Luxury and trophy assets: Losing its shine for the sovereign wealth funds

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Overview

The luxury industry grew again. In 2015, the luxury market exceeded €1 trillion in retail sales value, representing a growth rate of 5 percent year-over-year (at constant exchange rates). Three segments, including luxury cars, luxury hospitality, and fine arts, are the key drivers of the growth[1]. Personal luxury, one of the leading segments in the luxury industry, reached €253 billion in sales, representing real growth rates of 1-2 percent.

The Chinese consumer remains powerful in 2015. Chinese nationals account for 31 percent of global luxury purchases. Americans follow in second, responsible for 24% of luxury purchases, and Europeans in third, accounting for 18%. Meanwhile Japan remains relevant thanks to a strong local market and the influx of Chinese tourism.

As we look into the future of the sector, we can identify three main, interrelated forces that have an impact on the dynamics of the luxury goods industry. The first is the impact on the changing values and expectations of younger generations, specifically the millennials. The second force is the development of a digital economy that is transforming every market sector. E–commerce, social networks, social media, and platforms have had a deep impact on how businesses compete including luxury. The third driver is a growing desire for memorable experiences which is connected to the generational change in expectations and the influence of digital.

These three forces can then be translated into three important, interrelated issues for the sector: new generations of consumers to please, the rise of internet and technology, and the need and the challenge to create meaningful experiences.

Main issues affecting luxury goods industry today

While economic, social, and technological changes both affect and define opportunities in all business sectors, some have had a special impact on the luxury industry. We can identify ten specific issues that are key for the evolution of luxury sector as described below:

First, the challenge of growth as China's rapid economic development has slowed. Although most projections indicate that Chinese consumers continue to make up the largest portion of luxury purchases globally, the Chinese market is no longer the locomotive for the luxury goods industry it once was. The market in China has been hurt by slower economic growth, as well as by measures taken by the government to control corruption. As a result, in 2015 we saw luxury brands make the decision to shrink their networks in China and Hong Kong. As an example LVMH has closed 3 Louis Vuitton stores in China, including the first outlet in Guangzhou. Burberry and Coach have scaled down in Honk Kong where rents are rising and Chinese visitors are decreasing.

Second, the management of price as currency fluctuations and different taxations systems generate disparity in prices. Pricing in the luxury goods industry has become increasingly challenging as a result of price transparency, currency evolution, and the importance of global tourism. Price harmonization is a challenge faced by luxury brands.

Transparency of international price differentials (a result of the growth of e-commerce and global tourism), has provided new challenges for the traditional pricing system that priced items sold in Hong Kong and China between 25% and 40% higher than in Europe, excluding taxes.

With the euro falling by about 20% against the yuan in 2015, this price gap has widened to as much as 60%. Reducing price gaps should discourage gray market trading and protect branding. In 2015, Chanel took a leadership role and decided to harmonize pricing of some key products worldwide, reducing prices in China for several key items, while simultaneously increasing them in Europe. Other companies are rolling out more affordable luxury items for the Chinese market in an effort to reduce price differentials without impacting existing merchandise.

Third, creating memorable experiences is vital for luxury strategies. Being successful at providing a memorable experience is the main area of focus for luxury executives today. Polarization of choices is the result of abundant information, broad access to luxury products, and the aim to be unique and differentiate. While economic slowdown has caused customers to become more price and quality conscious, they are less so when provided with customized service and meaningful experiences. Affluent consumers spend more money and give a far greater share-of-wallet to experiential luxury – trips and visits – as an alternative to luxury products[2]. Today's luxury consumer are "highly digital, mobile and social" and have extremely high expectations for a seamless, digitally enabled, multi-channel shopping experience[3].

1 Currency fluctuations and luxury globe-trotters boost global personal luxury goods to over a quarter trillion Euros, Bain & Company (2015).

2 According to research conducted by The Boston Consulting Group and Business of Fashion on luxury experiences and Deloitte's report on Global powers of luxury goods 2014.

3 According to Altagamma-McKinsey Digital Luxury Experience Observatory global study.

Technology and digital, personalization & customization, physical human contact and "wow moments" as the four pillars for building a memorable experience of luxury[4]. Particularly personalization, customization and the result on protecting exclusivity remain at the core of the luxury business strategy.

Fourth, 2015 was the year of digital luxury disruptors when luxury startups achieved valuations of unanticipated size, such as Farfetch, valued at over $1billion in its last financing round becoming a fashion-tech unicorn. Conversely, some start-ups experienced a hit in their valuations. Gilt Group, has agreed to sell for $250million, much lower than its formerly achieved $1.1 billion value. The growth of online retailers has impacted the way luxury firms compete in the market.

Notable events in 2015 include the merger of the largest e-commerce sites, Yooxs and Net-a-Porter, as well as Chanel's decision to sell online, starting with eyewear and sunglasses categories.

Fifth, overall urban tourism accounts for more than half of total luxury turnover. In Europe more than 60% total sales of personal luxury are to tourists. The evolution of urban tourism trends is particularly important due to the geographical concentration of luxury consumption. There is a competition among cities to become luxury capitals. The top 25 cities account for about one-third of total luxury point of sales, while the top 10 cities account for 20 percent[5].

As tourism grows so does travel retail that is increasingly capturing luxury consumers on the move. Airport retail now accounts for 6 percent of the global luxury market, a growth rate of 29 percent in current exchange rates (18 percent in constant exchange rates). Extensions, improvements, and the launch of new airports contribute to the development of this channel.

Sixth, polarization is driving consumer and retailer success at both ends of the economic spectrum. While luxury good digital clients grow substantially at one end of the economic spectrum, we see value-driven marketers and mass-market retailers serving consumers at the "extreme value" end[6]. On one hand low-income families are focused on family-budget management, while high-income households are more concerned about time-management and convenience, and laying less regard to price. Polarization impacts behavior on social media, mobile, and the Internet.

The number of luxury consumers worldwide has more than tripled over the past 20 years and is expected to reach 400 million consumers by 2020. Luxury goods price increase above inflation rates for the last decade as the result the arrival of new companies to the most selective part of the market as well as the more intensive development of products at high end (personalized, limited edition, etc.).The arrival of new companies to the most selective part of the market can also be indicative of this polarization and, above all, of more demanding customers.

Seventh, digital business was reaffirmed as a key component of business strategy for luxury brands. E-commerce grew to 7 percent market share of luxury in 2015, nearly doubling its penetration of luxury distribution since 2012 and growth is only expected to continue, with forecasts suggesting that 50% of Chinese luxury consumption will be made online by 2020, according to Bain report. The value of luxury products and services searches grew in 2015. In terms of product category, watches was confirmed as the most popular within personal luxury. Also, the search for fashion items increased beyond the search for handbags and accessories. Omnichannel is the buzz world as 78 percent of shoppers use two or more channels during their path to purchase. These multichannel shoppers have been found to be worth up to 208 percent more than single-channel luxury shoppers and 78% of luxury clients would check online before making their purchase, according to Deloitte research and the study by IE Premium Observatory respectively[7].

Social media also saw new innovative initiatives in 2015. Burberry joined forces with Mario Testino for a Snapchat initiative. Instagram strengthened its position as a key social network for fashion and luxury. Instagram models (instamodels) has been highly successful based on visibility. This is exemplified by the success of Kendall Jenner, who has 44 million followers, and of 17-year old Lucky Blue Smith, a leader among male instamodels. Luxury firms are heavily promoting branded mobile apps, iPad catalogs, and mobile web sites in order to maintain customer relationships and to keep clients connected to their brands 24/7.

Eighth, innovation in processes and products in luxury. 2015 was also the year of wearable technology also in luxury. The iWatch was launched with a price range between $350 and $10,000. The premium position was reinforced by a collaboration between Apple and Hermès, to create a product that combines new technology with artisan tradition. Many believe this is a positive sign for the future of the sector as it brings to the pool of clients the millennial generation not heavy users of luxury watches up to now.

4 As identified by Research IE Premium and Prestige Business Observatory. "Keys to memorable experiences".

5 According to research by Luca Solca for the Exane BNP Paribas Luxury Report (2015).

6 Polarizing Economics: Sell to the masses, dine with the classes?, Catterton Investments (2014).

7 The Importance of the Internet for Consumers of Premium and Luxury Products, IE Premium & Prestige Business Observatory (2012).

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Regarding process of development of luxury products, 3D technology is here to stay and is finding new applications in luxury fashion beyond customized jewelry and watches. Until recently, 3D printing was limited to conceptual items, such as those produced for Iris Van Herpen's haute-couture show. Chanel's use of 3-D printing for tweed pieces in their latest haute couture show suggests that the technology is beginning to impact the modus operandi on a larger scale and making its way into more wearable pieces.

Ninth, strategy and management in luxury companies have acquired a different dimension. On one hand as creativity has enhanced the value proposition of luxury brands and remains at the heart of any luxury organization.

On the other hand fashion and luxury are beginning to take their digital propositions more seriously, hiring Chief Digital Officers to better integrate digital strategy thinking into their core. For example, LVMH hired Ian Rogers, a Senior Director from Apple to lead their digital strategy. Alibaba also poached an Apple employee, bringing him onboard as their head of global intellectual property enforcement in an effort to fight counterfeiting. More professionalized digital developments have led to an abundance of data and challenges luxury brand managers to find the "sweet spot" that reconciles management based on analysis with that based on creativity. The role of talent and creativity is reinforced in the strategy of luxury companies, and with it comes the need to keep a well-designed balance between management of data and creativity.

Tenth, as new clients of luxury bring their new values with them, sustainability and responsible innovation has become increasingly important when making a purchase decision. Luxury's newest generation of clients are global, educated, and discerning, and will demand that luxury brands be exemplary citizens, demonstrating both environmental and social responsibility. Corporate Social Responsibility (CSR) continues to gain relevance. In fact, this is the topic with the most significant increase in importance in 2015 for luxury brands according to IE Luxury Barometer 2015.

Millennials' desire for authenticity is increasing. The trend began with local music and hospitality, but has since gone mainstream. Millennials increasingly prefer function and practicality over brand names is causing major shift retail, a shift in which many retailers are winning. While their parents derived status from brand names and product ownership, the millennial shopper distastes logos, prefers to spend on food, technology, and vacations, and favors brands with meaning and a purpose to improve the world[8].

Corporate activity and M&A transactions

In terms of luxury industry corporate activity, M&A transactions in the luxury sector over the last two years reveal three major trends[9]. Deals taking place to regain control of elements of the value chain, particularly design, product development and distribution. Puig, Spanish, Barcelona based fragrance company taking control of Jean Paul Gautier business is an example. A second trend is luxury goods companies acquiring digital knowledge and competitiveness by integrating cutting edge technology start ups. Luxottica Group acquisition of glasses.com from Wellpoint falls in this category. Additionally, a continued interest of private equity in the sector, eager to capture growth opportunities. Varenne purchased Florentine maison Roberto Cavalli in a MBO transaction, Partners Group bought a 25% in Spanish jewelry brand Joyeria Tous or Investindustrial acquisition of Sergio Rossi Spa from Kering are all examples.

In 2015, 141 deals were made within the luxury perimeter, 51 focused in hotels, 33 in apparel and accessories and 19 in cosmetics and fragrances. The average turnover of acquired companies was $425M and large size deals were concentrated in apparel and accessory sector and hotels.

Qatar is already an investor of Tiffany, Porsche, LVMH or Annya Hindmarch as well as Paul Zileri or Harrods. Qela was started in 2013 by Qatar Foundation as the first local luxury brand. Regarding acquisitions in the fashion space Valentino was first and now the French fashion brand Balmain was acquired in 2016.

The slowing economic development worldwide, including China and oil based economies, creates a new landscape where firms need to work to identify new sources of growth for the luxury sector. The fact that the number of high net worth individuals has decreased for the first time since 2007, adds to the challenge of reinvention for luxury brands that had relied on sales increased of super expensive products and categories.

Growth in the luxury sector has to be based on fostering digital growth, providing memorable experiences and targeting new clients that demand new values. The focus on digital growth calls for leaders to rethink how they will achieve a seamless experience and how they can build synergies between digital and brick-and-mortar, including how they tailor product collections for online and offline retail.

8 Millennials are rejecting a strategy Coach, Abercrombie & Fitch, and Michael Kors have relied on for years, Business Insider (2015).

9 Global Fashion & Luxury market: Private Equity and Investors Survey, Deloitte (2016).

Sovereign wealth fund investments in the luxury industry

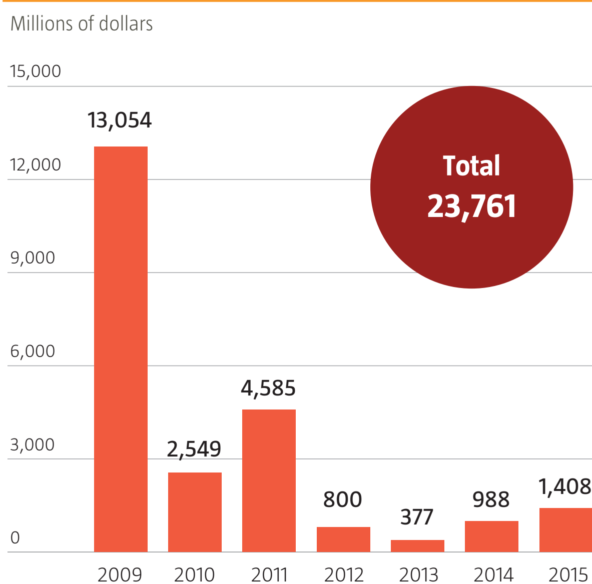
Despite the growth experienced in 2015, the luxury industry is showing signs of flattening out. 2016 has been marked by three factors suggesting a degree of caution is required in forecasting the behavior of investments in this sector over the short- and medium-term: a) a slowdown in global economic growth and international trade to 3.1% and 2.8% respectively, according to the IMF and the WTO, levels very similar to those recorded by these bodies in 2014; b) the number of people worldwide declaring assets of US$30 million or more - UHNWIs [10]- has fallen for the first time since the start of the financial crisis in 2007, down 3% on 2014, meaning there are 5,500 fewer members of this select club[11]; c) a marked decrease in demand for luxury goods and services, as reflected in the 12% fall in sales of apartments in Manhattan for over US$10 million compared to 2014[12], the terrible results of major auctions in London, with sales down by more than 30% at both Christie´s and Sotheby´s, and the 15% decline in sales of collectors cars (following a 490% increase in value over the last 10 years[13]).

There are a number of reasons for this situation, including the dramatic falls in oil and gas prices, expectations of higher interest rates in the USA, the weak recovery in western economies and the sharp economic slowdown in China and other emerging markets, such as Russia and Brazil. These factors have all impacted adversely on sovereign wealth funds, many of which are from emerging countries that devote a large share of their funds to mitigating the problems of their domestic economies through countercyclical policies. These have seen their incomes from commodities and budget surpluses contract significantly, while also being hit by substantial depreciations in many of their assets. Taken together with the prevailing geopolitical uncertainty, these factors have served to undermine the investment capacity of some of these vehicles.

Against this backdrop, sovereign wealth funds have decided to go back to focusing on seeking returns, such as those currently offered by the realty sector, the corporate bond market and safe haven securities, such as US fixed income, leaving riskier investments and acquisitions of trophy and iconic assets until conditions improve. This has not always been the case. During the commodities super-cycle, non-realty trophy assets[14][15] - strongly related to the luxury industry - were on the radar of sovereign wealth funds. Such assets were acquired as part of a clear investment strategy, in which the funds were seeking attractive returns and, in some cases, protection against inflation, while at the same time also trying to attract luxury companies and brands to their home countries and position themselves as "world-class investors"[16] (see Chart 1).

Chart 1

Sovereign wealth fund's investments in the luxury industry (2009-2015)



Source: Author's elaboration, 2016.

The first major investments by sovereign wealth funds in the luxury industry took place in the 1970s and early 1980s in the automotive industry. In 1974, the Kuwait Investment Authority sovereign wealth fund bought 14% of the Daimler Benz group, the owner of marques such as Mercedes and Maybach, for US$1 billion. In 1983, its London-based UK subsidiary, the Kuwait Investment Office, bought 10% of the Volkswagen group, currently the owner of marques such as Porsche, Bentley and Lamborghini, for US$141 million. With these investments, the fund was seeking returns from the burgeoning European automotive industry of the 1980s, and also to associate itself with marques such as Mercedes and Volkswagen, which at the time were considered luxury brands, with few models aimed at the mass market.

[10] Ultra high-net-worth individuals.

[11] The Wealth Report, Knight Frank (2016).

[12] CityRealty (2016).

[13] The Wealth Report, Knight Frank (2016).

[14] It has also purchased trophy assets in the realty sector. Noteworthy deals include the 2008 purchase of 75% of the Chrysler building by Abu Dhabi Investment Council for US$800 million, and, more recently, its contribution of 95% of the US$705 million needed for construction of the Shard in London.

[15] See the chapter on investment by sovereign wealth funds in the hotel sector.

[16] See the chapter analyzing the investments of sovereign wealth funds in the art sector in the 2015 Sovereign Wealth Fund Report.

Infographic 3

Qatar's main investments in the luxury sector 2009-2016

PERCENTAGE OF TOTAL INVESTED CAPITAL (2009-2016)

AMOUNT OF INVESTMENTS (Millions of dollars)

STAKE XX%
YEAR OF PURCHASE (XXXX)

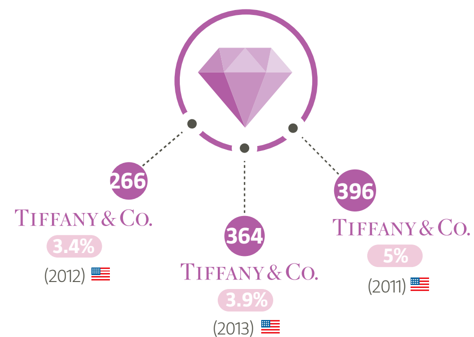
INVESTORS

QATAR INVESTMENT AUTHORITY

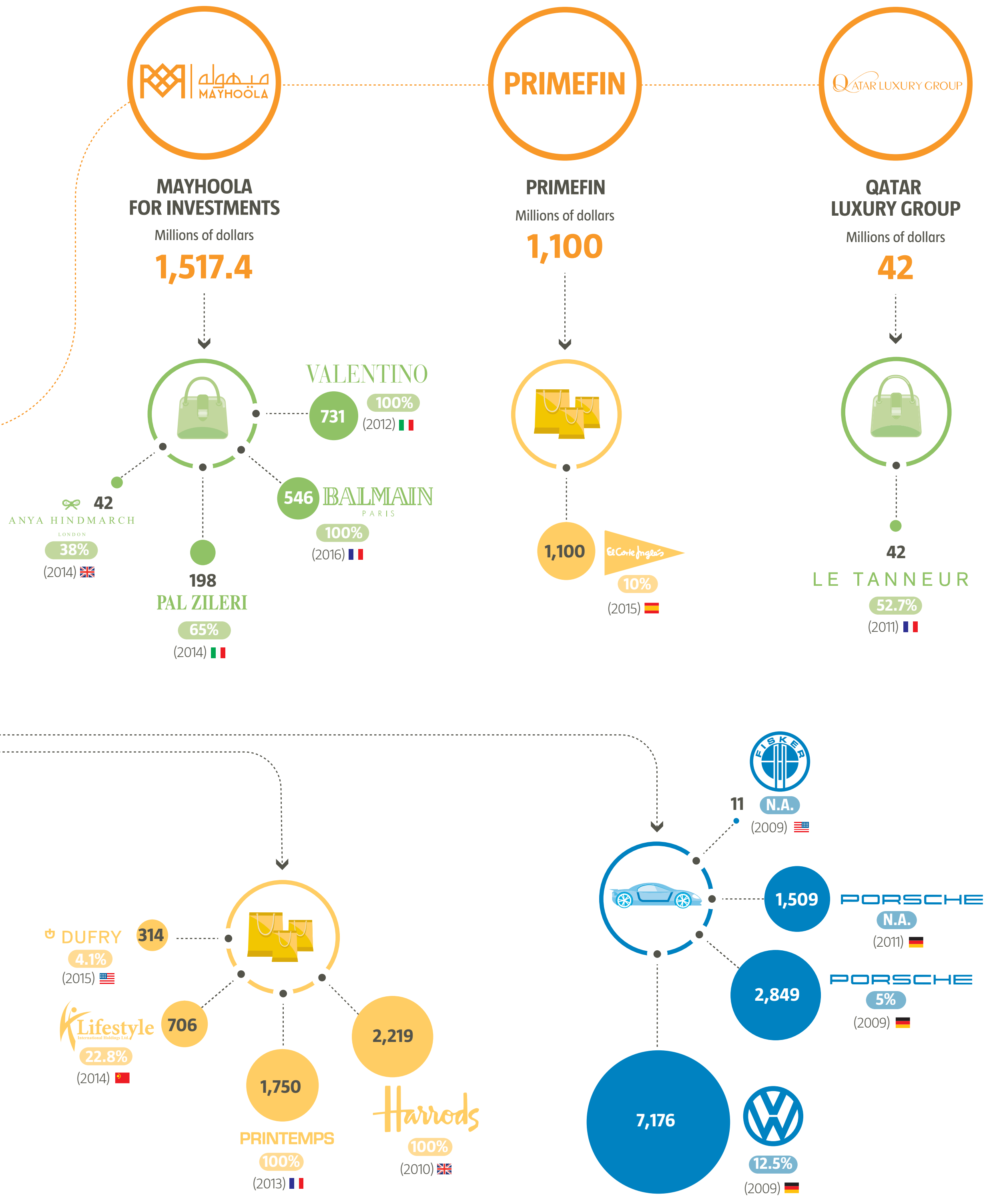
Millions of dollars

18,280

720
LVMH
1.1%
(2011)



Source: Author's elaboration, 2016



MAYHOOLA
ميهولة
PRIMEFIN
QATAR LUXURY GROUP
MAYHOOLA FOR INVESTMENTS
Millions of dollars
1,517.4
PRIMEFIN
Millions of dollars
1,100
QATAR LUXURY GROUP
Millions of dollars
42
VALENTINO
731
100%
(2012)
546
BALMAIN
PARIS
100%
(2016)
42
ANYA HINDMARCH
38%
(2014)
198
PAL ZILERI
65%
(2014)
1,100
10%
(2015)
42
LE TANNEUR
52.7%
(2011)
11
N.A.
(2009)
1,509
PORSCHE
N.A.
(2011)
2,849
PORSCHE
5%
(2009)
7,176
12.5%
(2009)
DUFRY
314
4.1%
(2015)
Lifestyle
706
22.8%
(2014)
1,750
PRINTEMPS
100%
(2013)
2,219
Harrods
100%
(2010)

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The Qatar Investment Authority fund has pursued such investments to such an extent that they have become its trademark. Qatar's sovereign wealth fund has invested over US$16.5 billion in acquiring non-realty trophy assets[17] over the last fifteen years. This has made it a real specialist and set the bar for this sector (see Infographic 3). As in the Kuwaiti case, its initial investments were in companies in the automotive sector. In 2009, it took an US$11.3 million stake in the leading manufacturer of hybrid vehicles, the USA's Fisker[18], and, through its subsidiary Qatar Holding[19], invested US$7.176 billion in the Volkswagen Group[20] and US$2.848 billion in Porsche, taking stakes of 12.5% and 10% in their capital, respectively, as part of the merger of the two companies. Two years later, in 2011 it invested US$1.509 billion in a rights issue by Porsche, so as not to see its holding diluted[21]. It currently has 14.6% of the shares of the world's second largest car manufacturer, having at once stage controlled 17% of the shares of the Group resulting from the merger.

The Qatari fund has not limited itself to investing in the automotive industry. Over the last decade it has concentrated a lot of its efforts on acquiring trophy assets in the fashion, jewelry and department-store sectors. It carried out its most audacious investment in 2010, when it paid US$2.219 billion for London's iconic Harrods store. The investment was carried out by Qatar Holding, which has seen its investment rewarded with substantial dividends, exceeding £100 million over recent years[22]. And the investment has also resulted in the opening of branches of the exclusive store in the tiny Emirate's capital, one of which is in the spectacular Hamad International Airport. Three years later, repeating its Harrods strategy, it put up more than US$2 billion to acquire 100% of the luxurious Printemps store in Paris - beating Galeries Lafayette, which was also interested in acquiring the asset - from Deutsche Bank (with a 70% stake) and the Borletti Group (30%). More recently, the fund, and some of its executives, have been taking stakes in the capital of other major stores, such as China's Lifestyle International Holdings, which operates the Sogo malls in Hong Kong, in which it bought a 22.7% stake for US$705 million in 2014, and el Corte Inglés, where the former prime minister of Qatar and ex-CEO of the Qatari sovereign wealth fund acquired a 10% holding in the stores of the Areces family, for US$1.1 billion in 2015. In 2015, it also spent US$313.7 million on acquiring 4.1% of the airport retail operator Dufry, helping the Swiss company to take over its closest competitor, Italy's World Duty Free, in concert with Singapore's two funds, GIC and Temasek. In the first two cases, the plan is to use the Qatari fund's holding to foster international expansion, opening both stores in the Middle East.

The fund has also been very active in the high fashion and jewelry sectors. Its portfolio includes: 1.1% of the French luxury-goods conglomerate LVMH Moët Hennessy, which owns brands such as Louis Vuitton, Loewe and Christian Dior, which it acquired for US$719.6 million in 2011; and Tifanny, in which it has invested over US$1 billion in various deals[23], making it the largest shareholder with a holding of 12.8%, ahead of The Vanguard Group (7.9%), JP Morgan (6.9%) and BlackRock (5.6%). In addition, we should also include the deals carried out by Mayhoola, a vehicle of Qatar's royal family and closely connected to the Emirate's sovereign wealth fund, including its purchase of Valentino in 2012 (for US$731 million), its holdings of 38% of Anya Hindmarch and 65% of Pal Zileri (acquired for US$42.4 million and US$137[24] million, respectively, in 2014) and the acquisition of Balmain in 2016 (for around US$546 million).

Other sovereign wealth funds in the region were infected by the same bug and, driven by imitation and excess liquidity from their hydrocarbon resources, embarked on a search for their own trophy assets. Thus sovereign wealth funds from the Emirates - in direct competition with the Qatari fund to see which could acquire the most prestigious trophy assets - have acquired holdings in companies such as Ferrari (of which Mubadala acquired 5% in 2005 for US$137 million[25]), Mercedes-Benz Gran Prix (in which Aabar, the non-oil branch of IPIC, invested US$1.691 billion to purchase a further 10% of the F1 team, taking its holding to 40%) and the McLaren Group (in which Bahrain's Mumtalakat fund achieved control of 50% of the shares in 2013, having invested US$13 million to acquire an additional 8%). These investments in F1 must have fostered the construction of the Abu Dhabi circuit and the holding of the F1 grand prix there in 2009. They must also have been the catalyst for development of the Ferrari World amusement park in 2010, and the consolidation of the Bahrain grand prix, which was held for the first time in 2004[26]. This clearly reveals that there was a much more ambitious strategy behind these investments than just

[17] It invested over US$26.6 billion in trophy realty assets in Europe and North America over this period. Sovereign Wealth Center (2016).

[18] It participated in the funding round (Series C) through its subsidiary Al Gharrafa Investment, together with Quantum Fuel Systems Technologies, Kleiner Perkins Caulfield & Byers, Palo Alto Investors and Thomas Lloyd Capital. Venture Beat (2009).

[19] Following the most recent restructuring of the fund, Qatar Holding's international investments will pass to the Qatar Investment Authority, with the subsidiary through which the fund had carried out its main acquisitions ceasing to exist. Bloomberg (2016).

[20] The investment in Volkswagen has been less successful than anticipated. The emissions-fraud scandal led to the fund - the third largest shareholder, with 14.6% of the capital - losing around US$5 billion in just three months. Bloomberg (2016).

[21] Following the merger of Volkswagen and Porsche, the fund sold 10% of Porsche to the Porsche and Piëch families in 2013. Bloomberg (2013).

[22] Companies House (2015).

[23] Tiffany annual report (2015).

[24] Including a package of the Italian company's debt, valued at €61 million.

[25] It sold the holding to the Fiat Group for €167 million, five years later, in 2010. Financial Times (2010).

[26] Mumtalakat also took a 9.1% holding in Daimler, the parent company of Mercedes, in 2009, for US$2.654 billion.

achieving returns or linking the image of these brands to the funds and, therefore, their countries, as has subsequently been demonstrated. This rationale could also have been behind IPIC's 2010 investment in multi-millionaire Richard Branson's space company, Virgin Galactic Ventures, of which it acquired 32% for around US$280 million. Will we see the first commercial space flight take off from Abu Dhabi in the next few years?

Acquisitions of trophy assets in Asia have so far been led by Singapore's sovereign wealth funds, GIC and Temasek. GIC's investments in high fashion and jewelry companies include its acquisition of 2.3% of Tod's, it's 2001 acquisition of 4% of Bulgari and its US$48.9 million investment in Jimmy Choo in 2015, giving it a 5.4% stake un the Malaysian designer's company[27]). Other noteworthy investments in luxury retailers include the joint purchase by GIC and Temasek of 14.2% (7.1% each) of the Swiss airport retail operator Dufry for US$1 billion, and, in 2011, GIC's US$170 million capture of 10% of the company that operates the 17 luxury stores of China's Intime chain, the base for some of the main brands of the LVMH Moët Hennessy and Kering groups in the Asian giant. Despite being awash with liquidity, Chinese funds have been very timid in their approach to non-realty luxury assets, concentrating instead on building positions in the financial, energy and industrial sectors. For the moment, we can only point to CIC's investments in Diageo (investing US$364.4 million in 2009 for 1.1% of the producer of spirit drinks such as Zacapa and Johnnie Walker) and L'Occitane (acquiring 1.9% of the French cosmetics company in 2010 for US$50 million), and SAFE's 2014 investment in Fiat Chrysler, in which it acquired 2% of the manufacturer of iconic marques such as Ferrari and Maserati, for US$241.6 million.

It seems certain that we will see more investments by these funds in non-realty trophy assets over the coming years, but not at the pace we saw in the golden decade for commodities and global trade. These assets have - to an extent - lost some of their sparkle, for sovereign wealth funds at least.

[27] Jimmy Choo, annual report (2015).