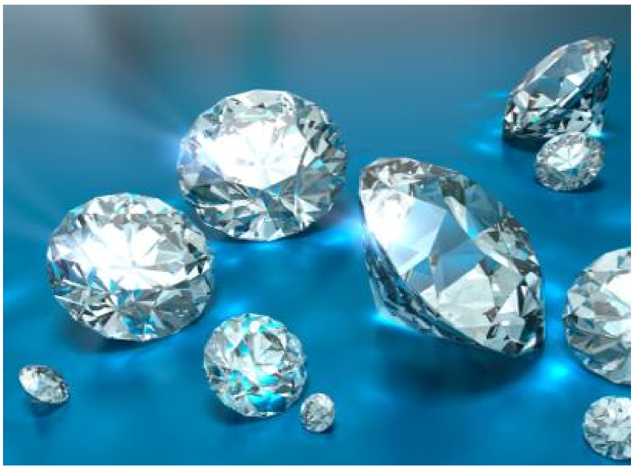
By Tim Jackson, 30 June 2011

In the second part of WGSN's coverage of the 2011 FT Business of Luxury Summit, we focus on discussions around the costs of doing business in the global luxury industry.

As the theme What Price Luxury? suggests, the 2011 FT Business of Luxury Summit was very much concerned with issues of price, cost and value associated with doing business in the global luxury industry.

The macro-economic analyses, presented in the first part of WGSN's coverage of the event, concluded that the luxury goods industry has a bright future with demand still strong in BRIC countries. Currency trends, however, have a clear impact on the financial health of the increasingly global luxury businesses.

Opening the panel discussion on global pricing and currency impacts on the luxury industry, Rachel Sanderson, Milan correspondent for the Financial Times, noted Prada's IPO launch was accompanied by a statement in the IPO prospectus that one of the main risks to its business model is currency fluctuation.



Akris, 2011, Spring/summer, Paris Fashion Week, Paris

Currency trends & price variations

Patrick Zweifel, chief economist at Pictet Asset Management, identified three key future trends in the currency market which luxury brands should be aware of: greater flexibility in exchanges rates, meaning less governmental intervention in the FX markets; the postponement of monetary unions such as those planned in the Gulf and across selected Asian countries; and the continued depreciation of the US dollar.

The US dollar has depreciated by approximately 20% since 2002 and Zweifel observed that a 10% depreciation of the dollar currently leads to a 20% appreciation of commodity prices. He agreed that the depreciation trend in the US dollar may undermine its role as principal reserve currency, and suggested that a basket of others including the Euro, Yen and a developing economy currency could be an alternative.

WGSN TAKEAWAYS

- *A greater flexibility in exchange rates, the postponement of some monetary union proposals and the continued depreciation of the US dollar are three currency market trends luxury brands should be aware of*
- *Hedging cost prices of raw materials against currency fluctuations though advanced buying is increasingly important for luxury brands*
- *For fashion-driven brands, however, hedging is only realistic for two seasons, noted Peter Kriemler of Swiss brand Akris*
- *Currency fluctuations alone do not explain retail price variations in luxury markets of more than 50% in some cases*
- *China's role in raw materials costs is fundamental. Demand from China for some commodities has increased some prices by more than 1000% compared to 10 years ago*
- *Commodity prices will trend upwards driven by demand and increased costs of production*
- *Vertical integration allows luxury brands to better manage cost in an inflationary environment for raw materials*
- *Retaining control over raw materials is increasingly important to ensure provenance*
- *The diamond sector is looking at ways to hallmark*

diamonds to reassure brands and consumers that they are ethically produced

Peter Kriemler, global president of Swiss fashion house Akris, reiterated the difficulties that fluctuating exchange rates have on pricing and margin for luxury brands. He revealed that five months ago the company bought two years supply of cashmere at a fixed price in order to hedge against future currency fluctuations, adding that in most respects hedging is realistic only for two seasons in fashion.

Kriemler also noted the variability in retail prices as another example of influences on global trading. iPad retail prices range worldwide, from the equivalent of □580 in New York to □820 in Paris. Other price variations he cited included a 26% price difference in Louis Vuitton products between South Korea and France; a Tiffany product with a price variation of 43% between New York and Japan; and an identical Gucci watch carrying a 63% retail price difference between the UK and South Korea. He speculated that currency differences alone would not account for such retail price variations.

Philippe Léopold-Metzger, CEO of Richemont-owned Swiss luxury watch maker Piaget SA, agreed that hedging cost prices of raw materials through advanced buying is important for luxury brands. He revealed that 97% of Piaget's watches utilise gold in their manufacture, (the remainder using Titanium), with the average retail price at □25,000. Not only has the price of gold increased but that the price of diamonds has doubled in the last six months. He said: "Our number one job at the moment is to secure the vital raw materials and components.

"The challenge today is to secure the deliveries. So today I am buying diamonds whatever the cost as the opportunity cost of not getting the goods is much greater than the (increased) price I would have to pay."

Léopold-Metzger reiterated the significance of hedging, which is a process undertaken centrally by Richemont. "I think Richemont is trying to forecast what the net cash exposure is one year down the road and they are hedging against the (US) Dollar, the Yen and the Renminbi. But this is done at the group level. Our job is to run our brands more efficiently. One of the things we are not authorised to do is to speculate on commodities."

Currency valuations

In general there was a belief that commodity currencies are overvalued and a number of speakers offered views on the fair valuations of foreign currencies. Zweifel argued that the Swiss Franc had been "massively undervalued" before the 2008 financial crisis and added that the Renminbi is currently not as undervalued as most people think.

Earlier Jim O'Neill, chairman of asset management at Goldman Sachs, had commented on asset valuations and concluded that China is fairly valued, particularly since it had started to address inflationary pressures 18 months earlier, that India was overvalued and Russia is cheap but risky.

In terms of currencies, O'Neill concluded that the Yen is far too high and that it is easy to dislike all the major currencies at the moment: "If you are sitting in Dusseldorf or Frankfurt...that's why the Swiss Franc is so strong, because lots of wealthy people in Europe don't like the Euro and given the (current) situation in the United States the last thing you want to do is own the (US) Dollar, which raises deeper issues about what the world's monetary system will look like by the end of this decade.

"If China is as big as we think it will, we might not have the foreign exchange system that we have today. In the meantime the (US) Dollar will be the least worst of a bad bunch. That’s why gold is so strong."

Commodities

Peter Whitcutt, global director strategy and business development at mining group Anglo American, which owns a 45% share of DeBeers and is the world's largest producer of platinum, examined the impact of commodities on luxury brands.

He argued that the huge scale of China's demand for a range of minerals and metals has impacted prices since commodity supply is relatively fixed. As an illustration Whitcutt said 50% of the total global demand for iron ore and copper is from China, the impact of this demand has been to increase the price of some commodities in excess of 1000% compared with 10 years ago: "Therefore what happens in China is fundamental."

In fact, Whitcutt expects commodity prices to trend upwards driven by demand and the increased costs of production arising from the capital intensity of mining: “Five years ago it cost $5,000 per ton of capacity for a copper mine, now it's close to $10,000 and we see that going to $15,000 per ton. So the prices required to incentivise people to build new capacity to make future supply available is a lot higher than it has been."

He added that the quality of residual resources may not be as good: "The best resources have already been mined out so the next resources to be mined will, by definition, be worse. Copper for example, even 10 years ago the average grade being mined was 1.6% (of every ton) copper. Now that is 1.1% and that’s going down even further. Mining inflation is running in the low double digits and some analysts see it going to 18%. Future production is going to more expensive."

Brand management

Vertical integration emerged as a theme across a number of speakers. Akris' Kriemler stressed the significance of a fully vertical operation to being able to manage costs in an inflationary environment for raw materials and stated that it is crucial in managing quality and the value chain.

Léopold-Metzger explained that Piaget manufactures 100% of its watches in Switzerland: “When I sell a watch today I make the watch myself. I make the case, the bracelet, I set the diamonds, I make the movement and that way you see much more control on the pricing and have greater efficiency in our manufacture."

John Studzinski, senior managing director of asset management firm The Blackstone Group, noted that control over raw material sources is increasingly important. Tiffany, for example, only procures gold from mines that they own to ensure its provenance.

Anglo American’s Whitcutt also stressed the importance of ethical mining reminding delegates how significant it is in the diamond sector: “It’s interesting for us to see whether for some of our commodities one can effectively hallmark them in a way that can provide assurance that everything associated with the production of that product will be acceptable.

This is important for us currently, in terms of accessing resources, but it should become a more important issue for people looking at securing resources.” He noted that DeBeers was looking at hallmarking diamonds on an individual diamond by diamond basis.

An additional benefit of vertical integration was noted by Rene Beyer, CEO of Swiss watchmaker Beyer Chronometrie, who commented that the structure is a key means of controlling and avoiding the counterfeiting of luxury goods.