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Over the past quarters, several luxury brands reported weak earnings. A consumption slowdown in China is putting pressure on the companies. Many see this only as a temporary effect. The article discusses the deeper challenges for luxury brands in the Chinese market.

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The announcement of the Apple watch triggered an intense discussion on whether a technology company will revolutionize yet another industry. Is the Swiss Watch Industry, who reported $22 billion in watch exports in 2012, facing a new age of time?

LUXURY BRANDS: CHANGING THE RETAIL REAL ESTATE LANDSCAPE............... PAGE 6
First the internet, then the global recession changed stationery shopping. Since the recession, mall operators have struggled to drive traffic to their properties. Some turned towards experimental shopping, led by luxury brands.
This Report is the first in an ongoing series on the Luxury Goods Industry. From time to time over the course of the year we will report on important happenings in this enormous global business, which Bain, the consulting firm, estimates registered sales of $1.1 trillion in 2012.

What constitutes a “luxury” good? The word means different things to different people. For our purposes, we will be writing about products from automobiles, fine timepieces and jewelry to haute couture, goods whose brand names are so well known they help define the buyer within society at large.

Luxury has always been in demand, but over the past 20 years the global reach of luxury goods makers has expanded to the point where sales growth in this highest market segment has outpaced growth among more broad-based consumer goods companies. Indeed, spending on all manner of luxury items has risen at double the global rate of the gross domestic product. During that time period, Bain estimates the universe of luxury goods consumers has tripled, to roughly 330 million.

The super-rich are not the main drivers of this growth, though they are definite participants.

Rather, most of the buyers merely qualify as prosperous, with annual incomes of up to $180,000, according to Bain.

Until this year, Wall Street saw this trend and responded to it.

Over the last five years the annual return of the Standard & Poor’s Global Luxury Index, comprised of 80 publicly-traded luxury goods makers and service providers, was 18.4 percent, compared to an annual gain of 14.9 percent for the S&P 500.

As we go to press, performance of these stocks during 2014 was less than stellar. Through November, the index fell by 5.4 percent, compared to a gain of 10.4 percent for the S&P 500. Trees don’t grow to the sky, but the pull-back also reflects changes that are taking place in the industry; in this, our first issue, we intend to look at some of those key trends.
CLOUDS OVER THE CHINESE LUXURY MARKET:
A STRUCTURAL CHANGE FOR THE INDUSTRY

For much of the past decade, China has been the key driver of the global growth in sales of luxury products and services. But over the course of the past eighteen months a number of factors—some predictable, others less so—have combined to slow what had been a torrid pace. The upshot of these developments is that China has been transformed from a veritable gold mine into a market with a more challenging operating environment for purveyors of luxury goods.

In retrospect, some sort of slowdown was bound to occur. Recently released earnings reports of many global luxury brands are comparatively poor. Revenues only grew modestly and profits are down, in some cases like Prada severely, who reported for the third quarter of 2014 a 44% decrease in profits against a sales drop of 5.6%.

From 2004 to 2012, sales of foreign luxury brands rose at an annualized rate of 25 percent. That record catapulted China into the fifth-largest market for luxury goods, trailing the United States, Japan, Italy and France. Based on that performance, many analysts were confidently predicting that by the end of the decade China would surpass the U.S. as the world’s leading luxury goods market.

That forecast may yet happen, but a sales slowdown that began in 2013 makes it seem much more problematic.

What has happened to bring this about? It depends who you talk to—and what you look at.

Executives at luxury brand companies attribute slumping sales to President Xi Jinping’s “tiger and flies” anti-corruption, anti-ostentatious display of wealth campaign, an effort that has discouraged consumers from buying and wearing luxury brands.

Currently, there seems to be widespread consensus among these executives that the slowdown in “conspicuous consumption” is temporary. Such thinking may be naive.

President Xi’s campaign has already gone far deeper and lasted much longer than anyone imagined. It seems likely to continue indefinitely, because corruption is damaging the very legitimacy of the Communist Party. By fighting corruption and the ties between political leaders and members of China’s wealthiest citizens, Xi is attempting to quell what could erupt into civil unrest. The fight to prevent that from happening will therefore continue.
In addition to political factors, luxury goods companies are also being forced to adapt to changing behavioral patterns among Chinese consumers. Put another way, the days when wealthy Chinese would pay any price to own a foreign luxury brand are becoming a distant memory.

To be candid, pricing patterns adopted by luxury goods companies hastened this change.

The rise of newly-rich Chinese has led to a sharp increase in foreign travel. Reflecting that development, over the last five years luxury brands sales not only increased sharply in Mainland China, but also with Chinese customers snapping up these products abroad, mostly in Hong Kong and in Europe.

This foreign buying laid bare a large price differential between the luxury goods sold in Mainland China and those sold in the rest of the world. For years, the industry maintained a practice of marking up luxury goods sold in China by anywhere from 25 percent to 40 percent, excluding taxes; the number is around 70 percent if taxes are included.

The price differential was compounded by luxury goods companies tacking on significant additional price increases on goods sold in China, increases that far outpaced inflation.

It will take time to whittle down the price differential, but paring back prevailing prices on products already sold in China will be much more difficult, and will require the development of a “more affordable” product category consisting of new products at lower price points. This is where brands like Tiffany, Coach or Tory Burch come into play with their strategy of well-designed premium products at more “democratic price-points”.

Shopping is perhaps the most important attraction luring Chinese tourists to Western countries, but a narrowing of price differentials probably will not encourage consumers to stay home.

Just four percent of Chinese hold passports, according to recent estimates, compared to 30 percent of Americans and 70 percent of Britons, but China’s numbers are increasing by 10 million to 15 million a year.

However, it is not only about price. Consumer taste, also driven by the anti-corruption movement, evolved from ostentatious branding to more subtle designs. With that came some fatigue for mega brands, which could present a market opportunity for creative industry newcomers such as the Shinola brand.

The rise of the Internet and e-commerce in China is easing the entry of “more affordable luxury” into the Chinese market and represents what looks like a double-barreled threat to luxury goods purveyors.
One threat is physical. Over the past decade luxury brands have invested hundreds of millions of dollars in bricks and mortar boutiques. Companies that have made these investments face rapidly rising rent and personnel costs even as internet shopping becomes more and more widespread.

In 2009 e-commerce represented roughly 3 percent of China’s retail sales. That figure is projected to reach almost 16 percent in 2014.

Luxury goods purchases are part of the online wave, a trend that bodes well for American premium brands, who currently are more adept at operating e-commerce businesses than other, more traditional luxury goods companies.

Then there is the other threat: internet speed.

It used to be a rule of thumb that a company needed at least thirty years to build a global brand. Thanks to the internet, that time frame has been reduced to about 18 months.

To sum up, demand for luxury products in China is not fading, despite the problems and challenges noted above. But the hurdles they have created are not temporary. The Chinese market is evolving; it is imperative that luxury good business models take note and change with the times.

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**THE IMPACT OF SMART WATCHES**

The introduction of Apple Computer’s entry into the smart watch sweepstakes is a seminal event for a small but likely fast-growing segment of the market for high-tech timepieces. But fears—expressed by some—of a repetition of what happened to makers of mechanical watch movement time pieces in the wake of an earlier technological revolution are overblown.

Four decades ago, the rise of the introduction of Japanese quartz watches caused a sensation and came close to destroying the Swiss watch industry.

The end didn’t arrive, however. Soon enough, the attributes that had kept the Swiss on top for many, many years reasserted themselves, even as the less appealing aspects of quartz watches become increasingly apparent.

In fact, today’s fearful reaction is as much a reflection of the respect Apple and its products have had on the retailing business as memories of the quartz revolution.
Traditionally, technology and fine timepieces have little in common. Technology products—from computers to cellphones—have short lifecycles. They are built to be replaced and will be, as long as each new generation proves superior to its predecessor.

Fine watches, by contrast, are made to last. Hermès likes to define luxury as “that which can be repaired.” Where high-tech gadgets are all about product features—the more the better, it seems—a fine watch is really about who you are and your passion for a mechanical piece of art that happens to measure time, a piece of art that can be passed down through generations.

It is doubtful smart watches will ever qualify as heirlooms. They will not compete with haute horlogerie brands like Patek Phillippe or Vacheron Constantin.

What they will do is transform what we call the “attainable” market, and impact the middle market. Initially, smart watches will compete with sport and fashion watches. In fairly short order, they will shift the category from mere measurement of time to a highly personal, integrated lifestyle product.

And they will sell.

NextMarket Insights forecasts the smart watch market will grow from 3.2 million units in 2013 to 373 million units by 2020.

This sort of outlook is forcing the hand of traditional watch brands. Fossil, for example, reportedly entered into a partnership with Intel to develop smart watches. The Swatch group, whose brands include, amongst others, Omega and Breguet, has announced an initiative to develop a Smart Watch by 2015. The Smart Watch trend will forge new business alliances between software companies and watchmakers collaborating on software and hardware innovations that will focus on functional as well as emotional product characteristics.

The real threat posed by smart watches is to the entry-level, low-tech quartz watch makers like Casio and Timex. Companies in this space will certainly “taking a licking.” At this juncture, it remains to be seen if they will “keep on ticking.”
The rise of e-tailing, the havoc caused by the recent Great Recession and the increased homogenization of the American shopping experience have combined to generate an upheaval in the country’s real commercial real estate landscape. The upshot: increasingly, luxury retailers are becoming the new mall magnets in the nation’s shopping malls.

This development has not happened overnight. The ease of internet shopping combined with the drab sameness of visiting most local malls were the initial forces behind the rise in e-tailing. The tremendous shake-out in store occupancy rates due to the fall-out from the financial crisis and the collapse of the real estate market exacerbated the trend.

Retail real estate continues to recover from the carnage of the 2007-2009 period, but the gains are uneven. Some areas, like San Francisco and San Diego, are very strong, with low vacancy rates. But other cities, like Reno, Nevada; Memphis, Tennessee and Cleveland, Ohio continue to languish.

If there is one constant, it is the performance of high-end shopping centers, known in the trade as Class A malls.

The internet notwithstanding, consumers still like to go to malls to shop; they just need an exciting, attractive reason to go. Luxury retailers are providing that attraction.

Last year, the nation’s best-performing shopping centers all shared a few common characteristics: high levels of tourists; a strong local economy; luxury anchor tenants, from Neiman Marcus to Bloomingdales and Saks; and a very high density of luxury brand boutiques. Put another way, these centers feasted on a strong and steady stream of consumers who flocked to what was on offer: an attractive shopping experience.

As a consequence, these Class A malls are now driving the retail real estate recovery. Average vacancy rates at these malls is running between 2.5 percent and 5 percent; by contrast, vacancy rates at so-called Class C malls hover around 11 percent.

The success of Class A malls and the movement toward what is being called “experience shopping” has spawned the development of new shopping area concepts located outside conventional malls.

One example is the Miami (FL) Arts District, a neighborhood which in the last two years has evolved into a vibrant destination for residents and visitors.
The retail composition of the District is a mix between major luxury brands like Hermès, Louis Vuitton and Cartier along with smaller boutiques like Anya Ponorovsaya, restaurants and bistros as well as cultural event venues.

Looking ahead, it seems quite likely malls of the future will be populated by higher-end retailers on one end of the spectrum and of-price players at the other. Increasingly, retailers selling mid-priced hard goods will be squeezed out. We can expect mall owners to upgrade so-called Class B shopping centers—home to most mid-priced stores—to limited high-end inventory. And developers and planners will carefully analyze new “experience locations” like the Miami Arts District as potential models to redevelop and revitalize inner city areas.