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The Splendour of the Luxury Goods Market

– A strong and stable growing sector

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In 2022, the energy crisis, the war in Ukraine, inflation, and elevated food prices dominated the economic landscape and caused a significant decline in the bond and stock markets. However, the consumption of luxury goods was remarkably resilient. In this insight, we show that this aligns with historical patterns and explain why the luxury market is so robust.

"The global personal luxury goods market has grown by 6% per year (CAGR) from 1996 to 2022."

Strong and stable growth with rapid recovery after economic downturns

According to Bain & Company, the global personal luxury goods market has grown by 6% per year (CAGR) from 1996 to 2022, with only two significant declines. The first occurred during the financial crisis of 2008-2009, resulting in an 8% decrease in sales in EUR. However, the market rebounded quickly, not least due to a surge in Chinese luxury consumption the following years. The second decline occurred in 2020, during the Covid-19 pandemic, leading to a 22% decrease in EUR. The decline was primarily due to restrictions and store closures, as the luxury goods market relies heavily on physical sales. Consequently, demand returned swiftly when societies reopened. Although the luxury market is susceptible to economic downturns, historical data suggests that demand typically rebounds quickly.

Louis Vuitton Moët Hennessy (LVMH), perhaps the most well-known luxury conglomerate, has fared even better than the market as a whole when looking at revenue. Over the past 20 years, the company has achieved a revenue CAGR of 10% in EUR, with only three periods of decline. In 2003, there was a 6% decrease due to the SARS outbreak in Asia, adverse currency impacts, and divestments. During the financial crisis, LVMH experienced a 1% decline in sales, outperforming the luxury market by 7%. Lastly, during the COVID-19 pandemic, the company experienced a 17% decline, again outperforming the luxury market by 5%. In all instances, LVMH's revenue recovered quickly.

> *"Pricing power is a function of the desirability of the brand. Desirable brands can increase prices and non-desirable brands cannot."*

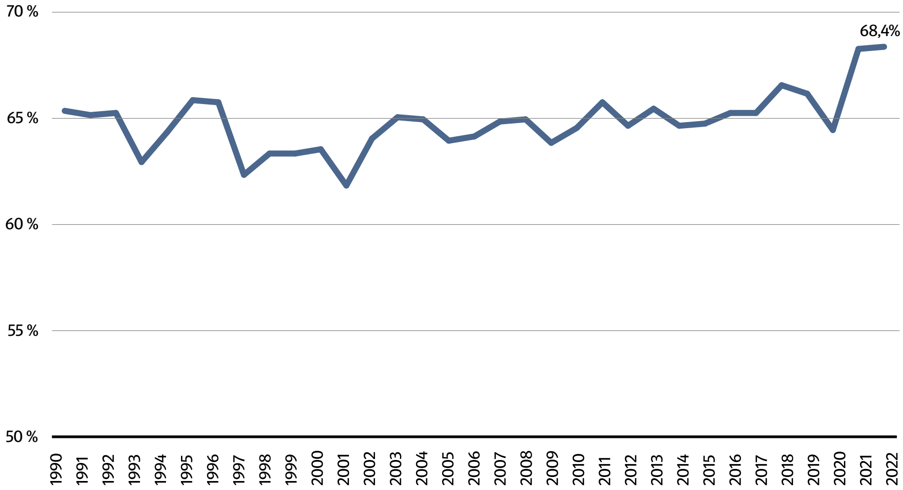
Pricing power

One factor that insulates the luxury market from the impacts of inflation and interest rate increases is the significant pricing power that luxury brands enjoy, thanks to the inelastic demand for luxury goods. The CFO of LVMH, Jean-Jacques Guiony, emphasized the importance of this aspect during the 3Q 2022 conference call:

"The reality is that pricing power is a function of the desirability of the brand. Desirable brands can increase prices and non-desirable brands cannot. It's as simple as that. So what it is about is developing strategies, marketing, products, distribution strategies that will increase the desirability of the brand, so that in tough times or in other times, we can reflect into prices the cost of doing business."

Despite the inflation and energy crisis, Louis Vuitton, the largest brand in LVMH's brand portfolio, was able to implement price increases in 2022, demonstrating its pricing power. For example, LVMH raised the price of its high-end bag,

Figure 1
LVMH gross margins



Source: Bloomberg, 2023

the Capucines bag, by 26% in 2022 and its entry-level handbag, Neverfull, by 20%[1] . This pricing power has played a role in the company's strong financial performance, as evidenced by high and stable gross margins, reaching a record-high in 2022 of 68.4%, see figure 1 above.

You only live once

A key factor contributing to the robust performance of LVMH and the luxury industry in 2022 was the accumulation of savings by consumers during the COVID-19 pandemic. The realization that life is short and a desire to make the most of it resulted in a "you only live once" (YOLO) mentality, particularly among Americans who became the leading personal luxury consumers in 2022, as reported by Bain & Company, see figure 2 on page 5.

Whether Americans continue to spend on luxury goods as they did in the wake of the Covid-19 pandemic remains to be seen. However, it is worth noting that in 2017, Millennials (then aged 25-37) earned similar incomes as their parents (Generation X) did at the same age (75,000 USD2[2]) and significantly more than their grandparents (the Baby Boomers) did at that age (64,000 USD[2])[3]. Still, Millennials have far less savings than previous generations. At the age of 34, Baby Boomers accounted for 26% of total US savings, whereas Generation X accounted

[1] BNP Paribas Exane, 2023 In 2017 dollars
[2] In 2017 dollars
[3] Pew Research Center, 2019

"The expanding middle class in China will increase the demand for luxury goods in the country."

for 14% when they were 34 years old, and Millennials only 9%[4]. It seems the YOLO mentality gets stronger for every generation. Data also suggests that the youngest generation (Generation Z) starts buying luxury items three to five years earlier than the Millennials did[5] (social media may play a role here). These generational factors could add significantly to growth for the industry over the next decade.

The growing middle class in China is a driver of sales

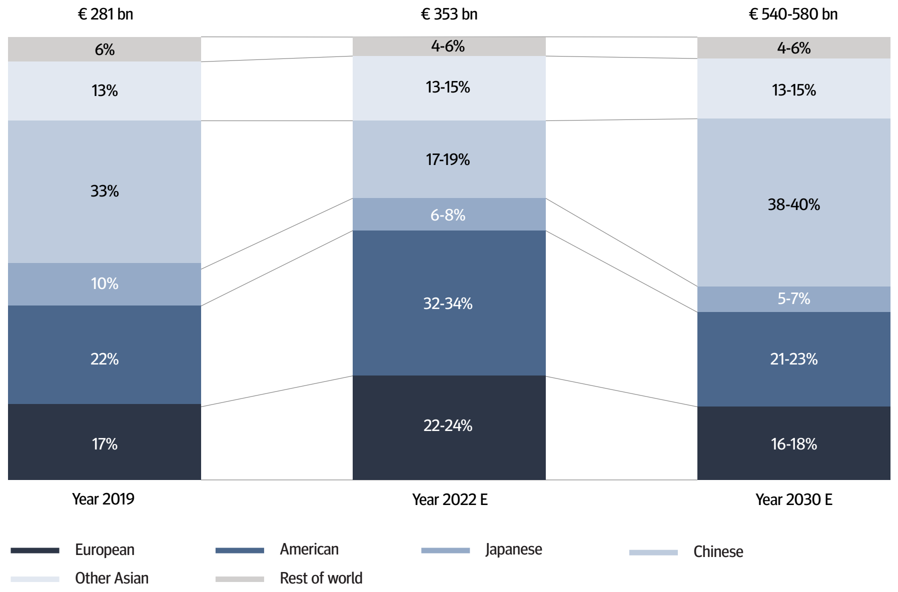
In August 2021, President Xi Jinping presented the "Common Prosperity" objective, which aims to promote greater equality by balancing income and wealth distribution. We think that this means that China will become even more important for the luxury market's growth.

In our view, the expanding middle class in China will increase the demand for luxury goods in the country. This perspective is supported by projections from Bain & Company, which anticipate that the Chinese consumer will comprise 38-40% of the overall market by 2030 (33% pre-pandemic), see figure 2 on page 5.

Increased regulation in the luxury goods sector may be a threat to growth. For example, in 2013, China cracked down on bribery and corruption, which strongly

[4] US Federal Reserve, 2022
[5] Bain & Company, 2022

Figure 2
Share of global luxury goods market



Source: Bain & Company, "Renaissance in Uncertainty: Luxury Builds on Its Rebound," 2023

discouraged purchases of luxury-gift items, among other things. Furthermore, China is trying to reduce incentives for its people to buy abroad. However, Chinese luxury brands lack the rich heritage that European brands have, meaning there are no domestic substitutes. One could also worry about higher taxes on luxury goods to redistribute wealth, but that would only increase incentives to buy luxury goods abroad.

Conclusion

As active investors, we are looking for companies that can maintain and expand their competitive position and possibly build new business areas based on their business models' financial strength and optionality. These are the type of companies we call "Compounders" who control their future with a clear potential to deliver sustainable and long-term growth.

We believe the luxury goods market possesses many of these characteristics. It has displayed stable and strong growth underpinned by structural factors such as 1) pricing power, as evidenced by high and surprisingly stable gross margins; 2) increased appetite among younger generations for the finer things in life; and 3) the growth in China now increasingly being driven by the middle class. We believe these characteristics allow us to find compounding stocks in the luxury goods sector.

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