ACT LEADING TREASURY PROFESSIONALS

The Association of Corporate Treasurers

Examiners Paper, Case Study and Solutions

MCT ADVANCED DIPLOMA CASE EXAMINATION

Based on De Luxe plc

October 2015

QUESTION 1

Evaluate the main factors that are likely to be (i) the key drivers of continuing double-digit revenue growth over the next five years and (ii) the main threats to revenue growth.

(10 marks)

QUESTION 2

Select at least four key areas where the treasury and corporate finance functions need to focus attention over the next five years, given your views about the company's future growth opportunities and threats. Justify your choice of key areas.

(8 marks)

QUESTION 3

This question refers to Section 5: Financials of the Case Study.

Required:

a) **Summarise the risk/return characteristics and performance of the company's shares over the last four years, using the financial ratios provided in the Financial Profile.**

(7 marks)

b) **Assess whether recent returns have been unduly inflated by any over-valuation of the shares, using the valuation ratios provided in the Share Price Data and Equity Analysis.**

(3 marks)

It has been suggested that the company is currently generating and retaining more cash than is required to support continuing growth and that the dividend policy should be revised upwards.

c) **From your analysis of the last five years' profits and cash flows suggest a higher, sustainable level of regular dividends and summarise the pros and cons of such a change.**

(6 marks)

(Total 16 marks)

QUESTION 4

It has been argued that De Luxe shareholder value could be increased by gearing up the company's balance sheet.

Required:

a) **Explain the theoretical rationale behind such a proposal and any practical as well as theoretical arguments against implementing such a policy for De Luxe plc.**

(8 marks)

b) **Calculate the company's current WACC, based on current market interest rates, current equity returns and the current amounts of equity, debt and cash.**

(3 marks)

c) **Estimate the maximum net debt that the business could reasonably carry on a sustainable basis, bearing in mind the company policy on property leases.**

(8 marks)

d) **Calculate what the company's WACC would be given a revised capital structure based on your answer to Question 4c, allowing for any revised level of shareholder and lender risk. Quantify the impact of your revised WACC on the company's EV.**

(5 marks)

(Total 24 marks)

QUESTION 5

The Company currently holds in excess of £600m in cash, deposits and money market funds (MMFs) on balance sheet. Some of this may be held as lease rental cover. Regulation on MMFs is due to change shortly, making them less attractive.

Required:

Devise a policy for investing these monies.

(10 marks)

QUESTION 6

Comment critically on the level and trend of net working assets in the Financial Profile (Case Study, Section 5 Financials).

Given the strategic / business model, explain whether:

it will need to be increased further
is now optimum
it could be reduced

(10 marks)

QUESTION 7

The Company acquired a business in China in which the seller retained a 15% economic interest.

As part of the sale agreement, the Company has a call option exercisable from 01.01.2016 and the seller has a put option, exercisable from 01.01.2021 on the 15% interest.

Under IFRS39 the present value of the put option is recognised as a non-current financial liability on the B/S and as a reduction in non-controlling interests.

The key inputs applied in arriving at the value of the put option liability are the future performance of the Group's business in China; the average historical De Luxe plc multiple; and the risk adjusted discount rate for China, taking into account the risk-free rate in China. The future performance of the business is estimated by using management's business plans together with long-term observable growth forecasts.

The call option becomes exercisable shortly.

Required:

The Finance Director asks you to list and explain the factors which the Board should consider when periodically reviewing whether or not to exercise the call.

(10 marks)

QUESTION 8

The Company is blurring the boundaries between physical and digital distribution to exploit changes in customer behaviour, eg:

- iPads-in-store
- collect-in-store
- customer 1-2-1 tool in-store
- online

This helps make pricing more transparent globally.

Meantime the global tide of tourists ebbs and flows in response to strengthening and weakening currencies, forcing some luxury goods companies to lower or raise local currency prices in response.

So the company has decided to review its currency hedging policy, bearing in mind that some shareholders invest in the company because of its diverse exposure to currencies.

Required:

a) Identify the sources of the Company's currency transaction risks.

(3 marks)

b) Propose and justify objectives for a hedging policy.

(3 marks)

c) Determine a policy to satisfy your chosen objectives.

(6 marks)

(Total 12 marks)

The Association of Corporate Treasurers

MCT ADVANCED DIPLOMA
CASE STUDY
BACKGROUND INFORMATION

October 2015

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1.0 INTRODUCTION

1.1 Group Overview

De Luxe Group plc is a British luxury fashion house which designs, produces and sells products under the De Luxe brand.

Summary Financials	**2014 GBPm**	**2015 GBPm**
Turnover	2329.8	2523.2
EBIT	445.4	440.3
PAT	332.3	341.1
Gross debt	143.0	65.12
Net debt	(402.5)	(552.2)
Shareholders' funds	1208.0	1451.5
Average market cap.	6010.5	6852.5

De Luxe is a single brand company, which grows by extending product range and market scope rather than by acquiring new brands. The product range comprises women's, men's and children's clothing, accessories and beauty products. The company operates in three regions: Asia-Pacific, Europe-Middle East-India-Africa and the Americas, accounting for 39%, 36% and 25% of revenue respectively. Distribution is via retail outlets, wholesale supplies to department stores/franchisees and licencing, each channel accounting for 70%, 27% and 3% of revenue respectively.

De Luxe is a FTSE 100 company, with negative net debt and unrated.

1.2 Review of 2015 Results

The Chief Creative Officer and Chief Executive Officer commented;
"We are pleased to report a strong full-year performance, with revenue up 11% and adjusted profit up 7% underlying. Against a challenging external backdrop, our global team focused ever more intensely on our core, including celebrating the British-made products that are our brand signature, and extending our online and offline integration.

At this early stage of the year we are seeing increased uncertainty in some markets. Against this background we will continue to manage our business dynamically – capitalising on the significant opportunities we have by channel, region and product to create long-term shareholder value".

1.3 Core Strategies

The Group's core strategies are summarised here and discussed in more detail in Section 2;

Inspire with the brand
Realise product potential
Optimise channels

Unlock market opportunity
Pursue operational excellence
Build our culture

1.4 Particular Characteristics

Characteristics of the luxury goods business which distinguish it from the more conventional commercial company will emerge as you read through Sections 2 and 3 of the Case Study, eg:

- Unique (single) brand image at the heart of the business
- Global market scope commitment
- Flagship store in each geographic location, the establishment of which is the company's major capex item
- Metrics specific to the immediate returns on this capex
- Four "seasons" plus "festivals" in specific regions
- Digital technology as the key to creating overlapping multi-chain global business while creating a personal one-to-one relationship with each customer
- All channels feeding off single inventory
- Operational leasing instead of asset purchase.

2.0 BUSINESS PROFILE & ANALYSIS

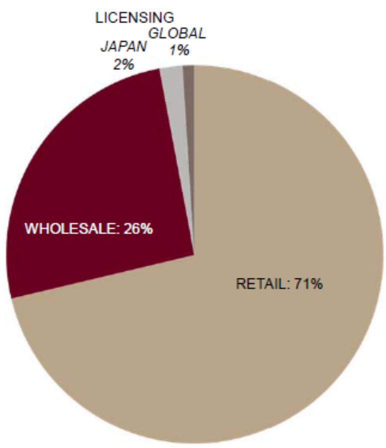
2.1 The Business

The following slides are extracts from a company presentation; they include a detailed analysis of the Group's business model, break-down of turnover by product, channel and geography, and key aspects of the company's product/market strategy for improving profitability and continued growth.

DE LUXE PLC

- **AUTHENTIC BRITISH HERITAGE**
  – Rooted in integrity of outerwear
- **ONE GLOBAL BRAND**
- **DIVERSIFIED BUSINESS MODEL**
  – By channel, region and product
- **BROAD CONSUMER APPEAL**
  – Across genders and generations
  – Core luxury and millennial consumer
- **BRAND MOMENTUM DRIVEN BY DIGITAL INITIATIVES**
- **EARLY BENEFITS FROM INVESTMENT IN OPERATIONAL INFRASTRUCTURE**
- **STRONG FINANCIAL POSITION**

REVENUE BY CHANNEL



FY 15 REVENUE
£2,523M

UNDERLYING REVENUE GROWTH

	FY 2013 %	FY 2014 %	FY 2015 %
RETAIL	**12**	**15**	**14**
WHOLESALE*	**1**	**2**	**1**
LICENSING#	**(1)**	**2**	**0**
	8	**17**	**11**
RETAIL COMPS	**5%**	**12%**	**9%**

* FY 2015 EXCLUDES £175M OF BEAUTY SALES. INCLUDING BEAUTY SALES, WHOLESALE REVENUE INCREASED BY 6% UNDERLYING
* FY 2014 EXCLUDES £144M OF BEAUTY SALES. INCLUDING BEAUTY SALES, WHOLESALE REVENUE INCREASED BY 32% UNDERLYING
\# FY 2013 EXCLUDES £27M OF FRAGRANCE ROYALTY. INCLUDING FRAGRANCE ROYALTY, LICENSING DECREASED BY 23% UNDERLYING

GROWTH OPPORTUNITIES BY CHANNEL

• **BLURRING PHYSICAL AND DIGITAL AS CONSUMER BEHAVIOUR EVOLVES RAPIDLY**
– iPads in-store generate over 25% of digital revenue
– Collect-in-store in about 200 stores including China and Japan
– Customer 1-2-1 tool in over 450 stores in 30 countries (see note below)*

• **OFFLINE**
– Focus on retail productivity and enhanced service
– Focus on flagship and emerging markets

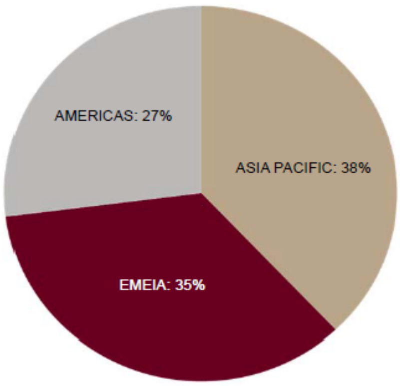
• **ONLINE**
– Most complete product offer
– Supported by investment in mobile, fulfilment and service
– Third-party digital retailers

• **REFINE WHOLESALE**
– Travel retail
– Emerging market franchisees
– US department stores

• **JAPAN TRANSITION**

*NOTE: 1-2-1 is a tool for customers to register a personal profile with De Luxe. Purchases are logged on this profile – eg date, store location – and in future the customer can go into any store anywhere and arrange for a replacement, repair, etc. without evidence of purchase.

REVENUE BY REGION



FY 2015 RETAIL/WHOLESALE REVENUE
£2,455M

	FY 2013 %	FY 2014 %	FY 2015 %
ASIA PACIFIC	**13**	**18**	**9**
EMEIA#	**7**	**17**	**12**
AMERICAS	**6**	**24**	**16**
	9	**19**	**12**

UNDERLYING REVENUE GROWTH
Europe, Middle East, India and Africa

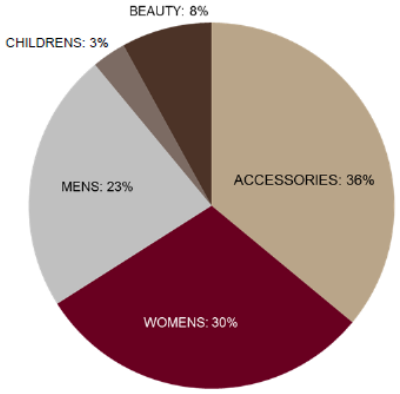
GROWTH OPPORTUNITIES BY REGION

• **ASIA PACIFIC (OVER 85% RETAIL)**
– China: optimise retail and assortments
– Japan: build brand
– South East Asia: high potential markets
– Wholesale: travel retail opportunity

• **EMEIA (OVER 65% RETAIL)**
– Travelling luxury customer: store and service investment in flagship markets
– Middle East/India: taken greater control
– Wholesale: ongoing rationalisation in Europe

• **AMERICAS (ABOUT 65% RETAIL)**
– Relocate/renovate presence in flagship markets
– Digital penetration double the global average
– Wholesale: dedicated space in selected doors
– Latin and South America: use retail and wholesale as appropriate to capture growth

REVENUE BY PRODUCT DIVISION



	FY 2013 %	FY 2014 %	FY 2015 %
ACCESSORIES	**8**	**12**	**12**
WOMENS	**7**	**10**	**11**
MENS	**14**	**12**	**10**
CHILDRENS	**9**	**8**	**1**
BEAUTY	**-**	**-**	**26**

FY 2015 RETAIL/WHOLESALE REVENUE
£2,455M

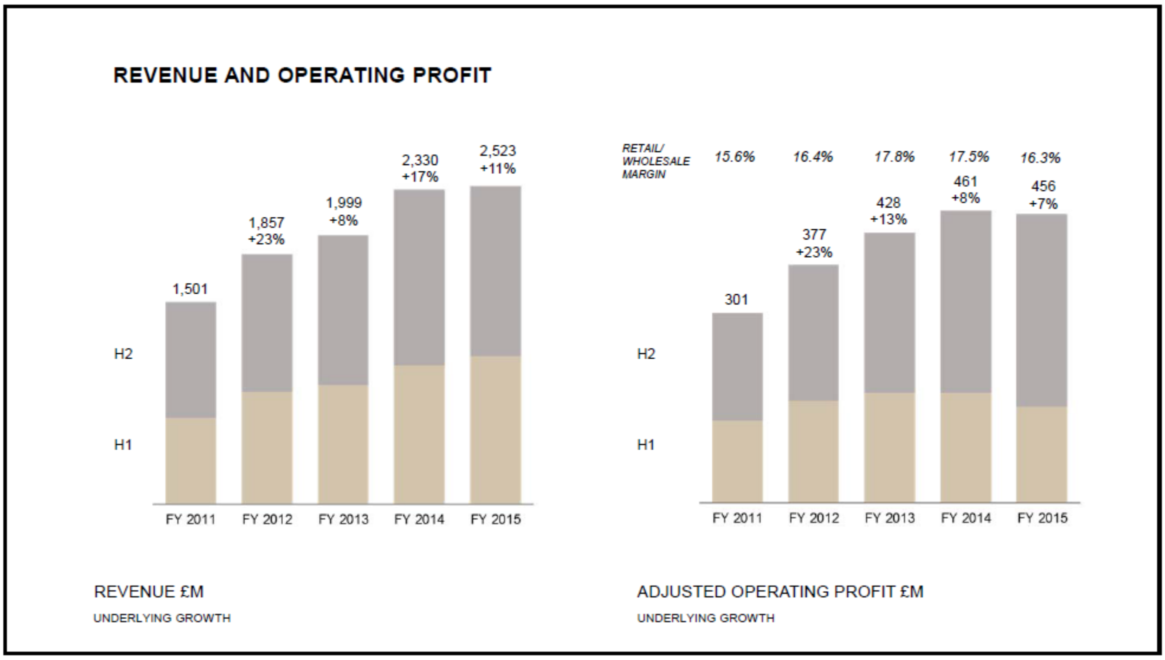
UNDERLYING REVENUE GROWTH

GROWTH OPPORTUNITIES BY PRODUCT DIVISION

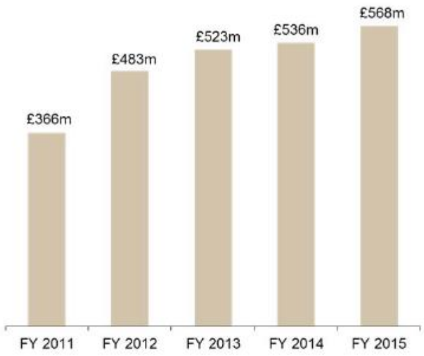
• **APPAREL**
– Relaunched trench coat heritage
– Around half of revenue from outerwear
– Grow mens tailoring
– Develop childrens with region-specific strategies

• **ACCESSORIES**
– Around half of revenue from large leather goods
– Innovate soft
• Heritage scarves and runway-inspired ponchos
• Personalisation
– Significant opportunity in mens accessories

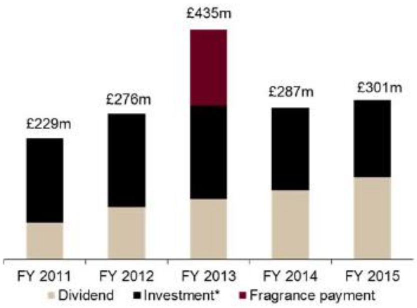
• **BEAUTY**
– Large market; under-penetrated compared to peers
– Fifth product division



STRONG CASH GENERATION



CASH INFLOW FROM OPERATIONS

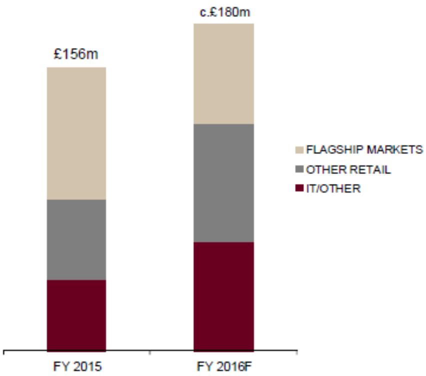


USES OF CASH

* INVESTMENT IS CAPITAL EXPENDITURE PLUS ACQUISITION SPEND

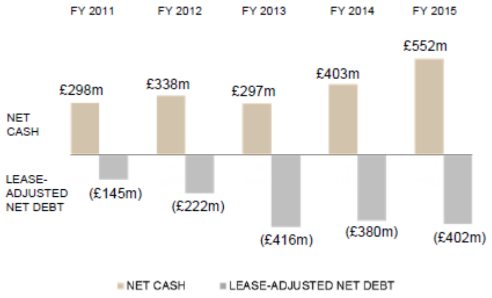
CAPITAL EXPENDITURE FOCUSED ON RETAIL

- **CAPITAL EXPENDITURE PLANNED AT c.£180M IN FY 2016**
  - About two-thirds retail
  - Biased towards Asia Pacific
    - Including a number of projects in Japan
    - A flagship in Korea
    - Continued upgrade of the store portfolio in China
- **FY 2016 STORE OPENINGS**
  - Opening about 15-20 mainline stores, closing about 15-20



CAPITAL EXPENDITURE

NET CASH/(DEBT)



- **NET CASH OF £552M**
  - After nearly £1bn of investment over last five years
  - Over £700m of capital expenditure
  - Over £200m on acquisitions, including Beauty and China
- **LEASE-ADJUSTED NET DEBT OF £402M**
  - Calculated as five times annual minimum lease charge less net cash
  - Shift to retail and flagship markets
- **DIVIDEND UP 10% IN FY 2015**
  - Payout ratio 46%, up from 42%
  - As move progressively to 50% payout ratio

NOTE: Some cash is invested in money market funds (MMFs) but impending regulations designed to reduce riskiness may render these less flexible and more expensive to use.

STRATEGIES

INSPIRE WITH THE BRAND

REALISE PRODUCT POTENTIAL

OPTIMISE CHANNELS

UNLOCK MARKET OPPORTUNITY

PURSUE OPERATIONAL EXCELLENCE

BUILD OUR CULTURE

INSPIRE WITH THE BRAND

• **DISTINCTIVE BRITISH IDENTITY**
– Celebrated the opening of new flagship stores in Shanghai and Los Angeles
– Runway shows in London
– Further strengthened global brand awareness

• **INNOVATIVE USE OF DIGITAL MEDIA** (see note below)*
– Improving engagement with existing and potential customers
– Partners included Facebook, Twitter, Instagram, WeChat and Line

• **INVESTING IN CUSTOMER INSIGHT AND ANALYTICS**
– To better understand the core luxury customer
– To drive productivity and efficiency improvements

*NOTE Re. use of digital media, retailers are creating new ways of retailing that merge the experience of shopping on-line and in-store so that each touchpoint is consistent, cumulative and compelling. For example, the store assistants in one luxury retailer are armed with iPads that can show customers new ideas, and check stock levels instantaneously. More than that, tags on the products in-store are connected to the video screens, so that the screen can showcase what a customer is carrying. If that sounds like 'store as showbusiness' then that's exactly the point – the physical store has to function not just as a shop but as theatre, flagship and entertainment destination. (Source: A digital retail consultant).

REALISE PRODUCT POTENTIAL

• **STRONG DEMAND FOR HERITAGE TRENCH COATS AND CASHMERE SCARVES**
– Mainline sales of outerwear and soft accessories grew nearly 20%
– Simplified assortment of trench coats
– Monogramming introduced for cashmere scarves

• **MENSWEAR REVENUE UP 10% UNDERLYING**
– Under-represented category for Burberry
– Mens outerwear and tailoring performed strongly
– Double-digit growth in outerwear, supported by core replenishment styles and tailoring

• **ACCESSORIES**
– Scarves drove growth for both mens and womens
– Mens now about 20% of total accessories

• **BEAUTY DELIVERED 26% UNDERLYING GROWTH**
– Growth in fragrance was underpinned by the successful launch of My De Luxe

OPTIMISE CHANNELS

- **RETAIL NOW 71% OF REVENUE**
  – Opened 16 mainline stores, closed 17

- Over half openings in flagship markets

- Seven airport stores
  – Product and customer service initiatives drove average selling price and conversion

- **INVESTING IN DIGITAL COMMERCE**
  – Launch of enhanced mobile site
  – Improved user experience including search, payment and fulfilment

- **DIGITAL THIRD PARTIES**
  – Reach
  – Revenue
  – Reputation

UNLOCK MARKET OPPORTUNITY

- **FOCUS ON CHINESE LUXURY CUSTOMER**
  – At home and when travelling
  – Double-digit % growth from the Chinese customer globally
  – Continued store evolution and elevation in China

- **PROGRESS IN JAPAN TRANSFORMATION**
  – Comparable sales growth about 30%
  – Opened Osaka flagship, relocated Omotesando store
  – Investing in brand awareness

- **STRENGTHENING AND ELEVATING BRAND IN AMERICAS**
  – Concentrating investment in flagship markets
  – Improving and rationalising positioning in US department stores

PURSUE OPERATIONAL EXCELLENCE

• **NEW DIGITAL FULFILMENT APPROACH IN CHINA**
  – Improved stock availability and reduced delivery times
  – Enhanced customer experience
  – UK and US planned in FY 2016

• **OPTIMISING ASSORTMENTS**
  – Store profiling initiative to drive productivity
  – Aligning our merchandising globally
  – Build by fixture, climate and customer

• **UPGRADING CORE IT SYSTEMS**
  – To underpin future growth and productivity initiatives

BUILD OUR CULTURE

• **FAIR AND SUSTAINABLE EMPLOYMENT PRACTICES**
  – Accredited UK Living Wage employer

• **ACTING RESPONSIBLY**
  – Environmental impact and sustainable practices

• Sustainable cotton farming initiative in Peru

• Green tariff electricity to over 35% of operating space

• Ethical trading activities extended to Beauty and raw material suppliers

• **SOCIALLY RESPONSIBLE**
  – Donate 1% of Group adjusted profit before tax to charitable causes

DIGITAL AS A DIFFERENTIATOR

• **INNOVATION**

• **REACH AND ENGAGEMENT**

• **DIGITAL INTEGRATED WITH RETAIL**

• **LEARNING ABOUT THE CUSTOMER**

• **FULFILMENT**

• **DIGITAL THIRD PARTIES**

DRIVING PRODUCTIVITY – THE CUSTOMER OPPORTUNITY
CUSTOMER INSIGHT

- **DATA TO INFORM DECISION MAKING**
  - Single global view of customer
    - Who, when and where customer shops

- **RETAIL**
  - Right product, in the right store, at the right time
  - Refine customer service

- **CUSTOMER VALUE MANAGEMENT**
  - Retain and grow existing customers through personalised

- Experience

- Products

- Service

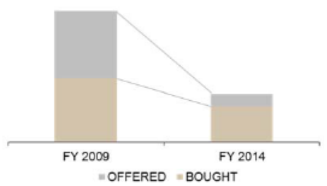
- **DIGITAL**
  - Site optimisation

- Design, content and performance

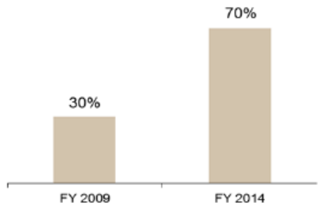
- **MARKETING**
  - Marketing effectiveness

DRIVING PRODUCTIVITY - THE PRODUCT OPPORTUNITY

- **RATIONALISED ASSORTMENTS**
- **INCREASED CONSISTENCY**
  - Global buy
  - Replenishment
- **ELEVATED ASSORTMENT**
- **FUTURE OPPORTUNITIES**
  - Store profiling
  - Warm climate stores
  - Automated allocation
  - Virtual single pool of inventory



OPTION COUNT



CONGRUENCY OF ASSORTMENT AMONG REGIONS

DIRECTLY OPERATING BEAUTY

- **SIGNIFICANT OPPORTUNITY**
  – Large market; under-penetrated compared to peers
  – Most widely encountered projection of brand
  – Full alignment with apparel and accessories

- **BEAUTY IS FIFTH PRODUCT DIVISION**

- **BUILDING FOUNDATION FOR GROWTH**
  – Establish fragrance pillars
  – Successful launch of My De Luxe
  – De Luxe Rhythm product extensions
  – Scaling fragrance distribution
  – Unlocking make-up

- **GROWTH TARGET**
  – About 10-15% at constant FX in FY 2016

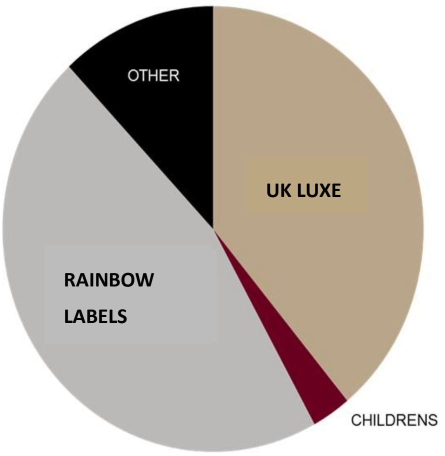
JAPAN – LICENSED PRODUCT

- **APPAREL LICENCE WITH OSAKA HIDEKI**
  – c.£500m at retail
  – Licensee's UK collection
  – Childrens
  – Rainbow Labels

- **THREE OTHER LICENCES**

- **ORDERLY EXIT OF LICENSED "UK Luxe"**
  – Licence expires 30 June 2015
  – Concession closure by end September 2015
  – Carefully managed inventory clearance

- **RAINBOW LABELS**
  – No De Luxe association
  – Younger customer
  – Successful contemporary apparel lines
  – Distinct from De Luxe; not luxury
  – New licence with existing partner
  – Luxe Life rebrand
  – De Luxe retains intellectual property



FY 2015 JAPAN LICENSING REVENUE

£53M

JAPAN – BUILDING OUR LUXURY BUSINESS

• **OPENED FIRST STORE SIX YEARS AGO**
  – Comparable store growth was about 30% in FY 2015

• **BUILDING RETAIL PRESENCE**
  – Open free-standing stores in key markets

• Relocated Omotesando

• Opened Osaka flagship
  – Partner with department stores
  – Currently 5 stores and 13 concessions

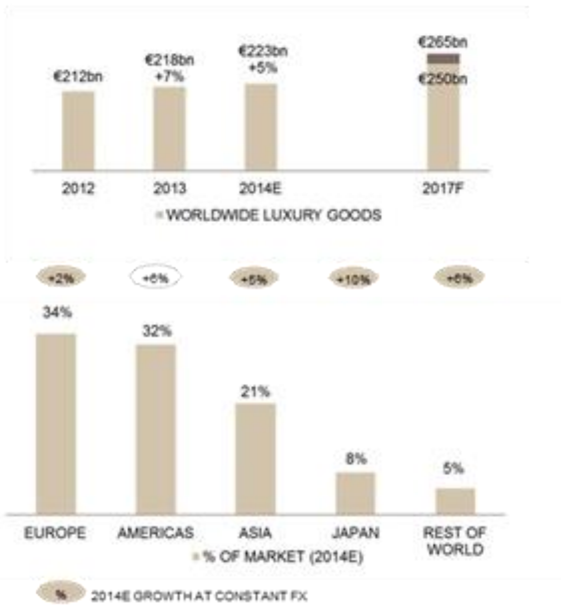
• **BUILDING DIGITAL PRESENCE**
  – Transactional website live since 2011
  – Blur physical and digital in store
  – Collect in store now available
  – Pursue opportunities with third party digital players

• **REPOSITION THE BRAND**

• **LONG-TERM VISION**
  – Luxury brand positioning
  – About 10% of group revenue, in line with peers

LUXURY FORECAST TO GROW 4-6% CAGR TO 2017

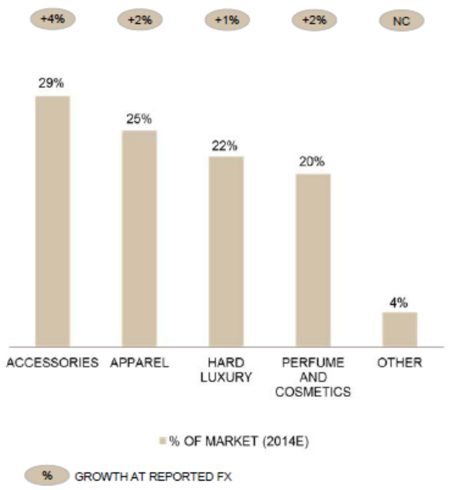
- **LUXURY GOODS TO CONTINUE TO GROW**
  - Currency a significant factor
    - 2014E growth +2% at reported FX
    - 2014E growth +5% at constant FX
  - 2014 market impacted by several events
    - Weather
    - Geopolitical tensions
  - Online fastest growth channel
    - +28% in 2014E



SOURCE: "SECTOR SURVEY"

BROAD-BASED PRODUCT GROWTH FORECAST

- DYNAMIC TREND OF OUTERWEAR IN BOTH MENS AND WOMENS APPAREL
- MENS ACCESSORIES MAINTAINING GROWTH MOMENTUM
- SHOES OUTPERFORMING LEATHER GOODS



SOURCE: BAIN/ALTAGAMMA

FY 2016 OUTLOOK

RETAIL	Low single-digit % growth in retail revenue from net new space
WHOLESALE	Unchanged at constant FX in H1 - Excluding Beauty, low single-digit % decline at constant FX Beauty up about 10-15% at constant FX in FY 2016
LICENSING	Down about 40% at constant FX
RETAIL/WHOLESALE PROFIT	If exchange rates remain at current levels* reported profit will be about £10m higher than at FY 2015 rates
GROUP ADJUSTED PBT	H2 weighted
INTEREST	c.£1m
UNDERLYING TAX RATE	c.23%
DIVIDEND POLICY	Moving progressively to 50% full year payout based on adjusted diluted EPS
CAPITAL EXPENDITURE	c.£180m
DEPRECIATION/AMORTISATION~	c.£140m

* EFFECTIVE RATES AS AT 14 MAY 2015, TAKING INTO ACCOUNT THE CURRENT HEDGED POSITIONS
~ EXCLUDES £15M AMORTISATION OF FRAGRANCE AND BEAUTY LICENCE INTANGIBLE ASSET

STORE PORTFOLIO

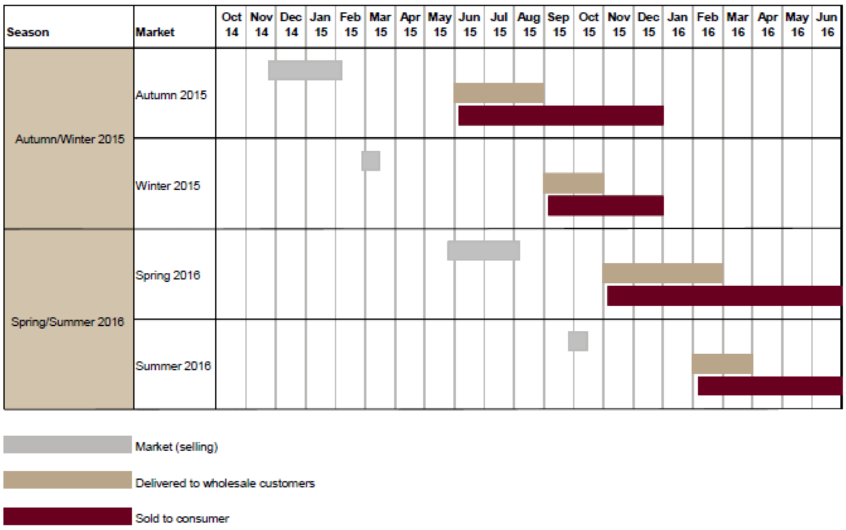
GLOBAL

	Directly-operated				
	Stores	Concessions	Outlets	Total	*Franchise stores*
At 31 March 2014	215	227	55	497	*70*
Additions	16	12	3	31	*5*
Closures	(17)	(26)	(1)	(44)	*(8)*
At 31 March 2015	214	213	57	484	*67*

BY REGION

	Directly-operated				
At 31 March 2015	Stores	Concessions	Outlets	Total	*Franchise Stores*
Asia Pacific	63	143	13	219	*12*
EMEIA	73	62	24	159	*49*
Americas	78	8	20	106	*6*
Total	214	213	57	484	*67*

WHOLESALE CYCLE



AMERICAN DEPOSITARY RECEIPT PROGRAMME

De Luxe plc has an American Depositary Receipt (ADR) programme that trades on the Over-The-Counter ('OTC') market in the US.

An ADR is a receipt that is issued by a depositary bank representing ownership of a company's underlying ordinary shares. ADRs are quoted in US dollars and trade just like any other US security. The company has a sponsored Level 1 ADR programme for which The Bank of New York Mellon acts as Depositary.

Ratio: 1 ADR = 1 ordinary share

Exchange: OTC

3.0 COMPETITIVE ENVIRONMENT

3.1 Exclusively for Everybody (Economist, 13.12.2014)

Exclusively for everybody

The modern luxury industry rests on a paradox—but is thriving nonetheless, says Brooke Unger

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AT THE TRANG TIEN PLAZA shopping mall in Hanoi, Vietnam's capital, on some evenings a curious spectacle unfolds. Couples in wedding finery pose for photographs in front of illuminated shop windows, with Salvatore Ferragamo, Louis Vuitton and Gucci offering the sort of backdrop for romance more usually provided by the sea or the mountains. The women are not wearing Ferragamo's Vara pumps, with their distinctive bows, or toting Vuitton's subtly monogrammed handbags. They cannot afford them. Tran Van Cuon, who assembles mobile phones at a Samsung factory, posed with his fiancée in a brown suit and bow tie that cost him the equivalent of $150. Some day he hopes to become a customer in the mall. Until then, he will proudly display the photos in his home.

To stumble across an outpost of European luxury in a relatively poor and nominally socialist country is not all that surprising. Luxuries such as silk have travelled long distances for many centuries, and even modern luxury-goods makers have been pursuing wealth in new places for more than a century. Georges Vuitton, son of Louis, the inventor of the world's most famous luggage, showed off the company's flat-topped trunks (better for stacking than traditional round-topped ones) at the Chicago World's Fair in 1893. The oil-rich Middle East has been a magnet for expensive foreign trinkets since the 1960s. The Japanese became insatiable consumers in the 1970s. Today, two in five Japanese are thought to own a Vuitton product. And now it is China's turn to lap up luxury.

As luxury-goods sales have expanded geographically, they have also spread across the social scale. When Coco Chanel created her No. 5 perfume in the 1920s she reserved it for her best couture clients, but in the following decade she sold it in smaller bottles so that more women could afford it. Cartier's "Les Must" jewellery in the 1970s put the brand within reach of consumers who could only yearn for Panthère necklaces and Tank watches. Many other brands followed Cartier's *sortie du temple* (descent from the temple), seeking to broaden their appeal while retaining their cachet. Not all succeeded.

Over the past 20 years the number of luxury-goods consumers worldwide has more than trebled to 330m, according to Bain & Company, a consulting firm. Their spending on expensive jewellery, watches, clothing, handbags and so on has risen at double the rate of global GDP. Most of these new buyers are not the very rich but the merely prosperous, with incomes of up to €150,000 ($188,000). Shares of listed luxury companies have far outperformed those of other companies (see chart, next page).

Consumers' rush to quality has created billionaires at a rate that Silicon Valley might envy, especially among the main shareholders of luxury conglomerates that have gathered together many of the best-known ▸▸

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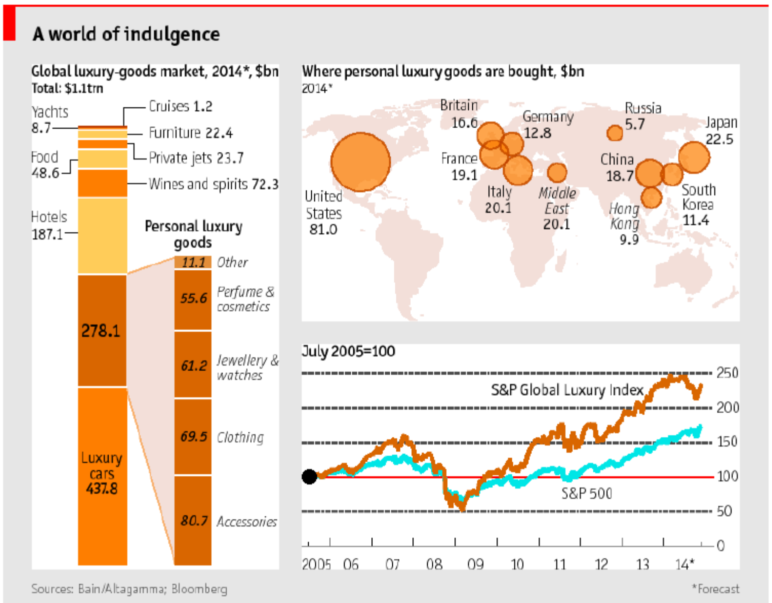


brands. They include Bernard Arnault, a French tycoon who controls LVMH, owner of Louis Vuitton, Moët & Chandon champagne and a host of other brands, and his rival François-Henri Pinault, whose Kering group owns Gucci, a big Italian leather-goods maker. Nick Hayek's Swatch Group and Johann Rupert's Richemont (Cartier's owner) are powerhouses in watches and jewellery. Among the owners who have made fortunes from selling stakes to investors in the past few years are Brunello Cucinelli, whose eponymous company makes casual-chic clothing at serious prices, and Remo Ruffini, a fellow Italian who floated Moncler, a maker of down jackets.

Personal luxury goods are just one small corner of this empire of opulence. Upmarket options can be found in industries from health care to banking, though most analysts leave such things out of their reckoning. Using consumers' own perception of what constitutes luxury goods and services, the Boston Consulting Group reckons that $1.8 trillion was spent on such items in 2012. The biggest category is travel, followed by cars and then personal luxury goods. Bain comes up with a smaller sum for a similar spread of sectors (see chart). But luxury's boundaries are fuzzy and hotly disputed.

This special report will concentrate on personal goods, which face the tricky task of trying to achieve global scale while maintaining the artisan roots that give them rarity appeal. Ultra-expensive cars will make only a brief appearance, and yachts will just sail by on the horizon: globally, only 14,000 people are able to afford a really big one. But the report will include such fast-growing "experiential" sectors as hotels and wine, which are growing faster than things to buy and own.

To view the world through the lens of luxury is to see it subtly altered. Some of the normal rules do not apply to luxury-goods makers, even though in many ways they are similar to other consumer-goods companies. The cost of production is not usually a prime concern and capital investment is generally modest, except for watches. A really prestigious item can be a "Veblen good", named after an American economist born in the mid-19th century who noticed that demand for some goods actually rises as they get more expensive because they confer yet more status. And the margins even on lesser luxury goods are much better than on mass-market items.

Luxury companies like to set their own agenda. Their creative directors oversee both the development of new products and the way they are presented in magazines, shop windows and online. "We are not going to let people influence the vision," says Patrick Albaladejo, deputy managing director of Hermès, a French luxury house so august it claims not to have a marketing department.

Luxury companies often get the most attention for the things they sell least of. Karl Lagerfeld, Chanel's creative director, made headlines this year by sending his models down a catwalk decked out as a grocery shop. But "the bread and butter of the company are chemicals," explains Armando Branchini of the Altagamma Foundation, which represents Italian luxury firms. Luxury perfumes and cosmetics are thought to account for over half of Chanel's business.

Diageo, a big drinks company, has a "Reserve" division that gives special attention to its priciest tipples, such as Johnnie Walker Blue Label whisky. They are marketed through the patient cultivation of the coolest bars and influential "advocates". "You need to be a black belt in relationships when it's about luxury," says James Thompson, who runs the division.

Luxury's lens does odd things to the map as well. Europe is still the pre-eminent maker; its brands account for 70% of the world's luxury consumption. Germany matters in cars and yachts, but the real powerhouse is Italy, which serves as the workshop for French fashion and leather goods as well as its own. Luxury is "one of the few industries where Europe has a sustainable competitive advantage", says Michael Ward, managing director of Harrods, a posh London department store. America is both an underexploited market, given its wealth, and a base for brash competitors such as Coach, Michael Kors and Kate Spade, which are challenging established European brands with a more affordable take on luxury. China, already a voracious consumer, is just beginning to stir as an exporter.

The pope doesn't wear Prada

Of late, though, the champagne has gone a bit flat. The war in Ukraine and the sanctions imposed on Russia in response have put off rich citizens of that country, among the giddiest new consumers. The Japanese went on a spree early this year ahead of a rise in value-added tax, then stopped spending. The Ebola epidemic in Africa and pro-democracy protests in Hong Kong, where Chinese mainlanders do much of their shopping, have unnerved consumers. Most important, slower economic growth and the anti-corruption campaign mounted by Xi Jinping, China's leader, have dampened the spirits of Chinese shoppers, who now account for nearly a third of the global demand for personal luxury goods. The share prices of recently listed luxury companies have fallen by a quarter this year. After two decades when annual growth averaged nearly 6%, the rate this year will be just 2%, predict Bain and Altagamma.

These passing crises come on top of more profound changes. One of them is a shift from "having" to "being", especially in rich countries, where the well-off are becoming less keen on owning and more interested in experiencing things. Consumers in China are turning from monogrammed showiness to subtler elegance. Younger people everywhere have their own ideas about how to consume luxury, helped by social media and e-commerce. Inequality is a growing concern from Berlin to Beijing. Last year a pope whose red shoes were widely (but wrongly) thought to have been made by Prada, an Italian fashion house, gave way to one who shuns the Apostolic Palace for a guesthouse. That captures the mood and contributes to it.

Sobriety has bypassed some sectors, including fine wine and expensive cars. Yacht sales, too, are buoyant again after a period in the doldrums in the late 2000s, and today's yachtsmen often add a helicopter or two to their order. But mostly substance is winning over style.

In some ways, today's preoccupation with sustainability plays into the hands of luxury-goods makers. With their ample margins, they can afford to reduce the environmental damage they cause. "Luxury can show the path that answers the major issues of our century," argues Marie-Claire Daveu, Kering's sustainability chief. By and large, makers of luxury goods employ European workers rather than sweatshop serfs in Bangladesh. The key trend now, says Diageo's Mr Thompson, is "away from show for its own sake towards knowledge, appreciation, craft and heritage—something with a story." ■

Definitions

A rose by many names

Why luxury is so hard to pin down

WHAT EXACTLY IS luxury? The concept is both slippery and divisive, not least because so many purveyors wish to lay claim to it. It is adjacent to excess, enjoyment of it may bespeak shallowness, and those who possess it are often undeserving. Luxury makers need to dissipate such doubts.

As luxury has become more widespread, defining it has got harder. The language associated with it is replete with qualifiers. It can be "authentic", "absolute", "aspirational" or "affordable". Jean Cassegrain, the chief executive of Longchamp, a leather-goods and clothing company, positions his "optimistic luxury" brand between affordable Americans such as Coach and the more upmarket Louis Vuitton. Parts of this universe, like *haute couture* and *haute horlogerie* (the watchmaking version), have organisations to back them up, but they leave a lot out, such as ready-to-wear clothing. Altagamma, which produces annual re-

Saintly or sinful?

Appreciation of luxury goes in circles

LUXURY HAS A long pedigree. Homer's warriors slaughtered each other for booty as much as for glory. Priam, the Trojan king, assembled "twelve robes, handsome, rich brocades" and "a magnificent cup the Thracians gave him once" as part of a ransom for the return of the body of his fallen son, Hector. More often, though, luxury has been portrayed as a menace to martial spirit and moral fibre. Christians associated luxury with sinful self-indulgence. In the rose window of Notre Dame, luxury is represented "as a woman titivating herself in front of a mirror", says Christopher Berry in his study "The Idea of Luxury", published in 1994.

Sumptuary laws were devised over the centuries to discourage dissipation, curb imports of expensive fripperies and (often hypocritically) preserve distinctions of rank. Those of the Aztecs were particularly tough: *macehualtin*—members of the labouring class—who displayed finery and precious objects could be put to death. The Venetian republic had three *provveditori delle pompe*, luxury police who ensured that sumptuary strictures were observed. Rules in the Tokugawa (Edo) period in Japan specified what sort of toys parents could give their children.

Attitudes changed with the Enlightenment and the advent of liberal economics. In the 1600s British merchants rejected "bullionist" arguments that the import of luxury goods weakened the economy by depleting gold reserves. A century later Adam Smith and David Hume portrayed luxury as a spur to industry and to social co-operation. It is "peculiar" to "polished and...luxurious ages" that "industry, knowledge and humanity are linked together by an indissoluble chain," wrote Hume in his essay, "Of Refinement in the Arts" (originally called "Of Luxury"). Samuel Johnson introduced a

Sun King and supermodel

feelgood factor to the enjoyment of luxury: "You cannot spend money in luxury without doing good to the poor." For these thinkers, luxury was all tied up with commerce, liberty, peace and social mobility.

At the time they were writing, the French had already laid the groundwork for the modern luxury industry. Jean-Baptiste Colbert, Louis XIV's finance minister, taxed imports, offered subsidies and enforced quality standards to promote French production of the sumptuous textiles and lace that were *de rigueur* at the Sun King's court; then he pushed exports. "Fashion is to France what the gold mines of Peru are to Spain," he proclaimed. But Elisabeth Ponsolle des Portes, boss of the Comité Colbert, France's club of luxury producers, says the country's luxury know-how goes back to the troubadours of the 12th century.

Thorstein Veblen, the economist who gave his name to the sort of goods that become more desirable as their price rises, had political grounds for sneering. Luxury is a form of waste that arose to confer status on an essentially useless class, he argued in "The Theory of the Leisure Class", published in 1899. "Conspicuous consumption of valuable goods is a means of reputability to the gentleman of leisure." Both Veblen's and Hume's ideas remain potent.

ports on luxury along with Bain, applies a simple price standard: a luxury handbag costs €850 or more.

But that leaves the question of why you might want to spend that kind of money. Brunello Cucinelli, who turned his idea of enlivening cashmere with bright colours into a clothing business with revenues of €322m and a stockmarket capitalisation of around €1 billion, provides one answer. He runs his company from Solomeo, a timeless village perched on an Umbrian hilltop. There, Mr Cucinelli has set up schools dedicated to crafts such as tailoring and gardening and a "neo-humanist academy".

Mr Cucinelli considers his products to be "absolute luxury", and not many would disagree. A men's cardigan knitted from Mongolian cashmere can cost more than €1,600, not least because it is made in his hilltop Utopia. Italian manufacture is not merely an assurance of quality; without it the business would lose its point, Mr Cucinelli suggests. Europe is of "inestimable value" to the company and, he believes, to its customers. He adds to the aura by insisting that his workers take a 90-minute lunch break. With Mr Cucinelli selling it, that cardigan will feel as good to the soul as it does to the touch.

All luxury makers like to tell some version of this story, and some have longer histories. Breguet, part of Switzerland's Swatch Group since 1999, boasts that Napoleon was one of the "most faithful clients" for its watches. Karl Lagerfeld, a pony-tailed German fashion designer, is the spiritual son of Coco Chanel. Burberry, which was founded in 1856, calls itself an "old new company". It is "the combination of timelessness and modernity [that] makes these brands successful", says Mr Arnault of LVMH.

Tell me a story

Craft and a sense of place are almost always part of the narrative. Hermès attractively defines luxury as "that which can be repaired". The company keeps expatriate repairers in centres such as New York, Shanghai and Tokyo. Vertu, a company that makes handsets costing ten times as much as an iPhone, justifies the price by pointing out they are "handmade in England".

For some of the most discerning customers, the products of pretty much any company you have ever heard of fall short of real luxury, which is defined by extreme rarity. Breguet produces perhaps 15,000 watches a year. Greubel Forsey makes a mere 100, one for each employee. Rolls-Royce makes 4,000 cars a year, many of them to order. But they are commonplace compared with the 38 that will roll out of the "atelier" of Pagani, an Italian manufacturer, this year. The quality of such "meta-luxury" objects may be no better than those produced by slightly less exclusive marques, but they come over as more intimate and closer to their creators.

At the other end of the scale, companies bristle when their credentials are questioned because their prices are less exalted or they manufacture in China. Coach, which mainly sells leather goods, uses the same materials as European brands, but its soul is in New York, its creative hub. Manufacture is a collaboration between designers there and craftsmen in China, says Coach's boss, Victor Luis. He thinks the idea that luxury and approachability don't go together is "almost offensive". Similarly, Longchamp's Mr Cassegrain argues that it is "almost racist to characterise made in China as bad".

The broad conclusion from all this may be that luxury is in the eye of the beholder. To qualify, it seems to demand a stretch from those who would claim it. For the rich, that exertion may take the form not of scattering money but of spending time or learning about an object or an experience. The acquisition of luxury is both an attempt at transcendence and an act of appropriation, like the picking of the apple in the garden of Eden. Perhaps that was mankind's first luxury good. ■

The business case

Beauty and the beasts

Think global, act artisan

YOU MIGHT EXPECT the headquarters of LVMH on the Avenue Montaigne in Paris to show off its full range of brands, from Sephora (cosmetics) to Moët & Chandon (champagne). They do get some play in a small museum housed in the lobby. But up on the ninth floor, where Mr Arnault presides over his luxury empire, there is tribute to just one, Louis Vuitton. Two paintings of the LV monogram by Takashi Murakami hang opposite the reception desk, and a little pyramid of handbags sits nearby.

The decor tells you something about Mr Arnault's group. Louis Vuitton is the company's biggest brand by far, accounting for about a third of its sales and nearly half its profit. A Louis Vuitton shop window is the first close encounter with luxury for many people, and the brand often pioneers new markets. Its first shop in China opened in 1992. It is "the number one brand in the world and will stay so", Mr Arnault declares.

Critics sniff that canvas creations like the Neverfull tote, spangled with logos and sold by the hundreds of thousands, are commodities, not luxury. "It's difficult to say you're a luxury brand if everyone on the planet can buy your product," says Barbara Coignet of 1.618, an organisation that promotes luxury with an environmental and social conscience. Misgivings about excessive scale extend to the publicly listed companies that own the brands, such as LVMH, Kering and Swatch. "Real luxury is slowly fading away because of the big luxury groups," complained Lapo Elkann, an Italian entrepreneur, at a recent *Financial Times* conference on luxury. "They standardise the aesthetics of brands to generate more profits for shareholders."

The holding-company model is not the only successful one. Chanel belongs to the secretive Wertheimer family; Hermès is publicly traded but managed by its founding family. Both have largely avoided the criticism that bedevils Big Luxury. Italy's lux-

Biggest and best 1

European luxury firms

	Selected brands	Main products	Total sales 2013, $bn
LVMH	Louis Vuitton Moët & Chandon Bulgari Guerlain	Leather goods and fashion Champagne Jewellery Perfumes	36.38
RICHEMONT	Cartier Van Cleef & Arpels Net-A-Porter Piaget	Watches and jewellery Jewellery Online fashion Watches and jewellery	13.29
KERING	Gucci Boucheron Bottega Veneta Yves Saint Laurent	Leather goods and fashion Jewellery Leather goods and fashion Fashion	12.17*
swatch	Breguet Blancpain Omega Harry Winston	Watches Watches Watches Watches and jewellery	8.50
HERMÈS PARIS		Leather goods, accessories, fashion and jewellery	4.69
PRADA		Leather goods and fashion	4.48†
BURBERRY		Fashion and accessories	3.65‡

*67% of sales from luxury †Year to end Jan 2014 ‡Year to end March 2014

Sources: Company reports; *The Economist*

ury houses are mostly stand-alone companies, controlled by their founding families even when they are publicly traded and professionally managed. Young firms often try to keep their distance from the big groups, either turning to private-equity investors or staying independent. British brands are "very reluctant to take outside investment", says Michelle Emmerson, chief executive of Walpole, an association of British luxury firms.

The soft-spoken Mr Arnault has become France's richest man by overcoming such resistance. His career in luxury began in 1984 when he picked up Dior, a venerable *haute couture* house, in the bankruptcy sale of an industrial group. A few years later he wrested control of Louis Vuitton from Henry Recamier, who had married into the founding family and expanded the brand's two shops into a network of 125. Other *maisons*, such as Céline and Givenchy, followed into Mr Arnault's clutches. With Dior and Louis Vuitton he took production and distribution back from licence- and franchise-holders to boost their cachet.

In 1999 he lost a battle for control of Gucci to his arch-rival, Mr Pinault. Mr Arnault's stealthy acquisition of a stake in Hermès, revealed in 2010, appalled conservative Parisians. His interest was purely financial, he insisted; in September he agreed to distribute the shares to LVMH's investors, giving them (and himself) a handsome profit. But his image as a monogrammed Machiavelli persists. "Arnault never met a brand he liked that he didn't want to make bigger," comments Hélène Le Blanc, a luxury-industry consultant.

There are good reasons for bigness, both for brands and for the companies that own them. Listed European luxury groups have expanded their global market share from 39% to 42% over the past five years whereas independents' share has dropped from 50% to 43%. Luxury, ironically, benefits from economies of scale. The Swatch Group dominates Swiss watchmaking, with a 45% market share, in part because the industry involves large investments and high fixed costs. Cosmetics are the most high-tech part of luxury and their distribution is more akin to that of detergent than of jewellery, so most brands license that side of their business to specialists such as L'Oréal and Procter & Gamble.

There are good reasons for bigness, both for brands and for the companies that own them

In "soft luxury" categories like handbags and clothes, where production is low-tech and costs are variable, the benefits of scale are in retailing and marketing. Key money paid up front to open a shop can cost up to £10m ($16m) on London's Bond Street; the cost of fitting it out comes on top of that. Annual rent can be £1m. A big brand, or one belonging to a strong group, can wait to break even. A small one risks bankruptcy if sales sag, says Mr Branchini of Altagamma. To secure prime space in shopping malls, it helps to belong to a holding-company convoy led by a large brand.

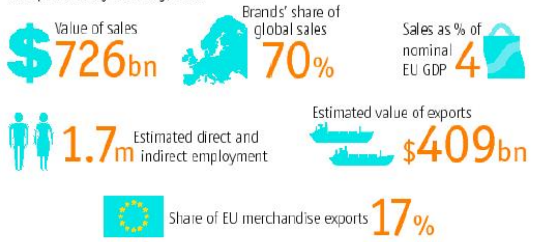
Perhaps equally important is the big groups' clout with publishers of glossy magazines and "key opinion leaders" whose fashion-packed blogs, videos and Instagram streams reach millions of followers. Media spending is correlated with traffic in stores, so large brands can open bigger and better ones. Luca Solca of Exane BNP Paribas, an investment bank, has dubbed this the "mega-brand virtuous cycle". Most big companies have become retailers in their own right. This gives them better margins, along with control over the presentation of their wares and markdowns on unsold stock. By this measure, Louis Vuitton is ahead of the others: it sells only through its own network of 462 points of sale.

In theory at least, the groups help the smaller brands they acquire to grow faster. Under Kering's tutelage Bottega Veneta, an Italian leather-goods maker renowned for the woven *intrecciato* of its handbags and shoes, has gone from being a niche brand to revenues of more than €1 billion. Kering encouraged Christopher Kane, a British fashion designer who is part of its stable, to open his own stores, and guided Italy's Brioni to move out of women's wear and into men's accessories and shoes. Small brands also benefit from centralising the boring bits of the business, such as logistics. The brightest prospects in the industry are for "small brands in big conglomerates", says Julian Easthope of Barclays Capital, an investment bank.

Mr Arnault thinks LVMH's main contribution to its *maisons* is its ability to recruit talented managers. In stand-alone companies "a bright person is rapidly blocked," he says. At LVMH he or

Serious money 2

Europe's luxury industry, 2013



Source: Frontier Economics, ECCIA

she can move from fashion to jewellery to wine. The groups are looking for productively split personalities, with "the capacity to be inspired by creativity in a rational way", as Mr Arnault puts it. Kering is on the lookout for similar qualities. "When the fashion show is over, the business side takes over," says Jean-François Palus, its managing director.

Occasionally this gets out of hand. The point of the big groups is to foster profitable growth, but too much of it or the wrong sort can tarnish a luxury brand. In 2004 Gucci set itself a goal of doubling its sales within eight years. To achieve that, the company produced many more canvas double-G-dappled handbags than was healthy for the brand.

The trick is to polish a brand to a high sheen and then to disseminate the glow through the full product range without letting it dull. Hermès and Chanel have lately been better at this than the big groups' main brands. That is not because they are small: Hermès has 315 stores and €3.8 billion in revenue, and Chanel's sales are three-quarters the size of Louis Vuitton's. But each has its own knack for teaming exclusivity with accessibility.

Managing the mystique

Hermès starves the market. Customers have to wait six months or more to buy its most famous products, its Kelly and Birkin handbags, each one handmade by a single craftsman. Although Hermès makes an estimated 70,000 Birkins a year, prices on the secondary market can be 50% above the retail price. Hermès's growth is limited by the scarcity of high-quality raw materials and of craftsmen, who take two years to train up, points out Mr Albaladejo. Hermès sells plenty of less expensive products, including scarves, wallets and towels. But €500 will merely buy you an expensive scarf, not a cheap handbag.

Chanel will not sell a handbag for much less than €2,000 but moves millions of €30 lipsticks. Few brands stretch as gracefully from mass production to *haute couture*. Many of its cosmetics are made by Intercos, a contract manufacturer, but the company also provides a haven for endangered crafts still vital to the most exalted tiers of fashion. Paraffection, a subsidiary, houses century-old firms that specialise in things like embroidery and making artificial flowers, both for Chanel and other brands. The husbandry practised by Hermès and Chanel contrasts with the approach taken by Italy's Giorgio Armani, whose half-dozen sub-brands each sell similar products at different prices.

LVMH and Kering have both been burnishing their biggest brands lately. Since a strategic review in 2010, Gucci has reduced sales of its cheapest handbags from a third of the total to less than 5%. Mr Arnault, for his part, announced an "adjustment to the strategy" last year which involved a big reduction in new store openings and a greater emphasis on leather products. Customer service was also beefed up. These moves to higher ground have slowed the big brands' growth and conceded territory to lower-priced competitors. "When Vuitton and Gucci move upmarket, that makes more space for us," says Longchamp's Mr Cassegrain.

But fast-growing smaller brands seem unlikely to eclipse Louis Vuitton. "People said in 1989 that Louis Vuitton was already too big. Now it's ten times the size," says Mr Arnault. He is as ambitious for it as ever. A dazzling new arts centre in Paris designed by Frank Gehry, called the Fondation Louis Vuitton, opened amid a flurry of publicity in October. In a riposte to those who see the LV monogram as a vulgar status-seeking symbol, the company commissioned six "iconoclasts", including Mr Gehry, to come up with playful new designs for it. Mr Lagerfeld (who is creative director of LVMH's Fendi label as well as of Chanel) cheekily devised a punchbag with matching gloves and a trunk to house them. The designs are now on display at most of Louis Vuitton's flagship stores, including the one in Shanghai. ■

China

Beyond bling

Tastes are changing, but appetites remain keen

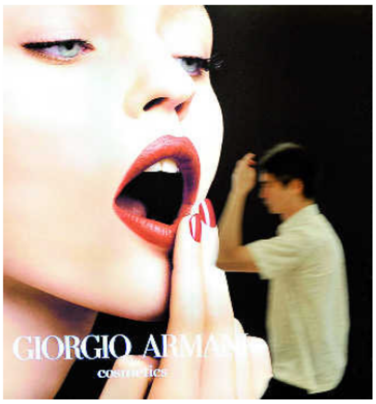
IF LUXURY MEANS Bond Street or the Place Vendôme for you, Hong Kong comes as a shock. Billboards touting Swiss watches and Italian shoes dominate the skyline. At shopping centres, high-wattage façades compete for space. Louis Vuitton's lights square up against Burberry's cinema screens.

This Vegas-like glitter reflects the novelty of luxury in China, and the country's new importance to luxury. Today nearly one-third of all personal luxury goods sold worldwide are bought by Chinese consumers. Their spending is divided more or less equally among the mainland, the Chinese-speaking territories of Hong Kong, Macau and Taiwan, and the rest of the world. Mainlanders become familiar with the brands through marketing and shopping centres at home. When they visit Hong Kong they are "on a mission", says Pascal Perrier, chief of Burberry's Asian operations. The gaudy signage helps guide them to shopping destinations they have already picked out.

Chinese shoppers came to the rescue when the financial crisis in 2008 cast a pall over luxury. Since then 70-80% of global growth in the sector has come from China, according to Barclays Capital. Once-fading European brands, such as Britain's Aquascutum, which makes traditional clothing, have sought second lives there. Others, like Lancôme, a cosmetics-maker, are presenting themselves as more luxurious there than they are seen at home. "Now our culture is so imbued and involved in good and bad ways by luxury penetration," says Yi Zhou, an artist who has collaborated with luxury brands. "Instead of the theatre we go to store openings…I feel like I live in an airport."

The rush to China intensified after the 2008 Beijing Olympics, with luxury brands swarming into shopping malls as fast as they could be built. It was a "game of space invaders", says Erwan Rambourg, a banker and author of a new book, "The Bling Dynasty". President Xi Jinping's crackdown on corruption, along with slower economic growth, has now changed the mood.

His anti-extravagance measures amount to a mini cultural revolution. Chinese newspapers report falling sales of such delicacies as hairy crab and sea cucumber as banqueting halls go ▸▸



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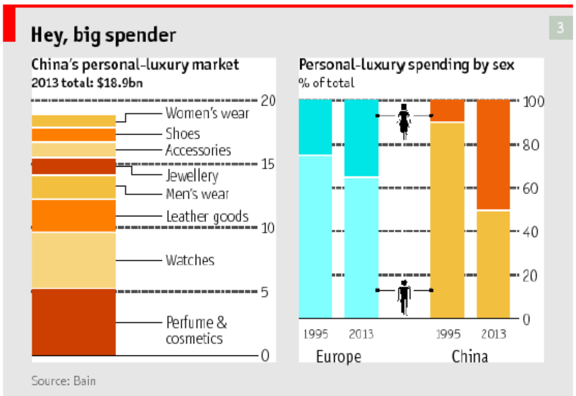


quiet. Hotels have asked to have stars knocked off their ratings. One airline, China Southern, rebranded its first-class cabin "business class". Paul & Shark, an upmarket Italian clothing brand, used to take corporate orders for 300 polo shirts at more than 3,000 yuan ($490) apiece, to hand over as gifts. Those days are over, says Alice Wong of ImagineX, which operates the company's shops in China.

European brands that catered to pre-Xi giving and guzzling suffered most. In the first nine months of this year exports to China of Swiss watches, which had become a common ornament on the wrists of public officials, were more than 10% down on the same period in 2012. Sales at Rémy Martin, maker of $2,500-a-bottle Louis XIII cognac, plunged 13.4% in the half-year to September 30th. A slower economy has also reduced the growth in the number of newly affluent families, defined as those having just entered the income bracket of €15,000-75,000 a year. It dropped from 6m in 2010 to 4m in 2012.

The luxury market in mainland China, worth $18.9 billion in 2013 (see chart 3), will shrink for the first time this year, predicts Bain. Still, few brands are thinking of giving up. Mr Arnault says it will remain "one of the most promising markets". But it is becoming more complex, more sophisticated, more international and harder to navigate.

Luxury in China began as a male-oriented pursuit, centred on liquor and wristwatches, but is now becoming more feminised, with handbags, shoes and fashion featuring strongly. Experienced consumers are graduating from bling to sophistication with a speed that Mr Arnault describes as "spectacular". But many Chinese idiosyncrasies will persist, including a penchant for shopping abroad and a big discount market that mingles the real with the fake. Luxury brands have to work out how to cover that range.

One promising group of consumers is the offspring of the one-child-policy era, born in the 1980s and 1990s. They are the single focus of attention for their parents and often two sets of grandparents, giving them access to plenty of cash. Another, potentially huge, market is women, whose "vision and status" was changed by Mao Zedong, says Pierre Denis, chief executive of Jimmy Choo, whose stilettos featured in "Sex and the City". Their new self-confidence translates into sales. And even if growth rates are slowing, there will still be more people with more disposable income. Spending on luxury by the rich (households earning at least €75,000) will nearly quadruple between 2012 to 2020, according to Exane BNP Paribas. But it will be dwarfed by the spending power of merely affluent households, which will double to €90 billion and account for 70% of luxury consumption.

Veteran consumers are moving from very famous brands to somewhat less familiar ones. In a survey of consumers in Beijing and Shanghai carried out by Bain last year, Hermès and Prada were found to have displaced Louis Vuitton and Gucci among the three brands that consumers wanted most, and Burberry and Bottega Veneta had entered the list of the most popular ten. As shoppers become more price-conscious, affordable American brands are making inroads. Coach is advancing into second-tier cities and Kate Spade is just getting started in China, a "very big opportunity", says its chief executive, Craig Leavitt. A fad for all things South Korean has also boosted brands such as Sulwhasoo ▸▸

The clamour for glamour

China is not the only growth story

"FOR NIGERIANS," SAYS John Obayuwana, "the bigger the logo the better." Mr Obayuwana owns Polo Luxury Group, a chain of shops in Nigeria and Ghana selling things like Swiss watches and Montblanc pens. His rich initial customers have been joined by middle-class consumers with a penchant for European luxury. Nigeria is a difficult market, with shoddy infrastructure and few decent shopping malls. So for the foreseeable future Nigerians will do most of their upmarket shopping at emporia like Harrods in London, where they outspend Americans. But as emerging countries get more prosperous, they are becoming increasingly important to luxury-goods makers.

The 15 fastest-growing emerging markets will provide 90% of the growth in consumption of luxury beauty products and women's wear over the next ten years, says Nathalie Remy of McKinsey, a consultancy. China will account for nearly half that growth, which leaves plenty of opportunities in other developing countries. Whereas makers of packaged consumer goods must fan out across entire countries to reach their markets, luxury makers can concentrate on the main cities.

South-East Asia is "a half-China", says Mr Cassegrain of Longchamp. For now, the inventor of the folding Le Pliage nylon tote does only 6% of its business in the region, but that is two-and-a-half times as much as three years ago. Half of Latin America's luxury sales are in Mexico, in part because that country has slashed duties on imports. Brazilians, who face higher tariffs, tend to shop in Miami.

Oddly, for all its wealth, even America is a developing market of sorts for European luxury-goods makers. It has 30% of the world's high-net-worth individuals (people with more than $1m in liquid assets) and nearly a quarter of global GDP, but consumes less than a fifth of the world's personal luxury goods, notes Olivier Abtan of the Boston Consulting Group; and its consumers are younger than those in Europe or Japan. North America is "probably the safest growth driver we can imagine", says Michele Norsa, chief executive of Salvatore Ferragamo.

For small luxury houses, it may be better to pursue a modest share of a slow-growing mature market than to leap into fast-growing emerging economies, says Ms Emmerson of Walpole British Luxury. Lots of Europeans own luxury goods but buy them infrequently. Mesmerised by the dynamism of developing markets, luxury brands are turning Europeans off by pushing up prices and churning out stylish but ephemeral designs, argues Ms Remy. Europe could be "a land of opportunity" if only luxury-goods makers would seize it.

(which makes cosmetics).

The shift to niche brands should not be exaggerated. "Only really fashionable girls buy Céline and Fendi bags," says Cheng Yan, whose Shiliupo Report (the name means something like very gossipy grandma) has 160,000 subscribers on WeChat, a social-network and messaging service. First handbags are "always with a logo", and Louis Vuitton's remain the most popular.

"Luxury brands had a very easy ride" in China, says Emmanuel Hemmerle, a headhunter based in Shanghai. "Now they have to think." The first generation of luxury-goods managers spent their time negotiating with landlords, who decided which brands would occupy their shopping malls (and gave preference to Vuitton, Gucci and Chanel). The new climate demands executives who are good at visual merchandising and customer service. It is telling that the newish chief of Louis Vuitton in China, Christophe Sadones, has come from the hotel business.

Why pay more?

However tempting the displays at Beijing's Shin Kong Place and Shanghai's Plaza 66, Chinese consumers will do most of their shopping elsewhere. Luxury-goods prices in China are 40-50% higher than in Europe, in part because of high import duties and consumption taxes. The Chinese are keen bargain-hunters, so they buy abroad or on the internet.

Last year the Chinese took some 100m trips outside the mainland, many of them to such destinations as Hong Kong's Harbour City, Manhattan's Fifth Avenue and Milan's Via Monte Napoleone, armed with detailed shopping lists. In Paris, buses bearing Chinese tourists deposit them at Galeries Lafayette, a department store. Two-thirds of Chinese visitors to Britain in 2011 went to Bicester Village, an upmarket discount mall near Oxford. Sightseeing is a secondary concern. Mainlanders in Hong Kong spend 73% of their budget on shopping, says Mr Rambourg.

This is bound to increase. According to Mr Rambourg, currently just 4% of Chinese hold passports, compared with roughly 30% of Americans and 70% of Britons, but numbers are growing by 10m-15m a year. A relaxation of visa rules is likely to lure more Chinese to Britain and America. Swiss watchmakers were puzzled to see a spike in American sales in August, normally a slow time of year; then they realised the buyers were wealthy Chinese dropping off their children at university. Even at home the Chinese shop on the move. Just half of all sales in Shanghai are to local residents.

Stay-at-home bargain-hunters have a plethora of online choices, some of them provided by websites that co-operate with the brands. Mei.com holds "flash sales" of unsold stock; The Outnet, the discount arm of Britain's Net-A-Porter fashion website, serves as an online outlet mall. But most of them come through the murky channel known as *daigou*, which offers genuine products at big discounts to Chinese list prices. The stock may come from independent shops in Europe, or in some cases from the brands themselves, which pass goods on to independent resellers. Agents spirit the goods into China for a fee, usually without paying import duty. Some transactions are arranged through networks of friends but many take place online. Taobao, one of China's main e-commerce businesses, has a website dedicated to *daigou*, g.taobao.com. Up to 30% of luxury sales in China come through this channel, reckons Bruno Lannes of Bain.

Daigou outlets sometimes mix fakes with the real thing, which is why Ms Cheng warns her readers against them. China's commerce ministry has proposed cutting import and consumption taxes to discourage the grey market and boost domestic sales. But in a political climate which frowns on luxury, that is unlikely to happen, so black and grey are likely to remain fashionable colours. ■

Demographic trends

Marques for millennials

Young people choose and buy differently

THE MOST COVETED ticket at London's half-yearly fashion weeks is to Burberry's Prorsum show, where the British trench coat-maker presents its upmarket ready-to-wear clothing. Christopher Bailey, the brand's chief creative officer and CEO, likes to surprise his audience. At the birds-and-bees-themed unveiling of his women's wear for spring and summer 2015, held in September in London's Kensington Gardens, the sartorial novelty was an indigo wasp-waist denim jacket. The digital novelties included a highlights tape on YouTube that let viewers zoom in to focus on various aspects of the show, such as the music. Twitter used the occasion to launch in-tweet purchasing for luxury.

This is a big change from the traditional model of presenting fashion in which designs are conceived at the top, handed down to journalists and buyers at fashion-week set-pieces and pop up in the shops four or five months later. Technology has narrowed the distance between designers and consumers and sparked a conversation. YouTube, Instagram, WeChat and the like have "completely disrupted" the way fashion companies communicate, says Imran Amed, editor of *The Business of Fashion*, an online journal.

This is the first of three technology-induced changes that will profoundly affect luxury brands. The second is a shift from selling in physical stores to online. The third, for now only just visible in the distance, is a technology-related change in the way luxury goods are made.

The digital transition is running alongside a demographic one. By 2026 the main consumers of luxury will be millennials (or generation Y), people born in the 1980s and 90s, says Unity Marketing, an American market-research firm. Brands with pedigrees can use technology to win this age group over, as Burberry is trying to do. Newer ones can employ it to break through.

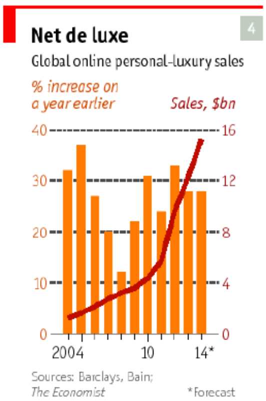
A study by the Boston Consulting Group reckons that millennials "are geared to pleasure rather than to possessions", mak- ▸▸

Burberry was among the first to spot millennial potential

ing them less inclined to buy things. They are assertive, sceptical of authority and nonconformist, none of which bodes well for traditional luxury brands. On the other hand, photo-sharing social media like Instagram put a premium on appearance, argues Mr Denis of Jimmy Choo, which should be a good thing for companies like his. In the same vein, Eric Briones, a French consultant who has written a book about the millennials' relationship with luxury, says they consume it "without remorse".

But not uncritically. Brands must prove that their products are worth the price, not rely on mystique alone. Generation Y-ers tend to be unimpressed by logos but entranced by "codes", subtler ways of conveying a brand's identity. The red soles of Christian Louboutin's shoes and the quilting on Chanel's 2.55 handbags are the sort of signs that young consumers can make their own, says Mr Briones. Unhappy customers can sound off on websites such as styleforum.net. Some millennials also want luxury goods to be made in ways that damage neither workers nor the environment.

Burberry was among the first to spot millennial potential. In the early 2000s Britain's ostentatiously vulgar "chavs" (a particular group of loutish lower-class youths) were sporting the brand's distinctive tartan plaid as their unofficial uniform. It appeared on baseball caps, even dogs. Angela Ahrendts, an American who became the company's chief executive in 2006 (and has recently left for Apple), made the digital courtship of millennials a centrepiece of her strategy for reviving the brand. Today Burberry is unabashedly digital. Two-thirds of its staff are under 30 and use social media to talk both to each other and to Burberry's customers.



Burberry sees its website and its shops as complementary. It even struck a deal with Amazon to list beauty products on the online retailer's site. In the six months to September 30th Burberry booked a year-on-year rise in revenue of 14%, largely thanks to buoyant digital sales. It recently assumed direct control of its cosmetics and fragrances business, hoping to "disrupt beauty through digital".

Disruption is not something that comes naturally to most established luxury brands, but when they embrace it they sometimes do it well. Creative directors are increasingly targeting millennials. The mission of Louis Vuitton's newly appointed creative director, Nicolas Ghesquière, is to "reboot the monogram", making it less of a logo and more of a code, says Mr Briones.

Live-streaming of catwalk shows is now common practice, as is giving celebrity bloggers front-row seats alongside editors of the main fashion bibles. Brands feed their "communities" with streams of images on Instagram and Pinterest and Hollywood-quality videos on YouTube. Cartier's L'Odyssée de Cartier, starring a bejewelled panther, has been seen 17.6m times.

But the conversation between luxury makers and their public can easily take an awkward turn. Stella McCartney, a designer who likes to display her social conscience, got into trouble when her company's Instagram stream featured a photo of a painfully skinny model. On receiving complaints from fans, her company removed the photo and declared its enthusiasm for people of all colours, shapes and sizes.

Actually selling luxury online is more difficult than talking about it. Even brands that dabble in it doubt that any website can match the experience of shopping in a boutique. "To buy a luxury product you have to touch it," says Mr Arnault. Many companies offer just a small range of their products for digital sale, and some none at all.

But e-commerce is making inroads. Net-A-Porter, a website that pioneered internet sales of upmarket fashion, has a customer base of 6m women and has persuaded some 650 brands to offer their wares on its platform. For now only about 8% of all luxury sales are online, but they are growing at a rate of 25-30% a year, says Claudia D'Arpizio of Bain's Milan office. Much of this is at the expense of independent boutiques. If the share of digital sales goes much above 10%, investment in stores "will be rethought", she says.

Goodbye to Bond Street?

The future is "direct to the consumer through the internet", says Nathan Morse, who runs the business side of Hannah Martin, a London jeweller. It belongs to a new generation of luxury houses with no hang-ups about e-commerce (and not enough money to open a lot of stores). They may have short histories, but they have stories. Hannah Martin's androgynous pieces are fashioned by hand in London.

It used to take 30 years to build a global brand, says Uché Okonkwo-Pézard of Luxe Corp. Thanks to the internet, "now you can become global in 18 months." That has spawned new brands as well as business models. Bargain-hunters can turn to online outlets like The Outnet or flash-sales sites such as vente-privee and mei.com. People who want to hire can try Bag Borrow or Steal or LuxTNT, a Hong Kong startup. Second-hand luxury is available from stylesequel and InstantLuxe. Such services have been around for a long time, notes Stephanie Phair of The Outnet, but they have been "supercharged because of the internet".

The final challenge is to decide how far to incorporate technology into the making of luxury, and perhaps into luxury itself. Iris van Herpen, a Dutch fashion designer, uses 3D printing to construct her garments. Ralph Lauren makes a handbag with a light and a smartphone charger. Suppose machines could stitch Birkin bags better than the craftsmen at Hermès or etch watch dials more finely than Vacheron Constantin's *guillocheurs*? "The big gap between hand work and technology will become smaller and smaller," predicts Ms van Herpen. Luxury can embrace innovation; what it must be wary of is obsolescence. ■

The future of luxury

Experience counts

Providers of luxury need to offer more than expensive baubles to take advantage of a growing market

"TEN YEARS AGO you would have auctioned handbags." Ben Elliot, the boss of Quintessentially Group, a concierge service that helps the rich organise their lives, is explaining a shift in the way that money is raised for charity. These days a kickabout with David Beckham, or perhaps a cycling trip from Venice to Rome, would be more effective: "It's about the bragging rights of doing something others can't do," he says.

If sophisticated consumers are shifting their preferences from handbags to handlebars, makers of luxury goods need to pay attention. The rich set trends, and their notions of luxury trickle down. European consumers now "put more value on inward things", Mr Elliot thinks. Revenues of upmarket hotels this year are expected to grow by 9%, four times the rate of luxury-goods sales. Even the Chinese are tilting a bit from having to being: during this year's Golden Week, an autumn season of concentrated consumer frenzy, the number of transactions in shops was 30% up on last year but that in restaurants and hotels rose by 52%, according to UnionPay, a payment-card company.

What qualifies as an experience people are prepared to pay for is also changing, to something more elaborate, more private and sometimes even stripped almost bare of conventional comforts. David Leppan, a South African-born millionaire, is not much interested in conventional luxury, but reckoned that a recital by Plácido Domingo at Seville's Alcázar palace, arranged by NetJets, a firm that hires out private planes, was "pretty much priceless". Mr Elliot's colleagues at Quintessentially cite the Antarctic Ice Marathon as the sort of activity its clients appreciate. Swish hotels nudge guests away from the familiar to the authentic. "Luxury can be the absence of strawberries in wintertime," says Frank Marrenbach, who runs the Oetker Group's chain of hotels. His chefs prefer to offer seasonal fruit.

In a YouTube video for Johnnie Walker Blue, a top-of-the-range whisky, two friends (played by Jude Law and Giancarlo Giannini) swap ownership of a beautiful old sailing boat on the basis of unlikely wagers. If ownership does become separate from enjoyment, makers of luxury goods will have something to worry about. That moment may not have arrived yet, but as consumers become more sceptical, more discriminating and more interested in experiences, it is coming closer.

It is not as though the rich have stopped buying stuff. The average billionaire owns $6m-worth of luxury goods, not to mention yachts worth $22m, according to Wealth-x, a research firm founded (and later sold) by Mr Leppan. But increasingly such purchases form part of an experience. In the video Mr Law needs a new made-to-measure suit for the dance that will win him the bet on the boat. Savoir Beds, a British firm, is making a rotating bed for the new owner of a French château so that he can enjoy the view both of the surrounding countryside and of the fireplace on the opposite wall. Sellers of less bulky luxuries who make bespoke products for their best clients often add events to their offering. Ferragamo, the Italian shoemaker, treated its favourite Chinese customers to a trip to its workshop in Florence.

Just for you and me

Make it special

Most consumers are not in that league. More than a third of luxury handbags sell for less than €500. The ranks of people who covet such goods are destined to grow; once hooked, they will trade up. Globally, McKinsey expects the number of big-city households in emerging markets with incomes of more than $70,000 a year to treble by 2025.

Makers of luxury have come to realise that the paradox of industrial craftsmanship can be pushed only so far. To captivate new clients and keep the older ones on board, brands will have to invest shopping with a sense of occasion and give ordinary customers some of the individual attention they have lavished on their biggest-spending ones. Increasingly, that is what they are doing. When Burberry launched a perfume in September, it gave customers a chance to inscribe bottles with their own initials, both in shops and online.

Consumers still want to hear the story that luxury tells, perhaps more than ever as the world comes to seem more rootless and mass-produced. In London's Savile Row a small crowd of men and women, nattily clad in mid-20th-century garb, recently staged a demonstration against two shops selling clothes by Abercrombie & Fitch, an American fashion chain. "Give Three-Piece a Chance," demanded their placards. To the demonstrators, the intruder was the antithesis of Savile Row's made-to-measure tailoring. "We're not proper Savile Row-type people," said the protest's organiser, Gustav Temple, who edits an obstreperously nostalgic magazine called *The Chap*. "But we hope to be one day." The brides of Trang Tien Plaza would understand. ■

3.2 Currency swings create market inequalities (© Financial Times, 8 June 2015)

Retail values: Is it time to close the gap in global pricing strategies? By *Elizabeth Paton*

A price war is raging among the world's largest luxury groups. Aggressive currency headwinds have battered parts of the industry, inflating manufacturing costs and spreading large pricing variations among sales regions.

The gulf between prices for luxury handbags, watches and jewellery in Europe and China is the widest it has been for three years, according to Sanford C. Bernstein, a research company, as weaknesses in the euro upsets the pricing strategies of high-end brands.

The knock-on effect of the euro's slide and the stronger US dollar and Swiss franc has led to the likes of Richemont, Burberry and Chanel raising prices in Europe, while cutting them in dollar-denominated markets, including parts of Asia. This is an effort to reduce a disparity that has transformed the global luxury retail landscape.

For example, Japan has seen an 83 per cent rise in Chinese tourist numbers this year, as has South Korea, as the widening price difference of up to 40 per cent with mainland China sends shoppers to new markets. Meanwhile, the US, the world's largest luxury market by sales, has seen a fall in traveller spending, as Chinese, Latin American and Russian tourists stay away.

There are notable exceptions that are resisting the currencies tide – at least for now. Swatch Group said last month that it would not change prices on the basis of short-term currency swings, and would rather lose on margins while retaining market share.

Meanwhile, Kering and Hermès have shied away from a levelling of prices, saying that increasing them in Europe would risk affecting domestic sales.

"We have a very strong French and European customer base," Axel Dumas, chief executive of Hermès, said in March. He said he expected sales this year to grow 8 per cent in constant currency terms.

"If we significantly increased our prices at this juncture, that would mean giving up on local customers, and that is something we do not want to do."

Given that many luxury consumers buy products as long-term investments, price stability has been considered a core characteristic of the sector, with any falls running the risk of eroding faith in the value and exclusivity of purchases by core clientele.

But some executives insist that narrowing the gap is essential if the industry is to regain control over where and how millions of customers choose to spend their money.

“We need price equilibrium around the world,” Jean-Claude Biver, president of LVMH’s watch and jewellery division and chief executive of Tag Heuer, said this year. “If you have a 20 per cent price difference between countries, there are lots of clever people out there who will take advantage of it by creating a grey market, buying 100 watches in one country then selling them in another. We can’t get 20 per cent back simply through creativity, so the only thing to do is to raise prices to maintain equilibrium.”

Some experts say brands such as Tag Heuer and Montblanc have used the currency fluctuations to revise their currency pricing approaches, which had risen too far towards the market’s high end, affecting sales.

They say the likes of Patek Philippe and Cartier appear to be using shifts as a chance for wholesale partners to ease inventory levels.

But one industry watcher describes Chanel’s price cuts as “drastic”. “I don’t see other players following them,” he says. “It potentially signals the overwhelming exposure of their handbags business to non-European consumers.

“If you have a little domestic business in Europe, or sell predominantly to Chinese tourists, then increasing prices won’t hurt you. But for bigger European brands such as Prada, Hugo Boss or Gucci, it is a different story.”

The pressure on luxury brands may ease, however, as the Chinese government attempts to boost onshore consumption by cutting tariffs on select consumer goods from June 1, including for luxury products.

This measure alone will not significantly affect pricing, but luxury houses hope it may force digitally-savvy Chinese shoppers, aware that details of global prices are a click away, to think twice before spending abroad. And, while the weaker euro is still a problem for many European companies, sales made abroad count for more when converted back. The weak euro has also given a huge boost to tourist flows into western Europe. However, in spite of this, few luxury brands are saying what they think may lie over the horizon.

3.3 Luxury Goods Face a Global Reckoning (© Financial Times, 11 June 2015)

As if the luxury goods industry were not already in a fragile mood, Johann Rupert, chairman of Richemont, owner of Cartier and Van Cleef & Arpels, gave it more to worry about this week. He warned of the damage it faces from growing wealth inequality, and resentment among the have-nots of those who flaunt luxury watches and jewellery.

"What keeps me awake at night is how society will cope with structural unemployment and envy, hatred and class warfare," he told the FT Business of Luxury Summit in Monaco, discussing his fear that artificial intelligence will kill jobs. "The people with money will not wish to show it. If you child's best friend's parents are unemployed, you won't want to buy anything showy."

From where I sat, listening to him, a revolution did not appear to be in progress. Ferraris were driving up to the hotel and multi-decked yachts, some with helicopter pads, filled the harbour. "You are as paranoid as I am," Ralph Lauren once told Mr Rupert, who concluded: "If you have a healthy dose of paranoia, you survive."

But just because you are paranoid, it does not mean that people are buying as many of your watches as they used to. Even if Mr Rupert's dystopia has yet to materialise, some cracks are appearing in the luxury goods industry after a two decade-long boom. During that time, global luxury sales have only fallen twice – in 2003 and 2008-09 – and then rebounded immediately.

One crack is in the market for "affordable luxury" of the kind offered by US companies such as Michael Kors, Coach and Kate Spade, which have grown strongly since 2010. Kors disclosed a 6 per cent fall in quarterly same-store sales last month, with tourist shopping in the US down and consumers shifting from watches to lower-priced jewellery. Coach has suffered similarly.

A second crack, even more worrying for the industry, is the weakness in luxury goods and fashion sales in China. This is a result of the crackdown on Communist party corruption, which has hit the local habit of giving expensive gifts to well-connected officials. Bain and Co expects that luxury goods sales will fall in China in 2015 after years of being the biggest growth market.

A word that designers abhor – "discount" – was mentioned freely in Monaco. "We Chinese demand discounts. We love discounts!" said Sir David Tang, founder of Richemont's Shanghai Tang and an FT contributor. He recalled talking to one of China's richest women about shopping in Europe. "How much discount? And I want the [sales tax] back," she said.

Sluggish sales and high prices in China compared with Europe have made Gucci and others run half-price sales to lure shoppers back into their expensive flagship stores. "The good old time for luxury brands in China is gone. I don't know when it is coming back – maybe never," said Jiang Shan of Prowon Consulting, a Shanghai-based adviser to wealthy shoppers.

The luxury industry is hardly falling apart. Global sales of luxury goods rose by 2 per cent to €223bn last year, triple the size of the market 20 years ago, according to Bain. But the industry's capacity to defy financial gravity is in question. It "badly needs a new growth frontier", warned Luca Solca, an Exane BNP Paribas analyst.

Much hope is attached to expanding digital sales. Mr Rupert appealed this week for LVMH and Kering, the French luxury groups, to join the online retailer being created by the merger of Yoox of Italy and Richemont's Net-a-Porter. E-commerce currently contributes only about 6 per cent of luxury sales, compared with 32 per cent through branded stores, so there is room to grow.

But Mr Rupert is right to fret about the bigger picture. The market for fashion and luxury has deepened and broadened during the past two decades. Not only the wealthy but also the middle classes were eager to acquire high-quality, aspirational goods. "Hard luxury" watches and jewellery, and accessories such as Chanel handbags, are widely flourished as style signifiers.

This is being challenged at both ends of the market. Faltering results at Coach and Michael Kors reflect subdued income growth in the US, despite the economic recovery. The broader segment of shoppers on whom the industry now relies find themselves less able to afford affordable luxury.

There are still plenty of millionaires and billionaires in the world – more than ever. But the China crackdown shows what can occur suddenly to conspicuous consumption. Officials there no longer want to be seen wearing expensive watches or driving in flashy cars. A life of luxury will continue as usual in US and European enclaves such as Palm Beach and Monaco, but elsewhere the mood could swing.

Perhaps discretion will be in more demand: minimalist jewellery instead of bling; Audis instead of Ferraris (although Ferrari plans an initial public offering); silver watches rather than gold chronometers. A yacht is hard to disguise, but is can be sailed out of sight of public beaches.

On the bright side, a reckoning would allow designers to offer something new. "They thrive on this grungy, poor, out-of-a-job look," Mario Testino, the Vogue and Burberry photographer remarked sadly of some fashion photographers' work, contrasting it with his sunny, optimistic approach. They could be on to something, Mario.

4.0 FINANCE AND TREASURY

4.1. Company Policy on Net Debt.

The Group leases various retail stores, offices, warehouses and equipment under non-cancellable operating lease arrangements. The leases have varying terms, escalation clauses and renewal rights. The group has commitments relating to future minimum lease payments under these non-cancellable operating leases as follows:

Amounts falling due:

Within one year	£205.4m
Between two and five years	£513.1m
After five years	£264.4m
Total	£982.9m

Operating lease charges are a key element of business operating costs and, given the prime locations of the company's stores, they are expensive and liable to sharp increases. Company policy is therefore to manage what it defines as "lease-adjusted net debt", with the lease-based adjustment to debt calculated as five times the annual minimum lease charge less net cash. At March 2015 net cash was £552m and lease-adjusted net debt was £402m. Company policy is to hold sufficient cash to cover the capitalised leasing obligations.

4.2. Dividend Policy.

The company's declared objective is to move the pay-out ratio from the current 46% progressively to 50%.

4.2. Put and Call Options.

Following the acquisition of the company's retail and distribution business in China, a non-Group company retains a 15% economic interest in the Group's business in China. Put and call options exist over this interest stake which are exercisable after 1st January 2016 in the case of the call option, and after 1st January 2021 in the case of the put option. The net present value of the put option liability has been recognised as a non-current financial liability under IAS 39. The present value of any payment under the call option would be different should De Luxe decide to exercise the call option. Ultimately the put option liability is subject to a contractual cap of £200m.

4.3. Bank Overdrafts and Borrowings.

Included in the £65.2m bank overdrafts is £60.9m representing balances of cash pooling arrangements in the Group. The Group has a number of uncommitted overdraft and borrowing facilities agreed with third-party banks. In November 3014 the Group entered into a £300m multi-currency revolving credit facility with a syndicate of third-party banks, which replaced the previous similar facility. The facility matures in November 2019 with options to extend for an additional tear. At March 2015 there were nil outstanding drawings on this facility.

4.4. Treasury Policy.

Risk management is carried out by Group Treasury based on forecast business requirements to reduce financial risk and ensure sufficient liquidity is available to meet foreseeable needs and to invest in cash assets safely and profitably. Group Treasury does not operate as a profit centre and transacts only in relation to the underlying business requirements. The Group uses derivative instruments to hedge certain risk exposures.

The Group operates on a global basis and earns revenues, incurs costs and makes investments in a number of currencies. The Group's financial results are reported in Sterling. The majority of reported revenues are earned in non-Sterling currencies, with a significant proportion of costs in Sterling. Therefore the Sterling value of reported revenues, profits and cash flows may be reduced as a result of currency exchange rate movements.

The Group seeks to hedge anticipated significant external transactional cash flows using financial instruments. The Group monitors the desirability of hedging the net assets of non-Sterling subsidiaries when translated into Sterling for reporting purposes, but the Group has not entered into any transactions for this purpose in the current or previous year.

5.0 FINANCIALS

Equity Analysis Model De Luxe plc **Income Statement**			Historical Data		
Month / *Accounts date*	**2011**	**2012**	**2013**	**2014**	**2015**
March / *Currency / units*	**GBP mill**	**GBP mill**	**GBP mill**	**GBP mill**	**GBP mill**
Audit / man / fcst	**audited**	**audited**	**audited**	**audited**	**audited**
Number of months	**12**	**12**	**12**	**12**	**12**
Sales Revenue	**1,501.3**	**1,857.2**	**1,998.7**	**2,329.8**	**2,523.2**
(Cost of Sales)	(491.6)	(558.3)	(556.7)	(671.3)	(757.7)
Gross Profit	**1,009.7**	**1,298.9**	**1,442.0**	**1,658.5**	**1,765.5**
(Selling & Distribution Costs)	(333.5)	(459.4)	(573.1)	(673.6)	(762.9)
(Administrative Expenses)	(373.1)	(462.6)	(440.8)	(524.6)	(547.4)
Exceptionals etc. +/-	(1.0)		(82.3)	(14.9)	(14.9)
Other Expenditure Details (for information)					
(Personnel Costs)	(309.7)	(358.7)	(387.0)	(441.3)	(468.1)
(Depreciation & Impairment of Tangible Assets)	(53.7)	(74.3)	(94.5)	(105.6)	(104.0)
(Amortisation & Impairment of Goodwill)					
(Amortisation & Impairment of Intangibles)	(12.6)	(24.6)	(28.0)	(45.3)	(38.7)
(Operating lease payments)	(88.5)	(112.0)	(142.6)	(156.5)	(190.9)
Operating Profit	**302.1**	**376.9**	**345.8**	**445.4**	**440.3**
Non-operating Income & Expenditure					
EBIT	**302.1**	**376.9**	**345.8**	**445.4**	**440.3**
Interest Received & Paid					
Other Financial Income & Expenditure	(3.2)	(10.2)	5.2	(1.7)	3.7
Interest Received	1.9	2.9	3.4	3.9	4.4
(Gross Interest Paid)	(5.1)	(3.6)	(3.7)	(3.2)	(3.8)
Profit before Tax	**295.7**	**366.0**	**350.7**	**444.4**	**444.6**
(Tax charge)	(83.2)	(100.6)	(91.5)	(112.1)	(103.5)
Profit after Tax	**212.5**	**265.4**	**259.2**	**332.3**	**341.1**
Extraordinaries, Discontinued Operations etc	(6.2)	(0.3)	-	-	-
Profit / (Loss) for the Year	**206.3**	**265.1**	**259.2**	**332.3**	**341.1**
Attributable to Non-controlling Interests	(2.1)	1.8	4.9	9.8	4.8
Attributable to Owners of Company	**208.4**	**263.3**	**254.3**	**322.5**	**336.3**
(Preference Dividends)					
(Ordinary Dividends)	(87.1)	(109.5)	(127.0)	(140.7)	(155.2)
Retained Profit for Year	**121.3**	**153.8**	**127.3**	**181.8**	**181.1**
Statement of Gains and Losses	(9.8)	(1.5)	39.0	(53.7)	41.7
Total Comprehensive Income	196.5	263.6	298.2	278.6	382.8
EBITA (before Exceptionals & all Amortisation)	**315.7**	**401.5**	**456.1**	**505.6**	**493.9**
EBITDA (before Exceps. Deprn, & all Amortisation)	**369.4**	**475.8**	**550.6**	**611.2**	**597.9**
Cash Earnings (Before Goodwill, Exceps.& Extraords)	**215.6**	**263.6**	**336.6**	**337.4**	**351.2**
Cash Retained Profit (Before Goodwill, Exceps & Extraords)	**128.5**	**154.1**	**209.6**	**196.7**	**196.0**

Equity Analysis Model
De Luxe plc
Balance Sheet

	Historical Data				
Accounts date	**2011**	**2012**	**2013**	**2014**	**2015**
Currency / units	**GBP mill**	**GBP mill**	**GBP mill**	**GBP mill**	**GBP mill**
Goodwill					
Other Intangible Fixed Assets	114.7	133.1	210.2	195.4	193.5
Property, Land & Buildings & Capital Work	144.5	174.5	226.9	231.6	269.5
Plant, Equipment & Vehicles - net	137.3	154.3	182.2	166.8	167.0
Financial Investments, Tax & Pension Assets & Deriv.	82.6	101.6	120.5	119.1	148.7
Medium-term Trade-related Assets	15.2	22.3	39.9	42.3	60.5
Total Fixed Assets	**494.3**	**585.8**	**779.7**	**755.2**	**839.2**
Stocks, Inventories, Work in Progress	247.9	311.1	351.0	419.8	436.6
Trade and Other Receivables	132.5	145.2	159.6	231.4	260.3
Other financial assets & investments	13.5	8.3			
Cash and Short-term Investments	466.3	546.9	426.4	545.5	617.4
Tax Assets, Derivatives, Assets for Sale & Other	9.9	13.3	29.5	13.6	19.7
Total Current Assets	**870.1**	**1,024.8**	**966.5**	**1,210.3**	**1,334.0**
Total Assets	**1,364.4**	**1,610.6**	**1,746.2**	**1,965.5**	**2,173.2**
Short-term Debt	168.4	208.6	129.8	143.0	65.2
Trade and Other Payables	283.4	324.4	339.8	399.8	406.0
Corporation Tax Payable	60.0	53.7	80.9	76.6	86.8
Provisions, Derivatives & Other Current Liabilities	22.5	10.1	13.0	12.3	22.8
Total Current Liabilities	**534.3**	**596.8**	**563.5**	**631.7**	**580.8**
Medium & Long-term Debt					
Medium-term Trade Payables	84.4	104.9	108.0	107.4	117.1
Tax, Pension & Other Long-term Provisions	12.0	17.5	21.9	18.4	23.8
Total Non-current Liabilities	**96.4**	**122.4**	**129.9**	**125.8**	**140.9**
Issued Share Capital	0.2	0.2	0.2	0.2	0.2
Share Premium Account, Treasury Shares	192.5	202.6	203.6	204.8	207.6
Revaluation Reserve					
Other Reserves	154.5	157.4	197.3	150.3	192.2
Revenue Reserves	366.4	507.1	615.9	810.1	1,000.9
Total Capital and Reserves	**713.6**	**867.3**	**1,017.0**	**1,165.4**	**1,400.9**
Non-controlling Interests	20.1	24.1	35.8	42.6	50.6
Total Shareholders' Funds	**733.7**	**891.4**	**1,052.8**	**1,208.0**	**1,451.5**
Accumulated depreciation	245.0	278.4	387.7	450.9	533.8
Average Cost of Debt %	2.72%	1.91%	2.19%	2.35%	3.65%

Equity Analysis Model					
De Luxe plc					
UK-Style Cash Flow Statement					
		Historical Data			
Accounts date	**2011**	**2012**	**2013**	**2014**	**2015**
Currency / units	**GBP mill**	**GBP mill**	**GBP mill**	**GBP mill**	**GBP mill**
Number of months	**12**	**12**	**12**	**12**	**12**
CASH FLOW FROM OPERATING ACTIVITIES					
Operating Profit	302.1	376.9	345.8	445.4	440.3
Tangible Asset Depreciation	53.7	74.3	94.5	105.6	104.0
Dec(Inc) in Stock / Inventories	(58.9)	(61.8)	(39.2)	(68.2)	(15.1)
Dec(Inc) in Debtors / Receivables	(11.4)	(17.6)	(32.0)	(73.8)	(43.8)
Inc(Dec) in Creditors / Payables & Advance Payments	51.3	60.0	27.6	45.2	23.1
All other non-cash adjustments & Exceptionals	29.6	50.7	126.3	81.3	59.6
Cash Generated from Operations	**366.4**	**482.5**	**523.0**	**535.5**	**568.1**
Dividends Received from Associates					
(Tax Paid)	(98.1)	(108.2)	(99.0)	(111.1)	(114.4)
Net Cash from Operating Activities	**268.3**	**374.3**	**424.0**	**424.4**	**453.7**
CASH FLOW FROM INVESTING ACTIVITIES					
Income Received from Investments					
Interest Received	1.9	2.7	3.5	3.4	3.8
(Purchase of Tangible Fixed Assets)	(86.5)	(126.1)	(158.1)	(129.5)	(127.8)
Disposal of Tangible Fixed Assets			0.1	3.0	
(Purchase of Subs, Intang., Financial & Forestry Assets)	(73.8)	(50.5)	(162.9)	(27.1)	(31.3)
Disposal of Subsidiaries, Intangibles & Financial Assets					1.3
Net Cash from Investing Activities	**(158.4)**	**(173.9)**	**(317.4)**	**(150.2)**	**(154.0)**
CASH FLOW FROM FINANCING ACTIVITIES					
(Interest Paid)	(5.1)	(3.3)	(2.6)	(2.6)	(2.6)
New Shares Issued	8.1	5.6	1.4	3.6	3.2
(Repurchase / Redemption of Shares)	(6.6)	(60.7)	(46.4)	(24.7)	(19.2)
(Costs of Issuing / Redeeming Equity)					
Total Increase in Debt	24.0				
(Total Decrease in Debt)	(24.1)		(1.3)		
(Dividends Paid on Ordinary Shares)	(67.4)	(95.9)	(113.5)	(130.7)	(144.9)
(Preference and Minority Dividends Paid)	(1.3)	(3.3)	-	-	(0.4)
Miscell. Financing Costs e.g. derivatives, bank fees					
Net Cash from Financing Activities	**(72.4)**	**(157.6)**	**(162.4)**	**(154.4)**	**(163.9)**
Net Cash Flow from Ops. Investing & Funding	37.5	42.8	(55.8)	119.8	135.8
Change in Cash	(2.1)	80.6	(120.5)	119.1	71.9
Change in Overdraft	39.6	(37.8)	64.7	0.7	63.9

Equity Analysis Model							
De Luxe plc							
Cash Flow Analysis							
		Historical Data					
	Accounts date	2011	2012	2013	2014	2015	Period
	Currency / units	GBP mill	GBP mill	GBP mill	GBP mill	GBP mill	Total
Cash Flow Summary		audited	audited	audited	audited	audited	2011-15
	Number of months	12	12	12	12	12	
CASH FLOW FROM OPERATIONS							
	Operating Profit	302	377	346	445	440	1,911
	Other Non-cash & Exceptional Items	30	51	126	81	60	348
	Investment Income						
"Cash Profit"		**332**	**428**	**472**	**527**	**500**	**2,258**
	(Increase) / Decrease in Net Working Assets	(19)	(19)	(44)	(97)	(36)	(215)
	Tangible Asset Depreciation	54	74	95	106	104	432
	Net Capital Expenditure	(87)	(126)	(158)	(127)	(128)	(625)
	(Tax Paid	(98)	(108)	(99)	(111)	(114)	(531)
	(Dividends Paid)	(69)	(99)	(114)	(131)	(145)	(557)
Free Cash Flow before Interest		**113**	**149**	**153**	**167**	**181**	**762**
	(Net Interest Paid)	(3)	(1)	1	1	1	(1)
Internal Cash Flow		**110**	**148**	**153**	**168**	**182**	**762**
ACQUISITION & FINANCING CASH FLOWS							
	(Acquisitions),Disposals,(Investments)	(74)	(51)	(163)	(27)	(30)	(344)
	Increase / (Decrease) in Share Capital	2	(55)	(45)	(21)	(16)	(136)
	Increase / (Decrease) in Debt	(40)	38	(66)	(1)	(64)	(133)
	(Increase) / Decrease in Cash	2	(81)	121	(119)	(72)	(149)
Net Financing Cash Flow		**(110)**	**(148)**	**(153)**	**(168)**	**(182)**	**(762)**

Equity Analysis Model

De Luxe plc

Share Price Data

			Historical Data			
Accounts date	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Currency / units	**GBP mill**	**GBP mill**	**GBP mill**	**GBP mill**	**GBP mill**	**GBP mill**
	12	**12**	**12**	**12**	**12**	**12**
Number of Shares & Eps						
Basic Earnings per Share (pence)	18.8	47.9	60.4	58.3	73.6	76.4
Adjusted Earnings per Share (pence or equiv.)	**35.9**	**49.9**	**62.8**	**71.6**	**77.0**	**78.3**
Interim Dividend Per Share (pence)	3.5	5.0	7.0	8.0	8.8	9.7
Final Dividend Per Share (pence)	10.5	15.0	18.0	21.0	23.2	25.5
Total Dividends Per Share (pence)	**14.0**	**20.0**	**25.0**	**29.0**	**32.0**	**35.2**
Average number of common shares	432.6	435.0	435.9	436.2	437.9	440.0
Average number of preference shares						
Share Prices						
Common Share Price - Low (£)	7.46	13.20	16.10	15.48	16.87	19.29
Common Share Price - High (£)	3.60	6.12	10.34	9.98	12.67	13.88
Common Share Price - Average (£)	5.53	9.66	13.22	12.73	14.77	16.59
Risk rating						
Variability %	35	36	38	39	33	29
Beta (actual or estimate)	1.29	1.26	1.27	1.19	1.16	1.15
Assumed Market Risk premium	**4.19**	**4.19**	**4.19**	**4.19**	**4.19**	**4.19**
UK 5-year Gilt Yield	**4.37**	**2.28**	**1.96**	**0.72**	**0.85**	**0.85**
3-month LIBOR or equivalent	0.61	0.76	1.08	0.49	0.55	0.54
Market Capitalisation						
Market Capitalisation - Common Stock	2,390	4,201	5,763	5,553	6,468	7,297
Market Capitalisation - Preference Stock	-	-	-	-	-	-
Market Capitalisation - Total	2,390	4,201	5,763	5,553	6,468	7,297
Minorities	13	20	24	36	43	51
Net Debt	(262)	(311)	(347)	(297)	(403)	(552)
Enterprise value [EV]	**2,142**	**3,910**	**5,440**	**5,292**	**6,108**	**6,796**

Equity Analysis

Equity Ratios						
Underlying Eps Growth %		39.0%	25.9%	14.0%	7.5%	1.7%
P/E Ratio	15.4	19.4	21.1	17.8	19.2	21.2
Market / Book Ratio of Equity	4.05	5.89	6.64	5.46	5.55	5.21
Dividend Cover	2.6	2.5	2.5	2.5	2.4	2.2
Dividend Yield %	2.5%	2.1%	1.9%	2.3%	2.2%	2.1%
Total Return to Shareholders %		78.4%	39.5%	(1.5%)	18.5%	14.7%
EV Valuation Multiples						
EV / Sales	1.81	2.60	2.93	2.65	2.62	2.69
EV / Book Capital Employed	6.27	9.26	9.99	7.00	7.58	7.56
EV / EBITA	9.6	12.4	13.5	11.6	12.1	13.8
EV / EBITDA	7.97	10.58	11.43	9.61	9.99	11.37
EV / Staff Costs	9.7	12.6	15.2	13.7	13.8	14.5
EV / Sustainable Free Cash Flow	16.0	15.6	16.6	14.1	15.2	17.8

Equity Analysis Model
De Luxe plc

Financial Profile

	Historical Data				
Accounts date	**2011**	**2012**	**2013**	**2014**	**2015**
Number of months	***12***	***12***	***12***	***12***	***12***
Annual % Growth Rates					
Sales Growth	26.7%	23.7%	7.6%	16.6%	8.3%
Operating Profit Growth	39.5%	24.8%	(8.3%)	28.8%	(1.1%)
EBITA Growh	41.8%	27.2%	13.6%	10.9%	(2.3%)
Net Earnings Growth before Exceps & Extraords.	42.0%	22.3%	27.7%	0.2%	4.1%
Margins and Cost Structure					
Cost of Sales % sales	(32.7%)	(30.1%)	(27.9%)	(28.8%)	(30.0%)
Gross Profit % Sales	67.3%	69.9%	72.1%	71.2%	70.0%
Selling & Distribution Costs % Sales	(22.2%)	(24.7%)	(28.7%)	(28.9%)	(30.2%)
Administrative Expenses % Sales	(24.9%)	(24.9%)	(22.1%)	(22.5%)	(21.7%)
Personnel Costs % Sales	(20.6%)	(19.3%)	(19.4%)	(18.9%)	(18.6%)
Depreciation % Sales	(3.6%)	(4.0%)	(4.7%)	(4.5%)	(4.1%)
Lease Payments % Sales	(5.9%)	(6.0%)	(7.1%)	(6.7%)	(7.6%)
Total Amortisation % Sales	(0.8%)	(1.3%)	(1.4%)	(1.9%)	(1.5%)
Total Exceptional Items % Sales (+/-)	(0.1%)		(4.1%)	(0.6%)	(0.6%)
EBITA% Sales	21.0%	21.6%	22.8%	21.7%	19.6%
EBIT % Sales	20.1%	20.3%	17.3%	19.1%	17.5%
Profitability / Return on Capital Employed					
EBITA % Capital Employed (pre-exceptionals)	72.4%	72.6%	60.3%	62.8%	54.9%
Pre-tax Target Rate of Return 0n Book Value	100.1%	102.9%	55.9%	61.2%	59.7%
EBITA % Market Enterprise Value	8.1%	7.4%	8.6%	8.3%	7.3%
Pre-tax Target Rate of Return on Market Value	10.8%	10.3%	8.0%	8.1%	7.9%
Asset Utilisation / Capital Intensity					
Sales / Total Assets	1.10	1.15	1.14	1.19	1.16
Stocks % Sales	16.5%	16.8%	17.6%	18.0%	17.3%
Debtors % Sales	9.8%	9.0%	10.0%	11.7%	12.7%
Creditors & Advance Payments % Sales	24.5%	23.1%	22.4%	21.8%	20.7%
Net Working Assets % Sales	1.9%	2.7%	5.1%	8.0%	9.3%
Intangibles % Sales	7.6%	7.2%	10.5%	8.4%	7.7%
Tangible Fixed Assets % Sales	19%	18%	20%	17%	17%
Depreciable Assets % Sales	9%	8%	9%	7%	7%
Net Capex % Annual Depreciation	161%	170%	167%	120%	123%
Average Age of Depreciable Assets (years)	4.6	3.7	4.1	4.3	5.1
Tax Ratios					
Effective Interest Rate [P&L] %	2.7%	1.9%	2.2%	2.3%	3.7%
Effective Tax Rate [P&L] %	28.1%	27.5%	26.1%	25.2%	23.3%
Cash Tax Rate [Cash Flow] %	33.2%	29.6%	28.2%	25.0%	25.7%
Balance Sheet Gearing & Leverage					
Leverage: (Net Debt % Capital Employed)	(74%)	(64%)	(39%)	(50%)	(61%)
Net Debt % Enterprise Value	(8%)	(6%)	(6%)	(7%)	(8%)
Interest Cover Ratios					
Interest Cover: (EBITA / Net Interest Paid)	99	574	1,520		
Interest Cover: (EBITDA / Net Interest Paid)	115	680	1,835		
Cash Flow before Interest / Cash Net Interest	35.34	248.33	(169.44)	(209.00)	(150.50)
Income Leverage (Debt Repayment Ability)					
Gross Debt / Cash Retained Profit (years to repay)	1.3	1.4	0.6	0.7	0.3
Net Debt / EBITDA	(0.84)	(0.73)	(0.54)	(0.66)	(0.92)

ADVANCED DIPLOMA

CASE STUDY EXAMINATION - NOTE FORM ANSWERS

OCTOBER 2015

Question 1 **[18.0 mins, 10 marks]**

[Marking scheme: ⅓ mark for each good point].

<u>Key Drivers.</u>

GDP growth in key markets i.e. Western Europe/ Middle East, Americas and Asia Pacific. Especially growth of disposable income (of the wealthy) for luxury goods and travel. Especially growing, emerging markets.
Expansion of existing market shares and entry to new markets.
New store openings and store expansions/enhancements (capital expenditure).
Focus on flagship stores in China, Japan and Americas, also travel locations.
Closing small, inefficient, badly-located stores.
Conversion of wholesaling to retailing.
Expansion of /investment in digital off-line service and dovetailing with on-line service.
Selective acquisitions.
Selective exploitation of product lines geographically.
Maximum support and exploitation of brand.
Expanding Beauty (especially under-penetrated) and Men's product sales.
China/Asia slowdown/rising Global GDP, Reducing, terrorism – threat to travel, slower conversion to retail reducing concessions, reduction of Brand appeal – fashion trends local political uncertainty, US resistance to UK brand, fierce competition New entrants – companies, products brands Tariffs adverse fx Brand piracy, grey markets Selective exploitation of product ? Geographically

<u>Constraints.</u>

China and Asia slowdown/crisis.
Global GDP reducing.
Terrorism – threat to travel.
Slower conversion to retail versus concessions.
Reduction of brand appeal e.g. US or damage to brand image.
Local operating difficulties.
Fiercer competition, brand piracy, grey market etc.
New entrants – companies, brands, products
Adverse tariffs
Persistently adverse FX.

Question 2 **[14.4 mins, 8 marks]**

[Marking scheme: potential 2 marks for each key issue identified, based on

credibility of the issue and quality of justification for including it].

There is a lot of focus on channels and "blurring physical and digital as consumer behaviour evolves rapidly". Too much inventory in a seasonal high fashion business is risky. There is now a single pool of inventory in China, integrating on-line and off-line inventory – "channel-agnostic inventory". This will be rolled out in 2015 in the UK and US. A project to upgrade IT has started and investment in retail and digital is a priority. In store, (i) iPad generate 25% of digital revenue, (ii) 200 stores have collect-in-store and (iii) there is a customer 1-2-1 tool in 450 stores in 30 countries.

Allegedly, equity holders are seeking fx exposure so hedging is not necessarily routine practice.

They are experimenting with pricing differentials to compensate for big currency swings but there is the risk of cross border arbitrage.

Flagship stores are critical to success in new markets and the related investment is their major item of capex, investment being "fitting out" as stores are leased. Store sales density and IRR per sq. ft. are some of the metrics used. Other sector specific store metrics are in-store product offered to product bought and congruency of assortment in stores across regions.

Market to book runs at 5+ times, despite negative net debt this is not a metal basher.

So important areas are:

- channel mix to optimise ROCE, inventory that is channel-agnostic
- currency risk
- cash holding and cash investment
- investment appraisal/capital structure/dividend policy

Student choices of key areas were:

- Currency risk	mentioned by 85% of students
- Cash balance management	mentioned by 70% of students
- Capital structure	mentioned by 65% of students
- Investment appraisal	mentioned by 35% of students
- Subsidiary financial organisation	mentioned by 30% of students
- Inventory	mentioned by 16% of students

For treasury to add value, close involvement with the business is critical.

Responses to this question were very good and the pass rate was 95%, although it was surprising that so few mentioned net working assets, the subject of Question 6.

Of course this has been (but may not always be) an evergreen question. But even if it didn't appear as a question, students critically reading the case in the period before the exam might be expected to look for key areas in order to understand the dynamics of the business.

Question 3 [25.2 mins, 14 marks]

Q3.a. (12.6 mins, 7 marks)

[Marking scheme: ⅓ mark for each good point].

Shares higher than average risk (beta 1.15 but down from 1.29).
Required return on equity = 0.85 + (1.15 x 4.19) = 5.67%.
Total return to shareholders (calculated annually) ranges from minus 1.5% to plus 39.5%, so clearly beating the required R.o.R on average.
Compound annual rate of growth in share average price = 4^{th} root of 16.59/9.66 = 14.5% (77% over 4 years). (N.B. FTSE 100 up only 19% over the period).
Annual dividend yield = 2.1%, total return approximately 26.7% - excellent by any standard. On a quick estimate – probably about 16% if dividends were re-invested.
Dividend well covered by earnings (average cover 2.42). So no threat to existing dividend policy.
Annual compound growth rate in adjusted eps was less than share price at 11.9%, but declining from 39% to 1.7%, so can higher eps growth be resumed? But growing market confidence in company and its strategy/management, as evidenced by P/E up from 15.4 to 21.2 Basic eps before adjustments grew at 12.4% p.a. Adjusted eps is now only slightly better than basic eps (102%) in contrast to 2010 (190%) – the potential has been delivered.
Cash cover for dividends has averaged 649 + 488 / 488 = 2.33 – very good and pretty stable. Note 649 = Internal Cash Flow from 2012 to 2015, 488 is Dividends Paid from 2012 to 2015.

Q3.b. (5.4 mins, 3 marks)

[Marking scheme: ⅓ mark for each good point].

P/E has risen from 15.4 to 21.2 (up 38%) London Stock Exchange probably on an average P/E of about 11, but with luxury goods retailing on maybe 15 to 20. So the P/E trend reflects growing market confidence, given company's delivery on re-structuring and realisation of up-side potential via sales and profit growth, but maybe now looking a little "toppy".

EV / EBITDA up from 7.97 to 11.37 (up 52%, but still not excessive?)
EV / Book Capital up only 21% and EV / Sustainable Cash Flow only 11%, so not such big increases in EV relation to the fundamental value drivers i.e. assets and cash flow.

But bigger increases in value relative to sales and employees – better margins and operating efficiencies.

Q3.c. (10.8 mins, 6 marks)

[Marking scheme: ⅓ mark for each good point].

Company has generated 762m over the 5-year period (418m after acquisitions), compared with the dividends paid of 557m, so plenty of spare cash for increased dividends.

Steady 11% growth in cash profit, 16.3% growth in cash before dividends – with increases every year in both. So a very stable pattern of cash flows. 20% growth in dividends.

Capex 145% of depreciation over the period, when replacement capex probably needs only about 115% - clearly investing to support sales growth via stores openings etc. Ratio for 2015 was 123%

Increases in working capital steadily consuming more cash (wc ratio up from 1.9% to 9.3% over the period), also to support sales growth of 14% on average. Cash and p&l tax rates recently around 25%.
Internal Cash Flow after all this is always positive and growing.

So, sustainable cash flow becomes:

Internal Cash Flow	182m	
Add back dividend	145m	
Extra capex, say[11]	(20m)	
Extra working capital, say[12]	(5m)	(both lower than average in 2015)
SCF	302m	

This gives dividend cover of 302/145 = 2.09, with a margin of 157m

Company policy is to increase dividend pay-out to 50%, with eps cover down to 2.0.

In 2015 this would give dps of 39.15p, up 11.2%, with extra cash dividends paid of 16m, a total paid of 161m – very comfortable and conservative (cash cover by our SCF of 1.93x).

Assume cash cover reduced to 1.5 (67% pay-out), which would give a sustainable dividend for 2015 of 201m, which still leaves plenty of margin (101m) for cash flow volatility (+/- 10m annually) In term of eps this is a pay-out ratio of about 64%, cover 1.55. From cash flow considerations alone the cash dividend pay-out could be as high as 80%, paying 250m and still leaving surplus cash flow of 52m!

Any such change would have to be communicated to the market, supported by rigorous numbers and arguments, but stepped up gradually to allow shareholders to adjust their perceptions and portfolios accordingly.

The company has clearly been a growth share rather than a dividend yield share, as demonstrated above in 3.a. But, even if the growth rate continued or accelerated and margins got somewhat squeezed (some indications of that) the company is clearly generating more cash than it needs for internal purposes, so the argument is that it should return more cash to shareholders. The company has not been and does not intend to be a major acquirer, so a cash chest is not needed for that, unlike other companies in other sectors.

Question 4 **[19.8 mins, 11 marks]**

Q4.a. **(14.4 mins, 8 marks)**

[Marking scheme: 0.4 mark for each good point].

The theoretical argument;
is that using more debt increases shareholder value by reducing the WACC, via the tax-shield effect. (Modigliani Miller modified for tax optimal capital structure)

Essentially the added tax-shield value = debt x interest rate x tax rate / WACC.
e.g. an extra 1,000m of debt would add 1,000 x 3.7% x 23.3% / 6.1% = 141m, It is a much lower figure than when interest rates and tax rates were both much higher (e.g. 1,000 x 6% x 35% / 9% = 233m.)

Market cap is 7,297m, so this is not a big % impact.

The M-M theory of optimum WACC is completed by the notion of the "bankruptcy [10] effect" where the disproportionately higher costs of debt and equity tip the WACC upwards at very high levels of gearing.

[N.B. for simplicity it is assumed here that the extra debt is used to reduce share capital.]

Added value is delivered via enhanced eps;
1,000m could redeem 1,000/16.59 = 60.28m shares, reducing total shares to 440 – 60 = 380m rounding.
Earnings would reduce by the after-tax cost of extra interest (1,000 x 3.7% x 0.767) = 28.4m, from (440 x 78.3p =) 344.5m to 316.1m.
Shares would reduce by 1,000 / 16.50 = 60m. Therefore eps goes to 316.1 / 380 = 83.18p, a 6.2% enhancement.
But the shares are now more risky.

Practical considerations.
Also the Classic M-M theory assumes critically that companies can borrow and deposit at the risk-free rate, except at very high levels of gearing. Holding lots of cash (at a lower rate than debt) as well as debt also reduces the benefits of gearing to companies like De Luxe.

Impact not so big now lower tax and interest rates as above (closer to the M-M theory of no tax on debt costing only the risk-free rate). Optimal leverage might be nearer 20% than previous 50%

Lower interest and tax rates reduce the M-M U-shape, as illustrated above. Companies are arguably more conservative on leverage risk and less comfortable with relying on debt especially short-term bank facilities so liquidity at a greater premium than pre 2018.

This would be a big change in financial policy for the De Luxe, so would have to be explained thoroughly and (agreement reached with broad chunk of shareholders) old arguments for cash retention modified. Special dividend or share buy-back (mechanics). De Luxe policy on cover for leases
Debt availability and cost credit rating impact
Reduced financial and strategic flexibility

Q4.b. **(5.4 mins, 3 marks)**

[Marking scheme: ⅓ mark for each good point].

Average cost of debt = 3.7%, after tax 2.8%
After-tax return on cash, say = 0.3%
Required return on equity = 0.85 + (1.15 x 4.19) = 5.67% (bonus mark if between 5% and 8%)

Gross debt % EV = 65/6,796 = 1.0%
Cash % EV = 617/6,796 = 9.1%
Equity = (7,297 + minorities 51)/6,796 = 108.1%.

WACC = (1.081 x 5.67%) + (0.01 x 2.8%)-(0.091 x 0.3%)

= 6.129 + 0.028 – 0.0273 = **6.13%**

(bonus mark if between 5% and 8%)

Q4.c. **(14.4 mins, 8 marks)**

[Marking scheme: ⅓ mark for each good point].

I expected some discussion of the treatment of leases from a credit point of view and appropriate adjustment of the credit metrics – see last section of these marking notes.

N.B. For information only;

Company policy is to hold five times annual minimum (operating) lease rental charges, amounting to 190.9 X 5 = 954m, as cover for those future lease payments (note that this number can be seen from note 4.1 in the information as the difference between two ‘net debts’ but could equally have been expressed as 5 X 205.4 = 1,027m. It can also be implied as 7.6% of sales).

The company treats this as debt for its own purposes. Net cash of 552 therefore become “net debt” of 402m. This is a very conservative approach to ensuring that contractual rental payments, which can rise significantly and unpredictably, can always be met.

“Interest” on leases = ⅓ x 190.9 = 63.6 = 6.67% (1)

5 x 3

A multiple of 5 in this case is not a reliable method for estimating the capital value of the property leases especially. It can be easily demonstrated on a spread-sheet that, at say 5% actual interest rate the multiple of 5 only works on a 6-year loan (approximately). On a 20-year loan the valuation multiple is 12.5 times rental payments, on 15 years it is 10.4, and on 10 years it is 7.7 times.

Finance leases are capitalised under the accounting rules and included as fixed assets on one side of the balance sheet and as trade payables (not financial debt) on the other. If capitalised operating leases were accounted for in this way **both** the asset and the liability would appear on the balance sheet.

Under the rule of thumb used by most of the candidates Interest is assumed to be one third of annual lease payments and depreciation / debt repayments two thirds. So the implied interest on leases = 0.333 x 190.9 = 63.6m = 6.67% (100% /5 / 3). Depreciation is 0.667 x 190.9 = 127.3m.

These figures were used for illustrative purposes although they do not really apply in this case.

With reference to the 5% examples above; interest payments on the 20-year loan actually amount to 38% of the annual lease payment averaged over the loan life. They represent approximately 33.3% on a 17-year loan.

To achieve the 5-year multiplier and the 33.3% interest proportion it requires a loan of 7+ years at 10%. This is a too high for current interest rates and too short a term for property leases.

However, if the capitalised leases are included in total debt then EBIT and EBITDA also have to be adjusted – which virtually all candidates failed to appreciate so did only half of the calculation (see later for illustrative calculations).

Maximum debt (leaving operating leases out of the calculation.

The company is currently un-levered, with debt of 65 and cash of 617
Assume that the company adopted a policy of targeting the equivalent of a single-A rating, De Luxe having a risk rating slightly above average, all things considered.

If an EBIT interest cover of, say, 7.0 were adopted then maximum interest would be 440.3/7 = 62.9. Add back interest received of 4.4m to give gross interest paid of 67.3m, assuming company maintains same levels of cash.

At the company's average interest rate (assume unchanged) of 3.7% this gives maximum gross debt of **1,819m and** net debt of 1,202m.

1,200 represents 2.0 times EBITDA of 597.9, also 18% of EV, and gives EBITDA interest cover of 9.5 times – all acceptable/comfortable ratios.
Note that it is also 1,200 / 2,173 = 55% of balance sheet assets, which might cause concern. We have established in 3.c. that cash flow will be nowhere near stretched to cover extra interest of around 60m.

From the shareholder perspective the risk to them will increase as indicated by the re-geared beta of 1.42 (see Q4.d. for calculations). This is high for a quoted company. Alternatively one could set an observed stock market maximum beta of, say, 1.5 and work back to maximum net debt of 1,558m, **gross debt of 2,175m.**

Conclusion maximum gross debt between 1,800m and 2,000m.

<u>Including capitalised leases.</u>

In the P&L lease costs are deducted from operating costs and split between depreciation and interest. In the cash flow statement the interest element is added back to EBIT, the depreciation is increased, interest paid is increased and loan repayments are increased.

	Existing accounts	adjustments	Leases capitalised
EBITDA	597.9	190.9	788.8
Deprn. & amortisn.	157.6	127.3	284.9
EBIT	440.3	63.6	503.9
Net interest (paid)	0.6	(63.6)	(63.0)
Profit before tax	444.6	0.0	444.6
Gross debt	65	954	1,019
Net debt	(552)	954	402
Market cap.	7,297	0	7,297
EV	6,796	954	7,750
Total assets	2,173	954	3,127
Shareholders' funds	1,452	0	1,452
Cash profit	500	63.6	563.6
Depreciation	104	127.3	231.3
Cash before interest	181	190.9	371.9
Net Interest (paid)	1	(63.6)	(62.6)
Operating cash flow	182	127.3	309.3
Change in debt	(64.0)	(127.3)	(191.3)
Net financing flow	(182.0)	0	(182.0)

Net debt % book capital	(61)%		22%
Net debt % EV	(8)%		5%
Net debt / EBITDA	(0.9)		0.5
Cash interest cover	(181)		5.9
EBITDA / Interest	(997)		12.5
EBIT / Interest	(734)		8.0
EV / EBITDA	11.4		9.8
Interest rate (approx)	3.70%	6.67%	6.58%

Q4.d. **(9.0 mins, 5 marks)**

[Marking scheme: ⅓ mark for each good point].

Assume EV remains the same for now at 6,796m (tax shield value in theory only about 16m).
Cash 617m (9.1%), gross debt 1,819 (26.8%), market cap. of equity = 5,594 (82.3.0%)

Need to re-calculate geared beta;
Ungeared beta = 1.15/ (1+ (0.767 x (-552/7297)) = 1.22 – the net cash is reducing the risk to shareholders so un-geared beta is higher than geared.
Re-geared beta = 1.22 x (1+ (0.767 x 17.7/82.3)) = 1.42 – **Note that this is high for a quoted company.**

Required return on equity = 0.85 + (1.42 x 4.19) = 6.8%
Assuming borrowing costs increase by 1.0% to 4.7%, i.e. 3.6% after tax.

WACC = (0.823 x 6.8%) + (0.268 x 4.7%) – (0.091 x 0.03%) **= 6.74%**
Previously 6.13% so, contrary to M-M theory WACC increases because of the additional cost of riskier debt plus the negative impact of large cash balances.

Assume that 302m is a reasonable estimate of 2015 sustainable cash flow **before dividends** (see answer to 3.c.above).

Current EV = 6,796 = 302 / (WACC-g)
Solving, using current WACC of 6.13% gives implied growth of 0.0613 - (312 / 6,796) = 0.0169 = 1.69%

Re-calculating EV with the higher WACC of 6.74% gives;
302 / (0.0674 - 0.0169) = 5,980 – **a loss in value of 816m (12.0%).**

Question 5 **[18 mins, 10 marks]**

[Marking scheme: as well as reference to the usual SLY features (security, liquidity, yield) looking for recognition and discussion of at least two De Luxe-specific dimensions, eg (i) to (vii) below for a pass; thereafter further recognition of De Luxe-specific issues and quality of discussion].

For some students, £600m cash relative to £2,500m revenue triggered a vanilla SLY dump (Security, Liquidity, and Yield). SLY applies but on its own this was not enough to pass. The key to the answer is the company-specific factors, as you would expect at MCT level in the Case Examination. So what are they?

A number of company-specific factors bear on the cash holding:

- (i) usual precautionary liquidity purposes
- (ii) cover for lease rentals
- (iii) provision for new flagship store capex
- (iv) cash to maintain dividend in a downturn
- (v) opportunistic acquisitions (but not major ones)
- (vi) significant reliance on MMF
- (vii) some cash may be trapped

Questions 3, 4 above deal with the rationale for the amount of some of the cash holdings.

But what should the policy be for how it is held?

- given the factors above, much of the cash could be termed out, with the opportunity for some yield pick-up, eg (ii), (iii), (iv)

- so need to segment the cash holding according to the need, decide on the appropriate maturity and review periodically to pick up altered circumstance

- re. MMFs, regulators are concerned about the ability of MMFs to maintain Constant Net Asset Value (CNAV) status, other than for high quality sovereign debt versions

- banks are not enthusiastic about short-term deposits because these impact the new bank liquidity ratios but additional segmentation into operating cash (preferred by banks) might be helpful.

- in addition banks continue to be potentially weak counterparties and corporate bank deposits may be subject to bail-in

- repos/tri-party repos have the advantage of collateral and of customised components

Response to the Question fell into two categories: half were very weak and half were good passes. The dividing line was the ability to pick up on De Luxe-specific issues, including MMFs.

Question 6 **[18.0 mins, 10 marks]**

[Marking scheme: expect analysis of trends from 2011 to 2015; opinion supported by reference to the case about appropriate future trends of stock, debtors and creditors; as a guide there are four elements (analysis of numbers plus three NWA components) so expect three credible points per element].

There are conflicting requirements here:

- physical offer in store for display purposes
- inventory to satisfy spot purchases today or tomorrow
- minimising duplication of inventory globally.
- minimise end-season unsolds (fire sale could damage image)
- supporting wholesale channel (25% revenue)
- securing key suppliers

Table 1 shows Net Working Assets relative to Sales (1a) reproduced from the Financial Profile and also in absolute £ terms (1b).

TABLE 1: NET WORKING ASSETS

Year	2,011	2,012	2,013	2,014	2,015	
1 (a) SALES %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	Relative Change as Proportion of Sales %
Stocks % Salea	16.5	16.8	17.6	18.0	17.3	0.8
Debtors % Sales	9.8	9.0	10.0	11.7	12.7	2.9
Creditors % Sales	- 24.5	- 23.1	- 22.4	- 21.8	- 20.7	3.8 Note 1
Net Working Assets % Sales	1.8	2.7	5.1	8.0	9.3	7.5

1 (b) SALES £m	1501.3 £	2523.2 £	Absolute Change as a Use (+) of funds or a Source (-)
Stocks £m	247.9	436.6	188.7
Debtors £m	147.7	320.8	173.1
Creditors % Sales	-367.8	-523.1	-155.3 Note 2
Net Working Assets £m	27.5	234.3	206.5

NOTES: **1. Creditors as a % of Sales (ie, relative to Sales in a particular year) has fallen from 24.5% (2011) to 20.7% (2015), thus adding 3.8% to NWAs % Sales**

2. However in absolute £ terms, because Sales have increased from £1.5bn to £2.5bn, creditors is making a larger reduction to £NWAs in 2015 than in 2011, ie a reduction of £155.3m

Stocks have been steady around 17% Sales. Debtors has increased by about 3% and creditors decreased by about 4%.

Table 2 compares the actual 2015 £ amounts with what these would have been if the 2015 % numbers stayed at 2011 levels.

TABLE 2

	1 2011 %	2 2011 £	3 2015 £	4 @ 2011 % £2,015	3 - 4 £
Stocks	16.5	247.9	436.6	416.6	20.0
Debtors	9.8	147.7	320.8	248.2	72.6
Creditors	-24.5	-367.8	-523.1	-618.2	95.1
	1.8	27.5	234.3	46.6	187.7

Table 2 shows that the increase in NWA investment between 2011 and 2015, allowing for growth in sales, is due mainly to Debtors (£72.6m) and Creditors (£95.1m).

Holding stock levels stable has been an achievement, accomplished in part by reducing the range of size and colour for a specific garment "in store" but making it available to view (colour) on screen and to deliver from "channel-agnostic" inventory "next day".

Debtors relates to Wholesale. This should be challenged with the marketing function. Unless there has been a structural change in the wholesale relationship or an increase in competitive pressures, there should be some scope to claw back some of the £72.6m excess investment (compared with 2011).

But debtors also includes deposits and pre-payments, presumably involving suppliers. This may be a necessary part of securing core supplies from an inadequately financed source.

The data suggests that creditors are being paid earlier. Again this may be to secure core suppliers. Creditors also now includes a non-current liability for the discounted value of the put option re the minority stake.

Overall, it is possible to rationalise why debtors/creditors have traded upwards/downwards. But it has been a gradual change over four years, in parallel with a similar upward trend in cash balances (£466m to £617m AFTER the NWA "excess" of £187m). So it could just reflect a slackening of control of cash in a time of plenty!

In general candidates concluded that stock levels were reasonable but that economies might be possible for debtors and creditors.

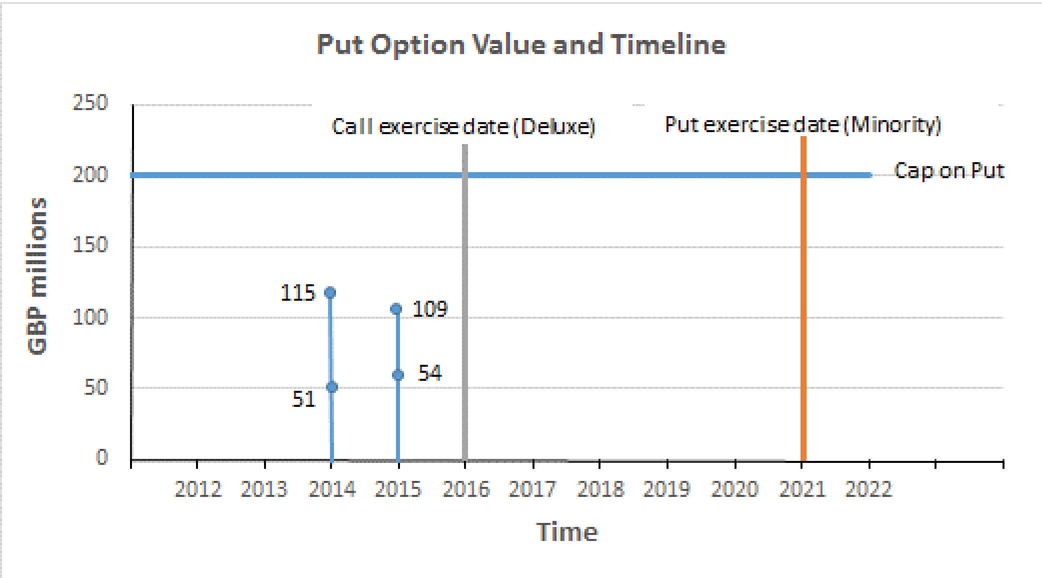
Question 7 **[18.0 mins, 10 marks]**

[Marking scheme: looking for evidence that candidate understands the Question; thereafter expect minimum of five De Luxe-relevant points to pass].

The Call/Put time line is pictured below at y/e 2015 (2014). The put values were:

Undiscounted	GBP 109m (GBP 115m)
Discounted	GBP 54m (GBP 51m)

Note that this data was not in the background material but is not needed for a full answer to the question.



The Put Option value is based on:

- future performance of the Chinese business
- discounted at the risk adjusted discount rate for China
- average historical De Luxe plc multiple

Presumably the call is there to allow De Luxe to buy out the minority if things are going really well and the put is there to guarantee an escape for the minority if they are not. [data requested about detail of the option structures].

At one level, the need is for an analysis of outcomes based on future scenarios for the business. Given a time horizon(s), is the cost of exercising the call less than the benefit of acquiring the minority? If so is this the best use of funds.

Beyond a five year horizon, the likelihood of the put exercise needs to be considered as well.

At another level, the desirability of a continuing relationship with the minority owner needs consideration. Does it provide strategic benefits, e.g. access to local markets or power centres or does it risk the stake falling into unfriendly hands?

So specific factors to consider include:

- Is the Put Option valuation a reasonable estimate of economic value, eg about right, above, below?

- What are the probabilities of error around the valuation?

- De Luxe preferences for continued involvement of minority, eg a necessity, a help or a hindrance.

- What is the long-term view about China, eg engage further, stay flexible, exit? (Stress/reverse stress tests).

Scenario: if the valuation typically represents a fair price and De Luxe wishes to buy out the minority, then unless the minority is a nuisance, De Luxe can postpone until the put exercise date, unless future liquidity is in question, i.e. ability to pay, say, GBP £200m in 2021 instead of GBP 54m now.

Scenario: if De Luxe prefers the minority to stay in but the valuation greatly exceeds the cap at 2021, a choice would be necessary involving putting an economic value on the minority's future presence versus absence.

There are numerous possible scenarios but the dominant factors would seem to be preferences about the minority's future involvement, views about the long-term prospects of this particular business in China and if there is a lot of uncertainty about these, staying flexible.

Question 8 **[21.6 mins, 12 marks]**

[Marking scheme: Q8.a. minimum three core sources to pass; Q8.b. minimum of three core goals (two flagged in the Question) to pass; Q8.c. looking for evidence that candidate has an overall grasp of the range and complexity of issues – so coherent assembly of at least six points to pass].

Q8.a. **(5.4 mins, 3 marks)**

Raw materials are sourced from the highest quality source, eg cotton from Peru, for delivery to any manufacturing location. These transactions will be third party.

There is manufacture in the UK, in Italy and elsewhere which can be shipped to any store or inventory location in the Group. These transactions will be intra-group or third party.

There are lease rentals payable in the country of locations currency.
There are also some overseas licensing fees.

And there is also price list risk, exacerbated by big swings in some major currencies, eg GBP, USD, EUR, CNY. Luxury goods customers can afford to go to Paris to buy for themselves and friends instead of London if EUR falls against GBP.

Q8.b. (5.4 mins, 3 marks)

Objectives:

- Bear in mind shareholder appetite for fx risk, but beware of using it as an excuse for inaction.

- Insulate the market place people from the distractions of managing fx risk by prescribing unambiguous rules for dealing with it. This is a high margin business so a focus on increasing sales rather than complex hedging may yield higher return.

- Create the degree of "price equilibrium" desired by marketing. Again, the focus must be the customer.

- Subject to the above but taking precedence where there is a conflict of interests, protect the solvency and profitability of the Group and the ability to deliver on dividend expectations.

This is not the only possible set of goals but it is a fairly obvious one given the Case narrative. Pricing decisions in a group such as this are likely to be centrally decided and so a centralised policy is feasible, thus requiring a good relationship with marketing.

Q8.c. (10.8 mins, 6 marks)

Re. shareholder appetite for fx risk, this is satisfied typically at two levels – at the primary level by not hedging product cost and revenue flows which arise in fx back to the group functional currencies and at the secondary level by the fact that currency volatility is usually accompanied by economic activity volatility. So with the current Chinese volatility, even if GBP/CNY subsidiary flows are hedged, reducing the immediate impact of CNY decline the impact of lower economic activity in China will mean less revenue and less earnings for a UK Group doing business with or in China. So for De Luxe increasing primary hedging does not entirely or perhaps even significantly frustrate fx risk appetite.

Insulating subsidiaries from complex fx risk management:

There is no single right way but one approach is:

- Intragroup flows routed through a hub which assumes the fx risk.

- Third party purchase by subsidiaries hedged locally as they arise or if not feasible then routed through the hub.

- Hub nets exposure and agrees a policy with Group for 100% hedge as risks arise or for limited position-taking.

- Subsidiaries made aware of how decisions they take can upset Group fx risk, eg delaying budgeted cash flows like dividends, licencing fees (although these are likely to be centrally decided).

Price equilibrium: there is no “right” answer to this issue.

However it is mitigated in that De Luxe has four “seasons”, so has an excuse to reprice across the company every quarter, or even more frequently if the market presence is mostly digital.

So with normal levels of fx volatility, the policy could be to hold prices in each currency until next season.

However, when there are abnormal shifts which grossly disadvantage particular locations, marketing should have the right to adjust in collaboration with Treasury.

Beware of skill levels in companies such as this, presence on the ground in many countries will be light and so this is possibly better managed centrally, but again subject to skill levels in treasury and the parent.

Finally, higher margins generally make hedging less necessary than if margins are small and arguably this sort of risk is a nice one to have, it goes with the large sales potential.